Partnership Equity Compensation

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This Practice Note addresses the federal income tax aspects of partnership equity compensation arrangements, including profits interests, capital interests and options on partnership interests. This Note also provides a general overview of partnership tax, as it relates to equity compensation.

It has become increasingly common for businesses of all kinds to be conducted through:

- Limited liability companies.
- Limited liability partnerships.
- Other entities treated as partnerships for federal income tax purposes.

The benefits of using a limited liability company (LLC) or a partnership as a business entity are numerous and well-documented, and include:

- The ability of a partnership to make distributions of operating income without incurring a second layer of tax.
- Flexibility in structuring economic and governance arrangements among the partners or members of the partnership.
- The ability to deliver a buyer of the business a step-up in the basis of the assets of the partnership on a tax advantaged basis (potentially generating a higher purchase price).

As partnership entities have become more popular, there is increased interest in equity compensation programs for partnerships. The use of equity as a compensation tool in the partnership context implicates many legal disciplines, including:

- Tax law.
- State statutory law.
- Securities law.

This Note focuses on the federal income tax aspects of partnership equity compensation arrangements.

EQUITY COMPENSATION IN THE PARTNERSHIP CONTEXT

The principal types of equity incentives available in the corporate context are also available for partnerships and include:

- Outright equity grants (both restricted and unrestricted).
- Options.

However, certain specific equity compensation tools, most notably incentive stock options, are reserved to corporate issuers. A particularly powerful equity incentive, the profits interest, is solely the province of partnerships. While a profits interest strongly resembles an option in economic effect, the superior tax characteristics of the profits interest make it the preferred partnership equity compensation tool, largely rendering options on partnership interests irrelevant. More complicated corporate equity compensation arrangements, such as restricted stock units, can also be replicated in the partnership environment, but are relatively uncommon.

Partnership equity compensation programs raise many of the same tax issues as arise with corporate programs including:

- Timing and character of income inclusion for the service provider.
- Tax treatment for the employer.

Like corporate equity compensation, partnership equity compensation is largely (with certain exceptions) governed by the provisions of Section 83 of the Internal Revenue Code (IRC). However, in addition to these more familiar rules, partnership equity compensation is also subject to the complex overlay of Subchapter K of the IRC (IRC §§ 701-776). Further, the law relating to partnership arrangements is not nearly as well-developed as the law relating to corporations. This is, in part, due to:

- The relatively recent popularity of LLCs and partnerships as a preferred form of doing business.
- The complexity of the underlying tax law.

- The fact that, unlike corporations, LLCs and partnerships are largely creatures of contract, allowing for virtually unlimited economic and ownership flexibility.

As a result, there are many uncertain and unsettled areas in the realm of partnership equity compensation.

Several different types of entities, including LLCs, are taxed as partnerships for federal income tax purposes (see *Partnerships as Pass-through Entities*). For convenience, all entities taxed as partnerships are referred to as partnerships in this Note.

OVERVIEW OF PARTNERSHIP TAX

Partnerships as Pass-through Entities

The different types of domestic entities that are taxed as partnerships for federal income tax purposes (absent an election to be taxed as a corporation), include:

- General and limited partnerships.
- Limited liability partnerships.
- Limited liability companies.

Various types of foreign entities may also be taxed as partnerships under US tax law, although in many cases an affirmative election is required. However, while the general principles discussed in this Note apply to all types of entities that are treated as partnerships, the particular type of entity in question can affect certain tax consequences. Entities taxed as partnerships are not taxable in their own right. Rather, the income or loss realized by a partnership is passed through to its owners (via a Schedule K-1 to the entity's annual tax return or Form 1065) and reported on the owners' tax returns (whether or not any cash is distributed to the owners). This fundamental trait of partnerships permeates the challenges and opportunities inherent in equity compensation planning in the partnership context.

Types of Partnership Interests

Equity interests in partnerships generally fall into one of two categories:

- **Capital interest.** This entitles the holder to a share of partnership capital (current assets of the partnership).
- **Profits interest.** This entitles the holder to a share of partnership profits (future appreciation or income of the partnership). By definition, absent special arrangements, the holder of a profits interest does not share in the value of the partnership as of the date the profits interest is issued.

(See *Partnership Equity Compensation*.)

Capital Accounts

A partner's share of the capital of the partnership (including any undistributed profits) is reflected in the partner's capital account. Capital accounts are fundamentally important to partnership taxation in that, in one way or another, capital accounts track a partner's economic interest in the partnership. Many partnership agreements provide for liquidating distributions to be made in accordance with the positive balances in partners' capital accounts. On liquidation of the partnership at any time, the balance in a partner's capital account should be exactly equal to the amount of the liquidating distribution the partner is entitled to receive.

Capital Account Adjustments

Capital accounts may be adjusted by unrealized gains or losses on certain events (a "book-up" or "book-down"). Additionally, for purposes of the information presented on Schedule K-1, capital accounts may be maintained on a General Accepted Accounting Principles (GAAP) basis (which may reflect accounting income instead of taxable income). Although partnerships using GAAP capital accounts on Schedules K-1 are generally also required by their governing documents to maintain capital accounts in accordance with tax principles, not all do.

For more information on capital accounts, see *Standard Document, LLC Agreement: Multi-member, Manager-managed: Drafting Note: Capital Accounts*.

Allocations

Income and loss of the partnership is generally first netted at the entity level, and net income or loss is then allocated among the capital accounts of the partners according to the economic arrangement concerning the sharing of profits and losses.

Distributions

Distributions are payments made to partners out of their capital accounts (essentially a withdrawal of a partner's pass-through share of the capital of the entity, including capital that represents taxed but undistributed income).

PARTNERSHIP EQUITY COMPENSATION

The types of partnership equity compensation include:

- Capital interests.
- Profits interests.
- Options on partnership interests.

Because of their flexibility and attractive tax characteristics, profits interests are by far the most commonly used partnership equity compensation tool. Capital interests are generally seen only where the value of the equity grant is relatively modest, because the grant is small in amount and/or the value of the issuer is relatively low. However, a profits interest can be effectively used where the grant is meaningful in amount and/or is made by an entity of significant value. Options also do not compare well to profits interests and are therefore relatively unusual in the partnership context.

Grant of a Capital Interest

What is a Capital Interest?

A capital interest in a partnership is an interest that entitles the holder to share in liquidating distributions in connection with a liquidation of the partnership immediately after the interest is granted (*Rev. Proc. 93-27*).

Compensation Income

Under IRC Section 83, the grant of a capital interest is treated as current compensation to the recipient in an amount equal to the fair market value of the capital interest. Absent a special election, the receipt of a capital interest is generally taxable when the interest becomes vested (that is, when it is not subject to a substantial risk of forfeiture) (IRC § 83 and Treas. Reg. § 1.83-3(e)).

Generally, IRC Section 83 provides that on a transfer of property to a service provider, the service provider includes in income as compensation the excess of the fair market value of the property transferred over the amount paid for the property. If, at the time the property is transferred, it is subject to a substantial risk of forfeiture (generally present where the interest is forfeited if the holder fails to meet certain time-based or performance-based vesting conditions) then either the service provider:

- Will only include income as the substantial risk of forfeiture is eliminated (that is, as the property vests).
- May make an election under IRC Section 83(b) (83(b) election) to include the income immediately on being granted the property. Where an 83(b) election is made, a later forfeiture does **not** trigger a tax loss to the extent of the amount initially included in income.

The partnership generally deducts the amount of compensation included by the service provider as a trade or business expense under IRC Section 162. The deduction is allocated to the partners in accordance with their partnership interests immediately before the grant of the interest to the service provider.

Just as in the corporate context, often a service provider issues a note to a partnership in exchange for a capital interest. The note is often then paid down out of amounts that would otherwise be distributed to the service provider in respect of the partnership capital interest, including amounts payable relating to a sale of the partnership. If the amount of the note is equal to the fair market value of the interest acquired (and if the note bears adequate interest), there is no compensation element to the issuance because there is no spread between the value of the interest and the amount paid. If the interest is subject to vesting, an 83(b) election is generally appropriate because:

- Accelerating the tax event does not result in the recognition of any income.
- The provider's holding period begins immediately.

Although one of the objectives of the note arrangement is to minimize the risk that the service provider will ever be out-of-pocket on the note, the note represents a bona fide obligation of the service provider (which may well serve the partnership's desire that the provider be invested in the business). Significantly, if the partnership's sole recourse on the note is the ability to repossess the acquired partnership interests, the note may be recharacterized as a compensatory partnership option (on the theory that the service provider is not taking any downside risk as an equity holder). In that case:

- Distributions to the service provider in respect of the equity would be treated as compensation income.
- Payments on the note would be treated as the exercise of a compensatory option (see *Options on Partnership Interests*).

Fair Market Value

Generally, fair market value for purposes of IRC Section 83 can include valuation discounts for lack of marketability and/or minority interest. However, regulations proposed in 2005 (*Proposed Reg. 1.83-3(l), 1.83-6(b), 1.721-1(b)(1), 1.761-1(b), REG-105346-03*) (Proposed Regulations) would provide partnerships with the option of making a safe harbor election to have all compensatory partnership interests valued at their liquidation value. In this respect, the Proposed Regulations are consistent with Revenue Procedure 93-27.

For profits interests, the liquidation value approach would result in a $0 value for tax purposes and would be quite beneficial. However, for capital interests, it is reasonable to expect that applying a liquidation value may result in the recipient of the interest being barred from applying valuation discounts (which are largely based on the continued operation of the business). In effect, the Proposed Regulations would require partnership interests to be valued based on a hypothetical sale of the partnership as a whole rather than a hypothetical sale of the relevant partnership interest.

Subchapter K and the Entity/Aggregate Dichotomy

The dark side of a partnership's tax flexibility and efficiency is the complexity of Subchapter K. Part of that complexity is due to the fact that:

- Certain provisions of the tax law are premised on treating a partnership as an entity.
- Other provisions are based on the notion that a partnership is an aggregation of assets.

The entity/aggregate dichotomy becomes relevant in a surprising way in the context of partnership equity compensation.

The tax treatment of the **partnership** when a compensatory capital interest is granted is unclear. The primary issue is whether the issuance of a capital interest is taxable to the partnership or whether, by contrast, the partnership should, like a corporation issuing stock in the compensatory context, simply deduct the amount taken into income by the partner (based on the excess, if any, of the value of the interest over the amount paid), without including any gain. The following example illustrates the possible tax treatment of the issuing partnership.

Example: Assume that partnership AB has two partners, A and B. Each of A and B owns 50% of the partnership. A acquired its interest in the partnership by contributing an asset with a tax basis of $20 and fair market value of $100. B acquired its interest in the partnership by contributing $100 in cash. Initially, each of A and B has a capital account of $100, and the partnership has aggregate basis in its assets of $120. The assets of the partnership have an aggregate fair market value of $200. AB decides to issue a 25% interest in AB to C in consideration of C's services to AB. C is therefore going to be granted a capital account of $50, reducing each of A and B's capital account to $75.

The grant to C is of a capital interest as, on a liquidation of the partnership, C is entitled to $50 of value. Therefore, on grant, C received taxable income. Quantification of the amount of that taxable income is somewhat unclear.

- Under a strict liquidation value approach, the amount of income would likely be $50.
- Under IRC Section 83, proper value would be determined based on the fair market value of the partnership interest.

This could result in a different number if valuation discounts, such as for a lack of marketability or minority interest, are taken into account.

Additionally, because of its pass-through nature, there is significant uncertainty whether AB should recognize any portion of the untaxed gain inherent in its property as a result of the issuance of the capital interest. Although under IRC Section 1032, a corporation does not recognize gain or loss on the issuance of its own stock to a service provider as compensation, there is no comparable rule in the partnership context.

If the partnership were to recognize gain in connection with the issuance of partnership interests, the proper calculation of that gain is still uncertain. Treating the partnership as a pure entity (that is, the partnership interest is the property being transferred), the proper basis for computing gain would be the partnership's basis in its own interests (which is $0). Therefore, in this example (assuming that C recognizes $50 in income), partnership AB would recognize $50 in gain, with an offsetting $50 deduction for the compensation paid to C.

Treating the partnership as an aggregate of its partners (that is, the partnership is treated as transferring a pro rata portion of each of its underlying assets), the proper basis for computing gain would be the partnership's basis in its assets. The partnership has aggregate basis of $120 and aggregate value of $200. Therefore, a transfer of a 25% interest would, under this analysis, trigger 25% of the $80 in gain, or $20. Because the $20 of gain is attributable to the property contributed by A, this gain would be allocated to A under IRC Section 704(c). It would then be matched by a $50 deduction, which would be allocated $25 to A and $25 to B.

The Proposed Regulations make clear that there should be no tax event to the partnership on a grant of a compensatory capital interest (essentially applying the principles of IRC Section 1032 to partnerships in this context).

Given that the Proposed Regulations suggest a desire on the part of the Internal Revenue Service to clarify that it does not interpret IRC Section 83 as requiring a partnership to recognize gain on a compensatory transfer of a partnership interest, many, if not most, practitioners are comfortable taking a like position, even in the absence of the finalization of the Proposed Regulations.

Grant of a Profits Interest

What is a Profits Interest?

A profits interest is generally (with certain exceptions) an interest that, on a liquidation of the partnership immediately after the grant of the profits interest, **would not** allow the recipient to participate in liquidating distributions. Rather, the recipient would only share in future profits. As a general matter, the receipt of a profits interest is not taxable to the recipient at the time of grant or vesting, but instead results in tax as allocations of taxable income are made in respect of the profits interest or on the sale of the interest.

The Revenue Procedure 93-27 Safe Harbor

Revenue Procedure 93-27 provides a safe harbor for the grant of certain profits interests. Under the revenue procedure, a capital interest is an interest that gives the holder a share of the proceeds if the partnership's assets are sold at fair market value and the proceeds are distributed in a complete liquidation of the partnership (Rev. Proc. 93-27). A profits interest is then defined as "a partnership interest other than a capital interest."

Therefore, the key question in determining whether a partnership interest is a profits interest is whether its liquidation value is $0. If so, the grant of the partnership interest is not subject to tax. This is in marked contrast to the valuation of corporate equity compensation, which, even where the liquidation value is $0 is generally attributed some "option" or discounted cash flow-based value.

However, the safe harbor does not apply if either:

- 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.
- Within two years of receipt, the partner disposes of the profits interest.
- The profits interest is a limited partnership interest in a "publicly traded partnership."

(*Rev. Proc. 93-27.*)

Case Law

If an interest intended to be a profits interest does not fall within the safe harbor of Revenue Procedure 93-27 (for example, if the holder disposes of the interest within two years of grant), it is not necessarily taxable. Instead, interests outside the parameters of the Revenue Procedure must be tested under the relevant case law to determine whether the receipt of the interest would result in immediate tax consequences. The two foundational cases that examine the proper tax consequences of the receipt of a profits interest are *Diamond v. Commissioner, (492 F.2d 286 (7th Cir. 1974)) and Campbell v. Commissioner (943 F.2d 815 (8th Cir. 1991)*).

Both Diamond and Campbell focus on whether, under the facts and circumstances of the case, a profits interest granted for services had a readily ascertainable fair market value on grant. Where the value of the interest could not be ascertained, the courts generally supported treating the interest as having no value as of the grant date. Therefore, even where a profits interest falls outside of the safe harbor of Revenue Procedure 93-27, a taxpayer may rely on a facts-and-circumstance-based argument to support profits interest treatment.

The Distribution Threshold

To satisfy the requirements for a profits interest, partners other than the profits interest holder must be entitled to receive distributions at or before the liquidation of the partnership at least equal to the net fair market value of the partnership at the time the profits interest is issued. The amount that must be distributed to other partners is often referred to as the distribution threshold. The distribution threshold requirement must be satisfied only on liquidation of the partnership. Therefore, a profits interest holder may share in operating income on an unlimited basis immediately on issuance, so long as the distribution threshold is met on liquidation.

As a matter of practice, however, frequently the distribution threshold is measured by reference to all distributions (that is, distributions of operating income and liquidating distributions), so that the profits interest holder does not share in any distributions until the aggregate distributions of all types received by other partners is equal to the distribution threshold.

Catch-up Allocations

Where there is a desire to issue a profits interest that, even with a distribution threshold, provides the holder with a share of the value of the enterprise as of the grant date, a so-called "catch-up" allocation can be utilized. A catch-up provision generally provides that the holder of the profits interest receives 100% (or some other disproportionately large share) of the income of the partnership generated after the grant of the profits interest until the profits interest holder has built up a capital account equal to its proportionate share of existing value. So long as the business generates sufficient profits (including gain on a sale of the business), the profits interest holder can realize the same economic value as the holder of a capital interest. Likewise, by virtue of the disproportionate allocation of income to the profits interest holder, the other partners obtain the net effect of a deduction in an amount equal to the amount the partnership would have deducted on the grant of a capital interest, albeit at a different time and of a potentially different character (for example, if the income allocated to the profits interest holder is long-term capital gains income subject to a reduced tax rate).

Profits Interests Subject to Vesting

Where a capital interest is granted subject to a substantial risk of forfeiture, then unless an election is made to treat the interest as having been received immediately on grant, the tax event associated with the grant occurs when the property vests. Revenue Procedure 2001-43 provides a different rule for a restricted profits interest, where no election is necessary to treat the interest as vested on grant so long as the recipient is treated as a partner for tax purposes and begins to receive income allocations on a fully vested basis immediately on grant.

Importantly, Revenue Procedure 2001-43 applies only to profits interests described in Revenue Procedure 93-27. This means that an 83(b) election is generally advisable for a vesting interest that does not fit within the Revenue Procedure 93-27 safe harbor but is still regarded as a profits interest under case law. In addition, common practice is to file an 83(b) election with respect to all profits interests that are subject to vesting because:

- It is impossible to determine with certainty at the time of issuance that a profits interest will necessarily fit within the safe harbor (because it may be sold within two years).
- There is virtually no downside to doing so in typical circumstances.

Under the general rule requiring that allocations be made on a fully vested basis, the issuance of a profits interest subject to vesting can have adverse tax consequences if not properly managed. The following example illustrates this issue.

Example: A is issued a 10% profits interest in partnership BC, which is subject to two-year cliff vesting. That is, during the two year period after the grant of the profits interest, if A stops providing services to BC, A's interest is forfeited. BC provides that during this two year period, distributions to A are held in abeyance pending the vesting of the interest. In year 1, BC earns $1,000 of taxable income.

- If $100 of income is allocated to A (as provided in Revenue Procedure 2001-43), A will have $100 of taxable income without any cash with which to pay the tax (so-called phantom income).
- If $100 of income is not allocated to A (that is, A does not receive allocations until after substantial vesting), then, absent some form of catch-up, A either gives up the entitlement to the income earned before vesting or the $100 ultimately distributed to A is compensation income (rather than a partnership distributive share). Additionally, because BC did

not follow the requirements of Revenue Procedure 2001-43, if the 10% interest initially issued to A has appreciated in value during the vesting period, this appreciation in value is treated as the grant of a capital interest, and is subject to immediate taxation.

To address the phantom income issue for the recipient of a restricted profits interest, it is customary to provide the profits interest holder with a right to receive distributions in the amount of the tax liability associated with an income allocation (a so-called tax distribution) even while the profits interest is unvested. Providing for tax distributions raises the issue of whether, in the event of a forfeiture of the profits interest, the holder must return to the partnership the amount of tax distributions previously received. One argument in favor of this type of clawback obligation is that, if the profits interest is forfeited, the profits interest holder recognizes a loss to the extent of prior income included.

Therefore, the profits interest holder should have a tax loss that is equivalent in amount to the income previously recognized by the profits interest holder, although the character of that benefit **may** differ from the character of the income recognized. Although this type of clawback of tax distributions can be compelling in theory, as a practical matter, it is rarely used.

One way to potentially avoid or limit income tax allocations (and associated tax distributions) for a profits interest holder is to limit the streams of income in which the profits interest holder participates. For example, an employer might provide a service provider with a profits interest that is limited to certain large capital events (such as a change in control or sale of a business unit). The theory underlying this kind of profits interest is that it is intended to compensate the service provider for contributing to an increase in the entity's enterprise value, but not operating income. Because the service provider does not share in operating income, the necessity for allocations of taxable operating income (and associated tax distributions) is, in theory, obviated, and the service provider is permitted to participate in growth in enterprise value on a tax-advantaged basis.

While this approach is used frequently, its tax efficacy is subject to some debate. Conceivably, an arrangement that pays out only on an exit event could be viewed as a disguised cash bonus program, which, if successfully argued, would defeat capital gain treatment and could raise concerns under IRC Section 409A, which places restrictions on when deferred compensation can be paid. For more information on IRC Section 409A, see *Practice Note, Section 409A: Deferred Compensation Tax Rules: Overview*.

Treatment of Profits Interests under Proposed Regulations

The Proposed Regulations provide for new rules for the treatment of partnership profits interests, which will be effective on finalization of the Proposed Regulations. Under an elective safe harbor in the Proposed Regulations, a compensatory partnership interest for which an election is made is valued at its liquidation value. For a partnership profits interest, so long as the safe harbor election is made and the liquidation value of the partnership interest is zero, this would effectively preserve the current rules as set out in Revenue Procedure 93-27.

The Proposed Regulations also address the treatment of profits interests that are subject to vesting by requiring that an 83(b) election be made in all cases at the time that a profits interest is issued for it to be treated as vested on issuance. If no 83(b) election is made:

- No allocations are made in respect of the profits interest until vesting occurs.
- Any distributions in respect of the interest are taxed as compensation income.

If no 83(b) election is made, to the extent that the value of the partnership has increased at the time of vesting, the profits interest may have become a capital interest (as the profits interest would, if granted on the vesting date, have a liquidation value above $0). Therefore, the liquidation value of the partnership interest as of the vesting date would be taken into account as ordinary compensation income (and deducted as such by the partnership).

If an 83(b) election is made and allocations are made in respect of a profits interest (or a capital interest), which are later forfeited, the Proposed Regulations require that the partnership account for the forfeiture using forfeiture allocations. Forfeiture allocations generally provide for an allocation of gross items of income, gain, loss or deduction (but only to the extent available for the year of the forfeiture) that, in effect, reverse the partner's undistributed income inclusions. The amount of forfeiture allocations is equal to:

(1) Total distributions to the partner with respect to the forfeited interest minus amounts paid for the interest minus

(2) Total net income (or loss) allocated to the partner with respect to the forfeited interest.

Example: A received a profits interest on January 1, 2012, subject to total risk of forfeiture if he terminated his employment before January 1, 2014. During 2012, A was allocated $1,000 of income and received a $350 distribution (to pay the tax on the allocated income). On January 1, 2013, A terminated his employment and forfeited the $650 remaining in his capital account.

A receives a loss allocation equal to (x) $350 (distributions) minus $0 (amount paid for the interest) minus (y) $1,000 (total allocations) equals ($650) in losses. As is generally the case on a forfeiture of property with respect to which an 83(b) election has been made, no tax losses are allocated in respect of amounts included by the service provider in income as a result of making an 83(b) election with respect to the receipt of a partnership capital interest.

Taxation of Profits Interest Income

A profits interest, like a capital interest, is an interest in the streams of income earned by the entity in which the interest is granted. It is also a separate "partnership interest," which is a capital asset in its own right. This can lead to some unexpected tax results on a liquidity event with respect to the profits interest, as the form of the transaction can dramatically impact the character of the income recognized.

A profits interest holder's holding period in its partnership interest begins on the date the interest is granted. This holding period is relevant for determining the character of gain on either a:

- Sale of the profits interest to a third party.
- Distribution in respect of the profits interest in excess of the holder's basis.

The holding period of the partnership in its assets, however, begins on the date that the partnership acquired those assets. This latter holding period ultimately governs the character of gain that is allocated in respect of a profits interest. Consider the following example:

Example: AB is a partnership that owns a plot of raw land (which it intends to develop) as its only asset. The land is a capital asset. AB acquired the land on January 1, 2012, for $1 million (a fair market value based on its development prospects). On January 1, 2013, based on a full appraisal, the land still has a fair market value of $1 million. AB grants C a 10% profits interest, entitling C to share in 10% of the operating income generated by the land, and 10% of any proceeds of capital transactions in excess of $1 million. Because the profits interest has a liquidation value of $0 on the grant date, it is a valid profits interest. In November of 2013, it is discovered that land held by AB has large natural gas deposits and is therefore worth approximately $3 million.

Scenario 1: AB sells the land and distributes the proceeds. If AB sells the land for $3 million in November 2013, it will have capital gain income of $2 million. Because AB has held the land for more than one year, the gain will be long-term capital gain. $200,000 of the gain will be allocated and distributed to C pursuant to its profits interest. Because gain is characterized at the partnership level, this gain will retain its long-term character, even though C has held his partnership interest for less than one year.

Scenario 2: A, B and C sell their partnership interests for an aggregate purchase price of $3 million. In the partnership interest sale, C will be entitled to receive $200,000 of proceeds. This gain will be capital. However, because C has held his partnership interest for less than one year, the capital gain is short-term and is taxed at the ordinary income rate.

Because partnerships are pass-through entities, gain on the sale of a partnership interest is not necessarily capital in all cases. IRC Section 751 requires that a portion of the gain on a sale or redemption of partnership interests be characterized as ordinary to the extent attributable to certain ordinary income assets, including:

- Cash-method receivables.
- Inventory and depreciation recapture (commonly referred to as "hot assets").

Additionally, legislation has been proposed in Congress that would treat income attributable to certain partnership interests issued for investment management services (so-called "investment services partnership interests") as ordinary, even if the income is attributable to capital assets of the partnership.

Options on Partnership Interests

Compensatory options on partnership interests are relatively uncommon, largely because while options and profits interests are fundamentally economically equivalent, a profits interest is taxed more favorably.

Both options and profits interests represent the opportunity to participate in appreciation above a set value. For an option, that value is the strike price of the option while for a profits interest the value is the distribution threshold.

Although partnership options and profits interests are economically similar, they differ in the following important tax and practical respects:

- A profits interest is almost always issued without payment by the holder. Therefore, unlike an option holder, a profits interest holder can become an equity owner without any "skin in the game."
- The tax consequences of the equity grant arise for a profits interest holder on the date of issuance and for an option holder on the date the option is exercised (a partnership cannot issue "incentive stock options").
  - Assuming an interest qualifies as a profits interest, no income is recognized by the holder on grant, but the holder's holding period for capital gains purposes begins on that date.
  - On the grant of a compensatory option to acquire a partnership interest, no income is recognized by the option holder, but, unlike a profits interest, the option holder's holding period does not begin at that time. Instead, the tax consequences associated with acquiring the equity interest arise on exercise of the option. At that time, the holder typically recognizes compensation income in an amount equal to the excess of the fair market value of the partnership interest over the strike price, and the holding period with respect to the partnership interest begins.
  - From the partnership's perspective, the exercise will trigger a deduction equal to the income recognized by the exercising option holder which is allocated to the historic partners. The cash benefit of that deduction can be meaningful and can in fact result in the aggregate after-tax proceeds of all partners over the life of the partnership being greater than if a profits interest is used to provide the same economic interest to service providers.

- The option holder is not a partner until he exercises the option.
- The character of income recognized by a profits interest holder and of an option holder can also be highly different.
  - Although no income is recognized by the holder of a profits interest on the grant of the interest, the holder will recognize income in connection with allocations of current income subsequent to issuance and of gain realized in connection with liquidation transactions. Current income allocated to the holder will generally retain the character of the income as received by the partnership. On an exit event involving a sale of partnership assets, the character of the gain (that is, ordinary or capital) realized by the partnership will flow through to the partners. If the exit involves a sale of partnership interests, the holder of a profits interest will recognize long-term capital gain if the holder has held the interest for more than a year from the date of original issuance (subject to the discussion above of hot assets).
  - The holder of a compensatory option recognizes no income before the date of exercise or disposition of the option, but on exercise recognizes income equal to the excess, if any, of the then fair market value of the underlying interest over the strike price of the option. That income typically will be compensation income. Following exercise, the holder will be taxed on the holder's share of income allocated to the holder in the same manner as a holder of a profits interest. However, if an exit transaction occurs by way of a sale of partnership interests, the holder of an interest acquired on exercise of an option will not recognize any long-term capital gain unless the holder exercised the option more than a year before the exit event. Because the exercise of an option frequently requires the payment of a significant out-of-pocket strike price, the option holder will often choose not to exercise until an exit is imminent, which will effectively deprive the holder of the benefit of long-term capital gain treatment.

Comparison to Cash Deferred Compensation Plans

Under current law, a capital or profits interests in a partnership, whether or not subject to vesting, is not treated as a deferred compensation arrangement for purposes of IRC Section 409A's income acceleration and penalty tax provisions (although the presence in the applicable Treasury Regulations of a broad reservation on the treatment of partnerships for this purpose might result in subsequent regulations that change this position). Therefore, there is generally more flexibility around designing a vesting equity award than a conventional cash-based deferred compensation plan.

COLLATERAL CONSEQUENCES OF PARTNERSHIP EQUITY COMPENSATION

Payroll Taxes

The fixed periodic compensation of a partner (effectively, a partner's salary) is self-employment income rather than employee wages. Therefore, this compensation is subject to self-employment tax paid through estimated tax payments instead of employer withholding under the Federal Insurance Contributions Act (FICA) rules. A partner's salary is reported to the partner on a Schedule K-1 rather than a Form W-2. Where an equity award results in a person moving from employee to partner status for the first time, this change in reporting and payment schemes can be confusing and somewhat uncomfortable for the individual, and the implications should be thoroughly explained.

Benefit Plan Participation

Partners are subject to numerous limitations on their ability to participate in tax-advantaged benefit plans. These limitations generally do not apply to common law employees. For example, a partner may not participate in a cafeteria plan sponsored by the partnership and, while a partner may participate in a partnership-sponsored health plan, the cost of coverage is generally fully taxable to the partner (subject to an "above-the-line" deduction on the partner's personal return in many cases). Again, the changes in moving from employee to partner status can be very important at a personal level and must be taken into account and addressed as part of an effective equity compensation arrangement, particularly for those persons who will first become partners as a result of the equity award.

Special Issues in Service Partnerships

Redemptions: Characterization of Income

Where a service provider receives a profits interest, the profits interest is ordinarily subject to a repurchase right on the part of the granting partnership. While it is often assumed that income recognized by a partner on redemption of his partnership interest will be capital (even taking into account the "hot asset" rules), this is not necessarily the case in certain service partnerships. Where the partnership at issue is one in which "capital is not a significant income producing factor" (generally, a partnership organized to provide services such as an accounting, legal, medical or other professional partnership), a portion of the payment in redemption of the partnership interest may be characterized as distributive share of partnership income or as a guaranteed payment (that is, deferred salary, possibly raising IRC Section 409A issues) instead of as the proceeds of a capital transaction.

Under IRC Section 736, payments in complete redemption to a "general partner of a partnership where capital is not a significant income producing factor" are treated as distributive share or guaranteed payments if the payments are attributable to "unrealized receivables" of the partnership or (more significantly) to "goodwill of the partnership except to the extent that the partnership agreement provides for a payment with respect to goodwill." (IRC Section 736(b)(2).) Therefore, with respect to goodwill, service-based partnerships may elect in their governing documents whether payments in redemption that are attributable to a "premium" over the book value of balance sheet assets will or will not be characterized as a "payment with respect to goodwill." If not, the payments will be ordinary distributive share or, if determined without regard to partnership profits in the year of payment, as guaranteed payments for services (that is, deferred compensation). Treatment as distributive share or a guaranteed payment is generally highly beneficial to the remaining partners, as it provides them with a current deduction for the buy-out premium. The corollary, however, is that it is generally treated as ordinary income to the partner being redeemed.

Treatment of the payment as a payment "with respect to goodwill" is generally beneficial to the partner being redeemed as goodwill is a capital asset. However, the partnership is disadvantaged, as instead of immediately deducting the payment, the payment is capitalized, and (if an IRC Section 754 election is in effect) is amortized over 15 years instead of being deducted currently.

By its terms, the special rule governing redemptions attributable to goodwill of a service partnership only applies to general partners. Therefore, the treatment of members of an LLC is left ambiguous. Some practitioners believe that this rule should not apply at all to members of LLCs absent a change to the statute. Others take varying positions as to who should be treated as a general partner in an LLC, with some viewing any partner who provides services as a general partner and others viewing only managing members with significant control over governance as general partners.