Vasquez & Company LLP
Certified Public Accountants and Business Consultants

Insights for Smarter Decisions

As a member of the RSM US Alliance, we would like to share the following with you.

Using partnership compensatory devices in succession planning

Los Angeles
+1 213.873.1700

Sacramento
+1 916.503.3269

San Diego
+1 619-254-6605

Manila
+1 213.873.1720

For more information:
solutions@vasquezcpa.com

Using partnership compensatory devices in succession planning

Unique aspects of closely held partnership exit strategies

Prepared by:

Anne Bushman, Senior Manager, Washington National Tax, RSM US LLP
anne.bushman@rsmus.com, +1 202 370 8213

April 2015

The most recent U.S. Census Bureau information available on the number of business tax returns filed shows that partnerships1 make up approximately 35 percent of the non-proprietorship businesses in the United States. As a result, many of the closely held businesses considering succession planning in the near future will be operating in the partnership form. The ownership structure and tax treatment of partnerships[1] differs from corporations enough that the planning may look quite different as well. This fifth article in a series on the use of compensatory devices in succession planning explores the unique application to partnerships.

1 References to "partnerships" herein refer to state law partnerships and limited liability companies taxed as partnerships.

Partnership succession planning overview

Previous articles in this series have focused on succession planning using employee stock ownership plans (ESOPs), succession planning using retirement plans and equity compensation as a succession planning device. A partnership may be able to use all of these options, but in slightly different ways from corporations,because (1) partnerships do not have stock, and (2) partners are not considered employees, even when they work for the business, so their compensation plans are different. A partnership that desires to implement an ESOP would need to first incorporate since an ESOP has to own stock, but otherwise that option is available, as explained in the previous article. Partnerships generally have retirement plans for their employees, but sometimes have unique retirement plans for partners in addition to the general retirement plans discussed in the previous article. And again, since partnerships do not have stock, partnership equity compensation options differ from the stock-related payments discussed in the previous article.

Nonetheless, partnerships come in a variety of sizes, and many partners may struggle when considering how to transition the business. As with other middle-market businesses, the business value may limit the number of available buyers. For example, if current owners have grown the business to a significant size, the purchase price for successor managers to fund a buyout of current owners may be much higher than when the current owners acquired the business.

Middle Market Insight:
Partnerships with large numbers of partners (e.g., large accounting and law firms) do not generally have the same ownership transition dilemma because their partnership or buy-sell agreements usually have a put option that requires the partnership or other partners to buy a certain partner's interest when he or she is ready to exit the business. Partnerships with fewer partners should consider this option if such an internal transition fits their business.

In cases where finding an internal buyer may be a hurdle, existing partners will need to consider alternative ways to identify and obtain a buyer, such as offering to sell to an outside firm, searching for outside individuals willing to buy a partnership interest or perhaps changing the partner compensation structure to incentivize internal managers to step into ownership. Obviously, a number of factors, including client transitions for professional service firms, need to be considered in connection with these options. However, this series focuses specifically on the use of compensatory devices in succession planning, and the following discussion addresses partner payment options and how these options may be helpful tools in a succession plan.

Types of partner payments

Guaranteed payments
In lieu of salaries or wages, partners usually earn a guaranteed payment. Similar to wages paid to other employees, the business gets a deduction for the guaranteed payments made to partners. Rather than the partner receiving an annual Form W-2 reporting the guaranteed payment, the partner's Schedule K-1 from the partnership includes the amount of the partner's individual guaranteed payment, which the partner reports as self-employment income.

Bonus payments
In addition to guaranteed payments, which are generally fixed amounts, partners may receive bonuses that are more discretionary. Businesses can tie bonuses to company performance, unit performance or individual performance to ensure that partners are incentivized to grow the business. A bonus system can be set up to increase a partner's guaranteed payment, thus allowing the business to deduct the bonus, or it may take the form of one of the options below. It should be noted that these bonuses do not differ significantly from bonuses that may be offered by corporations; however, in the partnership context, these bonuses are not treated as wages since the partners are not technically employees.

Distributions
Since partnership income flows through to partners and is taxed at the partner level, the business usually distributes cash to the partners to cover their tax liabilities on the partnership's income. A distribution is not a deductible item for the partnership, but is instead treated as a reduction to the partners' equity. Likewise, distributions do not represent taxable income to the partners, but reduce their bases in their partnership interests. Basically, distributions are a way to get cash out of the business for the owners' use.

Profits interests and capital interests
As mentioned, because partnerships do not have stock, stock options and some of the other compensatory tools are not available in a partnership. Instead of stock, partnership equity includes profits interests and capital interests. A profits interest provides the holder the right to share in the profits of the business. To compete for talent with corporations that can give management stock options, many partnerships use profits interests as a form of equity compensation for key executives. If certain facts are present, a safe harbor allows a profits interest to be treated as having zero value, which means that the partner does not pay any tax upon the receipt of the interest, and the partnership does not receive a deduction.

A capital interest differs from a profits interest in that a capital interest shares in the rights to the partnership's assets, rather than its profits. Thus, if a partnership liquidates in a given year, the liquidation proceeds are an asset to be divided amongst the capital interest partners. Unlike a profits interest, a capital interest does provide a current accumulation to wealth. Thus, it is a taxable event to the person receiving it if the value of the capital interest exceeds what he or she paid for it. In a typical partnership, the same partners own the profits and capital interests. However, if a partnership begins to compensate management with equity interests, the ownership of the different types of units may begin to differ slightly.

Partner retirement plans
One unique aspect of partnerships relates to retirement planning for partners. Partners are generally not employees, but they are allowed to be treated as employees for purposes of participating in qualified retirement plans. In addition, partnerships may have other plans in place to compensate partners after they leave the business. These additional plans may be used similarly to nonqualified deferred compensation plans, which can be structured with more flexibility than qualified plans to allow partners to defer more income to future years, or they may be used to effectively finance the buyout of the partner's equity. For example, when a partner exiting the business owns 10 percent of the equity, the partner deserves payment not only for 10 percent of the book value of the business, but also for any

additional amount by which the actual fair market value of his or her interest exceeds book value.

One way to finance the future payments that will be due to retiring partners is to fund them currently by setting aside some cash in an account and using that account to make future retirement payments. Another common way partnerships fund partner retirement is by agreeing to make certain defined future payments during retirement and making each payment out of business earnings in the year the payment is made. For example, a partner's retirement plan may state that he or she will receive 90 percent of the average of his or her final three year's compensation for a 10-year period after exiting the partnership. This amount is effectively what the partnership owes the partner for the fair market value of his or her interest, and it will be paid out of partnership profits in each of those 10 years. The tax treatment of partner retirement payments of this type will depend upon whether they are treated as payments for the partner's share of partnership property, a distributive share of partnership income or a guaranteed payment.

Middle Market Insight:
Each of the above types of payments can be structured in a number of ways. All partnerships have profits and capital interests for which exiting partners must be paid, but the types of payments used during and after ownership varies among partnerships. In addition, a partnership can choose to allocate the payments amongst partners in a number of ways. This ability to have various classes of ownership is one of the main advantages of operating in the partnership form. Those classes of ownership may be divided into tiers of partner groups to allow a given tier to receive a higher guaranteed payment or a different bonus formula, for example. This flexibility allows the partnership to incentivize owners using different payment levels, even though all of their payments are received as owners, rather than in the form of the typical compensation packages given to employees.

Using partner payments to facilitate succession planning

Previous articles in this series explained how compensatory devices could be used to directly transfer ownership of a business or to indirectly aid succession planning by reducing the business value to increase the number of potential buyers for the business. Partners face the same succession planning hurdles as corporate shareholders while positioning their businesses for an ownership transition, but the compensatory tools available to them have to be used differently since partners are not employees. For example, a partnership can use a defined contribution retirement plan and partners can participate in the plan. However, rather than basing plan contributions on compensation, the partner income used for determining contributions to the plan must be based on the partners' income or loss passing through from the partnership for other than limited partners, because partners are considered self-employed and do not earn compensation.

As discussed above, partnerships can provide an additional direct benefit to partners by setting up another form of partner retirement plan. This plan either reduces current cash in the partnership or creates a future cash need, both of which reduce business value. When structuring these plans, partnerships need to take into account the effects these could have on potential future partners. These plans can be structured to help future partners buying into the partnership and minimize any burden related to paying past partners out of current partner profits.

Another succession planning option is to offer profits interests to current management. This option can tie management's income to the performance of the business and incentivize them to grow, and to stay with, the company. At the same time, current owners' profits interests would be diluted, causing a potential buyer for the remaining interest to need to pay less for it.

Even if these options are not attractive enough to encourage current management to take over ownership of the entity, or if the business does not have successor managers ready to inherit the upper-level positions, implementing some of these partner payments may be a valuable way to encourage outside talent to enter your partnership. Which option a given partnership uses will differ depending on the business's specific circumstances. For example, a middle-market business with three partners who are all planning to exit in the next five years may need to choose the option(s) that best position it for an outside firm to buy the business, because an internal buyout of the entire business in that short time frame may not be feasible.

Conclusion

In some ways, partnership succession planning will not differ much from other business types. Partners need to consider a number of objective and subjective factors, including whether successor managers are identified and capable and what the company's financial situation is, just like other businesses. Compensatory devices can aid in an overall succession plan for all types of businesses, but the nature of the payments and the ways they may help differ for partnerships. If your partnership does not have a succession plan in place, discuss these options with your tax advisor to determine how they may help you and your business to position for a future ownership transition.

+1 800 274 3978
www.rsmus.com

wp-nt-na-all-0716

RSM