

**To:** Private Equity Fund Clients  
**From:** Fund Services Group  
**Date:** August 5, 2001  
**Re:** **Distribution Provisions in Venture Capital Fund Agreements**

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We frequently are asked to comment upon provisions governing cash and property distributions by venture capital and other private equity funds. These provisions typically are complex and there are many alternative techniques.

Reprinted below is an article titled "Distribution Provisions in Venture Capital Fund Agreements." The article was written by Jonathan Axelrad and Eric Wright, both members of the Fund Services Group, and initially published in the November 1997 issue of *The Venture Capital Review*. While the article is focused upon venture capital fund agreements, the issues that are discussed apply to all types of private equity funds.

The article 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.

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## **Introduction**

As observers of the venture capital industry are aware, there has been a marked convergence of deal terms in venture capital fund agreements over the last few decades. Despite innovations such as carried interest hurdle rates and declining management fees, many fund agreement provisions (including those governing carried interest allocations, investment limitations, management fees, conflicts of interest, transfers, withdrawals and indemnification) tend to look quite similar from one fund agreement to the next. For each provision, the parties generally select terms from among a small number of paradigms that are well-known within the industry.<sup>1</sup>

One significant exception to this general rule is the set of fund agreement provisions governing the timing, and apportionment among the partners, of operating distributions. In fact, based upon our experience, the number of alternative distribution arrangements in common use seems to be increasing. This article describes a number of the most frequently used distribution arrangements, and seeks to show that the multiplicity of such arrangements arises because no single approach can satisfy all the economic goals of the

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<sup>1</sup> This is not to suggest that the substance of deal terms (*e.g.*, rate of carry, amount of management fee, extent of investment limitations, degree of supervision regarding conflicts, etc.) is the same in all fund agreements. There is, of course, wide variation based upon the relative negotiating positions of the parties. However, it does appear that in most cases the provisions containing these deal terms tend to reflect only a few different approaches to understanding the term in question.

general and limited partners, even when they agree that one party's goals should be accorded priority over the others'.<sup>2</sup>

For purposes of simplicity, the following discussion ignores the impact of management fees (whether based upon fixed amounts such as committed capital or upon variable indices such as the fund's net asset value) and the costs of organizing a new fund. In addition, the discussion assumes that: (i) the general partner contributes no capital to the fund so that its share of fund capital and profits is solely a function of the carried interest;<sup>3</sup> (ii) the carried interest is a standard 20 percent, with no hurdles, floors or similar modifications; and (iii) liquidating (as opposed to operating) distributions are based upon the parties' respective capital account balances so that the aggregate amount of distributions received by a party over the term of the fund is governed by the fund agreement's profit and loss allocations rather than the parties' approach to operating distributions.

### **Distribution Timing**

Arguably, an ideal distribution arrangement would result in the fund holding each portfolio security only for so long as the security's prospective risk-adjusted rate of return equals or exceeds the fund's target IRR so that, overall, the fund's performance equals or exceeds that target. This simple goal is made complex by a number of factors including the following: (i) differing perspectives among the general and limited partners as to what the target IRR of the fund should be; (ii) questions as to when the general partner's ability to "add value" to an investment ceases; and (iii) non-IRR goals of the parties, such as the desire for liquidity.

*IRR Considerations.* From a limited partner's perspective, capital arguably should be held by the fund only for so long as the fund's IRR exceeds the limited partner's IRR on non-fund investments ("Outside IRR"), this being the limited partner's opportunity cost of holding the fund investment, by at least enough to cover the cost of the general partner's carried interest.<sup>4</sup> Of course, many limited partners would prefer to

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<sup>2</sup> As used herein, the term "general partner" refers to the group of individual venture capitalists managing a fund, and the term "limited partners" refers to the fund's passive investors. We recognize that, in this age of limited liability companies and multi-tiered structures, these terms may not be strictly accurate.

<sup>3</sup> While this assumption makes the math easier to present, there are a number of reasons why general partners typically invest a significant amount of capital in their funds. These include: (i) a desire on the part of limited partners that the general partner have some "skin in the game" to help align the interests of the parties; and (ii) advice of tax counsel that the general partner contribute a meaningful amount of capital to ensure the general partner's status as a "partner" of the fund for income tax purposes (which, in turn, allows the general partner to receive in-kind distributions of portfolio securities on a tax-free basis and to pay tax on its allocated share of the fund's recognized profits at reduced capital gains rates). Tax lawyers often disagree on the minimum amount of capital that a general partner should contribute but, based on Revenue Procedure 89-12, 1989-1 C.B. 798 issued by the Internal Revenue Service, generally view one percent of total capital commitments (up to a maximum of \$500,000) as a safe harbor. Typically, with respect to the capital that a general partner invests in a fund, it is treated under the fund agreement in the same manner as a limited partner.

<sup>4</sup> In this context, the "cost" of the general partner's carried interest is a function of the fund's distribution history and methodology. For example, assume that a fund with \$100 million of contributed capital has generated gains of \$100 million. Further assume that both the Outside IRR and the fund's prospective rate of return are expected to be 10%. If, in Case 1, the fund has made no distributions to date, the next year's returns will be \$20 million, allocated \$16 million to the limited partners and \$4 million to the general partner. If, in Case 2, the fund has previously returned all of the limited partners' capital, the next year's returns will be (i) \$10 million to the limited partners on their \$100 million of outside (*i.e.*, distributed) capital, (ii) \$8 million to the limited partners as their share of the fund's \$10 million return on the undistributed \$100 million, and (iii) \$2 million to the general partner as its share of the same \$10 million return. If, in Case 3, the fund had liquidated and distributed the entire \$200 million (\$20 million to the general partner as a carried

receive distributions of portfolio securities that are expected to continue to generate returns in excess of their Outside IRR (so that such returns will not be subject to the general partner's carried interest), but limited partners generally should be willing to maintain a fund investment so long as their net returns from such investment exceed the Outside IRR. Given the fact that limited partners typically allocate only a small portion of their total portfolio to "alternative" asset classes such as venture capital, a limited partner's Outside IRR generally will approximate the total public market rate of return.

From the general partner's perspective, the appropriate target fund IRR may depend upon a number of factors. For example, general partners typically operate their current fund with an eye to the formation of a successor fund. To most easily raise a successor fund, a general partner would like to point to a current fund IRR that compares favorably with the returns of other venture capital funds, which returns may substantially exceed the Outside IRR. This may induce a general partner to give the limited partners a bonus — a distribution of securities whose projected rate of return is greater than the Outside IRR, but less than the competitive venture capital rate.

On the other hand, a general partner that does not intend to raise a successor fund may seek to maximize the fund's absolute profits (and therefore the value of the carried interest) rather than the fund's IRR. Such a general partner may be induced to withhold distributions even if the fund's IRR is less than the Outside IRR so long as the general partner continues to be allocated carried interest profits at a rate that exceeds the product of the general partner's Outside IRR and the liquidation value of its fund interest. Based upon our experience, this type of behavior is rarely a concern because most general partners either intend to raise a successor fund or are members of a venture capital organization that intends to raise successor funds regardless of whether particular individual general partners continue to participate.

*Added Value.* The possibility that the general partner may inappropriately withhold distributions in order to maximize the absolute profits of the fund is one reason why some limited partners seek mandatory distributions in respect of portfolio securities (such as within a brief period following an IPO or merger with a public company). Another is that the special ability of the general partner to "add value" to portfolio investments through active participation in, or insight with respect to, underlying portfolio companies is perceived by some limited partners as restricted to the pre-public stage of each portfolio company's development. In consequence, some limited partners insist that prompt distributions be made with respect to publicly traded securities so that limited partners can make their own individual hold/sell decisions. However, a study recently conducted by faculty at the Harvard Business School (the "HBS Study") found that general partners significantly outperform the market in making post-IPO hold/distribute decisions.<sup>5</sup> This suggests that general partners may continue to add value at least for so long as they remain intimately involved with, or knowledgeable about, a post-IPO portfolio company. Such value may be lost if the general partner is forced to make distributions under the fund agreement.

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interest on the \$100 million of gain and the remaining \$180 million to the limited partners), the next year's returns will be \$18 million to the limited partners and \$2 million to the general partner. By reference to Case 3 (in which the general partner will receive no additional carried interest distributions), it may be concluded that the "going forward" cost of the carried interest in Case 1 is \$2 million and in Case 2 is zero. Of course, as discussed below, simply seeking a zero going forward cost of carried interest may not result in the highest overall IRR to the limited partners.

<sup>5</sup> See P. Gompers and J. Lerner, *Venture Capital Distributions: Short-Run and Long-Run Reactions*, Harvard Business School unpublished working paper, April 1996.

Another problem with forced distributions concerns the window period during which such distributions must be made. If the window is sufficiently narrow, limited partners may be induced to anticipate a distribution by selling short the securities to be distributed, an activity that can (intentionally or unintentionally) drive down the market value of such securities.<sup>6</sup> To the extent that market prices do decline as a consequence of short selling, the parties harmed may include the general partner, since the general partner's carried interest in respect of a portfolio security typically is determined with regard to the market price of that security on (or within the few days preceding) the date of distribution, as well as those limited partners that have not similarly sold short.

*Other Goals.* Finally, both general and limited partners may be induced to modify the timing of fund distributions in order to satisfy non-IRR goals, such as liquidity. For example, a general partner may seek early distributions to supplement its income from management fees. This goal may be particularly powerful for general partners that are not receiving management fees from prior funds. A limited partner may seek such distributions as part of an overall program of controlling the portion of the limited partner's assets exposed to the risks of the venture capital asset class. Or, in the alternative, a limited partner may seek to postpone distributions (and encourage reinvestment of sale proceeds by the fund) in order to avoid the transaction costs of investing distribution proceeds in other assets.

### **Distribution Apportionment**

In addition to selecting a mechanism for determining when distributions will be made, the partners must select a mechanism for determining how the cash and securities comprising such distributions will be apportioned. In many respects, the apportionment of distributions is a zero-sum game. All other things being equal, each partner will prefer to receive the greatest share of early distributions, leaving the others to receive correspondingly larger shares of later distributions.<sup>7</sup> Beyond this simple principle, however, the parties must also consider the (possibly perverse) incentives created by a given distribution arrangement and the likelihood that such arrangement will result in a clawback of operating distributions received by the general partner.

*The Problem of Perverse Incentives.* The commonly used distribution arrangements discussed below will, in some or all cases, preclude the general partner from receiving a full 20 percent of each operating

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<sup>6</sup> Failure by the parties to maintain the confidentiality of a forced distribution provision in the fund agreement may also result in short selling by third parties, which could magnify the negative impact of such a provision.

<sup>7</sup> If the partners' earnings from the investment of distributed assets are taken into account, the order in which partners receive distributions can have a substantial effect on their respective benefits from participating in the fund. For example, take the case of a fund that returns 3x on total contributed capital of \$100 million. Assume that the limited partners contribute \$25 million to the fund at the beginning of years one through four, that distributions of \$60 million are made to the partners at the end of years five through nine, and that the remaining fund assets are distributed at the end of year ten. Assume further that the partners' outside rate of return is 10 percent, compounded annually. The aggregate amount distributed to the partners under any distribution scheme will be the same—approximately \$260 million to the limited partners and \$40 million to the general partner. However, if operating distributions initially are apportioned 80% to the limited partners and 20% to the general partner (so long as the general partner's capital account is above zero), then the total return to the limited partners, including earnings on distributed amounts, will be approximately \$346.8 million. The total return to the general partner in this case will be approximately \$57.6 million. If, in the alternative, operating distributions initially are apportioned solely to the limited partners until they have received a return of their capital contributions, with the remainder apportioned 80 percent to the limited partners and 20 percent to the general partner, the limited partners' return will be increased by approximately \$7.8 million, to approximately \$354.6 million, while the general partner's total return will be reduced by the same amount to approximately \$49.8 million.

distribution made by the fund. To the extent that distributions to the general partner are so limited, the general partner may be induced to time distributions, or to select particular securities for distribution, in a manner that maximizes its own return, rather than the return of the partners as a group.

For example, in order to accelerate the time at which it will be entitled to receive distributions, the general partner may be motivated to distribute assets as quickly as possible. This generally will be consistent with the interests of limited partners to the extent that the general partner causes the fund to dispose of underperforming securities (*i.e.*, securities whose prospective risk-adjusted rate of return is less than the fund's target IRR). However, if the fund has an insufficient number of underperforming securities, the general partner may be induced to prematurely distribute "winners" (*i.e.*, securities whose prospective risk-adjusted rate of return is equal to or greater than the fund's target IRR).

This will deprive the limited partners of benefits that arise from having such securities in the fund. For example, a limited partner that, in light of the HBS study, views an in-kind distribution of portfolio securities as a "sell" signal may dispose of prematurely distributed winners before maximum IRR has been achieved because the integrity of the "signal" has been compromised. Similarly, distribution of immature winners may reduce the "value added" that results from the general partner's active involvement with, and on behalf of, portfolio companies.

Moreover, the general partner may be motivated to distribute underperforming securities in kind rather than sell them at the fund level. This is a concern for limited partners because underperforming securities often will decline in value immediately following distribution as the limited partners "rush to the exit." The value of a general partner's overall carried interest typically is determined, in part, by reference to the value of securities at the time of distribution (and only rarely is determined with regard to subsequent declines in the value of such securities). Accordingly, a general partner that would not participate (or would participate only to a small extent) in a particular distribution with regard to underperforming securities has a strong incentive to distribute in kind since the burden of such decline will be borne principally (if not entirely) by the limited partners. Conversely, if the general partner would materially participate in the distribution, the general partner would have a greater incentive to conduct a disciplined sale of the underperforming securities at the fund level if doing so would be consistent with obtaining a maximum sale price.

Some limited partners (typically those that are tax-exempt) seek to eliminate the general partner's ability to distribute underperforming securities in kind by insisting that all fund distributions be in cash. This technique can be quite burdensome for taxable partners (both general and limited) when the fund is forced to sell (in a taxable transaction) securities that could have been distributed in kind (on a tax-free basis).<sup>8</sup>

Needless to say, the perverse incentives described above are not the only forces acting upon general partners. Other incentives (such as reputational concerns and loyalties arising from long-term relationships with limited partners) clearly play a significant role in determining how venture capital funds are managed. The point to be taken from this discussion is that perverse incentives tend to dis-align the interests of the parties, to the potential consternation of all involved.

*Clawback Issues.* Any arrangement under which the general partner may receive distributions before the limited partners have received a complete return of capital, or may receive more than 20 percent of any subsequent distribution, can result in the general partner having received, over the term of the fund,

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<sup>8</sup> See "Tax Distributions," below.

distributions that exceed 20 percent of the fund's net profits ("excess distributions").<sup>9</sup> This is true because net profits existing at any time prior to the fund's final liquidation may be offset by subsequently realized losses. In response to this possibility, limited partners typically insist upon a "clawback" provision in the fund agreement that, in connection with the liquidation of the fund, requires the general partner to return any excess distributions received during the fund's term.

Even as they insist upon the inclusion of clawback provisions in fund agreements, however, limited partners generally hate to see such provisions in operation. There are two principal reasons for this. First, the need to claw back distributions from a general partner indicates that the general partner has received excess distributions amounting to an interest free loan. Second, it may be easier to insert a clawback provision into the fund agreement than to actually enforce it, since the general partner may, at the time the clawback arises, lack sufficient recoverable assets to satisfy the obligation.

Nevertheless, due to the negotiating strength of general partners and the parties' desire to avoid perverse incentives, many fund agreements contain distribution arrangements that create the potential for clawbacks.

### **Common Distribution Arrangements**

In light of the complex and conflicting interests and goals described above, it is not surprising that general and limited partners have created a diverse array of alternative distribution arrangements. Set out below is a description of some of the more common approaches we have seen in our practice. While the list is roughly in order of decreasing subordination of the general partner's distributions, it is not possible to range these approaches along a single axis. In particular, the actual limitations on general partner distributions imposed by a number of these arrangements will vary with the particular facts and circumstances.

*Return of Capital Contributions.* Under this arrangement, no distributions are made to the general partner until the limited partners have received distributions equal to the amount of their capital contributions. Thereafter, distributions are made 80 percent to the limited partners and 20 percent to the general partner. This arrangement provides limited partners with the greatest percentage of early distributions. In the absence of distributions made before all capital has been contributed, as well as overriding distributions such as tax distributions, this arrangement also eliminates clawback risk. It does, however, maximize the perverse incentives and timing disadvantages faced by the general partner.

*Return of Capital Contributions With General Partner Catch-Up.* This arrangement is similar to the "Return of Capital Contributions" method in that all limited partner capital contributions are returned prior to the general partner receiving any distributions. Once limited partner capital contributions are returned, however, the general partner receives 100 percent (50 percent under one common variant) of succeeding distributions until it has received aggregate distributions equal to 20 percent of the total distributions made by the fund since inception. Thereafter, distributions are made 80 percent to the limited partners and 20 percent to the general partner. While this arrangement somewhat mitigates the timing disadvantages faced by the general partner (by increasing its potential share of earlier distributions), it may actually enhance the effect of perverse incentives (and thereby increase distributional gamesmanship) because of the key pivot points at which the general partner's share of distributions goes up from zero to 100 (or 50) percent, and from there

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<sup>9</sup> A negotiated variable in the calculation of excess distributions is whether management fees and similar fund operational expenses are taken into account in the determination of net profits. Moreover, as discussed below, the general partner often is not required to return excess distributions to the extent that such distributions are deemed "tax distributions."

down to 20 percent. Specifically, the general partner may be induced to defer distributions of particular securities in anticipation of a pending increase in its distribution apportionment or to accelerate distributions of such securities in anticipation of a pending decline.

*Split Distributions.* Under this distribution arrangement, each amount available for distribution is divided into separate "return of capital" and "profit" components relating to the cost basis and appreciation associated with the portfolio security being distributed (or, in the case of a cash distribution, the portfolio security in respect of which the cash was received by the fund). Return of capital amounts are distributed to the limited partners, while profit amounts are distributed 80 percent to the limited partners and 20 percent to the general partner.

For example, assume that the fund invests \$100 in X Company. If the X Company stock appreciates in value from \$100 to \$200 and is distributed, there is a \$100 return of capital amount and a \$100 profit amount. Accordingly, the first \$100 would be distributed to the limited partners and the remaining \$100 would be distributed 80 percent to the limited partners and 20 percent to the general partner. Because the general partner will receive a distribution with respect to each profitable investment, the general partner's timing disadvantages are eased. Perverse incentives also may be reduced (but not eliminated, since the general partner still will not participate in distributions of securities with a built-in loss).

*Net Asset Value.* Under this arrangement, the general partner receives 20 percent of each distribution only to the extent that, immediately following the distribution, the net asset value of the fund equals or exceeds the aggregate unreturned capital contributions of the limited partners. Under a common variant, the general partner receives 20 percent of each distribution only to the extent that, immediately following the distribution, the net asset value of the fund exceeds the aggregate unreturned capital contributions of the limited partners by a specified percentage thereof (typically 10-25 percent). This "cushion" of assets in excess of the limited partners' unreturned capital contributions reduces the likelihood of a clawback by increasing the amount of subsequent losses that would have to be incurred before the general partner had received distributions greater than 20 percent of the fund's net profits.

*Slice Distributions.* Under this arrangement, the general partner receives 20 percent of each distribution, but is required to simultaneously contribute to the fund an amount equal to 20 percent of the "return of capital" component of the securities being distributed (or in respect of which a cash distribution is made).

For example, assume that the fund invests \$100 in X Company. If the X Company stock appreciates in value from \$100 to \$200 and is distributed, there is a \$100 return of capital amount and a \$100 profit amount. Under the Slice Distribution method, the general partner would receive \$40 in X Company stock, but would be required to contribute \$20 in cash to the fund. This arrangement is similar to one in which there is no carried interest and the general partner makes a capital commitment equal to 20 percent of the fund's aggregate capital commitments, but is required to make capital contributions in respect of its capital commitment only as distributions are received.

One difficulty with the Slice Distribution method is that a general partner may lack the cash to make a capital contribution in connection with an in-kind distribution. Under these circumstances, the general partner may be induced to defer making the distribution until it has sufficient cash available, even at the expense of the fund's overall IRR. The fund agreement may try to address this problem with forced distributions provisions. Alternatively, the fund agreement may provide for net distributions pursuant to which the general partner makes its contribution to the fund by forgoing a portion of the securities it would otherwise receive.

Interestingly, a Slice Distribution provision that incorporates a net distribution approach may result in the same ultimate apportionment as the Split Distribution method.

Another difficulty with the Slice Distribution method is that the simultaneous contribution of cash, and receipt of in-kind distributions, by the general partner may be deemed a taxable "disguised sale" of the distributed securities by the fund to the general partner.<sup>10</sup> The risk of disguised sale treatment, and its adverse tax consequences to all of the fund's taxable partners, is substantially increased if the general partner has the option of simply receiving a net distribution. Since a general partner that has cash available to make a capital contribution in connection with a distribution of securities may, in the alternative, purchase securities of the same type in the public market without triggering a deemed taxable transaction at the fund level, a Split Distribution may be more efficient from a tax perspective than a Slice Distribution (while yielding the same desired post-distribution holdings of securities).<sup>11</sup>

*Positive General Partner Capital Account Balance.* Under this method, the general partner may receive 20 percent of each distribution to the extent that doing so will not reduce its capital account balance below zero. So long as the fund's capital accounts are marked to market, this approach prevents the general partner from receiving distributions that are expected to give rise to a clawback. In general, this method allows the general partner to receive larger distributions than the Net Asset Value method (without the cushion) only to the extent that the general partner's capital account reflects actual capital contributions made by the general partner to the fund. It minimizes perverse incentives, but does little to prevent the possibility of a clawback due to the subsequent realization of losses.

*Additional Features of Distribution Arrangements.* There are numerous possible modifications to the foregoing distribution arrangements. Among the most common are hurdle rates, separate treatment for cash distributions, and escrows.

*Hurdle Rate.* Those methods that tie distributions to a return of the limited partners' capital contributions may be modified by "grossing up" the limited partners' unreturned capital contributions to reflect a hypothetical "baseline" rate of return (typically around 8 percent). For example, under a hurdle rate-modified Return of Capital Contributions approach, the general partner may not receive distributions until the limited partners have received aggregate distributions equal to the sum of their capital contributions and an 8 percent return thereon. The addition of a hurdle rate generally has the effect of further subordinating the general partner's right to receive distributions and increasing the possible consequences of perverse incentives.

*Separate Treatment for Cash.* Some fund agreements provide that cash distributions will be made 100 percent to the limited partners (until they have received a return of capital), while in-kind distributions will be made using another method (such as the Split Distribution or Net Asset Value). There are several justifications for this approach. For example, some parties view in-kind (as opposed to cash) distributions as unique investment opportunities in which the general partner should always be able to participate. Others (particularly taxable investors) appreciate this method because it encourages the general partner to make in-kind distributions rather than selling securities at the fund level and triggering recognition

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<sup>10</sup> Internal Revenue Code Section 707(a).

<sup>11</sup> For example, consider the fund's distribution of X Company stock. In a standard Slice Distribution, the general partner will pay \$20 in cash and receive \$40 in X Company stock, possibly triggering recognition of taxable gain at the fund level. In a Split Distribution, the general partner would simply receive \$20 in X Company stock, and could use its cash to buy \$20 in X Company stock on the public market, all without significant risk of triggering taxable gain.

of taxable gain. This method may also reduce the perverse incentive to distribute underperforming securities in kind (to the extent that the general partner participates in such distributions).

*Escrow.* A limited partner may wish to reduce the perverse incentives that would be placed upon the general partner by a distribution arrangement which limits the general partner's ability to share in operating distributions, yet also wish to minimize the risk that a clawback right would be unenforceable due to the general partner's lack of liquid assets at the time the clawback amount is determined. One possible solution is to allow the general partner to participate in most or all distributions, provided that the general partner's share of such distributions is deposited into an escrow.

Since one goal of the escrow is to maximize the likelihood that assets will be available to satisfy the clawback, an ideal escrow (viewed from the limited partner's perspective) would contain assets at least sufficient to cover the general partner's maximum potential clawback obligation.<sup>12</sup> Any excess assets could then be disbursed to the general partner without risk. In practice, however, even those general partners willing to consider an escrow arrangement usually will resist provisions that protect against remote contingencies by requiring the escrow of unreasonably large amounts. In our experience, disbursements usually are permitted whenever the combined net asset value of the fund and the escrow exceeds 110-125 percent of the limited partners' unreturned capital contributions.

Typically, all gains and losses resulting from the investment of escrowed assets are solely for the general partner's account unless, and to the extent that, such assets are used to satisfy the clawback. Most often, the general partner has exclusive rights to manage the investment of escrowed assets, subject to limited restrictions such as a prohibition on investment in tangible property or non-marketable securities. By these means, the general partner is induced to view escrowed assets as its own, rather than as the fund's or the limited partners'. The result, hopefully, is that the general partner will be less subject to perverse incentives than if the general partner shared to a lesser extent in early fund distributions or was unable to manage escrow account assets as it saw fit.

## **Tax Distributions**

In general, venture fund partners (both general and limited) are required to pay income taxes on their allocated shares of realized fund income and gain, on a flow-through basis, without regard to whether such income and gain is actually distributed by the fund. Moreover, the tax law requires that realized income and gain be allocated among the partners in accordance with their underlying economic interests in the fund's profits and losses (and not on the basis of their priority in the fund's operating distribution arrangement). This means that taxable income and gain generally will be allocated: (i) 20 percent to the general partner and 80 percent to the limited partners whenever the fund has cumulative net profits; and (ii) 100 percent to the limited partners whenever the fund has cumulative net losses.<sup>13</sup>

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<sup>12</sup> The general partner's maximum clawback obligation at any time will be equal to the amount by which distributions previously received by the general partner would exceed 20 percent of the fund's overall net profits if, at such time, all of the assets still held by the fund declined in value to zero.

<sup>13</sup> The determination of whether the fund is in a net profit or loss position may be affected by the fund's choice of accounting method (*e.g.*, GAAP, modified mark-to-market, or tax realization). Without regard to the accounting method used in the fund agreement for the maintenance of capital accounts, many accountants prepare venture fund tax returns using the tax realization method.

Faced with the prospect of flow-through tax liability, taxable venture fund partners typically insist that the fund agreement provide for mandatory annual "tax distributions." Since the amount and timing of tax distributions have little correlation with the anticipated IRR of fund investments, such mandatory distributions ideally would be limited to the amount necessary for the fund's partners to pay the taxes currently due on allocated fund income and gain. In practice, it is not quite that simple.

First, it may be difficult to determine the partners' actual tax liability. Rates differ with the type of partner (*e.g.*, individual, corporate, tax-exempt and foreign) and the types of taxes to which the partners are subject (*e.g.*, federal, state, local and foreign). For example, a maximum tax bracket individual resident in California may face a blended federal and state income tax rate on capital gains ranging from a low of approximately 27.5 percent (long term gains with no limit on the deductibility of state taxes for federal income tax purposes) to a high of approximately 48.2 percent (short term gains with an 80 percent reduction in the deductibility of state taxes). Most corporate partners domiciled in California would face a blended state and federal rate of approximately 40.7 percent, without regard to the type of income or gain realized, while tax exempt partners may face a tax rate of zero and foreign partners may be taxable (at varying rates) only on the fund's income from interest and dividends. Since attributes affecting a partner's effective tax rate may change from one year to the next, and the impact of special rules may not be determinable until the partner completes its tax return for the year in question, it generally is not practicable to require that tax distributions precisely match the tax liabilities of the partners.

Second, partners that are not subject to tax, or that are subject to tax only at very low rates, may object to tax distributions that are calculated differently for each partner on the grounds that even partners nominally taxable at high rates may receive distributions in excess of their actual tax liability due to a variety of factors (such as the ability to offset losses from other investments against gains allocated by the fund).

In consequence, most fund agreements calculate tax distributions on the basis of simplifying assumptions. These include: (i) applying a single "deemed" tax rate (typically in the range of 40-46 percent) to all distributions; or (ii) applying a separate deemed tax rate to each class of fund income and gain (*e.g.*, ordinary income as well as short, medium and long-term capital gain), where the deemed rate is the highest blended federal and state rate that may be applicable to an individual who is allocated income of that class. Other variations include making tax distributions only to individual and corporate partners and taking into account certain types of local (*e.g.*, New York City) or foreign taxes. In order to avoid the entire complex matter whenever possible, many fund agreements provide that tax distributions will not be required for years in which: (i) the fund's net taxable income and gain is less than a threshold amount (*e.g.*, \$500,000); or (ii) the fund has made other distributions (*e.g.*, discretionary distributions) at least equal to the amount of tax distributions that otherwise would have been required.

One vexing rule of tax law, often ignored in preparing tax distribution provisions, states that an individual partner may use his or her allocated share of the fund's "miscellaneous itemized deductions" (such as management fees and other fund operational expenses) in determining the individual's actual tax liability only to the extent that such deductions exceed two percent of his or her adjusted gross income (the "Two Percent Floor").<sup>14</sup> For a fund in an overall net profit position, the general partner may be allocated 20 percent

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<sup>14</sup> Internal Revenue Code Section 67(a). Management fees and similar fund operating expenses might be deductible without regard to the Two Percent Floor if the fund were deemed to be engaged in a "trade or business." However, most venture capital funds seek to profit from long-term investments rather than from fees for services or short-term swings in the market prices of portfolio securities. Such funds should not be deemed to engage in a trade or business for income tax purposes. *See, e.g., Mayer v. Commissioner*, 67 T.C.M. 2949 (1994) and the numerous cases cited therein.

of income and gains and as much as 20 percent of management fees and other fund operational expenses. If these items were netted in calculating the tax distribution to the general partner and the Two Percent Floor applied, the general partner may face an actual tax liability substantially in excess of the distribution amount. Accordingly, tax distribution provisions generally should presume that management fees and other fund operational expenses are not deductible in calculating the tax distributions to be made to individual partners. Under most fund agreements, tax distributions must be made in cash. There are three principal reasons for this. First, a partner that sells appreciated securities distributed by the fund may incur additional tax liability attributable to the gain recognized on such sale.<sup>15</sup> Unless the sale proceeds cover both the initial flow-through tax liability giving rise to the tax distribution and the additional liability arising from the sale, the partner will face a cash flow shortage. Second, triggering tax liability from the unnecessary sale of appreciated securities is inefficient. If the fund has sufficient cash to cover the partners' tax distributions, forcing the partners to sell distributed securities in order to pay taxes simply accelerates the recognition of taxable gain that could otherwise have been deferred. Finally, partners that receive in-kind distributions of portfolio securities may decide, as a matter of portfolio management, to hold the securities for investment. Forced sale of such securities to pay taxes may interfere with the partners' respective portfolio management strategies.

A final issue regarding tax distributions concerns clawbacks. As discussed above, clawback provisions typically require that a general partner return distributions in excess of 20 percent of the fund's overall net profits. Under a common exception to this rule, however, clawback may not be required with respect to all or a portion of the tax distributions received by the general partner. The rationale for this exception is relatively straightforward. Tax distributions, at least in theory, are used by the general partner to pay taxes attributable to flow-through liability from the fund. To the extent that such distributions are so used, they are unavailable to be returned to the fund via a clawback.

To many, this is a counterintuitive result. Typically, a clawback will arise after the general partner is allocated profits (which give rise to operating distributions, whether tax or discretionary) and then allocated offsetting losses. Why can't the general partner simply obtain a refund of taxes paid on the early profits by filing a return showing the subsequent losses? The principal reason is that noncorporate taxpayers generally are not permitted to "carry back" capital losses (such as from the sale of portfolio securities) in order to offset income and gain recognized in prior years.<sup>16</sup> Instead, such capital losses generally may be used only to offset future capital gains (if any) or future ordinary income (but only to the extent of \$3,000 per year).<sup>17</sup> Under these rules, a fund that realizes taxable income and gain followed by losses in a subsequent year may generate a net tax liability for the general partner even if net carried interest profits are zero.

The issue of excluding tax distributions from the clawback is thus one of allocating among the partners a potential tax cost that is completely unrelated to the ultimate net profitability of the fund. To the extent that the clawback includes tax distributions, the general partner may be required to pay that cost out of his or her own pocket. Similarly, that cost may be paid by the limited partners if tax distributions are

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<sup>15</sup> In general, a partner selling appreciated securities that were distributed in kind by the fund must pay tax on all of the appreciation inherent in such securities, including appreciation that accrued while the securities were held by the fund. Internal Revenue Code Sections 731 and 732.

<sup>16</sup> Internal Revenue Code Section 172(d).

<sup>17</sup> Internal Revenue Code Section 1211(b). Of course, a clawback might also be triggered by the accumulation of losses attributable to management fees and other fund operating expenses. Internal Revenue Code Section 172(d) prohibits carrying such expenses back to offset income and gain from prior years. Under the Two Percent Floor, use of such expenses to offset future income and gain is also sharply limited.

excluded from the clawback. Some fund agreements resolve this problem by excluding only a portion of tax distributions from the clawback and thereby requiring all partners to share the potential downside.

### **Conclusion**

It should come as no surprise that negotiations over venture fund distribution arrangements often are difficult and time consuming. The issues involved include zero-sum games (the party that receives the greatest share of early distributions wins), problems of perverse incentives (limited partners that impose a harsh distribution arrangement on the general partner may find themselves receiving large in-kind distributions of underperforming securities), opportunities to mishandle valuable information (forced distributions may reduce gamesmanship, but at the cost of creating false "sell" signals), and seemingly unfair tax rules (a fund with no net profits can still generate positive net tax liability). By focusing on these issues during the negotiation process, however, parties can at least seek to agree upon a method that has the fewest disadvantages in light of their respective situations.