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Tax

Taxation of Carried Interests for Senior Level Fund Managers (Part One of Four)

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Carried interest arrangements have been common for years in many types of private investment funds (Funds), including private equity, real estate and hedge funds. Carried interest arrangements can be controversial, in part, because of the ability of Fund Managers (defined below) to treat the pass-through of earnings in certain types of Funds as long-term capital gains for tax purposes, notwithstanding that the carried interest arrangement provides for compensation in connection with the performance of personal services by the Fund Manager.

This four-part series summarizes the principal U.S. federal income tax and related design considerations associated with carried interest arrangements for individuals (Fund Managers) who are employed by or otherwise provide services to sponsors of Funds.

This first article provides background on carried interest arrangements and examines relevant analytical considerations, including the statutory scheme; judicial background; proposed regulations; applicable revenue procedures; and capital shifts and book-ups. The second article will outline practical and design considerations, including 83(b) elections; fee-waiver provisions; and the tax treatment on the repurchase or disposition of profits interests or the payment in liquidation of profits interests. The third article will review additional practical and design considerations, including the treatment of profits interests and capital interests as separate interests in a partnership; dual-status issues; phantom income; and tax distributions. The fourth article will explore the final practical and design considerations, including forfeitures; the structuring and administration of profits interests; and deferred compensation arrangements.

Introduction

Note that this series is intended to provide background to those interested in the design of carried interest arrangements and to serve as a useful practical checklist of relevant tax considerations; it is not intended to be either a comprehensive analysis of the large number of tax issues that may arise in the context of carried interest arrangements or serve as a catalogue of all potential design considerations.

In a typical carried interest arrangement, a Fund Manager receives an interest in an entity taxed as a partnership (Carry Vehicle) that entitles the Fund Manager to share in a portion of the profits realized by a Fund. The “carry” nomenclature derives from the excess of the share of the amount of the profits paid to the holder relative to the actual dollar amount that is contributed to that holder’s capital account. A typical Phantom Carried Interest Arrangement (as defined below) attempts to replicate the economics of a carried interest arrangement through an

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unfunded unsecured promise to pay that is taxable as deferred compensation. The defining common characteristic of a carry program is that the Fund Manager is entitled to an interest in Fund returns without having to invest a proportionate share of the capital in the Fund.

Because the focus of this discussion is on compensation for senior personnel, this article will primarily deal with partnership arrangements or entities taxed as partnerships. In contrast, a "phantom" or "notional" carried interest arrangement granted as a contractual obligation of the Fund Manager or an affiliate (Phantom Carried Interest Arrangements) generally results in ordinary income for the Fund Manager and deductible expenses for the sponsor. Those deductions may be more or less valuable, depending on the structure of the sponsor and whether its owners are U.S. taxpayers or individuals for which the limitations applicable to deductions under Section 212 of the Internal Revenue Code of 1986 (the Code) apply.

While such arrangements avoid the controversy and analytical complexity and uncertainty associated with carried interest arrangements, they do require compliance with Section 409A of the Code, which involves its own unique set of complexities, uncertainties and risks (and could raise additional issues under Section 457A of the Code). By contrast, Internal Revenue Service (IRS) Notice 2005-1 excludes from the coverage of Section 409A of the Code the issuance of partnership interests that are not guaranteed payments for services (*i.e.*, the types of interests granted under carried interest arrangements, such as those that are the primary subject of this article) as long as the recipient is not required to include the interest into income at issuance.

When designing and implementing a carried interest arrangement, the sponsor may wish to have the participants be considered partners for general or tax purposes. For example, on the business side, the sponsor may not want the participant to have any number of rights that a partner might have (although, in a variety of situations, concerns of this type can sometimes be addressed by contract). These types of business considerations will not generally arise in the context of carried interest arrangements for true owners and other similarly situated senior personnel because such individuals will already be (or are readily acceptable to existing owners as) owners (*e.g.*, partners).

On the tax side, there may be concerns with:

- the dislocation that can arise for a participant when the participant receives a Form K-1 but was expecting a Form W-2;
- the loss of certain tax benefits that only apply for employees; and
- the distortions that can arise under the Self-Employed Contributions Act (SECA) as compared with the Federal Insurance Contributions Act (FICA), where under SECA the service provider will effectively pay both the provider's and the recipient's share of the taxes (in contrast to the result under FICA, where the employer pays the employer's piece).

These types of tax considerations will often be somewhat manageable for owners and other senior personnel to the extent that the individuals are already familiar with and amenable to partner-type (as opposed to employment-related) tax rules.

See "France Welcomes Foreign Asset Managers With Softened Tax Treatment of Carried Interest" (Dec. 6, 2018); and "Primer on Deal-by-Deal Funds: Balancing Deal Uncertainty Issues Against Attractive Carried Interest Opportunities (Part Three of Three)" (Nov. 8, 2018).

Profits Interest in a Tax Partnership: Analytical Considerations

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Carried interest arrangements offer the opportunity for Fund Managers to participate in a Fund's economic profits in a manner that generally retains the tax characterization of each item of gain, loss, income or deduction of the Fund. That result arises out of the intersection of the partnership tax provisions of Subchapter K of the Code and the compensation provisions of Sections 61 and 83 of the Code.

Statutory Scheme

Subchapter K of the Code governs the treatment of entities taxed as partnerships. Subchapter K includes Section 721 of the Code, which governs the purchase of partnership interests for cash, property or services. Upon purchase of a partnership interest, the acquirer generally has a basis in his or her partnership interest, which is then treated as a capital asset. Section 83 provides that property transferred in connection with the performance of services is included in the gross income of the employee in an amount equal to the fair market value of the property over the amount paid, generally at the first time at which the property is not subject to a substantial risk of forfeiture.

See "Use by Hedge Fund Managers of Profits Interests and Other Equity Stakes for Incentive Compensation" (Apr. 18, 2014); and "Ways Fund Managers Can Compensate and Incentivize Partners and Top Performers" (Dec. 14, 2017).

Judicial Background

The seminal cases of *Diamond v. Commissioner* and *Campbell v. Commissioner* addressed the intersection of the partnership and tax provisions of the Code, coming to different conclusions based on distinguishable facts. While this article does not provide a full review of those cases, a summary of the background is helpful to understand today's difficult issues.

In *Diamond*, Philip Kargman had acquired the buyer's rights in a contract for the sale of an office building for $25,000. Kargman asked Sol Diamond, a mortgage broker, to obtain a mortgage loan for the full $1,100,000 purchase price of the building. Diamond succeeded in obtaining a $1,100,000 mortgage loan. On December 15, 1961, Diamond and Kargman entered into an agreement that provided that:

- the two were associated as joint venturers for 24 years (the life of the mortgage) unless earlier terminated by agreement or by sale;
- Kargman was to advance all cash needed for the purchase beyond the loan proceeds;
- profits and losses would be divided 40 percent to Kargman and 6 percent to Diamond; and
- in the event of a sale, proceeds would first be devoted to repayment to Kargman of money supplied by him, and net profits thereafter would be divided 40 percent to Kargman and 60 percent to Diamond.

The purchase proceeded as planned, and closing took place on February 18, 1962. On March 8, 1962, Diamond assigned his interest to Kargman for $40,000. The U.S. Court of Appeals for the Seventh Circuit affirmed the lower court's decision that the profit interest had a determinable market value at the time it was awarded, as evidenced by the sale of that interest barely three weeks later, and therefore that the taxpayer should have recognized income at the time of his receipt of the interest.

By contrast, in *Campbell*, William Campbell was employed by Summa T. Group, a collection of business entities involved in the formation and syndication of limited partnerships. Campbell

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served as vice president and director for most members of the Summa T. Group, including Summa T. Realty, Inc., a real estate brokerage and consulting firm. Campbell negotiated a new compensation agreement under which he received, for his services, special limited partnership interests in the partnerships that he helped form and finance.

The Tax Court concluded that the fair market value of the interests should have been taxable for Campbell upon receipt under the principles of Section 83. On appeal, the U.S. Court of Appeals for the Eighth Circuit noted that in *Diamond*, "where the service provider became a partner solely to avoid receiving ordinary income, we have no doubt that the receipt of the profits interest was for services provided other than in a partner capacity." Campbell's interests, however, were not transferable and were not likely to provide immediate returns. Thus, the Eighth Circuit expressed "doubt that the [T]ax [C]ourt correctly held that Campbell's profits interests were taxable upon receipt." Furthermore, the court agreed with Campbell's argument that the interests had only uncertain value. Thus, the Eighth Circuit reversed the Tax Court's decision that the profits interest should have been taxable at grant.

Proposed Regulations

In 2005, in Notice 2005-43, the U.S. Department of the Treasury (Treasury) and the IRS released a proposal (collectively, the Proposed Compensatory Partnership Regulations) intended to provide greater clarity on the inconsistencies and conflicts between Subchapter K and Section 83 of the Code as they relate to partnership-related compensatory arrangements. The Proposed Compensatory Partnership Regulations imposed substantial challenges in respect of the design of carried interest arrangements, based on an analysis that gave relatively greater weight to Section 83 conceptual concerns in circumstances where those concerns intersected with Subchapter K theory. Those rules were never finalized.

In 2015, the IRS issued new proposed regulations under Section 707(a)(2) (the Proposed Section 707(a)(2) Regulations). These were primarily intended to address certain management-fee-deferral arrangements, a related, but substantially more limited and less ambitious objective than that underlying the Proposed Compensatory Partnership Regulations. The Proposed Section 707(a)(2) Regulations nevertheless have implications for certain design features unrelated to management-fee deferrals, including capped allocations of partnership income; allocations for one or more years under which the service provider's share of income is reasonably certain; allocations of gross (as contrasted with net) income; and allocations that are otherwise predominantly fixed in amount, reasonably determinable under the facts and circumstances or designed to assure that sufficient net profits are highly likely to be available to make the allocation to the service provider. The Proposed Section 707(a)(2) Regulations therefore have relevance to the design of carried interest arrangements. Even though they were relatively well-received by some commentators, they have not been finalized.

See "Tax Regulators Attack Hedge Fund Manager Efforts to Disguise Management Fees (Part One of Two)" (Aug. 27, 2015).

Revenue Procedure 93-27 and Revenue Procedure 2001-43

Revenue Procedure 93-27 provides that "the [IRS] will not treat the receipt of such an interest as a taxable event for the partner or the partnership," provided that:

- there are no liquidation rights or other features that would indicate that the recipient has received an interest in capital of the Fund or the sponsor;

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- the individual does not dispose of the interest within two years after receipt;
- the Fund's assets as to which the profits interests relate are not "related" to a substantially certain and predictable stream of income; and
- services are rendered to or for the benefit of the partnership.

The foregoing conditions may affect various design issues required to be addressed in the context of implementing a carried interest arrangement. Among the considerations that may arise are those relating to:

- valuation, since a threshold based on a mark that may be lower than actual fair market value might be considered an interest in capital of the Fund;
- preferential allocations of profits, since a right to a preferential allocation of profits might suggest an interest in a certain and predictable stream of income, which could be affected by the nature of the Fund's assets; and
- put and call rights on termination of employment, since the operation of put or call rights might result in participants having an interest in capital (rather than just profits) or give rise to the appearance of such an interest.

Revenue Procedure 93-27 does not expressly address how, or even whether, Section 83 applies to profits interests. Revenue Procedure 2001-43 clarifies the application of Revenue Procedure 93-27 to profits interests that are subject to vesting. Such interests will be deemed to have been transferred on the date of grant (notwithstanding that they may be subject to a risk of forfeiture following grant) for purposes of determining whether they qualify as interests only in profits of a partnership, provided that:

- the partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant, and the service provider takes into account the distributive share of partnership income, gain, loss, deduction and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest;
- upon the grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation or otherwise) for the fair market value of the interest; and
- all other conditions of Revenue Procedure 93-27 are satisfied.

Revenue Procedure 2001-43 does not explicitly provide that profits interests meeting the foregoing conditions are taxable under Section 83 principles. It does say that "taxpayers to which this revenue Procedure applies need not file an election under Section 83(b) of the Code." That formulation, however, does not clearly resolve the longstanding tension between the application of Section 83 and Subchapter K to these interests. In practice, Revenue Procedure 2001-43 most clearly impacts issues in the design of carried interest arrangements that relate to allocations on unvested awards.

Capital Shifts and Book-Ups

The intersection of Subchapter K and Section 83 may also result in other capital account operational issues, including potential issues related to capital shifts and book-ups.

Under Section 1.721-1(b)(1) of the Treasury Regulations, a shift in capital among partners could be regarded as a taxable event both for the partner receiving capital and those deemed to transfer

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an interest, to the extent that the interest transferred includes unrealized gains. Where a carried interest arrangement involves participation by Fund Managers in a Carry Vehicle that has unrecognized gains, the addition of a new Fund Manager participant or the allocation of additional units could be deemed to result in a capital shift, depending on its impact on the capital account of Fund Managers under the organizational documents governing the Carry Vehicle. Care must be taken to ensure that the addition of new Fund Managers does not inadvertently result in a capital shift under the provisions concerning accounting for capital accounts in the relevant agreement.

Similarly, Subchapter K generally provides that a partnership may, and in certain cases must, mark to market the value of its assets, including where there is an issuance of new partnership units. Generally, a "book-up" is a revaluation of a partnership's capital accounts based on the fair market value of the partnership's assets. The book-up is not itself a taxable event, but the partnership's approach to accounting for partners' capital accounts could cause complications, and unintentional tax results, in connection with the issuance of profits interests. Specifically, care must be taken to ensure that a failure (intentional or not) to book-up Fund Manager capital accounts does not result, under the Carry Vehicle's allocation and distribution provisions, in an economic allocation of a portion of the Carry Vehicle's unrealized gains to persons who are subsequently granted profits interests.

See "How Can Hedge Fund Managers Use Profits Interests, Capital Interests, Options and Phantom Income to Incentivize Top Portfolio Management and Other Talent?" (Aug. 22, 2013).

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