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Aggregator Entity Design Choices for Profits Interest Awards

Presentation for:
Executive Compensation Webinar Series
March 13, 2025

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About Anthony “Tony” Eppert

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- Tony practices in the areas of executive compensation and employee benefits
- Before entering private practice, Tony:
  - Served as a judicial clerk to the Hon. Richard F. Suhrheinrich of the United States Court of Appeals for the Sixth Circuit
  - Obtained his LL.M. (Taxation) from New York University
  - Obtained his J.D. (Tax Concentration) from Michigan State University College of Law
    - Editor-in-Chief, Journal of Medicine and Law
    - President, Tax and Estate Planning Society

Upcoming 2025 Webinars

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- 2025 webinars:
  - Ideas to Increase the Life Expectancy of an Equity Plan’s Share Reserve (4/10/25)
  - Designing Change-in-Control Bonus Plans or Management Carveouts (5/8/25)
  - ABCs of Total Shareholder Return (TSRs) Awards (6/12/25)
  - Pros and Cons of Various Fringe Benefits to Offer Executives (7/10/25)
  - Anatomy of ISS (8/14/25)
  - Preparing for Proxy Season: Start Now (Annual Program) (9/11/25)
  - Non-Employee Director Compensation (10/9/25)
  - Pros, Cons and Contrasting Secular Trusts and Rabbi Trusts (11/13/25)
  - Year-End Review of Any Missed Executive Compensation Items (12/11/25)

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Our Compensation Practice – What Sets Us Apart

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- Compensation issues are complex, especially for publicly-traded companies, and involve substantive areas of:
  - Tax,
  - Securities,
  - Accounting,
  - Governance,
  - Surveys, and
  - Human resources
- Historically, compensation issues were addressed using multiple service providers, including:
  - Tax lawyers,
  - Securities/corporate lawyers,
  - Labor & employment lawyers,
  - Accountants, and
  - Survey consultants

Our Compensation Practice – What Sets Us Apart (cont.)

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- The members of our Compensation Practice Group are multi-disciplinary within the various substantive areas of compensation. As multi-disciplinary practitioners, we take a holistic and full-service approach to compensation matters that considers all substantive areas of compensation

Our Compensation Practice – What Sets Us Apart (cont.)

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- Our Compensation Practice Group provides a variety of multi-disciplinary services within the field of compensation, including:

Traditional Consulting Services

- Surveys
- Peer group analyses/benchmarking
- Assess competitive markets
- Pay-for-performance analyses
- Advise on say-on-pay issues
- Pay ratio
- 280G golden parachute mitigation

Corporate Governance

- Implement "best practices"
- Advise Compensation Committee
- Risk assessments
- Grant practices & delegations
- Clawback policies
- Stock ownership guidelines
- Dodd-Frank

Securities/Disclosure

- Section 16 issues & compliance
- 10b5-1 trading plans
- Compliance with listing rules
- CD&A disclosure and related optics
- Sarbanes Oxley compliance
- Perquisite design/related disclosure
- Shareholder advisory services
- Activist shareholders
- Form 4s, S-8s & Form 8-Ks
- Proxy disclosures

Design/Draft Plan

- Equity incentive plans
- Synthetic equity plans
- Long-term incentive plans
- Partnership profits interests
- Partnership blocker entities
- Executive contracts
- Severance arrangements
- Deferred compensation plans
- Change-in-control plans/bonuses
- Employee stock purchase plans
- Employee stock ownership plans

Traditional Compensation Planning

- Section 83
- Section 409A
- Section 280G golden parachutes
- Deductibility under Section 162(m)
- ERISA, 401(k), pension plans
- Fringe benefit plans/arrangements
- Deferred compensation & SERPs
- Employment taxes
- Health & welfare plans, 125 plans

International Tax Planning

- Internationally mobile employees
- Expatriate packages
- Secondment agreements
- Global equity plans
- Analysis of applicable treaties
- Recharge agreements
- Data privacy

Purpose of this Presentation

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- The purpose of this discussion is to discuss:
  - Why aggregator entities are sometimes used to facilitate the grant of profits interests equity awards (a.k.a., mirror back-to-back profits interest grants);
  - Factual scenarios where use of an aggregator entity should be considered;
  - Design considerations; and
  - Different types of documentation used to implement such awards
- Some of the foregoing is discussed within the slides and some of the foregoing is discussed off slides
- For purposes of the following slides all references to "partnerships" includes LLCs taxed as partnerships

Background: Corporation v. Partnership

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- Corporations
  - Equity incentives generally consist of common or preferred stock in the form of:
    - Restricted stock and/or stock settled RSUs (*a.k.a*., full value awards),
    - Stock options and/or stock-settled SARs (*a.k.a*., appreciation-only awards), and
    - Performance shares and/or stock-settled performance units
  - Additionally, synthetic equity (*a.k.a*., phantom equity) can also be used to create incentives that are comparable to equity ownership (though no actual equity is issued under a synthetic equity program)
    - Examples include cash-settled RSUs, SARs and performance units
- Partnerships
  - A partnership is not a taxable entity; instead, entity levels of income, deduction, credits, etc., are allocated to, and reported by, the partners
  - Partner allocations is a primary reason why the taxing regime for compensatory equity interests in the partnership context are more complex

Background: Partner v. Employee Classification

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- An individual cannot be both a partner and an employee in the same entity
  - And grants of HoldCo equity to employees of its disregarded entity do not work to protect employee classification
- Thus, the beginning point of any analysis is to determine whether partner or employee classification is important
- If the individual is only an employee, then:
  - Any income to the recipient would be W-2 compensation that is subject to withholding;
  - Such W-2 compensation would be taxed to the employee at ordinary income rates and the partnership should be entitled to a corresponding compensatory deduction
  - The recipient could participate in any retirement plans that are sponsored by the partnership;
  - Any premiums paid for accident and health insurance, or for group term life insurance, could be excluded from the recipient's gross income by the employee participating in a 125 plan (*a.k.a.*, a cafeteria plan for the purpose of paying premiums with pre-tax dollars);
  - The value of meals that were furnished to the recipient for the partnership's convenience could be excluded from the recipient's gross income; and
  - Any fringe benefits that were provided to the recipient could be excluded from the recipient's gross income pursuant to Section 132

Background: Partner v. Employee Classification (cont.)

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- In contrast, if the individual is a partner of the partnership, then:
  - Any income would be reported on a Schedule K-1;
  - The partnership would not be required to withhold on payments to the recipient, however, any payments characterized as a "guaranteed payment" would be subject to self-employment tax;
  - The partner would have to make quarterly estimated tax payments (as opposed to having income withholding on wages);
  - The partner would be liable for the full amount of employment taxes as a self-employed individual (as opposed to the partnership paying 50% of such employment taxes if the individual were an employee);
  - If the partnership sponsored a retirement plan, the partner would be able to participate only if the underlying plan documents were amended to include partners (*i.e.*, typically, the standard retirement plan document does not include partners, so an amendment would be required); and
  - Any premiums paid for accident and health insurance, or for group term life insurance, would have to be paid by the individual with his or her after-tax dollars (*i.e.*, a partner is not eligible to participate in a 125 plan/cafeteria plan, and therefore, cannot pay premiums using pre-tax dollars)

Background: Capital v. Profits Interest

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- Both the grant of a capital interest and a profits interest are equity-based awards, however, neither a capital interest nor a profits interest is defined in the Code

- A "capital interest" is generally defined as an interest that would provide the service provider with a share of the proceeds if the partnership's assets were sold at fair market value and then distributed to its partners
  - Such can take the form of restricted interests, options to acquire interests, conditional promises to be settled in equity (*i.e*., RSUs, SARs and performance units)
  - A benefit of a capital interest is that it provides the service provider with enterprise value in the partnership as of the date of grant (*i.e*., a full value award)
  - A drawback of a capital interest is the tax consequence associated with the receipt of a full value award

- The tax consequences to receiving a capital interest include:
  - To the extent it is vested (or is unvested with an 83(b) election), the service provider would recognize ordinary taxable income equal to the fair market value of the capital interest, minus any monies paid for such interest
  - Under Section 83, the partnership would be entitled to a compensatory deduction at the time (and in the amount) that the service provider recognized ordinary taxable income (as a planning note, consider whether the partnership agreement should allocate any compensatory deductions arising from the grant of the capital interest to only those partners that existed immediately prior to the grant)

Background: Capital v. Profits Interest (cont.)

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- A “profits interest” is generally defined as an equity interest other than a capital interest. It provides the service provider with a share of future partnership profits and NO interest in the capital of the partnership that existed prior to the date of grant
  - It is intended to provide an incentive for the service provider to pursue enterprise growth
  - Some of the benefits associated with receiving a profits interest include:
    - Favorable tax treatment for the recipient (no tax at grant or vesting),
    - It represents actual equity in the partnership,
    - The service provider will generally recognize capital gains treatment upon a sale of the partnership to a third party, and
    - The character of income at the partnership level is generally retained when distributed to the service provider

- Tax consequences to the service provider in receiving a profits interest include:
  - Under Rev. Proc. 93-27 and 2001-43, the service provider would not recognize any taxable income on the date of grant
  - Under Section 83 proposed rules and Notice 2005-43, the service provider would not recognize any taxable income on the date of grant if the liquidation safe harbor was timely elected
    - However, to the extent the interest is subject to a vesting schedule, the above would apply only if the service provider makes a timely 83(b) election
    - Due to the above inconsistency, a most common practice is for the service provider to make a “protective” 83(b) election when the profits interest award is granted

Background: Profits Interest & Rev. Proc. 93-27

- Receipt of a profits interest is generally not a taxable event to the recipient if Rev. Proc. 93-27 is satisfied. This means that a recipient is generally taxed only:
  - As the partnership allocates items of income, or
  - When subsequent appreciation from the date of grant is realized
- However, Rev. Proc. 93-27 would not apply, and thus receipt of a profits interest could be taxable, if any of the following apply:
  - The recipient disposes of the profits interest within 2 years of receipt (though in some instances a 3-year holding period is required);
  - 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;" or
  - The profits interest is an interest in a publicly-traded partnership
- The impact of granting a restricted profits interest (*i.e.*, one subject to a vesting schedule) was unclear under Rev. Proc. 93-27

Background: Profits Interest & Rev. Proc. 2001-43

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- Rev. Proc. 2001-43 provides that a grant of a restricted profits interest, or the vesting of such interest, would not be a taxable event if the requirements of Rev. Proc. 93-27 and Rev. Proc. 2001-43 are satisfied
  - In other words, whether an interest qualifies as a profits interest is tested at the time of grant without regard to whether the interest is subject to a vesting schedule

- Compliance with Rev. Proc. 2001-43 requires the following to be satisfied:
  - The service provider must be treated as the owner of the interest from the date of grant, including that the service provider take into account his or her distributive share of partnership income, gain, loss, deduction and credit associated with that interest;
  - Neither the partnership nor its partners may take any deductions (neither at grant nor at vesting) for the fair market value of the interest; and
  - All other conditions of Rev. Proc. 93-27 must be satisfied

Background: Profits Interest, Section 83 & Notice 2005-43

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- Proposed regulations under Section 83 (the "***Proposed Regs***") and Notice 2005-43 were published in 2005 to govern the granting and vesting of a capital interest and/or a profits interest in a partnership
  - Notice 2005-43 contains a proposed Revenue Procedure that, if and when effective, would obsolete Rev. Proc. 93-27 and Rev. Proc. 2001-43
- The Proposed Regs provide NO distinction between a capital interest and a profits interest
- The Proposed Regs clarify that the principles of Section 83(b) would apply to capital and profits interests that are not vested (*i.e.*, those subject to a vesting schedule)
- Under the Proposed Regs, and absent a timely 83(b) election, a service provider would not be treated as a partner for tax purposes until his or her interest vests
- If the service provider makes an 83(b) election AND the partnership adopts the liquidation safe harbor (discussed on next slides), the service provider's ordinary taxable income would effectively be eliminated

Background: Profits Interest & Valuation Issues

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- The valuation of a compensatory partnership interest is important because it dictates:
  - How much the service provider will recognize as ordinary income, and
  - How much the partnership will allocate to its partners with respect to the corresponding deduction

- Fair market value could be determined by:
  - 3rd party independent appraiser,
  - Someone knowledgeable within the partnership and following the rules comparable to inside valuations under Section 409A, or
  - Adopting the "liquidation safe harbor" under the Proposed Regs. and Notice 2005-43

- Under the liquidation safe harbor, fair market value is determined by the partnership's liquidation value
  - Generally, the liquidation value of a compensatory interest is the amount the service provider would receive if the partnership sold all of its assets at fair market value immediately after issuing the compensatory interest and then liquidated after paying all liabilities
  - May be elected for capital interests and/or profits interest

Background: Profits Interest & Valuation Issues (cont.)

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- Generally, the following elements must be satisfied in order to qualify under the liquidation safe harbor:
  - The partnership agreement (or other legally binding agreement) must contain certain provisions that:
    - Authorize the partnership to elect the safe harbor, and
    - Require the partners to comply with the safe harbor requirements
  - The partnership's tax matters partner must attach a document to the partnership's tax return in the year of election that states the election is irrevocable as to compensatory interests issued while the election was effective
  - The election cannot be effective prior to the date the partners executed the document implementing the election; thus, no retroactive elections are permitted
  - The partnership interest cannot be:
    - Related to a substantially certain stream of income;
    - Represent an interest in a publicly-traded partnership; or
    - Transferred in anticipation of a subsequent disposition (which is presumed if the interest is sold, disposed of, puttable or callable, within 2 years from receipt of the award, with the exception being the death or disability of the service provider)

Background: Profits Interest & Valuation Issues (cont.)

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- The safe harbor election is terminated upon the earlier of:
  - The date the qualifying elements are not satisfied
  - The date any party involved takes a position that is inconsistent with the election
  - The partnership affirmatively elects to revoke the safe harbor (filed by the tax partner on the partnership's tax return for the year of revocation)
- Once terminated, the safe harbor cannot be again elected until five years after the year the election was revoked
- In a classroom setting the safe harbor might NOT be desirable upon a service provider's receipt of a compensatory capital interest (assuming it has value) because traditional valuation discounts would not be used (lack of marketability, minority interests, etc.)
- However, in the practical setting safe harbor treatment is likely desirable to a service provider receiving a profits interest because the receipt would have no value, which is the perfect time to make an 83(b) election

What Is an Aggregator Entity?

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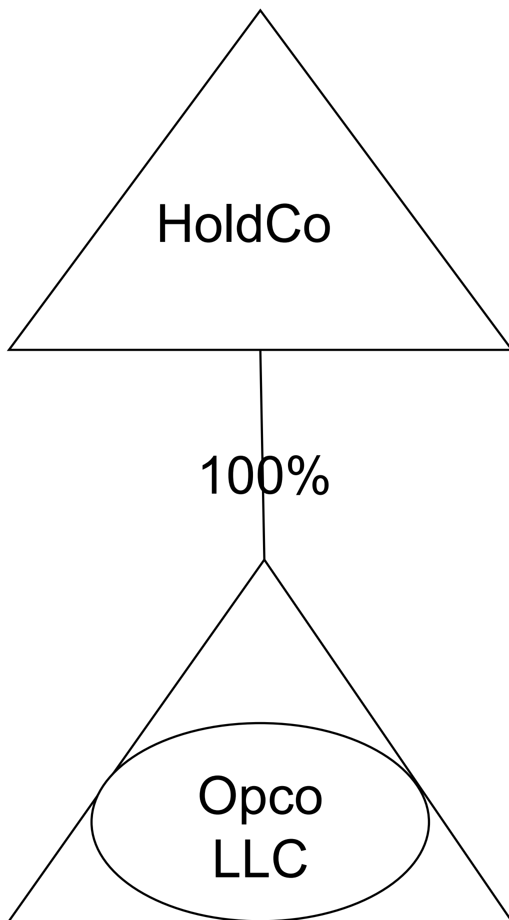

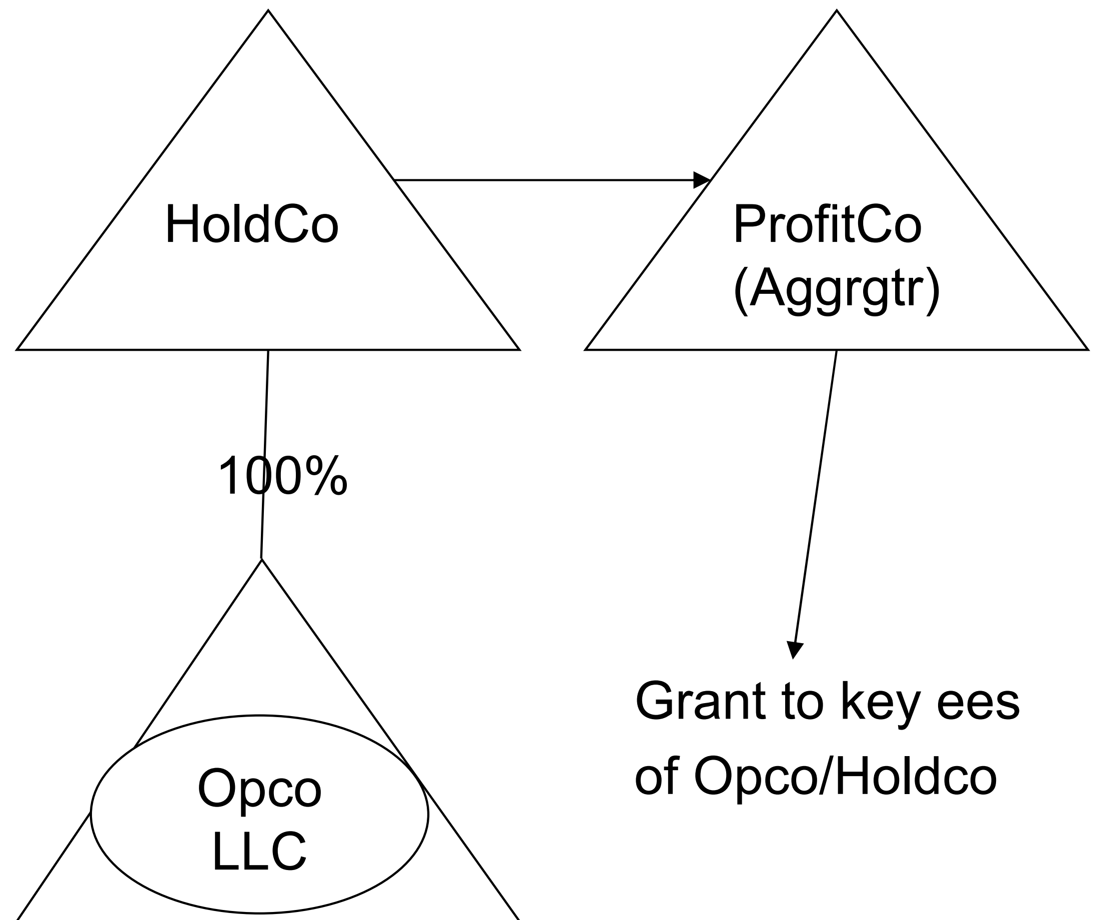

Disregarded entity, employment status destroyed

HoldCo grants profits interest to ProfitCo ProfitCo to Ees. Ee classification maintained

Reasons for Using an Aggregator Entity

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- There are various reasons where use of an aggregator entity makes sense, including:
  - To maintain employee status because otherwise an individual cannot be both a partner and an employee in the same entity
  - To visually block access to books and records (*i.e.*, the partner could still have rights to the books and records of the aggregator entity, but would lack such rights with respect to the entity whose equity is being granted to the aggregator)
  - In some situations the management team's political capital is on par with or exceeds that of the investors. In these situations the investors might agree to an upfront dilution (*e.g.*, [10]%) that is held by management at the beginning of the relationship
    - The management team might desire control of the rollout of the full equity pool, both currently and in the future;
    - The management team might desire the economic windfall associated with any portion of the [10]% that remains unallocated as of an intended liquidity event (though other solutions exist also), capture such at capital gains rates, and use the threshold value from the original grant; and
    - The management team might desire the economic windfall associated with forfeitures (though other solutions exist also) for the same reasons as the prior bullet

Structure of Mirrored Awards

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- Generally, when an aggregator entity is used, HoldCo grants a profits interest award to the aggregator, and then the aggregator grants an identical profits interest award to Opco employee (though the structure really depends upon where the employees reside within the org chart)
  - Typically, the award is mirrored as to type and terms
  - For example, and subject to the terms of the arrangement, if Opco employee fails to satisfy the vesting schedule, then forfeiture occurs between Opco employee and aggregator, and that forfeiture is mirrored and occurs again between aggregator and HoldCo
  - Other areas to mirror or consider include: Manager rights, voting rights, distributions, ROR, ROFR, drags & tags, etc.

- The above is a market practice by PE shops, however, some accountants have taken a position that Rev. Proc. 93.27 would not apply in the context of an aggregator entity because the recipient of the profits interest award was not providing services to the grantor in the above example (instead, services were provided to Opco)
  - This position was contradicted in In *ES NPA Holding LLC v. Commissioner*, T.C. Memo 2023-55 (May 3, 2023), where the Tax Court concluded, among other things, that indirect grants are acceptable (*i.e.*, satisfy the requirement of "to or for the benefit of")

Don’t Forget Next Month’s Webinar

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- Title:
  - Ideas to Increase the Life Expectancy of an Equity Plan’s Share Reserve
- When:
  - 10:00 am to 11:00 am Central
  - April 10, 2025

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