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***Private Equity Pathways* — Exploring Carried Interest in Upper Tier Private Equity Structures****Speakers: Josh Gelfand, Tom Gray, and Thao Le****Recorded: April 30, 2025****Aired: May 21, 2025****Thao Le:**

Welcome to *PE Pathways*, our podcast series where experienced dealmakers share their thoughts on current private equity and M&A trends and developments. Today, we are going to discuss carried interest and incentive compensation issues in a private equity industry.

My name is Thao Le and I am a partner in the Private Equity practice of Troutman Pepper Locke, and I'm happy to be joined today by my fellow partners, Josh Gelfand, and Tom Gray. Josh is a member of our firm's Employee Benefits and Executive Compensation practice, and Tom is in our Tax practice.

Tom, Josh, welcome.

**Josh Gelfand:**

Thank you very much, good to be here.

**Thao Le:**

Great. So, let's get started. Carried interest is a key component to the compensation packages for many private equity professionals. Every few years, we hear some buzz about members of Congress wanting to tax carry. But before we get into how a carry is taxed, I think we should start with the fundamentals and understand what it really is. So, Josh, what is a carried interest and how do we utilize that to incentivize private equity professionals?

**Josh Gelfand:**

Yes, so that's a great question. Carried interest is essentially one of the main ways in which private equity funds generate revenue for managing investments, so they'll pull it, they'll have an investment fund, and they'll manage the investment. And a carry is an income stream or interest that they get in that investment fund, based on the profits generated by the fund.

So, usually there's a return of the investment capital, perhaps plus a return on investment. And then after that invested capital is returned, then a percentage of the ownership interest and distributions from the fund revenue goes up to the manager. The way in which, often you may have heard of like an 80/20 structure. And the way in which the incentive team, the investment management team is incentivized is essentially by allocating to those individuals a portion of that carried interest, of that piece.

The technical term, from a tax perspective, is a profits interest. And the way that a profits interest essentially is structured and you can have a whole podcast just on the taxation of profits interest. But essentially, there are safe harbors under the tax rules that say that if you qualify for a profits interest, then your interest is a real partnership interest. It's not taxed on grant or on vesting. And then when you get a distribution from the underlying partnership, which can also be an LLC, tax as a partnership. But when you get the underlying distribution, it gets the benefit of the tax characterization of the underlying distribution.

What does that mean? That means that you can get capital gains treatment, long-term cap gains treatment on a distribution, and still be a member of the investment management team. So, it's a very – or it can be – a very tax-efficient way to incentivize the team members by giving them a share of the essential revenue but also taxed at better rates than you otherwise would get. So, there's a lot of benefits to that obviously.

**Tom Gray:**

I just wanted to throw in one thing here is that this is with respect to funds, and funds are created as partnerships for tax purposes. So, it doesn't work if it's a corporation. A profits interest, a carry, is based on an allocation in a partnership structure.

**Thao Le:**

That's a good point, but a couple of things that you guys were saying that made me pause a little bit because I heard the word “long-term.” So, that seems to me, if I'm a private equity professional, that sounds to me like a handcuff that I have to be around for a while, right? Because this isn't something that pays out immediately, right? Josh, I mean, isn't this really a tool that private equity firms utilize as a bit of an anchor for retention and also reward for performance? So, you want to talk a little bit about that?

**Josh Gefland:**

Yes, that's exactly right. I mean, I think that the way to think about it is in terms of an incentive tool, the goal is to align the investment management professionals with the interests of the private equity manager, and also obviously the investor, the third-party investors. So, you do that by saying, you're essentially in with us, out with us. There might be, and we'll get to this in a little bit, there's vesting conditions that are often put on these arrangements for the individuals. But they also have to stick around for a while in order to get paid out, right?

First of all, there's the obligation that you don't get a distribution until the underlying assets in the fund are sold, which is one thing obviously at a profit, but then also to satisfy one of the requirements to fall within a profit's interest, you also have to not have disposed of the interest for two years after it's granted. So, you've got a holding period requirement to begin with, and then Tom can jump in, I'm sure, with explaining what it means also to have a long-term hold for a cap gains treatment because it's changed a changed a little bit. Those are all requirements.

Essentially, it might be helpful even to take a step back and say, “What are the requirements to satisfy and qualify as a profits interest to get these beneficial tax treatments?” Essentially,

there's some safe harbor rules that the IRS has put out, but the easy ones to think about, the main ones are it has to be an interest only in the profits of the venture. You have to have only future upside entitlement based on what the liquidation value of the award is today. So, meaning that if you liquidated the fund today, you shouldn't share in any of the distributions from the waterfall. You only share in the future upside. Then also, you can't dispose of it for two years. You have to start being treated as a partner from day one. And then finally, the basic one, there has to be a risk that it's not some definitive, dependable stream of income, it can't look quite like that.

So, those are kind of the rules of thumb in terms of what's required, and if you meet all these requirements and you're getting the interest because you're providing services to or for the benefit of the partnership, then you can meet these requirements and qualify as a profits interest.

**Thao Le:**

I've heard these terms, people talking about a real profits interest or a phantom profits interest. I mean, aren't they all somewhat phantom? Do they actually mean something, I should say?

**Josh Gefland:**

So, there is, and there's a lot of confusion, I think, amongst people about this, but yes, there is a major distinction between what I'll call real carry and phantom carry. So, real carry is where the individual or whenever the service provider gets an actual partnership interest in the partnership or the LLC, meaning that they're going to be – they're treated as a partner for tax purposes, they're getting a K1, they're going to have imputed income, they're getting profits and loss allocations, that whole arrangement. They actually own a piece of property in ownership interest.

A phantom award, on the other hand, is just a contractual compensatory arrangement that says, "I'm going to pay you some amount of money or pay you in some other form based on X, Y, Z, if you do this. And we're going to try and get as close as we can economically to the terms of a profits interest. But it's going to be taxed at ordinary income rates. It's going to have to qualify or be exempt from section 409(a) of the tax code, which is, I think everyone hates hearing the words 409(a) because it regulates.

I'll give a very quick, super high-level explanation of what that is. 409(a) is the section of the tax code that governs what's called non-qualified deferred compensation, which you could think of as just compensation that vests in one year and could be payable in a future taxable year. So, you can imagine that could be 100 different things. But if you have a phantom award that says, "We're going to pay you – you vest over time, and then we'll pay you in seven years when we liquidate the fund," that's vesting in one year payable in a future year and suddenly you're going to be under 409(a)'s ambit if you're a US taxpayer.

The problem is, aside from the fact that obviously it's not as tax efficient because your tax that ordinary income rates, 409(a) is very stringent on when you are allowed to set payment events, payment dates for when you get paid, and you don't have a lot of discretion, and oftentimes the times at which you'll want to pay because you're paying out your carry won't fit squarely within

what's permissible under 409(a). So, usually we have to get creative and either pay people and say you never vest, you've got to be in your seat when we make a distribution to get your phantom payout, or you have to do what we might call a fixed data award, which is to say, "Okay, we're probably going to liquidate the fund in the next six years." So, we're going to say, "We'll pay you everything you otherwise would have gotten and we'll pay you in year seven, because we're pretty confident that we're going to get all the payments by then." And then after year seven rolls around, you can't get any more payments and you won't get any payments before year seven.

So, you can imagine the conversation with the investment professional here is, "Oh, everyone else is getting paid over the next five years. You're going to have paid six years out in lump sum, they don't love that. But sometimes we have to find ways that work under the tax rules to make it all work."

**Thao Le:**

So, the takeaway I see it is that carried interest and phantom interest is carried interest is that you are a true owner in one of the upper-tier entities that gets the profit from the fund. You're an owner and you just wait over time to see what that is. And then the phantom is just really contractual right in a very simplistic way to a bonus, to be paid at a certain point subject to 409(a). But when you look at it, we're going to focus on the carried interest part because it's much more tax beneficial. Tom, how are they really taxed? And I keep hearing this Section 1061 and how it may apply to carried interest. What is Section 1061? And really, how does that impact carry interest, if at all?

**Tom Gray:**

Well, yes, so it's a great question. 1061 has been around since 2017. As you mentioned earlier, there's discussion on how carried interest should be taxed. Some people see it as, it should be treated as compensation for services. But the tax rules now have it as an allocation of the underlying income. So, if the fund sells an asset and generates capital gain, the carried interest holder gets an allocation of that capital gain. If it's been held for more than a year, that's long-term capital gains taxed at 20%. If it's short-term, it's short-term capital gains taxed at ordinary income rates, can be as high as 35%.

Because of all the pushing back and forth between various members of Congress and various concerned parties, there have been legislation proposed regulations that would have eliminate the allocation aspect and treated it as compensation income, subject to self-employment taxes. But in 2017, Section 1061 was promulgated and that applies to applicable partnership interests. And to the extent that any gains are attributable to that applicable partnership interest, you have to have a three-year hold period.

So, anything less than three years, three years or less, will be taxed at short-term capital gains. Let's take the example of a fund that holds an asset for two and a half years, sells it, the investors get long-term capital gain treatment because it's been held from more than one year, the carried interest holder, however, is going to be taxed at short-term capital gains. How this affects a private equity holder, a fund manager, it depends on the whole period because if their whole period is expected to be five years, 1061 is not going to really be applicable. When you

go into the hedge fund world, if everything is short-term capital gains because it's being sold within a year, doesn't really matter. It's that period of one to three years where people get really concerned. I've been on deals, and I'm sure people listening have seen the situations where you get to that point and the deal is closing and it's two years, nine months that the asset has been held, and all of a sudden, they realize, well, the tax return is not what they were expecting.

**Thao Le:**

Another term that I often hear thrown around are carried interest waivers. Certainly, you see that from an investor going into a fund and they may get a “waiver” in the sense of a reduced carry, or a carried interest waiver could be a waiver in its entirety. But so, what are you seeing as a carried interest waiver now and how does that impact possibly the recipients who have a profits interest that we just carried?

**Tom Gray:**

So, we have the carried interest. We have our fund, our GP is getting the carry. And let's say there are capital gains that are going to be allocated, but they're within those three years. So, 1061 would apply. The waiver would allow the GP to not get that allocation and instead get future allocations that would qualify for the three-year hold period and therefore be treated as long-term capital gains.

Now, proposed regulations had been previously issued that said these arrangements will be closely scrutinized and put a kind of hesitant on that. But when final regulations were issued, that reference was no longer there. So, it becomes a question of whether or not the carried interest waiver is actually something that would work. So, it becomes – it's up in the air, I would say. Use caution if you are perceived that way.

**Thao Le:**

Gotcha. Let's pivot a little bit and let's say that we have a good moment of carry being paid. So, in a typical fund structure for everyone that carry doesn't typically get paid until you have some type of exit event with your underlying portfolio, where you're able to sell the asset at a nice valuation that gets you through what we call the distribution waterfall and priorities, to the point where you're able to pay out the carry. This is a term that we often call crystallized. So, what happens when a carry interest is crystallized, Tom?

**Tom Gray:**

Well, so let's say, the underlying investment is a really long-term hold period, 10 years, whatever. And the parties involved that are sitting there saying, “Well, we want to make sure we are properly incentivizing our managers who need a share of interest.” In order for us to get this, we know that within a certain amount of time, there is going to be an increase in value. Maybe there are thresholds that need to be met, properties being developed that are going to be leased out. And once those leases are entered into, we know there's going to be this value that's going to be there. So, the parties will agree on a crystallization event. If a certain event happens, then the carry will be crystallized at that time. The value is determined and the parties will get into an

agreement as to how to do the valuation, what is going to be valued, and then the amounts that would otherwise be allocated to the GP and the carry is going to be crystallized. And that's going to create a partnership interest for that GP that's equivalent with the other limited partners.

So, where they would have gotten 80%, all the investors and the GP gets 20 now, the GP is in that group with those investors because they have a real partnership interest. There's a lot of questions that come into when that carry is crystallized, is that something that creates in and of itself a taxable event? Well, you could go back and forth with a lot, but I think most practitioners would say no, because what's really happening is you're redistributing among the partners all this future appreciation and all the profits that have been created. So, there's really, as long as there's been no specific allocation of those profits to the existing partners so that they're capital accounts and that's a term in partnerships that the capital accounts record basically the value of your interest.

As long as that appreciation hasn't been booked into those capital accounts, most practitioners are going to say, "No, there's no capital shift here that creates a taxable event." And then what happens with that crystallized partnership interest is, again, up to the partners. Maybe it's going to be redeemed for cash. Maybe it's going to continue as a fully participating partner, maybe partially redeemed, partially sold to the other limited partners. It is a kind of a deal-by-deal scenario with the particular fund and the managers determining what is the best course of action going forward.

**Thao Le:**

I'd like to explore this a little bit more because earlier on, when we were talking about carried interest being granted to the investment professionals, we said that you are a partner in a partnership. Whether it's a partnership or an LLC, you have what we call equity in that legal entity. Then you're making a distinction, it sounds like, Tom, when you're talking about crystallizing a partnership interest, that's for tax purposes, right?

**Tom Gray:**

Right. You're changing your partnership interest. So, this becomes into a kind of an analysis of does that create this taxable event? Are you exchanging one partnership interest for another partnership interest? If you look at it as that, still you get to a point where you can argue that there's no taxable event, but that crystallization really changes your allocations and your distribution rights because you're becoming like everybody else, that investor. You have that value in that partnership that has now, "crystallized." You're not waiting to this exit event that is then going to allocate everything to you and distribute out the proceeds to you.

**Thao Le:**

Okay. So, the short answer is call the tax professionals to go through the crystallization of a partnership interest. Let's change course a little bit and talk a bit more about the negotiation of the terms of a profits interest grant. So, you've got a new hire or someone you just recently promoted within a private equity firm, and part of their compensation package is to give them some profits interest. Josh, what are you seeing as far as the common terms as far as the push

in the pool on negotiating the terms of a profit interest between the private equity firm and the individual?

**Josh Gefland:**

I think part of that, it's important to think about the distinctions between profits interest, carried interest, whatever you want to call it, in the upper-tier fund space, versus how it works at portfolio companies. Because I think even the investment management team at a fund is used to thinking about it in terms of incentive equity at the portfolio companies.

The differences in terms of how it's treated and how the different pieces are negotiated really depends a lot, turns a lot on the fact that there is a difference in the incentive structure and what you're trying to get to, right? If you're at a portfolio company and you give someone in the management team equity, what you're trying to do is drive them towards an exit of the

portfolio company and maximize value. So, you're going to say, there's certain vesting and the vesting is based on performance of the investment and you get paid out when we exit the investment. That all makes sense.

When you come at it from the perspective of an upper tier entity, the incentives are a little bit different or they're aligned a little bit differently. So, I think a lot of times on the upper tier level entities, vesting is going to be keyed off of time-based, often I see time-based vesting based off of the initial closing of the fund, and it's usually, because I think a lot of managers view the heavy lift as it were as the fundraising stage. So, once you've done that, that's when you start to get credit in terms of service and performance, and so you start oftentimes vesting based off of that, and then as distributions come in, when there's liquidations, you start sharing.

I think some of the big contentions really stem from that. So, how does vesting work? What's the timeline? Is it going to be five years? Is it going to be seven years? Is there going to be oftentimes a portion of it is held back until final liquidation of the last investment, assuming for a moment that we're talking about the closed-end fund? There's questions a lot, I think a major question, which usually is dependent on the philosophy of the manager, is, "Are we going to pay out distributions based on vesting or based on 100% vested?" Meaning, if you're only 50% vested in your interest, does that mean you only get 50% of a distribution, or do you get a whole distribution? But if you leave, then you give up half of your future payouts.

So, those are times and bones of contention that are often negotiated. Once you've got your structure in place, it's oftentimes locked in. If I come in two years into everything and everyone else has got a particular arrangement, it's going to be really hard for me to negotiate a different package within the rest of the team. But those are big issues and questions that come up a lot. Holdbacks, because if you're going to have a claw back on fund distributions. Well, oftentimes, because these are individuals we're talking about, so you're not going to want to – as a manager, you're going to want to keep some amount of cash on hand from them to ensure that if there is an obligation for a claw back, that there's cash available from each of the individual partners to fund their portion of the obligation. How that works is another contention.

**Tom Gray:**

Josh, I got a question for you.

**Josh Gefland:**

Sure.

**Tom Gray:**

If I'm a partner now, what kind of rights as far as vote selling my interest do I have?

**Josh Gefland:**

So, oftentimes – that's another fight sometimes or negotiation. I'd say the majority of the times that I've seen, although every deal is different, and every negotiation is different, but oftentimes these are non-voting interests. Because generally speaking, the manager of the carry partnership is going to be making all of the decisions. Where you have some flexibility or where I've seen variation is on determinations around what changes can be made that disproportionately and adversely affect the profits interest, the carried interest holders, right?

So, you can oftentimes, there's flexibility where the GP can basically do whatever it wants, as long as everyone's affected proportionally, and you're not hurting one particular individual as compared to others or as compared to other groups. But in terms of voting rights, it's very rare, I think, to see that.

Repurchase rights, I think put rights are a rarity. Obviously, the circumstances can vary based on a particular deal. Call rights, repurchase rights of the company's discretion really depends, depends a lot on the philosophy of the fund. I've seen it both ways. I've seen it where they have a call right on termination until the end of the fund. I've seen it where they don't give a call right at all because their view is, if you've done the work and you've vested, then you should share in your level of value. You could also potentially freeze value on the distributions once the person leaves. There's many different ways to do it and it can also vary depending on the structure of the fund. Because the way, and again, and all kind of is designed to align with what the goals are of the fund.

So, if you have been a closed-ended fund with an expected seven-year lifetime, it's easy to say you'll vest over time, we'll pay you out on liquidation, and we're going to hold back a portion until final liquidation. If you've got an open-ended fund or an evergreen, it's kind of hard. You're going to have to address the structure differently because there's never going to be a final closing down directly to the fund. The same way if you have a family office or other investments where it might be a buy and hold, it's going to be tricky to say, "Well, we'll pay you when we liquidate if you might not liquidate for 100 years." So, you got to factor in, a lot of the terms will depend on what the design is of the fund and how they expect it to generate revenue.

**Thao Le:**

I would agree with what Josh is saying, at least in my experiences. It's certainly the carried interests are non-voting when they're granted to the employees. As far as the type of put and the call rights, the put rights are very rare. The call rights are very common for the private equity firm to be able to repurchase and free up that interest or that pool, for new hires and recruiting and replacement.

But I also think a big factor is where you are on the totem pole. The higher you are in management, for example, you may have a little bit more leeway with negotiating your overall package. But I think for the standard type of rank-and-file employees who are able to participate and carry, basically take the terms that are based on the philosophy of the firm that's granting it to them.

**Josh Gefland:**

Yes, I can completely agree with that.

**Tom Gray:**

I got another question for you. Let's say we have a manager and want him to participate in the carry and he's a Swiss citizen living in Switzerland. Do you think there's going to be any additional complications?

**Josh Gefland:**

Yes. So, we were talking a little bit earlier about real carry versus phantom carry. But I think what we didn't touch on is why you might need to give someone phantom carry as opposed to real carry. If you're a US taxpayer, you might need to get it because you might not be an accredited investor, or perhaps there's other reasons under the Investors Act that this person cannot participate.

On a foreign perspective, it's extremely difficult to grant what we're calling profits interest, carried interest, to a US taxpayer. Most jurisdictions do not recognize the concept of a profits interest. What you end up running into as an issue is, if you're trying to grant it, aside from the potential tax implications to the person of being a member of a US partnership, oftentimes it'll result in adverse tax consequences, potentially just ordinary income taxation at grant, maybe, depending on the jurisdiction, outside the US. So, oftentimes, if we're granting an interest to a non-US taxpayer, it'll oftentimes be structured as a phantom interest in order to address those issues.

Depending on the size of the entity, I've got one client that's got operations all over the world. So, whenever they've got non-US taxpayers, that person is employed by a Swiss entity, you'll say. The Swiss entity will grant them the phantom interest. That'll be the payor. And therefore, they're running payroll. They're doing all of the tax requirements in Switzerland, but it's a bonus arrangement to avoid all of these issues. And because it's a non-US taxpayer, they're not subject to the 409(a) requirements I was talking about before.

So, for them, oftentimes, and again, we can't opine on foreign tax law, but oftentimes there's no limitation on saying you can only be paid on these delineated dates. You can have more flexibility to pay them as and when distributions of the carrier made. So, that gives you at least some benefit. But I'll say one thing that I learned from my own experiences, you got to also make sure that you get verification that those people are not US taxpayers. Because on more than occasion, I've had a situation where the person is living in Hong Kong, but it turns out that they've got a US passport and they are US – and so even though they are there, they are still subject to the US tax code, and therefore we have to structure around that for their foreign bonus arrangements.

**Thao Le:**

Well, I think this shows that we do live in a global economy and when you're structuring equity incentives or pseudo equity incentives, there's certainly flexibility within the upper tier levels. And a topic for another day and future episode of *PE Pathways* is a similar type of incentive compensation for individuals at the portfolio company level. Today's discussion focused on the upper tier, meaning the fund and above.

We've had a great discussion today about it. I really want to thank both of you for spending your time today talking with me through these developments and issues, and we want to thank our audience for listening today as well. So, please keep your eyes open for future episodes of *PE Pathways*, where we bring experienced dealmakers on to share their thoughts on current private equity and M&A trends and developments. You can find the latest episodes wherever you get your podcasts.

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