Executive Compensation and Private Equity Transactions

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Overview

- Entities in the "private equity" arena use a variety of compensation arrangements for their service providers.
  - Some compensation is paid in the form of cash compensation for services, but that results in ordinary income and (by definition) uses cash funds.
  - Most private equity funds use a combination of cash compensation and equity compensation for their service providers.
  - While some equity grants are in "whole units", most are in the form of a "profits interest" or "carried interest."

Equity Awards

- Under Section 83, the recipient of property provided as compensation for services generally will recognize ordinary income when that property is received.
  - If the property is not vested as of the date of grant, then the income recognition is postponed until vesting.
  - The amount of income is equal to the FMV of the property on the date it is granted or, if later, the date it becomes vested.
  - This includes equity interest in partnerships and LLC.

Profits Interest Awards

- A grant of a “profits interest” in a partnership or an LLC is treated differently for tax purposes.
- Revenue Procedure 93-27 states that, if a person receives a profits interest for past or anticipated services, the transfer of the profits interest is not taxable to the partner or to the partnership due to a special valuation rule.

Profits Interest Awards

- The special valuation rule provided by Revenue Procedure 93-27 allows taxpayers to assign a zero value to the profits unit award on the date of grant.
  - Taxation is determined based on liquidation value for the entity on the date of grant.
  - No value is assigned to the entity’s growth potential.

Profits Interest Awards

- Revenue Procedure 93-27 applies to a profits interest grant if:
  - the profits interest does not relate to a substantially certain and predictable stream of income from partnership assets,
  - the partner does not dispose of the profits interest within two years of receipt, and
  - the profits interest is not granted by a publicly traded partnership.

Profits Interest Awards

- If the requirements of Revenue Procedure 93-27 are satisfied, the profits interest award has no value for income tax purposes when granted.

- But Revenue Procedure 93-27 didn't answer all of the questions, including whether a Section 83(b) election would be required for a profits interest award. It also does not answer what happens if a transfer occurs for ANY reason within 2 years of issuance.

Profits Interest Awards

- Revenue Procedure 2001-43 expanded the scope of Revenue Procedure 93-27 by providing that if a partnership grants a substantially nonvested partnership profits interest to a service provider, the service provider will be treated as receiving the interest on the date of its grant.

Profits Interest Awards

- Revenue Procedure 2001-43 also:
  - Eliminated the Section 83(b) election filing requirement for profits interests, including prior awards.
  - Provides that the vesting date for an award does not delay taxation if this ruling applies.

Profits Interest Awards

- Revenue Procedure 2001-43 applies if:
  - the partnership and service provider treat the service provider as the owner of the partnership interest from the date of its grant and the service provider takes into account his or her distributive share of partnership income, gain, loss, deduction and credit associated with that interest;

Profits Interest Awards

- upon the grant of the equity interest or at the time the equity interest becomes substantially vested, neither the partnership nor any of its partners deducts an amount for the fair market value of the interest; and
- each of the conditions of Revenue Procedure 93-27 are satisfied.

Profits Interest Awards

- What if Revenue Procedures 93-27 and 2001-43 don't apply to an award?
  - The Section 83(b) election would still close the compensation transaction and cause future gains to be treated as capital gains. But what is the value – is it still zero if you lose the presumption?
  - Campbell v. Comm'r., 943 F.2d 815 (8th Cir. 1991), provided that a profits interest grant had no determinable value. Also indicated, in dictum, that receipt of a profits interest for services is not taxable.

Profits Interest Awards

- The IRS has recently stated that it will interpret the safe harbor in Revenue Procedure 93-27 strictly.
- *"The safe harbor, by its terms, says you don't qualify for it if you have a disposition within two years, and so if you had that disposition, you're not qualifying now."*
  - Curtis Wilson, IRS Associate Chief Counsel, AICPA Fall Tax Meeting, 11/4/15.

Employee Classification Issue

- Profits interest awards create some issues for recipients and issuers:
  - Ownership of a partnership interest … makes the recipient a partner for tax purposes.
    - The IRS has consistently stated that a partner cannot be an employee of a partnership.
    - Many entities, however, treat service providers who hold partnership interests as “employees” for federal tax purposes. This creates risks for tax reporting, tax withholding and audit purposes.

Employee Classification Issue

- In GCM 34001 (Dec. 23, 1968) and GCM 34173 (July 25, 1969), the IRS stated that for employment tax purposes, a partner may not be both a partner and an employee in the same partnership.

- Similarly, Revenue Ruling 69-184 states that a partner may be either a partner in a partnership or an employee of a partnership, but not both, for employment tax purposes

Employee Classification Issue

- Does this matter? Maybe…
  - Based on Revenue Procedure 2001-43, the IRS could argue that treating the recipient of a profits interest as an employee is an indication that the partnership does not consider the person to be a "partner," which is a requirement under that ruling. If that is the case, then the protection of the ruling might not apply, resulting in taxable income to the "employee" on each future vesting date.

Employee Classification Issue

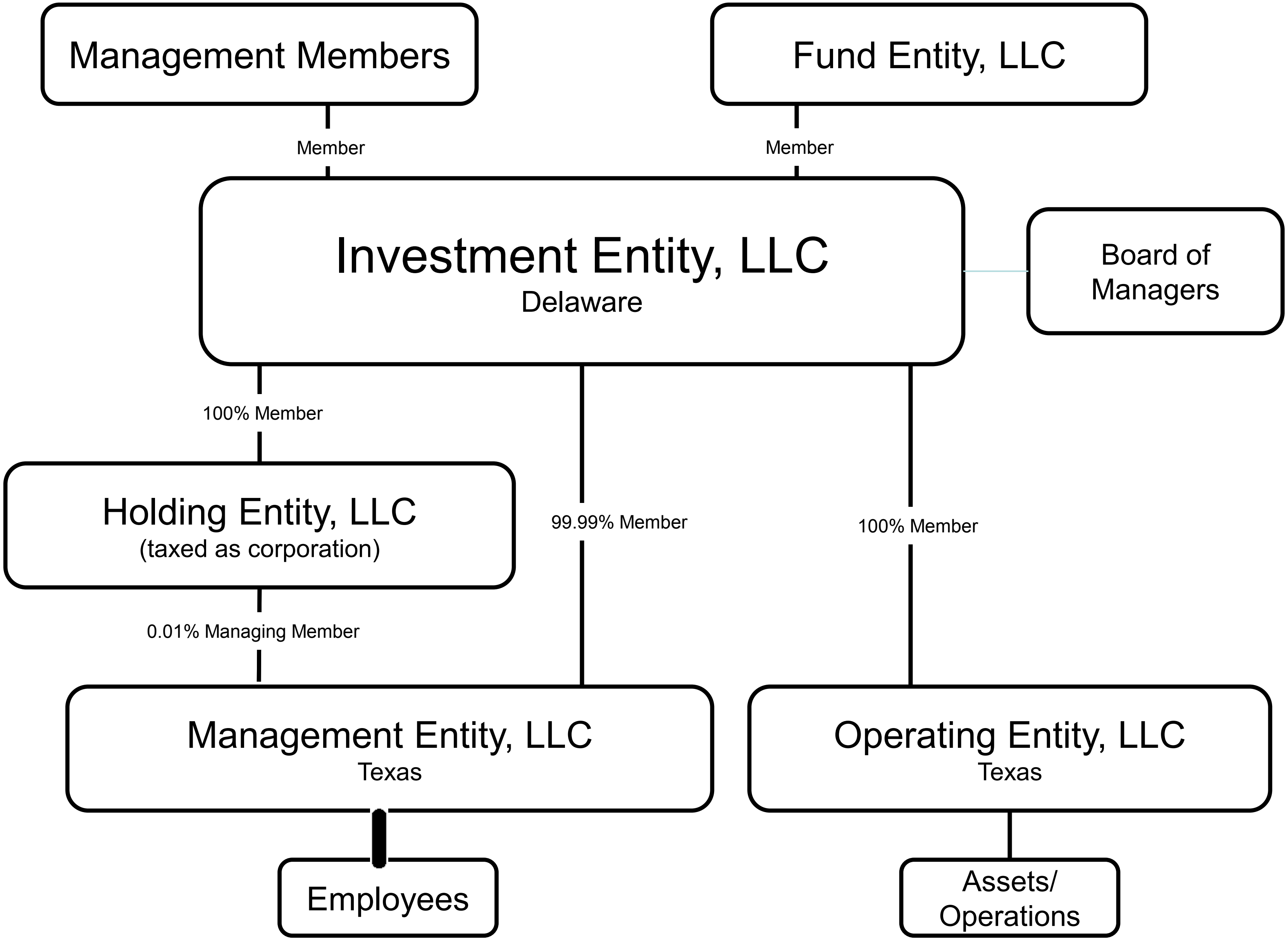
- Does this matter? Maybe…
  - This can disqualify the employer's cafeteria plan and its HRA plan, since each limit participation to "employees."
  - There also may be a failure to properly withhold and file FICA and employment tax returns and estimated taxes. And those returns are signed under penalty of perjury.

Employee Classification Issue

- Does this matter? Maybe…
  - And, Code Section 6664 generally prohibits a taxpayer from taking a tax position unless there is substantial authority or a reasonable basis for the tax treatment of an item and the taxpayer discloses the tax treatment on the taxpayer's income tax return (using Form 8275, Disclosure Statement).
  - This also could prevent a tax preparer from signing the tax return ….

Employee Classification Issue

- So what do you do?
  - Tiered Partnerships and/or parallel partnerships
    - A partner in an upper-tier (or brother/sister) partnership entity could properly be treated as an employee of a lower-tier (or brother/sister) partnership if he or she does not hold a direct interest in the other partnership entity (or vice versa).


Management Members
Fund Entity, LLC
Member
Member
Investment Entity, LLC
Delaware
Board of Managers
100% Member
Holding Entity, LLC
(taxed as corporation)
99.99% Member
100% Member
0.01% Managing Member
Management Entity, LLC
Texas
Operating Entity, LLC
Texas
Employees
Assets/ Operations

Employee Classification Issue

- Holding Entity Structures
  - In some cases, a partner will use an S corporation to hold his interest in the partnership. This may be a strategy to reduce overall self-employment taxes or it may be intended to retain employee status.
  - It is unclear whether interposing an S corporation would be a successful strategy, however, since this may involve a "transfer" of the partnership interest to the S corporation.

Alternative Structures

- Some entities use a different award structure than some other private equity funds:
  - The operating entity makes a grant of profits interests to a holding entity owned by the management service providers and, sometimes, the operating entity as well.
  - At the time an equity award is granted to the holding entity, that holding entity makes a parallel grant of a profits interest to the service provider.
  - The two grants are effectively “tied” in value.

Alternative Structures

- This structure allows award recipients to not be classified as "partners" in the operating entity for employment and income tax purposes.
- But this structure is somewhat different than the structure described in Revenue Procedures 93-27 and 2001-43.
  - Those rulings assume a direct award of equity to a service provider.
  - The conclusions of those rulings arguably should apply to this structure but there is not any IRS guidance on point.

Alternative Structures

- Since this structure is different than the structure described in Revenue Procedures 93-27 and 2001-43, each service provider (employee) who receives an award in the investment entity is typically required to file a Section 83(b) election.
  - That action will accelerate any ordinary income received on the grant date.
  - The key issue is whether there is any value for the equity on that date. Based on a hypothetical liquidation analysis, taking into account distribution waterfall provisions, return of capital requirements and similar concepts, there should not be.

Alternative Structures

- Grant process considerations:
  - Where possible, management equity awards should be issued at closing to avoid a need to “book up” gain after a closing date due to appreciation in the value of the acquired entity.
  - A new valuation of the operating entity is required each time a grant is made. This can be cumbersome, which merits making grants in groups to minimize that burden.
  - The award agreements are more complicated if a noncompete is included due to the need to provide a business description, geographic area and duration.

New IRS Guidance/Fee Waivers

- On July 23, 2015, the Internal Revenue Service issued long-awaited proposed regulations discussing the taxation of management fee arrangements commonly used by private equity funds and their management.

- The proposed regulations address the tax treatment of “disguised” payments for services under Section 707(a)(2)(A) of the Code, where a partner has rendered services to a partnership in a capacity other than as a partner.

Fee Waivers: Background (cont'd)

- The proposed regulations target purportedly abusive situations where private equity funds use management fee waivers to convert services income, taxable at the ordinary rates, into income items meriting capital gain treatment.

Fee Waivers: General Rule

The proposed regulations provide that an arrangement will be treated as a disguised payment for services, instead of an allocation of partnership income, if, at the time the parties enter into or modify the arrangement such that:

- (1) the service provider, either in its capacity as a partner or in anticipation of becoming a partner, performs services, directly or indirectly, through a delegate, to or for the benefit of the partnership;

Fee Waivers: General Rule (cont'd)

- (2) there is a related direct or indirect allocation and distribution to the service provider; and

- (3) when viewed together, the performance of services and the allocation and distribution are "properly characterized" as a transaction occurring between a partnership and a person acting other than in that person's capacity as a partner.

Factors

Whether an arrangement constitutes a disguised payment for services depends on all of the facts and circumstances. The proposed regulations specify six nonexclusive factors that may indicate that an arrangement is a disguised payment for services:

- The arrangement lacks significant entrepreneurial risk.
- The service provider holds, or is expected to hold, a transitory partnership interest or a partnership interest for only a short duration.

Factors (cont'd)

- The service provider receives an allocation and distribution in a time frame comparable to the time frame that a nonpartner service provider would typically receive payment.
- The service provider became a partner primarily to obtain tax benefits that would not have been available if the services were rendered to the partnership in a third-party capacity.
- The value of the service provider's interest in general and continuing partnership profits is small in relation to the allocation and distribution.

Factors (cont'd)

- The arrangement provides for different allocations or distributions with respect to different services received, the services are provided by related persons (as determined under the Internal Revenue Code), and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly.

The Arrangement Lacks Significant Entrepreneurial Risk

- The first factor regarding significant entrepreneurial risk is the most important and often will be determinative.

- The presence or absence of significant entrepreneurial risk is based on the service provider's entrepreneurial risk relative to the overall entrepreneurial risk of the partnership.

- The proposed regulations identify five arrangements that presumptively lack significant entrepreneurial risk:

The Arrangement Lacks Significant Entrepreneurial Risk (cont'd)

- capped allocations of partnership income if the cap would reasonably be expected to apply in most years
- allocations for a fixed number of years under which the service provider's distributive share of income is reasonably certain
- allocations of gross income

The Arrangement Lacks Significant Entrepreneurial Risk (cont'd)

- an allocation (under a formula or otherwise) that is predominately fixed in amount, is reasonably determinable under the circumstances, or is designed to assure that net profits are highly likely to be available to make an allocation to the service provider

- arrangements in which the service provider waives its right to receive payment for the future performance of services in a nonbinding or untimely manner

Consequences

Once an arrangement is treated as a disguised payment for services under the proposed regulations, the arrangement is treated as a payment for services for all other purposes of the Code.

The proposed regulations conclude by applying these factors to a set of management fee arrangements in a series of examples encompassing typical management fee features, including:

- clawback provisions;
- control over allocations and distributions by a related party; and
- the timing of fee waivers.

Safe Harbor Modification – Rev. Proc. 93-27

- Rev. Proc. 93-27 contains a safe harbor for holders of carried interests to be treated as partners and achieve capital gain treatment on certain partnership gain allocations.

- In the preamble to the proposed regulations, the IRS also announced related changes to Rev. Proc. 93-27 concerning the issuance of “profits interests” (also known as “carried interests”) to service providers.

Safe Harbor Modification – Rev. Proc. 93-27 (cont'd)

- The IRS proposed modifying the revenue procedure to include an additional exception for "profits interests" issued in connection with a partner foregoing payment of a substantially fixed amount for the performance of services, including a guaranteed payment or a payment in a nonpartner capacity.
- The IRS also stated that Rev. Proc. 93-27 does not apply to transactions in which one party provides services and another party receives an associated allocation and distribution of partnership income or gain.

Possible Implications of the Proposed Regulations – Entrepreneurial Risk

The proposed regulations make very clear that entrepreneurial risk is essential to a successful fee waiver.

- Entrepreneurial risk does not exist if the waived fee amount can be paid from net gains in any 12-month accounting period and an affiliate of the management company controls the investment and distribution decisions.
- Entrepreneurial risk does exist if the service provider's priority allocation depends on the results over the life of the investment partnership and there is an enforceable clawback obligation to repay any amounts that exceed the priority allocation at the end of the life of the partnership.

Possible Implications of the Proposed Regulations – Entrepreneurial Risk

- Entrepreneurial risk only exists if the service provider’s allocation is subject to the performance of the entire investment portfolio.

This is a very high standard.

Possible Implications of the Proposed Regulations – Rev. Proc. 93-27

The regulations contain a surprising development regarding the long-standing guidance under Revenue Procedure 93-27, the "safe harbor" for profits interests, aka "carried interests."

- Suggest IRS might exclude all management fee waivers from the Rev. Proc. 93-27 safe harbor method for valuing of profits interests (liquidation value method).
- Give the IRS more room to challenge valuations of these interests, or at least provide another reason for taxpayers to think twice before engaging in fee waivers in the future.

Conclusion/Q&A

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