

# FINANCIAL SERVICES TRENDS

## HOW TRUMP'S TAX REFORM HAS CHANGED THE COMPENSATION STRUCTURES OF HEDGE AND PRIVATE EQUITY FUNDS

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Now that the dust has somewhat settled on the sweeping changes imposed by the Tax Cut and Jobs Act of 2017 (TCJA), hedge and private equity fund owners have started to adjust their employee compensation packages as well as their own investor fee structures. To better understand the alterations being implemented, let's first discuss how alternative investment managers are compensated and then the options available to them for securing premier talent.

### Management Fees and Profit Reallocation

Hedge and private equity fund managers generally make their money through two avenues.

- A fixed percentage of the net assets under management (that is, each investor's capital) is typically charged quarterly and collectible regardless of profits. This management fee is commonly 2% unless the investor is given a break as a founder/provider of seed money. Increasingly, founders are dictating the terms of their fees, demanding they be charged a smaller percentage. Management fees, generally sourced as sales to a specific state (which will be discussed further below), are self-employment income subject to that tax if flowing to an individual, and, when paid to a New York City-based non-corporate entity, subject to the 4% Unincorporated Business Tax (UBT). As these management fees are taxed in all these ways with no beneficial lower tax rate, their cash flow is generally designated by the fund to cover payroll, rent, utilities, consultants, software, and equipment such as chairs or computers. This income is generally not eligible for the new 20% deduction afforded certain pass-through entities through the new Internal Revenue Code (IRC) §199A as it probably is one of the "specified trades or businesses" rendered ineligible.
- A variable portion of the profits is sometimes named the incentive reallocation, carry, promote or carve-out. Historically, a typical rate charged is 20%. As with the reduced management fees mentioned above, seed investors sometimes negotiate being charged a smaller percentage or, in some cases, no carry at all. Often, hurdle rates (for example, a fixed percentage or the federal LIBOR rate must be cleared) and/or high-water marks (an investor's cumulative losses to date must be recovered first) are utilized. If this profit is paid as a reallocation through a pass-through entity such as a limited liability company or limited partnership instead of as a fee for services rendered as an independent party, there are tax advantages. The most salient being that the portion of current income attributable to unrealized gains remains unrealized for the manager because the character of

the income (ordinary, long-term capital gain, portfolio deduction) is retained when passed through a partnership to its partners. The partners of the managing entity can also benefit from the lower tax rates granted to long term capital gains and qualifying dividends (the highest rate of which from a federal standpoint is currently 20%). However, this is another facet of the law that changed with the TCJA – in order to get the beneficial tax rate on long-term capital gains under new IRC §1061, the general partner entity must have held its carry interest three years and the investments themselves must have been held for three years as well. The trading strategy of the entity granting the profits interest does, however, have a substantial effect on the benefits offered, especially in light of the TCJA. If the fund turns over its portfolio frequently and is classified as a "trader," the fund's expenses are classified as "above-the-line" deductions and directly reduce an individual investor's Adjusted Gross Income (AGI) when passed through. If the fund holds onto investments and tries to benefit from long-term appreciation, it will be classified as an "investor" and the professional expenses and management fees will instead be classified as miscellaneous itemized deductions if flowing to an individual. Miscellaneous itemized deductions are no longer deductible at all under TCJA. For years prior to 2018, these were deductible, if they exceeded 2% of AGI, as individual itemized deductions if the standard deduction was not elected, and the taxpayer did not pay Alternative Minimum Tax. The Net Investment Income tax of 3.8% also applies to individuals with modified AGI in excess of \$200,000 (\$250,000 for married filing joint taxpayers). Corporate partners are not subject to similar deduction limitations and are indifferent to the fund's classification as a "trader" or "investor," as they are indifferent to the holding period of the investments – setting up a potential conflict between different types of investors. A common misperception is that this classification is an election. It is not. It is based on the strategy employed and the implementation of such, not on how the fund wishes to be classified. Managers interested in having their own IRA accounts invested in the carry vehicle should be wary of use of leverage or any business-like income such as loan origination fees, oil and gas royalties or real estate rental income, as these can possibly create Unrelated Business Taxable Income and a current tax bill. As for sourcing, most states employ a "trading for your own account exception" that classifies investment-type income as being sourced only to where the ultimate investor resides. More recently, star performers and senior staff are more frequently receiving a piece of the carry. Historically, the carry was reserved for the fund's creators.



## Partner vs. Employee in Light of New Carry Rules of IRC §1061 and the TCJA

The attractiveness of being a partner versus an employee has changed with implementation of the new IRC §1061. Now that carry interests can only receive the beneficial tax rate on long term capital gains if the holding period exceeds three years, the benefit of being a partner in a hedge fund has slightly diminished as less of their income is likely to be generated by such a longer holding period unless that's the strategy the fund employs. For most private equity enterprises or real estate partnerships, the minimum holding period of three years should have little to no impact. However, new IRS partnership audit rules should also be considered by an employee when he or she is considering the offer to become a partner.

Fund managers regularly use structuring options such as receiving management fee income through a limited partnership or subchapter S corporation to help minimize self-employment taxes. However, proper classification as a limited partner has begun to be looked at more closely by the IRS and should be considered.

Before 2018, some funds paid employees' bonuses (based on how profitable the fund was) out of the management vehicle as wages, creating an ordinary loss in the management company, while receiving long-term or unrealized gains in the carry vehicle. Regardless of whether this practice might motivate governmental jurisdictions such as New York City to argue the management company and general partner are one vehicle instead of two (under the premise that no entity can operate perpetually at a loss) and subject any overall profit to the New York City UBT, it is also affected by the TCJA. Under new IRC §461(l), non-business losses greater than \$250,000 for an individual (\$500,000 for couples filing married joint – both limits of which are adjusted for inflation after 2018) are disallowed. An "investor" fund running its management company at a loss could find such losses disallowed at the owner level. As such, these owners may wish to change how they compensate their employees and instead give them a piece of the carry vehicle so that these owners don't receive a management company loss that is deferred.

Another consequence of the TCJA is that many individuals in high income tax rate states such as New York, New Jersey and California are limited on the amount of state income tax they are able to take as an itemized deduction on their individual returns. Entity level taxes such as the NYC UBT, however, are deductible at the entity level and are creditable against the individual's New York City income tax. By leaving profit in the management company that is subject to the NYC UBT, the owners can essentially get some credit for New York City UBT paid on their New York City returns. Depending on the individual's overall tax picture and taking into consideration the other issues below, leaving profit in the management company

and instead paying bonuses as part of the carry vehicle as partnership interests might be more beneficial for the owners.

### Impact imposed by method of accounting

If the management company utilizes the accrual method of accounting, the actual exchange of cash would not have to take place up to 75 days after year end, giving the company more time to determine its actual profitability and how much it would like to pay high performers, as well as offering a short respite if cash flow is an issue. This delay is only available for unrelated parties under IRC §267. Unless one related party includes in income the expense owed by another related party, the other party must wait to deduct the expense until the same period as the year of income inclusion regardless of whether each uses the accrual or cash methods of accounting. For purposes of this rule, a partnership and "any person who owns (directly or indirectly) any capital interest or profits interest of such partnership" would be considered a related party. So, too, would an S corporation and "any person who owns (directly or indirectly) any of the stock of such corporation." This rule should not be forgotten when a fund pays its management fee at quarter-end and the cash does not change hands until the following year – depending on the ownership, the management company must pick up the income in the same period as the deduction is taken by the investors.

Historically, management companies employed the cash basis method of accounting to benefit from the pre-2009 deferred compensation rules as they applied to fees received from foreign investors who weren't sensitive to the period in which they could take the offsetting expense deduction. However, this advantage was mostly lost with the enactment of IRC §409A and §457A which will be covered below.

### Receipt of a Partnership Capital or Profits Interest

Instead of receiving a bonus on his or her Form W-2 as compensation, a star employee could be awarded a partnership interest in either the entity earning the management fee or the one earning the carry or both.

Partnership interests are classified in one of two ways. Revenue Procedure 93-27 defines those classifications:

1. A capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. This determination is generally made at the time of receipt of the partnership interest.
2. A profits interest is a partnership interest other than a capital interest.



Receipt of a capital interest is taxed upon its grant as ordinary income with its value being determined as above.

Receipt of a profits interest, with some caveats, is generally not taxed upon grant, but only on its future share of taxable profits.

Vital to either type is documenting clearly whether voting or management rights are included and how future disputes are to be settled to minimize litigation. So too is determining value in as objective a way as possible when someone leaves - either voluntarily or otherwise - and detailing the logistics. Thinly traded Level 3 Financial Accounting Standards Board Topic 820 assets that have not been sold and are still held by a carry vehicle and a company's goodwill/brand name for a management company will obviously both be susceptible to much debate around how much a departing partner's share should be valued.

Partnerships should contemplate undergoing a formal valuation to quantify the capital interest grant and have both parties sign off.

"Catch-up" provisions are sometimes utilized when a profits interest is granted after the first year of the fund so that the partner will receive a fixed percentage of the historical profits despite not participating in the first or subsequent years. These are much more prevalent in private equity than in hedge funds.

Upon grant of a profits interest subject to vesting (which is explained below), a protective IRC §83(b) election should be made by the recipient in case such interest is later classified by a governing authority as a capital interest either partially or fully. Such an election presumably would allow any subsequent goodwill-type appreciation to be taxed as capital and not as compensation. Other types of appreciation would be taxed according to the character creating it - interest income or unrealized receivables as ordinary income, for instance. Some sort of voting rights, the more substantial the better, should be granted with any profits interest to strengthen the argument a partnership interest is being granted and this isn't just disguised compensation.

Generally, most fund managers are not going to be able to benefit from the new IRC §199A 20% deduction for partnerships as they will fall under one of the "specified trades or businesses" specifically excluded. However, limited amounts of loan origination might qualify, as could some other spin off income if the common ownership rules don't apply. Also, the restrictions don't apply to Real Estate Investment Trust (REIT) dividends. The entity will generally need to have wage expenses and/or depreciable property, however, to create a material IRC §199A deduction, as the deduction is limited to the greater of 50% of the business W-2 wages or 25% of the business W-2 wages plus 2.5% of the unadjusted basis

immediately after acquisition of all qualified business property. Since the IRC §199A deduction is taken at the individual level, it is possible a partner will fall under the taxable income floor and not be subject to the "specified trades or business" rule. To do so, a partner must make less than \$157,500 (\$315,000 for taxpayers filing married jointly) to have no limitation apply. Above these thresholds the deduction is phased out until at \$207,500 (\$415,000 for taxpayers filed married jointly), it is completely gone. The taxpayer must be a true partner, however, and not be an employee - meaning they should be given some voting rights, capital at risk, etc.

### Implications of Becoming a Partner

Before signing on to be a partner, an employee should consider what will be different. He or she will now receive a Schedule K-1 rather than a Form W-2 and will, thus, need to pay both sides of their Social Security and Medicare taxes. It may also become necessary to pay estimated federal or state income taxes, as withholdings will no longer be done mandatorily. Filings in many states may become required and that burden will probably bring higher fees to prepare the more complicated tax returns. Filings may be required in jurisdictions where only customers/investors are located, without necessarily having a physical presence. Recently, more and more states have implemented market-based sourcing and economic nexus rules for sales. State filings may also be required if the employee receives a cut of the carry and that carry is earned on entities receiving loan origination fees, oil and gas royalties or real estate income. If foreign-based structures are utilized, additional disclosures will be required that, if missed, could result in material fines - though relief may be available under some circumstances.

Cash distributions may not necessarily match partnership taxable income. Cash flow, especially in the private equity universe, can limit the ability of the fund to distribute to help partners meet their tax obligations. And distributions may not be mandatory - partners with greater seniority may dictate no distributions if they aren't required.

Medical insurance coverage and participation in retirement plans will also change as the rules for partners don't mirror those for employees.

Limited partners are generally at risk in terms of liability only to the sum of their capital account while general partners have no such limit and could potentially lose personal assets meeting the partnership's eventual obligations. A new limited partner would, therefore, be putting his initial investment at risk when contributing to the partnership and could possibly lose everything for some mistake or malfeasance committed before his or her admittance.



## How the New Partnership IRS Audit & Carry Rules Come Into Play

The new partnership audit rules that began with years starting after December 31, 2017 have an impact on this issue of liability. But they can be opted out of for partnerships with less than 100 partners and no pass-through entities as partners. Opting out can protect the new partners from assessment of tax and penalties for previous mistakes the IRS uncovers currently. The new rules allow the government to penalize the partnership and, thus, the current partners for any past transgressions. Opting out isn't mandatory, however. A new partner should consider this when given the choice of becoming a partner or not. Penalties can be allocated curatively to partners who were present at the time of wrongdoing, however, newer partners may have little input into how allocations are done. Limitations of cash flow or how income is earned currently may need a few years for everything to even out.

A new limited partner isn't always required to contribute capital. This practice, however, can have consequences. Without any capital account in the carry partnership vehicle, the IRS or other jurisdictions could argue that any income allocable to such a partner be deemed not a share in profits but rather a fee paid to a third party similar to a consulting fee. Practitioners often recommend partners to have capital at risk for this reason and investors often demand it to show the managers are similarly invested in profits of the fund. If such an argument were won by a taxing authority, the recipient of the carry would no longer defer paying tax on unrealized gains, would lose the long-term capital gain and qualified dividend lower federal tax rates and even be subject to self-employment tax on those earnings.

The new carry rules of IRC §1061 are affecting how managers invest their own money in their funds. In the past, many fund managers immediately moved any earned carry from a general partnership interest to a limited partnership interest by distributing out the interest to the individual and then recontributing it to the fund. This took the investment out of the general partner entity, thus putting it in the control of the individual manager instead and, perhaps, offering protection if the managing entity or one of its employees committed malfeasance as the interest would no longer be an asset of the general partner entity. When a manager wishes to invest his or her own capital in the fund, it is very important to not mingle such moneys with any carry to retain a reduced one-year holding period for long term capital gains on invested non-carry capital. Earned carry would still need a three-year holding period. Some managers are setting up separate entities to hold these general partner investments but, by moving all of their invested capital to another entity, the carry vehicle is now at risk of being classified as not a partner.

## Confidentiality and Other Considerations of Existing Partners

Regardless of whether new limited partners receive no voting or governance rights, all partners of a filed partnership return can request a copy from the IRS for a nominal fee. These new partners may only participate in one side pocket or a specific tranche of a large portfolio, but they can see what filings have been made for the full fund or fund's managing entities. More senior partners may not want that.

Raising an employee to partner status can also increase their authority to act on behalf of, and represent, the partnership. Courts have sometimes found partners' malfeasance is more damning than that of an employee.

If the new partner works or resides in a different jurisdiction than other employees or partners, withholdings might be due by the partnership. This could be for a foreign partner or just someone in a different state.

Finally, a fund's founders should consider their long-term goals before beginning to admit new partners. If their end game is to sell the entity, it's generally better not to share the wealth. More hands in the cookie jar leaves more people to redeem out or consent to a future sales price. In the early years of a fund, offer of a partnership interest may help keep a star employee around when cash is tight but founding partners should keep in mind this might have long-term implications.

## Use of C Corporations

With the TCJA's new corporate income tax rate of 21%, some funds are exploring setting up the management companies as C corporations. C corporations will still have the double layer of taxation, first at the corporate rate on profits and then at the shareholder level on dividends (or capital gains upon disposition by the shareholder). The highest individual marginal tax rate for 2018 is 37% for non-qualifying dividends or short-term capital gains or 20% for qualifying dividends or long-term capital gains. The 3.8% net investment income tax of IRC §1411 should also be considered. New rules for foreign-based income have further complicated matters as practitioners are contemplating use of foreign corporations to help minimize the tax on that income. To calculate what is most beneficial, fund managers really need to know their future income and expenses to do a comparison. There is no guarantee their situation might not change completely in the following year or that a higher tax rate will not be imposed later on by another presidential administration. Many practitioners are warning against their use for those reasons, but also because of how difficult it is to extract an asset from a corporation if it has built-in gains. Partnerships are typically much more flexible.



Those interested in structuring a carry receiving vehicle as a C corporation need to be aware of the personal holding company tax and accumulated earnings tax. If a fund trades everything short term and has material expenses, this might be under consideration. If more than 60% of the corporation's adjusted gross ordinary income is passive-type personal holding company undistributed income, there is a 20% premium tax imposed. The accumulated earnings tax of 20% is imposed on earnings left in a corporation that exceed the "reasonable needs" of a business.

### Subchapter S Corporations

Another structuring option is to employ Subchapter S corporations instead of partnerships to receive a fund manager's compensation, either the carry or the management fee. If the shareholders are compensated with wages equivalent to what their position would pay on the open market, their remaining pass-through profit is not subject to the self-employment tax. Numerous entities set this compensation figure at the maximum wage subject to Social Security tax (\$132,900 in 2019). Limited partnership management companies often pay a guaranteed payment equal to that same maximum amount and argue any remaining profits are those paid to a limited partner on his or her share of ownership-type profits and not a substitute for wages.

The new partnership IRS audit rules that began on January 1, 2018 don't apply to S corporations. S corporations are, however, restricted on the types of owners they can have - non-resident aliens, corporations and partnerships cannot own shares. Converted S corporations that receive passive-type income have to be careful not to have accumulated earnings and profits from their years as a C corporation or the S corporation election can be lost. S corporations can't have different types of shares, either - total income is allocated based on number of shares. In contrast, partnerships can use side pockets and benchmarks. There was some question when IRC §1061 was first issued as to whether S corporations would be able to avoid the three-year holding period requirement of the carry but it has since been clarified that S corporations have the same longer holding period requirement.

Pass-through income from S corporations can qualify for the IRC §199A 20% deduction but it is subject to the same limitations and issues discussed above for partnership income.

### Conflicts in Compensation Bonus Calculations

When incentivizing superstar employees, most fund managers try to align the desires of their investors with those of their high performers so that each will be motivated to stay. However they achieve this, managers need to comply with the rules and regulations of all data protection laws, the Commodity

Exchange Act, the Investment Advisers Act of 1940, and the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Tying an employee's bonus only to his or her own managed portfolio's return can produce unwanted consequences. Big gambles can effectively be encouraged. Competition over cash earmarked to pay for expenses such as research, marketing and finding deals can ensue. Fights over whose portfolio gets more cash to invest will likely occur. Employee morale can be dampened or destroyed. Even tax results can be affected.

- Prior to detection by management, two traders competing for resources and not communicating or working towards a common goal could invest in contrary ways in the same security unintentionally. This could result in deferring recognition of realized losses. Straddle rules apply to the partnership as a whole, not to an individual trader's portfolio.
- Two traders not communicating could also both invest in the same positions. This reduces diversification and could result in losses from wash sales under IRC §1091. Again, the partnership's holdings in total are subject to the rules, not each trader's portfolio.

On the other hand, if each individual is judged solely on his or her accomplishments, superstars are less likely to feel they're being dragged down by other less successful performers' perceived inadequacies. Unless the metrics are adjusted for each duty assigned, this approach could even seem unfair as some people's tasks are more profit driven and their portfolios not employed solely for hedging. A compromise to this dilemma would be to offer bonus pools for teams. Any of these solutions can be tied to ascertainable benchmarks.

As with the carry, bonuses can sometimes only be earned when certain hurdles and/or high-watermarks are surpassed. Certain fact patterns can create confusion, however. Some will also apply to the earned carry.

- If performance is negative but it clears the hurdle, are employees given bonuses?
- And from which revenue stream if no carry is earned - are net management fee funds used?
- Instead, should a bonus payable roll into next year?
- What happens if the employee leaves before there are profits and the bonus payable did roll forward? Is it lost or still paid?
- Is there a different result if the employee passes away or becomes disabled?

Breakpoints, or how often money can be pulled from the fund, will also affect use of hurdles and benchmarks. Withdrawals allowed on a monthly or even bi-weekly basis may tend to



overly reward short-term results that may be contrary to the fund's intent and the more steadfast investors' desires. In private equity, this may be less of an issue because of lock-in periods restricting withdrawals. Betting on the long-term can, of course, have the opposite results when investors' thirst for more current profit increases.

### Deferred Compensation After IRC §409A and §457A

Funds can use deferred compensation arrangements to help defer recognition of taxable income, but also to incentivize high performers to stick around. Some have designated only certain titled people or those making a certain amount of money to be eligible for these arrangements. In these cases, both IRC §409A and §457A should be considered.

Before IRC §409A and §457A, fund managers could defer their cut of the incentive reallocation, and often management fee, earned from both U.S. tax exempt investors and foreign investors for ten years or more (when utilizing "back to back" arrangements). As an added benefit, fund managers could also defer paying tax currently on earnings destined to pay future employee bonuses. Employees could also benefit, sometimes being offered the chance to let their future compensation grow as the foreign fund increased in value.

Everything changed after 2008. "Substantial risk of forfeiture" became a requirement of continued deferral. Any guaranteed moneys needed to be included in income currently with grandfathered moneys required to be brought back into income by 2017.

Any income required to be included by IRC §457A should be taxed currently. Falling afoul of IRC §409A instigates immediate taxation with a 20% penalty and a premium interest charge. Short-term deferrals are allowed, however, if a bonus/fee is paid within 2 ½ months of year end – March 15 for calendar year taxpayers - after ceasing to have a substantial risk of forfeiture. Starting in 2009, a fee for services rendered any time this year paid more than 12 months after this year's close would trigger IRC §457A's 20% penalty and premium interest charge.

Not all countries conform to U.S. rules regarding sourcing income or paying foreign employees. Many states' laws do mirror that of the federal government, but some don't and, as such, all jurisdictions with employees, investors or investments should be examined.

### Before or After Tax Vesting

When looking to retain top talent and preserve the life of a fund, hedge and private equity managers often subject those employees' remuneration to a vesting timetable.

Before-tax bonus deferrals are easiest to revoke if the vesting conditions are not met. Current management company partners receive no deduction until such bonus is paid, so revoking the unvested and unpaid bonus has no effect on either the payor or recipient. When this bonus can grow if the fund continues to profit before the amount is paid to the employee, the partners may wish to hedge against such appreciation. Up until the bonus is ultimately paid, partners experience a cash flow disparity in such a situation, as they are required to invest moneys that have been taxed and they must also pay tax currently on any profit of this hedge. To account for this disparity, some arrangements only allow the deferred bonus to grow post-tax.

- Profit 12%
- Partners' income tax rate 50%
- Deferred bonus profit post-tax  $12\% * (1 - 50\%) = 6\%$

Mandating that bonuses be put back into the fund after correlating taxes have been paid on these moneys by the employee gives the existing partners a current expense deduction and perhaps added assurance that the employee is invested in the fund's long-term success. If the amounts are significant, these moneys could fund new deals and ensure the fund's continuation. But this practice also taxes the employee on something that is not yet fully theirs or completely vested. To ease this burden, tax distributions can be made.

To prevent transparency of disputes to the fund's investors, such required reinvestment is typically funneled through a different entity where any clashes can be tackled. Doing so, generally would exclude such moneys from partaking in the fund's management or voting. Using this separate entity can aid in fulfilling the "accredited investor" and "qualified purchaser" exception minimums provided by the Securities Act of 1933 and Investment Company Act of 1940. However, the Securities and Exchange Commission implemented the phrase "knowledgeable employees" to allow more investment and, so, this might be less important. To subject these employee reinvested moneys to the fund's expenses (management fees, for instance) and any restrictions to redemptions ought to be addressed.

Before tax vesting generally benefits the employee and is easier to implement as it can be done with a single document. After tax vesting may appear beneficial to the existing partners, but it can necessitate much more effort. Creation of a new entity to handle the reinvested funds will cost more in professional fees for set up and tax filings. So, too, will resources be expended in making vesting schedules and entity agreement addendums covering forfeiture conditions.



## Vesting: Serial Versus All-or-Nothing

Typically, there are two sorts of vesting: serial or all-or-nothing.

Cliff vesting, under the all-or-nothing approach, has the entire amount passing into the control and pocketbook of the recipient at a specified point in the future. Leaving voluntarily before such date nets the individual nothing.

A fraction of the total compensation is vested to the recipient over a fixed period of time in the serial or graded method. 20% every December 31 over five years is one example that is predominant in the hedge and private equity fund world, but any period can be used. Leaving voluntarily before the full amount is vested usually means sacrificing the remainder.

How to treat the recipient's death, disability or termination without cause should be covered by the documents. Normally, the recipient must be in good standing upon getting the vesting. If a new position on offer compensates the would-be recipient for any lost funds on departure, the power of utilizing vesting to keep such recipient around will clearly be diminished.

## Motivating Retiring or Departing Partners to "Make Nice"

When funds want people to depart on good terms, they can offer incentives for those willing to sign agreements of non-disparagement, non-competition, non-solicitation of employees or investors, and/or non-disclosure of confidential, proprietary or trade secrets. These are used for retiring partners with or without sunset distributions as well as those leaving otherwise.

Payment of sunset distributions are used when a partner has been around a minimum number of years and instead of redeeming him or her out immediately, which would net the existing partners no current deduction, his or her exit is engineered over time. The retiring partner receives less and less of the net management fees or the carry in succeeding years which works to shift taxable income away from the continuing partners. Ultimately, though, the retiring partner receives the same amount of cash, but in a more tax-efficient manner for the remaining partners. Such an arrangement typically comes with a gradually declining cut of any future partnership sale as time goes on.

## Clawbacks of Vested Compensation

Funds utilize "clawbacks" to recover compensation that may or may not be already vested, though usually it is the latter. The most straightforward method by which an employer may establish clawback rights comes through express contract provisions – which may be set forth in employment agreements, plan documents, or award agreements. Besides failing to

achieve certain goals or tenure, a recipient can lose potential remuneration or even paid remuneration through misbehavior.

In the absence of contractual rights, the "faithless servant" doctrine may provide an employer with a means for recouping already-paid moneys. Recovery under that common law doctrine depends on state law but often protects employers if an employee's material and substantial misconduct violates his or her contract of service or if he or she has engaged in a misconduct that constitutes a breach of the duty of loyalty or good faith. Various states interpret this doctrine differently and some such as Connecticut, Florida or Rhode Island choose not to conform to it at all. Complications arise when choice of law also comes into play. If an LLC is organized in Delaware, does most of its business in New Jersey but has a fight with a employee who is a New York City resident, which state's laws govern the dispute? To mitigate these uncertainties and their potential for future litigation, an employer's clawback rights should be spelled out clearly in employment contracts and organizational agreements.

Keep in mind that when federal and state income taxes, as well as Social Security and Medicare taxes, have already been paid, recovery of those taxes on clawed-back compensation can be particularly complex and onerous. It is also frequently not feasible for an employer to recover cash that a misbehaving employee has already received and spent. As a result, many employers prefer to rely not on clawbacks of paid-out compensation but instead on "hold backs" (through a deferred compensation approach).

## The Mechanics of Clawbacks

Which source of income pays for the attributable compensation and in what form, whether it be wages or an ownership interest, govern how clawbacks operate.

Clawbacks of unpaid before-tax compensation are the easiest to implement as both parties have not recognized their existence for tax purposes – that is, no deduction has been taken for their payment and no income has been picked up by their would-be recipient. This is possible through a deferred compensation approach, which generally must be limited to the top 20% of an employer's workforce (in order to qualify the arrangement for an exemption from ERISA's participation and funding rules).

When an employer requires the reinvestment of a potential bonus before it vests and gets paid to the employee at a future time, after-tax compensation clawbacks can sometimes be prohibited by local employment law as payroll taxes will have already been remitted on these moneys. This occurs when the company takes a deduction for compensation paid, the employee recognizes such income, and then the moneys must





be reinvested back into the fund until a certain time period elapses and it becomes free and clear property of the employee. Recovery of the corresponding payroll taxes, income tax withholding and tax distributions is especially difficult in those cases where the moneys do not end up vesting. Because of these hazards, recouping only paid-out moneys is probably the route easiest and least vulnerable to litigation.

Being offered a piece of a management company that ultimately doesn't vest creates other issues. Following Revenue Procedure 2001-43, profits should be allocated to a partner receiving a profits interest in year one even if such partnership interest does not fully vest until a later year. Otherwise, the grant could be construed as a capital interest and taxed immediately. What happens if that partnership interest never vests and the would-be recipients have paid tax on the share of the profits allocated to them? To our knowledge, this issue has not yet been addressed directly by any authoritative IRS guidance. Many practitioners have taken the position that the other partners would receive ordinary income to the extent of the sacrificed value of the unvested interest and that the would-be recipient would have a capital loss for the amount of taxable income he or she had previously recognized into income. If taking this position and the income were not to fall under the definition of a "specified trade or business" under IRC §199A (for instance, many forms of real estate income or a limited amount of loan origination fees), the first year's profits could benefit from the 20% deduction from income at the partner level if all the other hurdles of the deduction were cleared. Under Proposed Regulation §1.199A-1(e), the 20% deduction does not reduce the partner's basis. Thus, if a recipient forfeited the first year's profit allocation and took the position that the loss in Year 2 was a capital loss, he or she could pay tax on 80% of profits and take 100% of those profits as a capital loss in the second year, although this result would be the same if the taxpayer received a fully-vested partnership interest that was disposed of for a loss in Year 2. It is a situation in which recognizing the full capital loss is more likely than normal. However, this also has not been addressed under current law.

The impact of receiving a profits interest in the entity receiving the profit reallocation depends on the type of investments held by the underlying fund.

- In the years prior to the carry of the private equity fund being crystallized, there are likely no consequences to the recipient if the granted interest never becomes vested and it is lost (i.e., forfeited and never paid out).
- In years when a private equity fund or hedge fund is paying an incentive fee currently and a profits interest is granted, various scenarios can play out.

- Serial vesting – If a new partner receives 3% of income in Year 1, 6% in Year 2, etc., the unearned profits are simply lost. If a forfeiture event happened in Year 2, the partner would keep the 3% but not get the 6%.
- Cliff vesting – If the reward is 8% of profits for staying 3 years, but zero if the would-be recipient leaves beforehand, the would-be recipient would pick up 8% of taxable income from the first day to argue such a grant was a profits interest under Rev. Proc. 2001-43. If the would-be recipient were to leave after two years, and before the amount became vested, what would happen? Curative allocations and tax distributions perhaps could be used. However, with the potentially different character of income and loss generated by funds, it may be nearly impossible to achieve a loss equitable to the income already recognized. Portfolio deductions from an investor fund, for instance, are no longer deductible to an individual. However, remaining partners may not care much about somebody leaving and the person may not care, either, if he or she is able to negotiate a preferable partnership arrangement at a new firm or a higher salary with a new employer to make up for this difference.

## Options

### *Partnerships*

Most funds tend to avoid options and only award profits interests. Value generally doesn't increase on an option on partnership profits interest until it is exercised. Capital interest options receive treatment akin to a stock option but aren't recognized as capital gain. It is generally not feasible for private equity LLCs to promote employee stock ownership plans (ESOPs), provide restricted stock, grant options of stock, or pay out to employees shares or the rights to such.

### *Corporations*

Options issued under employee stock purchase plans ("ESPPs") and incentive stock options (commonly called "ISOs" or "statutory options") are two tax-favored possibilities for C corporations to take advantage of for the lower 21% tax rate or other reasons.

- Employee stock purchases plans – Under IRC §423, if nine conditions are met (such as grants being made only to employees, stockholder approval of the ESPP, option purchase prices that are not less than the lesser of 85% of market value of the stock when granted or 85% of the exercise value, equal rights and treatment for all eligible employees, no grants to owners of 5% or more of the company and no employee may purchase more than \$25,000 of stock in one year), an employee can essentially exercise an option to purchase the stock at a discount (which is non-taxable at the time of exercise) and as long as the stock is held for 1 year and at least 2 years after being granted, the employee only recognizes ordinary income equal to the lesser of: (i) the actual gain that results from the sale (meaning the amount by which the market value of the shares on the date of sale, gift or death exceeds the purchase price), or (ii) the purchase price discount (however, if the purchase price is based on the lower of the value of the stock on the first or last day of the offering period, the purchase price discount is computed as of the first day of the offering period). All additional gain upon the sale of stock is treated as long-term capital gain. If the shares are sold and the sale price is less than the purchase price, there is no ordinary income, and the employee has a long-term capital loss for the difference between the sale price and the purchase price.
- Incentive stock options – Under IRC §422, with other restrictions such as shareholder approval of the plan, the term of ISOs can't be longer than 10 years, the exercise price must be the same or more than the stock's fair market value and the ISO by its terms cannot be exercised by, or transferred to, a person other than the employee during his or her lifetime. In addition, ISOs cannot be granted to an employee who will then own more than 10% of the company (unless the option term is five years or less and the exercise price is not less than 110% of the stock's value on the grant date). Tax-favored capital gains treatment for all gain on the sale of the shares purchased through exercise of ISOs is only available if they have been held for at least 2 year period after the ISO has been granted and the underlying stock has been held for at least a year after exercise. When exercise occurs after the holding periods are met, employers are not given a deduction for any of the gain on the shares sold. If the holding periods are not met, it is treated as a disqualifying disposition and the gain is treated partly as ordinary income to the recipient (based on the excess of the stock's value on the exercise date over its exercise price), and the corporation gets a corresponding deduction. Any future gain is capital.

There is no taxable event upon grant or exercise of an ISO (other than possible alternative minimum tax at exercise). If an employee separates from service, then any ISO held must be exercised within three months of termination to retain the ISO tax preferential treatment. There is a limit on the amount of ISOs that can be provided to an employee. The aggregate fair market value of the stock provided to an employee on the date of the ISO grant which is exercisable for the first time in any calendar year cannot exceed \$100,000. An ISO with a vesting period that can be exercised before the vesting has occurred will still be subject to the \$100,000 limitation and the AMT is applicable. However, a section 83(b) election could be made on the transfer of the stock for AMT purposes.

### Other incentives


Among other incentives offered by funds to persuade their superstars to stick around are health insurance, employer offered retirement plans with matching, and life insurance. They can also throw in use of luxury or more pedestrian vehicles and generous expense accounts (which may no longer be deductible as entertainment expenses by the company under the TCJA). The tax law differs on retirement plan contributions and health insurance for an employee versus a partner, and those differences should be taken into account when an employee is considering becoming a partner.

### Conclusion

To avoid the pain and financial suffering of having a high-performing employee leave with no assurance of being able to replace him or her, hedge and private equity funds have many avenues of incentives they can offer. By coupling such incentives with restrictive clawbacks and vesting, funds can help to ensure these superstars stick around for years to come. Whatever route is taken, the sweeping changes of the TCJA need to be considered as well as the fund's portfolio, goals for the future and methods of trading.

*For more information on how hedge or private equity fund compensation structures can be tailored to specific needs while also navigating the far-reaching changes of the TCJA, please contact our team at Mazars USA LLP.*

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