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by Isaac P. Grossman and Hunter J. Book

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In this article, Grossman and Book argue that the inconsistency in holding periods for carried interest and general long-term capital gain presents a new conflict for private equity sponsors.

Mergers and acquisitions activity has been historically sensitive to potential changes in tax rates. Not long ago, after the 2020 presidential election, M&A activity was spurred on as sellers raced to close deals, partly in response to President Biden's proposals to increase capital gain rates.[1] History may soon repeat itself. November elections are right around the corner, and Biden's recent 2024 budget proposal includes a significant increase in both the capital gain rates and the 3.8 percent Medicare tax.

While the proposed tax rate increases may not be adopted exactly as drafted, many pundits are expecting at least some increase in tax rates. Also, as Congress and the administration grapple with the coming sunset of numerous provisions of the Tax Cuts and Jobs Act, increasing capital gain rates may be an attractive source of revenue to help finance the extension of popular tax breaks — like the increased standard deduction — that are scheduled to sunset.

It is no surprise that the 2024 budget proposes to deny long-term capital gain treatment for carried interest. Ending the preferential treatment of carried interest as long-term capital gain has long been an appealing revenue-generating option for policymakers. Yet despite several recent efforts to treat carried interest as ordinary income, long-term capital gain treatment has displayed remarkable resilience over the past few years. Congress's only recent material change to the carried interest rules came with the enactment of section 1061 in 2017, imposing a three-year holding period requirement for carried interest to qualify as long-term capital gain.

In January 2021 Treasury published final regulations providing further guidance under section 1061. The new three-year holding period for carried interest stands in stark contrast to the one-year holding period that generally applies to the disposition of capital assets. The inconsistency between the three-year holding period for carried interest and the one-year holding period for general long-term capital gain can present a new conflict for private equity sponsors.

The conflict can arise when a private portfolio company is held by a private equity fund for less than three years but more than one year (an "interim investment"). In light of recent proposals to increase the long-term capital gain rates, private equity sponsors might feel pressure from their investors to preemptively dispose of interim investments to avoid potential tax rate increases on those investments. However, doing so within the three-year holding period will prevent the sponsor from enjoying long-term capital gain rates on its carried interest on those interim investments (assuming the entire carried interest concept survives the evolving tax policy debates).

One potential solution is to take advantage of the carried interest waiver provisions that appear in many private equity funds. Under those provisions the sponsor may waive its carried interest on an investment; in return, the sponsor is granted additional future profits from other investments to compensate for its lost carry. However, that solution is not straightforward.

[1] *See, e.g.*, Deloitte, "M&A Tax Talk: Power Shift, Tax Shift?" (Jan. 2021).

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First, the carried interest on an interim investment may be too rich to waive, especially for a mature fund that has only a few remaining investments available as a source for recovery of the lost carry. Second, the government has increasingly focused on the grant of profits interests during the life of the fund (for example, management fee waivers). Presumably, the new profits interests would need to be funded solely from growth realized after the issuance of those new profits interests (perhaps supported by revaluation of the fund when those additional interests are issued); those new profits interests may have their own three-year holding period.[2]

Finally, the preamble to the proposed regulations under section 1061 cautioned taxpayers that the IRS may challenge the use of carry waiver provisions to avoid section 1061 under antiabuse provisions as well as substance-over-form principles. Specific limitations are yet to be adopted in published guidance.

Some obvious solutions simply do not work. Under the final regulations, an installment sale would not provide a viable solution. An installment sale of a portfolio company within the three-year holding period that provides for the payment of proceeds after the three-year holding period would not escape section 1061. The relevant date for the three-year test would be the date of disposition, even if proceeds are received after the three-year period.[3]

A compromise could provide a partial but unsatisfactory solution. For example, the fund might structure a sale of a portfolio company as a transaction with two stages: a stage 1 sale occurring in the current year, and a stage 2 sale occurring in a following year. In stage 1 the fund would sell only a portion of its equity in the portfolio company (perhaps even just preferred shares or super voting shares) to a buyer. The initial sale could provide the buyer with a leading role in the company while the fund retains significant economic value.

After the three-year holding period has passed the fund could sell the remaining shares in stage 2. For the stage 1 sale, the carried interest would fail the three-year holding period requirement under section 1061, but investors would be able to avoid any increase in capital gain rates. Conversely, upon the stage 2 sale, the carried interest would satisfy the three-year test, but investors would be exposed to increased capital gain rates. Obviously, this type of arrangement would require a flexible buyer willing to initially acquire an incomplete interest in the portfolio company and then deal with a minority owner in operating that business. That compromise might leave nobody fully satisfied.

A better solution would be to bifurcate the sponsor's carried interest (with its three-year holding period) from the investors' capital interests (with their one-year holding period). The bifurcation could be accomplished in several ways.

For example, the fund could make an in-kind distribution of the interim investment to the investors and the sponsor. After the distribution, the sponsor would directly hold shares of the portfolio company (reflecting the value of the carried interest attributable to the portfolio company). A potential buyer could acquire 100 percent of the portfolio company by (1) acquiring the shares held by the sponsor in a tax-free rollover transaction for equity of the buyer or its affiliate and (2) acquiring all remaining equity of the portfolio company held by the investors for cash. The sponsor would then retain the buyer equity until the three-year period has passed.

Of course, that arrangement may not appeal to all sponsors. For example, a sponsor may be willing to accept rollover equity of the buyer only if it is accompanied by assurances regarding value and liquidity. Unfortunately, a protective redemption provision or a similar put/call arrangement with the buyer could compromise the tax-free nature of the rollover or stop the sponsor's holding period.[4]

It is worth noting that there have been recent legislative proposals to tighten section 1061 by closing perceived loopholes. Those proposals include specific regulatory authority to address the avoidance of section 1061 through distributions. One recent legislative proposal

[2] *See* prop. reg. section 1.707-2(d), Example 6.

[3] *See* reg. section 1.1061-4(b)(4).

[4] *See* reg. section 1.1092(b)-2T(a)(1).

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would have treated all transfers of a carried interest as taxable dispositions, even if a transfer would have otherwise fallen within an existing nonrecognition provision. Finally, many funds are not permitted to make in-kind distributions of equity that is not publicly traded.

A more creative solution would be to effectively bifurcate the sponsor's carried interest (with its three-year holding period) from the investors' capital interests (with their one-year holding period) by "crystallizing" the carried interest. This "crystallization" would effectively convert the sponsor's carried interest attributable to the fund's investment in the portfolio company into an ordinary partnership interest reflecting the current fair market value of the carried interest. Arguably, this crystallization would not generally trigger a current taxable event for the sponsor (assuming the crystallization does not result in a shift of "hot assets" or liabilities) and would not restart a new three-year holding period for the sponsor.[5]

In connection with the "crystallization," the portfolio company could be recapitalized so that the fund holds two different classes of equity of the portfolio company (for example, classes A and B). The sponsor's carried interest attributable to the portfolio company could be replaced by an ordinary partnership interest, which would continue to be subject to the three-year holding period rules. This sponsor interest would track only one class of shares held by the fund (say, Class A) while the investors' capital interest can be replaced by a capital interest that tracks only the other class of equity held by the fund (say, Class B).

A potential buyer could then acquire 100 percent of the portfolio company from the fund by acquiring (1) the Class A shares held by the fund in a tax-free rollover transaction for equity of the buyer or its affiliate and (2) all Class B shares of the portfolio company held by the fund for cash. The sponsor would then retain the buyer equity (indirectly through the sponsor's tracking equity in the fund) until the three-year period has passed.

[5]*See* Michelle M. Jewett, "The Crystallization of Carried Interests," *Tax Notes Federal*, May 30, 2022, p. 1335.

The approaches discussed above have different advantages. The best option will depend on the anticipated structure of a sale, the buyer's willingness to accommodate a complex transaction structure, and which options (if any) are permitted by the fund's operating agreement. The examples below illustrate two possible approaches.

Example 1: Taxable transaction with tax deferred rollover. The sponsor holds a 20 percent carried interest in the fund. The fund acquires 100 percent of the equity of the portfolio company (PC) for $100. One year later, the fund negotiates a $300 sale of PC to an unrelated buyer that is a limited liability company treated as a partnership for U.S. federal income tax purposes.

Before the sale, PC undergoes a recapitalization in which its sole class of equity is converted into Class A equity (which is beneficially owned solely by the sponsor and equal to the value of the sponsor's carried interest attributable to PC) and Class B equity (which is beneficially owned solely by the limited partners of the fund). The Class A equity is worth $40 (20 percent of the $200 of appreciation), while the Class B equity is worth $260. The sponsor's carried interest attributable to the fund's investment in PC is crystallized into an ordinary interest in the fund that tracks the Class A equity of PC.

The fund's sale of 100 percent of the equity of PC to the buyer is structured as a sale of (1) the Class A equity in exchange for $40 of rollover equity of the buyer and (2) the Class B equity in exchange for $260 of cash. All gain on the sale of Class B shares is allocated to the limited partners of the fund, while the sponsor realizes no gain until the fund disposes of the rollover equity of the buyer in a taxable disposition (if the IRS does not challenge the crystallization under substance-over-form principles). Assuming the sale of the rollover equity occurs after the three-year holding period has been met, the sponsor may qualify for long-term capital gain rates.

Example 2: Tax-free reorganization. The sponsor holds a 20 percent carried interest in the fund. The fund acquired 100 percent of the equity of the portfolio company (PC) for $100. One year later, the fund negotiates a transaction whereby PC is merged with and into the buyer, an unrelated

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publicly traded corporation, solely in exchange for common stock of the buyer worth $300.

Before the merger, the sponsor's carried interest attributable to the fund's investment in PC is crystallized so that the sponsor is entitled to receive $40 of the buyer's common stock (that is, 20 percent of the $200 appreciation). The remaining $260 of buyer common stock is shared pro rata among the fund's limited partners. Once the sponsor has crystallized its carried interest, the sponsor would not be entitled to carried interest on any future appreciation of the PC shares or buyer common stock held on behalf of the limited partners.

After the merger, the fund's limited partners are offered the opportunity either to receive their share of the buyer common stock as a distribution in kind (after which they can sell the shares) or to defer taxation on the shares by having the fund retain the shares on their behalf. The fund would retain the sponsor's share of the buyer common stock until the three-year holding period has concluded.

The upcoming election and recent tax proposals may trigger an M&A rush. The interplay between tax policy and investor strategies underscores the complex calculus facing private equity sponsors in navigating the uncertain landscape ahead. However, no two buyers and sellers are exactly alike, and private equity sellers might need to exercise extra caution when deciding which investments to sell, when to sell them, and how they are sold. ■

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