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## The Return-ReducingRipple Effects of the "Carried Interest" Tax Proposals

Heather M. Field

*University of California Hastings College of Law*

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## THE RETURN-REDUCING RIPPLE EFFECTS OF THE “CARRIED INTEREST” TAX PROPOSALS

by

*Heather M. Field\**

### ABSTRACT

The debate rages on about how to tax private equity fund managers and hedge fund managers who, as part of their compensation, receive rights to share in fund profits (“carried interests”). Commentators have paid relatively little attention, however, to the impact that proposals to change the tax treatment of fund *managers* will have on fund *investors*, other than to suggest that investors could suffer because managers may try to raise management fees or because overall fund profitability may decline. This Article argues that there is a much subtler reason why the carried interest tax proposals that are aimed at fund managers pose economic risks to fund investors. The reason is that a change to the tax treatment of carried interests changes the economic relationship that investors and managers created and consented to in their fund agreement, often after extensive negotiations. Specifically, the proposed increase in tax rates on carried interests, when coupled with common provisions found in fund agreements (namely, “clawback” provisions and “tax distribution” provisions), increases the risk that the economic burden of losses will be shifted from the managers to the investors without compensation; incentivizes managers to take more risk when managing fund assets; otherwise erodes the alignment of manager/investor incentives; and delays the return of investors’ capital contributions, thereby imposing a time-value-of-money cost on the investors.

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\* Professor of Law, University of California, Hastings College of the Law. I would like to thank Gregg Polsky and Victor Fleischer for comments on earlier drafts of this Article, and I would like to thank Susie Morse for her valuable input. I also appreciate the opportunity to present this project at the Spring 2012 Northern California Tax Professor Roundtable, and I thank all of the event participants, particularly Mark Gergen, for their helpful feedback.

This Article explains the indirect route through which the carried interest tax proposals create these return-reducing ripple effects. This Article also provides guidance to investors about how they can protect themselves from harm. More broadly, this Article illustrates how changes in law can alter the economic relationships to which private parties consented under carefully negotiated contracts, thereby creating unintended (and potentially adverse) consequences to parties who are not the desired targets of the law change.

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## I. INTRODUCTION

Over the past few years, there has been a vigorous debate about how to tax private equity fund managers, venture capital fund managers, and hedge fund managers who, as part of their compensation, receive rights to share in fund profits (“carried interests”).<sup>1</sup> Recently, Mitt Romney’s

presidential campaign has intensified this debate because part of Romney’s immense wealth comes from tax-advantaged carried interests that he received in connection with his work with the private equity firm of Bain Capital.<sup>2</sup> Despite the robust academic, legislative, and media discussions about carried interests, relative little attention has been paid to the way in which fund *investors*<sup>3</sup> could be impacted by proposals to change the way fund managers (like Romney) are taxed on carried interests.<sup>4</sup> Some of the

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1. See, e.g., Noel B. Cunningham & Mitchell L. Engler, *The Carried Interest Controversy: Let’s Not Get Carried Away*, 61 TAX L. REV. 121 (2008); Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1 (2008) [hereinafter Fleisher, *Two and Twenty*]; Philip F. Postlewaite, *Fifteen & Thirty-Five—Class Warfare in Subchapter K of the Internal Revenue Code: The Taxation of Human Capital Upon the Receipt of a Proprietary Interest in a Business Enterprise*, 28 VA. TAX REV. 817 (2009); David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715 (2008); Karen C. Burke, *The Sound and Fury of Carried Interest Reform*, 1 COLUM. J. TAX L. 1 (2010) [Burke, *Sound and Fury*].

2. See, e.g., Heidi Przybyla & David J. Lynch, *Carried Interest Debate in Spotlight Amid Romney Tax Release* (Feb 1, 2012), <http://www.businessweek.com/news/2012-02-01/carried-interest-debate-in-spotlight-amid-romney-tax-release.html>; Peter Lattman, *Romney Disclosure Reignites Debate Over Carried Interests* (Jan. 17, 2012), <http://dealbook.nytimes.com/2012/01/17/romney-disclosure-reignites-debate-over-carried-interest-tax/>; Daniel Schafer & Richard McGregor, *Bain Chiefs May Rue the Romney Factor* (Jan. 30, 2012) <http://www.ft.com/cms/s/0/4b2d88e8-4b60-11e1-b980-00144feabdc0.html#axzz1m7vHuo1A>; The Daily Show with Jon Stewart at 2:15–6:20 (Jan. 24, 2012) <http://www.thedailyshow.com/full-episodes/tue-january-24-2012-elizabeth-warren>.

3. References herein to funds and fund investors refer to private equity funds, venture capital funds, hedge funds, and similar investment or real estate funds that are largely unregulated and whose managers are compensated, at least in part, based on a percentage of the fund’s profits. In contrast, this Article does not address mutual funds or other funds that are subject to significant regulation by the U.S. government or whose managers’ compensation is based on something other than a percentage of the fund’s profits.

4. This may be because some commentators conclude that fund investors are unlikely to be materially affected by the proposals. See, e.g., Alan J. Auerbach, *U.C. Berkeley Professor Recommends Capital Gains Tax Reform*, 2007 TAX NOTES TODAY 174–57 (Sept. 6, 2007) (concluding that “[i]f half of the tax increase were shifted to investors, this . . . would imply a reduction of at most around 2 basis points in the annual return [for investors] . . . and quite possibly much less.”); Orin S. Kramer, *Hedge Fund Manager Dismisses Claims that Higher Taxes on Private Equity Would Harm Pension Funds*, 2007 TAX NOTES TODAY 174–46 (Sept. 6, 2007). Additionally, the limited attention to fund investors may be because investors in funds are generally sophisticated parties who, except for investors that are pensions and charitable foundations, are relatively unsympathetic constituencies. Cf. Stephen Labaton & Jenny Anderson, *Pension Effect From Tax Plan is Called Slight*,

commentators that do address the consequences for fund investors suggest that managers may try to pass along part of their increased tax burden by, for example, increasing management fees or increasing the size of the managers' carried interests.<sup>5</sup> Other commentators believe that fund investors' returns are likely to be reduced because of the overall harm these commentators believe will befall the economy and the fund industry if the carried interest proposals pass.<sup>6</sup> But the impact on fund investors deserves more careful analysis, particularly because public and private pension funds, foundations, and endowments (and not merely wealthy private individuals) are typically the majority investors in funds.<sup>7</sup> This Article provides this analysis.

This Article argues that, while the limited commentary correctly identifies the possibility that proposals to change the tax treatment of carried interests could reduce returns to fund investors, there is a much subtler and more troubling reason for these reduced returns. The reason is that a change to the tax treatment of carried interests changes the economic relationship that investors and managers created and to which they consented in their

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N.Y. TIMES, Sept. 7, 2007, at C1 (noting that “critics of the tax proposals have maintained that fund managers would pass on any increase to investors, thus lowering the returns of pension funds that millions of Americans rely upon for their retirement.”).

5. See, e.g., Leon M. Metzger, *Former Hedge Fund Vice Chair Testifies on Use of Offshore Hedge Funds*, 2007 TAX NOTES TODAY 174–55 (Sept. 6, 2007) (responding to arguments “that if all carried interests were taxed at ordinary rates, it might lead to fund managers’ increasing their compensation beyond the typical ‘2 and 20’ arrangement, which would reduce the returns of investors like pension plans and endowments”); Bruce Rosenblum, *Private Equity Council Chair Testifies on Carried Interest Taxation*, 2007 TAX NOTES TODAY 174–49 (Sept. 6, 2007) (“PE sponsors may look at ways to offset the higher tax burden through changes in economic terms that will adversely impact their LPs.”).

6. See, e.g., Diana Furchtgott-Roth, *Skewing the Playing Field for Investment Partnerships*, 127 TAX NOTES 1291 (June 14, 2010) (arguing that increased taxes on carried interests may lead to less efficient capital markets, resulting in harm to investors); Jack S. Levin, *Kirkland & Ellis Partner Argues Against Taxation of Carried Interests as Ordinary Income*, 2007 TAX NOTES TODAY 174–47 (Sept. 6, 2007) (arguing that taxing carried interest as ordinary income poses a “substantial risk [that] the flow of entrepreneurial investments will indeed be reduced, with significant harm to our vibrant economy[,]” which in turn could harm pension funds and university endowments that invest in the funds, thereby harming American workers and students).

7. See Prequin Special Report, *Institutional Investor Outlook for Hedge Funds in 2012*, fig. 8 (Nov. 2011) [http://www.prequin.com/docs/reports/Prequin\\_Special\\_Report\\_Hedge\\_Funds\\_2012.pdf](http://www.prequin.com/docs/reports/Prequin_Special_Report_Hedge_Funds_2012.pdf) (showing that more than 50 percent of hedge fund investors are foundations, endowments, or pension funds); J. COMM. TAX’N, PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS, (JCX-41-007) 37 (July 10, 2007) (same for venture capital funds).

fund agreement, often after extensive negotiations.<sup>8</sup> An increase of the tax rate applicable to managers’ carried interests alters the way in which investors are impacted by common fund agreement provisions, namely “clawback” provisions<sup>9</sup> and “tax distribution” provisions.<sup>10</sup> Among other consequences, investors face the possibility that the economic burden of a larger amount of fund losses will be shifted from the managers to the investors without compensation; investors suffer an increased likelihood that the managers will take risks that exceed the amount of risk to which the investors intended to consent when originally investing pursuant to the fund agreement; investors sustain other erosions of the alignment of manager/investor economic incentives with respect to the management of fund assets; and investors incur greater time-value-of-money costs arising because the fund may not return their capital contributions as quickly as expected. Fundamentally, an increase in the tax rate applicable to carried interests, when coupled with clawback provisions and tax distribution provisions in fund agreements, can result in these economic distortions because managers must pay tax on the allocations of the carry throughout the life of the fund and because those interim carry allocations may not accurately reflect a manager’s ultimate entitlement (based on the aggregate fund earnings over the entire life of the fund).

Fund investors may be able to protect themselves from these adverse consequences by negotiating with managers about the fund agreement that creates their economic relationship. But the investors must first understand the indirect route through which they could be adversely affected by the carried interest proposals. Thus, the goals of this Article are to explain how, and in what circumstances, the carried interest tax proposals are likely to

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8. Extensive negotiations among sophisticated parties generally reflect a joint-tax perspective; that is, the parties will negotiate against the backdrop of the existing tax law in order to maximize their aggregate welfare (minimize their aggregate tax) and share the tax savings among them. *See generally* Chris William Sanchirico, *The Tax Advantage To Paying Private Equity Fund Managers with Profit Shares: What is it? Why is it Bad?*, 75 U. CHI. L. REV. 1071, 1077–79 (2008); Burke, *Sounds and Fury*, *supra* note 1, at 2–5, 23–24; Ethan Yale & Gregg D. Polsky, *Reforming the Taxation of Deferred Compensation*, 85 N.C. L. REV. 571, 579–80 (2007).

9. As will be explained in more detail in Part III.A.1., under a “clawback” provision, a manager can be obligated to return money to the fund if it turns out that early distributions to the manager from the fund exceeded the amount of the profit to which the manager is ultimately entitled.

10. As will be explained in more detail in Part III.B.1., under a “tax distribution” provision, a fund makes distributions of cash to partners in amounts sufficient to enable the partners to pay the tax due on their allocable share of fund profit.

adversely affect fund investors, and to provide some guidance to investors about how to respond to these consequences.

More broadly, this Article illustrates how changes in the law can alter the economic relationships to which private parties consented under carefully negotiated contracts, thereby creating unintended (and potentially adverse) consequences to parties who are not the desired targets of the law change. Query the extent to which legislators considering changes to the law ought to take into account these types of secondary effects that are created when a change in law ripples through previously established economic relationships.

Several caveats are warranted before moving to the rest of the Article.

First, this Article takes no position on whether Congress should pass legislation to increase the tax rate applicable to carried interests. This is not because I am indifferent. I have an opinion on the issue, but I do not think that the potential indirect impact of the legislation on fund investors adds much, if anything, to that normative debate. On the other hand, the analysis of the potential impact on fund investors is (I hope) quite useful (1) as fund investors contemplate how, if at all, they should change their behavior if the legislation is enacted, (2) as scholars and businesspeople continue to develop their understanding of the agency relationship between managers and investors in the private fund context, and (3) as scholars and legislators consider alternatives for tax reform, taking into account how changes in the law can alter the economic consequences of pre-existing contractually-created relationships among private parties.

Second, this Article does not, on its face, distinguish between investors in private equity funds, investors in venture capital funds, and investors in hedge funds.<sup>11</sup> Clearly, the presence and magnitude of the issues discussed herein will vary depending on factors including the type of fund, the fund's particular investment strategy, the fund's method for calculating the carry, and the fund's timeframe for distributing the carry to the manager. Thus, rather than focusing on specific categories of funds, I focus on fund agreement *features* — particularly clawbacks and tax distributions — that are likely to increase economic risks to investors.<sup>12</sup>

Third, this Article assumes that the carried interest tax proposals, if enacted, would increase the tax rate applicable to a substantial amount of the

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11. See generally Adam H. Rosenzweig, *Not All Carried Interests are Created Equal*, 29 NW. J. INT'L L. & BUS. 713, 716–21 (2009) (providing a nice explanation of major differences between private equity funds and hedge funds) [hereinafter Rosenzweig, *Carried Interest*]; see also Andrew W. Needham & Christian Brause, *Hedge Funds*, 736 Tax Mgmt. (BNA) III.A. (2011) [hereinafter Needham & Brause, *Hedge Funds*].

12. Note that these features are generally less common in hedge funds than in private equity funds. Needham & Brause, *Hedge Funds*, *supra* note 11, at III.C.

General Partner’s (GP’s) carry. That is, this Article assumes (1) that the manager of the fund (or an affiliate of the manager) is the fund’s GP<sup>13</sup> and is a taxable U.S. person(s) or is a flow-through vehicle comprised of or ultimately owned by a taxable U.S. person(s),<sup>14</sup> and (2) that the relevant funds earn a substantial amount of income that is characterized as long term capital gain (LTCG), such that a substantial amount of the carry is taxable to the GP at a 15 percent federal income tax rate.<sup>15</sup>

Finally, in order to focus on the impact of the increase in federal income taxes, the examples in this Article use only federal (and not state) income tax rates.<sup>16</sup> Thus, this Article assumes a 15 percent rate for LTCG and a 40 percent rate for ordinary income (because 40 percent allows for relatively easy calculations and because top marginal rates may go back up to 39.6 percent).

With those caveats out of the way, the remainder of the Article will proceed as follows. Part II will provide background about fund manager compensation and the carried interest tax proposals. Part III will discuss the potential problems posed for fund investors by an increase in the tax rate applicable to carried interests, and will focus on two particular features of fund agreements — clawbacks (covered in Part III.A.) and tax distributions (covered in Part III.B.) — that raise these issues. For each feature, I will describe how the fund agreement provision typically works, explain how an increase in the tax rate applicable to carried interests could change how the provision affects fund investors, and provide suggestions for fund investors to consider in response. Part IV concludes.

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13. In some funds, the manager bifurcates its economic interests between two affiliated entities. See Gregg D. Polsky, *Private Equity Management Fee Conversions*, 122 TAX NOTES 743, 745–49 (Feb. 9, 2009). For simplicity, the remainder of this discussion sets this distinction aside.

14. The GP of investment funds are typically LLCs or LPs in which individuals are the interest-holders. See JACK S. LEVIN, STRUCTURING VENTURE CAPITAL, PRIVATE EQUITY, AND ENTREPRENEURIAL TRANSACTIONS ¶ 1006.1 (2011) [hereinafter LEVIN, VENTURE CAPITAL]; Needham & Brause, *Hedge Funds*, *supra* note 11, at VI.C.

15. Note that this assumption means that this Article’s analysis is likely less applicable to hedge funds than to private equity funds because the investment strategies of hedge funds rarely produce long term capital gain. See Rosenzweig, *Carried Interests*, *supra* note 11, at 718.

16. Note that this disregards possible employment tax consequences of the carried interest proposals. Currently, a GP’s carried interest is generally not subject to employment tax, but proposals to change the tax treatment of carried interest contemplate the possibility of subjecting the carry to employment taxes. If this employment tax issue is taken into account, the return-reducing ripple effects described in this Article become even more pronounced.



## II. BACKGROUND

Brief overviews of fund manager compensation and the proposed legislation provide background for the analysis.<sup>17</sup> Readers familiar with these topics may wish to skip directly to Part III.

### A. *Brief Overview of the Structure and Taxation of Fund Manager Compensation*

Private equity funds, venture capital funds, and hedge funds are typically structured as limited partnerships, in which the investors are the limited partners (LPs) and the manager is the GP. Managers of these funds generally receive two different economic rights in exchange for their services. First, the manager is paid a management fee, commonly equal to 2 percent of assets under management. Second, the manager is granted a right to share in the profits of the fund. Typically, this “carried interest” or “carry” entitles the manager to 20 percent of the profits earned by the fund. Details of the carried interest vary from fund to fund. These details include (1) when the manager is entitled to receive distributions on account of the carried interest (including distributions of the manager’s entire share of profits or distributions of smaller amounts of money that are intended to be sufficient to enable the manager to pay taxes due on the manager’s share of profits (“tax distributions”)),<sup>18</sup> and (2) whether and to what extent the manager is obligated to return money to the fund if it turns out that early distributions of carry exceeded the amount of the profit to which the manager was ultimately

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17. See generally LEVIN, VENTURE CAPITAL, *supra* note 14, at ch. 10; Andrew W. Needham, Private Equity Funds, 735-2d Tax Mgmt. (BNA) pts. III & V–VI (2011) [hereinafter Needham, Private Equity Funds]; Needham & Brause, Hedge Funds, *supra* note 11, at pts. III & V–VI; Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1070–78 & 1088–90 (2003) [hereinafter Gilson, *Venture Capital Market*]; Henry Ordower, *Demystifying Hedge Funds: A Design Primer*, 7 U.C. DAVIS BUS. L.J. 324 (2007); Stephanie R. Breslow, *Selected Excerpts from PLI’s Private Equity Funds: Formation and Operation, 1st ed., Chapter 2: Terms of Private Equity Funds*, 1782 PRACTISING LAW INST. CORP. LAW & PRACTICE COURSE HANDBOOK 225 (2010) [hereinafter Breslow, *Selected Excerpts*].

18. See generally LEVIN, VENTURE CAPITAL, *supra* note 14, at ¶ 1003.5; Needham & Brause, Hedge Funds, *supra* note 11, at III.B.; Breslow, *Selected Excerpts*, *supra* note 17, at §§ 2.7.3, 2.8.1[D][4]; see, e.g., Gregory J. Nowak, *Hedge Fund Agreements Line by Line: A User’s Guide to LLC Operating Contracts 2nd ed.*, ASPATORE LINE-BY-LINE 1, ¶ 7.10 (2009) [hereinafter Nowak, *Hedge Fund Agreements*], (providing sample language); DOW JONES, PRIVATE EQUITY PARTNERSHIP TERMS & CONDITIONS 47 (2009) [hereinafter DOW JONES, PARTNERSHIP].

entitled (a “clawback” obligation).<sup>19</sup> The fund agreement provisions regarding the calculation of the GP’s carried interest, including the clawback provision in particular, are among the most heavily negotiated provisions in fund agreements and are among the most important provisions to both GPs and LPs.<sup>20</sup>

The management fee and the carried interest are subject to different federal income tax treatments. The management fee is just salary compensation, and thus, it is taxed to the manager at ordinary income rates.<sup>21</sup> The taxation of the carried interest is more complicated. Generally, the manager is not subject to tax upon the initial receipt of the carried interest.<sup>22</sup> Rather, the manager is taxed on its allocable share of the fund’s profits, if and as the fund recognizes income.<sup>23</sup> The character of that income to the manager generally depends on the character of the income to the fund.<sup>24</sup>

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19. See generally LEVIN, VENTURE CAPITAL, *supra* note 14, at ¶ 1003.1–4; Needham & Brause, Hedge Funds, *supra* note 11, at III.B.; Needham, Private Equity Funds, *supra* note 17, at Worksheet 3 (providing sample language); Breslow, *Selected Excerpts*, *supra* note 17, at § 2.8.1[G]; DOW JONES, PARTNERSHIP, *supra* note 18, at 42. There are a number of other details of carried interests that vary from fund to fund, including whether the manager shares in profit from the first dollar or whether the manager shares in profit only after a specific “hurdle rate” of return has been achieved. See generally DOW JONES, PARTNERSHIP, *supra* note 18 (providing details about the prevalence of a wide variety of terms in private equity fund agreements). However, I highlight the issues of tax distributions and clawbacks because, as discussed later, these are the features of carried interests that may lead to return-reducing results for fund investors if the tax rate applicable to carried interests is increased.

20. Center for Private Equity and Entrepreneurship, Tuck School of Business at Dartmouth, *Limited Partnership Agreement Survey Results – GPs* 11-12, 38-39 (June 2004) [http://mba.tuck.dartmouth.edu/pecenter/research/pdf/survey\\_results\\_GP.pdf](http://mba.tuck.dartmouth.edu/pecenter/research/pdf/survey_results_GP.pdf); Center for Private Equity and Entrepreneurship, Tuck School of Business at Dartmouth, *Limited Partnership Agreement Survey Results – LPs* 9–10, 36–37 (June 2004) [http://mba.tuck.dartmouth.edu/pecenter/research/pdf/survey\\_results\\_LP.pdf](http://mba.tuck.dartmouth.edu/pecenter/research/pdf/survey_results_LP.pdf) [hereinafter Tuck, LP Agreement Survey – LPs].

21. I.R.C. § 61. This basic description of the tax treatment for management fees assumes that there has been no effort to recharacterize the management fee into an increased carry.

22. A carried interest is merely one version of what the partnership tax law refers to as a “profits interest” — a partnership interest that has a liquidation value of zero as of the time of grant and that is granted in exchange “for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner[.]” Rev. Proc. 93-27, 1993-2 C.B. 343. Profits interests, and hence carried interests, are generally not subject to tax upon grant. *Id.* There are a variety of proposals to change the tax treatment of the carried interest, and these will be addressed in Part II.B. *infra*.

23. I.R.C. §§ 702(a), 704.

24. I.R.C. § 702(b).

Thus, if the fund's income is entirely LTCG (as is much of the income in private equity funds in particular), then the manager generally pays tax at long term capital gains rates on the income allocable to the manager on account of the carried interest.<sup>25</sup>

*B. Legislative Proposals Regarding the Taxation of Carried Interests*

Many commentators criticize the current tax treatment of carried interests, arguing that the income earned by the managers on account of the carried interest is compensation for services and ought to be taxed at ordinary income rates like other labor income.<sup>26</sup> For example, one of the criticisms of Mitt Romney is that it is unfair that Romney was able to pay tax at capital gains rates on income earned as a result of his work at Bain Capital, while other people pay tax on labor income at higher ordinary income tax rates.<sup>27</sup> In response to the critiques of the tax treatment of carried interests, legislators, commentators, and most recently, the president, have put forward proposals that would change the tax treatment of carried interests.<sup>28</sup> While some of the details vary from proposal to proposal, the

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25. Fund managers do not always pay tax at LTCG rates on the income allocable to them on account of their carried interests. If, for example, the fund earns interest, rent, or other ordinary income, then the manager will pay tax on its share of that income at ordinary income rates. However, as mentioned in the introduction, this Article assumes that the fund's income consists largely of LTCG income. To the extent that fund income allocated to the manager would be characterized as ordinary income to the fund (more common in hedge funds), the income would already be ordinary income to the manager, and the carried interest legislation would not change the tax result (except to the extent that the carried interest legislation imposes employment taxes on the carry). *See supra* note 16.

26. *See, e.g.*, Fleischer, *Two and Twenty*, *supra* note 1; Mark P. Gergen, *Reforming Subchapter K: Compensating Service Partners*, 48 TAX L. REV. 69 (1992) (proposing that "a compensatory allocation to a partner [such as an allocation on account of a carried interest] be treated [for tax purposes] as salary paid by the partnership").

27. *See, e.g.*, Jack O. Nutter, *Private Equity, Carried Interest and Mitt Romney* (Jan. 18, 2012), <http://www.marketwatch.com/story/private-equity-carried-interest-and-mitt-romney-2012-01-18>; *see also supra* note 2.

28. *See, e.g.*, American Jobs Act of 2011, H.R. 12, 112th Cong. § 412 (2011) (reflecting President Obama's proposal to tax 100 percent of carried interest allocations as ordinary income); American Jobs and Closing Tax Loopholes Act of 2010, H.R. 4213, 111th Cong. Sess. § 412 (2d. Sess. (2010) (provision passed by the House to tax 50–75 percent of carried interest allocations as ordinary income, but excluded from the final legislation); H.R. 2834, 110th Cong. (2007) (original proposal, introduced by Rep. Sander M. Levin, to tax all carried interest allocations as ordinary income).

proposals typically seek to tax all or part of the return on carried interests as ordinary income rather than capital gain.<sup>29</sup>

The nuanced differences between these proposals are generally irrelevant for purposes of this Article's analysis, so I will not belabor those details here. It is enough, for purposes of this Article, to know that the carried interest proposals generally would cause fund managers to be taxed at ordinary income rates on some or all of their share of fund profits attributable to the carried interests. For funds that earn income that is characterized as LTCG, enactment of any of these proposals would increase the tax rate applicable to income allocated to the GP on account of the GP's carried interest.

### III. THE CIRCUITOUS ROUTE BETWEEN INCREASED TAXES ON FUND MANAGERS AND REDUCED RETURNS FOR FUND INVESTORS

Query how an increase in the tax rate applicable to fund *managers'* carried interests might affect fund *investors*. Commentators note that carried interest proposals may adversely affect overall fund profits, in which investors share, and that managers may try to pass along to fund investors part of their increased tax costs by, for example, increasing management fees or increasing the carry rate.<sup>30</sup>

There is a much subtler reason, however, that investors may suffer reduced returns if taxes on fund managers are increased. Specifically, a change to the tax treatment of carried interests changes the economic relationships that managers and investors intended to create under their fund agreements. Under clawback provisions and tax distribution provisions, both of which are commonly found in fund agreements, an increase in the tax rate applicable to managers' carried interests can (unless the fund agreements are changed in response to a change in the tax treatment of carried interests)<sup>31</sup> increase the risk that the economic burden of losses will be shifted from the managers to the investors without compensation, lead managers to take more

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29. See *supra* note 28. The proposals changed over time to address comments, to incorporate technical modifications, and to reflect attempts at compromise. However, the proposals generally reflect the basic concept of taxing at least some portion of carried interest allocations as ordinary income.

30. See *supra* notes 5 & 6.

31. The analysis in this Article assumes that the carry, clawback, and tax distribution provisions of fund agreements are not changed in response to the change in the tax treatment of carried interests. This assumption enables the Article to explain the harms that could befall investors if the taxation of carried interests is changed and investors indeed fail to negotiate for changes to these fund agreements. In response to these potential adverse consequences, this Article makes recommendations about how investors might want to change the fund agreements.

risk than they take now, otherwise erode the alignment of manager/investor incentives, and delay the return of investor capital contributions, thereby imposing a time-value-of-money cost on the investors. These consequences may be surprising because they arise indirectly, largely as a result of the way taxes affect the operation of common fund agreement provisions.

If, however, fund *investors* appreciate how they can be adversely affected by legislation that is nominally targeted at fund *managers*, fund investors can better protect themselves from harm by paying careful attention to, and negotiating about, the clawback provisions and the tax distribution provisions in fund agreements. This section addresses both provisions, and for each provision, explains the provision, the risks to investors that could arise from the provision if taxes on carried interests increase, and the potential investor responses.

Clawback provisions, which create the more complex and likely more problematic consequences for fund investors, are examined first. Then, this section discusses tax distribution provisions, which can also adversely affect investors if tax rates on carried interests increase.

#### A. *Clawback Provisions*

To the extent that the fund makes any carry distributions to the GP during the life of the fund, fund agreements typically include some type of clawback provision in order to recoup excess distributions of carry to the GP.<sup>32</sup> The efficacy and impact of clawback provisions<sup>33</sup> can change if tax rates on the GP's carry increase, and LPs should be sensitive to these potential changes particularly given that many LPs consider clawbacks to be among the most important economic provisions in the fund agreement.<sup>34</sup>

This section explains how clawback provisions can help protect LPs in general, and how the operation of a clawback provision is affected by taxes on the GP's carry. Then, with this background, this section analyzes how and to what extent an increase in the tax rate applicable to the GP's carry can exacerbate the possibility of shifting losses from the GP to the LP and the possibility that the GP will be incentivized to take increased risk.

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32. See Needham, Private Equity Funds, *supra* note 17, at III.B.4. (discussing clawbacks) and Worksheet 3 (providing language for a sample clawback provision); LEVIN, VENTURE CAPITAL, *supra* note 14, at ¶ 1003.2–4.

33. Admittedly, clawback provisions may not work perfectly now to protect LPs from potential over-distributions to GPs. This is particularly true if no portion of the GP's carry is segregated into an escrow from which the clawback obligation can be fulfilled. See DOW JONES, PARTNERSHIP, *supra* note 18, at 42–43 (discussing the prevalence of clawback guarantees and escrows). However, the carried interest tax proposals can make clawback provisions less effective; this is true even if the clawback provision is coupled with an escrow. See *infra* note 67.

34. See Tuck, LP Agreement Survey – LPs, *supra* note 20, at 9–10.

Finally, this section provides some suggestions to LPs who want to limit the amount of additional risk that they assume as a result of the interaction between clawback provisions and an increase in taxes on carried interests.

### 1. *Understanding Clawbacks*

A fund risks distributing too much value to the GP if the GP’s carry is calculated based on the fund’s aggregate profits over the life of the entire fund<sup>35</sup> and the fund makes cash distributions throughout the life of the fund (i.e., before the amount of the GP’s total carry is finally determined).<sup>36</sup> This problem could arise if, for example, early transactions produce profits (seemingly entitling the GP to a large carry), while later transactions produce losses (reducing the size of the total carry to which the GP is ultimately entitled).

In order to protect LPs’ economic interests in this situation, fund agreements often contain clawback provisions, which require the GP to return part of the previously distributed carry, so that the GP only retains an amount equal to 20 percent of the aggregate profit earned by the fund. The basic concept is relatively straightforward, but a fair bit of background is needed in order to appreciate how increased taxes on carried interests can make a clawback less effective at protecting LPs. Examples are helpful in providing this background.

#### (a) *Example #1 — How Can LPs Be Harmed in the Absence of a Clawback?*

##### (1) *Hypothetical & Analysis*

Most fund agreements have some sort of clawback,<sup>37</sup> but to appreciate the importance of a clawback, imagine a fund agreement that entitles the GP to a 20 percent carry on the fund’s aggregate profits and that

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35. The risk of over-distribution of the carry and, thus, the need for a clawback provision are avoided if the carry is calculated on an investment-by-investment basis without aggregation or is calculated in another way in which carry amounts, once calculated, would not be reduced by subsequent losses. *See* Needham & Brause, *Hedge Funds*, *supra* note 11, at III.C. (noting that hedge fund carries are typically calculated this way, vitiating the need for clawback provisions). Of course, calculating the carry on an investment-by-investment basis changes the economics and means that GPs will earn carries on deals that succeed, but will not suffer monetary losses with respect to deals that do not succeed.

36. This is quite common particularly in private equity funds. *See* Needham, *Private Equity Funds*, *supra* note 17, at III.B.3 & III.B.4.

37. *See* DOW JONES, *PARTNERSHIP*, *supra* note 18, at 42.

lacks a clawback.<sup>38</sup> Assume that five LPs each contribute \$200 to the fund,<sup>39</sup> and the fund immediately uses that \$1000 to invest in two assets: Asset A is purchased for \$400, and Asset B is purchased for \$600.<sup>40</sup>

Assume that, during Year 2, after Asset A has increased in value, the GP causes the fund to sell Asset A for \$550 cash, generating a profit of \$150. Twenty percent of this profit (\$30) is allocated to GP,<sup>41</sup> and the remainder of the profit (\$120) is allocated to the LPs.<sup>42</sup> If the fund makes distributions of all cash available, the fund would distribute the entire \$550 of proceeds from the sale of Asset A. Specifically, if the fund agreement first provides for a return of the LPs' capital contributions with respect to the particular investment and then provides for a distribution of profits, a total of \$30 would be distributed to the GP on account of the GP's carried interest, and the remaining \$520 would be distributed to the LPs (consisting of \$120 of profit earned on Asset A and \$400 return of capital).<sup>43</sup>

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38. For ease, assume that the GP is entitled to the carry on the first dollar of profit, with no hurdle rate, and that there are no management fees or expenses.

39. Assume, for purposes of simplicity of calculations, that the GP does not make a capital contribution. Typically, a GP makes some capital contribution (often 0.2 percent of the total capital) both (1) so that, from a business perspective, the GP has "skin in the game," thereby better aligning the GP's interests with the LP's interests, and (2) to provide comfort that the GP will be treated as a true partner for federal income tax purposes. *See generally* Rev. Proc. 89-12, 1989-1 C.B. 798 (setting out a 1 percent standard as the minimum contribution to be a partner, declining to 0.2 percent for large partnerships), *obsoleted by* Rev. Rul. 2003-99, 2003-2 C.B. 388; Breslow, *Selected Excerpts*, *supra* note 17, at § 2.5.3. Although Rev. Proc. 89-12 is obsolete, practitioners still use it to provide an indication about the level of investment the IRS may require to establish "partner status." *See, e.g.*, Eric B. Sloan & Matthew Sullivan, *Deceptive Simplicity: Continuing and Current Issues with Guaranteed Payments*, 933 PRACTISING LAW INSTITUTE: THE CORPORATE TAX PRACTICE SERIES: STRATEGIES FOR ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURING 87-1, n.86 (2010).

40. At this point, each of the LPs has an outside basis and capital account of \$200, and the GP has a zero outside basis and zero capital account. I.R.C. § 722; Reg. § 1.704-1(b)(2)(iv)(b)(1).

41. This takes the GP's outside basis to \$30 and the GP's capital account to \$30. I.R.C. § 705(a)(1); Reg. § 1.704-1(b)(2)(iv)(b)(3).

42. Assuming that the LPs are equal partners, the \$120 allocated to the LPs would be split among the 5 LPs, so each would receive an allocation of \$22. As a result, each LP would have an outside basis and a capital account of \$222. I.R.C. § 705(a)(1); Reg. § 1.704-1(b)(2)(iv)(b)(3).

43. *See, e.g.*, LEVIN, VENTURE CAPITAL, *supra* note 14, at ¶ 1003.4 (describing this as a "middle ground" approach to distributions). As a result, each LP ends up with an outside basis and a capital account of \$120, and the GP ends up with an outside basis and a capital account of zero. I.R.C. § 733; Reg. § 1.704-1(b)(2)(iv)(b)(4). The same distributions would be made in the example if the fund

If, in Year 3, Asset B declines in value to \$500 and the GP causes the fund to sell it at that price, the fund would experience a \$100 loss on that asset. As a result, the net profit earned by the fund during its life would be \$50 (\$150 gain from Asset A minus \$100 loss from Asset B). Thus, the GP should only be entitled to a total carry of \$10 (20 percent of the \$50 net profit), and the remaining net profit (\$40) should belong to the LPs. But, the GP already received a distribution of \$30 during Year 2. Because an early transaction produced profits and a later transaction produced losses, the fund distributed too much money to the GP.

In the absence of a fund agreement provision to the contrary, the \$500 proceeds from the sale of Asset B would be distributed to the LPs as a return of the LPs’ capital contribution. That is, rather than allocating the \$100 loss \$20 to the GP and \$80 to the LPs, the entire \$100 of loss is allocated to the LPs.<sup>44</sup> Thus, upon a distribution in accordance with capital accounts,<sup>45</sup> the LPs only receive a total distribution of \$500.<sup>46</sup> As a result, the

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agreement first provided for distribution of profits, followed by a return of the LPs’ capital contributions with respect to the investment, but this distribution scheme is relatively uncommon. *Id.* at ¶1003.2. If, however, the fund agreement provided that the LPs are entitled to a return of their entire capital contributions before the GP receives *any* distribution (other than tax distributions), this example would operate a little differently. *Id.* at ¶1003.1, .5 (describing this distribution scheme). Specifically, a tax distribution of \$4.50 (15 percent of \$30 profits) would be made to the GP, and the remaining \$545.50 would be distributed to the LPs. In this situation, the amounts of the distributions are different than in the example from the text, but this scenario still raises the clawback problem described in this section because, as will be noted later, clawback obligations are generally net of taxes. *See infra* Part III.A.1.c.

44. Technically, the allocations would work as follows: Typically, losses would be allocated first to reverse prior allocations of profit. *See* LEVIN, VENTURE CAPITAL, *supra* note 14, at ¶ 1002.2. Thus, \$80 of the loss (80 percent) would be allocated to the LPs, and \$20 of the loss (20 percent) would be allocated to the GP (bringing the GP’s net profit allocation down from \$30 to the GP’s rightful \$10 carry). However, in the absence of a deficit restoration obligation (which GPs in investment funds typically do not have except to the extent of any clawback), an allocation of a \$20 loss to the GP would create a deficit balance in the GP’s capital account. Thus, an allocation of a \$20 loss to the GP would lack substantial economic effect, and the allocation would not be respected for federal income tax purposes. I.R.C. § 704(b); Regs. §§ 1.704-1(b)(2)(ii)(b), 1.704-1(b)(2)(ii)(d). As a result, the partnership tax regulations require the loss to be reallocated to the partners that would bear the actual economic loss — here, the LPs. I.R.C. § 704(b); Reg. § 1.704-1(b)(3)(iii). This reduces the LPs’ capital accounts by \$20, thereby reducing the amount of the distribution to which the LPs are entitled (assuming liquidating distributions are made in accordance with capital accounts). Alternatively, the distortion described in the text could be conceived of as a “capital shift” for federal income tax purposes, which would ultimately have a substantially similar tax result.

45. The allocation of the \$100 loss entirely to the LPs means that a \$20 loss would be allocated to each LP, reducing each LP’s outside basis and capital account



LPs would receive a total of \$1020 from the fund (\$520 in Year 2 and \$500 in Year 3), i.e., a net of only \$20 of profit rather than the \$40 to which the LPs are entitled (80 percent of the \$50 net profit). Additionally, the GP would keep the \$30 carry even though the GP's rightful 20 percent carry on the fund's net profits is only \$10.

(2) *The Many Problems Presented by Example #1*

Recall that, in the example, the parties agreed that the GP's carry is to be calculated on an *aggregate* basis, meaning that, under the foregoing facts, the GP should only be entitled to a \$10 carry. Clearly, the intended economic deal is distorted if the GP is allowed to keep \$30 when the GP has only "earned" a \$10 carry and if the LPs only receive \$1020 when they are "entitled" to \$1040.<sup>47</sup>

In addition, this arrangement provides an incentive to the GP to strategically time the fund's exit from various investments.<sup>48</sup> Specifically, the GP would be incentivized to cause the fund to exit profitable transactions (from which the GP receives a carry) prior to unprofitable transactions (which would reduce the GP's net carry if the exit from the unprofitable transactions occurred prior to or simultaneously with the exit from profitable transactions).<sup>49</sup>

Further, given the option-like nature of the GP's carried interest, the economic outcome of Example #1 could encourage increased risk-taking by the GP. Specifically, as commentators have explained, a carried interest,<sup>50</sup> upon grant, is akin to an at-the-money option on a 20 percent interest in the

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from \$120 to \$100. *See supra* note 43 (explaining that each LP's outside basis and capital account is \$120 prior to the loss allocation); I.R.C. § 705(a)(2)(A); Reg. § 1.704-1(b)(2)(iv)(b)(7).

46. One fifth of this total distribution, \$100 (i.e., the amount equal to each LP's capital account), would be distributed to each LP.

47. When a few more zeros are added to the end of these numbers (which would be a much better reflection of the magnitude of actual fund investments), the distortions described herein quickly add up to large sums of money.

48. *See also* Gilson, *Venture Capital Market*, *supra* note 17, at 1089 (explaining the timing incentive created by a carried interest in the absence of a clawback).

49. This incentive is "particularly acute" if the calculation of the carry, during the life of the fund, does not take account of unrealized losses. Needham, *Private Equity Funds*, *supra* note 17, at III.B.3.

50. Recall, we are assuming that the GP is entitled to a carry from the first dollar of profit, and that the entitlement to the carry is not subject to a hurdle rate. Implicit in this assumption is the assumption that this carry design reflects the parties' desired economic relationship, so the remainder of the discussion addresses how that desired economic relationship is altered by various factors.

fund.<sup>51</sup> When the fund earns a profit that would entitle the GP to a carry, the carried interest becomes an in-the-money option on the entire fund.<sup>52</sup> However, as soon as any non-forfeitable carry is distributed to the GP, the carried interest reverts back to (or at least become much closer to) being an at-the-money option on just the remaining portion of the fund. This “reset” of the option changes the GP’s risk-taking incentives — before the distribution of any carry, the GP’s incentive is to maximize the value of the entire fund, but after the distribution of a non-forfeitable carry, the GP’s incentive is to maximize the value of the assets *remaining* in the fund, even if that does not maximize the value of the *entire* fund (i.e., taking into account the portion of the fund that has been distributed). Reputational considerations and capital contributions by the GP may help to constrain the GP from taking excessive risk,<sup>53</sup> but the option-like nature of the carried interest affects the GP’s risk-taking incentives.

An example helps to illustrate this scenario.

Recall that the LPs in Example #1 contributed \$1000 and the fund used that \$1000 to purchase two assets. At this point, the GP’s carry is akin to an at-the-money option on 20 percent of the LPs’ interests in the fund — the carry has zero liquidation value, but it does have upside value if the fund assets increase in value.

In Year 2, when Asset A (which the fund has not yet sold) is worth \$550 and when the value of Asset B remains at its \$600 purchase price, the GP’s carry is in-the-money. That is, the GP’s option now has a liquidation value of \$30.<sup>54</sup> But because the GP’s economic entitlement still depends on the performance of the entire fund, the GP’s incentive still is to maximize the

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51. See Victor Fleischer, *The Missing Preferred Return*, 31 IOWA J. CORP. L. 77, 97–108 (2005) (explaining the option analogy) [hereinafter Fleischer, *Preferred Return*]; Gilson, *Venture Capital Markets*, *supra* note 17, at 1089–90.

52. This also occurs when the assets increase in value, such that they could generate a profit, ultimately entitling the GP to a carry.

53. Particularly where the GP is a repeat player in a small market, the GP does have reputation at stake, which could inhibit excess risk-taking even if the carry is out-of-the-money. See Gilson, *Venture Capital Markets*, *supra* note 17, at 1090 (discussing the operation of the “reputation market” as a constraint on risk-taking behavior); Fleischer, *Preferred Return*, *supra* note 51, at 101–02. Additionally, the larger the GP’s capital contribution, the less the carried interest incentivizes the GP to take excessive risk. See *supra* note 39.

54. If the value of the assets of the fund has increased by \$150, the GP would be entitled to a 20 percent carry on that profit ( $20\% * \$150 = \$30$ ). Alternatively, this could be understood by continuing with the option analogy — if the GP exercises the option, the GP would be entitled to an interest in the fund worth \$230 (20 percent of the \$1150 aggregate value of the fund assets) in exchange for an exercise price of \$200.

value of entire fund, taking into account the amounts already earned.<sup>55</sup> Assume that the GP has multiple mutually-exclusive ways that it might manage Asset B, including an approach that has a 20 percent chance Asset B will be worth \$2000, and an 80 percent chance that Asset B will be worth \$0. This approach has a \$400 expected value,<sup>56</sup> which is less than the asset's current \$600 value. This action would reduce the expected value of the entire fund by \$200, holding everything else steady. Thus, it is not in the LPs' interest for the GP to take this action. It is also not in the GP's interest to take this action because the reduction in the expected value of the entire fund would also reduce the total expected value of the GP's carry (in this example, down to \$0).<sup>57</sup> That is, with respect to taking this action with Asset B, the LP's and GP's interests are aligned.

In contrast, assume that the fund distributes the proceeds from the sale of Asset A in Year 2 and that the GP cannot be required to return the \$30 it receives in this distribution. The GP's economic incentive with respect to subsequent fund asset management decisions depends not on the performance of the entire fund in the aggregate, but rather only on the performance of the fund's remaining asset, Asset B (again, assume that Asset B is still worth \$600). This effectively turns the GP's carry back into an at-the-money (rather than an in-the-money) option. With this at-the-money option, the GP now *does* have an incentive to take the riskier approach to managing Asset B that is described above.<sup>58</sup> This is because, under the

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55. To the extent that the GP is risk averse, the in-the-money character of the carry could actually lead the GP to take too little risk with respect to subsequent management decisions. That is, the GP might opt for an approach to Asset B that will, with 100 percent certainty, result in \$605, rather than an approach to Asset B that, while subject to some uncertainty, will have an expected value of \$610 (e.g., 50 percent chance of \$590, 50 percent chance of \$630). However, for simplicity, this discussion will assume (unless otherwise stated) that the GP is a risk-neutral, rational actor or that other factors (e.g., fund agreement limitations on the type of investments the GP may make) constrain any (or most of the) incentive that the GP has to take too little risk.

56.  $(20\% * \$2000) + (80\% * \$0) = \$400$

57. Prior to choosing an action with respect to Asset B, the fund assets are worth \$1150 (\$550 value of Asset A plus \$600 value of Asset B). If the GP opts for the risky approach to managing Asset B, the expected value of Asset B under this approach is \$400. Thus, holding everything else steady, the expected value of the total fund assets would be only \$950 (\$550 value of Asset A + \$400 expected value of Asset B), in which case the GP would not be entitled to any money on account of the carry; the GP's earlier entitlement to a \$30 carry from Asset A would be totally eliminated.

58. Of course, the GP's choice of action does depend on what other alternatives are available for managing Asset B. Here, for purposes of simplicity, I just compare the 20 percent chance of \$2000 / 80 percent chance of \$0 approach to

approach described above (20 percent chance of \$2000 value, 80 percent of \$0 value), the GP has a 20 percent chance of earning additional carry if the value of Asset B increases to \$2000. If the risk fails, the GP will keep the \$30 carry previously distributed and get nothing more — the same result as if Asset B merely maintained its current \$600 value. Thus, the GP has nothing to lose (setting aside reputational issues)<sup>59</sup> by taking a risk with respect to asset management decisions of the fund that the LPs would not want to take.<sup>60</sup>

Moreover, this incentive for the GP to take this type of risk (i.e., a long-shot risk that would reduce the fund’s expected value) is increased if the carry becomes akin to an out-of-the-money option, which will happen as soon as the value of Asset B declines at all from its original \$600 value. And the risk-taking incentive continues to increase as the GP’s carry gets deeper and deeper out-of-the-money (i.e., if and as the value of Asset B declines more and more).<sup>61</sup>

(b) *Example #2 — How Might a Clawback Help Protect the LPs?*

Consider again the basic scenario presented by Example #1, but now assume that the fund agreement contains a complete clawback provision. A clawback provision corrects the economic distortions encountered in Example #1. The clawback requires the GP to return the over-distributed carry (i.e., \$20, which is the excess of \$30 carry received in Year 2 over the

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the status quo, assuming that the asset could maintain its value in the absence of action.

59. See Gilson, *Venture Capital Markets*, *supra* note 17, at 1090 (discussing reputational considerations); Fleischer, *Preferred Return*, *supra* note 51, at 101–02.

60. In general, an option-holder (such as the GP) and an equity-holder (such as an LP) will have incentives that are somewhat misaligned; generally, an option-holder, even an in-the-money option-holder, will prefer more risk than an equity-holder because the option-holder has similar upside potential but less downside exposure. As the option becomes more and more in-the-money (i.e., more equity-like), the option-holder’s risk preference will generally grow closer and closer to the equity-holder’s risk preferences. Conversely, the more out-of-the-money an option becomes, the more the option-holder’s risk preferences will diverge from the equity-holder’s risk preferences. Given this typical option-holder/equity-holder relationship, the point of the example in the text is that a fund agreement that provides for a GP carry without a clawback exacerbates the misalignment of risk-taking preferences.

61. Note that a carry that is out-of-the-money may be useful in helping to curtail any incentive the GP may have to take too *little* risk. This concept is built into fund agreements where the GP is only entitled to a carry after a hurdle rate is surmounted or preferred return is paid. See Fleischer, *Preferred Return*, *supra* note 51, at 101–06.

\$10 carry to which the GP is rightfully entitled).<sup>62</sup> Sometimes, the GP's carry distribution is placed in an escrow to ensure that the funds will be readily available to fulfill any clawback obligation.

Once the \$20 has been "clawed back" by the fund, the \$20 can be distributed to the LPs. As a result, the GP will have received its rightful 20 percent *aggregate* carry (\$10), and the LPs will have received a return of their capital contributions (\$1000) and their rightful 80 percent share of the fund's net profit (\$40). Thus, the GP and the LPs end up with net distributions that reflect the economic deal that the parties originally intended.<sup>63</sup>

Further, with the clawback, the GP has much less incentive to strategically time the fund's exit from transactions depending on whether they are profitable or unprofitable.<sup>64</sup> This is because excess carry distributed

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62. Technically, the clawback operates as a limited deficit restoration obligation. Regs. §§ 1.704-1(b)(2)(ii)(c), -1(b)(2)(ii)(d). Thus, when the fund has a \$100 loss in Year 3, \$20 of that loss can be allocated to the GP because even though that would appear to create a deficit in the GP's capital account, the limited DRO would erase that deficit. As a result, the allocation of the \$20 of loss to the GP will have substantial economic effect, and the GP ends up bearing the economic burden of that loss. Compare this result to the result, explained *supra* note 44, in the absence of a clawback. Again, this transfer of \$20 could be conceived of, alternatively, as a capital shift. *Id.* However, I think that the allocation concept better reflects the economic relationship created by the clawback, particularly if and as losses are harvested after gains but before the liquidation of the fund, and particularly if the clawback provision language specifically states that the GP fulfills the clawback by contributing to the fund. *See* Needham, *Private Equity Funds*, *supra* note 17, at Worksheet 3 (providing sample clawback language that requires the GP to fulfill the clawback by making a contribution to the fund).

63. Note that the GP should be entitled to a loss when it fulfills its clawback obligation and/or the fund liquidates. Technically, this can be conceived of as either (1) an allocation of \$20 loss to the GP, which is supported by the limited DRO reflected in the clawback (possibly at liquidation and particularly if interim clawbacks are made during the life of the fund), or (2) a recognition of loss upon the final liquidation of a partnership interest (where the GP contributes the \$20, giving the GP a \$20 capital account, but where the \$20 is actually distributed to the LPs). I.R.C. § 704(b) (\$20 allocation of loss to the GP); I.R.C. § 731(a)(2) (recognition of loss upon liquidation); *see also* David J. Schwartz, *Raising a Private Equity Fund—Economic Provisions: Carried Interest, Clawback and Management Fees*, 1824 PRACTISING LAW INST. CORP. LAW & PRACTICE COURSE HANDBOOK SERIES 97, 102–04 (2010). If the GP can fully use this loss, the loss will offset the excess taxes previously paid by the GP on the excess carry that was ultimately returned.

64. The GP may have other incentives to time the exit from particular transactions. For example, accelerating the exit from profitable transactions could make the fund look quite profitable, which could be useful to the GP if the GP is trying to raise a second fund during the life of the first fund. Also, the GP may still have a slight incentive to accelerate the exit from profitable transactions and delay

in connection with early exit from a profitable transaction must be returned, in whole or in part, to the fund if later transactions produce losses.

Additionally, while the GP’s carried interest is still equivalent to an option, the addition of the clawback means that the value of the previously distributed carry must be taken into account when analyzing the GP’s incentives regarding future management decisions.<sup>65</sup> That is, immediately after the distribution of the \$30 carry in Year 2, the carry’s in-the-money status remains unchanged. Thus, in the illustration provided above, the GP’s carry turns into an at-the-money option only after the clawback would consume the entire carry previously distributed to the GP (i.e., until Asset B declines in value to \$450, completely wiping out the fund’s profit from Asset A), and the carry turns into an out-of-the-money option only after the value of Asset B declines even further. As a result, the addition of the clawback negates (or at least mitigates) the increased incentive for risk-taking that arises in the absence of a clawback.

(c) *Example #3 — How Do Taxes on the Carry Affect the Operation of a Clawback?*

Clawback provisions are often limited to the amount of the GP’s “after-tax carry.”<sup>66</sup> That is, the GP can only be asked to return the amount of the carry previously received, reduced by the taxes paid (or assumed paid) on the GP’s carry.<sup>67</sup>

This cap can reduce the beneficial effects of a clawback that were described in Example #2. Consider again Example #2, where the GP is entitled to a 20 percent carry (calculated on an aggregate basis), but the carry is subject to a clawback. Recall that, in Example #2, \$30 was allocated and distributed to GP on account of the carry in Year 2. Assume that, in Year 2,

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the exit from unprofitable transactions because the GP could benefit from the time value of money on the early over-distributions of carry, but this incentive is likely to be relatively small. *See also* Gregg D. Polsky, *Private Equity Management Fee Conversion*, 122 TAX NOTES 743 (Feb. 9, 2009) (discussing how fee waivers can create incentives for GPs to time exits from investments).

65. This is because the GP’s ability to retain the \$30 carry is contingent on the *total* performance of the fund.

66. *See* Needham, *Private Equity Funds*, *supra* note 17, at III.B.4; Alan J. Pomerantz, *Example of Distribution/Clawback Provisions*, 541 PRACTISING LAW INST. REAL EST. LAW AND PRACTICE COURSE HANDBOOK SERIES 191 (2007) (providing a very nice example of the operation of a clawback that is capped at the after-tax carry).

67. This is generally the case even if the GP’s carry distributions are escrowed. Typically, even when there is an escrow of the GP’s carry, a portion of the escrowed funds are distributed out to the GP in an amount sufficient to allow the GP to pay the taxes on the carry. As a result, the carry escrow will often only contain the “after tax” carry.

GP paid (or is assumed to pay) \$4.50 of tax on the carry (15 percent tax on \$30). If the amount of any clawback is capped at the GP's after-tax carry,<sup>68</sup> the most that could be clawed back from the GP is \$25.50 (\$30 - \$4.50). If the clawback obligation is \$20 (as it was in Example #2), the clawback works to provide the parties with the economics to which they originally agreed. The cap presents no problem.

(1) *Loss-Shifting*

If, however, the fund only earned an aggregate profit of \$10 (i.e., the fund sold Asset B at \$460, producing a loss of \$140, wiping out all but \$10 of the \$150 gain from Asset A), the GP would only be entitled to a \$2 carry (20 percent of the \$10 aggregate profit). Thus, a full clawback would require the GP to return \$28 (the \$30 carry received in Year 2 less the \$2 carry to which the GP is rightfully entitled). But, if the clawback is capped at the amount of the GP's after-tax carry (\$25.50), the GP is not obligated to return the full \$28 of over-distributed carry. Thus, the LPs can only receive a total distribution from the fund of \$1005.50 (\$520 distributed in Year 2 + \$460 proceeds from the sale of Asset B + \$25.50 clawback from the GP), instead of the \$1008 rightfully owed to the LPs (\$1000 return of capital + 80 percent of the \$10 net profit). That is, the "after-tax" cap on the GP's clawback obligation results in the shifting of the economic burden of losses to the LPs.<sup>69</sup>

The maximum amount of losses that can be shifted from the GP to the LPs as a result of the after-tax cap on the clawback is equal to the tax paid (or assumed paid) by the GP on the carry. So, in this example, if the fund had zero aggregate profits and the GP would be entitled to a carry of \$0, the GP would return only \$25.50 pursuant to the after-tax clawback (rather than the full \$30 of carry received), thereby shifting a maximum of \$4.50 of economic losses from the GP to the LPs. Note that, because the maximum amount of economic loss that can be shifted from the GP to the LP is equal to the product of the applicable tax rate and the amount of the carry allocated

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68. Often, the "after-tax" carry is calculated using an assumed rate of tax. See Needham, *Private Equity Funds*, *supra* note 17, at III.B.4. (noting that the clawback provisions often assume that "the general partner bears tax at the marginal rates of a NYC resident and has no unrelated losses to shelter fund income").

69. See generally Howard E. Abrams, *Taxation of Carried Interests: The Reform that Did Not Happen*, 40 LOY. U. CHI. L.J. 197 (2009) (providing a useful explanation as to why an incomplete clawback can hurt LPs). Cf. Burke, *Sound and Fury*, *supra* note 1, at 12–14 (arguing that GPs should not be respected as partners in funds where incomplete clawbacks shift to the LPs the economic burden of taxes nominally imposed on the GP).

to the GP,<sup>70</sup> as the early carries increase in size, so too does the potential that the LPs will bear more than their share of subsequent losses.<sup>71</sup>

(2) *Increasing the GP’s Risk-Taking Incentive*

Again, the GP’s carried interest remains equivalent to an option, but any reduction in the maximum amount of the clawback makes the GP’s carry closer and closer to an out-of-the-money option. That is, in Example #3, the GP’s carried interest becomes an out-of-the-money option when the clawback obligation exceeds \$25.50 (i.e., once the value of Asset B declines by more than \$127.50, to below \$472.50). If Asset B is declining in value from \$600, it will be worth \$472.50 (i.e., the out-of-the-money threshold when the clawback is capped by the after-tax carry) before it is worth \$450 (i.e., the out-of-the-money threshold when the clawback can recoup the full amount of the carry). Thus, a clawback capped at the GP’s after-tax carry will create an incentive for increased risk-taking before a full (uncapped) clawback will create that incentive.<sup>72</sup>

2. *Appreciating How Clawback Problems Are Exacerbated by Increases to the Tax on Carried Interests*

The loss-shifting and risk-taking incentive effects of capping the clawback at the GP’s after-tax carry increase dramatically as the tax rate applicable to the GP’s carry increases.

Specifically as to the loss-shifting problem, the maximum economic loss that could be shifted from the GP to the LPs increases in proportion to the increase in the tax rate applicable to the carry. For example, recall the earlier examples where the GP received a distribution of a \$30 carry in Year 2. If the tax rate applicable to the GP’s carry is 40 percent rather than 15 percent, then capping the clawback at the GP’s after-tax carry ( $\$30 - 40\% = \$18$ ) could shift \$12 (rather than \$4.50) of economic loss from the GP to the

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70. This assumes that the amount of the carry that gets *distributed* is at least equal to amount of tax due on the carry that is *allocated* to the GP.

71. Further, as will be explained later, the potential that the LPs will bear more than their share of subsequent losses also increases as the tax rate applicable to the carry increases.

72. Risk-taking is not inherently problematic. The key, of course, is that parties understand the risks to which they are exposed and that the parties believe that they are adequately compensated for those risks. Thus, if LPs consent to a contract that creates a particular level of risk-taking incentive for the GPs and if a change in the tax law increases that risk-taking incentive, then the LPs become exposed to a level of risk to which they did not intend to be exposed.



LPs.<sup>73</sup> Said differently, where the tax rate increases by 267 percent (15% → 40%), the maximum potential economic loss that could be shifted from the GP to the LPs also increases by 267 percent (\$4.50 → \$12).<sup>74</sup>

The risk-taking incentive problem is also increasingly problematic as the tax rate applicable to the carry increases. Again, consider the example where the GP received a distribution of a \$30 carry in Year 2, and where the clawback is capped at the GP's after-tax carry. If the tax rate applicable to the GP's carry is 40 percent, the GP's clawback exposure is only \$18. As a result, the GP's carry becomes an out-of-the-money option when the clawback obligation exceeds \$18 (i.e., when the value of Asset B declines by more than \$90, to below \$510). Recall that, when the carry was taxed at 15 percent, the GP's carry only became an out-of-the-money option when the value of Asset B dropped below \$472.50. A comparison of these two scenarios illustrates that, if clawbacks are capped at the GP's after-tax carry, the carry subject to tax at 40 percent will create a stronger incentive for risk-taking than a carry subject to tax at 15 percent. Thus, if a clawback obligation is capped by the GP's after-tax carry, as the tax rate applicable to the GP's carry increases, the GP becomes increasingly likely to have an incentive for risk-taking that could inure to the detriment of the LPs.

Because GPs are often repeat players in the fund business, it is possible that the reputational markets could dampen the GP's risk-taking incentive.<sup>75</sup> If, however, the value of the fund assets decline enough to turn the GP's carry into an out-of-the-money option, the fund is likely already having trouble (although, the higher the tax rates on the carry, the less trouble the fund needs to be in before the carry turns into an out-of-the-money option). Troubled fund performance, by itself, creates adverse reputational consequences. Thus, query to what extent the possibility of *additional* market sanctions is likely to affect the GP's risk-taking choices.

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73. These numbers could be larger if early transactions produced larger profits because of an increase in the tax paid (or assumed paid) on those profits. This increases the amount of the distributed carry that could not be recouped under the clawback, and thus increases the amount of losses that could be shifted to the LPs.

74. Again, when dealing with dollar numbers that are more realistic (e.g., four or five orders of magnitude larger), the effects described herein could lead to significant economic losses for LPs.

75. See Gilson, *Venture Capital Market*, *supra* note 17, at 1090 (discussing the operation of the "reputation market" as a constraint on risk-taking behavior); Fleischer, *Preferred Return*, *supra* note 51, at 101–02. As mentioned earlier, capital contributions made by the GP can also serve as a check on GP risk-taking behavior. See *supra* note 39.

### 3. *Recommendations for Fund Investors Regarding Clawbacks*

Increased loss-shifting seems likely to be more problematic for LPs than increased risk-taking,<sup>76</sup> and each concern will be more problematic for some LPs and less problematic for others. Ultimately, the degree of concern depends on a wide variety of factors including the fund’s distribution scheme (including the timing of the distribution of the carry), the expected timing of the fund’s exits from various investments, the expected volatility of the fund, the LPs’ risk preferences, and the strength of the reputational and other contractual constraints on the GP’s behavior. For funds in which the LPs are concerned about the potential loss-shifting and/or risk-taking issues that arise from an increase in the tax rate on the GP’s carried interest, the LPs can try to mitigate these issues by negotiating about the terms of the carry and the clawback. Several potential approaches are available.

#### (a) *Revise How the Carry is Calculated*

One way for LPs to respond to the potential consequences of higher taxes on carried interests is to negotiate about how the GP’s carry is calculated during the life of the fund. The objective of this negotiation should be to make the interim carry calculations as reflective of the funds’ true net performance as possible, thereby reducing the likelihood that the GP receives an over-allocation and over-distribution of carry.

For example, assuming that the economic deal between the parties is that the GP’s carry should be 20 percent of the aggregate profits of the fund over the fund’s entire lifetime, the GP’s carry for any particular period could be calculated on a *cumulative* basis (rather than on a *deal-by-deal* or *year-by-year* basis), taking into account at least some prior year losses (if there are any). Further, the GP’s carry for any particular period could take into account not only that period’s *realized* gains and losses, but also any *unrealized* losses. Many funds already take one or both of these approaches.<sup>77</sup>

Both of these alternatives could reduce the GP’s current allocations on account of the carry, thereby reducing the likelihood of an over-distribution of carry that would trigger a clawback. Reducing the GP’s current allocations on account of the carry would also reduce the amount of tax paid (or assumed paid) on the carry, thus reducing the impact of any after-tax cap on a clawback obligation. Ultimately, the more closely interim

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76. This is because the latter is a shift in pre-existing behavioral incentives for risk-taking, on which there are external constraints (like reputation); the behavior may or may not change. In contrast, the adverse consequences of increased loss-shifting do not depend on the rationality of economic actors and are not subject to similar external constraints.

77. Breslow, *Selected Excerpts*, *supra* note 17, at § 2.8.1

distributions of carry reflect the GP's aggregate carry entitlement, the less likely a clawback will be needed, and the less impact the after-tax cap on the clawback is likely to have.

Of course, revising the method for calculating the carry in a way that would reduce the GP's current allocations and distributions of carry might be highly undesirable to the GP. While these changes should not ultimately change the amount of the aggregate carry to which the GP is entitled, these changes may defer the GP's receipt of some portion of the carry, thereby subjecting the GP to a non-trivial time-value-of-money cost.

(b) *Change the Tax Rate Used for Calculating the "After-Tax" Carry*

Whether the method for calculating the carry is revised, LPs could negotiate with the GP about the tax rate that is used for calculating the "after-tax" carry. Typically, fund agreements use either a particular rate that is stated in the agreement (such as 15 percent) or a rate that is determinable for a hypothetical taxpayer under a set of assumptions that are articulated in the fund agreement.

Where the cap on the clawback is calculated using a stated tax rate, the LPs may consider whether they are willing to agree to increase that stated rate to one that is higher than today's tax rates but lower than the tax rate that the carried interest tax proposals would impose on the GP's carry. For example, imagine a fund with a clawback that is capped at the GP's after-tax carry, using a stated tax rate of 15 percent. If the carried interest legislation passes, the GP will likely want the cap on the clawback to be calculated using a stated tax rate of 40 percent.<sup>78</sup> Instead, the parties could negotiate to use a stated tax rate between 15 percent and 40 percent (say, a compromise rate of 27.5 percent, to split the difference).

Similarly, where the cap on the clawback is calculated at a tax rate determined based on a variety of assumptions, the LPs could negotiate about the assumptions on which the amount of the after-tax carry is calculated. Those assumptions include assumptions regarding the rate of tax, regarding the location of the "hypothetical" taxpayer whose tax rate is used for calculating the after tax carry, and/or regarding the availability of losses to offset income from the carry. Where the after-tax cap on the clawback is determined based on a variety of assumptions, it is likely that an increase in the tax rate applicable to carried interest will automatically be incorporated into the "after-tax" determination, without any action or agreement by the LPs. Thus, if the LPs want to avoid the loss-shifting and risk-taking

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78. Where an existing fund agreement uses a "stated rate" for calculating the after-tax cap on the clawback, the GP is likely to approach the LPs in an effort to modify the agreement. The bargaining dynamic is likely reversed if the after-tax cap on the clawback is calculated at a rate determined based on a variety of assumptions.

consequences described herein, the LPs will likely need to approach the GP in an effort to modify an existing agreement.

Ultimately, if tax rates on carried interests increase, LPs may be willing to increase, at least to some degree, the tax rate (stated or assumed) used to determine the cap on the clawback. The lower the tax rate used for purposes of calculating the after-tax carry, the more complete the clawback.<sup>79</sup> Under a compromise agreement, the LPs likely would be agreeing to some increase in potential loss-shifting and likelihood of increased risk-taking, but the LPs may be able to limit their exposure to some degree.

(c) *Take the GP’s Tax Loss into Account when Calculating the “After-Tax” Carry*

Another alternative is to include an additional, but typically ignored, factor into the calculation of the cap on the clawback — the value of the tax loss that the GP will have as a result of forfeiting some or all of its previously taxed carry.<sup>80</sup> Calculations of the after-tax cap on the clawback typically ignore this factor, using the assumption that the GP does not have any capital gains against which the loss could be used.<sup>81</sup> This assumption is

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79. A more complete clawback is equivalent to an increase in the size of the GP’s limited deficit restoration obligation. *See supra* note 62. Alternatively, rather than arguing about the details of the clawback, the LPs could ask the GP to commit to an explicit limited deficit restoration obligation separate and apart from any clawback. Where the GP is committed to a limited DRO, losses (in an amount up to the limited DRO) can be allocated to the GP, even if the allocation to the GP of those losses would otherwise create a deficit in the GP’s capital account. As a result, the limited DRO would limit the possibility of loss shifting and would delay the GP’s incentive for increased risk taking. From a partnership tax perspective, the addition of a limited DRO would have a very similar economic impact as an increase to the size of the clawback obligation (or elimination/reduction of the after-tax cap on the clawback obligation). A limited DRO, however, could present as a different business issue than a clawback primarily because (1) a clawback is a limited DRO that is specifically tied to over-distributions of carry, whereas a more general limited DRO could be triggered in a wider variety of circumstances, and (2) a limited DRO may be located in a different part of the fund agreement than a clawback. I suspect that GPs are likely to resist this approach for the same reasons that GPs typically resist any DRO — they do not want to increase their downside economic exposure, particularly since this could increase the GP’s exposure to claims from the fund’s creditors. Nevertheless, this may be an option for LPs who are particularly concerned about loss-shifting.

80. *See supra* note 44 (explaining why a fulfillment of a clawback results in a tax loss for the GP).

81. Individuals cannot carry capital losses back to offset previously included capital gains, so use of the capital loss depends on whether the individual

quite likely incorrect in most cases. So, the calculation of the cap on the clawback would better reflect the true economics if the GP's clawback obligation is not only reduced by the full amount of the assumed tax bill on the carry, but is also *increased* by the value of the tax loss that arises when the GP pays the clawback. However, the inclusion of this additional factor is "often resisted by general partners because it involves an analysis of personal tax returns" (i.e., to determine the extent to which the GP is able to use the loss).<sup>82</sup>

Nevertheless, if the tax rate on the carry increases (thereby reducing the size of the after-tax clawback, and increasing the loss-shifting and risk-taking problems described earlier), LPs may feel more strongly about using a more economically accurate formula for calculating the cap on the clawback. In turn, the LPs may be able to put more and more pressure on the GP to agree that the clawback amount — the GP's after-tax carry — should take into account the value of the GP's tax loss resulting from the clawback. The "personally intrusive"<sup>83</sup> nature of the determination of the value of this tax benefit can be mitigated by either (1) using an assumed rate of tax benefit<sup>84</sup> (which need not assume full usability of the loss) or (2) by using the GP's good faith estimate of the value of the tax benefit.

Moreover, the enactment of the carried interest tax proposals actually increases the likelihood that the loss arising from a clawback payment will largely or fully compensate the GP for excess taxes paid on the carry. Given that the carried interest tax proposals would tax (some or all of) the carry at ordinary income rates, the GP's tax loss upon fulfilling a clawback obligation is arguably characterized as an ordinary loss rather than a capital loss.<sup>85</sup> Since ordinary losses are not subject to limitations on use to

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has capital gains from another source during the year of the loss or in subsequent years. I.R.C. § 1211.

82. Breslow, *Selected Excerpts*, *supra* note 17, at § 2.8.1[G][4]; *see also* Needham, *Private Equity Funds*, *supra* note 17, at III.B.4. ("Fund investors usually accept the possibility of a windfall to the general partner [that arises from ignoring the potential tax benefit to the general partner as a result of the clawback], perhaps in the belief that the general partner will earn positive returns on invested capital.").

83. Breslow, *Selected Excerpts*, *supra* note 17.

84. An assumed rate for calculating the GP's tax liability on the carry and an assumed rate for calculating the GP's tax benefit from the clawback can be simplified, on net, to a single assumed rate. For example, assuming a 40 percent tax rate on the carry and a 10 percent tax benefit on the clawback (discounted perhaps to reflect the GP's ability to use the benefit), could net out to an assumed 30 percent rate of tax for calculating the clawback cap (i.e., the amount of the GP's net after-tax carry).

85. I.R.C. § 165(c)(1). The availability of an ordinary deduction when the GP fulfills its clawback obligation is suggested by the tax benefit rule. There is some risk that the loss could still be characterized as LTCL even if the income was taxed as ordinary income. This is because repayment of the clawback obligation could be

which capital losses are subject, the LPs can argue that the calculation of the after-tax carry ought to assume full usability of any losses arising from the clawback obligation. Under this assumption, the GP’s argument against taking the value of the tax loss into account is significantly weakened (almost made meritless) because valuation of the loss would no longer require “an analysis of personal tax returns.” In turn, the LPs’ argument that the value of the tax loss should be taken into account when determining the GP’s clawback obligation (i.e., the after-tax carry) is significantly strengthened. That is, if the GP’s tax loss is ordinary and fully usable, the GP is quite likely to be able to recover any excess tax paid on the portion of the carry that the GP ultimately had to return.

This is particularly true given that the “make whole” rule of section 1341 arguably (but not certainly) applies to the GP’s loss,<sup>86</sup> which would

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considered to be a capital contribution that generates basis in the partnership interest. Then, when the GP does not receive that money back in the liquidation of the partnership, the GP may be viewed as recognizing a loss arising from the liquidation of the partnership, which is generally treated as a capital loss. I.R.C. § 731(a)(2) (flush language).

86. I.R.C. § 1341. Section 1341 applies if three requirements are met. First, the taxpayer must have included an amount in income for a prior taxable year because it appeared that the taxpayer had a right to the income. *Id.* at § 1341(a)(1). Carry distributions are made to GPs on the basis that GPs are entitled to that money; however, given the contingent clawback obligation, the GP’s entitlement to the carry distribution is arguably “apparent” and not certain. That said, there is some risk that the carry could be conceived of as an unchallengeable right to funds, which is undermined by the subsequent facts that trigger the clawback obligation. The difference between an “apparent right” to funds (that triggers section 1341) and an “unchallengeable right undermined by subsequent facts” (to which section 1341 does not apply) is slight, but it is critical for purposes of determining whether a taxpayer will benefit from the “make whole” provision of Section 1341. *See* BORIS I. BITTKER, MARTIN J. MCMAHON, JR. & LAWRENCE A. ZELENAK, *FEDERAL INCOME TAXATION OF INDIVIDUALS* ¶ 4.03[4], n.49 (2d ed. 2011) (citing cases) [hereinafter, BITTKER, MCMAHON & ZELENAK, *TAXATION*]. Second, for section 1341 to apply, “a deduction [must be] allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item.” I.R.C. § 1341(a)(2). A clawback obligation is triggered when it is determined that the GP did not, in fact, have an unrestricted right to the previously distributed carry, and the clawback obligation produces a tax loss allowable under section 165. Third, the deduction must exceed \$3000, and for purposes of this analysis, I assume that this threshold is satisfied. *Id.* at §1341(a)(3). *See also generally* BITTKER, MCMAHON & ZELENAK, *TAXATION*, *supra* at ¶ 4.03[4] (discussing the application of section 1341 to situations where taxpayer repays amounts received under claim of right); Matthew A. Melone, *Adding Insult to Injury: The Federal Income Tax Consequences of the Clawback of Executive Compensation*, 25 *AKRON TAX J.* 55, 84–95 (2010); Rosina

ensure that the GP's tax liability for the year of the clawback is reduced by *at least* the tax previously paid on the clawback amount,<sup>87</sup> thereby fully reimbursing the GP (setting aside the time value of money) for the excess taxes paid. Thus, if the tax loss will effectively refund to the GP all excess taxes paid on the portion of the carry that the GP ultimately had to return (setting aside the time value of money), the LPs have a very strong argument that the clawback obligation should be limited only to the pre-tax, and not after-tax, carry.<sup>88</sup>

(d) *Restructure the Carry as a Contingent Fee*

To the extent that the parties want greater certainty that, upon a forfeiture of amounts previously received, the GP will benefit from a reduction in tax liability at least equal to the tax previously paid on the amount forfeited, the parties could restructure the carry into an economic relationship to which section 1341 more clearly applies. For example, rather than structuring the GP's entitlement to 20 percent of profits as a profits interest in a partnership, the GP's entitlement to 20 percent of profits could be structured as a "contingent fee" equal to 20 percent of the total profits.<sup>89</sup> A contingent fee for services is a classic arrangement to which section 1341 applies.<sup>90</sup> A contingent fee could provide economics that are substantially similar to a carried interest, in that both can entitle the recipient to 20 percent of the profits earned by the enterprise.

Of course, a key difference under the existing tax law is that a contingent fee is taxed as ordinary income,<sup>91</sup> whereas the character of income received on account of a carry can be capital gain or ordinary income

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B. Barker and Kevin P. O'Brien, *Taxing Clawbacks: Theory and Practice*, 129 TAX NOTES 423, 425-435 (Oct. 25, 2010).

87. I.R.C. § 1341(a)(4), (5).

88. Where the value of a subsequent loss upon payment of a clawback is at least equal to the tax originally paid on the amount clawed-back, a clawback cap that takes into account the value of the tax loss when determining the GP's after-tax carry is equivalent to a clawback of the entire carry, unreduced by taxes. Again, an increase to size of the clawback is tantamount to an increase the GP's limited deficit restoration obligation, thereby reducing loss-shifting potential and delaying the incentive for increased risk taking. *See supra* notes 62, 79, and associated text.

89. My thanks to Gregg Polsky for this idea.

90. *See, e.g.*, Rev. Rul. 72-78, 1972-1 C.B. 45 (applying section 1341 to a contingent commission arrangement). Where the retention of a fee is contingent on the occurrence (or nonoccurrence) of subsequent events, the recipient has an apparent right to the funds, but the right to the funds is clearly challengeable. Thus, a contingent fee quite likely satisfies the first prong of Section 1341. *See supra* note 86.

91. I.R.C. § 61.

depending on the character of the partnership's profits.<sup>92</sup> This tax difference is quite meaningful today given that long term capital gains are generally taxed at 15 percent, whereas the highest marginal rate applicable to ordinary income is 35 percent.<sup>93</sup> If, however, the tax treatment of carried interests changes and income earned on account of a carry is taxed as ordinary income, the tax rate difference between a carry and a contingent fee is largely eliminated.<sup>94</sup> In the absence of the tax rate benefit for carried interests, parties may opt to restructure their arrangement to create similar economics while providing greater certainty that the GP would be made whole if the GP is ultimately obligated to return part of the profits previously transferred to the GP.

(e) *Conclusion Regarding the LPs' Response to the Clawback Issue*

Ultimately, the LPs must determine how much potential loss-shifting they are willing to bear and how willing they are to accept the possibility of increased risk-taking by the GP. This determination is relevant both for investors in newly formed funds and investors in existing funds, although the negotiating dynamics differ. Investors in new funds can negotiate about these issues as part of the initial negotiation about the fund agreement provisions. Investors in existing funds, however, must negotiate against the backdrop of existing fund agreements,<sup>95</sup> the economic impacts of which can be altered by the change in the tax law without any corresponding change in the compensation paid between the parties.

Either way, if the LPs (and their lawyers) appreciate how increases to the tax rate on the GP's carry can reduce the clawback, and how a reduction in the clawback poses economic risk to the LPs, the LPs can make informed decisions about whether and to what extent to negotiate for compensation for these risks, to negotiate to change the terms of the clawback to reduce these risks, to negotiate for other contractual protections against these risks, or to take other action.

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92. I.R.C. § 702.

93. I.R.C. § 1.

94. There may still be employment tax differences depending on the details of the carried interest tax proposal. *See supra* note 16.

95. In existing funds where the cap on the clawback is pegged to an assumed tax rate, LPs might be approached by GPs who wish to renegotiate the cap on the clawback. In other existing funds, the LPs might have to initiate the negotiation with the GP because the cap on the clawback might automatically change with any change to the tax rates applicable to carried interests (e.g., if the cap is pegged to the "applicable" tax rate or if the cap is determined in the good faith discretion of the GP).



B. *Tax Distribution Provisions*

An increase in the tax rate applicable to carried interests can change how LPs are affected not only by clawback provisions, but also by tax distribution provisions. Again, the impact on LPs is indirect. And while the issues raised for LPs as a result of the tax distribution provisions are likely less troublesome than the issues raised as a result of the clawback provisions, LPs should still be sensitive to their potential exposure.

This section explains how tax distributions operate and why they are needed. Then, with this background, this section discusses the possibility that tax distributions will increase if the tax on carried interests increases, and explains how LPs may be indirectly affected as a result. Finally, this section provides some guidance to LPs who are concerned about how they might be affected by the interaction between the tax distribution provision and the increase in taxes on carried interests.

1. *Understanding Tax Distributions*

Under the partnership tax rules, when a partnership earns income, the partnership itself is not taxed.<sup>96</sup> Rather, the partnership's income is allocated to the partners in accordance with the partnership agreement, and each partner pays tax on its allocable share of the partnership income.<sup>97</sup> This is true whether or not the partnership distributes cash to the partner.

Thus, when a fund earns income, that income is allocated to the partners in accordance with the fund agreement, and those partners pay tax on that income. If at least a significant portion of that income is concurrently distributed to the partners, the partners can use that cash to pay the tax due. However, where a fund does not make a corresponding distribution of cash from the fund, partners have "phantom income" — the partner may owe current income tax on income that the partner has not yet received.<sup>98</sup> Some partners have no problem with this result because, for example, they have ample cash flow from other sources, or they are tax-exempt. Many partners, however, find this "tax without cash" situation to be quite undesirable. In response, funds often provide for "tax distributions," particularly to the GP.<sup>99</sup>

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96. I.R.C. § 702.

97. I.R.C. §§ 702, 704.

98. Funds vary as to whether they generally distribute income as it is earned, so this "phantom income" issue is more of a problem for partners in some funds and is less of a problem in other funds. In particular, private equity funds (as opposed to hedge funds) commonly distribute proceeds quickly upon realization, reducing the prevalence of phantom income problems in these funds.

99. See Needham, Private Equity Funds, *supra* note 17, at III.B.5.; LEVIN, VENTURE CAPITAL, *supra* note 14, at ¶ 1003.5.

Specifically, distributions are made to designated partners in an amount intended to enable a partner to pay tax on the income allocated to that partner. These distributions typically have priority over other distributions in the regular distribution waterfall, and these distributions are typically treated as advances on distributions to which the particular partner would otherwise be entitled.<sup>100</sup>

Again, some of the details of tax distributions vary from fund to fund. For example, (i) tax distributions may be made to all partners or only to the GP,<sup>101</sup> (ii) tax distributions may be calculated using an assumed rate of tax or using an approach that is more tailored to the individual tax situations of the particular distributees,<sup>102</sup> (iii) tax distributions may be calculated on a year-by-year basis, deal-by-deal basis, or on a cumulative basis,<sup>103</sup> and (iv) cash remaining after the tax distributions have been made may be retained and redeployed in the enterprise, or remaining cash may be distributed to the LPs to return their capital contributions.<sup>104</sup>

Of course, funds that make current cash distributions in amounts equal to current allocations of income need not provide for tax distributions; partners in these funds receive plenty of cash to pay the tax on the fund income allocated to them. That said, to the extent that the fund regularly makes additional capital calls and the GP (and possibly others) reinvest the amount received in the distribution less the tax due (or assumed due), the fund effectively makes “tax distributions.” Further, funds that subject the GP’s carry distribution to an escrow also often make tax distributions out of the escrow to enable the GP to pay taxes on the escrowed funds.<sup>105</sup>

Ultimately, where there are delays between the time a partner is taxed on fund income and the time a partner is to receive that income, a tax distribution helps the partner overcome the cash flow issue and pay the tax due on the partner’s allocable share of fund income.

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100. See Needham, Private Equity Funds, *supra* note 17, at III.B.5.

101. For example, LPs who are tax-exempt, foreign, or quite liquid may not need tax distributions.

102. It is much more common to use an assumed rate. See Needham, Private Equity Funds, *supra* note 17, at III.B.5.

103. See Needham, Private Equity Funds, *supra* note 17, at III.B.5. (explaining that “[t]he effect of a cumulative approach is that gains in any particular year must exceed the excess of losses over gains in all preceding years before a member is entitled to a tax distribution”).

104. See LEVIN, VENTURE CAPITAL, *supra* note 14, at ¶ 1005 (explaining that it is a business decision as to whether the GP has the power to reinvest proceeds rather than to distribute the proceeds); Needham & Brause, Hedge Funds, *supra* note 11, at I.A. (explaining that hedge funds often have tremendous flexibility to “buy, sell and reinvest proceeds of sale”).

105. See *supra* note 67.

2. *Increasing Tax Distributions in Response to Increased Tax on Carried Interests*

In funds that earn significant amounts of LTCG income, the carried interest tax proposals would increase the amount of tax that the GP would owe on the carried interest. In turn, this could affect tax distributions. Specifically, GPs would want the size of the tax distributions to be increased in order to cover the higher tax bill applicable to the carry.

An increase to the amount of the tax distribution may already be built into some fund agreements such that the tax distributions will increase in amount without any additional negotiation or agreement between the parties. This is likely the case where the tax distribution amounts are based on a variety of assumptions.<sup>106</sup> For example, consider a fund agreement that defines the tax distribution to be the amount “reasonably required by the [GP] for payment of its federal, state, and local estimated (or other) taxes . . . relating to the [GP’s] distributive share of the income of the [fund].”<sup>107</sup> This language is broad enough to allow for the tax distributions to increase if the taxes on the carried interest increase; this can occur without any change to the terms of the fund agreement.

For funds that provide tax distributions, but do so at a stated rate (such as 15 percent), GPs would likely request an increase in the amount of the tax distribution to help cover the increased tax cost that the GP would have to bear.<sup>108</sup> And, for funds that do not provide tax distributions but whose terms result in phantom income, an increase in the tax rate applicable to the carry would increase a GP’s incentive to push for adding tax distributions to the fund agreement.

A GP may be able to make a relatively sympathetic case for increasing the tax distribution to the GP if the tax on carried interests increases. In particular, the GP could explain that tax distributions are merely advances on amounts that would eventually be distributed to the GP, so the GP will not end up with any more total money as compared to what the GP would receive if the tax distribution is not increased. And, although an increase in the tax distribution results in an earlier distribution of some funds to the GP, it is the federal government, and not the GP itself, that ultimately

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106. Recall that a similar approach is often used for purposes of estimating a GP’s “after-tax carry” that may be subject to a clawback. *See supra* Part III.A.3.b.

107. Nowak, *Hedge Fund Agreement*, *supra* note 18, at ¶ 7.10(a); *see also* Needham, *Private Equity Funds*, *supra* note 17, at Worksheet 5 (providing sample tax distribution language that is similarly tied to the relevant prevailing tax rates, rather than to an explicitly stated rate).

108. I have spoken with a handful of fund managers who indicated that this is how they are likely to respond if the carried interest tax legislation passes. Of course, this is anecdotal, but it seems like the logical move. I would likely recommend this course of action if I represented a GP.

has use of the increased amounts. That is, a GP would argue that the increased tax distribution does not really help the GP (other than to alleviate cash flow problems associated with the GP’s increased tax bill) because the GP cannot use that money in order to make other investments. On its face, this might seem like a reasonably compelling argument for increasing the GP’s tax distribution, but the LPs should be careful.

3. *Sensitizing LPs to the Secondary Effects of Increasing the GP’s Tax Distribution*

LPs should appreciate the subtle ways in which an increase to the tax distribution to the GP could affect the remainder of the economic relationship between the GP and the LPs, including the extent to which the alignment of the GP’s and LPs’ incentives is altered.

(a) *Eroding the Alignment of Incentives*

Carried interests, as currently designed, generally are regarded as quite effective at aligning the incentives of the GP with the incentives of the LPs.<sup>109</sup> This is because the GP’s return is directly proportional to the return that the fund assets produce for the LPs. The alignment of incentives largely avoids the potential agency costs that could be created when the fund investors allocate managerial authority over the fund assets to the GP. The alignment of interests is not perfect, and there are some minor agency problems,<sup>110</sup> though other features of the carry and the fund help to mitigate those costs, leaving the interests of the GP and the LPs largely aligned.<sup>111</sup> As discussed in Part III.A., one of the problems created pursuant to the clawback provision is the erosion of the alignment of incentives, particularly with respect to the incentive for risk-taking.

Tax distribution provisions can also erode the alignment of incentives, though in different respects. Specifically, funds that generally limit yearly distributions to tax distributions will have increased liquidity needs if the size of tax distributions to the GP is increased. These increased liquidity needs can cause the GP’s interests in deal harvesting to diverge

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109. Gilson, *Venture Capital Market*, *supra* note 17; Fleischer, *Preferred Return*, *supra* note 51; Robert C. Illig, *The Promise of Hedge Fund Governance: How Incentive Compensation Can Enhance Institutional Investor Monitoring*, 60 ALA. L. REV. 41 (2008), [hereinafter Illig, *Hedge Fund Governance*]; Matthew A. Melone, *Success Breeds Discontent Reforming the Taxation of Carried Interests—Forcing a Square Peg into a Round Hole*, 46 DUQ. L. REV. 421 (2008).

110. *See supra* note 60.

111. Gilson, *Venture Capital Market*, *supra* note 17; Illig, *Hedge Fund Governance*, *supra* note 109.

from the LPs' interests. This is because, under current law, both the GP and the LPs are subject to tax on their fund income at the same rates (LTCG), assuming that the LPs are also taxable U.S. persons.<sup>112</sup> A large portion of LPs are tax-indifferent,<sup>113</sup> but when GPs and LPs are subject to tax at the same rate, the GP and the LPs are likely to have similar interests in receiving tax distributions (i.e., both would likely want tax distributions of 15 percent of the allocated income). In contrast, under the carried interest legislation, the GP's income from the fund is recharacterized as ordinary income, increasing the GP's tax liability, but the tax rate on the LPs' income from the fund remains unaffected. Thus, if taxes are increased on carried interests, a GP's interest in increasing the tax distribution would be much stronger than the LPs' interests in doing so. As a result, it is likely that it would be primarily the GP, and not the LPs, that has an interest in ensuring that the fund has additional cash flow.<sup>114</sup>

Where the GP's desire for liquidity exceeds the LPs' desire for liquidity, the GP has an incentive to manage the fund's assets in a way that will ensure cash flow that is sufficient to cover the GP's larger tax bill, even if such management is not in the best interests of the LPs. This pressure may have little, if any, effect in situations where a fund exits a particular investment in exchange for cash, and all of that cash is made available for distribution. However, consider the situation where the fund has a limited amount of cash available for distribution, for example, because a taxable transaction yielded non-cash proceeds<sup>115</sup> or because cash proceeds from a transaction are needed to pay fund expenses. In these types of situations, as the size of the GP's needed tax distribution increases, the GP may become increasingly inclined to cause the fund to exit another investment prematurely in order to ensure that the fund has sufficient cash to cover the

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112. This assumes that the LPs are also taxable U.S. persons. This may or may not be the case. To the extent that the LPs are subject to lower tax rates, the GP's and LPs' preferences regarding tax distributions are already misaligned. Thus, if the tax on the GP's carry is increased, and the size of the tax distribution to the GP is correspondingly increased, then the alignment between the GP's and LPs' preferences is made *even worse*. That is, the GP's interest and the LPs' interests are misaligned when the GP is subject to tax at 15 percent and the LPs are subject to tax at 0 percent. But, the misalignment of interests is even worse when the GP is subject to tax at 40 percent and the LPs are subject to tax at 0 percent.

113. *See supra* note 7.

114. It is possible that, when the GP's tax distribution is increased, the LPs' tax distributions are also increased proportionately. Then, the LPs would have some increased interest in increased liquidity. But, even then, the LPs' desire for fund liquidity would be less than the GP's interest because the GP actually *needs* the money to satisfy a current liability to the government, whereas the LPs do not.

115. *See generally* Needham, Private Equity Funds, *supra* note 17, at III.C. (raising this possibility).

GP’s tax needs. Further, where the fund has limited cash flow, the GP, as its tax bill increases, may be increasingly disinclined to cause the fund to undertake efficient taxable transactions just because they yield non-cash proceeds.<sup>116</sup>

(b) *Altering Additional Aspects of the GP’s/LPs’ Economic Relationship*

An increase in the size of the tax distribution to the GP can cause other changes to the economic relationship between the GP and the LPs. These changes may be slight, but they remain worthy of mention because of how carefully the partners typically negotiate the economic relationship between the GP and the LPs. The specific manner of change depends, in part, on the remainder of the fund’s scheme for operating distributions.<sup>117</sup>

(1) *Delaying the Return of Capital to the LPs*

Consider a fund agreement that provides for tax distributions to the GP, followed by a distribution of remaining available cash to the LPs as a return of the LPs’ capital contributions.<sup>118</sup> Under this distribution scheme, an increase in the size of the tax distribution to the GP will reduce the amount of the current distribution to the LPs, thereby delaying the time at which the LPs receive a return of their capital contributions. This time value of money issue may or may not be problematic for the LPs, depending on the LPs’ expectations and needs regarding the rate at which their capital contributions are returned to them and depending on the magnitude of the increase in the amount of tax distributions.

(2) *Foregoing the Opportunity for the Fund to Reinvest the Increased Amounts Distributed as Tax Distributions*

Consider a different fund agreement that provides for tax distributions to the GP and the LPs, with remaining cash available retained by the fund. An increase in the tax distributions to the GP (whether or not accompanied by a proportionate increase to the tax distributions made to the LPs) will reduce the total amount of money available with which the fund

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116. This incentive actually exists as a result of the mere increase in taxes on the carried interest, whether or not the tax increase is accompanied by an increase in the tax distribution.

117. See generally Needham, Private Equity Funds, *supra* note 17, at III.B. (describing various distribution schemes); LEVIN, VENTURE CAPITAL, *supra* note 14, at ¶ 1003 (same).

118. See LEVIN, VENTURE CAPITAL, *supra* note 14, at ¶ 1003 (describing this distribution scheme).

can make additional investments. Of course, the tax distribution is merely an advance distribution of amounts to which the distributee will be ultimately entitled. However, the earlier this advance is distributed (the larger the tax distribution, the more money advanced earlier), the less time that money is in the fund, and the less time the fund will be able to earn returns by investing that money.

Again, this may or may not be problematic for the LPs, depending in part on the extent to which the fund's business model depends on retention and redeployment of the fund's capital over a particular term, and depending on the magnitude of the increase in the tax distributions.

#### *4. Recommendations for Fund Investors Regarding Tax Distributions*

The existence and magnitude of the foregoing concerns will, of course, vary from fund to fund and LP to LP. LPs should evaluate their particular situation to determine the extent to which these concerns are problematic for them. For example — Does the fund have significant liquidity constraints? When do the LPs expect to receive returns of their invested capital? How important is it to the fund's business model to retain and redeploy as much cash as possible?

The answers to these and other questions should inform both the LPs' assessments about the degree of any problems created by increased tax distributions and the LPs' response thereto. LPs may determine that the issues described in Part III.B.3 are not problematic, and do nothing. Or, LPs may determine that the issues are somewhat problematic but the LPs may accept these consequences because the LPs believe that the costs of accepting the risks are less than the costs of fighting with the GP about the tax distribution terms. Alternatively, LPs may determine that the problems created for them by increased tax distributions are sufficiently troublesome to justify their efforts to protect themselves from the potential adverse impact of increased tax distributions.

If the LPs want to negotiate with the GPs in an effort to minimize the consequences described in this part, there are different approaches available. One approach is to negotiate directly about the terms of the tax distributions in an effort to change the assumptions on which the amount of the tax distributions is calculated. Those assumptions include assumptions regarding the rate of tax, regarding the location of the "hypothetical" taxpayer whose tax rate is used for calculating the tax distributions, and/or regarding the availability of losses to offset income from the carry. This is similar to the approach described above in Part III.A.3.b as a potential response to the clawback issues.

Another approach is to negotiate about how the GP's *carry* is calculated, thereby negotiating indirectly about the amount of the tax distribution. For example, calculating the carry on a cumulative basis (rather than on a year-by-year basis) or calculating the carry net of unrealized losses could reduce the current allocations of carry,<sup>119</sup> thereby reducing the necessary tax distributions, thereby reducing the risks described in this part. This is similar to the approach described above in Part III.A.3.a as a potential response to the clawback issues.<sup>120</sup>

Ultimately, the LPs' response, if any, will depend on the particular facts and circumstances, but hopefully, this discussion enables the LPs (and their lawyers) to evaluate the magnitude of any potential concern created by increased tax distributions.

#### IV. CONCLUSION

The debate about the taxation of carried interests continues, raising a real possibility of an increase in the taxes paid by fund managers on the value they derive from their carried interests in funds. Under the carried interest proposals, fund managers would be the ones who pay higher taxes, but they are not the only ones who could suffer adverse economic consequences. The carried interest legislation puts fund investors at risk too, and not just because managers may try to raise management fees or carry rates or because overall fund profitability may decline. Rather, the carried interest legislation puts fund investors at risk of bearing more than their share of economic losses, at risk because managers might take increased risks with the fund assets, and at risk from other changes to the investors' economic relationships with managers.

The risks are raised not directly, but rather indirectly, as a result of common fund agreement provisions, specifically clawback provisions and tax distribution provisions. These may appear to be reasonable, carefully negotiated provisions that are part of industry norms for fund agreements. However, as this Article explains, these provisions, when coupled with an increase in the taxes imposed on carried interests, can have return-reducing ripple effects for fund investors. The route through which investors' economic interests could be affected may be complex, technical, and subtle, but the effect could be significant. And this is merely one example of how a

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119. This might change the timing of the allocation and distribution to the GP of the carry, but it should ultimately not change the total amount of the carry to which the GP is entitled.

120. The other approaches described as possibilities in response to the clawback issue (specifically (i) taking into account the GP's tax loss when calculating the after-tax cap on the carry and (ii) adding a limited DRO) are relevant to clawbacks but not to tax distributions.



change in law can create unintended consequences by rippling through private contracts, thereby altering the economic relationships created by those contracts and adversely affecting parties who are not the desired targets of the law change.

Ultimately, the carried interest legislation may not be explicitly aimed at fund investors, but fund investors ought to be aware of how the legislation could affect them. Armed with that knowledge, fund investors can decide whether to accept the potential consequences or whether to protect themselves by negotiating about the details of the fund agreements. Either way, fund investors need to know that (and how) they may be vulnerable.