Are the tax implications of equity compensation plans for partnerships in the US, substantially different to corporations?

This thought leadership paper, which contains views of our expert (Shishir Lagu), explains.

Shishir Lagu
Partner, Taxation

Tax implications of equity compensation plans for partnerships

Equity compensation plans for employees can be structured for pass through entities like partnerships or an organization treated as partnership (such as 'LLC'). However, these arrangements may have different tax consequences compared to Plans designed for Corporations.

Generally, the three most common ways to provide equity in an entity treated as a partnership for federal income tax purposes are awards of capital interests, profits interests and phantom units.

Capital interests

A capital interest is 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.

Profits interests

A profits interest is a partnership interest other than a capital interest. Essentially, it is an interest in the future profits and appreciation of the partnership, but not an interest in any liquidating proceeds that would be distributed at the time the interest is granted.

Phantom units

Phantom units represent a contractual right to receive a cash payment equal to the value of a unit of LLC/partnership interest upon defined payment events.

Broad tax implications

Profit interest	Capital interest	Phantom units
Type of interest:		
Recipient is the legal owner of partnership.	Recipient is the legal owner of partnership.	Recipient is not the legal owner of partnership.
Description:		
Recipient shares in future profits/loss of partnership & in future appreciation of the partnership.	Recipient shares in current value of partnership and future profits/loss of partnership.	Recipient shares only in future appreciation of the partnership and does not have any voting rights.

Broad tax implications (cont…)

Profit interest	Capital interest	Phantom units
Status of recipient whether employee or partner? (in case interest is given to employee):		
Partner	Partner	Employee
FICA and wage withholding vs. self-employment taxes:		
Payments received from partnerships by partners are subject to self-employment taxes. If a partnership pays part of the partner's tax, then the partnership will report the amount paid on the partner's behalf as a guaranteed payment to the partner. Additional self-employment taxes will be due on those guaranteed payments.		Payments to employees are treated as compensation & hence subject to all employment related taxes.
Tax implication in hands of recipient:		
No tax impact as the FMV of the interest is zero on the date of grant. 83(b) election is recommended.	83(b) election is made – Taxed as ordinary income at the date of grant at FMV. 83(b) election is not made – Taxed as ordinary income upon vesting at the then prevailing FMV.	Payments received would be taxed as ordinary income i.e. compensation.
Tax implication in the hands of partnership on grant of interest:		
None	Tax deduction at FMV of capital interest.	Tax deduction on compensation payments made with respect to phantom units.
Compliance:		
Schedule K-1- Partnership may be required to issue to recipient of interest. Recipient of interest will include K-1 in his federal & state tax return.	**Schedule K-1**-Partnership may be required to issue to recipient of interest. Recipient of interest will include K-1 in his federal & state tax return.	**Schedule K-1** – not applicable since recipient is considered an employee and not a partner. Recipient will receive W-2 from Partnership.
Voting Rights:		
Yes (Unless the operating agreement is amended to provide different classes/different voting rights)	Yes (Unless the operating agreement is amended to provide different classes/different voting rights)	None
409A implications:		
None	None	A phantom equity plan is subject to the deferred compensation rules of I.R.C. § 409A.

A comparitive analysis (cont…)

Broad tax implications (cont…)

Profit interest	Capital interest	Phantom units
Voting Rights:		
Effect of liquidity event:		
a) Shares only in appreciation of LLC value after the date of issuance. b) In case of disposition of interest, gain in exchange for all or a part of his interest in the partnership which is attributable to hot assets would be treated as ordinary income.	a) Shares in entire value of LLC. b) In case of disposition of interest, gain in exchange for all or a part of his interest in the partnership which is attributable to hot assets would be treated as ordinary income.	None. (Liquidation of the entity can be one of the distribution event)
Effect of profit/(loss) allocations:		
Default rule in percentage interest basis; variation from default rule as agreed in operating agreement.	Default rule in percentage interest basis; variation from default rule as agreed in operating agreement.	Does not participate in profit allocation

About us:

KNAV refers to one or more of KNAV International Limited (KNAV International); a not-for profit, non-practicing, non-trading corporation incorporated in Georgia; USA and its association of member firms, each of which is a legally separate and independent entity. KNAV International is a charter umbrella organization that does not provide services to clients. Services of audit, tax, valuation, risk and business advisory are delivered by KNAV independent member firms in respective global jurisdictions.

For expert assistance, please contact Shishir Lagu at : shishir.lagu@knavcpa.com or +91 98190 13046

Visit us at: www.knavcpa.com