

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

Structuring Distribution Waterfalls and Carried Interest Clawbacks; Carried Interest Sharing at the Fund Sponsor Level; Related Planning and Drafting to Address Tax Consequences

TUESDAY, JUNE 18, 2019

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

David H. Stults, Partner, **Kirkland & Ellis**, Chicago

Aalok Virmani, Partner, **Kirkland & Ellis**, Chicago

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 1.**

Tips for Optimal Quality

FOR LIVE EVENT ONLY

Sound Quality

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial **1-888-450-9970** and enter your PIN when prompted. Otherwise, please **send us a chat** or e-mail sound@straffordpub.com immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

Viewing Quality

To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.

Continuing Education Credits

FOR LIVE EVENT ONLY

In order for us to process your continuing education credit, you must confirm your participation in this webinar by completing and submitting the Attendance Affirmation/Evaluation after the webinar.

A link to the Attendance Affirmation/Evaluation will be in the thank you email that you will receive immediately following the program.

For additional information about continuing education, call us at 1-800-926-7926 ext. 2.

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the ^ symbol next to “Conference Materials” in the middle of the left-hand column on your screen.
- Click on the tab labeled “Handouts” that appears, and there you will see a PDF of the slides for today's program.
- Double click on the PDF and a separate page will open.
- Print the slides by clicking on the printer icon.

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

David H. Stults
david.stults@kirkland.com

Aalok Virmani
aalok.virmani@kirkland.com

Kirkland & Ellis LLP

June 18, 2019

Overview

- Typical waterfall variations and their economic implications for investors and the sponsor
- Carried interest clawbacks
- Carried interest sharing arrangements at the general partner level
- Tax ramifications, allocation provisions and tax distributions

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

Typical waterfall variations 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
 - Interim clawbacks/true-ups
 - “Fair Value Capital Account” approach: 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

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	
<i>Cumulative capital contributions</i>	95m	
Yr 3 proceeds to return invested capital	52m	Investors
<i>Year 4 sale proceeds</i>	58m	
<i>Cumulative capital contributions</i>	100m	
Yr 4 proceeds to return invested capital	48m	Investors
<i>Remaining Yr 4 proceeds</i>	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)

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

<i>Yr 3 Sale proceeds</i>	<i>50m</i>	
<i>Cumulative capital contributions</i>	<i>95m</i>	
Yr 3 proceeds to return invested capital	50m	Investors
<i>Year 4 sale proceeds</i>	<i>65m</i>	
<i>Cumulative capital contributions</i>	<i>100m</i>	
Yr 4 proceeds to return capital contributions	50m	Investors
Preferred return	4m	Investors
<i>Remaining Yr 4 proceeds</i>	<i>11m</i>	
GP catch-up on preferred return	1m	GP
<i>Remaining Profit</i>	<i>10m</i>	
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

	Fast catch-up	Slow catch-up
<i>Cumulative profit</i>	100m	100m
Cumulative LP preferred return	10m	10m
Next distributions	(100% to GP)	(50/50)
- GP	2.5m	3.33m
- LP	---	3.33m
<i>Remaining profit</i>	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

Partner-by-partner vs aggregated waterfall

- Partner-by-partner approach facilitates:
 - Reduction/elimination of fee and carry burden for certain partners (e.g., GP and estate planning vehicles of the Principals)
 - Excuse/exclusion of particular partners from specific investments
- Incremental accounting complexity is modest
- Typically implemented as follows:
 - Apportion distributions pro rata (according to capital contributions for the investment) among all partners participating in the particular investment
 - Distribute GP/affiliated partners' apportioned amount to them
 - Amount apportioned to each other partner runs through waterfall

Other considerations

- Losses / write-offs / write-downs
- Capital called in increments over investment period
- Tax distributions (discussed later)
- In-kind distributions
- Liquidation
 - “Distribution-driven” vs
 - “Allocation-driven”

Carried interest clawbacks

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
- Why does it happen?
 - Capital called in increments
 - American waterfall
 - Preferred return accrual
- Can it happen with a European waterfall?
- Tax considerations discussed later

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.

<i>Year 3 sale proceeds</i>	\$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 \$16 each and liquidates. Cumulative expenses as of Year 6 = \$20, funded by LP contributions.

<i>Year 5 sale proceeds</i>	\$10
Return of capital contributions	\$10 Investors
<i>Year 6 sale proceeds</i>	\$32
Return of capital contributions	\$32 Investors
Total proceeds to Investors	\$100
Cumulative fund profit	\$0
Total proceeds to GP	\$2
Clawback obligation (prior to after-tax cap)	\$2

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)
- 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.

<i>Year 3 sale proceeds</i>	\$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.

<i>Year 8 hypothetical liquidation value</i>	\$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	

Carried interest sharing arrangements at the general partner level

Characteristics of Across the Fund Carried Interest

- Participate at same percentage in all deals done prior to arrival, during service and after departure
- Vesting does not vary deal-by-deal (e.g., a deal sold in Y2 is not 100% vested upon sale)
- No ability to exclude individuals from appreciation on specific deals, but can exclude from appreciation overall as of some date (e.g. prior to admission)
- No ability to give deal team extra carry in individual deals
- Encourages attention to struggling deals by everyone at the firm
- Strongest alignment of interest with LPs



Example of Across the Fund Carried Interest

Principal (years of service)	Percentage Share	Vested Interest upon Departure
Principal A (1 year)	10%	2%
Principal B (2 years)	5%	2%
Principal C (6 years)	2%	2%

Characteristics of Deal-by-Deal Carried Interest

- Ability for people to “own their deals”
- Ability to incentivize “venture partners” or others who may be hired only for one or a limited number of companies
- Ability to have investment principals only participate in deals done while they are at the firm, and not before or after
- Ability to accelerate vesting on realized deals or to otherwise have deal-by-deal vesting (can avoid deals done near the end of the commitment period being substantially vested at closing)
- Ability to promote people over time into larger shares of carry on some, but not all, deals

Deal-by-Deal Carry Sharing Approaches

- 1) Some variation of the “let the chips fall where they may” approach



- 2) Equalize distribution ratios



Examples of Deal-by-Deal Carried Interest

Assume that each Principal receives 10% of the carried interest generated by its own deals and 5% of the carried interest generated by any other deals (and none has left the firm).

Sale of Principal A's deal	100m profit (20m carried interest)
	2m Principal A
	1m Principal B
	1m Principal C
Sale of Principal B's deal	100m profit (20m carried interest)
	1m Principal A
	2m Principal B
	1m Principal C
Sale of Principal C's deal	100m profit (20m carried interest)
	1m Principal A
	1m Principal B
	2m Principal C

Aggregate carried interest of \$60m from the fund, allocated \$4m to each Principal. All deals were profitable, and carry allocations align generally with results.

Examples of Deal-by-Deal Carried Interest

If, however, prior to the sale of Principal C's deal, Principal B sold its deal for a \$100 million loss:

Sale of Principal A's deal	100m profit	(20m carried interest)
	2m	Principal A
	1m	Principal B
	1m	Principal C
Sale of Principal B's deal	100m loss	No distribution
Sale of Principal C's deal	100m profit	No distribution due to prior realized loss
	0	Principal A [1m]
	0	Principal B [1m]
	0	Principal C [2m]

In a "let the chips fall where they may" approach, even though Principal A's deal was just as profitable as Principal C's deal, such that they both "earned" the fund the same amount of gross profit, Principal A receives twice as much carry as Principal C because Principal C's deal's profits were used to offset the loss generated by Principal B's deal at the fund level. One might also expect Principal B to receive \$0, since Principal B's deal was sold for a loss, but Principal B receives \$1m.

Examples of Deal-by-Deal Carried Interest

If the timing is reversed, and Principal C's deal is the first one realized:

Sale of Principal C's deal	100m profit	(20m carried interest)
	1m	Principal A
	1m	Principal B
	2m	Principal C
Sale of Principal B's deal	100m loss	No distribution
Sale of Principal A's deal	100m profit	No distribution due to prior
realized loss		
	0	Principal A [2m]
	0	Principal B [1m]
	0	Principal C [1m]

In a "let the chips fall where they may" approach, even though Principal A's deal was just as profitable as Principal C's deal, such that they both "earned" the fund the same amount of gross profit, Principal C receives twice as much carry as Principal A because Principal A's deal's profits were used to offset the loss generated by Principal B's deal at the fund level. One might also expect Principal B to receive \$0, since Principal B's deal was sold for a loss, but Principal B receives \$1m.

Is there a fairer way to apportion net carried interest under the deal-by-deal approach?

Examples of Deal-by-Deal Carried Interest – Equalized Distribution Ratios

In order to account for potentially arbitrary or inequitable results when certain deals generate losses, distributions of carry can be made so as to equalize the ratio of profits that ultimately are distributed to (and retained by) the Principals to the profits that *would* have been received by each Principal had there been sufficient aggregate carried interest to distribute to all Principals with a net positive “earned” carry, the full net positive carry “earned” by them.

Carried Interest “earned” by each Principal across all deals:

2m	Principal A
0m	Principal B
2m	Principal C

Actual aggregate distributable net Carried Interest:

4m

Target net Carried Interest distribution:

2m	Principal A
0m	Principal B
2m	Principal C

Note that to get the target distributions, assuming no future deals, Principal B would need to return \$1m

Examples of Deal-by-Deal Carried Interest – Equalized Distribution Ratios

If there were a second deal by Principal C (for a total of 4 deals), which was sold for a \$200m profit, the “earned” carried interest for each Principal across all deals would be:

4m Principal A

2m Principal B

6m Principal C

Actual aggregate distributable net Carried Interest: 12m

Target Carried Interest distribution for Deal 4 assuming prior distributions made per the prior example with no distributions returned by Principal B:

	Prior Carry Distributions	Target Carry	Incremental Carry Distributions
Principal A	2m	4m	2m
Principal B	1m	2m	1m
Principal C	1m	6m	5m

Selected tax considerations

Overview

- Flow-through taxation
- Capital accounts / allocation basics
- Carried interest and phantom income
- Characterization of certain carried interest income
- Carried interest clawbacks: tax considerations
- Expense allocations
- Tax distributions

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

Interaction between capital accounts and partner economics

- Allocation-driven agreements
 - Liquidation based on capital account balances
 - Means partner economics are ultimately dictated by allocations of income and loss among capital accounts
 - Greater tax certainty; potential economic uncertainty
- Distribution-driven agreements
 - Liquidation based on distribution waterfall
 - Means partner economics are dictated by the distribution waterfall
 - Greater economic certainty; potential tax uncertainty

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
- Book-ups rare in PE, venture and debt funds
- In-kind asset contributions are rare (other than in RE funds) so built-in gains also rare
- In profitable years, expense allocations follow profit allocations unless specific economic deal says otherwise

Sample allocation format: allocation-driven LPA

(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

Allocation-driven LPA (cont'd)

- Regulatory allocation provisions
 - Qualified income offset
 - Minimum gain chargebacks
 - Nonrecourse deductions
 - Rarely come into play for plain vanilla buyout/venture fund investing only in corporations
 - More relevant for real estate funds and flow-through investments
- “Fractions rule” (for real estate funds)

Sample allocation language: distribution-driven LPA

Items of Partnership **income, gain, loss, expense or deduction** for any fiscal period **shall be allocated** among the Partners **in such manner that**, as of the end of such fiscal period and to the greatest extent possible, **the Capital Account of each Partner shall be equal to the** respective net amount, positive or negative, **that would be distributed to such Partner** from the Partnership **or for which such Partner would be liable** to the Partnership under this Agreement, **determined as if**, on the last day of such fiscal period, **the Partnership were to (a) liquidate the Partnership's assets for an amount equal to their book value** (determined according to the rules of Treas. Reg. §1.704-1(b)(2)(iv)) **and (b) distribute the proceeds in liquidation in accordance with [Liquidation Provision / Distribution Waterfall].**

- References to “minimum gain” sometimes included
- Some regulatory allocation language often included

Fund allocations – hypothetical liquidation

Example

American waterfall; all capital from LPs

Three investments made as of Year 3 (cost \$30m each)

No prior exits

Investment 1 sold for \$55m in Year 5

Ignore expenses for simplicity

Accrued and unpaid preferred return as of sale date = \$4m

(Assume for simplicity that all \$4m of pref is allocable to Investment 1)

FMV of remaining investments \$200

Hypothetical liquidation (cont'd)

Distributions

<i>Yr 5 sales proceeds</i>	55m	
Return cost of Investment 1	30m	Investors
Preferred return on Investment 1	4m	Investors
<i>Remaining Proceeds</i>	21m	
“GP catch-up” on preferred return	1m	GP
<i>Remaining Proceeds</i>	20m	
20% carried interest	4m	GP
Residual 80%	16m	Investors

Allocations

	Investors	GP	Total
Capital accounts on Day 1, Year 5	\$90m	\$0	
Year 5 distributions	(\$50m)	(\$5m)	\$55m
Year 5 capital accounts before allocations	\$40m	(\$5m)	\$35m
Year 5 net profit			\$25m
Cumulative net profit			\$25m
Distribution entitlement (hypothetical liquidation)*	\$60m	\$0m	\$60m
Year 5 profit allocation	\$20m	\$5m	\$25m
Ending capital accounts	\$60m	\$0m	\$60m

*FMV of remaining investments ignored (hypothetical liquidation is based on book value)

Fund allocations – hypothetical liquidation (cont'd)

Example

Same facts, except that the accrued preferred return as of the date of the Investment 1 sale is \$12m (\$4m attributable to each investment)

<u>Allocations</u>	<u>Investors</u>	<u>GP</u>	<u>Total</u>
Capital accounts on Day 1, Year 5	\$90m	\$0	\$90m
Year 5 distributions	(\$50m)	(\$5m)	\$55m
Year 5 capital accounts before allocations	\$40m	(\$5m)	\$35m
Year 5 net profit			\$25m
Cumulative net profit			\$25m

Distribution entitlement (hypothetical liquidation)

Entitlement if ignore additional \$8m of unrealized pref:	\$60m	\$0m	\$60m
- Resulting Year 5 profit allocation	\$20m	\$5m	\$25m
- Ending Capital Accounts	\$60m	\$0m	\$60m

Entitlement if consider additional \$8m of unrealized pref:	*\$65m	(\$5m)	\$60m
- Resulting Year 5 profit allocation	\$25m	\$0m	\$25m
- Ending Capital Accounts	\$65m	(\$5m)	\$60m

- *But this approach assumes that GP's Year 5 carry distribution is automatically subject to clawback even though GP is in fact entitled to receive carry in Year 5 (i.e., inconsistent with American waterfall)*
- *This approach also causes GP's Year 5 distribution to exceed GP's tax basis*

** Although LPs would be entitled to \$68m, there is only \$60m of assumed asset value (plus \$5m GP clawback)*

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 GAAP write-offs that may not yet have resulted in tax loss allocations (assuming GAAP write-offs are considered “realizations” for waterfall purposes)
 - Recycling

Carried interest - phantom income Example 1

European waterfall, early winner, multiple investments, no prior realizations

3 investments of \$100 each made 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 3 distribution of \$225 Investment 1 sale proceeds

- \$225 to LPs to return capital

Carried interest - phantom income Example 2

American waterfall, prior GAAP writeoff not yet “realized” for tax purposes

3 investments of \$100 each made in Year 1. Investment 1 is written down to \$0 for GAAP purposes in Year 2, but not yet written off for tax purposes. Investment 2 is sold at end of Year 3 for \$240 when accrued preferred return on Investments 1 and 2 is \$32. All capital invested by LPs. For simplicity, assume no expenses.

Year 3 allocation of \$140 investment gain

- \$32 of gain to LPs in respect of accrued preferred return on Inv 1 & 2
- \$8 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 3 distribution of \$240 Investment 1 sale proceeds

- \$100 to LPs to return capital for Investment 1 (“realized” due to GAAP writedown)
- \$100 to LPs to return capital for Investment 2
- \$32 to LPs as accrued preferred return on Inv 1 & 2
- \$8 to GP as GP catch-up

Carried Interest Taxation

- Private equity funds are typically entities classified as partnerships for federal income tax purposes and the issuance of profits interests to service providers can be effected without current taxation – causing substantial controversy
- Section 1061 requires three-year holding period for long-term capital gain rates with respect to profits interests in an investment partnership
- This rule will generally apply to carried interest and profits interest received in respect of a management fee waiver
- Recharacterizes gains that do not meet holding period requirement as short-term capital gains
- Exceptions:
 - Capital interests: does not apply to partnership interests where right to share in partnership capital and profits is commensurate with (i) partner's capital contribution or (ii) value of interest taxed under Code Section 83
 - Partnership interests held directly or indirectly by a corporation (per IRS guidance, S corporations will not be considered corporations for this purpose)

Carried Interest Taxation – Holding Periods

- Which holding period is relevant?
 - Statute is not clear; applies to gain “with respect to” applicable partnership interests
 - For the sale of a partnership asset, the relevant holding period appears to be partnership’s holding period for the asset
 - For the sale of a partnership interest, the relevant holding period appears to be partner’s holding period for the interest
- Holding period for fund investments
 - Original investment vs. follow-on investments
 - Holding period of follow-on investments

Carried Interest Taxation – Other

- Are the following types of income or gain subject to recharacterization?
Were they meant to be?
 - Qualified dividend income: does not apply to qualified dividend income
 - Section 1231 gain: apparently does not apply to sale of property used in a trade or business (real estate, gain on sale of assets of flow-through portfolio company engaged in a trade or business)
 - Enterprise value of sponsor's business: to the extent provided in regulations, will not apply to income or gain attributable to any asset not held for portfolio investment on behalf of third party investors
- Self-employment tax? Net investment income tax?
- S corporations?
- Expecting guidance (and litigation)

Carried interest clawbacks – 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”)
- 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 almost always 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

Fund allocations – expenses (distribution-driven agreement)

3 investments of \$100 each made in Year 1. Investment 1 is sold at end of Year 2 for \$210. Expenses in each of Years 1 and 2 = \$10 of management fees (each year). For simplicity, assume no preferred return. LPs contribute all capital. Carried interest is computed net of expenses.

Year 1 allocation of \$10 management fee expense: All to LPs

Year 2 allocation of \$110 investment gain

- \$10 to LPs to reverse Year 1 expense allocation
- \$20 of gain to GP in respect of carried interest and \$80 of gain to LPs as residual profit

Year 2 allocation of \$10 management fee expense

- Follows gains: \$2 to GP and \$8 to LP (ignores reversal of prior losses)

Problem: Management fee expense deductions likely not usable by GP members

- But GP members are taxable on the management fee income
- Can we specially allocate expenses entirely to LPs?

Tax distributions

- Intended to address phantom income problem
- Often takes into account prior-year losses
- This can leave GP with tax liability in excess of cash in any given year
- May cover all partners or GP only
- Typically based on various assumptions/rules:
 - Fund income/loss is the only income/loss considered
 - Tax rates (residence, individual vs corporate, which people)
 - Character of income
 - Which taxes to include (federal and state income tax, Medicare tax, etc)
 - Counts toward future distributions
 - Reduce by prior/concurrent distributions

Tax distribution – example

European waterfall. 3 investments of \$100 each made in Year 1. Investment 1 is sold during Year 2 for \$225 when accrued preferred return is \$20. All capital invested by LPs. For simplicity, assume no expenses. No other income/loss during Years 1 or 2.

Year 2 allocation of \$125 investment gain (assume LTCG)

- \$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 (absent tax distribution)

- \$225 to LPs to return capital
- But GP members may have Year 2 tax liability of ~\$10 (i.e., 40.8% of \$25)

Issues to consider

- Since GP members' Year 2 tax liability is not due until Year 3, can/should GP retain part of \$225 Year 2 sale proceeds to cover tax distribution?
- Can GP make a tax distribution only to GP?
- Can GP call capital to cover tax distribution in Year 3?
- How is the \$10 tax distribution treated under the waterfall?