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Structuring Carried Interest After U.S. Tax Reform

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As a result of U.S. tax reform, U.S. fund managers are required to hold their investments arising from carried interest for three years in order to recognize long-term capital gain, rather than the previous one-year holding period requirement. This article examines the potential conflict between investors and U.S. investment fund managers resulting from this change. This article also illustrates the potential consequences of a ''carried interest waiver'' pursuant to which a U.S. fund manager may waive short-term capital gain in exchange for a larger share of future gain. Although the carried interest waiver is not without risk to U.S. fund managers, it may produce results beneficial to both fund managers and their investors as illustrated in the article's examples.

INTRODUCTION

Capital gains received by a U.S. investment fund manager pursuant to its carried interest have historically been taxed in the United States at the preferential tax rate applicable to long-term capital gain to the extent the underlying investment has been held for at least one year. In the context of a private equity fund, the one-year holding period requirement has typically not been a barrier to achieving long-term capital gain in light of the typical holding period of private equity investments, including the time it takes to effect a disposition.

IMPACT OF U.S. TAX REFORM

On December 22, 2017, significant changes were made to the taxation of carried interest, effective as of January 1, 2018, as part of the 2017 tax act.[1] The 2017 tax act included a new three-year holding period requirement for a partner to recognize long-term capital gain, where the partner in question received its partnership interest in exchange for the performance of certain services.[2] This rule was specifically targeted at investment fund managers' carried interest.[3] The three-year holding period is applied on an investment-by-investment basis, although it is not clear under current guidance whether portfolio company add-on investments will require taxpayers to bifurcate their holding period in an investment.[4]

Although it is not entirely clear, this same three-year holding period likely applies to a sale of the manager's general partnership interest in the fund to an unrelated party, based on a look-through to the underlying assets. A plain reading of the statute may suggest a one-year holding period applies to the sale of a general partnership interest, which would permit simple structuring (e.g., the formation of a separate

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[1] Pub. L. No. 115-97 (hereinafter the 2017 tax act).

[2] §1061(a), added by 2017 tax act §13309(a). All section references are to the Internal Revenue Code of 1986, as amended (Code), and the regulations thereunder, unless otherwise specified.

[3] *See* §1061(c)(1)-§1061(c)(3) (limiting the three-year holding period requirement to a circumscribed category of taxpayers that resemble fund managers, i.e., those whose activities consist of raising or returning capital and developing or investing in specified assets — a circumscribed category of assets intended to cover common assets held by funds, e.g., securities, commodities, certain real estate, financial instruments, etc.); *see also* H.R. Rep. No. 115-466, at 416-23 (2017) (House Report) (referencing the use of the term carried interest); *see also* §1061(b) and §1061(f) (authorizing the Treasury to issue regulations regarding the extent to which the three-year holding period will not apply to ''income or gain attributable to any asset not held for portfolio investment on behalf of third party investors'').

[4] *See generally* §1061(a) (providing that a taxpayer, if subject to these rules, must treat as short-term capital gain the excess of (a) the taxpayer's long-term capital gain from the partnership interest, determined as though a one-year holding period applied, over (b) the taxpayer's long term capital gain from the partnership interest, determined as though a three-year holding period applied).

general partnership entity for each investment, which entity could be sold as part of an investment exit). This phenomenon likely was the result of imperfect drafting during the legislation's frenzied implementation, and the language is sufficiently vague for the Internal Revenue Service and Treasury Department to apply a look-through approach and override attempts to circumvent the rule, although there may be a sufficient basis to attempt such structuring unless and until regulations or other additional guidance is released.

Moreover, the 2017 tax act requires fund managers transferring their partnership interests to a related party to recognize gain attributable to assets held for less than three years as short-term capital gain, although the scope of a related person is fairly limited at the moment.[5] Although it is likely that this provision was intended to address assignment-of-income concerns, it remains unclear as of this writing whether this applies to routine transactions that would otherwise be non-taxable (e.g., a transfer to an estate vehicle where family members may have an interest or grants of carried interest to new professionals out of an existing carried interest pool). Fund managers should consult their tax advisor and may want to wait for additional guidance before transferring their partnership interests to family members or estate planning vehicles, or making new profits interest grants that could have the effect of shifting carried interest.

MANAGER AND INVESTOR DIVERGENCE

In contrast to the treatment of fund managers, the historic one-year holding period used to measure long-term capital gain still applies to investors that are limited partners.[6] Accordingly, the general partner and limited partners, generally, would be subject to different tax regimes with respect to any portfolio company disposed of after the first year, but before the third anniversary of the portfolio company acquisition (the ''carry window'').

The dichotomy between the taxation of fund managers and their investors creates a potential conflict of interest (or appearance of such conflict) as it relates to the timing of dispositions. The example below shows two scenarios in which a fund acquires an investment in year one for $300 million and the fund manager has a 20% carried interest. In Scenario A, the investment is sold in year three for $550 million and the fund manager is taxed on its carried interest at ordinary rates. In Scenario B, the investment is sold in year four for $550 million and the fund manager is taxed on its carried interest at capital gains rates. For purposes of illustration, the example assumes that all gain is within the carried interest portion of the fund's waterfall (i.e., after the return of investor's capital and any rate of return hurdle the investors may be entitled to), assumes that the fund in question has a traditional 80/20 split of profits between the limited partners and general partner, and measures present value from the date of the initial investment.

EXAMPLE

ITEM	SCENARIO A	SCENARIO B
Discount Rate	8%	8%
Fund		
Net Income (Pre-Tax)	$250,000,000	$250,000,000
Net Present Value	$136,607,733	$104,266,419
Manager		
Income (Pre-Tax)	$50,000,000	$50,000,000
Income (After-Tax)	$31,500,000	$40,000,000
Net Present Value	$25,005,716	$29,401,194
Investors		
Net Income (Pre-Tax)	$200,000,000	$200,000,000
Net Present Value	$96,916,121	$67,514,926

As illustrated, the fund manager would benefit on an after-tax and present value basis if the disposition of an investment occurs after the conclusion of the carry window (Scenario B), while the investors would benefit on a present value basis if the disposition of an investment occurred during the carry window (Scenario A).

Ergo, it is easy to envision a scenario where a solicitation to purchase a portfolio company is received and rejected, or a hot market acquisition market cools, during the carry window. Further, fund managers may be incentivized to consider alternative monetization structures, such as leveraged recapitalizations, that may produce qualified dividend income taxed at long-term capital gains rates.

Although investment fund documents generally are designed to protect managers from conflict-of-interest claims by investors, and include a waiver of conflicts between the manager and investors, managers should reexamine these conflict waivers in light of the change in tax law, and consider including specific language and disclosure addressing the tax conflict created by the carry window in future documents. More generally, however, it would be wise for fund managers to consider structures that may align their interests

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[5] A person is related to a fund manager if the person is (a) a family member, meaning a spouse, child, grandchild, or parent, or (b) a colleague, meaning someone that performed a service within the current or prior three calendar years in any applicable trade or business in which the fund manager also performed a service. *See* §1061(d)(2)(A), §1061(d)(2)(B); House Report, at 422 (using the term ''colleague'').

[6] §1222(3), §1222(4); *see generally* §1061 (replacing the holding period in §1222(3) and §1222(4) for long-term capital gain). The one-year holding period also applies to a general partner's capital interest in a fund although this tends to be significantly smaller than the potential carried interest for a successful investment.

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with those of their investors in a manner that may maximize after-tax returns without creating unnecessary friction with their investor base.

LOOKING FOR QUICK-FIX SOLUTIONS

As an initial reaction to the 2017 tax act, a number of practitioners and fund managers sought a simple, quick-fix solution. In response to a perceived loophole in the 2017 tax act whereby the new holding period rules did not appear to apply to carried interest held through an S corporation, one initial proposal was for a fund manager to use an entity treated as an S corporation to hold its carried interest.[7] If this were effective, a manager could satisfy the requirement for the exemption, but avoid the double taxation that would arise if the carried interest were held by a C corporation. This ''loophole'' was a clear symptom of the frantic and haphazard process by which the bill was pushed through Congress; double taxation of C corporations was the likely justification for the exemption to the three-year holding period in the first place.

Not surprisingly, Treasury Secretary Steven Mnuchin quickly informed the Senate Finance Committee in February 2018 that the IRS had been instructed to issue guidance fixing this purported loophole, and on March 1, 2018, the Treasury Department issued Notice 2018-18 clarifying that the exemption applied only to C corporations. It is possible that Notice 2018-18 will be challenged on grounds that the guidance is not supported by the plain language of the statute, but given (1) the IRS's focus on the issue, (2) the legislative history of the statute, (3) the broad deference given to governmental agencies' interpretations of statutes under *Mayo Foundation for Medical Ed. and Research v. U.S.*,[8] and (4) the potential interest and penalties if such a challenge is unsuccessful, the S corporation approach may be palatable to only the most risk tolerant fund managers.

Other practitioners have considered using C corporations in order to qualify for the exemption to the three-year holding period, while accumulating gains and disposing of the shares to a buyer who could access the corporate assets in a more tax efficient manner or waiting to liquidate until the second layer of tax did not result in a lower after-tax return. Unfortunately, this approach may be administratively cumbersome and, as described above, may be tax-inefficient because it results in double taxation — first at the level of the corporation, and again when the corporation pays dividends. Although it is possible that the aggregate tax is ultimately lower, between the potential application of the personal holding company rules,[9] the inability to access gains without triggering additional tax and the limited potential savings, it is highly unlikely this structure would offer sufficient savings to justify the cost and complexity.

Any transaction structure relying on a synthetic disposition, in which the fund (or the general partner) retains an interest in a portfolio company held past the carry window, with the upside and the risk of loss effectively transferred prior to such date, is likely to be challenged on general principles of tax ownership or through the issuance of additional guidance by the Treasury Department.

THE CARRIED INTEREST WAIVER — STRUCTURE

A more promising structure to minimize the impact of the new three-year holding period rule is to design the carried interest in a manner that permits the general partner to waive gains from investments disposed of prior to the expiration of the carry window, but recoup the waived amount out of gains from investments sold after the carry window expires (a so-called ''carried interest waiver'').

A fund manager contemplating a carried interest waiver would have some flexibility in how to structure the arrangement.

The basic structure would involve drafting the initial partnership or LLC agreement with a distribution waterfall based on a pre-determined formula. Very generally, the formula would allocate the 100% of gain above a hurdle from the sale of assets held for three years or less to investors, with a corresponding make-up allocation from the sale of assets held beyond the expiration of the carried interest window to the general partner until the general partner received its 20% carried interest (assuming a traditional 80/20 share of profits), after which gains would be shared on the typical 80/20 basis.

Such an approach would be simple to implement and would be expected to be respected for tax pur-

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[7] The 2017 tax act provides that the holding period rules do not apply to partnership interests held by a corporation rather than an individual, but did not specify the type of ''corporation'' — C corporation and/or S corporation — that is eligible for this exemption. §1061(c)(4)(A); *see also* House Report, at 420.

[8] 562 U.S. 44 (2011), *granting Chevron* deference to certain regulations promulgated by the Treasury Department, *citing Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

[9] The ''personal holding company'' rules are designed to prevent corporations from accumulating their earnings instead of distributing those earnings as taxable dividends. The rules target closely held corporations that primarily produce passive income from investments, such as dividends, interest, rents and royalties. *See* §543.

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poses based on its substantial economic effect, at least if crafted in a manner that results in meaningful economic risk to the manager (i.e., risk that there may not be sufficient profits from investments held for more than three years to make up for the income foregone through the carried interest waiver). Although there is a permanence to achieving the meaningful economic risk described above, some amount of the risk could be mitigated by reducing the waived amount (i.e., taking a 10% return on assets sold during the carried interest window) such that the make-up amount would be reduced, or capping the waived amount at a predetermined dollar threshold.

On the other end of the spectrum, a fund manager could design an agreement providing the general partner with an option to waive its carried interest on an investment-by-investment basis or year-by-year basis over time. A similar make-whole arrangement would be provided for investments or years where the carried interest waiver was applied by the general partner.

Although there is no guidance directly on point, one may look to the rules applicable to management fee waivers for a blueprint. Section 707 and the related regulations contain rules addressing the situation where a fund manager waives its management fee (taxed as ordinary income) in exchange for a larger carried interest (generally taxed as capital gain). In particular, the rules seek proper characterization of the income, and the most important factor indicating that an arrangement is a payment for services is where the arrangement lacks significant entrepreneurial risk. It is common to show significant entrepreneurial risk by requiring the fund manager to waive their management fee prior to when the management fee is earned or accrued for tax purposes. Thus, in devising a carried interest waiver, a fund manager would likely want to limit it to a waiver of gains that have not yet crystallized.

Although beyond the scope of this article, fund managers may want to consider the benefits of a capital account book-up when disposing of an investment for which a carried interest waiver is in effect.

Whether the carried interest waiver actually is utilized will depend on investments being disposed within the carry window. Based on data from Hamilton Lane Inc., the *Wall Street Journal* reported that ''private-equity firms exited only 13 percent of deals in less than three years in 2016. . .a figure that has fallen steadily from a recent peak of around 80 percent in 2001.''[10] Nevertheless, including the carried interest waiver as an option could be valuable when an early exit opportunity arises, as illustrated in more detail below.

THE CARRIED INTEREST WAIVER — ILLUSTRATIONS

Each of the below examples assumes that all gain is within the carried interest portion of the fund's waterfall (i.e., after the return of investor's capital and any rate of return hurdle they may be entitled to, and that the fund in question has a traditional 80/20 split of profits between the limited partners and general partner. In addition, the present value calculations are measured from the date of the initial investment. For example, the investor return and carried interest resulting from a disposition after one year are be discounted to take into account the one-year deferral.

Table I, below, illustrates a situation in which a fund manager, who is entitled to a 20% carried interest, benefits from a carried interest waiver; the fund acquires two investments in year one for $300 million each, and sells the investments in year three and year four for $500 million each. In the ''No Waiver'' scenario, the fund manager receives its carried interest as usual and pays tax at a rate of 37% on the gain in year three and 20% on the gain in year four. In the ''Waiver'' scenario, the fund manager waives its carried interest with respect to the gain in year three, but in year four receives the waived amount plus its carried interest with respect to the gain in year four.

TABLE I

ITEM	NO WAIVER	WAIVER
Discount Rate	8%	8%
Fund		
Net Income (Pre-Tax)	$400,000,000	$400,000,000
Net Present Value	$164,431,047	$164,431,047
Manager		
Income (Pre-Tax)	$80,000,000	$80,000,000
Income (After-Tax)	$57,200,000	$64,000,000
Net Present Value	$43,525,528	$47,041,911
Investors		
Net Income (Pre-Tax)	$320,000,000	$320,000,000
Net Present Value	$103,276,563	$105,628,659

Notably, Table I illustrates that a carried interest waiver not only mitigates conflicts between the manager and investors, it may prove to be mutually beneficial by providing investors with a benefit in the ''Waiver'' scenario based on the time-value of money, while the fund manager also benefits on an after-tax basis by virtue of being taxed at a lower rate.

To illustrate the effect of a carried interest waiver in a slightly more complicated scenario, see Table II below, in which a fund acquires three investments in year one for $300 million each; investment one is sold for $500 million in year two; investment two is sold for $550 million in year four; and investment three is

[10] *See* Miriam Miriam Gottfried, *Private Equity Expected to Benefit From Tax Overhaul*, Wall St. J. (Jan. 24, 2018).

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sold for $600 million in year seven. The fund manager is entitled to a 20% carried interest, the receipt of which can be waived during any carry window and recouped from gain realized outside of a carry window.

TABLE II

ITEM	NO WAIVER	WAIVER
Discount Rate	8%	8%
Fund		
Net Income (Pre-Tax)	$750,000,000	$750,000,000
Net Present Value	$283,030,066	$283,030,066
Manager		
Income (Pre-Tax)	$150,000,000	$150,000,000
Income (After-Tax)	$113,200,000	$120,000,000
Net Present Value	$79,013,671	$80,929,688
Investors		
Net Income (Pre-Tax)	$600,000,000	$600,000,000
Net Present Value	$176,975,597	$181,867,956

As shown in Table II, the carried interest waiver would leave the fund manager with an additional $6.8 million of after-tax income, which equates to a nearly $2 million benefit to the fund manager in present value terms (calculated at an 8% discount rate). The carried interest waiver would not change the amount of income received by the investors, but it would provide a timing benefit to the investors valued at almost $5 million (determined pre-tax).

CARRIED INTEREST WAIVER — RISKS

Naturally, the carried interest waiver does present some meaningful risks to a fund manager. For example, a change in tax rates could distort the economics of the carried interest waiver. Table III below shows the same facts as Table II, but with a 25% tax rate on long-term capital gains (increased from 20%).

TABLE III

ITEM	NO WAIVER	WAIVER
Discount Rate	8%	8%
Fund		
Net Income (Pre-Tax)	$750,000,000	$750,000,000
Net Present Value	$283,030,066	$283,030,066
Manager		
Income (Pre-Tax)	$150,000,000	$150,000,000
Income (After-Tax)	$107,700,000	$112,500,000
Net Present Value	$75,425,626	$75,871,583
Investors		
Net Income (Pre-Tax)	$600,000,000	$600,000,000
Net Present Value	$176,975,597	$181,867,956

It is clear from Table III that the increased tax rate significantly diminishes the benefit of the carried interest waiver to the fund manager. The net present value benefit of the carried interest waiver (calculated using an 8% discount rate) to the fund manager goes from nearly $2 million in Table II, where the tax rate for long-term capital gains is 20%, to less than $450,000 in Table III, where the tax rate has increased to 25%.

In addition, if a fund adopts a carried interest waiver, it is possible that the fund manager is unable to make up the carry ''left on the table'' with respect to investments disposed of during the carry window because the sale of other investments does not generate sufficient income. For example, Table IV shows a fund that makes two investments in year one for $300 million each; investment one is sold for $600 million in year three; and investment two is sold for $350 million in year four. Without a carried interest waiver, the fund manager takes a 20% carried interest annually and is taxed at 37% on the gain in year three and 20% on the gain in year four. With a carried interest waiver, the fund manager waives its $60 million of carried interest with respect to the gain in year three, but there is insufficient gain in year four ($50 million) for the manager to make up the waived amount ($60 million) and receive the additional carried interest to which the fund manager is entitled with respect to the gain in year four ($10 million).

TABLE IV

ITEM	NO WAIVER	WAIVER
Discount Rate	8%	8%
Fund		
Net Income (Pre-Tax)	$350,000,000	$350,000,000
Net Present Value	$133,559,793	$133,559,793
Manager		
Income (Pre-Tax)	$70,000,000	$50,000,000
Income (After-Tax)	$45,800,000	$40,000,000
Net Present Value	$35,887,098	$29,401,194
Investors		
Net Income (Pre-Tax)	$280,000,000	$300,000,000
Net Present Value	$78,579,560	$96,808,300

The carried interest waiver may not be mutually beneficial where it is combined with changes to fund economics. For example, a fund manager might be willing to forego the amount of carried interest on the sale of an investment during the carry window, but try to negotiate with the investors for a larger carried interest with respect to other investments that are not sold during the carry window to mitigate the fund manager's risk. Table V, below, shows two scenarios in which a fund acquires two investments in year one for $300 million each; investment one is sold for $400 million in year three; and investment two is sold for $550 million in year four. In Scenario A, the fund manager takes a 20% carried interest annually and is taxed at 37% on the gain in year three and 20% on the gain in year four. In Scenario B, the fund manager waives its carried interest with respect to the gain in year three, but receives a 30% carried interest with respect to the gain in year four.

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TABLE V

ITEM	SCENARIO A	SCENARIO B
Discount Rate	8%	8%
Fund		
Net Income (Pre-Tax)	$350,000,000	$350,000,000
Net Present Value	$121,799,315	$121,799,315
Manager		
Income (Pre-Tax)	$70,000,000	$75,000,000
Income (After-Tax)	$52,600,000	$60,000,000
Net Present Value	$39,403,480	$44,101,791
Investors		
Net Income (Pre-Tax)	$280,000,000	$275,000,000
Net Present Value	$69,171,178	$66,672,076

The carried interest waiver in Scenario B causes the fund manager to receive an additional $7.4 million net present value benefit (calculated at an 8% discount rate). However, the investors in Scenario B receive $5 million less of pre-tax income due to the fund manager's 30% carried interest in year four, which more than offsets any time-value benefit to the investors from the carried interest waiver in year three. Thus, the investors receive a detriment in Scenario B valued at almost $2.5 million in present value terms (calculated at an 8% discount rate).

CONCLUSION

Among the options to mitigate potential adverse consequences under the 2017 tax act, the carried interest waiver presents an intriguing possibility for fund managers to consider. The alternatives appear to present very little upside or, in the case of the S-corporation structure, a significant risk of challenge by the IRS, which will be unattractive to most fund managers seeking to stay out of the headlines. Although not without economic risk, the carried interest waiver could meaningfully reduce tax at the investment manager level and has sufficient flexibility to allow limitations on the amount at risk.

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