

# Designing Compensatory Arrangements within Partnerships and LLCs

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## Housekeeping: About Anthony "Tony" Eppert



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- Tony practices in the areas of executive compensation and employee benefits
  
- Before entering private practice, Tony:
  - Served as a judicial clerk to the Hon. Richard F. Suhrheinrich of the United States Court of Appeals for the Sixth Circuit
  - Obtained his LL.M. (Taxation) from New York University
  - Obtained his J.D. (Tax Concentration) from Michigan State University College of Law
    - Editor-in-Chief, Journal of Medicine and Law
    - President, Tax and Estate Planning Society

## **Our Compensation Practice – What Sets Us Apart**

- Compensation issues are complex, especially for publicly-traded companies, and involve the substantive areas of:
  - Tax,
  - Securities,
  - Accounting,
  - Governance,
  - Surveys, and
  - Human resources
  
- Historically, compensation issues were addressed using multiple service providers, including:
  - Tax lawyers,
  - Securities/corporate lawyers,
  - Labor & employment lawyers,
  - Accountants, and
  - Survey consultants

## Our Compensation Practice – What Sets Us Apart (cont.)

- At Andrews Kurth Kenyon LLP, we have a holistic and full-service approach to compensation matters, that considers all substantive areas of compensation, including:



## Housekeeping: Upcoming 2017 Webinars

- Upcoming 2017 webinars:
  - Designing Equity Compensation Abroad (5/11/2017)
  - Expatriate & Secondment Agreements: Top 10 Issues to Consider (6/8/2017)
  - Pay Ratio Disclosure Rules: The A-Z Training Course (7/13/2017)
  - Trends in Designing Performance-Based Equity Awards (8/10/2017)
  - Preparing for Proxy Season: Start Now (Annual Program) (9/14/2017)
  - How to Properly Design a Nonqualified Deferred Compensation Plan (10/12/2017)
  - Navigating Employee v. Independent Contractor Classifications (11/9/2017)
  - Sharing the Dream: M&A Transactions & Retaining Key Employees (12/14/2017)
  
- Upcoming 2018 webinars
  - To be determined
  - Suggestions welcomed!

## Purpose of this Presentation

- The purpose of this presentation is to discuss design considerations with respect to compensatory arrangements within a partnership structure, including LLCs taxed as a partnership
- Unless otherwise indicated, all references within this presentation to a “**partnership**” are intended to include LLCs taxed as a partnership, and all references to “**Section**” shall be to the Internal Revenue Code of 1986, as amended (the “**Code**”)



## Background: Corporation v. Partnership

- Corporations
  - Equity incentives generally consist of common or preferred stock in the form of:
    - Restricted stock and/or stock settled RSUs (*a.k.a.*, full value awards),
    - Stock options and/or stock-settled SARs (*a.k.a.*, appreciation-only awards), and
    - Performance shares and/or stock-settled performance units
  
  - Additionally, synthetic equity (*a.k.a.*, phantom equity) can also be used to create incentives that are comparable to equity ownership (though no actual equity is issued under a synthetic equity program)
    - Examples include cash-settled RSUs, SARs and performance units
  
- Partnerships
  - A partnership is not a taxable entity; instead, entity levels of income, deduction, credits, etc., are allocated to, and reported by, the partners
  - Partner allocations is a primary reason why the taxing regime for compensatory equity interests in the partnership context are more complex

## **Background: Types of Partnership Payments**

- Any payment made by a partnership for services rendered has to be characterized by the Code, typically as one of the following:
  - A Section 162 payment to a non-partner, employee or consultant;
  - A guaranteed payment to a partner under Section 707(c);
  - A Section 707(a) payment to a partner other than in his/her capacity as a partner;
  - An allocation to a partner, treated as a payment for services under Section 707(a)(2)(A);
  - An allocation of profits to a partner under Section 704(b);
  - A partner's receipt of equity in accordance with applicable case law;
  - Receipt of a "profits interest" under 93-27 and 2001-43; and
  - Receipt of any other compensation under Section 83 (e.g., options, phantom units, appreciation units, etc.)

## **Background: Partner v. Employee Classification**

- In deciding what type of compensatory arrangement to use, the beginning point of any analysis is to determine whether the recipient is a partner or an employee
  
- If the recipient is only an employee, then:
  - Any income to the recipient would be W-2 compensation that is subject to withholding;
  - The recipient could participate in any retirement plans that are sponsored by the partnership;
  - The recipient would be subject to the 2% floor in determining the deductibility of business expenses;
  - Any premiums paid for accident and health insurance, or for group term life insurance, could be excluded from the recipient's gross income;
  - The value of meals that were furnished to the recipient for the partnership's convenience could be excluded from the recipient's gross income; and
  - Any fringe benefits that were provided to the recipient could be excluded from the recipient's gross income pursuant to Section 132

## **Background: Partner v. Employee Classification (cont.)**

- In contrast, if the recipient is a partner of the partnership, then:
  - Any income would be reported on a Schedule K-1;
  - The partnership would not be required to withhold on payments to the recipient, however, any payments characterized as a “guaranteed payment” would be subject to self-employment tax;
  - If the partnership sponsored a retirement plan, the partner would be able to participate only if the underlying plan documents were amended to include partners (*i.e.*, typically, the standard retirement plan document does not include partners, so an amendment would be required);
  - The recipient would NOT be subject to the 2% floor in determining the deductibility of business expenses;
  - Any premiums paid for accident and health insurance, or for group term life insurance, would NOT be excluded from the recipient’s gross income;
  - The value of meals that were furnished to the recipient for the partnership’s convenience would NOT be excluded from the recipient’s gross income; and
  - Most fringe benefits under Section 132 would be excluded from the recipient’s gross income, however, no exclusion could be provided for qualified transportation fringes or qualified moving expense reimbursements

## Types of Compensatory Alternatives

- Neither a capital interest nor a profits interest is defined in the Code
- A “capital interest” is generally defined as an interest that would provide the service provider with a share of the proceeds if the partnership’s assets were sold at fair market value and then distributed to its partners
  - Such can take the form of restricted interests, options to acquire interests, conditional promises to be settled in equity (*i.e.*, RSUs, SARs and performance units)
  - A benefit of a capital interest is that it provides the service provider with enterprise value in the partnership as of the date of grant (*i.e.*, a full value award)
  - A drawback of a capital interest is the tax consequence associated with the receipt of a full value award
- The tax consequences to receiving a capital interest include:
  - To the extent it is vested or an 83(b) election is timely made, the service provider would recognize ordinary taxable income equal to the fair market value of the capital interest, minus any monies paid for such interest
  - Under Section 83, the partnership would be entitled to a compensatory deduction at such time, and in the amount, that the service provider recognized as ordinary taxable income
    - As a planning note, consider whether the partnership agreement should allocate any compensatory deductions (arising from the grant of the capital interest) to only those partners that existed immediately prior to the grant

## Types of Compensatory Alternatives (cont.)

- A “profits interest” is generally defined as an interest other than a capital interest. It provides the service provider with a share of future partnership profits and NO interest in the capital of the partnership that existed prior to the date of grant
  - It is intended to provide an incentive for the service provider to pursue enterprise growth
  - Some of the benefits associated with receiving a profits interest include:
    - Favorable tax treatment for the recipient,
    - It represents actual equity in the partnership,
    - The service will generally recognize capital gains treatment upon a sale of the partnership to a third party, and
    - The character of income at the partnership level is generally retained when distributed to the service provider
  
- Tax consequences to the service provider in receiving a profits interest include:
  - Under Rev. Proc. 93-27 and 2001-43, the service provider would not recognize any taxable income on the date of grant
  - Under Section 83 and Notice 2005-43, the service provider would not recognize any taxable income on the date of grant if the liquidation safe harbor was timely elected
    - However, to the extent the interest is subject to a vesting schedule, the above would apply only if the service provider makes a timely 83(b) election

## Types of Compensatory Alternatives (cont.)

- Options can be granted in the partnership context
  - The use of options is uncommon in the partnership setting
  
- As of the date of grant and/or the date of vesting . . .
  - The optionee would not recognize any taxable income
  - The option would not cause the optionee to be a partner
  
- As of the date of exercise . . .
  - The optionee would have ordinary taxable income equal to the spread between the exercise price and the fair market value of the underlying units as of the date of exercise
  - The partnership would be entitled to a compensatory deduction and would have to comply with applicable withholding rules
  
- As of the date the underlying interest is sold . . .
  - Any future appreciation from the date of exercise would be captured by the optionee at short-term or long-term capital gains rates

## Types of Compensatory Alternatives (cont.)

- A phantom interest is typically a cash payment designed to mimic equity ownership
  - From the partnership's point of view, a benefit of using phantom interests is that, if properly communicated, it can create an employee-ownership culture without having to actually share equity
  - Another benefit is that the service provider is not required to file a Form K-1 because he or she is not a partner due to the receipt of a phantom interest
  - However, a drawback of a phantom interest is that it is taxed to the service provider at ordinary income rates (i.e., no opportunity for long-term capital gains)
  
- Example of a cash-settled phantom unit
  - Grant 1,000 phantom units that vest when the partnership's price per unit is \$50.00
  - The phantom units vests when the price per unit is \$75
  - If settled at vesting, the participant would receive \$75,000 (1,000 x \$75)
  
- Example of an appreciation-only unit
  - Same facts as above except that the grant is an appreciation only award
  - If settled at vesting, the participant would receive \$25,000 ([1,000 x (\$75 - \$50)])



## Profits Interest: Rev. Proc. 93-27

- Receipt of a profits interest is generally not a taxable event to the recipient if Rev. Proc. 93-27 is satisfied. This means that a recipient is generally taxed only:
  - As the partnership allocates items of income, or
  - When subsequent appreciation from the date of grant is realized
  
- However, Rev. Proc. 93-27 would not apply, and thus receipt of a profits interest could be taxable, if any of the following apply:
  - The recipient disposes of the profits interest within 2 years of receipt;
  - The profits interest ‘relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease;’ or
  - The profits interest is an interest in a publicly-traded partnership
  
- The impact of granting a restricted profits interest (*i.e.*, one subject to a vesting schedule) was unclear under Rev. Proc. 93-27

## **Profits Interest: Rev. Proc. 2001-43**

- Stands for the proposition that a grant of a restricted profits interest, or the vesting of such interest, would not be a taxable event if the requirements of Rev. Proc. 93-27 and Rev. Proc. 2001-43 are satisfied
  - In other words, whether an interest qualifies as a profits interest is tested at the time of grant without regard to whether the interest is subject to a vesting schedule
  
- Compliance with Rev. Proc. 2001-43 requires the following to be satisfied:
  - The service provider must be treated as the owner of the interest from the date of grant, including that the service provider take into account his or her distributive share of partnership income, gain, loss, deduction and credit associated with that interest;
  - Neither the partnership nor its partners may take any deductions (neither at grant nor at vesting) for the fair market value of the interest; and
  - All other conditions of Rev. Proc. 93-27 must be satisfied

## **Profits Interest: Section 83 and Notice 2005-43**

- Proposed regulations under Section 83 (the “***Proposed Regs***”) and Notice 2005-43 were published in 2005 to govern the granting and vesting of a capital interest and/or a profits interest in a partnership
  - Notice 2005-43 contains a proposed Revenue Procedure that, if and when effective, would obsolete Rev. Proc. 93-27 and Rev. Proc. 2001-43
- The Proposed Regs provide NO distinction between a capital interest and a profits interest
- The Proposed Regs clarify that the principles of Section 83(b) would apply to capital and profits interests that are not vested (*i.e.*, those subject to a vesting schedule)
- Under the Proposed Regs, and absent a timely 83(b) election, a service provider would not be treated as a partner until his or her interest vests
- If the service provider makes an 83(b) election AND the partnership adopts the liquidation safe harbor (discussed on next slides), the service provider’s ordinary taxable income would effectively be eliminated

## Profits Interest: Valuation Issues

- The valuation of a compensatory partnership interest is important because it dictates:
  - How much the service provider will recognize as ordinary income, and
  - How much the partnership will allocate to its partners with respect to the corresponding deduction
  
- Fair market value could be determined by:
  - 3<sup>rd</sup> party independent appraiser,
  - Someone knowledgeable within the partnership and following the rules comparable to inside valuations under Section 409A, or
  - Adopting the “liquidation safe harbor” under the Proposed Regs. and Notice 2005-43
  
- Under the liquidation safe harbor, fair market value is determined by the partnership’s liquidation value
  - Liquidation value of a compensatory interest is the amount the service provider would receive if the partnership sold all of its assets at fair market value immediately after issuing the compensatory interest and then liquidated
  - May be elected for capital interests and/or profits interest

## Profits Interests: Valuation Issues (cont.)

- Generally, the following elements must be satisfied in order to qualify under the liquidation safe harbor:
  - The partnership agreement (or other legally binding agreement) must contain certain provisions that:
    - Authorize the partnership to elect the safe harbor, and
    - Require the partners to comply with the safe harbor requirements
  - The partnership's tax matters partner must attach a document to the partnership's tax return in the year of election that states the election is irrevocable as to compensatory interests issued while the election was effective
  - The election cannot be effective prior to the date the partners executed the document implementing the election; thus, no retroactive elections are permitted
  - The partnership interest cannot be:
    - Related to a substantially certain stream of income;
    - Represent an interest in a publicly-traded partnership; or
    - Transferred in anticipation of a subsequent disposition (which is presumed if the interest is sold, disposed of, puttable or callable, within 2 years from receipt of the award, with the exception being the death or disability of the service provider)

## **Profits Interest: Valuation Issues (cont.)**

- The safe harbor election is terminated upon the earlier of:
  - The date the qualifying elements are not satisfied
  - The date any party involved takes a position that is inconsistent with the election
  - The partnership affirmatively elects to revoke the safe harbor (filed by the tax partner on the partnership's tax return for the year of revocation)
  
- Once terminated, the safe harbor cannot be again elected until five years after the year the election was revoked
  
- The safe harbor might NOT be desirable upon a service provider's receipt of a compensatory capital interest (assuming it has value) because traditional valuation discounts would not be used (lack of marketability, minority interests, etc.)
  
- However, safe harbor treatment is likely desirable to a service provider receiving a profits interest because the receipt would have no value, which is the perfect time to make an 83(b) election

## **Contract Terms: Vesting Schedule and Risk of Forfeiture**

- The compensatory award would typically be subject to a risk of forfeiture until the vesting schedule is satisfied
  
- The types of risks of forfeiture include one or more of the following:
  - A forfeiture of the unvested award for failing to satisfy a time-based schedule (e.g., vesting over a 4-year period with 25% vesting on each of the annual anniversaries of the date of grant);
  - A forfeiture of the unvested award for failing to satisfy a performance-based schedule (e.g., achieving EBITDA of x);
  - A forfeiture of the unvested award for failing to consummate a contingent event, such as a change-in-control transaction or an IPO;
  - A forfeiture of both the vested and unvested award for failing to timely execute restrictive covenants (e.g., a non-compete, non-solicitation, etc.);
  - A forfeiture of both the vested and unvested award for failing to timely execute the Operating Agreement or Partnership Agreement (applicable to equity-based awards);
  - A forfeiture of the vested and unvested award if the service provider's employment with the partnership is terminated for Cause;

## **Contract Terms: Vesting Schedule and Risk of Forfeiture (cont.)**

- [Continued from prior slide]:
  - A forfeiture of both the vested and unvested award if the service provider violates, as determined in the sole discretion of the partnership, any restrictive covenant; and
  - A forfeiture of both the vested and unvested award if the service provider fails to timely sign a release agreement at the time of his or her employment termination (i.e., such agreement acting to release the partnership from all known and unknown claims that the key employee might otherwise have against the partnership)
  
- Consider too whether vesting of the award should be accelerated (partially or wholly) upon the earlier of certain events, including:
  - The IPO of the partnership (or upon the pre-IPO reorganization transaction when the partnership is converted to a C corporation immediately prior to consummating the IPO);
  - A change-in-control of the partnership; and
  - A termination of the key employee’s employment with the partnership due to his or her “disability”



## **Contract Terms: Repurchase Right in Favor of the Partnership**

- Incorporated into the award agreement could be a provision that provides the partnership with the right of repurchase of any vested equity interest if the service provider's employment relationship with the partnership is terminated
  - However, such is necessary only to the extent not addressed in the partnership agreement
  
- The amount of the repurchase could be at the then fair market value if the employment relationship is terminated:
  - By the partnership for other than Cause; and/or
  - By the service provider due to his or her disability
  
- In contrast, the amount of the repurchase could be for no value (or for nominal value) if the employment relationship is terminated:
  - By the service provider for any reason;
  - By the partnership for Cause; and/or
  - By the service provider as the result of his or her death

## Contract Terms: Other Provisions

- Drag-along rights, tag-along rights and co-registration rights
  - These are typically set forth in the partnership agreement
  
- Voting proxy
  - A voting proxy can be implemented to the extent voting control is not otherwise addressed in the partnership agreement
  - For those partnerships that wanted to issue options and were persuaded otherwise, the governance otherwise associated with options could be replicated by:
    - Implementing a voting proxy as a condition precedent to receiving the award;
    - Consider assigning voting to the Board to vote proportionate to how the Board voted on the particular issue
  
- There are a number of ways to handle partnership distributions while the equity award is unvested, including:
  - Pay distributions at the same distributions are otherwise paid to the equity holders of the partnership
  - Delay payment of the distribution until the underlying equity interest vests, but don't forget to provide for a special tax distribution since the service provider will be taxed on his/her allocable share of the partnership's income

## **Select Issue: Hybrid Award Example**

- In this example, the business goal is to grant the participant a full-value award while minimizing taxation at the date of grant or vesting. This could be accomplished with either of the following hybrid award structures, consisting of the following two parts:
  - **Hybrid Structure #1:**
  - First, grant a profits interest award to the service provider
    - Thus, allowing for the service provider to recognize appreciation from the date of grant at capital gains rates
  - Second, add a phantom full value award with an appreciation ceiling
    - This phantom award would be granted in conjunction with the grant of a profits interest award, but the value of this phantom award would always be “in the money” and would never be greater than the threshold value determined in conjunction with the grant of the above profits interest
    - Upon settlement of the phantom award, the management partner would receive a cash payment equal to, and limited by, the threshold value of the profits interest award
    - This phantom award would be taxed at ordinary income tax rates, but could be structured so that taxation and any cash payment to the managing partner would happen at the same time

## Select Issue: Hybrid Award Example

- **Hybrid Structure #2:**
- First, grant an profits interest award to the service provider (same as prior example)
- Second, structure the profits interest to have a “catch-up allocation” to receive a high disproportionate share of future profits until the service provider’s capital account is “caught up” to the total capital accounts on the grant date of the profits interest
  - For example, if the goal is to provide the service provider with a 3% full value interest, the partnership could grant him/her a 3% profits interest. And on a going forward basis this service provider could participate in future profits of the partnership at a rate of 97% until his/her capital account is caught up to the capital accounts that he/she would have had if the award had been a full value award on the date of grant

## **Select Issue: Solving the Employee v. Partner Example**

- And if a goal is to ensure that the employer is not converting its W-2 income employees to employees with guaranteed payments, then the following structure could be implemented:
- Step 1 – Create a new sister entity
- Step 2 – Grant a profits interest award from the employing entity to the new sister entity
- Step 3 – Grant a profits interest from the employing entity to the new sister entity
- Step 4 – Simultaneously with Step 3, grant a full value capital interest from the new sister entity to the chosen employee of the employing entity. Need to ensure that the vesting schedules and forfeiture conditions are mirrored for the grants in Step 3 and Step 4

## Don't Forget Next Month's Webinar

- Title:
  - Designing Equity Compensation Abroad
- When:
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