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Partnership and LLC Equity Compensation

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This practice note addresses fundamental considerations in structuring equity compensation for general and limited partnerships, as well as limited liability companies (LLCs) that are classified as partnerships for federal income tax purposes. It summarizes alternative approaches commonly used by entities taxed as partnerships to provide key service providers the opportunity to become equity owners and the advantages and disadvantages associated with each approach. For simplicity, although this practice note generally uses the term partnership, the information is equally applicable to all entities classified as a partnership for federal income tax purposes, including general partnerships, limited partnerships, and LLCs.

This practice note is organized in the following topics:

- Special Partnership Compensation Considerations
- Incentive Effect Considerations
- Types of Partnership Equity Compensation

For further information on the taxation of partnerships and their respective partners and members, see Lexis Tax Advisor -- Federal Topical § 2D:1.01 and [Tax Planning for Partners, Partnerships, and LLCs § 4.01](#).

Special Partnership Compensation Considerations

There are several issues that are important to understand when advising clients on equity compensation matters for partnerships. Many of these issues are unique to partnership equity compensation, primarily because of the different tax regime applied to entities taxed as partnerships compared to entities taxed as corporations (including LLCs that elect to be taxed as corporations). For tax purposes, a partnership is a pass-through entity, meaning that income tax is generally not imposed at the entity level. Instead, a partnership's income, gain, loss, deduction, or credit (tax items) is allocated to its partners based on a method agreed to among the partners in the partnership agreement. The partners are liable for paying income tax on their distributive shares of the partnership's tax items as reported on their respective income tax returns. Importantly, partners are subject to tax on their distributive shares of a partnership's tax items (which is a tax reporting concept) regardless of whether the partnership makes distributions of cash to its partners (which is an economic concept). As such, it is necessary to distinguish between a partner's distributive (or allocated) share of the partnership's tax items and distributions of partnership cash.

An equity interest in a partnership can be either a capital interest or a profits interest (including profits interests treated as so-called applicable partnership interests under new tax rules discussed later in this practice note). There are also synthetic forms of equity (e.g., phantom equity) that provide the appearance but not the substance of true ownership.

As discussed in the subsequent sections of this practice note, each of these options has advantages and disadvantages. There are many considerations to keep in mind when designing partnership equity compensation plans, including the primary compensation goals (such as incentivizing performance and talent retention), the terms of the plan and plan awards (e.g., as to vesting schedules, redemption provisions, and transfer restrictions), and tax consequences.

Incentive Effect Considerations

When designing an equity compensation program, it is imperative at the outset to identify the organizational objectives to be achieved. These objectives can impact the choice of award type and the terms of the award. From a talent management viewpoint, the primary reason partnerships grant equity compensation is to attract, incentivize, and retain key service providers. By offering a service provider an equity stake, the partnership is able to align the economic interests of its existing partners with key service providers.

Whether an equity incentive award achieves the desired objective is strongly influenced by a variety of factors, including those discussed below.

Vesting

To strengthen the incentive and retention effects of equity grants, partnerships (like corporations) typically subject the award to vesting restrictions, which can incentivize service providers to remain with the business over a designated period of time (if vesting is time based) or to enhance performance (if vesting is performance based), or both. On the other hand, extended vesting periods or unrealistic performance standards can diminish the perceived value of an equity award.

Capital Contribution Requirement

The partnership will also need to determine whether service providers will be asked to contribute cash or other property to receive an equity interest in the partnership, or whether the equity grant will be entirely compensatory. A service provider who is required to contribute cash or other property to the partnership will have “skin in the game” due to having capital at risk. The psychological effect of having capital at risk tends to incentivize performance in a manner consistent with a well-designed program’s objectives.

Partner Status

Some service providers highly value receiving equity compensation because of the value attributed to being a business owner. Although becoming a business owner has important psychological benefits, the change in status from employee to partner has real economic consequences, not all of which are positive. For instance, as a partner, the service provider is required to make quarterly payments of estimated tax, becomes subject to self-employment tax, and loses certain employee tax benefits not available to a partner, as discussed below under Types of Partnership Equity Compensation.

Voting, Redemption Rights, and Transfer Restrictions

Partnerships often impose restrictions on equity awards that are intended to primarily serve a compensatory purpose. These restrictions are usually set forth in a partnership agreement that establishes the rights and obligations of the partners and may also be included in a separate equity award agreement.

Voting Rights

Voting rights are one of the key provisions in partnership agreements that are relevant to equity compensation. Some partnerships choose to grant equity interests to service providers using a separate class of equity that restricts voting and management rights. These restrictions typically allow existing owners to retain control of the business. However, such restrictions can also dilute the intended objective by diminishing the award recipient’s connection to ownership. In many cases where incentive equity holders are granted voting rights, there will be exceptions for certain types of significant decisions. Of course, the law of the state in which a limited partnership (or LLC) is organized may provide that certain rights may not be waived or impose other restrictions. As such, it is necessary to confirm whether the relevant state law may limit what can be provided for in a partnership agreement (or LLC agreement).

Redemption Rights and Transfer Restrictions

Many partnerships subject compensatory partnership interests to transfer restrictions and redemption or buy-back provisions.

Almost all partnership equity awards are subject to transfer restrictions, as businesses often desire to control or at least limit the acquisition of its equity by unaffiliated third parties. In addition, transfer restrictions must comply with federal and state securities laws, as applicable.

Redemption or buy-back rights are also common, which enable the partnership (or the other partners) to redeem or acquire the partnership interests of a partner at an established price based on the occurrence of specified events (e.g., if the recipient has a separation from service after vesting in all or a portion of the interest). This is especially important for operating partnerships that are closely held and do not want inactive partners or passive investors. Such provisions should be clear about how the transfer restriction will operate, including how the transferred interest will be valued upon disposition, whether transfer is optional or mandatory, the time period in which the transfer is permitted to occur, and terms of payment (e.g., payment partially in cash and partially with an installment obligation).

For partnership agreements that permit partners to sell their interests to third parties, the partnership (and/or other partners) may also have a right of first refusal providing the remaining partners (or the partnership) with a first option to acquire any interests that a partner proposes to sell to a third party (usually at the same price and on substantially the same terms as the proposed sale).

Since the loss of employee status and restrictions on transferability can adversely impact a service provider's willingness to participate in an equity compensation program, many partnerships provide key service providers with synthetic forms of equity grants, including equity incentives that are cash settled (e.g., unit appreciation rights, phantom interests, etc.)

Types of Partnership Equity Compensation

This section briefly describes capital and profits interests, as well as synthetic equity arrangements, addressing their advantages and disadvantages and the tax implications of each.

In addition to the considerations noted below for capital and profits interests, partnerships should take into account the increased costs and complexity of administering an incentive program that is equity settled. Such arrangements can result in increased compliance costs and added complexity arising from factors such as the need to obtain valuations each time equity is granted to a service provider. In addition, the preparation and execution of the applicable legal documents (including, where necessary, amending the partnership agreement) and securities law compliance matters all contribute to the increased complexity of these types of arrangements compared to incentive programs that are cash settled (e.g., cash bonus or phantom awards).

Capital Interests

For federal tax purposes, a capital interest in a partnership is a distinct type of equity interest. Specifically, a capital interest is defined as "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership." Rev. Proc. 93-27, 93-2 C.B. 343. That determination is made at the time of receipt of the partnership interest. *Id.*

Similar to grants of equity in a corporation, partnership capital interests can vest immediately, over a period of time, or based on performance. They can also be issued subject to restrictions, including transfer restrictions, redemption and buy-back rights, and rights of first refusal, as discussed above.

Tax Treatment of Capital Interest Grant

The tax treatment of an award of a compensatory capital interest in a partnership is governed by I.R.C. § 83, and turns on whether the interest is vested at the time of grant. I.R.C. § 83(a); 26 C.F.R. § 1.721-1(b)(1).

- **Vested capital interest.** A service provider awarded a capital interest that is fully vested upon grant will immediately include as taxable compensation an amount equal to the excess of the fair market value of the capital interest over the amount paid, if any, for the interest (generally referred to as the spread).
- **Unvested capital interest.** A service provider awarded a capital interest that is subject to a vesting provision (i.e., the interest is subject to a substantial risk of forfeiture; see [Substantial Risk of Forfeiture](#)) is not subject to tax upon grant (unless the service provider makes a Section 83(b) election, described below). Instead, as the interest vests, the service provider will be subject to tax on the spread.

26 C.F.R. § 1.83-1(a)(1).

In either case, the partnership generally deducts an amount equal to the compensation reported by the service provider. I.R.C. § 83(h). That deduction is allocated to the existing partners as provided for in the partnership agreement.

Given that the recipient of a capital interest is taxable on the spread at the time the award vests, consideration should be given to how the recipient would be expected to pay the tax. Since transfer and other restrictions limit the marketability of a vested capital interest, the award recipient may not have sufficient liquidity to pay the federal and state income tax imposed on the spread. To minimize

the financial burden on the award recipient, some partnerships combine the award of a capital interest with another cash-settled incentive such as a bonus payment. Other partnerships provide access to funds either by loaning funds directly to the award recipient upon favorable terms or arranging for access to a preferred third-party lender.

An issue that must be addressed by recipients of unvested capital interests concerns the start of the interest's holding period. To obtain the preferential federal tax rate associated with long-term capital gains, an individual must hold a capital asset for a period greater than 12 months. The holding period for an unvested capital interest generally does not begin to run until the interest vests, and even then, full vesting may occur over an additional period of years. If the holder disposes of the interest (or a portion thereof) within 12 months of vesting, he or she would not qualify for long-term capital gain treatment. Although a recipient of an unvested capital interest could accelerate the holding period by making a Section 83(b) election, as discussed in the next section, such an election is not without potentially adverse economic consequences.

A similar issue must be addressed when granting a compensatory option to acquire a capital interest in a partnership. To avoid being taxed on the spread at the time the option is exercised, many optionees delay exercise until there is clarity regarding the timing of a capital transaction. Since the holding period does not start until the option is exercised (assuming no additional vesting requirement), many award recipients would not qualify for the preferential long-term capital gain rate because the subsequent disposition of the capital interest often occurs within 12 months of the exercise date. On the other hand, grants of compensatory partnership options are rare and should generally be avoided. As more fully discussed below, the grant of a profits interest is more highly valued by key talent than the grant of a compensatory option on a partnership interest.

Section 83(b) Elections

A recipient of an unvested capital interest can minimize the taxable spread upon vesting, and start the holding period for long-term capital gain purposes, by making a timely Section 83(b) election. To be timely, the Section 83(b) election must be filed with the IRS within 30 days of the grant date and include required information about the interest. For more information on filing Section 83(b) elections for unvested partnership interests, see Lexis Tax Advisor -- Federal Topical § 2D:13.06, para. [2][c].

Whether a service provider makes a Section 83(b) election depends on his or her view of the partnership's future success. If a service provider is bullish on the partnership, there is a greater likelihood that a Section 83(b) election will be made because the spread on the grant date would be less than the projected spread on the vesting date. Of course, that election is not without potential risk. If the value of the partnership on the vesting date is less than its value on the grant date (or worse, the partnership declares bankruptcy subsequent to the grant date), the service provider would not be entitled to a refund of the tax paid based on the grant date value. The service provider would be limited to recognizing a capital loss upon later disposition of the interest or upon the bankruptcy of the partnership.

Other Tax Consequences of Capital Interests

A partner's distributive share of tax items from a partnership is taxable as either ordinary income or loss, or capital gain or loss, depending on the character of the tax item in the hands of the partnership. A guaranteed payment made to a partner is treated as ordinary income subject to self-employment tax. The partnership is allowed a deduction equal to the amount of any guaranteed payments, which is passed through to its partners.

When a partner eventually disposes of a capital interest, he or she will generally recognize capital gain equal to the net proceeds from the sale less the capital interest's basis. However, in some instances all or a portion of the gain can be recharacterized as ordinary income if certain "hot asset" rules apply pursuant to I.R.C. § 751 (see Lexis Tax Advisor -- Federal Topical § 2B:16.10 for details).

Profits Interests

For federal tax purposes, a profits interest in a partnership is another type of distinct equity interest. By definition, a profits interest is a partnership interest other than a capital interest. Rev. Proc. 93-27, 93-2 C.B. 343.

The simplest way to distinguish a profits interest from a capital interest is to ask whether, in a hypothetical liquidation of the partnership on the grant date, the recipient would be entitled to receive anything of value. If so, then the interest is a capital interest and the spread is taxable to the recipient, as discussed above. If not, then the interest is a profits interest, the receipt of which is not treated as a taxable event for either the recipient or the partnership. In other words, if the recipient of the interest only has a right to share in future profits (i.e., profits arising subsequent to the grant date) and in the future enterprise value (i.e., the fair market value of the partnership arising subsequent to the grant date), the interest is a profits interest.

Rev. Proc. 93-27 provides that if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, the IRS will not treat the receipt of that interest as a taxable event for the

partner or the partnership. However, that revenue procedure does not apply, and the receipt of a profits interest will be taxable to the recipient, if any of the following are true:

- **Certain income stream.** 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.
- **Disposition within two years.** Within two years of receipt, the recipient disposes of the profits interest.
- **Publicly traded partnership.** The profits interest is a limited partnership interest in a publicly traded partnership within the meaning of I.R.C. § 7704(b).

Rev. Proc. 93-27; see also Rev. Proc. 2001-43, 2001-2 C.B. 191.

Rev. Proc. 2001-43 provides an important clarification regarding the time for determining whether an unvested interest is a profits interest or a capital interest. Specifically, the revenue procedure provides that the required determination is made at the time the interest is granted, regardless of whether it is vested or unvested at that time (within the meaning of Regulation Section 1.83-3(b)), provided that, if the interest is to be treated as a profits interest, all of the following must be true:

- **Treated as partner.** The partnership and the recipient treat the recipient as the owner of the partnership interest from the date of its grant, and the recipient takes into account the distributive share of partnership tax items associated with the interest in computing the recipient's income tax liability for the entire period during which the recipient has the interest.
- **No deductions.** Upon the grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest.
- **Compliance with Rev. Proc. 93-27.** All other conditions of Rev. Proc. 93-27 are satisfied.

Traps to Avoid

Unless the award agreement provides otherwise, most recipients of profits interests are subject to the provisions of the partnership agreement (or LLC operating agreement, as the case may be) in the same manner as holders of capital interests. If the partnership agreement provides for final liquidating distributions to be made in accordance with the partners' positive capital balances (in order to have "economic effect"), the recipient of a profits interest would not receive any proceeds from the hypothetical liquidation of the partnership on the grant date because the recipient would not have a capital account balance as of that date.

Many current partnership agreements, however, do not provide for liquidating distributions to be made in accordance with the partners' positive capital account balances. Instead, these agreements provide for liquidating distributions to be made in the same manner as nonliquidating distributions. In the view of many investors, distributing liquidation proceeds according to the partners' positive capital account balances may interfere with the deal economics, which is of higher importance to them than complying with the economic effect requirement. Such provisions can create a serious tax issue for recipients of a profits interest.

As discussed above, the holder of a profits interest must not participate in the proceeds from a hypothetical liquidation on the grant date. However, if liquidation proceeds are distributed according to the agreement's general distribution provision, an award recipient may be hypothetically entitled to receive something of value following a hypothetical liquidation of the partnership on the grant date. The receipt of anything of value on that date would cause the interest to be classified as a taxable capital interest.

This issue can easily be avoided by building a distribution threshold or similar distribution hurdle into the partnership agreement. A distribution threshold provision requires that a minimum amount of cumulative distributions would be made with respect to other interests before the holder of a newly granted profits interest would receive a distribution arising from the hypothetical liquidation. The threshold merely provides a mechanism to avoid the unintended reclassification of a nontaxable profits interest into a taxable capital interest.

How the characterization of a partnership interest can turn on the chosen liquidation method is illustrated by *Crescent Holdings, LLC, et al. v. Commissioner*, 141 T.C. No. 15 (2013). In that case, an LLC classified as a partnership for federal income tax purposes granted a 2% interest to its chief executive officer. As a condition of receiving the interest, the CEO was required to remain in his position with the company for a three-year period. If he failed to so remain with the company, his interest would be forfeited. Prior to the end of the three-year vesting period, the recipient resigned as CEO and left the company.

Consistent with Rev. Proc. 2001-43, the company and the CEO treated the CEO as the owner of a partnership interest from the date of grant, and the CEO took into account his distributive share of partnership tax items in computing his income tax liability for the entire period during which he held the interest. The company did not, however, distribute any cash to the CEO during the entire

period he held the interest, although by agreement the company paid him amounts intended to cover the tax payments he made on his distributive share of partnership tax items.

Approximately three months before his interest would have vested, the CEO resigned. Shortly thereafter, the company declared bankruptcy. In the bankruptcy proceedings, a demand was made for the CEO to repay the amounts previously paid to him to cover his income tax liabilities on his distributive share of partnership tax items (on the ground that such amounts were essentially advance distributions made to a person who was a partner of the partnership).

The CEO argued that since his right to the interest never vested, the company should not have allocated any tax items to him during the years at issue. An opposing party argued that the CEO's interest was a profits interest and, under Rev. Proc. 93-27, he was liable for tax on his distributive share of partnership tax items during the periods at issue. Another party asserted that the interest in question was a capital interest and, because the interest was unvested, a distributive share should not have been allocated to him for the years at issue.

The Tax Court initially addressed the question whether the interest was a capital interest or a profits interest. After discussing the requirements of Rev. Proc. 93-27 and Rev. Proc. 2001-43, the court turned to the operating agreement to determine if the CEO would have received a share of the proceeds in a hypothetical liquidation of the company on the grant date.

Reviewing the dissolution provisions set out in the agreement, the court noted that the proceeds of the sale of the company and its assets were to be distributed first to the satisfaction of the company's debts and liabilities followed by satisfaction of the expenses of liquidation and the establishment of reserves for contingent liabilities. The balance, if any, was to be distributed to the members in accordance with the agreement's general distribution waterfall (and not in accordance with the partners' positive capital account balances). The waterfall provided for distributions first to members in the amount of their priority capital contributions along with a 20% annual return thereon. Thereafter, any remaining amount was to be distributed to the members in proportion to their then current percentage interest at the time of such distribution.

No priority capital contributions had been made to the company by any member as of the grant date. Therefore, one party argued that the CEO held a capital interest because he would have received proceeds from a hypothetical liquidation of the company on the grant date. Another party argued that the CEO held a profits interest because the CEO did not contribute cash or property in exchange for his interest, and therefore did not have a capital account.

The Tax Court concluded that the CEO held a capital interest because he would have received a share of the proceeds following a hypothetical liquidation on the grant date. As such, neither Rev. Proc. 2001-43 nor Rev. Proc. 93-27 was applicable. In contrast to a nonvested profits interest, the holder of a nonvested capital interest is not classified as a partner until the interest vests. As a result, the court ruled that the CEO should not have been allocated a distributive share of any partnership tax items during the years at issue. Moreover, the CEO was not required to repay the amounts in question because such amounts were not paid to him in a partner capacity.

As *Crescent Holdings* illustrates, when identifying the nature of a partnership equity interest, the safe harbors of Rev. Proc. 93-27 and Rev. Proc. 2001-43 only apply if the interest can initially be classified as a profits interest. Once the interest is properly classified as a profits interest, the safe harbors must then be adhered to so that the interest retains its desired status.

Other Tax Consequences of Profits Interests

As with capital interests, profits interests result in partnership allocations that are taxable at either ordinary income or capital gain rates, depending on the characterization of the income or gain to the partnership, and guaranteed payments received by a partner are taxed as ordinary income. Upon the redemption or sale of a profits interest, the holder will have a short-term or long-term capital gain, depending on how long the interest was held. As in the case of a capital interest, in some instances all or a portion of the gain can be recharacterized as ordinary income if certain hot asset rules apply pursuant to I.R.C. § 751.

Also, although Proc. 2001-43 expressly provides that it is not necessary to make a Section 83(b) election in connection with the grant of a nonvested profits interest (in contrast to the grant of a nonvested capital interest, as discussed above), many practitioners nonetheless recommend filing such an election showing a \$0 value as of the grant date. For a model, see [Section 83\(b\) Election Form \(Profits Interest\)](#).

As discussed above, a profits interest must not violate the safe harbor requirements of Rev. Proc. 93-27. For example, if a profits interest must be disposed of upon a change in control, which occurs prior to expiration of the two-year holding period, the interest would be reclassified as a capital interest carrying the corresponding tax consequences.

Applicable Partnership Interests

The tax reform legislation enacted in late 2017, formerly known as the Tax Cuts and Jobs Act (Pub. L. No. 115-97) (the Tax Act), added new I.R.C. § 1061. That section impacts the tax treatment accorded to a special type of profits interest referred to as an applicable partnership interest. These rules apply when the following conditions are met, subject to the limitations discussed further below:

- **Interest issued for performance of services.** An applicable partnership interest is any interest in a partnership which, directly or indirectly, is transferred to (or is held by) a taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business (defined below).
- **Interest in an applicable trade or business.** The interest is in an entity that conducts activities on a regular, continuous, and substantial basis that consist, in whole or in part, of raising or returning capital, and either (1) investing in (or disposing of) specified assets, or (2) developing specified assets. Importantly, to qualify as an applicable trade or business, the activity does not actually have to rise to the level of a “trade or business” as that term is generally used in the Internal Revenue Code.
- **Investment or development of specified assets.** The specified assets are securities, commodities, real estate held for rental or investment, cash or cash equivalents, options, derivative contracts with respect to any of the foregoing, and partnership interests in partnerships having an interest in any of the foregoing.

I.R.C. § 1061(c).

Special Holding Period for Applicable Partnership Interests

If a profits interest is an applicable partnership interest, the gain or loss reported by its holder is subject to a special holding period. Specifically, gains passed through to a service partner from the sale of a partnership’s portfolio investments, in addition to gains related to the disposition of the applicable partnership interest itself, qualify for long-term capital gain treatment only if held by the partnership or partner, respectively, for more than three years. The new holding period requirement for applicable partnership interests contrasts with the general rules under which a capital asset qualifies for long-term capital gain treatment if held for more than one year, and a profits interest must be held for more than two years. As a result, gain associated with an applicable partnership interest will be classified as short-term capital gain subject to tax at ordinary income rates unless the new three-year holding period requirement is satisfied.

Limitations on What Qualifies as an Applicable Partnership Interest

The three-year holding period associated with applicable partnership interests is not as broadly applicable or impactful as may initially appear. First, to the extent provided by the Secretary of the Treasury, the special holding period does not apply to income or gain attributable to any asset not held for portfolio investment on behalf of third party investors. I.R.C. § 1061(b).

Second, the new holding period requirement does not apply to a partnership interest held, directly or indirectly, by a corporation. Commentators have questioned whether this limitation applies to both C corporation and S corporations. Such a literal interpretation would appear self-defeating since an individual holder of an applicable partnership interest could avoid the special holding period requirement simply by establishing a single-member LLC classified as an S corporation to hold her investment. Although the failure to define corporation appears to be a drafting oversight, it is not clear whether the omission can be remedied using technical corrections or regulations rather than by a statutory amendment.

Finally, the special three-year holding period does not apply to a partner holding a capital interest in a partnership, regardless of whether the partnership is engaged in an applicable trade or business.

Related Party Transfer Restrictions

As noted above, the gain on disposition of an applicable partnership interest held for more than three years is generally classified as long-term capital gain even if the partnership has portfolio investments with a holding period of less than three years. However, if a partner disposes of an applicable partnership interest, directly or indirectly, to a related person, all or a portion of the resulting gain will be characterized as short-term capital gain to the extent portfolio assets of the partnership do not separately satisfy the three-year holding period requirement (and regardless of whether the partner held the interest for more than three years). I.R.C. § 1061(d) (2).

A related person is defined in I.R.C. § 1061(d)(2) as a member of the transferring partner’s family (within the meaning of I.R.C. § 318(a) (1)), or any person who performed a service within the disposition year or the preceding three calendar years in any applicable trade or business in which or for which the transferring partner performed a service.

For example, assume that Jane has held an applicable partnership interest in an LLC for more than three years. Further assume that the LLC has two portfolio assets, Asset 1, which has been held for more than three years by the LLC and Asset 2, which has been held for two years. If Jane has a gain upon her disposition of the applicable partnership interest to an unrelated person, the gain will be classified as long-term capital gain (without regard to the holding period of Asset 2). Alternatively, if Jane sells the interest to fellow LLC service member Joe, Jane will recognize long-term capital gain for that portion of the overall gain attributable to Asset 1 and short-term capital gain for that portion of the overall gain attributable to Asset 2. If Jane held a capital interest rather than a profits interest in the partnership, the entire gain would have been classified as long-term capital gain even if the holding period for the interest was less than three years, but for more than one year.

Effective Date

The special rules for applicable profits interests are effective for taxable years beginning on or after January 1, 2018, are not subject to any phase-ins or phase-outs, and are intended to be permanent. There are many unanswered questions regarding the special holding period for applicable partnership interests that must await technical corrections or the promulgation of regulations.

Employment Status and Benefits Issues Associated with Partnership Equity

Individuals who perform services on behalf of a partnership and receive either (1) vested capital interests (and, presumably, nonvested capital interests for which a Section 83(b) election has been made) or (2) profits interests (whether vested or unvested) must be treated as partners for tax purposes from the date of grant. That is, under long-standing IRS policy, a service provider cannot be treated as both a partner and an employee of the same partnership simultaneously. This has several important consequences that should be considered by the parties to help determine whether the benefits of receiving a partnership interest outweigh the drawbacks. Rev. Rul. 69-184, 1969-1 C.B. 256; Gen. Couns. Mem. 34173 (July 25, 1969); Gen. Couns. Mem. 34001 (Dec. 23, 1969); see also 81 Fed. Reg. 26,693 (May 4, 2016) (amending 26 C.F.R. § 301.7701-2) for recent temporary and final rulemaking on this topic for disregarded entities.

First, due to the pass-through nature of partnership taxation, partners report and pay income tax on their distributive share of partnership tax items (reported on Schedule K-1 to Form 1065) on their separate tax returns, regardless of whether the partnership makes an economic (cash) distribution to the partners. As noted previously, this can result in a timing issue, where a partner must currently pay tax on partnership tax items while receiving a distribution of the corresponding cash in a subsequent tax year. The income recognized in the current year is added to the partner's basis in his or her partnership interest thereby avoiding a second tax on the same income when later distributed. Most partnerships address the timing issue by including a provision in the partnership agreement allowing for a so-called tax distribution, which is simply an advance against future distributions that are used by the partners to pay current tax.

In addition, partners are not considered employees covered by payroll (FICA) tax, unemployment insurance, or wage withholding rules. Instead, they are taxed as self-employed individuals, who are generally subject to self-employment tax under *I.R.C. § 1402(a)*. The self-employment tax liability is usually equal to the combined employee and employer portions of FICA taxes for employees, although an above-the-line deduction for half the amount is usually available. Also, since there is no withholding by the partnership, partners must make quarterly estimated tax payments. Further complicating the tax situation, partners are often required to file income tax returns in each state in which the partnership has income tax nexus. In most states, the partnership is required to withhold and remit tax on behalf of nonresident partners.

A service provider's status as a partner also adversely affects eligibility for certain tax-favored employee benefit plans and arrangements. For example:

- **No tax-free employer-paid health insurance.** Since partners are not deemed to be employees, any premium costs for employer-provided health insurance borne by a partnership on behalf of a partner are treated as guaranteed payments, taxable as ordinary income (but such amounts are generally deductible by the partnership and by the partners). *I.R.C. § 105*; Rev. Rul. 91-26, 1991-1 C.B. 184.
- **No pretax health plan premium, FSA contribution, or other Section 125 "cafeteria plan" benefits.** Cafeteria plans may not provide pretax benefits allowed under *I.R.C. § 125* to nonemployees, including partners. Thus, for example, while a partnership's employees may be permitted to participate in a cafeteria plan and elect to pay for the partnership's health plan with pretax salary deferrals, or contribute to a tax-favored flexible savings arrangement (FSA) on a pretax basis, the partners may not. *I.R.C. § 125(d)(1)*; Prop. Treas. Reg. § 1.125-1(g)(2), 72 Fed. Reg. 43,950.

- **No income exclusion for HSA contributions.** A partnership's contributions to a health savings account (HSA) do not receive the same beneficial tax treatment as an income exclusion under I.R.C. § 223 as contributions made on behalf of employees. For applicable tax treatment, see I.R.S. Notice 2005-8, 2005-1 C.B. 368 (Jan. 24, 2005).
- **No income exclusion for employer-provided group term life insurance.** Partners are not eligible for the limited income exclusion for up to \$50,000 of group term life insurance for employees under I.R.C. § 79; 26 C.F.R. § 1.79-1(f).

On the other hand, partners are permitted to participate in and receive the same benefits as employees under a qualified retirement plan maintained by the partnership (I.R.C. § 401(c)(1)) and for the following I.R.C. § 132 fringe benefits: working condition fringes, de minimis fringe benefits, and no-additional-cost service and qualified employee discounts, on-premises athletic facility benefits (26 C.F.R. § 1.132-1(b)).

Avoiding Nonemployee Tax Treatment

Sometimes partnerships and LLCs use an alternative organizational structure to avoid causing a service provider to be classified as a partner upon receiving a compensatory equity grant. For example, the partnership may issue the award to a service provider's wholly owned LLC classified as an S corporation. Alternatively, it is common for some partnerships to organize management service companies that lease services to the partnership in which the interests are granted. Such alternative structures should be carefully considered in light of the risk that the IRS may disagree with the purported tax treatment and recast the characterization of the arrangement. In this regard, the IRS recently clarified its position that a partnership may not treat individuals holding an equity interest in the partnership as employees of a disregarded entity owned by the partnership and solicited comments on the topic of potentially permitting employee-like tax treatment for service-providing partners. 81 Fed. Reg. 26,693; 26 C.F.R. § 301.7701-2.

Another way to avoid the complexity and adverse employment implications arising from granting compensatory capital and profits interests awards is to forego true equity grants in favor of compensation alternatives that can achieve similar incentive and retention effects, such as phantom equity (discussed on the next section) or simple cash bonus plans (for a discussion on cash incentive plans, see the relevant sections of [Drafting Short- and Long-Term Incentive and Bonus Agreements](#)).

Phantom Equity

Rather than issuing true equity in the partnership in the form of a profits interest or capital interest, partnerships can instead grant so-called synthetic or phantom equity rights. Phantom equity arrangements are designed to resemble the economics of an equity interest (disregarding the tax effects). Phantom equity awards can be based on the full value of an equity interest (similar to a restricted stock unit or performance share), but are more often designed to provide a way to share in the future profits and/or growth of the partnership in the manner of a profits interest (similar to a stock appreciation right (SAR) award).

Phantom equity has become a very popular way for partnerships to compensate employees, because it has the flexibility but not the complexities of a true equity interest. Phantom equity arrangements can mirror many of the effects of granting a true equity interest by establishing payment terms regarding the amounts to be paid (or formulas to determine such amounts), timing of payments, vesting conditions, performance hurdles, and other conditions that, taken together, can mimic the terms for a particular class of equity holders under the terms of the partnership agreement (or the proposed terms of a class of incentive equity holders). Thus, for example, phantom equity holders may be made eligible for payments only if and when certain distributions are made to the partnership's actual equity-holding partners (or only after certain equity-holder classes receive a dollar threshold in distributions), and only to the extent vested at that time, in order to integrate the phantom incentive arrangement with the partnership agreement's distribution waterfall in the desired manner. Also, they may include terms that simulate redemption or cash-out rights, conversion rights (e.g., upon the occurrence of an IPO), and/or exit event bonuses to further simulate a true equity award.

Equity Appreciation Rights

A common type of phantom equity is equity appreciation rights, sometimes referred to as equity appreciation units or appreciation membership units. This type of award is analogous to SARs in the corporate context. They give recipients the right to receive a cash payment equal to the appreciation in value of a certain percentage of partnership interests (or membership units in the case of LLCs), from the date of grant until the date of settlement.

As with other types of awards, partnerships can be creative in designing the terms to meet their goals, for example, by establishing time-based and/or performance-based vesting schedules, setting fixed or event-driven settlement dates (e.g., upon a termination of employment without cause or a liquidation event), providing for forfeiture provisions (e.g., upon a for-cause termination), and fine-tuning the award payments (e.g., determining how the interests will be valued for purposes of the award).

Phantom equity arrangements can help align the interests of key talent with the partnership, since the ultimate reward is dependent upon enterprise success. Further, it does not have the drawbacks and additional complexity of true partnership interests described above. Also, the partnership may prefer phantom equity as a way to simulate the financial rewards of equity ownership without needing to grant any associated voting or other rights under the partnership agreement. On the other hand, phantom equity often is less favorable from a tax standpoint than true equity, since there is no opportunity to be taxed at capital gain rates, as noted in the following section.

Tax Treatment of Phantom Equity Awards and Section 409A

Since partnership phantom equity arrangements are typically cash awards, recipients are generally taxed when they receive payment, with the amount received being taxable at ordinary income rates. This is the main drawback of phantom compensation arrangements, since there is no opportunity for taxation at the more favorable long-term capital gain rates that exist for capital interests and profits interests. The partnership recognizes a corresponding deduction at the time the recipient recognizes the income.

Importantly, phantom equity awards (unlike true equity grants) can be subject to the nonqualified deferred compensation rules under I.R.C. § 409A and the implementing regulations thereunder (Section 409A). Unless they are structured to qualify for an exception (e.g., the short-term deferral exception), phantom equity arrangements must comply with the stringent rules under Section 409A. Under these rules, among other things, the terms of the award must only permit payments to be made in relation to a permissible payment event (e.g., a separation from service, disability, death, a change-in-control event, an unforeseeable emergency, or a specified time or pursuant to a fixed schedule).

The consequences for failing to comply with the Section 409A rules when applicable are severe, including acceleration of income recognition for any deferred amount that is no longer subject to a substantial risk of forfeiture and an additional 20% excise tax on such amount, plus potentially an interest penalty, imposed on the service provider. For an overview of the impact of Section 409A, see [Understanding Nonqualified Deferred Compensation Arrangements and Internal Revenue Code Section 409A](#).

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