

2013

Compensating Owners and Key Employees of Partnerships and LLC's

Elizabeth E. Drigotas

Steven R. Schneider

Repository Citation

Drigotas, Elizabeth E. and Schneider, Steven R., "Compensating Owners and Key Employees of Partnerships and LLC's" (2013).
William & Mary Annual Tax Conference. 697.
<https://scholarship.law.wm.edu/tax/697>

Compensating Owners and Key Employees of Partnerships and LLC's

Presenters:

Elizabeth Drigotas, Deloitte Tax

Steven Schneider, Goulston & Storrs PC

Partnership Payments for Services



- Partnership $\xrightarrow{\text{\$162}}$ Non-partner, employee or independent contractor
- Partnership $\xrightarrow{\text{\$707(c)}}$ Partner, guaranteed payment
- Partnership $\xrightarrow{\text{\$707(a)}}$ Partner, other than in capacity as partner
- Partnership $\xrightarrow{\text{\$707(a)(2)(A)}}$ Partner, allocation treated as payment for services

Partnership Payments for Services



- Partnership $\xrightarrow{\text{\$704(b)}}$ Partner, allocation of profits
- Partnership $\xrightarrow{\text{Case law}}$ Partner, receipt of equity (capital/profits)
- Partnership $\xrightarrow{\text{93-27 \& 2001-43}}$ IRS Safe Harbor Profits Interest
- Partnership $\xrightarrow{\text{\$83}}$ Other Comp: Options, Phantom Units
Appreciation Rights

Effect of Employee Classification

- Receives W-2 reporting wages
- Wages are subject to withholding
- Participates in retirement plans
- Employee is subject to 2% floor in deducting related business expenses.

Effect of Employee Classification

- Excludes from income:
 - Premiums paid for accident and health insurance,
 - Premiums paid for group term life insurance;
 - Value of meals furnished for the convenience of the employer;
 - Fringe benefits under section 132

Effect of Partner Classification

- Income reported on Schedule K-1 to Form 1065.
- No wage withholding, but guaranteed payments for services are subject to self-employment (“SE Tax”) tax under §1402. (Distributive share may be as well.)
- Retirement plans generally can include partners, but plan documents need to specifically provide for such inclusion.

Effect of Partner Classification

- No exclusion for insurance premiums or for meals and lodging for the convenience of employer.
- Can exclude most fringe benefits under §132, but cannot exclude qualified transportation fringes or qualified moving expenses reimbursement. Partner must provide services to qualify.
- Partner is not subject to 2% floor in deducting related business expenses.

Self-Employment Taxes Generally

- Section 1402(a)(1) – partners subject to SECA taxes on distributive shares of ordinary income.
- Section 1402(a)(13) – limited partners subject to SECA taxes only on guaranteed payments
- 1997 Proposed regulations provide 500 hour rule (among others) and treat LPs and LLC members similarly.

Self-Employment Taxes Generally

- Section 1411 – 3.8% tax applies to passive income that is not otherwise subject to section 1402 (started in 2013)
- Exception for real estate professionals under section 469(c)(7)
- Proposed Regulations

Self-Employment Planning

- Section 1402 planning
 - Tiered partnerships
 - Multi-class approach
- Effect of section 1411
 - Combining non-passive activities with traditional section 1402 planning
 - Significant real estate professional and partnership inside-outside basis disparity planning
- W-2 planning using tiered partnerships

Background and framework of compensatory LLC interests

Basic Concepts

- Types of interest: Capital & profits interest, profits-only interest; options
- Section 83 – timing rules
 - Property right
 - Vesting
 - Section 83(b) election (accelerates income from Vesting Date to Transfer Date)

Section 83

➤ Section 83 applies to:

- Property transferred in connection with the performance of services
- Vested property
 - No substantial risk of forfeiture, or
 - No transfer restrictions
- Compensation income = excess of fair market value over amount paid
- Section 83(b) election for nonvested property

➤ Section 83(h) – deduction or capitalizable cost equal to the amount includible by the service partner in receipt of the interest

Forfeiture

➤ Section 83 rules

- Reg. Section 1.83-2(a)
 - Service provider receives deduction equal to the amount paid for the interest less the amount realized on forfeiture
 - No deduction for amount taken into income as a result of Section 83(b) election
- Reg. Section 1.83-6(c)
 - Employer reports income equal to the amount of the deduction or capitalized cost received upon the issuance of the interest

Tax Consequences to Recipient

- Vested capital and profits – taxable on receipt.
- Nonvested capital and profits – taxable on vesting.
- Vested or nonvested profits only interest – generally not taxable on receipt or vesting.

Tax Consequences to Recipient

- Option – not taxable on receipt; taxable on exercise.
- Stock or Partnership Capital Interest – taxable on receipt.
- Appreciation rights – taxable when paid.
- Consequences of partner status.

Case Law

- *Diamond* – profits-interest sold less than three weeks later was ordinary compensation income
- *St. John* – profits-only interests not taxable – used liquidation value
- *Campbell* – 8th Circuit held profits-only interest not taxable

Overview of Regulations and Rev. Proc. Previous Approaches

➤ Rev. Proc. 93-27

- Receipt of profits interest for services provided to partnership not a taxable event to (potential) partner or partnership
- Literally does not apply if any capital interest given, even if nominal compared to profits interest
- Does not address whether share of profits must include operating income as well as capital appreciation

Overview of Regulations and Rev. Proc. Previous Approaches

➤ Exceptions to Rev. Proc. 93-27

- Profits interest relates to substantially certain/predictable stream of income from partnership assets (e.g., debt securities)
- Recipient disposes of the interest within 2 years of receipt
- Profits interest is a limited partnership interest in a “publicly traded partnership” within meaning of section 7704(b)

Overview of Regulations and Rev. Proc. Previous Approaches (cont.)

➤ Rev. Proc. 2001-43

- “Clarifies” that Rev. Proc. 93-27 applies to profits interest subject to vesting restrictions if certain conditions are met
 - Partnership and service provider treat service provider as owner of the interest from date of grant and service provider takes into account the share of partnership income/loss, etc... associated with that interest in determining her income taxes
 - No deductions are taken based on the profits interest at grant or vesting

Rev. Proc. 2001-43

- Applies Rev. Proc. 93-27 to unvested interest
- Tested on Transfer Date not Vesting Date
- No need to make § 83(b) election
- Must meet requirements of Rev. Proc. 93-27 and all parties must treat consistently

Proposed Regulations: Receipt of Partnership Interest in Exchange for Services

In 2005 Notice 2005-43 and Proposed Regulations were issued that were intended to replace Rev. Proc. 93-27 and 2001-43.

Currently held up by Carried Interest legislation.

New Liquidation Value Election

- Integrated rules – capital and profits interest.
- Default – willing buyer-willing seller test for value.
- Liquidation Value used for Safe Harbor Partnership Interest with Election.

Example – Liquidation Value Election

- Service Provider receives 10% vested partnership interest—
 - Profits interest disproportionately high;
 - Liquidation Value \$100 (capital interest);
 - FMV is \$2,000.
- Prior rule: compensation income equals \$2,000 because capital and profits.
- Proposed rule: If Liquidation Value election, compensation \$100, otherwise \$2,000.

Safe Harbor Partnership

- Transfer in connection with direct partner services.
- No predictable stream of income.
- Partnership not publicly traded.
- No anticipation of subsequent disposition.
- Liquidation Value election in effect.

Liquidation Value Election

- In effect at time of transfer.
- Made by partner filing Form 1065.
- Election irrevocable.
- Must be on behalf of partnership and partners.
- Must state effective date as on or after execution date.

Liquidation Value Election

- Attach copy to Form 1065.
- Partnership agreement (or separate document) must—
 - Authorize and direct partnership to make Liquidation Value Election;
 - Require partnership and partners to comply with safe harbor.
- Partnership record keeping requirements.

Planning with Profits Interest

Fill Up allocations

- Goal, provide economics of a capital interest using future profits
 - Using capital gains (including “book up” amounts)
- Structures
 - Disproportionately more gain allocations and less loss allocations
 - First income vs. back-end gains
 - Intervening capital events

Profits Interest Planning

- What if fill up allocations are insufficient?
 - Guaranteed payments?
 - Bonuses?
 - Gross income allocations?
- Other considerations
 - Transfers within the two year period
 - Interests given on the eve of liquidity events
 - Tiered partnerships
 - W-2 and consistent treatment as a partner

Alternative Compensation Arrangements

Goal is to provide compensation linked to equity value, without transfer of a partnership interest

- Options and equity appreciation rights
- Phantom equity units
- Phantom carry/distribution rights
- Incentive bonus

Application of Section 409A

- Section 409A applies to amounts deferred under any nonqualified plan that provides for the deferral of compensation, with certain exceptions
- The definition of nonqualified deferred compensation is broad: any arrangement that provides a legally binding right to compensation in one year that is payable in another
- Failure to comply with section 409A requirements related to timing of deferral elections and distributions results in an additional income tax at vesting of 20%, increased in some cases based on a penalty interest plus 1%

Compliance with Section 409A

- 409A must satisfy the election timing rules:
 - General rule: these decisions must be made no later than the end of the calendar year before the year in which the related service are provided.
 - Decisions with respect to the timing of payment made by a service recipient are required to be made no later than the date as of which a service provider has a legally binding right to the payment or, if later, the date as of which a service provider election would be required to be made.

Compliance with Section 409A

- Six permissible distribution events:
 - Separation from service
 - A fixed time, or pursuant to a fixed schedule, specified under the plan
 - Death
 - Disability
 - Change in control of a corporation
 - Unforeseeable emergency

Short-Term Deferral Exception

- An arrangement under which compensation is received no later than two and one half months following end of the tax year in which the service provider becomes vested in the right to receive such compensation.
- The measuring tax year is the year of the service provider or the year of the service recipient, whichever ends later.)

Stock Option/SAR Exception

- Options/SARs must be granted
 - Over service recipient stock
 - With an exercise price no less than FMV at date of grant
 - Option must be taxed under section 83 on exercise or disposition; SARs must provide only for appreciation in stock over stated exercise price
- The option/SAR cannot provide for deferral of income beyond exercise or disposition or, if settled in restricted stock, when the stock vests
- There are restrictions on the ability to modify options/SARs once granted
- A payment conditioned on exercise of an option or SAR is considered a discount to exercise price

Service Recipient Stock

- Definition of permissible class of stock
 - Any class of common stock may be used, regardless of whether publicly traded, aggregate outstanding value, transferability restrictions, or buyback rights
 - Dividend preferences prohibited
 - Liquidation preference permissible
 - Expect future guidance on other preference items

Service Recipient Stock (cont'd)

- Stock must qualify as common stock under section 305 and may not resemble deferred compensation
- Statutory stock options excepted
- Anti-abuse rule

Permissible Issuers of Stock

- The stock issued may be that of the service recipient, or
 - Any corporation that owns a controlling interest in the service recipient
 - Any corporation otherwise included in a chain of corporations, all of which have a controlling interest in another organization ending in the parent organization

Permissible Issuers (cont'd)

- Controlling interest is defined by reference to 1.414(c)-2(b)(2)(i) except that 50% is used instead of 80%
- If use of stock is based on legitimate business criteria, 20% interest based on facts and circumstances

Options and Appreciation Rights Over Partnership Equity

- Preamble to the regulations provides that the stock option and appreciation rights apply to partnership interests by analogy
- Key questions
 - Permissible class of stock
 - Determining fair market value
 - Treatment of distributions

Application of Section 409A

- Partners and partnerships can be service providers or service recipients
- Exception for a service provider that provides services to two or more unrelated service recipients
- This does not apply to a person or entity that provides management services --
 - Actual or de facto direction or control of the financial or operational aspects of a trade or business
 - Investment management or advisory services to a service recipient whose primary trade or business includes investment of financial assets (inc. in real estate), such as a hedge fund or a REIT.
- Section 409A does not apply if service provider is an accrual method taxpayer

Application of Section 409A

- Transfers of compensatory partnership interests are not subject to 409A
 - Transfers of restricted property are not “deferred compensation” for purposes of section 409A
- Guidance on options and SARs applies by analogy to equity rights with respect to partnership interests
 - Exception applies to options on common equity of a service recipient, with an exercise price not less than FMV at date of grant
 - Grant of options on LLC interests are not as easy to implement as options on stock

Application of Section 409A

Section 409A does apply to some arrangements

- Deferred compensation between partnership and its employees
- Deferred compensation of a cash basis partnership
 - Back to back deferrals: Deferral between Service Provider partnership and Service Recipient coordinated with deferral elections between Service Provider partnership and its service providers
 - Deferral arrangements can instead be run separately
- Payments under a retirement plan once excludible from SECA tax under 1402(a)(10)
 - Election can be made by the end of the year before the year in which section 1402(a)(10) applies

Application of Section 409A

➤ Requirements under 1402(a)(10)

- Written plan must provide terms and conditions for payments on account of retirement
- Payments must be bona fide retirement payments, with eligibility generally based on a combination of some or all of age, physical condition, or years of service
- Benefits must be provided
 - To partners generally or to a class or classes of partners
 - On a periodic basis
 - At least until death
 - Payments are not required to be substantially equal periodic payments

Application of Section 409A

- Notice 2005-1: Non-partner capacity payments under section 707(a) can be deferred compensation under section 409A. Q&A 7.
- Preamble to proposed regulations: Certain 707(c) guaranteed payments as payments that could be treated as deferred compensation
 - Guaranteed payment for services is not included in the income by the 15th day of the third month following the end of the taxable year of the partner in which the partner obtained a legally binding right to the guaranteed payment or, if later, the taxable year in which the right to the guaranteed payment is first no longer subject to a substantial risk of forfeiture.

Comparison

	Immediate Liquidation Rights	Interest Solely in Increase in Value	No Tax Upon Receipt or Vesting	Participation in Operating Income	Capital Gain Potential	State Law Member Status	No Limits on Employer Benefits	Section 409A and 457A Issues
Capital Interest	✓			✓	✓	✓		
Profits Interest		✓	✓	✓	✓	✓		
Options		✓	✓				✓	✓
Phantom Interest			✓				✓	✓
Appreciation Rights		✓	✓				✓	✓

Section 457A

- Service providers working for certain offshore entities will no longer be able to defer US income tax on their compensation for more than 12 months after the end of the payor's year in which the services required to vest in the compensation are complete
 - Without regard to whether there are additional performance conditions still in effect
- Nonqualified deferred compensation is defined in the same manner as under section 409A EXCEPT expanded to include equity appreciation rights

Section 457A

- If the amount of compensation is not determinable at the time that such compensation is otherwise includible in gross income, then:
 - Include when determinable
 - additional interest rate tax
 - 20% penalty tax

Section 457A: Nonqualified Entity

- Foreign corporation, unless substantially all of its income is
 - effectively connected with a U.S. trade or business or
 - subject to a comprehensive foreign income tax;
- A foreign or domestic partnership, unless substantially all of its income is allocated to people other than
 - foreign persons not eligible for a comprehensive income tax treaty or who are not subject to a comprehensive foreign income tax; or
 - organizations which are exempt from tax
- Aggregation rules apply

Section 457A Effective Dates

- Amounts deferred attributable to services performed after December 31, 2008
- Amounts attributable to services performed before December 31, 2008, are includible in the later of
 - the last taxable year beginning before 2018 or
 - the taxable year in which there is no longer a service-based risk of forfeiture.
- Treasury will provide a limited time period during which arrangements may be amended to allow payment to conform to the income inclusion under these provisions without violating section 409A

What is a Carried Interest?

- Legislation would add new IRC section 710
- A Carried Interest is broadly defined to include any partnership interest:
 - not related to a qualified capital investment
 - held by a person who performs specified investment manager services for a financial investment partnership
- Private Equity / Hedge Fund Managers structure funds with a 2 & 20 compensation structure
 - new rule would apply to the 20% carry

What would Carried Interest Legislation Do?

- Income from the Carried Interest would be taxed as compensation
- Various disposition events of the Carried Interest would accelerate tax
- Has the potential to taint even if capital interest unless it meets strict requirements
- Receipt of Carried Interest still tax-deferred
- Overall it would greatly complicate the tax rules with respect to Carried Interest and would require careful monitoring of all future transactions involving the Carried Interest

Circular 230

Pursuant to IRS Circular 230, please be advised that, to the extent this communication contains any federal tax advice, it is not intended to be, was not written to be and cannot be used by any taxpayer for the purpose of (i) avoiding penalties under U.S. federal tax law or (ii) promoting, marketing or recommending to another taxpayer any transaction or matter addressed herein.