

To: Private Equity Fund Clients and Friends
From: Fund Services Group
Date: January 24, 2002
Re: **Receipt of Carried Interest Subject to Vesting**

On August 2, 2001, the Internal Revenue Service issued Revenue Procedure 2001-43,¹ which generally provides that the receipt of a partnership profits interest as consideration for the performance of services is not a taxable event *even if the interest is subject to vesting*.

For most circumstances, Revenue Procedure 2001-43 is the final piece of guidance necessary to conclude that a venture capital or other private equity fund manager ("Fund Manager") will not be taxed upon receipt of a carried interest in a venture capital or other private equity fund ("PEF"). Moreover, Revenue Procedure 2001-43 generally eliminates the need for Fund Managers to file "83(b) Elections" in connection with the receipt of a carried interest. Thus, the Revenue Procedure is good news for both Fund Managers and tax compliance personnel at private equity firms.

However, Revenue Procedure 2001-43 may not eliminate the need to file an 83(b) Election with respect to a carried interest that is transferred within two years of receipt. Many Fund Managers transfer carried interests to trusts, partnerships or family members in order to serve estate planning or wealth management goals. A Fund Manager who anticipates the transfer of a carried interest generally should consider filing an 83(b) Election within 30 days after the carried interest is received.

Background

For many years, there was great uncertainty as to whether a person should be required to pay tax when they receive a partnership interest as compensation for services provided to the partnership. Following the controversial case *Campbell v. Commissioner*,² the Internal Revenue Service issued Revenue Procedure 93-27,³ which generally provides that the receipt of a partnership interest as compensation for services will not be taxable so long as the interest: (1) is a pure "profits interest" (*i.e.*, it has no liquidation value on the date of receipt); (2) is received solely as compensation for services performed in a partner capacity or in anticipation of being a partner; (3) does not relate to a substantially certain and predictable stream of income from partnership assets (such as government-backed securities); (4) is not disposed of within two years of receipt; and (5) does not relate to a "publicly traded partnership."

¹ 2001-34 I.R.B. 1.

² 943 F. 2d 815 (8th Cir. 1991).

³ 1993-2 C.B. 343.

Except with regard to the vesting provisions to which many Fund Managers are subject, Revenue Procedure 93-27 generally applies to the carried interests held by Fund Managers in their PEFs. Because carried interests tend to accrue liquidation value over time, it has been unclear whether the vesting of carried interests would be entitled to the protections afforded by Revenue Procedure 93-27. For this reason, tax advisors generally have recommended that Fund Managers file elections under Section 83(b) of the Internal Revenue Code with respect to carried interests, even though: (1) it was not completely certain that such elections would be effective to eliminate tax liability upon the occurrence of vesting events; and (2) such elections, because they must be individually executed by Fund Managers and filed within 30 days after each receipt of a carried interest, presented substantial compliance burdens and opportunities for error.⁴

To reduce the risk of tax liability, many vesting programs were designed to be prospective, rather than retroactive, in effect. Under a prospective vesting program, the termination of a Fund Manager's services triggers a reduction solely in the Fund Manager's share of future profits and losses, and the Fund Manager is deemed fully vested in all items of previously allocated profit and loss. By contrast, under a retroactive vesting program, the termination of a Fund Manager's services may trigger forfeiture of some or all items previously allocated or distributed to the Fund Manager.

Revenue Procedure 2001-43

Under Revenue Procedure 2001-43, vesting provisions associated with a carried interest are disregarded in determining whether a Fund Manager has received a pure profits interest. The entire carried interest is deemed to have been received at the date of issuance, regardless of whether any applicable vesting is prospective or retroactive. Thus, so long as the carried interest is issued before the underlying PEF has accrued net profits, or the carried interest is otherwise structured to have a zero liquidation value on the date of issuance, the Fund Manager generally will have no tax liability in connection with receipt of the carried interest.

Revenue Procedure 2001-43 greatly enhances the flexibility of Fund Managers and their advisors in designing vesting provisions relating to carried interests. Moreover, it specifically provides that 83(b) Elections need not be filed, thereby reducing the parties' tax compliance burden.

Please note, however, that the benefits of Revenue Procedure 2001-43 are available only if the parties fully respect the form of a carried interest as a true partnership interest. Accordingly: (1) the Fund Manager should report on his or her personal income tax return his or her allocated share of carried interest profits and losses; and (2) the issuer of the carried interest (*e.g.*, the underlying PEF and any "general partner" entity of which the Fund Manager is a member) should not claim any compensation or similar deduction in connection with issuing the carried interest.

Also note, as discussed above, that it may be prudent to file an 83(b) Election within 30 days after receiving a carried interest that is subject to retroactive vesting if it is anticipated that the carried interest may be transferred within two years of receipt for estate planning, wealth management, or other reasons.

⁴ Under an 83(b) Election, a taxpayer agrees to disregard the risk of forfeiture associated with a vesting program and to pay tax on the entire value of property received as compensation for the performance of services (determined on the issuance date as if the risk of forfeiture did not exist). Most 83(b) Elections filed by Fund Managers have claimed that the applicable carried interests had zero value on the date of issuance and that, accordingly, no tax was due.

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Revenue Procedure 2001-43 is deemed a "clarification" of Revenue Procedure 93-27, and generally should be effective for all open tax years.

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This memorandum is intended only as a general discussion of the information presented and should not be regarded as legal advice. For more information, please contact your Fund Services Group attorney.