Structuring Equity Compensation for Partnerships and LLCs
Navigating Capital and Profits Interests Plus Section 409A and Tax Consequences

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Structuring Equity Compensation for Partnerships and LLCs

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Overview – Discussion Topics

- Partnerships and LLCs – Core Principles
- Profits interests
- Capital interests
- Options
- Phantom arrangements
- Partner/employee status
- Section 409A considerations
- Corporate conversions
Partnerships and LLCs – Core Principles

- Classification Issues – LLCs generally taxed as partnerships unless elections are made to treat them as corporations

- Consequences of Pass-through Tax Treatment – No entity level tax and income, gain, loss and deduction flow-through to entity owners regardless of distributions by the entity
Partnerships and LLCs – Core Principles (cont.)

- Allocation and Distribution Provisions
  - Section 704(b) safe harbor
  - Capital account maintenance
  - Book-ups
  - Liquidating or not liquidating with capital accounts
  - Treatment of partnership distributions
  - Differences between distributions made with regard to income and distributions made without regard to income
Equity Compensation Alternatives – Profits Interests

- What is a profits interest?

- Case law
  - Diamond v. Com’r, 56 T.C. 530 (1971), aff’d, 492 F.2d 286 (7th Cir. 1974).
  - Campbell v. Com’r, 59 T.C.M. 236 (1990), aff’d in part and rev’d in part, 943 F.2d 815 (8th Cir. 1991).
Equity Compensation Alternatives – Profits Interests (cont.)

- **Rev. Proc. 93-27**
  - Provides guidance on what constitutes a profits interest and tax consequences associated with profits interests
  - Profits interest defined as an interest other than a capital interest. A capital interest is an interest that gives holder a share of proceeds if partnership’s assets sold at FMV and proceeds distributed in liquidation
  - If Rev. Proc. 93-27 applies, grant of profits interest not a taxable event for service provider or partnership
    - Applies if profits interest is granted to person for provision of services to (or for the benefit) of a partnership in partner capacity or in anticipation of being a partner
Equity Compensation Alternatives – Profits Interests (cont.)

– Does not apply if:
  • Profits interest relates to substantially certain stream of income from partnership assets (such as high grade debt security or net lease)
  • Profits interest is disposed of within two years
  • Profits interest is an LP interest in a publicly traded partnership
Equity Compensation Alternatives – Profits Interests (cont.)

- Rev. Proc. 2001-43
  - Provides guidance on treatment on profits interests subject to vesting requirements
  - Provides that Rev. Proc. 93-27 applies at the time of grant of a profits interest even if not vested if:
    - Service provider treated as owner of the partnership interest from the date of grant and takes into account allocations of income, loss, etc. in determining tax liability
    - Neither partnership nor partners claim a deduction upon grant or vesting of the profits interests

- 83(b) elections
- Importance of book-ups; valuations
- Effect of forfeiture
Equity Compensation Alternatives – Profits Interests (cont.)

- Is it a profits interest or a bonus arrangement?
- Current proposed regulations and other proposed guidance
- Common structural approaches for profits interests
- Carried interest legislation and the President’s budget
Equity Compensation Alternatives – Capital Interests

- **What is a capital interest?**
  - As of date of grant entitles holder to share of liquidation proceeds if partnership liquidated
  - Also entitles holder to share of future profits

- **Tax treatment of capital interests**
  - Similar to tax consequences associated with compensatory transfers of stock
  - Service provider recognizes income equal to FMV value of interest at time vested (less any amount paid). Basis equal to income recognized
  - 83(b) elections
  - Partnership (and therefore partners) get compensation deduction equal to FMV included in service provider’s income (subject to Sections 162 and 212)
Equity Compensation Alternatives – Capital Interests (cont.)

- Capital shift issues
- Valuation of capital interest – liquidation value or arm’s length sale price for capital interest
- Effect of forfeiture

- Is a “fill-up” a profits interest or a capital interest?
Equity Compensation Alternatives – Options on Partnership and LLC Interests

- Options to acquire capital interests
  - Similar to stock options
  - Upon exercise service provider and partnership have same tax treatment as grant of capital interest (taking into account payment of exercise price)

- Options to acquire profits interests
  - No income to service provider at time of exercise and no deduction for partnership
  - Generally not attractive to service providers from economic perspective
Equity Compensation Alternatives – Phantom Interests

- Similar to phantom stock
- Service provider recognizes ordinary income at time of payment
- Partnership gets deduction equal to amount paid
- Can be subject to Section 409A if not eligible for short-term deferral exception or other exceptions
Equity Compensation Alternatives – Phantom Interests (cont.)

- Section 409A structuring challenges if phantom interest holders are intended to share in event-based partnership distributions
  - Example: Real estate partnership ABC holds multiple parcels of real estate. The partnership agreement provides for the distribution of profits upon the sale of a parcel. ABC would like to grant fully vested phantom interests to employees that provide for distributions to be made to phantom holders upon the sale of a parcel. Doing so would, however, present Section 409A compliance issues because the sale of a parcel of real estate is not a Section 409A-permitted payment event.

- Possible design solutions include requiring the holder to be providing services at the time of distribution, imposing performance goal conditions on the right to payment, and providing for fixed payment date(s) on which payment is made in respect of all prior sales. Each can have significant drawbacks.
Partner/Employee Status

- Can a partner be an employee?
  - Case law – *Armstrong v. Phinney*, 394 F.2d 661 (5th Cir. 1968)
  - Practical considerations

- Income tax consequences of non-employee treatment
  - Withholding issues
  - Employment taxes
  - Employee deductions
  - State tax considerations
  - Compliance burdens
Partner/Employee Status (cont.)

- Employee benefit consequences of Non-employee status
  - Not eligible to participate in cafeteria plans
  - Health benefits not excluded from income, but deduction for premiums paid by self-employed
  - No group term life insurance exclusion
  - Qualified transportation and qualified moving expense reimbursements not available
  - Can still participate in qualified retirement plans
Applicability of Section 409A To Grants of Partnership Equity Interests

- Final regulations do not address partnership equity compensation
- Preamble says that until guidance issued can rely on Notice 2005-1
- Under Notice 2005-1:
  - May treat issuance of a partnership interest or an option to acquire a partnership interest in connection with performance of services under same principles as govern issuance of stock
    - Service provider stock requirement for options
    - Option modification/extension rules
  - If profits interest is treated under applicable guidance as not resulting in inclusion of income by service provider, then not Section 409A deferred compensation
  - May treat issuance of capital interest in same manner as issuance of stock
Applicability of Section 409A to Partnership Allocations and Partner Service Provider Payments

- Guaranteed Payments Under Section 707(c)
  - In general, guaranteed payments are payments made to a partner (in his capacity as a partner) without regard to the partnership’s income
  - The preambles to the proposed final regulations provide that “Section 409A applies to guaranteed payments described in Section 707(c) (and the rights to receive such payments in the future), only in cases where the guaranteed payment is for services and the partner providing the services does not include the payment in income [within the applicable short-term deferral period]”
Example: A joins an accounting firm as a partner on January 1, 2014. As a part of terms of his joining the firm, he is entitled to a $50,000 bonus payment regardless of partnership profits, on April 15, 2015, provided that he remains as a partner through the end of 2014. The $50,000 payment would be a guaranteed payment that constitutes deferred compensation subject to Section 409A.
Applicability of Section 409A to Partnership Allocations and Partner Service Provider Payments (cont.)

- Payments Made to a Partner for Services Rendered Other Than in His Capacity as a Partner Under Section 707(a)
  - Generally should be subject to Section 409A as if no partnership involved.
  - Example: A is a one-third partner in a partnership ABC that operates a multiple printing shops. A is also a professional architect and pursuant to a contract with the partnership provides architectural services to ABC during 2014 in connection with the opening a new print shop. Under the terms of the contract, A is entitled to a payment of $15,000 on December 15, 2014 and a payment of $15,000 on April 15, 2015. The payments are Section 707(a) payments, and the $15,000 payment on April 15, 2015 would be deferred compensation subject to Section 409A.
Applicability of Section 409A to Partnership Allocations and Partner Service Provider Payments (cont.)

- Partner’s Distributive Share of Partnership Income Under Sections 702 and 704
  - Not addressed by Section 409A regulations or other Section 409A guidance
  - Although not addressed by the IRS, a partner’s distributive share of income under Sections 702 and 704 from a partnership for which the partner provides services should not be treated as compensation for the partner’s services to the partnership for purposes of applying Section 409A
  - Note that the character of some or all of the income that flows through the partnership to the partner could be compensation income subject to Section 409A to the extent that the partnership has compensation income for services performed by the partnership
Applicability of Section 409A to Partnership Allocations and Partner Service Provider Payments (cont.)

- As result, Section 409A generally should not apply to the partner’s distributive share of the partnerships income (except to the extent that Section 409A applies to income received by the partnership for services provided by the partnership).

- Example: A and B are partners in an auto parts business and share profits equally. A expects to have an increased need for cash during for a three year period. To accommodate A, A and B amend the partnership agreement so that profits will be shared 60%-40% for the three year period after the amendment, with the split flipping to 40%-60% for the next succeeding three year period, and then equally thereafter. B should not be treated as having any Section 409A deferred compensation.
Applicability of Section 409A to Partnership Allocations and Partner Service Provider Payments (cont.)

- Payments to Retiring Partners Under Section 736 Payments
  - The preamble to the final regulations provides that these payments may be treated as not subject to Section 409A, unless the payments meet the requirements for being exempt from SECA taxes under Section 1402(a)(10).
  - Section 1402(a)(10) exempts payments to a retired partner if certain conditions are met, including that the payments be made on account of retirement and continue until the partner’s death.
Equity Compensation Alternatives – What is the Best Choice?

- Profits interests generally preferred
- Liquidity/exit considerations
- Partner/employee issues
- Complexity
Corporate Conversions

- General rules applicable when partnerships convert to corporations
- Treatment of corporate conversions to holders of profits interests
  - Possibility of compensation treatment
  - Valuation considerations
- Treatment of corporate conversions to holders of capital interests
- Treatment of corporate conversions to holders of compensatory options
- Treatment of corporate conversions to beneficiaries of phantom arrangements
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