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Taxation of Carried Interests for Senior-Level Fund Managers

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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 article 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 article 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.

Introduction

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 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.

Profits Interest in a Tax Partnership

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.

Analytical Considerations

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.

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% to Kargman and 60% 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% to Kargman and 60% 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 profits 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 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.

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;
- 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 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.

Practical and Design Considerations

83(b) Elections

Generally, a person who receives "property" in connection with the performance of personal services is taxable under Section 83 in respect of that compensation at the earlier of the time that the property is no longer subject to a substantial risk of forfeiture or is transferable, based on the fair market value of the property at that time. Section 83(b) allows a service provider to elect instead to be subject to tax upon the earlier transfer of the property to it, prior to it becoming substantially vested or transferable, based on its fair market value at the time of transfer. Accordingly, making a Section 83(b) election can limit the extent to which a service provider might be subject to tax at ordinary rates on appreciation in the value of property that has been transferred.

As noted above, Revenue Procedure 2001-43 provides that recipients of profits interest are not required to make Section 83(b) elections, even if the profits interests are not transferable and are subject to vesting conditions, in order to be entitled to the potential long-term capital gains treatment arising from the pass-through nature of partnership income. Nevertheless, because of the risks associated with compliance with the requirements of Revenue Procedure 93-27 and 2001-43 noted above, many practitioners advise clients to make protective Section 83(b) elections. This may be viewed as a particularly sensible approach where, for example, there is a concern that, contrary to the expectation of the parties, the interests granted may realistically be disposed of within two years. It may also be considered where the Fund may over time generate more predictable streams of income, even if unanticipated at the time of grant.

A Section 83(b) election allows the recipient of unvested "property" to include into income the value of the property upon transfer instead of including it into income at the time the property later vests (if it ever vests). The general idea behind a Section 83(b) election is to pay the tax at ordinary rates at a time at which it is presumed to have a lower value than at the time at which it is later scheduled to vest. As Section 1.83-2 of the Treasury Regulations indicates, the effect of a proper election is that "any subsequent appreciation in the value of the property is not taxable as compensation to the person who performed the services." There are no guarantees, however, that the property will in fact appreciate, and it is also possible that the individual will have failed to meet the vesting condition or will otherwise have forfeited the property prior to the scheduled vesting date. In that case, the individual will have paid taxes at ordinary rates without the ability to obtain a refund. Nevertheless, many individuals are prepared to take that risk, especially when the value at grant is relatively slight.

There may also be challenges as to whether the Carry Vehicle is the "right" service recipient for purposes of the Treasury Regulations under Section 83, even though there are places in the regulations that broadly refer to the grant of property in connection with the performance of services. Moreover, the very nature of a profits interest raises the question as to whether it is "property" for purposes of Section 83.

In addition, making an 83(b) election raises the question of how a profits interest should be valued for purposes of Section 83(b). Consistent with the outcome in *Campbell* and in Revenue Procedure 2001-43, many practitioners take the view that a profits interest should be deemed to have a value of zero at the time of grant for purposes of Section 83. While option-valuation approaches could be applied to the economics of a carried interest in a manner that attributes value to them at the time of grant, it is notable that a valuation of zero also provides an outcome that is consistent with the treatment of options under Section 83 – *i.e.*, no recognition of income required at the time of grant, but rather the income recognition event occurs at exercise for non-qualified employee stock options.

Fee-Waiver Provisions

Many sponsors, and particularly private equity firms, waive current management fees from sponsored investment funds and, in return, take profits interests in the funds. Under a typical "management profits interest" arrangement, a sponsor's general partner or investment manager entity will be deemed to have contributed capital in the amount of the waived fee and then be entitled to distributions equal to the capital contributed along with the investment return on such capital, but only to the extent that the Fund has sufficient net profits to support the distribution. This mechanism converts ordinary income (management fees) into capital gains (profit allocation), assuming that the underlying income consists of capital gains. The Fund must actually generate a sufficient level of profits to allocate to the service provider in order for the arrangement to have the intended tax effect. Fund Managers then participate in this arrangement by being partners in the sponsor's general partner or other entity having the investment in the Fund.

As described above, the Proposed Section 707(a)(2) Regulations, relating to disguised payments for services, were published in 2015 but have not been finalized. In the preamble, the Treasury stated its view that the proposed regulations reflect the legislative intent in the statute and legislative history, and thus current law.

Section 707(a)(2) provides the Treasury with broad authority to promulgate regulations involving disguised payments for services. In the legislative history, Congress expressed concerns that partnerships could inappropriately treat payments for services as allocations and distributions to a service partner even when the service partner acted in a capacity other than as a partner. The Proposed Section 707(a)(2) Regulations now provide six considerations that should be evaluated in determining whether or not a given arrangement should be regarded as a disguised payment for services. When comparing these factors to those articulated in the legislative history, only one is "new": if there are different allocations or distributions with respect to different services, where the services are provided either by a single person or by related persons, whether the terms of the differing allocations or distributions are subject to significantly varying levels of entrepreneurial risk.

The preamble to the Proposed Section 707(a)(2) Regulations indicates that the most important factor is whether the payment is subject to significant entrepreneurial risk as to both the amount and fact of payment. An arrangement for an allocation and distribution to a service provider that involves limited risk is treated as a fee and thus not treated as a partnership or profits allocation.

The Proposed Section 707(a)(2) Regulations provide that certain facts and circumstances create a presumption that an arrangement lacks significant entrepreneurial risk (unless other facts and circumstances establish the presence of significant entrepreneurial risk by clear and convincing evidence). For example, the Proposed Section 707(a)(2) Regulations indicate that a management-fee waiver with the following features could cast doubt on its legitimacy:

- capped allocations of fund income if the cap is reasonably expected to apply in most years;
- an allocation for one or more years under which the advisor's share of income is reasonably certain;
- an allocation of gross income;
- an allocation (under a formula or otherwise) that is predominately fixed in amount; is reasonably determinable under all the facts and circumstances; or is designed to assure that sufficient net profits are highly likely to be available to make the allocation to the advisor; or
- an arrangement in which a partner waives its right to receive payment for the future performance of services in a manner that is nonbinding or fails to timely notify the fund (and the partners in the fund) of the waiver and its terms.

Several of the examples in the Proposed Section 707(a)(2) Regulations consider arrangements in which a partner agrees to forgo fees for services where the partner also receives a share of future partnership income and gains. The examples, taken together, may suggest that if the following factors are present, the arrangement is more likely to be regarded as maintaining a sufficient level of entrepreneurial risk:

- the allocations and distributions in respect of the waiver interest are made out of (and only to the extent of) cumulative net income and gain over the life of the partnership;

- the partner receiving allocations and distributions in respect of the waiver interest agrees to return to the partnership any distributions that ultimately are not supported by allocations of cumulative net income and gain, and it is reasonable to believe the partner will be able to (and actually will) satisfy the clawback obligation if applicable; and
- the waiver of management fees occurs prior to the fund's first investment, the waiver is irrevocable and advance notice of the waiver is clearly communicated to all partners. A waiver made after the fund's first investment may be viable in certain situations, if each such waiver is made before the commencement of the partnership taxable year for which the corresponding fee would otherwise be payable, but additional restrictions and considerations will apply.

The use of a clawback mechanism would appear to be a highly significant factor in determining whether a given arrangement conveys the appropriate level of entrepreneurial risk. In one of the facts of an example, the absence of a clawback indicates "a significantly lower level of economic risk." The presence or lack of a clawback, however, is not the only consideration. The proposal also points to fees paid out of net income as an important factor, and it also suggests that gain be measured over the life of the partnership. This approach may not comport with many compensatory arrangements, particularly those that utilize a "deal-by-deal" approach. Given the insistence on having no "reasonably certain" income, concerns could arise even where only a small portion of the fee may be regarded as predictable. For example, would an adverse presumption apply in the case of a partnership that divides all profits 90% to a capital partner and 10% to a service partner, if the possibility of a single dollar of profit were considered highly likely? While this is an extreme case, there are similar interpretative issues concerning the focus on the "overall success of the enterprise" part of the test. Additionally, if the fee is asset-based rather than portfolio-wide based, could that present a more difficult challenge under this test?

Tax Treatment on Repurchase or Disposition of Profits Interest or Payment in Liquidation of Profits Interest

Carried interest arrangements typically anticipate the possible sale, to the Carry Vehicle or one of its affiliates, or redemption of profits interests, as well as the possibility that the Carry Vehicle will make a payment in liquidation of the interest upon the sale of an underlying business or business asset. While there are differences in the tax analysis, and a substantial number of potential subtleties, depending on the nature of the monetization transaction, the tax results to the Fund Manager are typically not materially affected by the method. Generally, the Fund Manager recognizes capital gain in the amount of the proceeds, assuming that the profits of the partnership, and any unrealized appreciation in the assets of the partnership at the time of any disposition, are capital in nature. Discrepancies may occur in limited circumstances, however, including in respect of, for example, hot assets and holding periods for underlying capital assets.

Treatment of Profits Interest and Capital Interests As Separate Interests in a Partnership

Revenue Procedure 93-27 assumes that the profits interest does not include a capital interest at the time of grant. Concerned about the potential unavailability of Revenue Procedure 93-27 (for example, if there is trepidation about meeting the two-year holding period or if the assets of the partnership are likely to give rise to a steady and predictable stream of income) or simply out of an abundance of caution, some practitioners have separately advised that clients not only make prophylactic Section 83(b) elections, but also contribute some small amount of capital to the venture in order to bolster the argument that the 83(b) election relates to property. While there are some cases that may be better candidates for this approach than others, the idea is to effect a purchase of a capital asset (the capital interest) and by so doing, not only rely on Section 83(b) to bolster the conclusion of Revenue Procedure 93-27, but also to provide for a separate independent Section 83(b) argument based on the interest having a value equal to the value of the capital interest. Most cases, however, do not usually indicate such prophylaxis to the extent the parties believe that the arrangement fits within the parameters of Revenue Procedure 93-27: a Section 83(b) election being deemed sufficient.

Needless to say, the facts of a given arrangement do not always conform to the parameters of existing authority. Practitioners need to be mindful of the analytic tensions when a given arrangement may not fit squarely within the factual predicates of Revenue Procedure 93-27. Can a taxpayer, for instance, bifurcate a compensatory interest in a partnership or Carry Vehicle if it wishes to make a capital contribution? Section 1.704-1(b)(2)(iv)(b) of the Treasury Regulations indicates that one can only have one capital account, even if there are several interests held with respect to the partner's interest. Additionally, some case law indicates the same, although it is in the context of general partner and limited partner interests, as opposed to profits and capital interests.

There is at least one private-letter ruling that would appear to take a more flexible approach to the question, although it should likely be viewed with caution in light of the numerous other questions that remain unanswered. That private-letter ruling appeared to indicate that the grant and vesting of the substantially unvested profits interest was treated as a nontaxable event even where the service provider also contributed an unspecified quantum of capital. In addition to being silent about the efficacy (or necessity) of any prophylactic Section 83(b) election in that case, the ruling is also opaque about the amount of capital that was contributed relative to the value of the profits interest awarded. Where a grantee is purposefully given both interests, there is the possibility of a capital shift at grant independent of the consequences under Revenue Procedure 93-27. The direct or indirect grant of a capital interest in tandem with a profits interest thus raises many issues for practitioners and business planners alike.

Dual-Status Issue

Many partnerships use a disregarded entity (DRE) for partners that seek to provide services in both a partner and an employee context in connection with a particular business enterprise. Specifically, many partnerships will establish a wholly owned limited liability company and "check the box" under Section 301.7701-2 of the Treasury Regulations with the limited liability company effectively being "disregarded" as separate from the partnership entity owner. Many have historically entertained this structure because of the long-standing position of the IRS that a partner cannot be both an employee and a partner at the same time with respect to the same partnership. The use of a DRE was designed to allow the partner to be treated as an employee at the DRE level while remaining a partner at the partnership-owner level.

The classification of a given service provider as a partner or employee is important because partners are not subject to wage withholding but are subject to the application of SECA. Partners are also not permitted to participate in certain employee benefit arrangements that are available to employees. Incorrectly classifying a service provider can give rise to significant legal and communication headaches, not the least of which could be a failure to appropriately withhold for those misclassified as partners and to provide for benefits for those inappropriately classified as employees.

In May 2016, the Treasury published temporary and proposed regulations indicating that an upper-tier partnership's use of a DRE will be insufficient to confer employee status on a partner of the partnership. Under this guidance, the DRE could be treated as a corporation for FICA purposes, but not for SECA tax purposes. In generally affirming its long-standing position that a given individual cannot be both a partner and an employee of a partnership, the 2016 guidance notes that the entity classification regulations "did not create a distinction between a [DRE] owned by an individual (that is, a sole proprietorship) and a [DRE] owned by a partnership in the application of the self-employment tax rule."

The use of a wholly owned DRE should therefore not alter the IRS's historical view to the effect that:

> (1) [b]ona fide members of a partnership are not employees of a partnership . . ., and (2) such a partner who devotes time and energy in the conduct of the trade or business of the partnership, or in providing services to the partnership as an independent contractor, is, in either event, a self-employed individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee.

In addition, it appears that the Treasury and the IRS used this opportunity to reaffirm the regulatory hostility to dual status generally, whether or not in the DRE context. Thus, the preamble states that the revenue ruling is still good law and that dual status relationships are generally not favored. This discussion is adverse to the general position that dual status is a viable structure for service-provider relationships. The Treasury and the IRS, however, did limit the scope of its guidance and indicated that there could be circumstances in which dual status may be appropriate:

> The [IRS] solicited comments on the appropriate application of the [longstanding] principles [invalidating dual status for service providers that are partners] to tiered partnership situations, the circumstances in which it may be appropriate to permit partners to also be employees of the partnership, and the impact on employee benefit plans . . . and on employment taxes if [the longstanding guidance] were to be modified to also be employees in certain circumstances.

While the IRS has left open the possibility of future exploration on the topic of dual status service providers, the discussion in the preamble should be troubling to proponents of the view that dual service arrangements are viable structures for service-based relationships.

Phantom Income

Partners in partnerships receive their allocable shares of partnership gain, loss, income, deduction and other items of partnership income and credits. Partners receive distributions, however, pursuant to the governing terms of the partnership agreement. This means that in some circumstances, participants in a Carry Vehicle under a carried interest arrangement may be treated as having "phantom" income for tax purposes for certain years even if they do not in fact receive a distribution with respect to that income from the Carry Vehicle. The extent, and the ultimate impact to employees, of any mismatch of income that can occur depends significantly on the type of assets underlying the Fund and its tax profile; the structure of the arrangement; and the availability of some of the mitigating features described below. For example, mezzanine debt funds may give rise to dramatically different phantom income issues than traditional private equity structures.

Phantom income typically arises because of the operation of the distribution waterfalls to which the Fund is subject, although it can also be a function of Fund taxable income (*e.g.*, from accruals or non-cash dispositions) without free cash. These waterfalls, usually set forth in the Fund documents, typically entitle investors to receive their capital back and, in some cases, a preferred return prior to any carried interest being earned by the manager. While many variations are possible, in a typical private equity fund, investors are often entitled to all returns of capital, a preferred return and, thereafter, a share of 80% in the profits.

While the manager and its employees participating in any carried interest arrangement may have to wait to receive any carried interest, Fund documents or tax rules may require that the first dollar of profit (and each dollar thereafter) be allocated to all investors. This means that the manager, and by extension the Fund Manager participants, may be allocated items of income for tax purposes prior to receiving cash from the Fund to pay the necessary taxes.

Tax Distributions

The idea behind a tax distribution is that investors (including for this purpose, the manager and the Fund Managers) are entitled to receive distributions to permit them to pay necessary taxes arising from phantom income. The distribution is an exception to the normal Fund distribution waterfalls – in effect, an advance – and is provided even though the terms of the Fund would not otherwise permit it.

The drafting of tax distribution provisions typically requires business judgment concerning the following design variables:

- Should institutional investors, including potentially tax-exempt investors, share in tax distributions, or should such distributions be limited to the Fund Managers?
- Should the determination of whether sufficient cash has been distributed to fund tax obligations be determined on an annual or cumulative basis?
- Should distributions on capital interests

be taken into account in determining the amount of tax distributions to be made in respect of profits interests?

- Should the amount of distributions be based on assumed or actual tax rates?
- If the amount of distributions is based on assumed tax rates, should the rates be the same for all participants, or should the rates be based on the jurisdictions in which the participant is based?
- Should there be a clawback of tax distributions in any termination situations or if the investment ultimately generates a loss?

Moreover, the tax distribution solution sometimes results in other complications. For example, some investors may be reluctant to override the economic deal and permit a manager entity to access liquidity from the Fund to pay Fund Managers' tax distributions. A sponsor may then either have to pass this constraint along, or otherwise build in a tax distribution mechanism internal to or external to the Carry Vehicle to ease the tax burdens of Fund Manager service providers. This may result in other disconnects between the sponsor and the Fund Managers and timing and "leakage" of economic returns.

Aside from the mismatch of income, some sponsors may have other business designs and incentives that would militate against the provision of such distributions. Some may choose not to permit employees to receive tax distributions in advance of a scheduled employee vesting date. In other instances, a sponsor (or in some cases, the investors) may preclude – or may be permitted to preclude – tax distributions above a certain threshold in the aggregate in order to reserve against the Fund's future clawback obligations to its third-party investors. Participants in such arrangements would be wise to both identify such provisions and make such arrangements as may be necessary to secure the necessary liquidity.

Forfeitures

Interesting questions can arise as to the tax consequences associated with the forfeiture of any Carry Vehicle interest. While the authors are unaware of any direct guidance on point, some practitioners believe that a Fund Manager forfeiting a profits interest in a Carry Vehicle could be treated as having a capital loss, assuming that the Carry Vehicle and the individual treated it as a capital asset in the first instance. On the other hand, a strict reading of the Section 83 regulations leads to the view that any such loss is limited to the excess of the amount paid for the property (which, in most cases and for present purposes, is likely small) over the amount realized upon the forfeiture.

The forfeiture of a partnership interest in the hands of a service provider raises a number of knotty technical and commercial issues. For example:

- Does the interest revert to the sponsor?
- Is it recycled for future grants?
- Is it automatically allocated pro rata among other participants in the carried interest arrangement?
- What are the commercial goals of the sponsor, and how do they conform to the complexities involved with requiring compliance with Subchapter K with respect to the operation of the Carry Vehicle?

Capital shift considerations may be relevant in these circumstances. As described above, a capital shift occurs when current capital – as contrasted with future profits – is shifted from one partner to another, which can occur in a non-obvious way in connection with forfeitures. For example, if unrealized gains associated with a profits interest are reallocated to the accounts of other Fund Manager partners upon the forfeiture of a profits interest, a capital shift may occur, particularly if the Fund Manager recipient became a partner after the Fund Manager who forfeited the interest. A capital shift is taxable under Section 1.721-1(b)(1) of the Treasury Regulations when a partnership interest is received in exchange for services provided, or to be provided in the future, to the partnership. As described above, many tax practitioners have addressed these concerns through book-ups, which may reduce capital shifts (or for profits interests, eliminate them). If Section 83(b) elections are made, many arrangements call for mandatory book-ups to limit the impacts of a capital shift.

Out of Profits

To qualify as a profits interest for tax purposes, profits interests must be granted with a liquidation value of $0. Some private equity sponsors may increase the profits-interest hurdle above the liquidation value (*e.g.*, $10) to incentivize a desired return to investors before employee participation in any positive economics. This arrangement can be thought of as similar to a premium stock option, where a company grants an option to purchase shares at a strike or exercise price above its fair market value on the grant date.

Profits interests may also be structured as "catch-up" units, which allow participants to share in a disproportionate amount of the profits until the "right" level of participation percentage is achieved. In some cases, this "catch-up" may be pursuant to a business arrangement intended to give new hires to share in the pre-hire value of the business.

For example, if a partnership worth $100 million on the date the profits interests are granted is subsequently sold for $110 million, a profits interest representing a 1%-ownership stake would receive $100,000 (1% of the $10 million profit). The same profits interest with a "catch-up" feature would receive $1.1 million (1% of $110 million funded from the $10-million profit). It is necessary, but not sufficient, that any "catch-up" be made solely out of profits. Even when made solely out of profits, the Proposed Section 707(a)(2) Regulations raise significant questions about whether such a catch-up provision would be inconsistent with the profits interest treatment because of the lack of sufficient entrepreneurial risk. There are circumstances in which an otherwise commercially acceptable catch-up provision may simply not work for tax purposes. This can occur if the amounts are paid from other fees or other residual amounts allocated to the Carry Vehicle. It can also occur if there are valuation errors in the process or the drafting of the underlying Carry Vehicle document is unclear.

The definition of profits under Subchapter K of the Code can raise its own interpretative challenges, and it is always important to make sure that tax and compensation professionals coordinate when structuring carried interest arrangements. Some may take an expansive view that almost all proceeds from a partnership can constitute profits for these purposes, while others may take a more cautious approach. For example, such issues can arise from differences between book at tax results, or when Fund Managers are entitled to share in profits on a deal-by-deal basis and the Fund has losses on an aggregate basis.

Metrics

Assuming that carried interests are in fact paid from the Carry Vehicle's profits for Subchapter K purposes, sponsors are generally free to design arrangements that reflect a variety of different reward structures. Incentive hurdles can include a number of commercially standard economic metrics, including profits, return on investment, multiple on invested capital and other specified determinants of performance. Tax structuring is important not only to assure fidelity to the basic principles of payments out of profits, but also because it is essential that any payments to Fund Managers comply with the complicated "substantial economic effect" regulation of Subchapter K.

Administration

In comparison to Phantom Carried Interest Arrangements, some believe that carried interest arrangements can be harder to administer because the arrangement has to flow through the Carry Vehicle or other Fund documents. Many also find it hard for some Fund Managers who are accustomed to being treated as employees to be treated as partners for tax purposes. The need to file Forms K-1 may be more difficult for some Fund Managers who are not familiar with partnership protocols. For many Fund Managers accustomed to W-2 wage reporting, the enhanced requirements and inherent complexities of Form K-1 can result in some initial dissonance and, in some instances, even economic dislocation owing to the nature of phantom income.

In addition, being treated as a partner for tax purposes also means that the individual once accustomed to participating in certain health and welfare arrangements open to employees – such as Section 125 plans and certain other exclusions – may be unable to do so without proper planning. Many may find that health insurance may cost more as the employer and employee portions of healthcare are allocated to the Fund Manager. Separately, there is also an impact on calculations for purposes of cash or deferred arrangements under tax-qualified plans such as Section 401(k) plans. Many Fund Managers soon discover, however, that the benefits of participating in a carried interest arrangement may outweigh those of participating in a Phantom Carried Interest Arrangement where the Fund generates capital gains income, which can be better preserved under the former model in the hands of the recipient.

At a minimum, sponsors will need to consider the costs and burdens of:

- establishing a Carry Vehicle and transferring some or all of the sponsor's right to incentive allocations under the Fund to the Carry Vehicle;
- drafting subscription agreements for the Fund Managers to invest in the Carry Vehicle;
- establishing the terms of the carry program regarding such issues as vesting, allocation of forfeitures and redemptions; and
- preparing award agreements stating the amount, vesting and other terms of the award and summarizing the general terms of the Carry Vehicle.

Award agreements evidencing a grant are common under both arrangements, but Fund Managers must technically be "members" of the relevant Carry Vehicle to benefit. This may also raise a number of commercial considerations from the standpoint of the sponsor. A sponsor may be concerned that it will have to provide information and voting to Fund Managers as if they were invested in the underlying Fund. While the Fund members are technically treated as partners from a tax perspective, the concerns are often overstated and can be addressed through the partnership or limited liability company agreement. The provisions of state law governing the arrangement will be important to consult for these and similar issues.

It is true, however, that some sponsors find it more difficult to retain flexibility in the types of grants that may be made to Fund Managers. Again, this is largely a function of the fact that the contours of any given award must flow through the economics of the underlying Fund and Carry Vehicle. Certain arrangements may be more attainable under a contractual or notional Phantom Carried Interest Arrangement, and Phantom Carried Interest Arrangements generally provide broader latitude in design than traditional carried interest arrangements.

On the other hand, traditional carried interest arrangements are also often said to be more flexible in terms of vesting and payout dates than Phantom Carried Interest Arrangements. As discussed below, Section 409A can often have a chilling effect on sponsors' abilities to craft commercial results that work effectively under that provision. For example, a traditional carried interest arrangement may have "rolling" payouts based on the amount of carry received by Fund Managers on an annual basis after the employee satisfies vesting conditions.

Deferred Compensation

An alternative to a carried interest arrangement is a Phantom Carried Interest Arrangement, in which the sponsor promises to pay deferred compensation to the Fund Manager. In a Phantom Carried Interest Arrangement, the Fund Manager owns no interest in any entity. The Fund Manager shares a portion of the fees it receives with its professionals on a contractual basis. The professionals' rights to payment are solely those of an unsecured creditor with respect to an unfunded commitment from the employer. Amounts are taxable as compensation under Section 61 and the timing principles of Sections 404, 409A and 451.

As a practical matter, the most difficult tax issues that arise in Phantom Carried Interests Arrangements occur by reason of Section 409A (and where applicable, Section 457A). As a result, most arrangements for senior personnel are arguably structured as partnership arrangements. Where a non-partnership arrangement is used, Section 409A will need to be considered. Section 409A applies whenever a service provider has a legally binding right to compensation during a taxable year that is, or may be, payable in a later taxable year. Section 409A prescribes the rules under which the service provider or service recipient may elect to defer the receipt of the compensation and the timing of payment. It generally proscribes accelerations or deferrals after the timing for payment has been fixed, subject to several important exceptions. The regulations implementing the rules are exceedingly detailed and complicated. There is no shortage of Fund sponsor frustration when otherwise commercially reasonable arrangements are proposed only to find difficulties under Section 409A. This is principally because replicating the business "deal" in a partnership setting to an arrangement that is subject to Section 409A is very difficult.

Specifically, Section 409A imposes rules that, in respect of nonqualified deferred compensation covered by Section 409A, restrict:

- the timing of when promises of deferred compensation may be made;
- the timing of payments;
- the timing of deferrals;
- the ability to extend deferral periods;
- the ability to amend or substitute nonqualified deferred compensation; and
- the ability to fund deferral arrangements through trusts or other arrangements located outside of the U.S.

Section 409A requires that all plans of deferred compensation be in both documentary and operational compliance. Violation of either of these may require the grantee to recognize:

- immediate inclusion in income for the year in which the failure occurs, all amounts of "deferred compensation" under the plan that is violated;
- an additional tax of 20% of the amount involved;
- certain additional interest and penalties; and
- immediate inclusion in income for the year in which the failure occurs, penalty taxes and interest for all other similar plans of deferred compensation for the affected individual – even if those plans are otherwise compliant with Section 409A.

As can be seen, the gauntlet that would need to be run for a Phantom Carry Arrangement is difficult and significant, especially where the arrangement is designed to operate under an exception from Section 409A, such as the short-term deferral exception. The kinds of Section 409A questions and issues (some of which are of a type that can also arise under Section 457A) that may arise for those trying to structure a Phantom Carried Interest Arrangement that results in wages rather than partnership income could include, for example:

- As a general gating matter, will the compensation be intended to be exempt from Section 409A as a "short-term deferral?"
- When is the compensation considered nonforfeitable for these purposes? For example, under what circumstances could there be a substantial risk of forfeiture for purposes of the short-term deferral rule if payment is triggered upon an initial public offering or the change in control of ownership of a given portfolio investment? (Questions like these could have relevance both under the rules governing short-term deferrals, where exemption from Section 409A is sought, and the rules governing permissible payment dates, where Section 409A applies.)
- Is the compensation considered payable at a permissible time as specified by Section 409A (especially given the general unavailability of a "you-get-paid-when-I-get-paid" construct)? Under what circumstances could such arrangements that are subject to Section 409A be treated as providing for permissible payment dates? Under what circumstances could payment contingencies result in a substantial risk of forfeiture for purposes of the short-term deferral exception?
- Will complications arise when trying to

protect those who may be terminated without cause prior to the date payment is to be made or the amounts to be paid become known?
- Are there restrictions that could apply in the context of negotiations surrounding separations of employment and modifications of any outstanding deferred compensation arrangements in connection with those negotiations?

These examples explain why, in many cases, the partnership-type structure, particularly for true owners and other similarly situated senior personnel, presents a path of lesser resistance.

Conclusion

Carried Interests can often align professional and investor interests. Given the technical sensitivities across multiple legal regimes and competing commercial designs, however, many tax professionals that advise them can often become frustrated with the applicable tax rules. Practitioners need to attend to the many tax and related considerations associated with the design and implementation of these arrangements.

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