PARTNERSHIP/LLC EQUITY COMPENSATION – PLANNING & POSSIBILITIES

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PUBLICATIONS AND HONORS

Warning for Taxpayers Prepaying Real Property Taxes in 2017, Strasburger's Tax Strategies (December 2017)

Co-author. Considering the Alternative Entity Structure of an LLC Taxed as an S-Corp, Today's CPA (March/April 2017)

Editor. Family Foundation Advisor, published by Civic Research Institute

Co-author. Congress Makes Signification Changes to Partnership Audit Rules, Today's CPA (July 2016)

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I. INTRODUCTION

A. Basics of Partnerships/LLCs

Partnerships and Limited Liability Companies ("LLCs") provide flexibility to their owners and employees, and there are innumerable ways for partners, members, and unitholders to receive compensation. The specific compensation methods depend, in part, on the tax classification of the partnership or LLC. LLCs may elect to be taxed as disregarded entities, partnerships, or C corporations. In this article we will focus most of our attention on LLCs and partnerships that are taxed as partnerships; however, we will contrast such with C corporation compensation options.

In addition to the usual planning complexities that come with partnership and LLC compensation, the Tax Cuts and Jobs Act of 2017 ("TCJA") added some new wrinkles to choice of entity and related compensation. We will discuss how the TCJA impacts compensation.

B. Compensation options

Partnerships and LLCs taxed as partnerships may provide "equity" compensation to owners through profits interests, capital interests, options, and phantom interests. For purposes of this section, we will refer to these partnerships and LLCs as "Partnerships." The various forms of compensation may be treated under the Code generally as non-partnership compensation under Section 162, partner guaranteed payments under Section 707(c), partner payments in a non-partner capacity under Section 707(a), allocations for services under Section 707(a)(2)(A), allocations of profits under Section 704(b), or as other compensation under Section 83.

Compensation as an employee (e.g., on Form W-2) has historically been of little interest to owners of Partnerships; however, with new Section 199A, the usefulness of W-2 wages to Partnerships is heightened. We will discuss this in Section II(b), but the first question is whether the compensation paid by a Partnership is compensation as an employee. If so, such compensation is reportable on Form W-2 and is subject to withholding and employment taxes. This classification may have some benefit to the employee with respect to retirement plans, health insurance, fringe benefits, etc. However, employees are subject to a 2% floor of adjusted gross income on any unreimbursed business expenses. Under the TCJA, such expenses are suspended for years 2018 through 2026.

If a person is classified as a partner, or non-employee, then there are no wages reported on Form W-2, but, rather, income is reported on Form 1065 (Partnership Return) and then on Schedule K-1 (Partner's Share of Partnership Income). There is no wage withholding on Schedule K-1 payments, but such payments are usually subject to self-employment taxes. Partners receiving Schedule K-1 also lose certain employee benefits, such as exclusions for insurance premiums, lodging, and meals for the convenience of the employer. On the other hand, the partner is not subject to the 2% of adjusted gross income limit on deducting unreimbursed business expenses (or the suspension of such under the TCJA).

No matter the form of compensation, most of the time self-employment taxes will be due. Under Section 1402(a) all partners are subject to self-employment taxes on their distributive shares of income. Similarly, Section 1402(a) provides that limited partners are subject to self-employment tax on guaranteed payments.

1. <u>Profits interests versus Capital interests</u>

After making the wage or partner distinction for withholding and employment tax purposes, we turn to the two general concepts for equity interests in Partnerships; profits and capital. Section 83 provides the timing rules for when an interest is taxable to the recipient. It determines if the person has an interest in property, when such interest vests, and provides several special provisions for accelerating or deferring income for certain interests.

Capital interests are ones that give the recipient the right to a share of proceeds upon liquidation of the entity in addition to participation in the profits of the entity. With respect to capital interests, Section 83 applies to property transferred in connection with the performance of services. If such property is "vested" (e.g., there is no substantial risk of forfeiture or transfer restrictions), then the property is considered compensation for services. Such compensation is taxed upon receipt based on the excess of fair market value over the amount paid for such property. If the property transferred is not vested then it only becomes taxable on vesting (e.g., after restrictions end), unless a Section 83(b) election is made to accelerate the income within 30 days of the grant of the interest.

For profits only interests in Partnerships, the receipt of such is generally not taxable on receipt or vesting. Similarly, an option is not taxable on receipt, but only upon exercise. The same is true for appreciation rights, which are taxable when paid to the partner or shareholder.

Over the years there has been litigation regarding whether profits-type interests in partnerships and LLCs are taxable when received in exchange for services.[1] The IRS, in Rev. Proc. 93-27, stated that the receipt of a profit interest for services performed by the recipient does not result in a taxable event to the partner or partnership. There are numerous exceptions to the IRS guidance that Partnerships need to consider. These include where the profit interest relates to a substantially certain and predictable stream of income from partnership assets (looking more like an equity interest), or where the recipient disposes of the interest within two years of receipt. Later IRS guidance stated that Rev. Proc. 93-27 applies to profit interests subject to vesting restrictions if certain conditions are met.[2]

2. Options and phantom membership units

Partnerships and LLCs may also use alternative means to compensate service providers, members, and partners. Both options and phantom interests allow for no tax upon receipt or vesting. Options can give the holder the right to acquire a capital or profits interest in the partnership or LLC. If the option provides the right to acquire a capital interest then, upon exercise, the option holder is treated as having received a capital interest and is taxed as noted above. If the option only provides the right to receive a profits interest, then there is no income to the recipient on exercise.

Similar to options, phantom interests cause no immediate taxable event to the recipient. A phantom interest is an agreement between the entity and the holder which provides the right to future payments at a time certain or on the occurrence of some future event. The amount of the future payments typically depends on the fair market value of similar non-phantom interests at the time the future payment is triggered. For example, a phantom interest could be tied to when certain distributions are made to actual equity members/partners. There is no taxable event with respect to phantom interests until some payout is made. The payout will be taxed as ordinary income and allows for a deduction to the payor.

Phantom interests allow businesses to compensate employees in a flexible manner without the more permanent grant of equity or a profits interest. Phantom interest recipients are not equity owners so they may still be employees of the business and issued Form W-2 for their wages (this becomes important for new Section 199A). However, phantom interests may be subject to Section 409A, which regulates nonqualified deferred compensation. The 409A rules require that phantom interests be tied to certain events, and based on certain pricing, otherwise, there are significant penalties on the recipients of the interests. There are numerous exceptions from Section 409A that should be considered if a business uses phantom interests to compensate workers.

	Liquidation Rights	Tax on Receipt	Share in Income	Wages for 199A	Employee Benefits
Capital Interest	Yes	Yes	Yes	No	No
Profits Interest	No	No	Yes	No	No
Options	No	No	No	Maybe*	Yes
Phantom Interest	No	No	Flexible	Maybe*	Yes

*Individual may have wages as employee in addition to grant of interest.

II. IMPACT OF TAX CUTS & JOBS ACT OF 2017

The compensation options discussed above did not fundamentally change after the passage of the TCJA. However, the TCJA does require some additional thought as to the most tax-efficient means to provide equity compensation.

A. Profits interests holding period for investment businesses

On the last Presidential campaign trail, there was significant emphasis on the taxation of profits interests (or "carried interests"). Both parties and Presidential candidates were concerned that certain individuals, namely private equity and hedge fund managers, were receiving unfair benefits based on the current tax law for profits interests. These fund managers would receive profits interests in the general partner of an investment fund for their management services. The fund would then pass through net capital gains to the general partner which, in turn, would pass the gain to the fund managers. Such gains would often be taxed as long-term capital gains at a rate of 23.8 percent. Many politicians believed that the fund managers should treat amounts received from their carried interest as wage income subject to higher marginal tax rates.

In response to these concerns, the TCJA changed the requirements for long-term capital gain treatment of profits interests for certain partnerships. For applicable partnership interests, the partnership assets that result in gain must be held for more than three years in order for the partner holding the interest to receive long-term capital gains treatment. An applicable partnership interest is one that is received by a partner in connection with substantial services in the investment and investment management business.

This change makes profits interests for investment management professionals a less attractive compensation method than under prior law. The good news is that the limitation is fairly narrow and will not

[1] See e.g., *Diamond v. Comm'r*, 56 T.C. 530, *aff'd*, 492 F.2d 286 (7th Cir. 1974); *Campbell v. Comm'r*, 943 F.2d 815 (8th Cir. 1991).

[2] See Rev. Proc 2001-43.

apply to businesses outside of the investment management realm.

B. Planning for the Section 199A deduction

The Section 199A deduction is complex and outside the scope of this article; however, it is important to touch on one component of new Section 199A that relates to compensation. For taxpayers with taxable income over $157,000 or $315,000 (joint), there are limitations on the Section 199A deduction for qualified business income. One important limitation is based on the wages paid by the trade or business generating the qualified business income. The limitation on the Section 199A deduction related to wages is as follows:

The deductible amount under 199A is the greater of:

(A) 50 percent of wages paid by the qualified trade or business,

OR

(B) 25 percent of the W-2 wages, and 2.5 percent of the unadjusted basis in tangible depreciable property.

This means that, for many taxpayers, the business needs to have wages paid in order to allow the partners, members, shareholders (S corporations) to obtain the benefit of Section 199A. Unfortunately, the plain text of the statute excludes guaranteed payments paid to members/partners from the definition of W-2 wages. Similarly, LLCs treated as disregarded entities where the sole member reports income, gains, and losses, on Schedule C would not have any W-2 wages.

As previously discussed, W-2 compensation has historically been of little interest to owners of partnerships and LLCs. Most owners preferred to hold equity interests that provided income as non-employees (allowing a range of business deductions). Such arrangements must now be re-evaluated in light of the Section 199A deduction.

For example, assume a partnership with 10 architects all of whom make over $1,000,000. The two founding partners have capital interests in the partnership and the eight others have profits interests. The profits interest partners don't own the assets of the partnership but do get a fixed minimum compensation amount each year. Assuming the partnership has no other employees, and no significant tangible assets, none of the partners could obtain any significant benefit from Section 199A. The partnership pays no wages and the profits interest partners' guaranteed payments do not count as wages or qualified business income.

In order to take advantage of Section 199A, the partnership might consider making some of the profits interest partners regular W-2 employees. In exchange for the new status, the partnership could grant such "employees" phantom interests, or options to convert to profits interests at a later date (perhaps after the Section 199A deduction expires in 2025). It might also convert other profits interest partners into capital partners whose income depends on the net income of the partnership each year. Then the partnership would have W-2 wages, no guaranteed payments, and the capital partners could obtain benefits from Section 199A.

C. Planning Choices with Section 83(i)

As we discussed before, Section 83 governs the timing of income inclusion for many forms of equity compensation. Typically the recipient of an equity interest is taxable when the interest is vested and transferable and not subject to a substantial risk of forfeiture. The TCJA created a new part of Section 83 which allows employees to elect to defer the tax on vested equity compensation that is not subject to a substantial risk of forfeiture for up to five years. This special deferral provision is only available to corporations (or LLCs that elect to be taxed as such) and is a consideration for businesses that compensate employees with equity interests.

New Section 83(i) provides an election to defer tax that would otherwise be owed upon receipt of stock following the exercise of an option or settlement of restricted stock. Congress provided this benefit to allow employees of private companies to defer tax on certain equity compensation; otherwise, such employees could owe significant taxes but not have the liquidity from the private stock.

Employees must make the 83(i) election within 30 days from the date on which the employee's rights to stock become vested and taxable. The employer must provide notice to the employee explaining the election and related deferral. Certain high-level employees are not eligible for the 83(i) election, including, the CEO, CFO, four highest paid officers, and a 1 percent or more owner.

If an employee makes the election, the income that would be taxable is deferred until one of the following events occurs:

- The stock becomes freely transferable
- The employee becomes an excluded employee (e.g., CEO)
- The stock is tradable on a securities market
- The employee revokes the election
- Five years from the date on which the stock became vested and otherwise taxable

From the employer's standpoint, no deduction is allowed on the equity compensation until such is taxable to the employee.

III. CONCLUSION

In sum, the TCJA has created new potential benefits to equity owners of partnerships and LLCs. At the same time, it has added incentives for pass-through businesses to have W-2 employees. As a result, we are likely to see an increase in alternative compensation structures for employees of partnerships and LLCs. These structures will allow employees to remain as such, but still participate in the growth potential of the enterprise.

If you, or your clients, have questions about the TCJA and compensation please feel free to reach out to:

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