CHAPTER 12

Demystifying Tax Planning When Using Carried Interests for Fund Managers, Promoters and Developers

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§ 12.01 INTRODUCTION

Benjamin Franklin proclaimed two certainties in life: death and taxes. While investment funds cannot help with the first, they can—in the context of compensation for fund managers, promoters and developers—certainly reduce the second. Compensation for labor is generally taxed at "ordinary income" tax rates. Income on capital is generally taxed at "capital gain" rates. Techniques have evolved to minimize the portion of a fund manager's income that would be taxed at "ordinary income" rates and maximize what qualifies for capital gain treatment. For example, an allocation of income in investment funds for providing services, often referred to or in the form of a *profits interest*, a *carried interest*, a *promote* or increased income through management fee waivers, can, with proper structuring, achieve income taxation at more favorable "capital gains" rates. This favorable treatment is authorized by partnership tax principles that determine the income tax character of a partner's income allocation by the character of the income earned by the investment fund.

Example: Munn contributes $1 million in cash to an investment fund. Surv, in return for managing the investment portfolio and who does not make a capital contribution, is entitled to receive an allocation of 20% of fund income. On behalf of the fund, Surv purchases $1 million of stocks in public companies, later selling

the shares for $1.1 million, causing the fund to realize a $100,000 long-term capital gain. Surv is allocated $20,000 of the long-term capital gain, and Munn is allocated the other $80,000 of the capital gain. In paying tax on the compensation for services at the capital gains rate rather than the ordinary income tax rate (thanks to the income characterization rules applicable to partnerships), Surv will cut her tax bill nearly in half.

And while death may be certain, high estate taxes on such fund interests need not be—partners can consider estate planning approaches like vertical slice planning or carry derivative agreements to transfer significant wealth transfer tax-efficiently to the next generation.

The focus of this paper is to examine the economics of interests in investment funds and then address the income, gift and estate taxation of interests in investment funds. The term *investment fund* refers broadly to pooled capital vehicles generally organized as partnerships for federal income tax purposes. Their financial structures differ significantly and generally fall into three broad categories of income-producing activities: (1) investments in marketable securities (*e.g.*, a hedge fund), (2) long-term investments in private companies (*e.g.*, a private equity fund), and (3) investments in real estate, including debt-financed real estate. These differences drive distinct economic and tax treatment of interests in an investment fund.

Each of these three classes of investment funds requires capital to invest and individuals to provide the services to operate the fund. Thus, for each of these funds, there are generally two categories of partners: the investors who provide the startup capital, whether in cash, property or a combination thereof (the "investors"), and the partners who provide services to the fund (the "service partners"), whether prior to the fund's formation (e.g., by designing a core element of the venture or bringing the parties together by promoting the activity to investors) or as future services in operating the fund (e.g., for managing the fund's investments). One complexity of the income tax treatment is that investors derive their income from allowing the fund to use their contributed capital (taxed as capital gains if the investment assets are sold as with hedge funds), while service partners derive their income by contributing their labor in the form of past or future services—and though labor is normally taxed as ordinary income, service partners can often achieve capital gains treatment for their profits interests. Furthermore, when the service partners have no capital at risk, investors frequently require that the fund structure the allocation of its income to provide themselves certain priorities upfront, with changes to the economics as capital is returned to them (the "*waterfall allocations*"). Finally, there can be different gift tax treatment of these various interests, depending upon how a capital interest or a profits interest is structured.

The objective of this paper is to demystify the interests of fund managers, promoters of private equity and real estate developers. Therefore, Part I of this paper will briefly

describe the fundamental income tax and partnership tax principles that apply. Part II describes how investment funds are financially structured between investors and service providers, using balance sheets to illustrate the impact of priority allocations and distributions among the partners. Part III discusses the federal income tax treatment upon the formation and operation of an investment fund. In particular, the materials address the income tax treatment when a service partner receives an interest in future profits, the contribution property rights created by services, waterfall allocations prioritizing capital return to investors and the impact of fee waivers designed to convert ordinary income into capital gains. Part IV addresses valuation issues, the impact of Code Section 2701 using "vertical slice" planning and the carry derivative alternative for investors and service partners who seek to transfer their interests to trusts for the next generation.

Overall, our objective is to provide an overview of the financial differences in how investors, fund managers, promoters and developers are compensated by the funds they create and the income tax treatment of such compensation. As the title of this topic is to *demystify*, we hope that this overview will be helpful.

§ 12.02 FUNDAMENTAL INCOME TAX AND PARTNERSHIP TAX PRINCIPLES

Before we examine the financial structure of hedge funds, private equity investments and real estate developments, it is helpful to describe the basic tax principles that are applied to these investments. These income tax principles are:

1. An individual who creates an asset that he owns is not taxable on the value he created ("imputed income") on his own behalf. Because he did not report the increase in the value of that asset, the individual's income tax basis in the asset is zero.
2. If the above individual contributes a zero-basis asset he created to a partnership in exchange for a partnership interest, no gain is reported, the basis in the partnership interest is zero and the partnership's basis in the contributed asset is also zero. However, the individual partner's capital account has a value equal to the value of the self-created asset contributed.
3. The character of a partnership's income is determined by reference to the partnership's purpose for the income-producing activity (for this purpose, the partnership is a separate entity from its partners). Example: If a partnership sells a capital asset at a loss, the partners must treat their share of the partnership's loss as a capital loss.
4. (a) A partner who provides services to manage the partnership's business or investment activity does not have to contribute property or cash to a partnership and is only entitled to a share of partnership

profits by providing the future services that contributed to the partnership's income.

(b) The partner who agrees to provide future services to manage the partnership's business or investments in return for a percentage of future partnership profits does not immediately report the expected share of future profits as income. Instead, the service partner reports the share of profits in income only when the income is reported by the partnership. The reason to wait is because the future income is dependent on the provision of the future services.

(c) If the future income is guaranteed to occur and the service partner is merely the partner who collects the income on behalf of the partnership, the partnership's future income is not dependent of the future services. Because the service partner's share of future income is certain to occur, the service partner must immediately report the profit allocation as income instead of waiting until the income is earned by the partnership.

5. A service partner sometimes decides to also invest in the partnership. In that situation the service partner is entitled to a share of partnership profits for providing future services and a separate share of partnership profits for a contribution of money or property to the partnership as an investor. In effect, the partner has two separate interests in the partnership, a profits interest for providing services and a separate profits interest for making a capital contribution.

§ 12.03 THE BASIC FINANCIAL STRUCTURE OF FUND INTERESTS AND WATERFALL ALLOCATIONS

Investment funds require capital to invest and individuals to provide the services to create and/or operate the fund. An investment fund is a vehicle that pools capital contributed from investors and requires others to provide the services to create and then operate the vehicle, generally operated as a partnership for Federal income tax purposes. There are three broad categories of investment funds: (i) investments in marketable securities (*e.g.* hedge funds), (ii) long-term investments in private companies (*e.g.* private equity funds) and (iii) a real estate fund (*e.g.* long-term investment in a debt-financed residential or commercial rental property). Because these vehicles have different financial structures, different expectations of the investors and different income tax treatment, we first need to review some of the fundamental income tax principles that generally apply to these different vehicles. Investors provide capital, either in the form of cash, property other than cash, or a combination of both. Service partners can provide services prior to the formation of the partnership by designing the venture, soliciting the investors, and later as future services in the operation of the partnership. Investors derive their income by allowing the partnership to use their contributed capital. In a hedge fund the money the investors contributed is invested in public stocks, capital assets that give rise to capital

gains or capital losses. Service partners derive their income by contributing their labor in the form of past or future services. *A fundamental partnership income tax principle is that the character of a partnership's income is determined by the partnership's purpose in holding the asset.*

[1] Types of Partnership Interests in an Investment Fund

From a federal income tax perspective, there are two types of interests one could have in an investment fund: a capital interest and a profits interest.

[a] Capital Interests

A capital interest is an interest in the assets of the fund which are distributable to the partner upon the partner's withdrawal from or the liquidation of the fund;[1] put another way, a capital interest represents the share of the proceeds the partner would receive if the assets were sold at fair market value and distributed in a complete liquidation of the fund (e.g., after paying off the debts and liabilities of the fund).[2]

[b] Profits Interest

A profits interest, on the other hand, is any fund interest which is not a capital interest;[3] generally, a profits interest represents a right to a share of the future profits and appreciation in the value of the assets in the fund. There are also a few different flavors of profits interest, depending on the type of fund the interest is intended to support. Relevant to fund managers, promoters and developers is the economics and taxation of:

1. A carried interest (a profits interest received in exchange for services provided to the fund; may require investors to receive a return of their initial capital and/or an internal rate of return before sharing in profits);
2. A promote (as used in these materials, a profits interest granted to a sponsor, typically in real estate or private equity, in return for services rendered prior to the formation of the venture, e.g., putting a deal together, acquiring initial assets or securing financing; sometimes also called an "acquisition interest");[4] and
3. A management fee waiver (e.g., the mechanism by which the administrative management fee owed to fund managers can be converted into a profits interest).

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[1] *See* Treas. Reg. 1.704-1(e)(1)(v).

[2] *See* Rev. Proc. 93-27, 1993-2 C.B. 343, Section 2.01.

[3] *See* Rev. Proc. 93-27, 1993-2 C.B. 343, Section 2.02.

[4] We note that the term "promote" is not defined in the Code and can be used to describe a variety of profits interests in investment funds. For purposes of these materials, we restrict the term "promote" to those profits interests granted for service-flavored property contributed to the fund.

[2] Four Ways That a Partner Might Receive an Interest in an Investment Fund

- She contributes money to the fund and receives a capital interest (an investor we'll call "Munn"),
- She contributes property other than money to the fund and receives a capital interest (an investor we'll call "Prop"),
- She contributes intellectual property[5] or other service-flavored property[6] that she created to the fund and receives a profits interest (a service partner we'll call "Ides"), or
- She performed or will perform services for the fund and receives a profits interest (a service partner we'll call "Surv").

It becomes important to remember that a carried interest, a promote, and a special allocation of partnership income are not capital interests. They are a right to receive an allocation of partnership profits received by a person who provides services on behalf of the partnership and who is not required to contribute property to the partnership.

Each of Munn, Prop, Ides or Surv could receive either a capital interest or a profits interest on account of their contributions to the fund, and over time, the nature of those interests can change as income is accumulated (causing the holder of a profits interest to also have a capital interest) or as capital interests are redeemed (causing such interest to be reduced or eliminated over time). Moreover, there are typically waterfall allocations which prioritize the return of capital to the investors from initial proceeds of the fund, with later adjustments to the economics of the split once the investors have recovered their initial investment.

Example: Waterfall allocations one might see in a private equity fund or a real estate fund occur when fund managers or promoters have a 20% profits interest that pays out only after a return of the investors capital and/or a priority allocation of partnership income to the investors:

1. Return of Capital. 100% of the profits are distributed to the investors who contributed capital to the fund until all such investors have received a return of their invested capital;
2. Preferred Return. 100% of the profits are distributed to the investors who

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[5] See *United States v. Frazell*, 335 F.2d 487, 487 (5th Cir. 1964) (nonrecognition treatment appropriate for intellectual property created prior to contribution to partnership where no obligation existed to create or contribute such property).

[6] See *Stafford v. United States*, 435 F. Supp. 1036 (M.D. Ga. 1977) (contribution of a lease and loan agreement negotiated by the taxpayer constituted a contribution of property, not services, to the partnership).

contributed capital to the fund until all such investors receive an annual rate of return (e.g., 8%) on their invested capital;

3. Catch-Up: Third, 50% of the profits are distributed to the fund managers and/or promoters who hold the 20% profits interest (with the other 50% going to the investors who contributed capital) in order to "catch-up" those profits interests to the amount that represents 20% of the overall profits of the fund (given that no profits were distributed to such partners in the first two stages of the waterfall); and

4. 80/20 Split: Fourth, having returned capital, paid out the preferred return, and caught up the profits interest holders, the remaining profits are split according to the agreed-upon split between capital investors and the service partners.

There are numerous flavors of waterfalls. The one described above is a whole-venture waterfall whereby the gains and losses are netted at the fund level; some investment funds use deal-by-deal waterfalls, whereby the economics are managed investment by investment, and others use partner-by-partner waterfalls, which calculate the carried interest or promote at the partner level rather than at the fund level. For purposes of these materials, we will use a whole-venture waterfall that calculates the carried interest or promote at the fund level to discuss the implications of the grant of a fund interest.

§ 12.04 APPLICATION OF FUNDAMENTAL INCOME TAX PRINCIPLES TO TYPICAL SITUATIONS

Before we discuss typical investment funds, it is helpful to examine how the courts treated different situations.

[1] The Key Employee

Senior owns a successful retail operating business that Senior established years ago. Senior is semi-retired and relies on a key employee to supervise daily business operations. The key employee receives a salary during the year and a year-end bonus, depending on the success of the business. The employee is reporting both the salary and the year-end bonus as compensation for services income. Instead of Senior paying a year-end bonus that is reported as compensation for services income and a deduction for the business, Senior adds the key employee as a partner in the business. The business becomes a partnership. The key employee receives a § 707(c) guaranteed payment to replace the salary. At year-end, Senior allocates a portion of the profits to the key employee to replace the year-end bonus. This special allocation follows the capital account maintenance rules[7] and has substantial economic effect.[8] Because the

[7] Treas. Reg. § 1.704-1(b)(2)(ii)(b).

operating business profits are ordinary income, the special allocation is ordinary income. Is this special allocation subject to employment taxes?

[2] Creation of Service-Favored Property

A surveyor (Prop) is hired to prepare geophysical maps for a partnership that intends to develop the land. Paying Prop her typical fee requires cash and will be taxed as ordinary income to Prop and is subject to employment taxes. Instead of Prop being hired to prepare the maps, Prop prepares the maps on her own and contributes the maps to the partnership as a contribution of property under Section 721. The capital account ($50,000 value) received for the maps equals what Prop would have charged for the maps.[9] Prop's basis for the partnership interest and the partnership's basis in the maps is zero. The partnership later sells the land at a profit. Prop's allocation of the sale proceeds equals the value of the capital contribution ($50,000) and the profit allocation from the sale (a % of the $70,000 capital account profit). The gain to the partnership is a Section 1231 gain. For Prop, $50,000 is a return of capital[10] and the remaining $70,000 is an allocation of Section 1231 gain. Instead of reporting the $50,000 for the maps as compensation income, Prop created service-flavored property treated as a contribution of property to the partnership. *See Section 735* for possible ordinary income treatment for the next 5 years.

[3] The Real Estate Promoter

Surv negotiates for the purchase of raw land that Surv intends to develop. Surv obtained a non-binding letter of intent to purchase the land for $10,000,000. Surv forms a real estate development company as a partnership. Surv contributes the option contract (basis of $0, value of $200,000) to the partnership for a $200,000 capital account. Munn contributes $10,000,000 cash to the partnership for a $10,000,000 capital account and has[11] a $10,000,000 basis in Munn's partnership interest. Munn's capital contribution is used to purchase the land. Munn expects to receive a priority *return on her investment and a return of capital so that her entire investment is* recovered. During this period, Surv has a 20% interest in profits after Munn's priority allocation is paid until all of Munn's investment is gradually recovered. After Munn's entire $10,000,000 capital contribution is recovered, all profits will be shared 50/50 (a waterfall allocation).

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[8] Treas. Reg. § 1.704-1(b)(2)(iii).

[9] *See United States v. Frazell*, 335 F.2d 487 (5th Cir. 1964) (nonrecognition treatment appropriate for intellectual property created prior to contribution to partnership where no obligation existed to create or contribute such property).

[10] IRC § 704(c)(1).

[11] *Stafford v. United States, 435 F. Supp. 1036 (M.D. Ga. 1977)* (a non-binding letter of intent to finance the construction of a building on the land is property).

[4] Conversion of Compensation Income Into Tax-free Income

An investment partnership is formed to invest in tax-free municipal bonds. The partnership hires Surv to purchase municipal bonds and manage the investment portfolio. If the partnership paid Surv a salary, the salary will be taxed to Surv as compensation income. Instead, the partnership admits Surv as a partner in the partnership to manage its investment portfolio in return for a 5% profits allocation. During the first year, Surv's K-1 allocates and distributes $100,000 of the partnership income to Surv. Surv characterizes the $100,000 allocation of income by the character of the income incurred by the partnership (the partnership is a separate entity). The partnership's income is excluded from gross income under Section 103 (municipal bond interest).[12]

[5] The Hedge Fund

Surv agrees to provide future services on behalf of an existing partnership as a partner in the partnership. Surv does not contribute any assets to the partnership. Surv's capital account upon admission to the partnership is $0. In return for managing the partnership's investment portfolio, Surv will be allocated 20% of the profits. Surv's K-1 profit allocation for the year is $100,000, consisting of $40,000 of interest income, $20,000 of qualified dividends, $10,000 of short-term capital gains and $30,000 of long-term capital gains. The charter of the income earned by the partnership determines the character of the income allocated to Surv. Surv's capital account is increased by Surv's $100,000 profit allocation. If all $100,000 is distributed to Surv, Surv's capital account is reduced back to zero. If only $90,000 of Surv's profit allocation is distributed, by allowing $10,000 of the income allocation to remain in the partnership, Surv's capital account is now $10,000.

[6] The Typical Hedge Fund Structure

In the typical hedge fund Munn contributes $98,000,000 of cash. Surv receives a 20% carried interest for services and makes a separate capital $2,000,000 capital contribution as an investor. The assets under management are $100,000,000. In addition, the partnership hires a separate management company that receives a fee for providing administrative services. The management company is an independent contractor, so it is not a partner. The management company's fee for providing these services is 2% of the value of the partnership assets. The management company is wholly-owned by Surv. The management company, as a separate entity, is not a partner and reports its 2% fee as compensation for services (ordinary income). The partnership has a corresponding business expense deduction. Partnership income before manage-

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[12] Consider Rev. Proc. 93-27, 1993-2 C.B. 343 (if the future profits are not subject to uncertainty and the risks of the activity, Surv will have to treat the receipt of a profits interest as a taxable event). If Surv must immediately report the present value of that future income, it is still tax-free income.

ment fee: $12,000,000. All short-term capital gains. Less: Administrative fee (2% of $100,000,000): $2,000,000 deduction. Partnership income after administrative expenses: $10,000,000. (Assume the investors do not receive a priority allocation for the use of their money.) Schedule K-1s: 80% allocation to investors $8,000,000 (98% allocated to Munn and 2% allocated to Surv) and the 20% allocation to Surv is $2,000,000. Both Surv's profit allocations are reported as short-term capital gains. And, Surv reports $2,000,000 as compensation income.

§ 12.05 ILLUSTRATIVE EXAMPLES OF A FUND'S FINANCIAL STRUCTURE

Investment funds are complicated financially. Because the investors' capital is at risk, investors typically require more favorable treatment because the service provider receiving an interest in partnership profits does have a risk of loss. Furthermore, investors like to see the service partner contribute cash or other assets to the partnership so that they also have a risk of loss. If the service partner makes a separate capital contribution, the service partner has two separate partnership interests, one as an investor looking for a return on their investment and the other as a service provider. Investors frequently require a priority allocation of partnership profits before any allocation can be made to the service provider.[13] Investors also require that their capital contributions be gradually redeemed as a return of their capital contribution. Once the investors receive distributions of their entire capital contribution, and no longer have any risk of loss, the profit-sharing allocations are changed (waterfall provisions) with allocations of a larger share of profits to the service partner. The next series of examples illustrate.

[1] Carried Interest

Munn and Surv decide to form a new investment fund focused on yield-oriented investments in marketable securities. Munn agrees to contribute the initial capital of the fund ($1 million), and Surv agrees to invest the cash and manage the investment portfolio in exchange for a carried interest of 20% of the fund's income (Surv agreed not to charge a management fee for this fund). In exchange for a capital contribution of cash, Munn receives a $1,000,000 capital account in the fund (representing Munn's right to receive all her investment back if the fund liquidated today), as well as a profits interest with respect to 80% of the fund's income. Surv receives a profits interest with respect to 20% of the fund's income (which, because it is received in return for services she renders to the fund, is treated as a carried interest). Munn and Surv agree that distributions of fund income will first be used to return Munn's initial capital contribution, with Surv receiving distributions only to pay her estimated taxes on

[13] Munn invests $10,000,000 in a partnership that Surv will manage for a 20% profits interest. Before determining the profits that will be shared 80/20, Munn is entitled to a priority allocation of income equal to 4% of Munn's capital contribution (4% x $10,000,000 = $400,000). For the year partnership income is $1,400,000. The first $400,000 is allocated to Munn, leaving the remaining $1,000,000 to be allocated $800,000 to Munn and $200,000 to Surv. In effect, this is a charge for the use of Munn's capital.

account of her carried interest. (To reduce administrative complexity, the partnership agreement states that Surv's estimated income tax rate is 40% for purposes of these distributions.) To further incentivize Surv, Munn agrees that the split of the profits will change once she receives back her $1,000,000 investment, with Surv then receiving 40% of the profits and Munn receiving 60%. The initial capital accounts for the fund look like this:

Capital Accounts			
	Munn	Surv	*Notes*
Initial capital contribution:	$1,000,000	$0	
Capital Account Total:	**$1,000,000**	**$0**	

In the first year, Surv successfully invests the portfolio and achieves a 10% rate of return on the fund's investments, generating $100,000 of income for the fund. Because of her 20% carried interest, Surv receives an allocation of $20,000, and Munn receives an $80,000 allocation with respect to her 80% profits interest. Using her 40% estimated income tax rate, Surv will receive a distribution of $8,000 ($20,000 x 40% = $8,000), and the other $12,000 will be distributed to Munn to redeem a portion of Munn's capital interest. Munn therefore will receive a $92,000 distribution (e.g., $80,000 of allocated fund income on account of her profits interest, and $12,000 as a partial return of her initial capital investment, which reduces her capital account). The capital accounts for the fund now look like this:

Capital Accounts (End of Year 1)			
	Munn	Surv	*Notes*
Initial capital contribution	$1,000,000	$0	
Income allocation	+ $80,000 (80%)	+ $20,000 (20%)	
Income distribution	- $80,000	- $8,000	*Surv's tax distribution*
Redemption distribution	- $12,000	- $12,000	
Capital Accounts	**Capital Accounts**	$12,000	

At the end of Year 1, the fund still has $1,000,000 of assets. If the fund liquidates, Munn will receive $988,000 and Surv will receive $12,000 (note that Surv already received an $8,000 distribution to pay her taxes on the $20,000 of income allocated to her, which reflects the overall deal of an 80/20 split of the fund's profits). Surv will receive a share of the fund assets upon liquidation (with respect to her $12,000 capital account) in addition to her carried interest (e.g., 20% of the profits until Munn is returned all her initial $1,000,000 investment, which then is increased to 40% of profits).

To continue the example, let's look at Year 2. Surv continues to invest wisely, and she achieves a 15% rate of return on the $1,000,000 of fund investments, earning $150,000

in Year 2. After allocating 80% of the profits to Munn ($120,000) and 20% to Surv ($30,000), and after making the 40% tax distribution to Surv ($12,000 = $30,000 x 40%) and the redemption distribution to Munn ($18,000), the capital accounts now look like this:

Capital Accounts (End of Year 2)			
	Munn	*Surv*	*Notes*
Capital accounts (Start of Y2):	$988,000	$12,000	
Income allocation (Y2):	+ $120,000 (80%)	+ $30,000 (20%)	
Income distribution (Y2):	- $120,000	- $12,000	*Surv's tax distribution*
Redemption distribution (Y2):	- $18,000	$0	
Capital Accounts	$970,000	$30,000	

At the end of Year 2, the fund still has $1,000,000 of assets. If the fund liquidates at the end of Year 2, Munn will receive $970,000 and Surv will receive $30,000 (reflected by Surv's capital account climbing to $30,000). Under the economics of this deal, Surv will continue to increase her capital account, receiving no further distributions of fund income except those needed to pay the tax on her income allocations, until Munn has been fully redeemed (at which point, assuming no appreciation in the fund assets, Munn will have a $0 capital account and Surv will have a $1,000,000 capital account).

As this example demonstrates, the financial structuring of the investment fund has significant impact on whether Surv owns a capital interest, a profits/carried interests, or a mix of both. How and when these interests are granted can have significant impacts on their federal income taxation, as discussed below.

[2] Promote

Ides secured favorable financing for a particular piece of real estate. With this financing commitment Munn and Ides form a real estate investment fund wherein Munn agrees to contribute the initial capital to purchase the real estate for $1,000,000 and Ides agrees to contribute the favorable financing agreement in exchange for a 20% promote. Munn receives a $1,000,000 capital account in the fund (representing Munn's right to receive all her investment back if the fund liquidated today), as well as a profits interest with respect to 80% of the fund's income. Ides is not treated as having made a capital contribution and instead receives a promote (a profits interest) with respect to 20% of the fund's income (which, because it is received in return for prior services she rendered and is not in exchange for any further services, is not treated as a carried interest). The partnership agreement provides that distributions of fund income will first be used to return Munn's initial capital contribution, with Ides receiving distributions

only to pay her estimated taxes on account of her promote. (To reduce administrative complexity, the partnership agreement states that Ides's estimated income tax rate is 40% for purposes of these distributions.) As in Example 1, Munn agrees that the split of the profits will change once she receives back her entire $1,000,000 investment, with Ides then receiving 40% of the profits and Munn receiving 60%.

Here, the financial structure of the fund in Example 2 is identical to the structure of the fund in Example 1, and the capital accounts for year 1 and year 2 in Example 2 look identical to the capital accounts from Example 1. The primary difference between Surv receiving a carried interest (Example 1) and Ides receiving a promote (Example 2) is the federal income tax treatment of those interests, which we will turn to next.

§ 12.06 THE FEDERAL INCOME TAX CONSEQUENCES TO GRANTS OF FUND INTERESTS

[1] Differentiating Between a Capital Interest and a Profits Interest

When discussing the economic structure of a partnership interest, it's common to evaluate the specific waterfall allocations—who receives how much money and when—rather than the tax terms "capital interest" and "profits interest" that determine allocations of partnership income. It is important to understand how interests in a partnership are classified and treated for federal income tax purposes to understand the economic effects of receiving, owning and transferring an interest in a fund.

The Treasury Regulations define a capital interest to mean "an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership."[14] A profits interest, according to Rev. Proc. 93-27, is any interest in a partnership which is not a capital interest.[15] The Treasury Regulations further state that "the mere right to participate in the earnings and profits of a partnership is not a capital interest in the partnership."[16] Therefore, to the extent that an interest in a fund represents a right to receive property upon withdrawal from or liquidation of the fund, such an interest is a capital interest. All other interests (e.g., rights to future profits of the fund) are a profits interest.

In this Part, we first discuss the federal income tax consequences upon the grant of a capital interest, including those that vest over time. We then discuss the more favorable treatment of profits interests, with specific focus on the treatment of grants of carried interests and promotes. Finally, we discuss the treatment of management fee income and how management fee waivers can transform the character of the income

[14] Treas. Regs. 1.704-1(e)(1)(v).

[15] Rev. Proc. 93-27, 1993-2 C.B. 343, Section 2.02.

[16] Treas. Reg. 1.704-1(e)(1)(v).

received from ordinary income (taxed at the highest rates) to long-term capital gains (taxed at favorable rates),[17] significantly improving the economic bottom line for fund managers, promoters and developers.

[2] Grant of Capital Interest

[a] The Economic Deal

The basic economic treatment of a capital interest is the present right to share in the existing net assets of the fund, as distinguished from a profits interest, which provides rights to a share of future income and appreciation. The value of the capital interest is reflected by a positive balance in the partner's capital account.

The question now is the tax treatment of a grant of a capital interest to a partner. Take a service provider who receives a 20% interest in an investment fund entitling her to 20% of not only all allocations but also all distributions of the fund, and not simply the future profits of the fund. Such a partner has received a capital interest. A capital shift occurs because if the fund were to terminate prior to any income being earned, the service partner would still receive 20% of the net assets of the fund. In investment funds, such grants are not typical, as it results in the investors who contributed capital allocating a portion of their capital to the service partner, reducing the amount distributed to them if the fund were to be liquidated. This deal, in effect, means paying the service partner before any profits are generated or any services are performed. However, some investment fund structures, such as those providing a vested interest in the fund, can be treated as a grant of a capital interest, and the tax treatment of such a grant is therefore important to understand.

[b] Tax Treatment of a Capital Shift

[i] Grant of a Vested Capital Interest

Generally speaking, the receipt of a capital interest in exchange for property contributed to the fund is a non-recognition transaction,[18] and therefore does not result in an income tax to the partners receiving their partnership interests. Thus, when (1) Munn contributes cash, (2) Prop contributes real estate, and (3) Ides contributes a pre-negotiated financing deal, Munn, Prop and Ides do not report any gain upon receipt of positive capital accounts in the fund.

The same is not true when a capital interest is received in exchange for services. Under Section 83, the grant of a capital interest in the fund in exchange for services performed or to be performed for the fund causes the fair market value of such capital interest to be included in the gross income of the service partner in the year the capital

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[17] For hedge funds that generate short-term capital gains, the tax advantages are limited.

[18] IRC § 721(a).

interest was granted, resulting in taxation under Section 61 at the ordinary income rate applicable to the service partner for that year. Thus, if Surv receives a capital interest in exchange for managing the investments of a fund, she will be taxed on the receipt of that interest in the year it is granted at her ordinary income tax rates and not the preferable capital gain tax rates. Note that this is typically a bad deal for Surv because structuring the deal as a profits interest instead could avoid both current taxation in the year the profits interest is received and could result in taxation at preferable capital gains tax rates. Moreover, it is also generally a bad deal for the capital investors, who are transferring a portion of their rights to their invested capital (*e.g.*, the capital interest shifted to Surv) before any services are performed.

Set-Up: Munn, Prop and Surv form an investment fund. Munn contributes $1,500,000 cash, and Prop contributes $1,500,000 marketable securities with a $900,000 basis. Surv does not make an initial capital contribution and will manage the investments of the fund. Under the partnership agreement for the fund, Munn, Prop and Surv will share in the fund equally, receiving identical allocations and distributions.

Result: Because the partnership agreement does not include waterfall allocations by which Munn and Prop receive a return of their initial capital before Surv shares in the fund profits, if the partnership were to liquidate immediately after formation, Surv would receive 33% of the cash and marketable securities. Surv therefore received a capital interest with a value of $1,000,000 (33% of $3,000,000 = $1,000,000) and will recognize $1,000,000 of ordinary income in the year Surv is granted the capital interest. At a 40% income tax rate (Federal and state), the tax will be $400,000. The capital accounts for the partners look like this:

Capital Accounts			
	Munn	Prop	Surv
Initial capital contribution:	$1,500,000	$1,500,000	$0
Deemed Contribution:	$0	$0	$1,000,000
Partnership Deduction	- $500,000	- $500,000	- $0
Capital Account Total:	$1,000,000	$1,000,000	$1,000,000

To harmonize the income recognition to Surv with the capital account maintenance rules in the Regulations,[19] we can treat the grant of the capital interest in two steps. First, the fund is treated as though it paid Surv the value of the capital interest ($1,000,000); second, Surv immediately contributes that $1,000,000 compensation to the fund in exchange for a capital interest. Surv received a capital interest equivalent to the income reported, and the other partners bear dilution via the compensation

[19] Treas. Reg. § 1.704-1(b)(2)(iv).

deduction ($500,000 each).[20] Any distributions upon liquidation will now align with the capital accounts, reflecting the economic deal that Munn, Prop and Surv will split all allocations and distributions from the fund equally. Because Surv reports $1,000,000 of income and pays income tax on the receipt of the capital interest, Surv's basis in the capital interest is $1,000,000.

[ii] Grant of a Capital Interest Subject to Vesting

Set-Up: The situation is the same as in Example 1, except Surv's one-third interest in the fund is subject to vesting: Surv receives 50% of the interest on each anniversary of joining the fund, with the interest fully vesting after two years. If Surv leaves prior to the second anniversary, Surv forfeits any portion of the unvested interest not yet received. If the fund liquidates in the first two years, Surv's vesting is accelerated so that Surv is treated as receiving all one-third of the interest prior to liquidation.

Result: As in Example 1, Surv's interest is a capital interest because at the time it is granted Surv has a right to a portion of the net assets of the fund upon liquidation. However, *when* does Surv receive an interest subject to vesting for tax purposes? Under Section 83, there are two options. Under the first option, each portion of a vested interest is deemed to be received at the time each vesting period ends. Therefore, Surv would be deemed to receive a 16.67% interest on each anniversary of joining the fund (50% vested of the 33% interest = 16.67%), and would recognize ordinary income with respect to such 16.67% interest each year. Importantly, if the value of the fund appreciated, the value of the 16.67% interest also appreciates, increasing Surv's taxable income (subject to ordinary income tax rates) each year.

The second option is to make an election under Section 83(b), which allows Surv to treat the entire interest subject to vesting as if Surv received it all at the initial time of grant (e.g., when Surv joined the fund). While the grant is still treated as ordinary income, Surv now treats all 33% as if received it at the beginning of the engagement with the fund, which (hopefully) is when the value of the fund's assets is lowest. The capital accounts and tax treatment for Surv are shown below, assuming that the value of the assets grows by 10% each year and that no distributions are made to the partners:

Capital Accounts (Example 2—No Section 83(b) Election)			
	Munn	Prop	Surv
Initial capital contribution:	$1,500,000	$1,500,000	$0
End of Year 1, pre-grant (10% ROR):	$1,650,000	$1,650,000	$0
Grant to Surv (50%, End of Year 1):	N/A	N/A	$550,000

[20] Because Prop transferred an asset valued at $500,000 with a basis of $300,000 to Surv, this is viewed as an exchange so that Prop reports a $200,000 gain on the exchange.

Capital Accounts (Example 2—No Section 83(b) Election)			
	Munn	Prop	Surv
Partnership Deduction (Year 1):	- $275,000	- $275,000	- $0
Capital Account (End of Year 1):	**$1,375,000**	**$1,375,000**	**$550,000**
End of Year 2, pre-grant (10% ROR):	$1,512,500	$1,512,500	$605,000
Grant to Surv (50%, End of Year 2):	N/A	N/A	$605,000
Partnership Deduction (Year 2):	- $302,500	- $302,500	- $0
Capital Account (End of Year 2):	**$1,210,000**	**$1,210,000**	**$1,210,000**

In the scenario in which Surv did not make a Section 83(b) election, Surv received a capital interest valued at $550,000 at the end of Year 1 and a capital interest valued at $605,000 at the end of Year 2. Surv's total tax liability in the no-Section 83(b) election scenario, using an assumed 40% tax rate, is **$462,000** (40% x $550,000 + 40% x $605,000).

Capital Accounts (Example 2—With a Section 83(b) Election)			
	Munn	Prop	Surv
Initial capital contribution:	$1,500,000	$1,500,000	$0
Deemed contribution:	$0	$0	$1,000,000
Partnership Deduction (at formation):	-$500,000	-$500,000	-$0
Capital Accounts (at formation):	$1,000,000	$1,000,000	$1,000,000
End of Year 1 (10% ROR):	$1,100,000	$1,100,000	$1,100,000
End of Year 2 (10% ROR):	$1,210,000	$1,210,000	$1,210,000
Capital Account (End of Year 2):	**$1,210,000**	**$1,210,000**	**$1,210,000**

In the scenario in which Surv does make a Section 83(b) election, she is treated as receiving her entire one-third interest at the time she joins the fund, when the interest is then valued at $1,000,000. Her total tax liability in the Section 83(b) election scenario, using her assumed 40% tax rate, is thus **$400,000** (40% x $1,000,000). She saved $62,000 by making the Section 83(b) election, paying 13.4% less tax than when she chose not to make the election. Given the possible tax consequences inherent to making grants of capital interests when the fund has appreciated assets, it is common that investment funds require those receiving vested interests to make the Section 83(b) election at the time of grant.

[3] Grant of a Profits Interest

[a] The Economic Deal

As discussed above, a profits interest in an investment fund gives the holder a right to share in the income generated by a fund's operations. As income is allocated to the partner, such amounts are reflected in the partner's capital account (giving rise to a capital interest with respect to such allocated income) and as they are distributed out to the partner correspondingly reduces such capital account. The amounts allocated to the partner follow the mechanics of the fund's waterfall provisions, meaning that the profit which should be allocated to the partner may be delayed to a later stage in the waterfall to first return capital and a preferred return to the fund's investors.

The question now is the tax treatment of a grant of a profits interest to a service partner. As discussed below, the primary advantages to a profits interest are: (1) the income allocated to the service partner retains its character as reported by the partnership, allowing for some or all of the income to be taxed at rates lower than the ordinary income rates that typically apply to compensation for services and (2) the income is not reported until there is an allocation of income to the partner at the end of the partnership's tax year, allowing for compensation to be deferred.

[b] Tax Treatment

As a threshold matter, the grant of a profits interest (whether carried interest, a promote, or another flavor of profits interest) is generally not a taxable transfer for federal income tax purposes. Rev. Proc. 93-27 provides a safe harbor in this respect—it states that "if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipate of being a partner, the [IRS] will not treat the receipt of such an interest as a taxable event for the partner or partnership." However, the safe harbor does not apply if:

1. The profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease;
2. If within two years of receipt, the partner disposes of the partnership profits interest;[21] or
3. If the profits interest is a limited partnership interest in a "publicly traded partnership."[22]

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[21] Rev. Proc. 93-27 only addressed the income tax treatment. Therefore, the zero value liquidation approach in Rev. Proc. 93-27 should not apply to a disposition of a profits interest as a gift.

[22] IRC § 7704(b).

Rev. Proc. 2001-43[23] clarified Rev. Proc. 93-27's safe harbor in the context of a profits interest that is subject to a substantial risk of forfeiture by providing that the determination of whether an interest is a profits interest for purposes of the safe harbor is determined at the time the interest is granted, even if the interest is not vested under of Section 83. Rev. Proc. 2001-43 provides that taxpayers do not need to file Section 83(b) elections, if the grant of the profits interest is not immediately taxable under the safe harbor. In effect, the grant of a profits interest does not create a positive capital account. Secondly, the event that causes the interest to be vested is not a taxable event.

Proposed regulations[24] and a proposed revenue procedure,[25] released in 2005, provide that a profits interest is "property" for purposes of Section 83 and would be subject to the Section 83(b) election. Under these proposals a service partner would be required to take into income the grant of a profits interest at its current value (though it adopted favorable valuation treatment by allowing the liquidation value,[26] which would be zero, to be used to value the profits interest, which would be higher than if it reflected the possibility of future success of the fund). Because the proposed regulations have not been finalized and because the proposed revenue procedure has yet to be adopted, the safe harbor under Rev. Proc. 93-27 is intact for now. Given the possibility that the grant of a profits interest could be taxable at the time it is granted if the facts fall outside of the safe harbor, many practitioners recommend filing a Section 83(b) election upon receipt of a profits interest, given it has no liquidation value at the time of grant and therefore no tax would be owed even if the safe harbor did not apply. It is common for purchasers of partnership interest to request copies of Section 83(b) elections for all grants of profits interests.[27]

The IRS also clarified that the application of Rev. Proc. 93-27 should be limited to the narrow situation it was intended to address[28] holding that the receipt of a profits interest does not result in deferred compensation for purposes of Section 409A if the grant is not includible in the partner's income. This is significant, as Section 409A

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[23] 2001-2 CB 191.

[24] REG-105346-03, 70 Fed. Reg. 29675 (May 24, 2005).

[25] Notice 2005-43, 2005-1 C.B. 1221.

[26] Prop. Reg. § 1.83-3(l)(1).

[27] The Tax Court held that the Rev. Proc. 93-27 safe harbor should be extend to apply to profits interests granted through tiered partnership structures, wherein a partner receives a profits interest in one fund while providing services to another fund in the structure. *ES NPA Holding, LLC v. Commissioner*, T.C. Memo. 2023-55. The case effectively extends the reach of Rev. Proc. 93-27 to the tiered partnership structures more commonly used by investment funds and reinforces the use of liquidation value in determining if a fund interest qualifies as a profits interest at the time of grant (and therefore was not a taxable event).

[28] Notice 2005-1, 2005-1 CB 274.

requires the immediate taxation of certain deferred compensation plans that do not meet its stringent election and distribution requirements, while also imposing an additional 20% penalty on such plans. While the final Section 409A regulations do not address the application of Section 409A to arrangements between partners and partnerships, taxpayers can continue to rely on the interaction of Notice 2005-1 and Rev. Proc: 93-27 in having comfort that Section 409A does not apply to gifts of profits interests.

So, when is income reported with respect to the grant of a profit interest if no income is reported when it is received? Under fundamental income tax principles, a partner reports its allocation of partnership income on the last day of the partnership's tax year and therefore not necessary in the year the partner's services were performed.[29] This can result in an advantageous deferral of income. Moreover, the income allocated to a partner retains its character (e.g., capital gains) based on how the income producing assets are held by the partnership despite that the profits interest itself arose as compensation for services performed for the partnership (consider that labor income is taxed as compensation for services). This fundamental principle has been applied by the courts[30] unless there is a statutory exception.[31]

[4] Grant of a Carried Interest or Promote

[a] The Economic Deal

A carried interest (often called a "carry") is a flavor of profits interest in which fund managers or sponsors receive a share of the profits of an investment fund, but only after the investors have been granted certain thresholds—commonly, a return of their contributed capital, and sometimes a preferred return or hurdle. Promotes (as such term is used in these materials) are typically granted to developers, sponsors or promoters on account of significant services rendered prior to the operation of the investment fund, including on account of certain acquisitions, arranging financing, or putting together the deals the fund will manage. Promotes are also commonly structured to be paid out after a return of capital and a preferred return to the investors.

The purpose of a carry and promotes is to align the incentives of the fund managers with those of the investors: the managers only earn their allocations once the fund has sufficiently successful. While fund managers may put in a small portion of the fund's capital (often called the "General Partner's commitment") and may receive a manage-

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[29] IRC § 702(a).

[30] In *Wheeler v. Commissioner*, 37 T.C.M. 883 (1978), the court held that the service partner's 25% share of the fund's realized capital gains income retained its character as capital gains when allocated and distributed to the service partner

[31] Under § 735 if a partner contributes property that was held as inventory while held by the partner that the partnership converts to a capital asset, the ordinary income taint continues for the next five years while held by the partnership.

ment fee to cover administrative expenses, carried interests and promotes tie the primary means by which these service partners are compensated to the performance of the fund's investments. The typical percentage for such interests is 20%, though the actual percentage and the waterfall allocations with respect to that carry or promote can vary significantly fund to fund.

One of the most attractive features of carry and promotes is that these interests are taxed based on the character of the investment fund's underlying income (unlike a salary or bonus, which are always taxed as ordinary income). As many investment funds hold capital assets that, when sold, recognize long-term capital gains, it is typical that income allocation from a carry or promote is taxed at long-term capital gains rates. The Tax Cuts and Jobs Act of 2017 added Section 1061, which increased the holding period with respect to these interests (albeit with certain exceptions) from one year to three years. Thus, fund managers are typically required to hold their carried interests for at least three years to benefit from the beneficial tax treatment using these profits interests.

[b] Tax Treatment

The grant of a carried interest or promote and the tax treatment of income with respect to those interests follows the rules for profits interests described above. However, as noted here, there is an additional hurdle for a carry or promote so that it qualifies as an "applicable partnership interest" (or "API") under Section 1061. Final regulations for Section 1061 were issued January 7, 2021.[32] Generally, Section 1061 applies to APIs held or transferred in connection with the performance of substantial services in an "applicable trade or business," unless an exception applies. An applicable trade or business is any activity which is conducted on a regular, continuous or substantial basis and which consists of raising or returning capital or investing, disposing, or developing certain assets, including securities, real estate and cash. Thus, carried interests and promotes for fund managers, developers and promoters are typically APIs subject to the three-year holding period under Section 1061. The three-year holding period applies to the sale of a carried interest or promote for long-term capital gain treatment. It does not impact the character income allocation during the three-year period.

There are a few exceptions to the application of Section 1061 and its three-year holding period requirement. First, Section 1061 provides an exception for gain with respect to capital interests (e.g., gain earned with respect to invested capital). For this exception to apply, allocations and distributions with respect to a partner's capital interests (e.g., those of a hedge fund manager after a book-up event) must be "reasonably consistent" with the rights applicable to investors in the fund (e.g., those

[32] Treas. Reg. § 1.1061-1, T.D. 9945 (2021).

with 5% or more of the aggregate capital balances of the fund). The final regulations confirm that capital interests will not be ineligible for the exception solely because the partner is not charged with management fees or a carried interest (as the capital interests of fund managers are typically carved-out) nor on account of a partner's right to receive tax distributions as advances against future distributions. Therefore, future allocations with respect to increased capital accounts of fund managers will not be subject to the three-year holding period of Section 1061 to the extent the capital interest such capital account reflects meets the exception requirements of Section 1061.

A second key exception from the application of Section 1061 are gains with respect to Section 1231. Section 1231 gains are generally those from the sale of depreciable personal property and real property used in a trade or business and held for more than one year. This is of particular relevance to developers, promoters and fund managers in real estate funds, wherein a significant portion of the fund's underlying income may include Section 1231 gains. A carried interest or a promote in such a real estate fund can escape application of Section 1061 and thus benefit from the shorter one-year holding period generally required for long-term capital gains.

Furthermore, as discussed below, the final regulations provide that Section 1061(d), which requires taxpayers to recognize gain on transfers of interests to certain related persons, does not apply to transfers where gain is not otherwise recognized, including gifts of such interests.

Finally, there are special concerns that apply to the grant of a promote, given such interest is granted with respect to past services. As discussed above, capital interests are included in a partner's income at the time of grant, while the receipt of a profits interest is not a taxable event. However, the non-recognition safe harbor under Rev Proc. 93-27 does not apply to a profits interest which relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease. Moreover, the partnership disguised payment for services rule[33] should be considered to the extent the profits interest lacks entrepreneurial risk (and thus may be recategorized as a payment for services subject to ordinary income tax rates and employment taxes). In order to preserve the beneficial tax treatment of a promote profits interest, it's important that the fund's allocation and distribution waterfall avoid early monetization of the promote and does not include predictable revenue streams so as to fall within the safe harbor of Rev. Proc. 93-27, thus maintaining its treatment as a profits interest for income tax purposes.

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[33] IRC § 707(a)(2)(A).

[5] Management Fees and Fee Waivers

[a] The Economic Deal

Fund managers typically charge the investment fund a separate management fee to pay for the administration of the investment fund. The management fee is paid by the fund to a separate entity that happens to be owned by fund managers. Most private equity funds, hedge funds, and real estate funds charge these fees as a percentage of committed or invested capital and are generally around 1–2% annually. The fee flows to a separate management company that is controlled by the fund manager and covers salaries and overhead for the management company's staff. These fees are treated like other service-based compensation: they result in ordinary income to the management company and are a deductible business expense for the fund. Unlike carried interests and promotes, which include entrepreneurial risk and are measured by a share of the investment fund's profits, management fees are fixed and predictable.

However, fund managers have an opportunity to change that tax treatment—converting the fees' ordinary income character into long-term capital gains—by use of management fee waivers. A management fee waiver is used to waive the right to collect some or all of the manager's fixed fee in exchange for an increased share of the fund's future profits. Fund managers can thus convert their fixed fees—taxed as ordinary income—into a profits interest that effectively increases the size of the manager's carried interest or promote percentage, taxed by the character of the fund's underlying income (e.g., sometimes long-term capital gains).

When providing services as a third party for a fixed fee of 1% to 2% of the value of the assets under management or of 1% to 2% of gross revenues, it is difficult to avoid ordinary income treatment. However, a trade-off can be negotiated by accepting a lower fee for a larger back-end participation in profits (like a larger carried interest). Moreover, other types of fees, such as an acquisition fee may be waived and replaced by a greater back end or profits participation. In some instances, it may be possible to grant a capital account to the fund manager in exchange for a contribution of "service flavored property" rather than solely a profits participation.[34] Note that the grant of a capital account for a contribution of service flavored property requires consideration of Section 704(c) principles, which require income recognition over time to take into consideration the difference between the book capital account (the agreed value of the contribution) and its tax basis (typically zero). In other words, what would be taxable as ordinary income at the inception of the arrangement can result in significant deferral under the Section 704(c) method and perhaps capital gain treatment as well.

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[34] See generally *Stafford v. United States*, 435 F. Supp. 1036 (M.D. Ga. 1977) (a non-binding letter of intent to finance the construction of a building on the land treated as property that was contributed to the partnership for a capital account based upon an agreed value).

[b] Tax Treatment

From a tax perspective, the management fee waiver must meet the Rev. Proc. 93-27 safe harbor and avoid treatment as a disguised payment for services.[35] So that the fund manager that owns the management company will not recognize income upon the fee waiver itself (e.g., as the manager does not recognize income upon the grant of a profits interest). The increased allocations of future income from the fund will instead be taxed under the principles that apply to a profits interest, as discussed above. Importantly, the IRS has repeatedly scrutinized these arrangements, emphasizing that to avoid recharacterization, the management fee waiver must involve a significant entrepreneurial risk and not function as a guaranteed payment. The 2015 proposed regulations with respect to management fee waivers[36] identify six non-exclusive factors that indicate an arrangement may constitute a disguised payment for services, the most important of which is the presence of significant entrepreneurial risk. The other five factors, which are all secondary to the significant entrepreneurial risk factor, include (1) the service partner holds the interest for only a short duration, (2) the service partner receives an allocation and distribution in a time frame comparable to when a non-partner would typically receive payment, (3) the service partner became a partner primarily for tax benefits not available if the compensation was received as a non-partner, (4) the value of the profits interest is small in relation to the allocation and distribution, and (5) if the arrangement provides for different allocations and distributions with respect to different services received, where the services are provided by the same person (or related persons) and the terms of the differing allocations and distributions are subject to levels of entrepreneurial risk that vary significantly. These factors all indicate that where a management fee waiver is used to convert a guaranteed payment into a right to future profits, such waiver will only be respected as a profits interest (and governed by the tax rules applicable to such interests) where significant entrepreneurial risk is at play and the other secondary factors do not suggest such waiver is a disguised payment for services. If the management fee waiver is respected, then it may be able to convert the character of the fund manager's compensation from ordinary income to long-term capital gains income (according to the underlying investments of the fund), significantly reducing the manager's tax burden.

Notably, while it was the IRS's contention that the proposed regulations reflected existing law, the text of Section 707(a)(2)(A) provided that it was subject to regulations prescribed by the Secretary, which regulations would not be effective until made final. However, the One Big Beautiful Bill Act amended Section 707(a)(2)(A) to clarify that the provision will apply as written (i.e., it is no longer contingent on final regulations) and is therefore self-executing. Thus, the prohibition on disguised payments for

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[35] *IRC § 707(a)(2)(A).*

[36] Prop. Reg. § 1.707-2(b), (c) and (d) Example 3.

services in Section 707(a)(2)(A) is one which any management fee waiver must carefully address in its structuring to achieve the beneficial tax treatment that a profits interest offers fund managers.

§ 12.07 THE FEDERAL TRANSFER TAX CONSEQUENCES TO TRANSFERRING INTERESTS IN A FUND

In this Part, we discuss the federal gift tax treatment of gifting fund interests, the nuances of valuing fund interests and strategies for transferring wealth tax-efficiently. We begin by looking at general considerations for transfers of fund interests, followed by a discussion of the application of Section 2701 and the vertical slice planning fund managers, promoters and developers grapple with when making gifts of their profits interests. Finally, we look at an alternative to vertical slice planning—the carry derivative agreement—as a means for transferring wealth with respect to carried interests efficiently while minimizing administrative burden.

[1] General Considerations and Tax Consequences for Transferring Interests

Just like any other asset owned by an individual, a vested carried interest, promote or other profits interest is a valuable property right that can be transferred to others by gift during life or by bequest upon a partner's death. Generally, the best time to transfer an interest in the future profits of a fund is at the outset of the fund, when investment performance is still speculative and no gains have yet accrued with respect to such profits interest. Such a profits interest will have its lowest value for gift tax purposes at this point, requiring the least use of a partner's lifetime gift exemption (or incurring the least in gift tax). However, valuation of these interests can be tricky—the profits interest still has an option value at the outset of the fund, and a multitude of factors (e.g., prior performance by the management team, interest rate environment, nature of the fund's investments) can drive the valuation prior to recognizing any investment income. Other issues further complicate the transfer of profits interests. It can be difficult to determine the amount to gift at the outset (given there is substantial entrepreneurial risk associated with a profits interest, it is difficult to foretell the future value of the interest). If such an interest is subject to future vesting, then what was intended as a single gift could in fact result in a series of gifts that occur over time as the interest continues to vest, with subsequent gifts more valuable than earlier gifts as the fund's investments mature.

On top of this natural uncertainty as to the value of an interest is the deemed gift rules under Section 2701. As discussed below, in the context of a typical investment fund, the transfer of a carried interest or promote without a pro rata transfer of a partner's capital interest can cause the profits interest to be valued as if all of the partner's capital interest were also transferred, causing the value of the gift for gift tax purposes to be much greater than anticipated. These materials discuss two solutions to this issue: the use of vertical slice planning and the use of carry derivatives.

[2] Introduction to Section 2701

Section 2701, enacted in 1990,[37] was designed to prevent the manipulation of values for interests in family entities that had preferred and common partnership interests. Prior to the 1990 legislation, individuals looking to reduce the value of interests in family entities for gift and estate tax purposes transfers in trust or directly to their descendants could create a partnership (or recapitalize an existing one) with two classes of interests: a preferred interest, with various discretionary rights, and a common interest that was later gifted where the common interest would be entitled to the appreciation in the value of partnership assets. The value of the preferred interests could be aggressively inflated by granting discretionary rights that the preferred interests could (but were not required to) exercise. Therefore, parents were able to gift the common interests to their children at low valuations while never actually exercising some or all of the discretionary rights of the preferred interests such parents retained, thus effectuating significant wealth transfers at significant discounts.

Section 2701 sought to address this by creating a new regime for valuing gifts of interests in partnerships and corporations to family members. Section 2701 seeks to *mitigate the manipulation of the value of a gifted interest (i.e., the interests transferred* to a junior family member) by inflating the value of the retained interest (i.e., the interests retained by the senior family member) through the use of extraordinary payment rights or distribution rights.

The special valuation rules of Section 2701 apply any time an individual transfers an interest in a partnership or corporation to a member of the transferor's family if, immediately after the transfer, the transferor (or any applicable family member) holds an interest in such entity that is an "applicable retained interest," or an interest in an entity that confers an "extraordinary payment right" or "distribution right." The term "member of the transferor's family"[38] includes the transferor's spouse, the lineal descendants of the transferor and the transferor's spouse, and the spouses of such lineal descendants. The term "applicable family member" includes the transferor's spouse, the ancestors of the transferor and the transferor's spouse, and the spouses of such ancestors. Thus, Section 2701 generally applies when an interest is transferred to a family member of a younger generation than the transferor (noting that siblings, aunts, uncles, nieces and nephews are not captured by these family definitions). The term "extraordinary payment right" includes a liquidation, put, call or conversion right wherein the exercise or non-exercise of such right affects the value of the interest, and wherein the exercise of such right is discretionary. The term "distribution right" includes the right to receive distributions from an entity that is controlled (e.g., holding

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[37] Pub. Law 101-508, § 11,602, 104 Stat. 1388-500.

[38] IRC § 2701(e).

50% or more of the voting power or fair market value) by the transferor and/or certain family members (including lineal descendants) immediately prior to the transfer; provided that, for limited partnerships, any interest in a limited partnership as a general partner qualifies as control. As senior family members who retain interests with extraordinary payment rights or distribution rights can simply elect not to take such payments or make such distributions, they could effectuate a significant transfer of wealth to the holders of the junior common interests (e.g., the families of their lineal descendants). The drafters behind Section 2701 were concerned with techniques which shifted growth out of the transferor's estate at minimal gift-tax cost.

Notably, Section 2701 is a labyrinth of complexity—for purposes of these materials, we highlight the general idea behind its deemed gift regime to emphasize the gift tax risks involved in transferring a portion of carry, promote or other profits interest to a partner's family. Generally, Section 2701's solution is to determine the gift tax value of the transferred interest to the junior family member using the "subtraction method," with a zero-value rule applying to the retained interest held by the senior family member. In short, the subtraction method determines the value of the transferred interest by taking the aggregate value of all equity interests in the transferred entity held by the transferor and applicable family members prior to the transfer and subtracting out the value of all equity interests retained by the transferor and applicable family members immediately after the transfer. If the retained interest is an applicable retained interest for purposes of Section 2701, then its value for this calculation is zero. Generally, the net result is that, for purposes of the gift tax, the value of the transferred interest is equal to the value of the transferred interest *plus* the retained interest. Thus, without careful planning to avoid the application of Section 2701, making a gift of a carry, a promote or another profits interest can have significant gift tax consequences which undercut a partner's goal of efficiently transferring wealth to the next generation.

[3] Strategies for Handling Section 2701: Vertical Slice Planning

Section 2701 contains a useful exception to the application of its deemed gift rules: if the retained interest is proportionally the same as the transferred interest, the zero-value rule does not apply to such retained interest. Thus, the value of a fund manager's transferred profits interest will not be inflated by the value of the retained capital interest to the extent that there is a proportionate gift of the fund manager's capital interest. This approach is called the "vertical slice." Imagine that all of a fund manager's interests in an investment fund were a cake. Instead of slicing off and transferring just the icing, well-known to be the best bit of cake (e.g., the carried interest with the greatest appreciation potential), and leaving behind the spongey, less sugary part (e.g., the capital interest), a vertical slice cuts through every layer of the cake (e.g., all of a fund manager's interests in the fund) to transfer a proportionate amount of all layers to the transferee. Under the vertical slice exception, the special valuation rules

of Section 2701 do not apply, and the value of the transferred interest (e.g., a portion of the fund manager's carry plus a pro rata portion of the capital interest) is simply the fair market value of what is transferred.

The following example illustrates the retention of retained interest proportionally the same as the transferred interest:

Example: Senior owns stock in public company with a $10,000,000 market value that is expected to increase in value. Senior forms a single-member limited liability company receiving a preferred interest valued at $9,000,000 with a fixed priority return and a common interest valued at $1,000,000 that is entitled to an allocation of all income over the preferred priority allocation of income. Senior gifts the common interest to an irrevocable non-grantor trust[39] for the benefit of Senior's descendants and reports a $1,000,000 taxable gift. Pursuant to the terms of the LLC operating agreement all the requirements under Section 2701 are satisfied. Because the rate of return on the preferred interest is fixed, all increases of LLC income and increases in the value of LLC assets are allocated to the common interest. In effect, Senior retained a 90% proportion of the value of the LLC and gifted a 10% proportion.

In most hedge funds, in addition to 20% of the common income allocation, Surv makes a separate contribution of $1,000,000, entitling Surv to a separate return as an investor. If Surv desires to make a gift of 80% of his carried interest, Surv is required to also gift 80% of the preferred interest.

Investment funds are not always so simple to cut up into neat proportions. Carried interests or promotes can be granted on an investment-by-investment basis, rather than at the fund level; or they could be granted annually for all investments made over the course of that year; or they could be subject to vesting, with a fund manager's portion of carry or promote growing as they continue to provide services to the fund. In these cases, the fund manager will need to make additional transfers of their interests to maintain the pro rata vertical slice that they crafted upon making their initial gift of interests to their family. As discussed above, management fee waivers can be used to convert guaranteed annual payments into grants of an additional interest in the fund's profits. Such arrangements create a new class of interests that also must be transferred (as another layer of the vertical slice) where such rights to the fund's profits are senior to the carry or promote. And if the capital interest layer of the vertical slice is subject to future capital calls, then the fund manager needs to also ensure that the family trust which is typically making such gift has adequate funds to meet those capital calls when

[39] With two taxpayers for federal income tax purposes, the LLC is a partnership for the federal income tax.

made (especially if the carry or promote will not yet have begun receiving allocations and distributions of fund income which could otherwise be used to fund such capital calls).

[4] Strategies for Handling Section 2701: Carry Derivative Agreements

For practical reasons, one does not want to transfer their carried interest. A second strategy to avoiding the deemed gift rules of Section 2701 is to instead use a carry derivative agreement to transfer the upside value of these profits interests. A carry derivative agreement is a contract between a fund manager and an irrevocable grantor trust for the benefit of the manager's family in which the trust purchases the right to receive certain amounts in the future if the carried interest or promote which the manager holds in an investment fund hits certain performance benchmarks. In effect, the fund manager is not transferring a profits interest subject to Section 2701 but rather is transferring a separate financial instrument whose value is tied to the economic performance of such profits interest (and to which Section 2701 does not apply). Thus, a carry derivative agreement allows a fund manager to transfer the economic benefits of her carry without transferring the actual interest in the fund, avoiding not only the Section 2701 deemed gift rules but also the various complications we raised above with respect to transferring fund interests (e.g., meeting capital call requirements, future gifts based on new allocations of carry, etc.).

The backbone of a carry derivative agreement is the formula which determines the value of the contract and the rights of the trust to receive amounts in the future. Generally, a carry derivative will state that, in exchange for an upfront purchase price paid to the seller (i.e., the fund manager), the purchaser of the contract (i.e., the trust) will receive payouts in the future based on certain settlement dates. These settlement dates are typically late in the fund's life (e.g., at year 6, year 8 and year 10) when the manager's carry or promote will be sharing in the fund's profits. The payouts at each settlement date may use a formula which first sums all distributions (less clawbacks) made to the fund manager with respect to his or her carry, then subtracts out a set hurdle (i.e., the amount the fund manager wants to first retain from her carry before transferring excess amounts to the trust), and then applies a set percentage (e.g., 60%, so that the fund manager retains sufficient funds with respect to the carry to pay the income taxes for the grantor trust) to arrive at the payout amount owed to the trust. The carry derivative can also include a cap, which is the maximum amount that the purchasing trust can receive under the agreement (so as to avoid overfunding the trust if the fund performs exceedingly well). These features—a hurdle, a percentage split, and a cap—are each useful levers to adjust the economics of the carry derivative agreement so as to customize it to the specific goals of a fund manager; they also each impact the value an appraiser will assign to the contract, thereby modulating the gift tax cost of the agreement (e.g., assuming the fund manager gifts the trust the cash used to enter into the agreement).

Example: The design of a carry derivative is based on a 20% carried interest, with a $2,000,000 hurdle so that the percentage split is 60%, and there is one settlement date at year 10 (e.g., the trust will receive 60% of the distributions with respect to the carry which exceed the first $2 million in distributions over the first 10 years of the fund). The contract is appraised at $750,000, and the trust purchases the contract from the fund manager. Over those 10 years, $15 million in distributions are made to the fund manager with respect to the 20% carry. On the settlement date, the fund manager pays the trust $7,800,000 ($15,000,000 in distributions less the $2,000,000 = equals $13,000,000, and 60% of $13,000,000 = $7,800,000). Therefore, for a gift tax cost of $750,000, the fund manager was able to ultimately transfer $7,800,000 to a family trust.

There are several key benefits to the use of a carry derivative agreement that make it more attractive than the vertical slice approach. A carry derivative agreement includes a great deal of flexibility with respect to the economics of the transfer, ensuring that a fund manager both shares in a sufficient amount of the economics (e.g., by use of the hurdle) and that a trust is not overfunded because too great an interest was transferred to the trust (e.g., by use of a cap). Because the carry derivative agreement is based on a set amount of the carry or promote, there is no adjustment for dilution due to new partners joining the investment fund or a loss of carry due to an early departure by the manager. Moreover, it avoids vesting issues completely, as no interest subject to vesting is actually transferred (but rather, a new financial instrument based on the economic performance of such interest is created). The trust is not responsible for funding any capital calls (since it does not receive any capital interest as part of the transfer, as it would when using a vertical slice approach), no additional transfers need to be made in the future if the fund manager receives additional capital or profits interests (as would be needed under a vertical slice), and the time horizon can be set (e.g., because the carry derivative is based on known settlement dates). And to be certain, a carry derivative is not without risks: the fund manager may not have the liquidity to settle the contract on account of a reduced carry due to dilution or vesting, requiring the use of a note to pay the settlement amount; the IRS could challenge the valuation of the price of the contract, possibly resulting in additional gift tax; and post-death payments can be taxable income to the trust (though resolvable by making the final settlement due at the earlier of the death of the fund manager and the last settlement date). A carry derivative can be straightforward and more flexible than the vertical slice approach.

[5] Valuation of a Carried Interest

There is a common misconception that the carried interest in a start-up fund or an early-stage fund is "worth nothing." As you may recall, in determining whether the grant of a profits interest must be reported as income at the time of the grant, Rev. Proc. 93-27 defined a capital interest as an interest in the assets of the fund which are distributable to the partner upon the partner's withdrawal from or the liquidation of the

fund, and a profits interest is any fund interest which is not a capital interest. When the fund is formed, the investors supply all the capital investments, and the profits interest does not provide any investment. Because the profits interest would not receive any distributions if the funds were immediately liquidated, it is thought that the profits interest has no immediate value for gift tax purposes. Rev. Proc. 93-27 did not address the value for a profits interest. It merely addressed when the service partner needs to report the value of future profits in the service partner's income.[40] Because a profits interest represents a right to a share of the future profits, it still has a current value for gift tax purposes. Although that valuation will be speculative, it still has some value. An appraiser would typically approach the valuation of carried interest by applying discounted cash-flow method, calculated on several factual assumptions (e.g., fund's committed capital or anticipated assets under management, expected return, nature of investments, expenses, and anticipated timing and amount of carried interest distributions). The appraiser would likely conclude that the value of carried interest is significantly greater than zero but substantially less than the present value of the fund's anticipated income over time.[41]

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[40] Because Rev. Proc. 93-27 only addressed when income is reported, the zero value liquidation approach in Rev. Proc. 93-27 should not apply to a disposition of a profits interest as a gift.

[41] The value of the service partner's profits interest is separate from the capital interest when the service provider made a separate contribution of cash or property as an investor. The vertical slice requirement bifurcates the service provider's gift as a gift of two separate assets, a profits interest and a capital interest.