

2016

Background and Framework of Compensatory LLC Interests (PowerPoint)

Brian J. O'Connor

Repository Citation

O'Connor, Brian J., "Background and Framework of Compensatory LLC Interests (PowerPoint)" (2016). *William & Mary Annual Tax Conference*. 755.

<https://scholarship.law.wm.edu/tax/755>

Copyright c 2016 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository.

<https://scholarship.law.wm.edu/tax>

An abstract graphic on the left side of the page, consisting of several overlapping, semi-transparent, light gray planes that create a sense of depth and movement, resembling a stylized arrow or a series of pages. The planes are oriented vertically and slightly angled, with some showing darker shading to indicate depth.

Background and Framework of Compensatory LLC Interests

NOVEMBER 9, 2016

Brian O'Connor

Co-Chair

Tax and Wealth Planning Group

Venable LLP

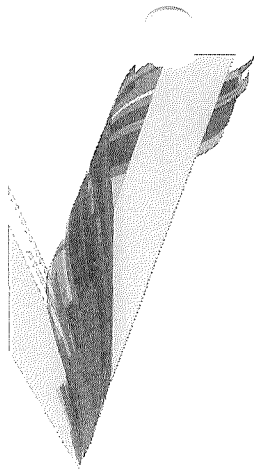
bjconnor@Venable.com

410.244.7863



Speaker Biography

BRIAN J. O'CONNOR co-chairs the Tax and Wealth Planning Group for the Washington, D.C. based law firm of Venable LLP. Mr. O'Connor practices in the areas of partnership, corporate, real estate and international taxation. Mr. O'Connor also teaches an advanced course on partnership taxation and the drafting of partnership agreements as an adjunct professor at Georgetown University Law Center. He regularly speaks across the country to professional groups on topics relating to business entities and taxation and is the author or co-author of numerous articles relating to business entities and taxation in professional journals and trade publications, including *The Journal of Taxation*, *The Journal of Pass-through Entities*, *Tax Notes*, *Tax Management Real Estate Journal* and *Business Entities*. Mr. O'Connor also has acted as a primary participant in the publication of the nationally recognized treatise *Tax Planning for Real Estate Transactions*. Mr. O'Connor has been regularly selected for The Best Lawyers in America for both Tax Law and Tax Litigation and Controversy and has been regularly included in Maryland Super Lawyers. Further, Mr. O'Connor was recently named a "Tax Lawyer of the Year" for Maryland. Before joining Venable, Mr. O'Connor was an attorney-advisor for the Office of Chief Counsel for the Internal Revenue Service where he participated in high profile legislative projects and drafted regulations and other published guidance relating to pass-through entities. He received his J.D. degree, magna cum laude, from Washington & Lee University and his LL.M. degree in Taxation, with distinction and the program's highest possible grade point average, from Georgetown University Law Center. Mr. O'Connor is a member of the Virginia, Maryland and District of Columbia Bars as well as the Tax Sections for the Virginia, Maryland and American Bar Associations.



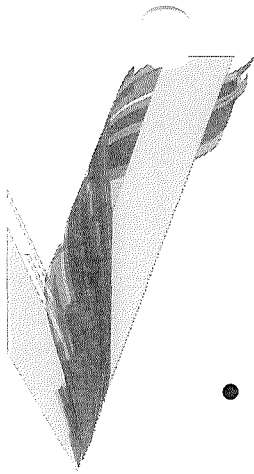
Basic Concepts

- 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)



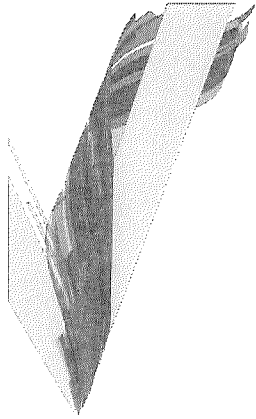
Section 83

- 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



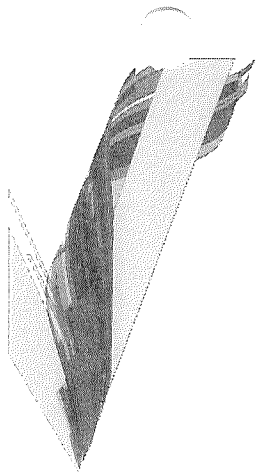
Forfeiture

- 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



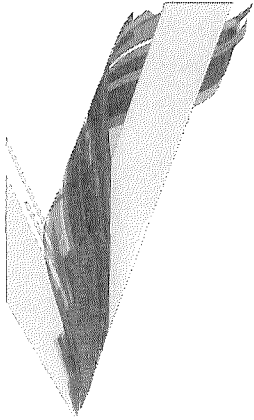
Tax Consequences to Recipient

- 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.



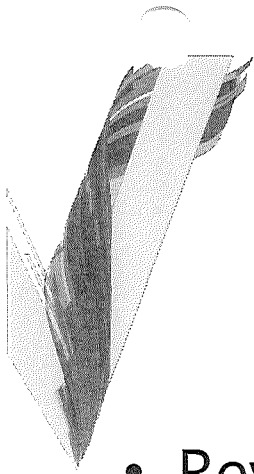
Tax Consequences to Recipient

- 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.



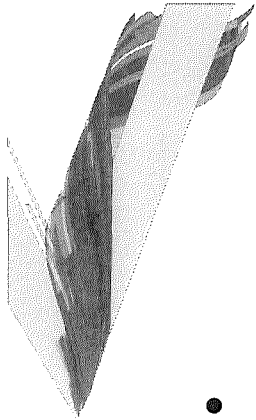
Case Law

- *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



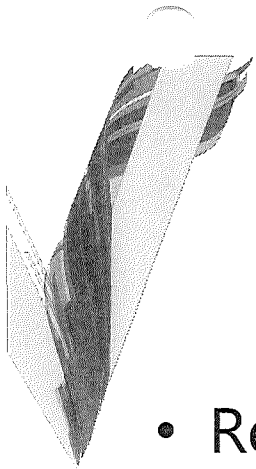
Overview of Regulations and Rev. Proc. Previous Approaches

- 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



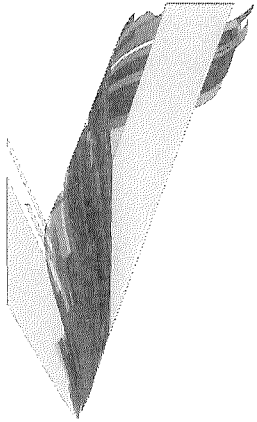
Overview of Regulations and Rev. Proc. Previous Approaches

- 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)



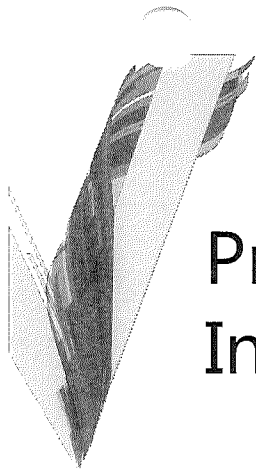
Overview of Regulations and Rev. Proc. Previous Approaches (cont.)

- 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

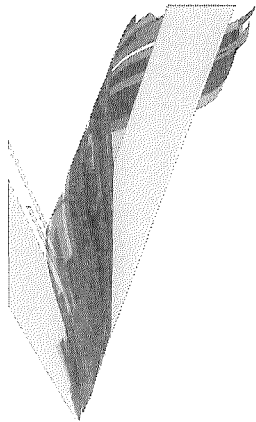
- Applies Rev. Proc. 93-27 to unvested interest
- Tested on Transfer Date not Vesting Date
- No need to make § 83(b) election
- Must meet requirements of Rev. Proc. 93-27 and all parties must treat consistently



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.



Comparison

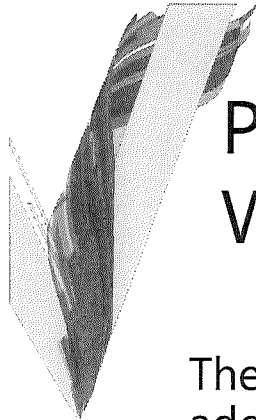
	Immediate Liquidation Rights	Interest Solely in Increase in Value	No Tax Upon Receipt or Vesting	Participation in Operating Income	Capital Gain Potential	State Law Member Status	No Limits on Employer Benefits	Section 409A and 457A Issues
Capital Interest	✓			✓	✓	✓		
Profits Interest		✓	✓	✓	✓	✓		
Options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



Proposed Regulations on Management Fee Waivers – and so much more

The IRS issued the much anticipated proposed regulations that severely curtail the practice of a fund manager waiving management fees in exchange for a share of future partnership profits. In essence the regulations tighten the necessary “entrepreneurial risk” required of the future profits interest plus list five other negative factors for recasting the profits interest back into a fee.

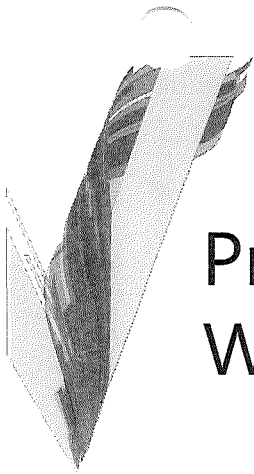
The Proposed Regulations are effective when finalized but, citing the legislative history, note that the entrepreneurial risk concept is part of current law.



Proposed Regulations on Management Fee Waivers – and so much more

The IRS also noted that Rev. Proc. 93-27 will be amended to provide an additional exception for profits interests given in exchange for a partner forgoing a substantially fixed right to payment for services. This latter change would mean that even if the fee waiver has the requisite entrepreneurial risk, there would still be a material risk that the IRS will treat the present value of the profits interest as compensation income.

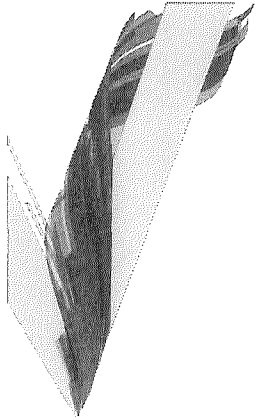
The additional exception will apply to a profits interest issued in conjunction with a partner forgoing payment of an amount that is substantially fixed (including a substantially fixed amount determined by formula, such as a fee based on a percentage of partner capital commitments) for the performance of services, including a guaranteed payment under section 707(c) or a payment in a non-partner capacity under section 707(a).



Proposed Regulations on Management Fee Waivers – and so much more

The Proposed Regulations modify an important “guaranteed payment” example that currently treats an allocation of profits over a fixed floor amount as always getting the benefit of profits interest treatment to the extent the profit share exceeds the floor amount. The example now always treats the fixed floor amount as a guaranteed payment even if the profits exceed the minimum floor amount.

Further, the Preamble appears to confirm the IRS position in Rev. Rul. 69-184, that a guaranteed payment to a partner cannot be treated as an employee payment (i.e., no W-2).

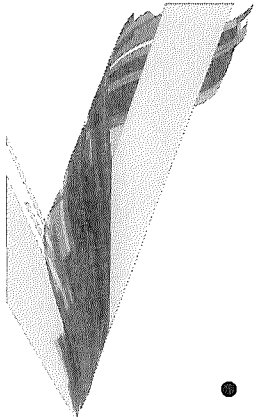


Planning with Profits Interest



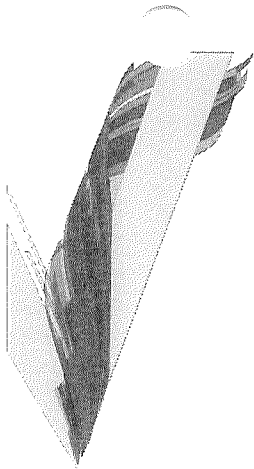
Fill Up allocations

- 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

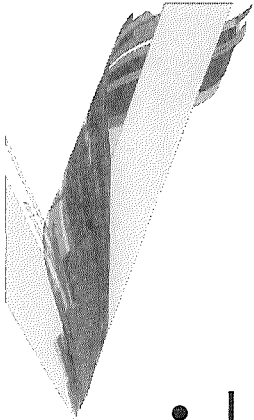
- What if fill up allocations are insufficient?
 - Guaranteed payments?
 - Bonuses?
 - Gross income allocations?
- Other considerations
 - Transfers within the two year period
 - Interests given on the eve of liquidity events
 - Tiered partnerships
 - W-2 and consistent treatment as a partner



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



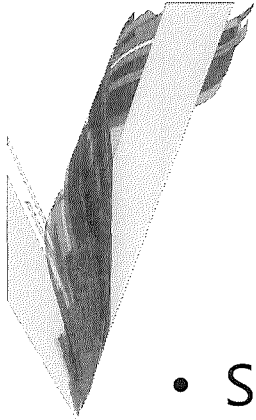
What is a Carried Interest?

- 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



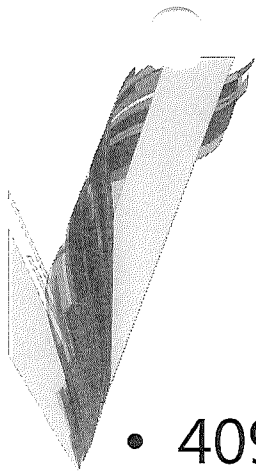
What would Carried Interest Legislation Do?

- 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.



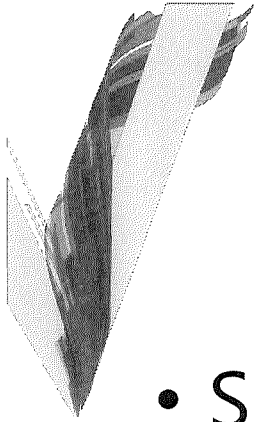
Application of Section 409A

- 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%



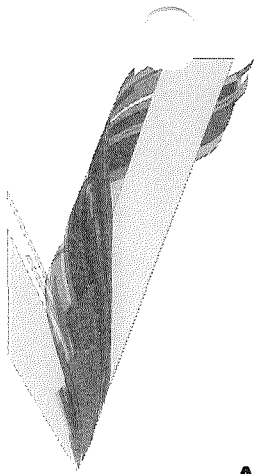
Compliance with Section 409A

- 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.



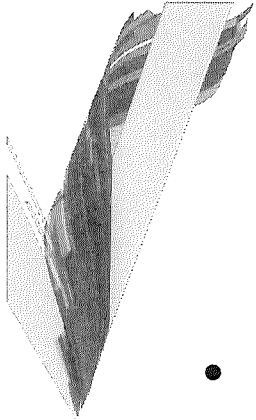
Compliance with Section 409A

- 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.)



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