PRIVATE INVESTMENT FUND
TAX & ACCOUNTING FORUM

Update on Management Fees and Carried Interest

Morgan Klinzing, Troutman Pepper

Michael Spiro, Finn Dixon & Herling LLP

FRA
Wilmington plc

Carried Interest Planning Strategies

Optional section descriptor here

Section 1061--Overview

- Reclassifies capital gain received from applicable partnership interest (API) or from disposition of API as short term if the holding period is less than 3 years
- API - any interest in a partnership which
  - directly or indirectly, is transferred to (or is held by) an Owner Taxpayer or Passthrough Taxpayer
  - in connection with the performance of substantial services by the Owner Taxpayer or by a Passthrough Taxpayer, or by any Related Person, including services performed as an employee
  - in any applicable trade or business (ATB) unless an exception in §1.1061-3 applies

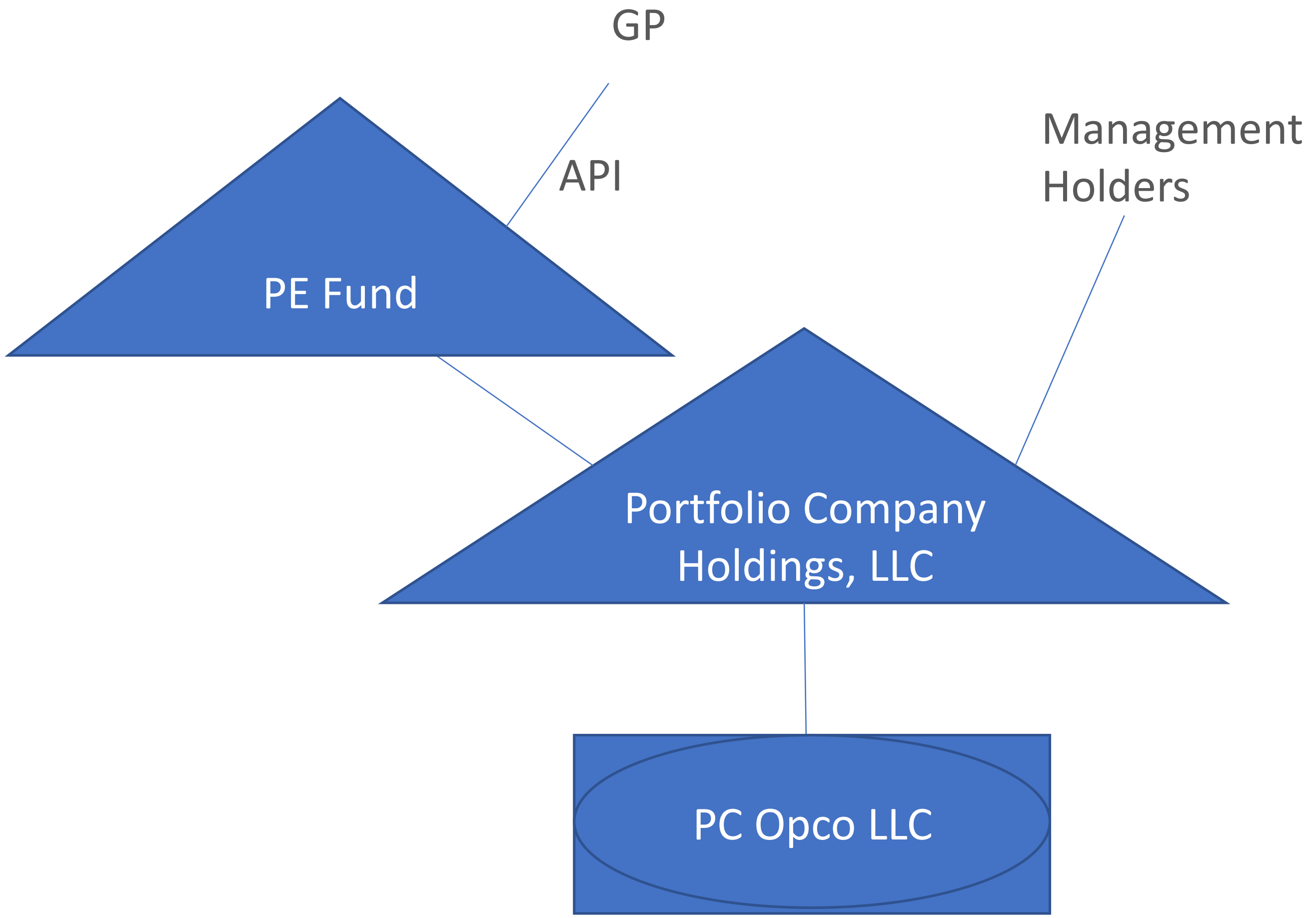
Applicable Trade or Business

- Investing or developing actions – actions involved either investing in (or disposing of) Specified Assets or Developing Specified Assets
- **Specified Assets**
  - Securities as defined by IRC Sec. 475(c)(2) – equity, debt instruments, derivatives, etc
  - Commodities as defined by IRC Sec. 475(e)(2)
  - Real estate held for rental or investment
  - Cash or cash equivalents
  - An interest in a partnership to the extent that the partnership holds Specified Assets
- **Developing specified assets**
  - Represented to investors, lenders, regulators, or other interested parties that the value, price, or yield of the portfolio business may be enhanced or increased in connection with choices or actions of a service provider.

1231 Exception

- The 3 year holding period applies only to capital gain—not non-capital gain taxed at the long-term capital gains rate:
- 1256 contracts
- Qualified dividend income
- Section 1231 gain.
- Section 1231 gain:
  - Gain from the sale of depreciable property used in a trade or business.
- Includes 197 intangibles (Treas. Reg. §1.197-2(g)(8))

Example 1: §1231 Gain



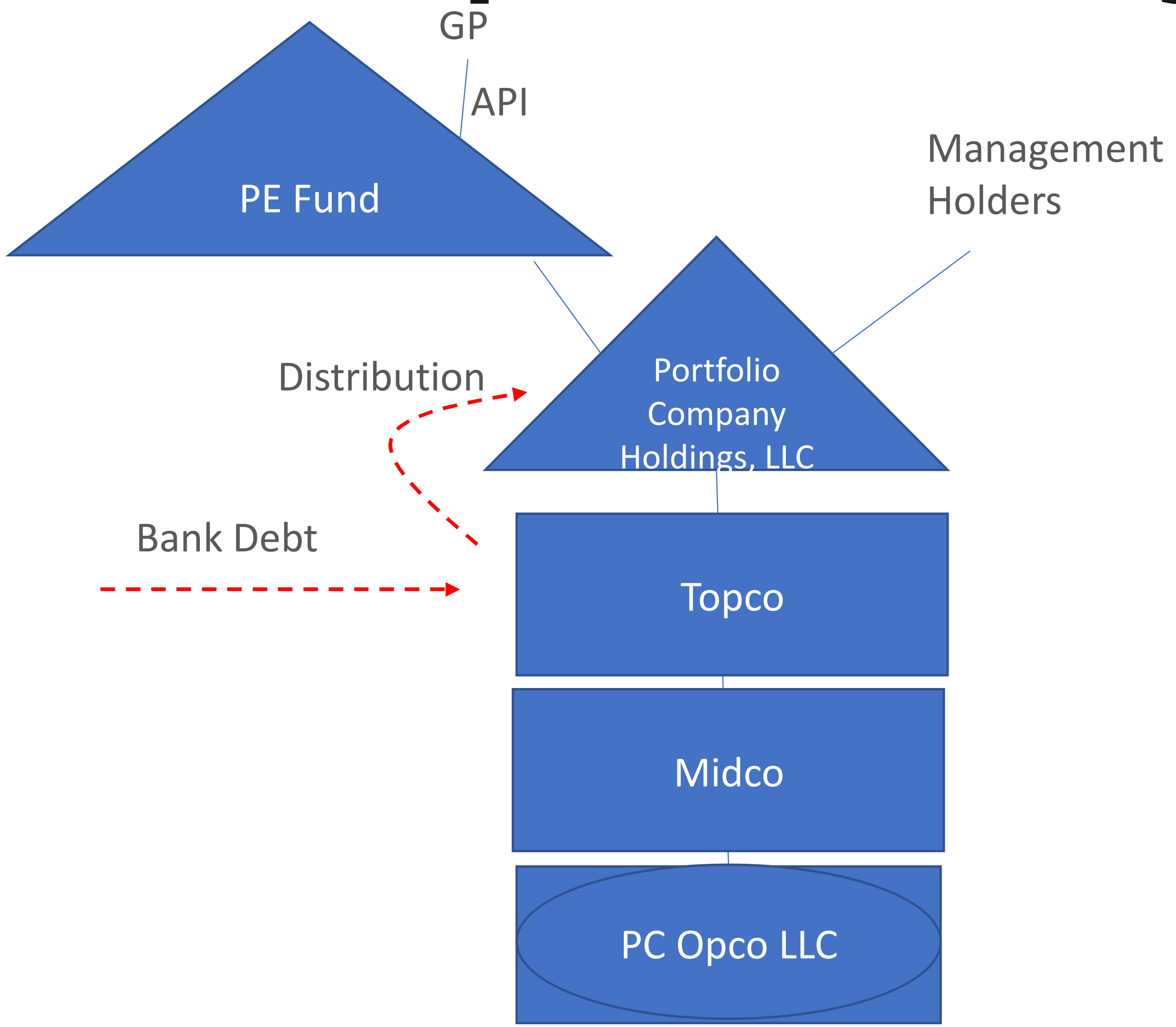
Scenario A: Sale of Portfolio Company Holdings LLC

- Assuming that the GP carried interest at PE Fund is an API:
  - Interests in PC Holdings LLC are capital assets (§741)
- Fund holding period in PC Holdings LLC will be based on (i) date of initial acquisition; and (ii) dates of any additional acquisitions of interests (Treas. Reg. §1.1223-3).
- For purposes of Section 1061, gain allocated to the GP carried interest in respect of the sale of PC Holdings LLC interests will be subject to the three-year rule.

Scenario B: Sale of PC Opco

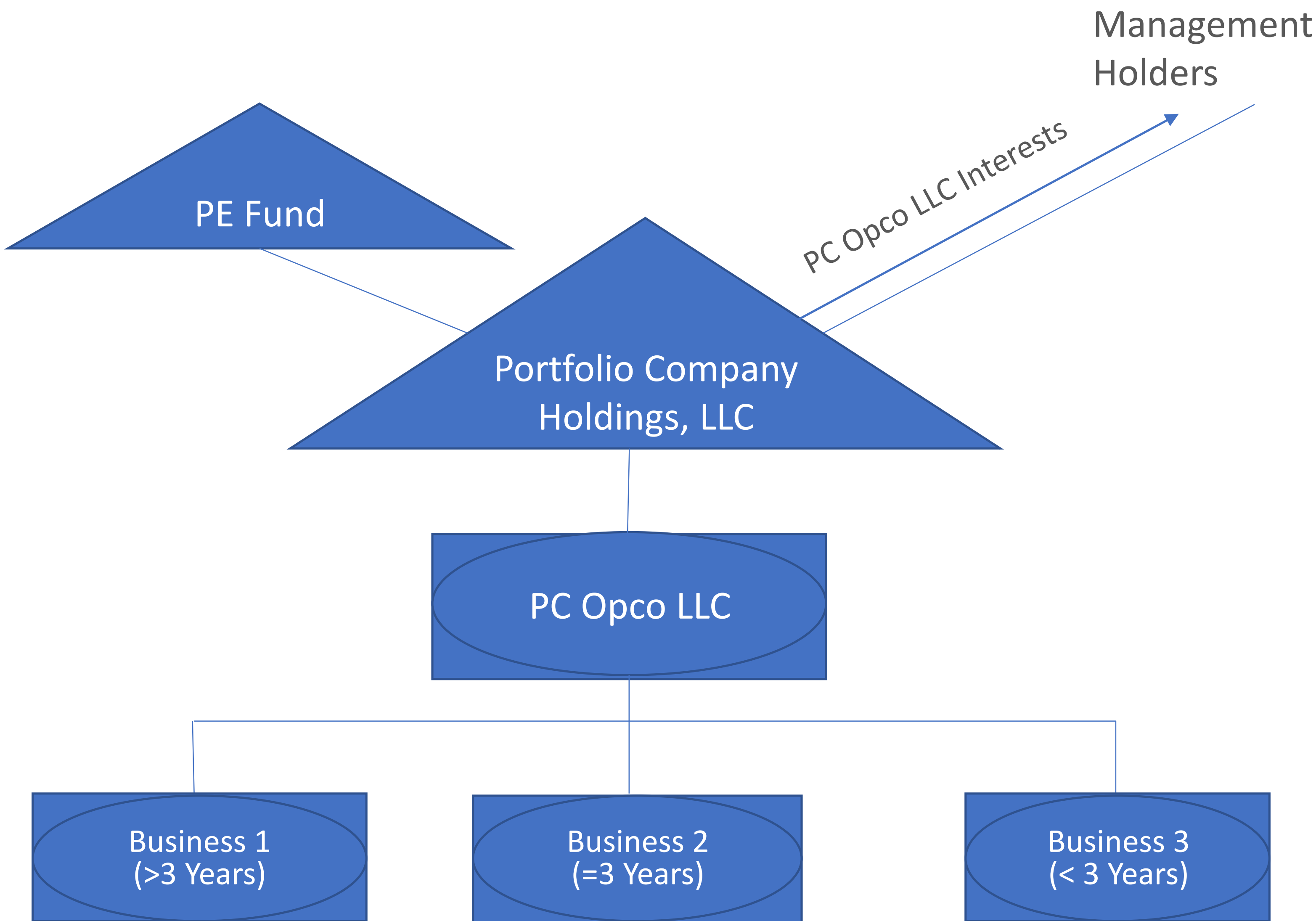
- PC Opco is a DRE.
- Sale of the interests of a DRE is treated as a sale of the underlying assets.
- If PC Opco has depreciable intangibles (due to the initial acquisition of PC Opco by PE Fund), those asset are 1231 assets.
- Character and holding period of assets is relevant for gain allocation in respect of GP carried interest allocation.
- 1231 gain will not be subject to the three-year rule.

Example 2: Leveraged Distribution



- Distribution classified as a dividend to extent of earnings and profits (E&P) of Topco.
  - Dividends not subject to 1061.
- Qualified dividends at the same rate as LTCG, so long as 60 day holding period met.
- E&P Blocker allowing a tax-free return of capital?

Example 3: Distribution to Facilitate Rollover

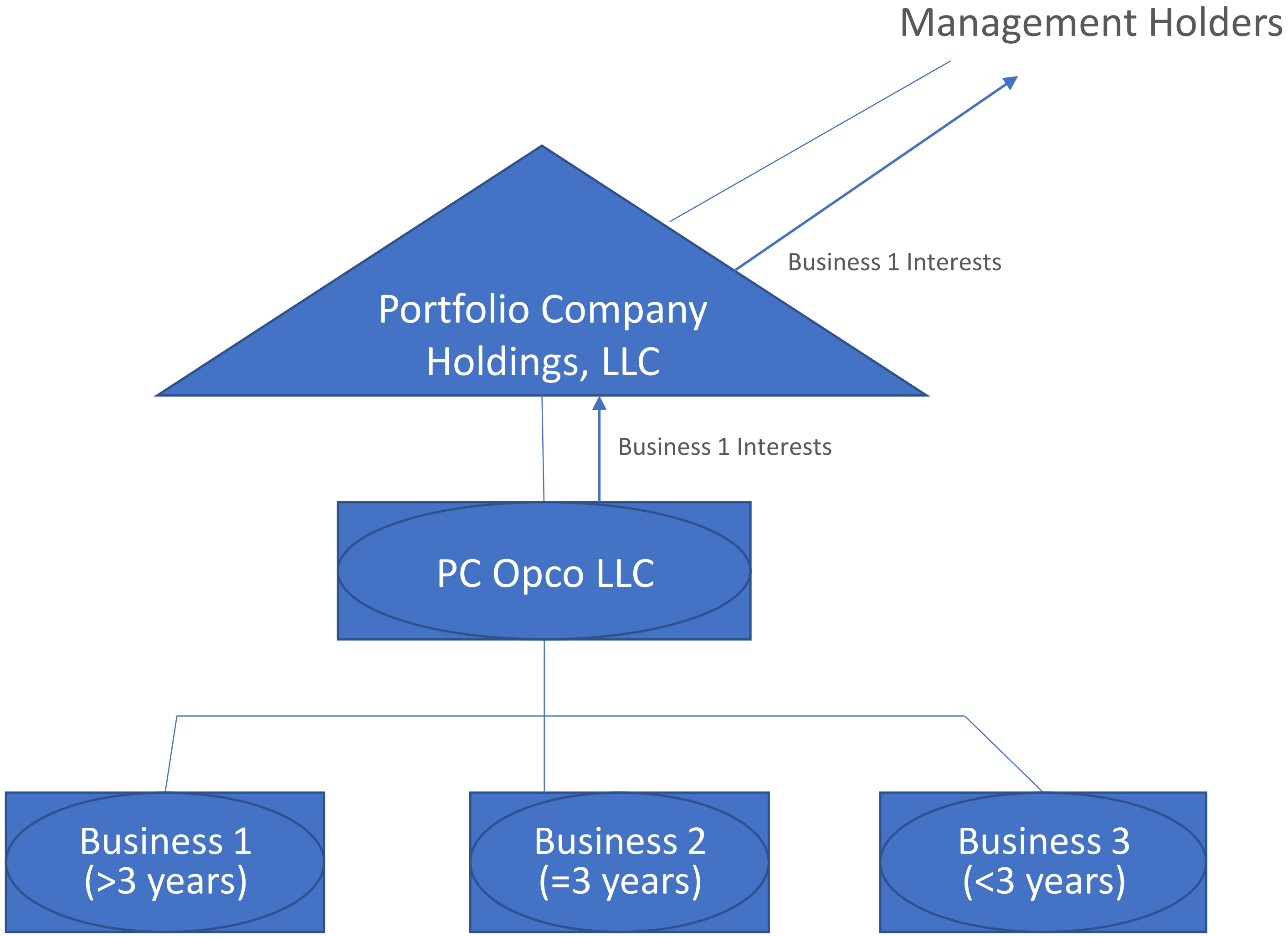


Does the §1231 Exception Apply?

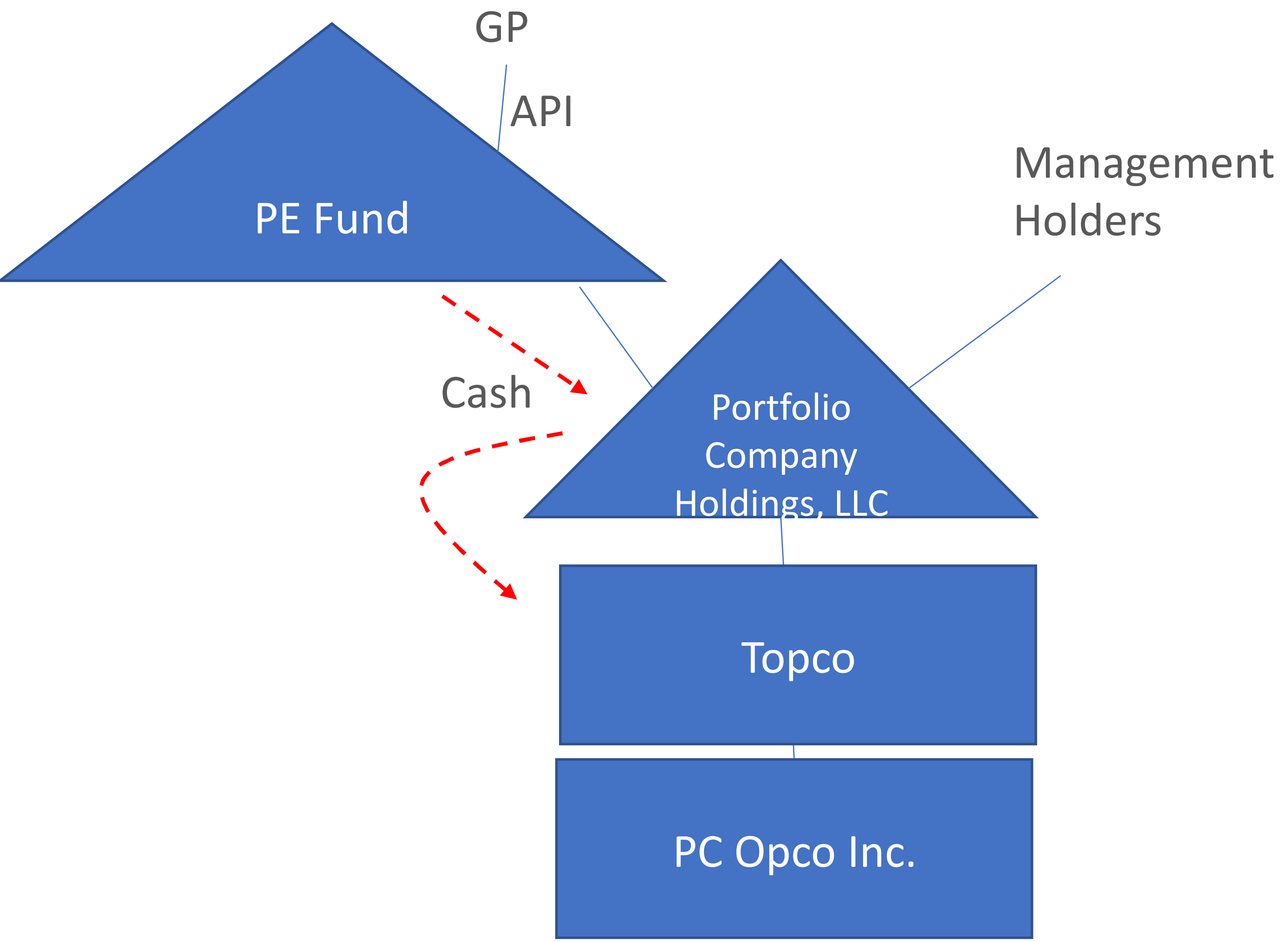
- PC Opco is target, but prior to sale, interests in PC Opco are distributed to Management Holders to facilitate contribution of those interests to the buyer in exchange for rollover equity.
- Rev. Rul. 99-5: if applicable, treated as a distribution of PC Opco property and contribution by PC Holdings and Management Holders to a new tax partnership.
- Is PC Opco now a partnership? Transitory? Does it depend on the Buyer form of entity (continuation vs. termination)?

Example 4: Managing Holding Period – Distribution

- If the in-kind distribution creates a new partnership, consider funding rollover with long-term assets.
- Consider cash balances and hot assets.
- Economic substance concerns?
- Step transaction?



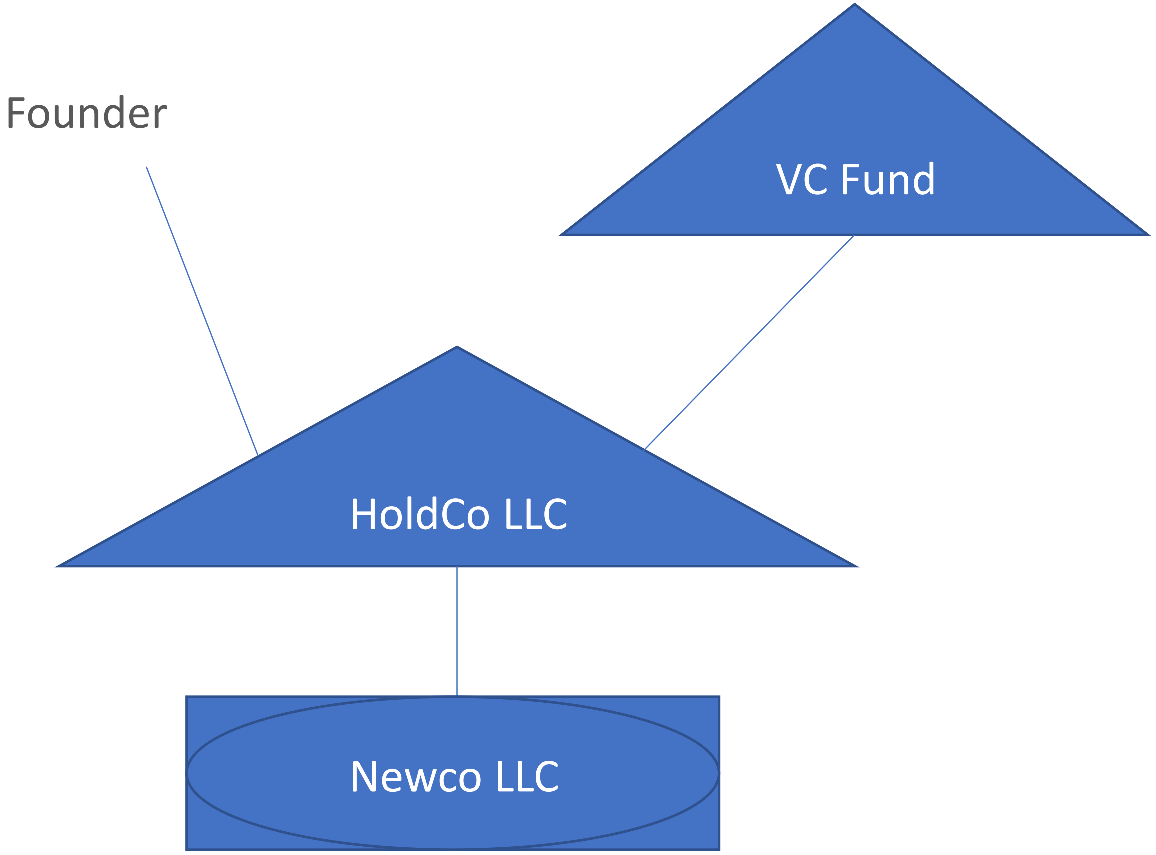
Example 5: Holding Period – Interim Funding



- Exit expected to be sale of Topco stock.
- Interim funding needed for bolt-on transactions or capex.
- How to fund?
  - Loan
  - Contribution for Equity
  - Contribution to Capital
    - Application of meaningless gesture rule?

Example 6: Holding Period – Acquisition

- 1/1/2020: Founder creates Newco LLC as disregarded Entity.
  - Newco LLC is a software business. Assets consist of IP, goodwill and customer lists.
- 6/30/2022: Founder contributes Newco LLC to Holdco LLC and VC Fund Invests $100X.
- 1/2/2023: Buyer acquires Newco business.

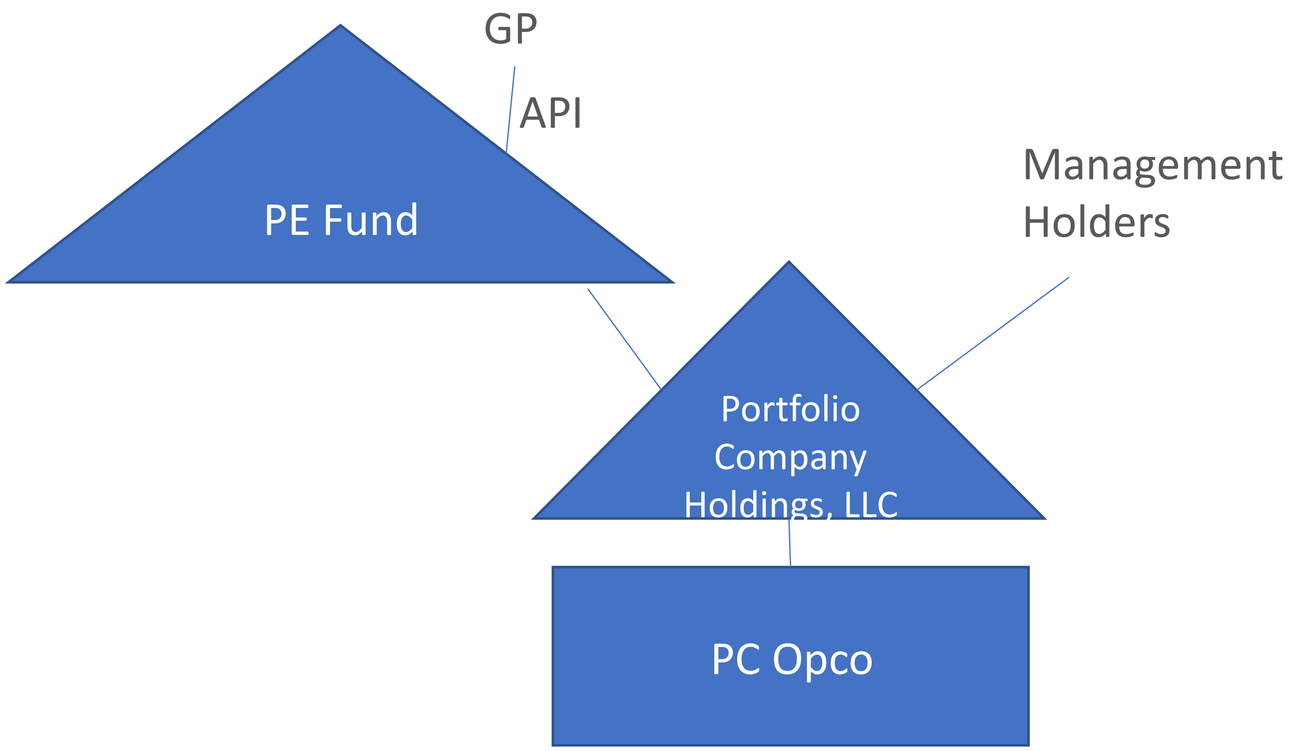


Holding Period Example: Analysis

- When Founder contributes Newco business to Holdco, treated as a contribution of assets to Holdco in exchange for a partnership interest.
  - Founder holding period in partnership interest includes the ownership period of Newco intangibles (commencing 1/1/2020) (§1223(1))
  - Holdco holding period in Newco intangibles includes the ownership period of Founder (commencing 1/1/2020)(§1223(2))
- When VC Fund contributes cash to Holdco, treated as contribution of cash to Newco in exchange for partnership interest. VC Fund commences new holding period in Holdco interest.
  - VC contribution does not change Holdco holding period in Newco Intangibles.
- When Newco is sold 1/2/23, character of gain is based on the Holdco holding period of the Newco business. (Rev. Rul. 68-79, Treas. Reg. Treas. Reg. 1.1061-4(b)(8)(ii))

Example 7: Deferred Closing

- Installment sale note to defer payments → doesn't work.
- Closing must actually be delayed to a later time.
- Look to benefits and burdens of ownership.
- Consider obligations to the LPs.



PRIVATE INVESTMENT FUND
TAX & ACCOUNTING FORUM

Carried Interest and Management Fee Waivers

Optional section descriptor here

FRA
Wilmington plc

Carried Interest Waivers

- Carried interest waivers allow the GP to waive allocation of income from investments disposed of prior to a three-year holding requirement and recoup the waived amount out of income from investments held for three years.
- Book-Ups in connection with waivers.
- Substantial Economic Effect?
- Disguised Compensation?

Transitory Allocations under Treas. Reg. §1.704(b)-1(b)(2)(iii)(b)

- If a partnership agreement provides for the possibility that one or more allocations (the "original allocation(s)") will be largely offset by one or more other allocations (the "offsetting allocation(s)"), and, at the time the allocations become part of the partnership agreement, there is a strong likelihood that –
  - The net increases and decreases that will be recorded in the partners' respective capital accounts for the taxable years to which the allocations relate will not differ substantially from the net increases and decreases that would be recorded in such partners' respective capital accounts for such years if the original allocation(s) and the offsetting allocation(s) were not contained in the partnership agreement, and
  - The total tax liability of the partners (for their respective taxable years in which the allocations will be taken into account) will be less than if the allocations were not contained in the partnership agreement (taking into account tax consequences that result from the interaction of the allocation (or allocations) with partner tax attributes that are unrelated to the partnership)
- the economic effect of the original allocation(s) and offsetting allocation(s) will not be substantial.

Disguised Compensation?

- In July 2015, the IRS issued proposed regulations under section 707(a) to limit the ability of a Fund to have a management fee waiver.
- Pursuant to the proposed regulations, management fee waivers (and presumably carried interest waivers) not subject to "significant entrepreneurial risk" are taxed as ordinary income from services under section 707(a).
- Proposed regulations designed to attack situations in which there is a high likelihood that the service provider will receive a profit allocation regardless of the overall success of the business.
- Proposed regulations include an example in which a management fee waiver arrangement is subject to significant entrepreneurial risk (the "Safe Harbor").

Disguised Comp: Proposed Safe Harbor

- Waivers need to be prospective, irrevocable, and LPs should be notified of the waiver.
- Allocations should be of net profit as opposed to gross income.
- Profits allocated in respect of the “make-up” should be neither highly likely to be available nor reasonably determinable.
- The GP should be subject to a clawback obligation.

IRS Position on Carried Interest Waivers

- IRS is aware that taxpayers are using carried interest waivers.
- Preamble to the proposed regulations under section 1061 provides:

  > The Treasury Department and the IRS are aware that taxpayers may seek to circumvent section 1061(a) by waiving their rights to gains generated from the disposition of a partnership's capital assets held for three years or less and substituting for these amounts gains generated from capital assets held for more than three years. . . Some arrangements also may include the ability for an API Holder to periodically waive its right to an allocation of capital gains from all assets in favor of an allocation of capital gains from assets held for more than three years and/or a priority fill up allocation designed to replicate the economics of an arrangement in which the API Holder shares in all realized gains over the life of the fund. These arrangements are often referred to as carry waivers or carried interest waivers. Taxpayers should be aware that these and similar arrangements may not be respected and may be challenged under [existing law].

- Final Regulations do not address the issue.

PRIVATE INVESTMENT FUND
TAX & ACCOUNTING FORUM

Carried Interest Proposal

Optional section descriptor here

Ending the Carried Interest Loophole Act

- Re-introduced November 15, 2023.
- Proposal by US Senate Finance Committee Chairman Ron Wyden (D-OR).
- Manager required to recognize deemed compensation annually at ordinary income rates and subject to self-employment taxes.

Ending the Carried Interest Loophole Act

- The “deemed compensation amount” calculated based on a specified rate of return on an applicable percentage of the invested capital of all partners over the partner’s share of invested capital.
  - Applicable percentage is the highest percentage of profits of the partnership that could be allocated with respect to the partner.
- JCT estimates that it would raise $63.1 billion over 10 years.

- Is a wealth tax constitutional?
  - *Moore* case is pending in the Supreme Court regarding the ability to tax offshore earnings without direct realization.

THANK YOU

PRIVATE INVESTMENT FUND TAX & ACCOUNTING FORUM

FRA
Wilmington plc