Paul|Weiss

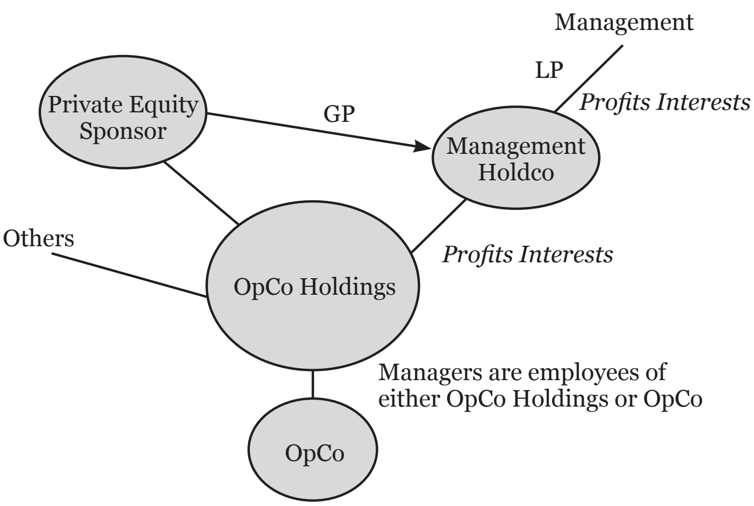
Private Equity Digest

May 2015, Issue 13

Using Management Vehicles to Structure Profits Interests

When private equity sponsors use profits interests[1] as a compensation incentive for management, the awards result in the manager becoming a partner in the partnership with the private equity sponsor, which can sometimes lead to tax and corporate governance complexities. One way to mitigate these complexities is to create a management holding company (or "Management Holdco") — a separate partnership vehicle that allows profits interests to be held indirectly.

This Management Holdco structure solves two potential problems. First, (a) if the managers are employed by an operating company which, for federal tax purposes, is treated as a pass-through partnership (as opposed to a corporation),[2] and (b) the managers receive profits interests or other interests in the same partnership as the private equity sponsor, then the managers would be treated as partners rather than employees. Using the Management Holdco arrangement would allow managers to be partners at Management Holdco, but retain their status as employees at the operating company,[3] which is useful to avoid certain tax complexities. If the managers were only treated as partners, and not as employees, the manager's annual cash compensation would be treated as a partnership distribution or guaranteed payment and reported on Schedule K-1s, rather than Form W-2s, and the managers would be subject to self-employment taxes instead of being subject to wage withholding. The managers would regulate their own tax payments and be required to pay estimated taxes quarterly. Further, as partners, the managers receive different tax treatment on health and welfare benefit plans, and would not be able to participate in certain fringe benefit plans. The Management Holdco structure allows the manager to be both a partner and an employee, which allows the managers to receive the same treatment as employees for tax and benefit purposes that employees are generally accustomed.

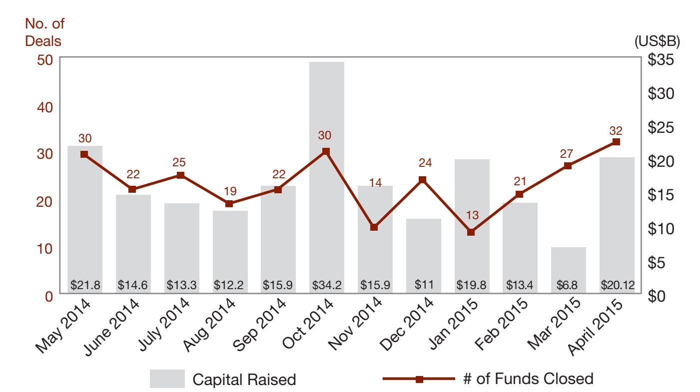


1 "Profits interests" are awards of allocation of the profits from a partnership. For managers who are U.S. taxpayers, profits interests can deliver capital gains treatment, rather than ordinary income treatment. For managers who are taxpayers outside of the U.S., the tax treatment of profits interests varies and may not be as tax advantageous.

2 If the operating company were a corporation, the managers would always be treated as employees and receive Form W-2s, regardless of a Management Holdco arrangement.

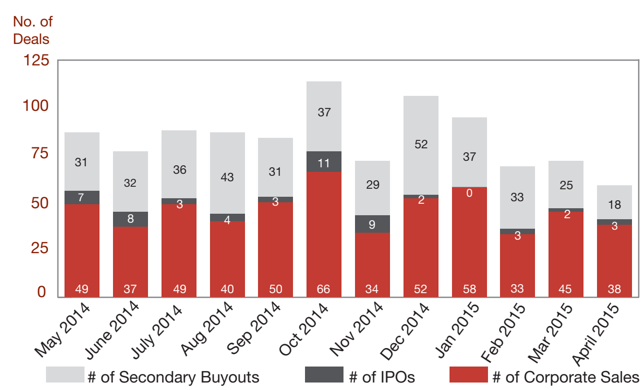
3 It should be noted that varied interpretations are taken by practitioners. A small minority view takes the position that the Management Holdco is simply an indirect holding that cannot bifurcate the manager's status as a partner versus employee. Another less common view takes the position that managers can be both partners and employees of the same entity, thus rendering these concerns moot.

U.S. Private Equity Fundraising



Source: Pitchbook

U.S. Sponsor-Backed Exits By Number



Source: Pitchbook

Second, the Management Holdco would simplify corporate governance, because the managers would not be partners of same partnership as the private equity sponsor. This way (subject to applicable law), rights to information, notices and consent at the partnership in which the private equity sponsor participates could be designed to be vested in the body controlling the Management Holdco (such as a shared general partner), rather than the managers individually.

By avoiding some tax and corporate governance complexities, the Management Holdco structure could potentially allow profits interests to appeal to a broader pool of managers. However, if a private equity sponsor chooses to broaden the pool of managers receiving profits interests, there are a few other considerations to keep in mind.

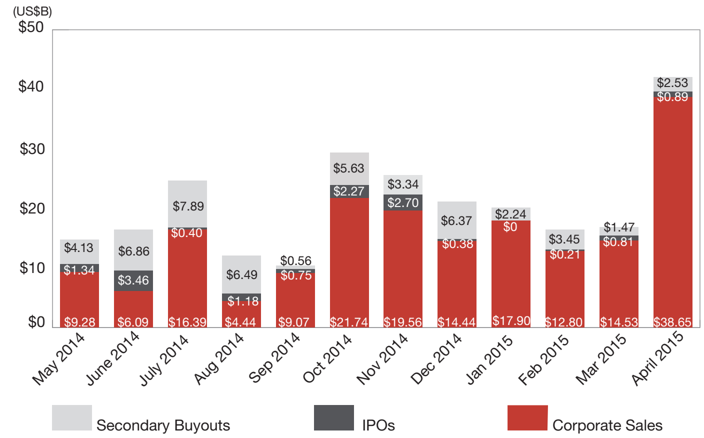
For instance, the IRS Revenue Procedures which establish the tax advantages of profits interests assume that the profits interests have been awarded "for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner." While key managers, such as the CEO or CFO, can be viewed as providing services to the partnership as a function of their position, the same argument may be harder to extend to lower-level managers or other service providers.

Additionally, securities law considerations should be kept in mind when granting profits interests to a broader pool. Profits interests are a type of security, and grants of profits interests would need to fall within an exemption from securities registration requirements.[4] For this reason, it is typical to ensure that profits interest recipients qualify as "accredited investors" (that is, sophisticated investors who satisfy certain income and wealth requirements). Granting profits interests to non-accredited investors can be tricky, because the federal securities exemption typically used for grants of securities to employees (Rule 701) is silent on how to value profits interests for purposes of staying below the imposed dollar thresholds.[5] Rule 701 also does not expressly recognize the indirect nature of the Management Holdco as an issuer, and thus potentially, certain thresholds which are based on a percentage of the total assets of the issuer or a percentage of the total class of securities, are less useful. If grants of profits interests to non-accredited investors cannot fall within the imposed dollar limits of Rule 701, then a private placement exemption would need to be used.

4 This assumes that the grant of the profits interests would qualify as a "sale" for purposes of securities law. If the manager was granted the award at no cost and no non-competition or similar covenant was required in connection with the award, it may be possible to take the position that the profits interest grant was not a "sale."

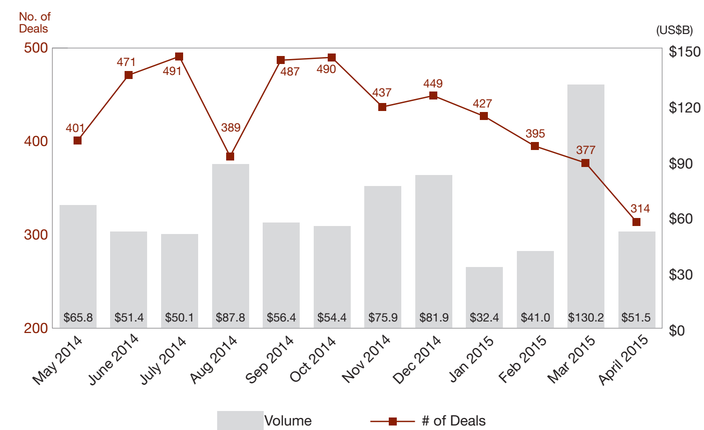
5 One view is that the profits interests are always valued at $0 at grant, by application of the tax rule that values profits interests on a liquidation basis; however, this approach would obviate any dollar threshold under Rule 701. Another view is that the profits interests should be valued on an accounting basis, such as through Black-Scholes; however, if the vesting is performance-based, the accountants may not assign any value to the profits interests because the results are not yet probable at the time of grant. Still another view is to value profits interests similar to how options are valued under Rule 701, which is to multiply the "strike price" (which would be distribution hurdle, in the case of profits interests) by the number of units granted. This view would be the most conservative.

U.S. Sponsor-Backed Exits By Dollar Volume



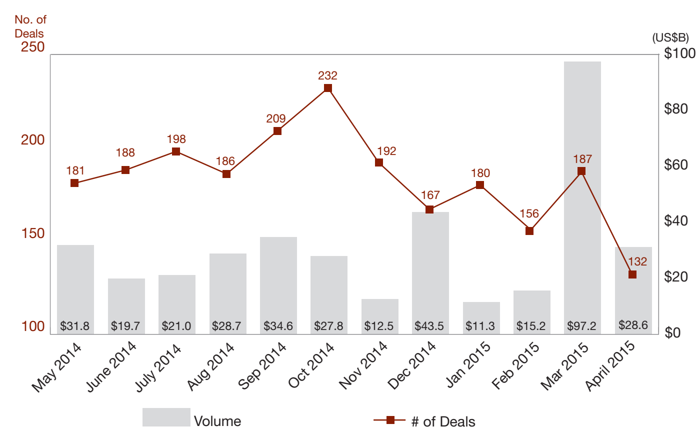
Source: Pitchbook

Global Sponsor-Related M&A Activity



Source: Dealogic

U.S. Sponsor-Related M&A Activity



Source: Dealogic

Treasury Finalizes Certain IPO Transition Rules under Section 162(m)

Public companies, defined as companies with equity securities registered under the Securities Exchange Act of 1934, are subject to deduction limitations under Section 162(m) of the Internal Revenue Code of 1986, as amended ("Section 162(m)"). Section 162(m) can limit tax deductions for compensation in excess of $1 million paid in any one year to any one of the top four officers of a public company (other than the CFO). The deduction limitation does not apply to "performance-based compensation" under a shareholder-approved plan.

Newly public companies are allowed a transition period before becoming subject to Section 162(m). During the transition period, the $1 million compensation deduction limitation does not apply to any compensation "paid" pursuant to a plan that existed before the company became publicly held, provided that the plan was described in the Form S-1 with disclosure that satisfied all applicable securities laws then in effect. The transition period generally continues until the first shareholders meeting held after the third calendar year following the IPO, but can expire earlier upon the expiration or material modification of the plan, or upon issuance of all stock or other compensation allocated under the plan.

One question newly public companies often struggle with is: What compensation is considered "paid" during the transition period? For stock-based compensation, the Treasury regulations under Section 162(m) provide that compensation attributable to stock options, stock appreciation rights ("SARs") and restricted stock would be treated as "paid" during the transition period if the award was granted during the transition period – *even if* the award is exercised or vested after the end of the transition period.

For restricted stock units, the answer was less clear, but the IRS recently promulgated guidance clarifying its position that restricted stock units do not receive the same treatment as stock options, SARs and restricted stock under the regulations. This means that restricted stock units are considered "paid" during the transition period only if the award is actually settled and paid during the transition period. If the restricted stock unit were granted during the transition period and paid after the transition period, the amount paid would be subject to the $1 million compensation deduction limitation.

This rule for restricted stock units applies whether the award is subject to service-based or performance-based vesting conditions. This rule similarly applies to phantom awards or other types of deferred compensation.

Thus, in order to take advantage of the transition rule for newly public companies, consider using grants of restricted stock, rather than restricted stock units, post-IPO. Restricted stock can be economically equivalent to restricted stock units (assuming the restricted stock units settle promptly upon vesting). Once the transition period expires, and the company adopts a shareholder-approved plan designed to comply with Section 162(m), performance-based restricted stock units can be designed to qualify as "performance-based compensation," which is an exception to the $1 million compensation deduction limitation under Section 162(m).

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