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Private Equity Carried Interest Clawbacks: Navigating Clawback Mechanisms, Fund Agreement Provisions, Tax Considerations

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Private Equity Carried Interest Clawbacks: Economic and Tax Implications for Sponsors and Investors

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Overview

- Fund waterfall options and carried interest economics
- Options for preserving the economic deal
- Tax implications of carried interest clawbacks
- Additional clawback considerations

Terminology

- Waterfall
- Investors / Limited Partners (“LPs”)
- Sponsor / General Partner (“GP”)
- Principals / GP Members
- Carried Interest / Carry
- Clawback
- Preferred Return / Hurdle
- Realized Investments
- Management Fee
- Expenses
- Allocations vs Distributions

Fund waterfall options and their economic implications for investors and the sponsor

Return-of-capital variations

- Priority return of all contributed capital before distribution of any preferred return or carried interest ("European waterfall")
- Return capital contributed for (or attributed to) "realized" investments only ("American waterfall") before carried interest distributions begin
- American waterfall variables include:
  - Definition of "realized" in relation to loss investments
    - "Written-off" vs "written-down"
    - Tax definition vs GAAP definition
  - Treatment of recapitalizations ("partial sale" approach is middle ground)
  - Timing for return of expense contributions ("allocable share" approach is common)
- Compromise approaches to return of capital (discussed later)

Preferred return and GP "catch-up" variations

- Preferred return variations
  - Waterfall may or may not include a preferred return
  - Preferred return rate variations
  - Preferred return calculation base variations
    - all investments vs only realized investments
    - all expenses vs expenses allocable to realized investments only
  - GP "catch-up" variations
    - Waterfall may or may not include a GP catch-up
    - Catch-up may be "fast" (GP gets 100% of next distributions)
    - Or slower (GP gets 80% or 50% of next distributions)

Hypothetical Fund

- Five investments made during investment period (aggregate cost $90m)
- Sale of first investment (cost $20m) in Year 3
- Sale of second investment (cost $20m) in Year 4
- Cumulative fees/expenses as of Year 3 sale date = $5m ($2m allocable to first investment), and $10m as of Year 4 sale date ($2m allocable to second investment), all funded with capital contributions
- GP's capital commitment is $0

Deal-by-deal carried interest distributions; no preferred return

- Yr 3 sale of first investment (cost $20m)
- Five investments made as of sale date (cost $90m)
- Cumulative expenses as of sale date = $5m ($2m allocated to first investment)

Yr 3 sale proceeds	52m	
Cost	20m	Investors
Expense recovery	2m	Investors
Profit	30m	
20% carried interest	6m	GP
Residual 80%	24m	Investors

Return all invested capital first; no preferred return

- Yr 3 sale of first investment; Yr 4 sale of second investment
- Investment cost as of Yr 3 and Yr 4 sale dates ($90m)
- Cumulative expenses as of Yr 3 sale date ($5m); Yr 4 sale date ($10m)

Yr 3 Sale proceeds	*52m*	
Cumulative capital contributions	*95m*	
Yr 3 proceeds to return invested capital	*52m*	Investors
Year 4 sale proceeds	*58m*	
Cumulative capital contributions	*100m*	
Yr 4 proceeds to return invested capital	*48m*	Investors
Remaining Yr 4 proceeds	*10m*	
GP 20% carried interest	*2m*	GP
Residual 80%	*8m*	Investors

Deal-by-deal carried interest distributions with preferred return

- Yr 3 sale of first investment (cost $20m)
- Five investments made as of sale date (cost $90m)
- Cumulative expenses as of sale date = $5m ($2m allocated to first investment)
- Cumulative preferred return as of sale date = $12m ($4m allocated to first investment)

Yr 3 sales proceeds	*57m*	
Return cost of first investment	*20m*	Investors
Expense recovery	2m	Investors
Preferred return	4m	Investors
Remaining Profit	*31m*	
"GP catch-up" on preferred return	1m	GP
Remaining Profit	*30m*	
20% carried interest	6m	GP
Residual 80%	24m	Investors

Full return of capital, with preferred return

- Yr 3 sale of first investment; Yr 4 sale of second investment
- Investment cost as of Yr 3 and Yr 4 sale dates ($90m)
- Cumulative expenses as of Yr 3 sale date ($5m); Yr 4 sale date ($10m)
- Cumulative preferred return as of Yr 4 sale date = $4m

Yr 3 Sale proceeds	*50m*	
Cumulative capital contributions	*95m*	
Yr 3 proceeds to return invested capital	*50m*	Investors
Year 4 sale proceeds	*65m*	
Cumulative capital contributions	*100m*	
Yr 4 proceeds to return capital contributions	50m	Investors
Preferred return	4m	Investors
Remaining Yr 4 proceeds	*11m*	
GP catch-up on preferred return	1m	GP
Remaining Profit	*10m*	
20% carried interest	2m	GP
Residual 80%	8m	Investors

GP catch-up

- Catch-up = disappearing hurdle
- No catch-up = permanent hurdle/preference (some real estate funds)
- Fast catch-up = most common buyout fund approach
- Slow catch-up = secondary funds and fund of funds

	Fast catch-up	Slow catch-up
Cumulative profit	*100m*	*100m*
Cumulative LP preferred return	10m	10m
Next distributions	(100% to GP)	(50/50)
- GP	2.5m	3.33m
- LP	---	3.33m
Remaining profit	*87.5m*	*83.33m*
- 20% GP carry	17.5m	16.67m
- 80% residual	70m	66.67m
Total GP profit distributions	20m	20m
Total LP profit distributions	80m	80m

Options for preserving the economic deal

Preserving the economic deal: overview

- Competing objectives
  - Sponsor wants carried interest distributions as soon as possible
  - Investors want capital returned as soon as possible (and want to avoid overdistribution to GP)
- "Fair Value Capital Account" limitation on distributions
- End-of-fund carried interest clawback
- Interim clawbacks/true-ups

Fair value capital account limitation

- Compromise between American and European waterfalls
- GP may receive carried interest distributions prior to full return of capital if/when:

  LPs' fair value capital accounts

  + cumulative distributions to LPs

  ≥ [120%] of LP capital contributions

- Fair value capital account = capital account if all assets valued at FMV

Carried interest clawback basics

- If GP is distributed (a) more than its carried interest percentage (e.g., 20%) of cumulative net profits (over the fund's life), or (b) any carried interest in a fund that ultimately does not satisfy the preferred return hurdle, GP must return any overdistributed carried interest (subject to a cap equal to the aggregate after-tax carried interest it received) to the partnership
- How do clawback scenarios arise?
  - Early gains / late losses
  - Capital called in increments
  - American waterfall
  - Preferred return accrual
- Can it happen with a European waterfall?
- Tax considerations discussed later

Carried interest clawback – example 1

Fund has American waterfall; LP commitments = $100; GP commitment is $0. No preferred return. Fund makes Investments 1 and 2 in Year 1 at cost of $20 each. In Year 3, Investment 1 is sold for $74. Cumulative expenses as of Year 3 = $8, funded with LP contributions.

Year 3 sale proceeds	*$74*	
Return of Investment 1 capital contribution	$20	Investors
Return of allocable expense contributions	$ 4	Investors
Carried interest	$10	GP
Residual 80%	$40	Investors

In Year 6, Fund sells Investment 2 for $10 and liquidates. Cumulative expenses as of Year 6 = $14, funded by LP contributions.

Year 6 sale proceeds	*$10*	
Return of capital contributions	$10	Investors
Total proceeds to Investors & GP	$84	
Total capital contributions	$54	
Cumulative fund profit	$30	
20% of cumulative fund profit	$ 6	
Total proceeds to GP	$10	
Clawback obligation (prior to after-tax cap)	$ 4	

Carried interest clawback – example 2

Fund has European waterfall; LP commitments = $100; GP commitment is $0. No preferred return. Fund makes Investments 1 and 2 in Year 1 at cost of $20 each. In Year 3, Investment 1 is sold for $60. Cumulative expenses as of Year 3 = $10, funded with LP contributions.

Year 3 sale proceeds	*$60*	
Return of capital contributions	$50	Investors
Carried interest	$2	GP
Residual 80%	$8	Investors

In Year 4, Fund makes Investments 3 and 4 at cost of $20 each. In Year 5, Fund sells Investment 2 for $10. In Year 6, Fund sells Investments 3 and 4 for $15 each and liquidates. Cumulative expenses as of Year 6 = $20, funded by LP contributions.

Year 5 sale proceeds	*$10*	
Return of capital contributions	$10	Investors
Year 6 sale proceeds	*$30*	
Return of capital contributions	$30	Investors
Total proceeds to Investors	$98	
Cumulative fund profit	($2)	
Total proceeds to GP	$2	
Clawback obligation (prior to after-tax cap)	$2	

Carried interest clawback – example 3

Fund has American waterfall; LP commitments = $100; GP commitment is $0. Preferred return is 8%. Fund makes Investments 1 and 2 in Year 1 at cost of $50 each. At the end of Year 2, Investment 1 is sold for $90; the accrued preferred return at that time is $16. Assume no expenses for simplicity.

Year 2 sale proceeds	*$ 90*	
Return of Investment 1 capital contribution	$ 50	Investors
Allocable share of accrued pref	$ 8	Investors
Catch-up	$ 2	GP
Additional carried interest	$ 6	GP
Residual 80%	$ 24	Investors

In Year 9, Fund sells Inv. 2 for $50 and liquidates when the accrued preferred return is $40.

Year 9 sale proceeds	*$ 50*	
Return of Investment 2 capital contribution	$ 50	Investors
Total proceeds to Investors & GP	$140	
Total capital contributions	$100	
Cumulative fund profit	$ 40	
20% of cumulative fund profit	$ 8	
Total proceeds to GP	$ 8	
Invested capital + preferred return	$140	
Actual distributions to investors	$132	
Clawback obligation (prior to after-tax cap)	$ 8	

Interim carried interest clawbacks

- Clawback obligation calculated prior to fund liquidation (e.g., 8th / 10th anniversary of fund commencement) based on hypothetical liquidation of fund at FMV
- Reduces period of time during which GP may be overdistributed
- But creates possibility of unwarranted return of carried interest (i.e., before full potential of all investments is realized)
- Interim clawback may ignore capital called, and preferred return accruing, since last realization/distribution
- Generally preferable to carried interest escrow because GP permitted to receive carry distributions on regular schedule
- Interim clawback distributions to LPs treated as advances of distributions under regular waterfall

Interim carried interest clawback - example

Fund has European waterfall; LP commitments = $100; GP commitment is $0. No preferred return. Fund makes Investments 1 and 2 in Year 1 at cost of $20 each. In Year 3, Investment 1 is sold for $60. Cumulative expenses as of Year 3 = $10, funded with LP contributions.

Year 3 sale proceeds	*$60*	
Return of capital contributions	$50	Investors
Carried interest	$2	GP
Residual 80%	$8	Investors

In Year 4, Fund makes Investments 3 and 4 at cost of $20 each. In Year 8, Investments 2 and 3 each have a value of $10 and Investment 4 is still valued at $20. Cumulative expenses as of Year 8 = $20, funded by LP contributions.

Year 8 hypothetical liquidation value	*$40*	
Return of capital contributions	$40	Investors

Total investor capital contributions	$100
Total distributions to Investors (including hypothetical liquidating distribution)	$98
Cumulative (hypothetical) fund profit	($2)
Actual distributions to GP	$2
Interim clawback obligation (prior to after-tax cap)	$2

Tax implications of carried interest clawbacks

Overview

- Flow-through taxation
- Capital accounts / allocation basics
- Carried interest and phantom income
- Carried interest clawbacks: tax considerations

Capital accounts and income/loss allocations

- What is a capital account and how is it adjusted?
  - Contributions, distributions, profit allocations, loss allocations
- Types of capital accounts
  - Financial reporting / GAAP
  - 704(b) capital account maintenance
  - Allocations of tax items

Fund allocations – underlying principles

- ***Key point***: allocations of income may precede or follow distributions of cash – can have tax without cash, or cash without tax
- Distribution-driven agreement: drive each partner's capital account to match that partner's distributable amount in "hypothetical liquidation"
  - Use of 704(b) "book" value in hypothetical liquidation
- Allocation-driven agreement: same fundamental principle guides drafting of allocation language, but allocations ultimately dictate distribution amounts
- Starting point: capital contributions are credited to capital accounts
- Typically allocate only realized gains/losses for tax purposes
- Capital account can go negative in certain situations (including a clawback scenario)

Typical allocation sequence

(a) Profits:

(i) Reverse residual loss allocations (i.e., tier (b)(iv) below)

(ii) Preferred Return allocation

(iii) GP catch-up

(iv) 80% to all Partners; 20% to GP (carried interest)

(b) Losses:

(i) Reverse residual profits (i.e., 80/20 profits)

(ii) Reverse GP catch-up

(iii) Reverse preferred return allocations

(iv) To the partners in proportion to their capital commitments

Carried interest and "phantom income"

- How does it happen? Examples:
  - European waterfall – various scenarios
    - Any time realized gain exceeds prior losses and accrued preferred return but LPs have not received distributions equal to invested capital plus preferred return
    - Example: early winner after multiple investments with no prior realizations
  - American waterfall
    - prior "permanent write-downs" that may not yet have resulted in tax loss allocations (assuming such write-downs are treated as "realizations" for waterfall purposes)
    - Recycling

Carried interest - phantom income example

Fund has European waterfall. Fund makes 3 investments of $100 each in Year 1. Investment 1 is sold at end of Year 2 for $225 when accrued preferred return is $20. All capital invested by LPs. For simplicity, assume no expenses.

Year 2 allocation of $125 investment gain

- $20 of gain to LPs in respect of accrued preferred return
- $5 of gain to GP in respect of GP catch-up
- $20 of gain to GP in respect of carried interest and $80 of gain to LPs as residual profit

Year 2 distribution of $225 Investment 1 sale proceeds

- $225 to LPs to return capital

Carried interest clawbacks – general tax considerations

- Clawback means GP allocated gains first, then losses later
- Losses are often capital losses
  - Usable only against capital gains (+$3k of OI per year)
  - GP members cannot carry back capital losses to offset prior income allocations
- Loss allocation also could consist of expense items (e.g., management fee expense, organizational expenses, etc)
  - Often, the tax deductions associated with these expenses are not usable by GP members
- Clawback may be net of taxes ("tax-effected")
  - Typically, only the clawback cap is tax-effected
- Tax-effected clawback may be increased by tax benefits (if any)

Carried interest clawbacks – effect on allocations of profits/losses to capital accounts

- GP clawback drives allocations of taxable income/loss
  - GP clawback arises only if GP has received carried interest distributions
    - GP with clawback obligation typically has been allocated taxable income (previously)
- Distribution-driven LPA
  - Hypothetical liquidation must take into account clawback
  - If clawback would occur, losses/expenses are allocated to GP
- Allocation-driven LPA
  - Same result; different language
  - In loss years, fund typically allocates loss first to GP to reverse prior allocations of carried interest

Clawback tax implications – Example 1

(Effect of clawback on GP allocations and tax liability prior to liquidation)

Fund has American waterfall and makes 3 investments of $100 each in Year 1. Investment 1 is sold at end of Year 2 for $225. All capital invested by LPs. For simplicity, assume no expenses or preferred return, and no tax distributions.

Year 2 allocations ($125 gain), distributions ($225 sale proceeds) and GP tax liability:

Carried interest allocation	$25	GP
Residual profit allocation	$100	Investors
GP federal income tax on allocated gain	~$6	(i.e., 23.8% x $25)
Sale proceeds distributed		
Return of capital on Investment 1	$100	Investors
GP carried interest	$25	GP
Residual proceeds	$100	Investors
Year 2 ending GP capital account	$0	(+$25 allocation - $25 distribution)

In Year 4, Fund sells Investments 2 and 3 for $50 and $25, respectively. Year 4 allocations ($125 loss), distributions ($75 sale proceeds) and GP tax results:

Reversal of previous carry allocation	($25)	GP (or is it ($19)?)
Residual loss allocation	($100)	Investors (or is it $106?)
Sale proceeds distributed	$75	Investors
Year 4 ending GP capital account	($25)	Or is it ($19)?
Tax character of GP loss allocation	Long-term capital loss	

Clawback tax implications – Example 2

(Effect of taxes on clawback calculation)

Same facts as in Example 1. Fund makes no further investments and then liquidates at the end of Year 6.

Excess carry distributions to GP	$25
Tax paid by GP members on carry allocations	$6
Possible clawback amounts	$19 or $25

Key Questions: Is the $25 of Year 4 capital loss (allocated to GP) taken into account in determining GP's clawback obligation? Should it be? If so, how?

Considerations:

- Fund's clawback calculation mechanics may include or exclude the $25 of capital loss
- In some cases, it may matter when the $25 of capital loss is realized (i.e., during Fund's life vs year of liquidation)
- In some cases, it may matter whether/when GP members are able to use the $25 capital loss (e.g., Year 4 vs Year 6 vs sometime after liquidation year)

Clawback tax implications – Example 3

(Tax implications for LPs)

Same facts as Example 2. Assume GP makes a clawback payment of $19.

Questions:

- Is the clawback amount paid to Fund or directly to LPs?
- What is the tax characterization of the clawback payment from the LPs' perspective?
- LPs' aggregate tax basis in Fund prior to liquidation is $25:

  $300 capital contributions
  \+ $100 gain allocated
  \- $275 distributions
  \- $100 loss allocated
  = $25 tax basis

  If clawback payment is only $19, how is the $6 difference treated for tax purposes from the LP's perspective?

Additional clawback considerations

Selected clawback features

- Partner-by-partner vs partners-as-a-whole
    - Implications of deal-by-deal preferred return
- Income-based computation vs distribution-based computation
- Effect of expenses
- Coordination with undertaking/guarantee
- Use of / coordination with GP level escrows

GP-level implications of carried interest clawbacks

- Clawback contribution requirements in GP agreement
  - Partner-by-partner allocation of giveback obligation
- Effect of personal guarantee on GP agreement
- Flow-through of tax implications to GP members
- Ability to accelerate clawback under GP agreement

Clawback workouts

- Deferral of clawback obligation
- Acceleration of clawback obligation (possibly with a discount)
- Forgiveness of clawback obligation
- Typical consideration
  - Reduction of future management fees
  - Reduction of future carried interest
- Tax implications
- Issues where GP members share differently in fee/carry income
- Issues with respect to departed / non-active GP members