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Private Capital Solutions

# Tax distributions and carry clawback

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# Introduction

Questions around tax distributions and carry clawback provisions in LPAs have come up in practice more often in recent months. We have written this Private Capital Solutions briefing to explore these topics in more detail.

## Executive Summary

Tax distribution provisions were originally designed to help individual carried interest holders manage tax liabilities that arise by reference to their holding of carried interest but before their receipt of distributions. The issue is particularly relevant for US taxpaying carry holders due to the accrual basis of taxation for carried interest in the US, contrasting with the distribution basis prevalent in other jurisdictions. Over time, these provisions have evolved and become more complex, and a diverse array of practices have developed, sometimes producing outcomes beyond their original purpose. Considering the significant commercial implications of tax distributions, including their effect on fund returns and the dilution of clawback benefits for investors (plus, on the GP-side, the potential deferral and reduction of carry distributions for carry holders who do not receive tax distributions) this has sparked debate as to what is their appropriate application.

In addition to exploring these commercial considerations, this article examines the nuances of how tax distributions are taxed, the calculation of clawback obligations and the tax implications of a clawback, challenges in obtaining tax refunds, recent regulatory considerations around disclosure and tax distributions functioning as advance carry. The complexity inherent in these issues highlights the need for meticulous drafting of LPA provisions both at the main fund level and the level of the carried interest partnership. Such drafting must strike a delicate balance between accommodating the tax payment needs of carried interest holders and safeguarding the interests of the fund and its investors.

# Tax distributions

## What are tax distributions?

In a typical closed-ended private capital limited partnership fund, with a fund as a whole/European-style waterfall, distributions are paid first to investors until they have received back their invested capital along with a preferred return before carried interest distributions are made. Tax distributions are an exception to this rule and enable a GP to be able to make distributions out of partnership assets to the carried interest holders ahead of their entitlement in the commercial waterfall. Tax distributions are to enable recipients to pay tax they suffer in respect of their holding of carried interest before they receive carry distributions.

As most jurisdictions only tax carried interest on a distribution basis, on the assumptions that (i) the fund itself does not have a US tax liability due to its investment activity; and (ii) carry is not held in escrow, tax distributions are usually only required where there are US taxpaying carry holders, as the US charges tax on carried interest on something akin to an accruals basis.

## Why are tax distributions required?

Put simply, US taxpayers pay tax on carried interest on a deemed liquidation basis where each year, to determine the carry holders' US tax liability, there is a deemed distribution through the commercial waterfall of both the income and gains realised in that year plus the cost of unrealised investments. As a result, in the case of a fund with a fund as a whole/European-style waterfall, tax usually falls due for US taxpaying carry holders considerably before the time at which the hurdle in the commercial waterfall is met and carry becomes payable to carry holders. This results in US carry holders suffering "dry" tax liabilities, and tax distributions are designed to provide them with the necessary funds to cover these. Tax distributions are treated as advance payments and are offset against future actual carried interest distributions from the fund (as further described below).

US tax liabilities arising before related UK tax liabilities in respect of carried interest has caused UK/US tax credit headaches for carry holders who are UK resident and US citizens. These crediting issues led to the introduction of the accruals basis election into the UK carried interest rules that allow an individual to irrevocably elect to pay UK tax on their carried interest in respect of a fund on a basis aligned with the US tax rules. While this election can be made by any carry holder, it is unlikely to be beneficial unless there is a corresponding US tax liability for the carry holder in relation to the fund in question.

## What is the range of provisions in LPAs for tax distributions?

A basic provision in a fund LPA would provide that a GP can make distributions to carried interest holders to enable them to discharge a tax liability arising from the holding of carried interest to the extent there are insufficient carry distributions in the relevant period to cover that tax liability. These tax distributions then operate to net against (and so reduce) carry distributions that would otherwise be made in accordance with the usual waterfall. The netting occurs on a gross basis, not an individual basis, meaning that even those carry holders who do not receive a tax distribution suffer a deferral as a result of tax distributions.

These fund LPA provisions should then track through to the carried interest limited partnership agreement ensuring that (i) tax distributions paid by the fund are on-distributed to those participants whose status gives rise to the entitlement to tax distributions at the fund level; and (ii) those same individuals (and not those who do not receive tax distributions) suffer the cost of the future netting.

The main distinction in drafting at the fund LPA level is whether there are tax distributions only to carry holders who have an actual tax liability or whether a tax liability is assumed for all carry holders.

We return to that fundamental question below, but there are other variations too including:

- **providing for distribution for impending not just due tax liabilities;**

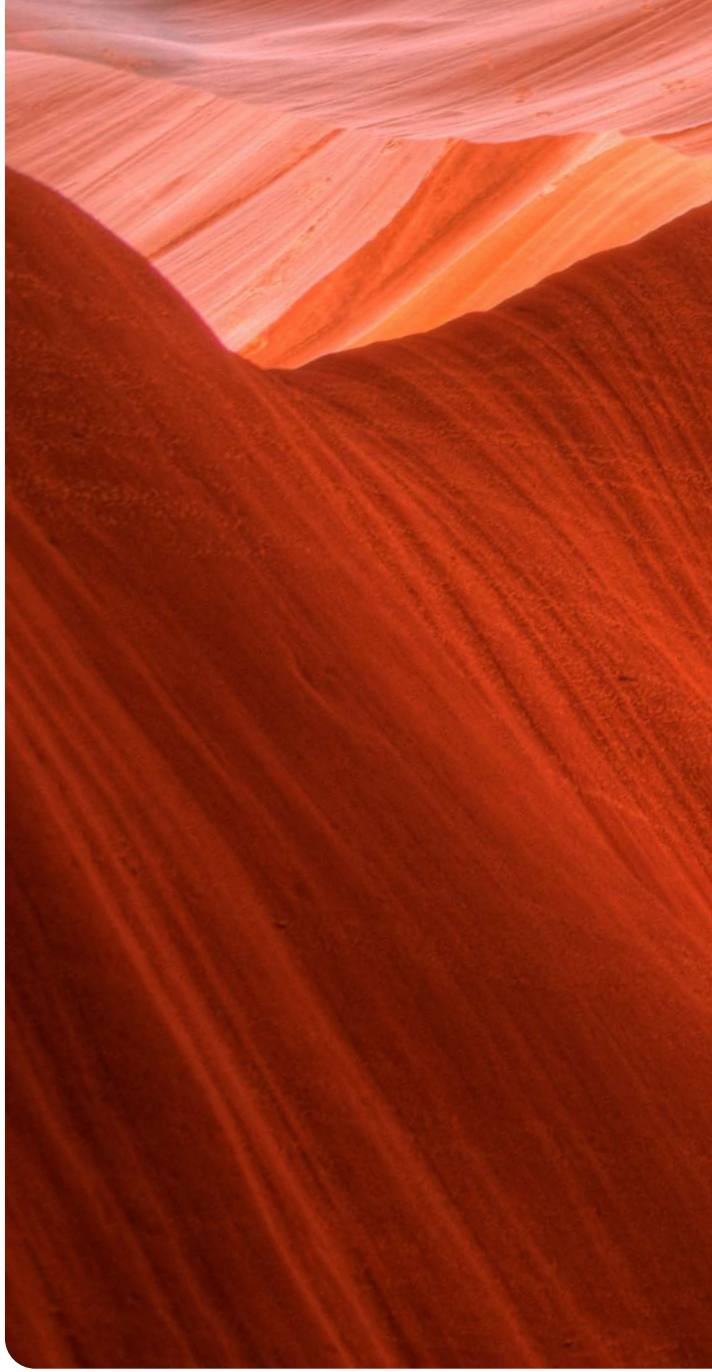
  It is advisable to allow tax distributions to be made for impending as well as realised tax liabilities. For example, if you have a UK resident US citizen carry holder, it might be useful for them (in terms of managing their UK/US tax credit situation) in, say, 2024 to be able to take a tax distribution relating to US tax that will relate to 2024 even though that tax will only fall due to be paid in 2025. That flexibility would allow tax distributions relating to 2024 profits be made during 2024 which would trigger a UK tax liability (on the tax distribution) in 2024 (helping in the alignment of UK and US tax points) and to allow payments of tax in the UK in 2024 which will aid the crediting of that tax against 2024 US tax. The benefit of this flexibility continues notwithstanding the introduction of the new accruals basis election referred to above.

- **assumed tax rate;** and

  Even if tax distributions are restricted to those with an actual tax liability, it is burdensome for the GP to work out each participant's actual tax liability relating to their holding of carried interest. It is therefore common to allow the GP to assume a quantum of tax liability (for those with an actual tax liability), on the basis of reasonable assumptions or (and this is more participant friendly) on the assumption that all taxable participants pay the highest marginal rate applicable to any participant.

- **repayment of previously paid tax.**

  We see tax distribution provisions which allow distributions to executives to refund tax they have paid personally, which could have been funded by tax distributions in an earlier year, but was not actually funded in this way.



While the standard position in European funds is for tax distributions only to be payable to carry holders with an actual tax liability, in the US, it is usual to assume all carry holders have the same tax liability (even if they are not in fact taxable on an accruals basis). This practice was perhaps not intended to change much, on the basis that, for a US fund with only US carry recipients, all participants will have an actual tax liability.

However, with the geographic diversification of teams, a US tax distribution provision can nowadays result in material tax distributions to non-US carry holders who do not pay tax on carry on an accruals basis. For those recipients, while they will have a tax liability on the tax distribution, that tax would only be for a portion of that distribution (i.e. their applicable tax rate on the distribution), leaving them with net carry proceeds. If the tax distribution is effected by reference to the highest US marginal rate of any recipient (which is north of 50% for New York City residents), that can mean that tax distribution provisions can result in material advance carry distributions to certain team members.

## How are tax distributions taxed?

For carry holders based in the US, tax distributions should not be taxable as they are the distribution of profits which have been taxed for US tax purposes. However, if a tax distribution recipient is resident outside the US, tax distributions themselves would normally be taxable.

In the UK, assuming the income-based carried interest (IBCI) rules are not in point (including where the carried interest is an employment related security), tax distributions should be taxed as carry with income tax treatment only to the extent the distribution is accompanied by allocations of underlying income by the fund partnership.

Turning to carry which is potentially within the IBCI rules, HMRC's view is that tax distributions are not "realisation model" carry distributions and so cannot benefit from the enhanced conditional exemption from IBCI if made after four years from the commencement of a fund. That means, according to HMRC, tax distributions made after the initial four years of a fund will likely be IBCI. We understand that is not a position adopted by all taxpayers, some of whom take a more purposive interpretation to the meaning of "realisation model".

On the plus side, HMRC do accept that the existence of a tax distribution does not taint future post-hurdle carry payments and prevent them being realisation model/safe harbour carried interest provided the tax distribution was (i) for the amount of the tax due only; (ii) paid from the fund to the executive; and (iii) paid for no other purpose than to cover the outstanding tax charge. While these three conditions cannot be found in the legislation they should give food for thought for those using tax distributions on a less precise basis.

## What are the commercial consequences of tax distributions?

The making of tax distributions has a number of commercial consequences that should be borne in mind. These include:

- **impact on fund returns;**

  Tax distributions take cash that could otherwise have been distributed to investors or indeed invested or reinvested. As such, tax distributions can impact both the returns of the fund and its DPI (the time it takes to return cost to investors). Managers are obviously sensitive to both, resulting in many only making tax distributions to the extent necessary, even if they have the ability to make them more broadly.

- **reduces the benefit of clawback for investors;**

  As set out below, tax distributions which are made (or could have been made) are sometimes (particularly under the "US standard") excluded from the carry clawback obligation. Therefore, the greater the actual/potential tax distributions, the greater the risk to the benefit to investors of the carry clawback provision.

- **deferral of non-recipients;**

  A significant potential consequence of tax distributions, if made to a significant degree but not to all carry holders, is that those carry holders who do not receive tax distributions (for example the UK team who are not US citizens) have their actual carry distributions deferred and potential reduced as a result of the subsequent netting. Even if the fund hits the hurdle, there will not be actual carry distributions until the prior tax distributions have been netted off. This positions the tax distributions as a "senior" strip ahead of the carry entitlements of other carry holders. As well as the impacted team members, investors might not like this misalignment.

- **deferral of recipients;**

  A related point is that, for those carry holders whose tax distributions are used by them to pay tax liabilities (i.e. the base case), without more, their receipt of carried interest that they can spend as they choose is deferred until after those carry holders who have not received tax distributions have caught up. This will be the case if (as you would expect) the carried interest LPA allocates the reduction in actual carry distributions post-hurdle (on account of prior tax distributions) solely to the recipients of those tax distributions but then provides for the non-recipients of tax distributions to fully catch up before the tax distribution recipients start to share in actual carry distributions. This means that non-recipients of tax distributions receive carry that they can spend as they choose (as only part of their carry distribution will be needed to pay tax) before tax distribution recipients, who are left waiting for their colleagues to catch up. We see some houses seeking to ameliorate this outcome by providing for a less than 100% catch up to those who have not received tax distributions so that all carry recipients get to "enjoy" actual carry distributions at the same time.

- **distributions to institutional investors in the carry partnership;**

  An interesting question which has arisen more often recently is whether tax distributions can or should be made to holders of carried interest who are not current or former team members (or the house); that is, to institutional holders of the carry. With the rise of stake sales and consolidation in the sector, there are an increasing number of institutional investors/funds holding carried interest. These vehicles could be entitled to tax distributions given the usually broad drafting of tax distribution provisions. However, depending on the circumstances, it might be said that tax distributions to institutional investors are not within the original purpose of tax distribution provisions, being to provide liquidity to the team in respect of dry tax liabilities.

- **tax distributions functioning as advance carry;**

  As noted above, when paid otherwise than to discharge actual tax liabilities, tax distributions operate as advance carry, accelerating carry distributions to carry holders and what's more potentially putting those distributions beyond the scope of clawback. Again, if this is a small minority of carry holders, it is probably not too concerning to investors, especially as it also serves to avoid the deferral issue above. However, if this is occurring to a greater extent, you can see why investors might be concerned.

- **UK regulatory considerations;**

  UK regulated investment firms that offer carried interest to their staff will need to comply with the FCA's Remuneration Code for investment firms (the MIFIDPRU Remuneration Code). Most firms subject to the Code are required to include provisions for malus (i.e. the ability to reduce points or entitlements prior to payment) and clawback (i.e. repayment of any distributions made) in the terms of any carry awards granted to management and senior staff. A special dispensation to not include clawback and certain other provisions is available for carry awards the terms of which provide that no distributions can be made within the first four years of the award.

  While there is a working assumption (but no published guidance) that tax distributions should not be caught by the four-year distribution restriction, if a firm were to make a tax distribution in excess of any actual tax liability, the FCA may well consider such excess to be in breach of the Code which could in turn affect the availability of the carry dispensation.

- **tax on the acquisition, as opposed to the holding, of carried interest;**

  Most tax distribution provisions provide for distributions to the carried interest participants in respect of tax (or indeed deemed tax) attributable to partnership income and gains. In those cases, tax distributions will only cover tax arising as a result of the holding of carried interest and by reference to the underlying income and gains of the fund. However, we do see tax distribution provisions which are drafted more broadly and explicitly (or could be read to) include tax arising on the award to the recipient of the carried interest itself.

  Using tax distribution provisions for tax on acquisition of carried interest is potentially controversial. Acquisition tax liabilities, particularly later in the life of a fund, are in a sense self-generated by a manager, could in theory arise multiple times in respect of the same underlying gains and are not necessarily aligned with investors accruing profit from the fund. As a result, we see these acquisition liabilities rarely covered by tax distribution provisions and, even where they are, those provisions rarely utilised for that purpose.

- **sale of carried interest; and**

  There are more sales of carried interest occurring in the market, either as part of stake sales or indeed internal transactions. One point to watch out for on carry sales is to ensure that prior tax distributions are taken into account in those transactions and that sellers who have received tax distributions are appropriated netted down for tax distributions received. A purchaser will also want to ensure it has properly understood the extent to which prior tax distributions will reduce future distributions on the interests it is buying. Once acquired, the question switches to whether the buyer will benefit from tax distributions post-acquisition, as noted above.

- **leavers.**

  The interaction of tax distributions and leaver provisions should also be considered. As noted above, the netting provisions in a fund LPA should track up into the carried interest limited partnership and provide that any netting at the fund level is suffered by the carry holders who actually receive the tax distributions. How that individual level netting operates for a leaver should be considered. If, for example, a leaver were to forfeit 50% of their carried interest but retain the other half, would 100% of the tax distributions received by that individual prior to forfeiture net against the 50% entitlement retained or would netting against the retained interest only be for 50% of the tax distributions previously received? The latter is probably fairer but the former better for the house (and remaining team members).

# Clawback

## What is clawback?

Clawback is the obligation of the carried interest partner, at the end of the life of the fund, to repay carry distributions if, over the life of the fund, the carried interest holder receives more than the agreed share of the investors' overall profits. Overdistribution can occur (for example) due to an early home run followed by a loss, or indeed due to tax distributions or other advance carry distributions.

## What is the range of provisions in LPAs in relation to clawback?

The standard provision is that a clawback obligation on a carry recipient is net of any tax paid or payable by the carried interest holder in respect of prior distributions. Like with tax distribution provisions, clawback provisions will need to be tracked through into carry documentation (including shadow award documentation) and it is usual for investors to both require this and to obtain an undertaking from the GP to enforce these provisions. You also see these enforcement obligations sometimes backed by a parent company guarantee or an escrow arrangement.

However, like with tax distributions, in determining the terms of a carry clawback provision, there is both a fundamental question, and other questions, to answer.

The fundamental question is whether tax distributions are excluded entirely from the clawback obligation, with the other questions including:

- if clawback is less any tax suffered (as is normal), whether that reduction is of (i) actual tax paid or payable; (ii) assumed tax based on reasonable assumptions of the GP; or (ii) assumed tax based on the highest marginal rate of any recipient;
- there are different levels of obligation in terms of mitigating/reclaiming tax previously paid in a clawback situation (with a fairly standard obligation, if there is one at all, being to use reasonable endeavours to recover any such tax from the relevant tax authority); and
- whether any tax benefits arising to carry recipients from satisfying the clawback should be taken into account in quantifying the clawback (for example if the participant will benefit from a capital loss that they might be able to monetise).

In US standard LPAs, which provide for tax distributions to all carry participants irrespective of their actual status, it is not uncommon to see excluded from the clawback obligation tax distributions which have been made or which the GP could have made. This position developed on the basis that all such distributions were used to pay tax and that there was not an easy way to get that tax back. However, as noted above, this first assumption may no longer be the case.

## What are the tax consequences of a clawback?

A carried interest clawback usually occurs several years after both the carried interest distribution and the time that any related tax was payable. There is usually no basis for participants to recover tax they have paid relating to carried interest which is subsequently clawed back. A tax benefit that might arise in this situation is that the amount clawed back and returned to the partnership by the carry holder could result in base cost in the partnership for the contributor which could give rise to a capital loss on the ultimate winding up of the fund. That might result in a tax related benefit for the carry holder in due course, but it is not a tax refund and is a benefit the timing and amount of which it is difficult to determine.

It might be hoped that it would be possible to allocate a loss at fund level to the carry holders in a clawback situation to allow an earlier enjoyment of a tax benefit in connection with the clawback. However, (i) that assumes there is a loss to allocate; and (ii) in the UK at least, due to the vagaries of the UK carried interest rules, a loss can only be allocated effectively for UK tax purposes in respect of carried interest where the transaction giving rise to a loss does not give rise to any proceeds for distribution to carry holders. That means that such losses will only arise on losses on FX forwards, complete write offs and/or negligible value claims. Even where a loss can be allocated, these can only generally be set off against capital gains (not income) and usually cannot be carried back.

Interestingly, in the UK, if the carried interest is structured as a phantom entitlement and paid as a bonus to an employee a refund of income tax (but not NICs) may be available in a clawback scenario. This will be the case if the satisfaction of a clawback counts as negative earnings for employment tax purposes in which case it may be set off against other income subject to certain limits.

The limited circumstances in which a tax refund will be available in a clawback scenario and the uncertainties of any tax benefits accruing from a clawback understandably push managers to seek to limit "benefit crediting" obligations in a clawback scenario.

## Are there regulatory considerations?

While the SEC private fund adviser rules have recently been struck out by a US court, they had included certain disclosure obligations in relation to clawbacks. Justifying the proposed inclusion of these disclosure rules (instead of their original proposal to not allow clawbacks to be reduced on account of tax liabilities), the SEC noted:

*"For example, many fund agreements only require advisers to restore the excess performance-based compensation (less taxes) to the fund, without requiring them to provide investors with any information regarding the adviser's related determinations and calculations, such as whether a clawback was triggered and the aggregate amount of the clawback. Without adequate disclosure, investors are unable to understand and assess the magnitude and scope of the clawback, as well as its impact on fund performance and investor returns. Further, not all investors may be able to ask questions successfully or seek more information about a clawback on a voluntary basis from their private fund's adviser. We believe that disclosure will achieve the rule's policy goal of protecting investors, while preventing unintended consequences that may have resulted from a flat prohibition."*

While the private fund adviser rules have been struck out, this development shows that carry clawback is an area of regulatory focus.

## Contacts

**Damien Crossley**
Partner
DD +44 (0)20 7849 2728
damien.crossley@macfarlanes.com

**Pete Chapman**
Partner
DD +44 (0)20 7849 2042
pete.chapman@macfarlanes.com

**Samuel Brooks**
Partner
DD +44 (0)20 7849 2337
samuel.brooks@macfarlanes.com

**Sophie Donnithorne-Tait**
Partner
DD +44 (0)20 7849 2670
sophie.donnithorne-tait@macfarlanes.com

**James McCredie**
Partner
DD +44 (0)20 7849 2129
james.mccredie@macfarlanes.com

**Alicia Thomas**
Partner
DD +44 (0)20 7849 2773
alicia.thomas@macfarlanes.com

**Joe Robinson**
Partner
DD +44 (0)20 7791 4211
joe.robinson@macfarlanes.com

MACFARLANES

Macfarlanes LLP | 20 Cursitor Street London EC4A 1LT

T +44 (0)20 7831 9222 | F +44 (0)20 7831 9607 | DX 138 Chancery Lane | macfarlanes.com

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