

PRESENTED AT

28th Annual LLCs, LPs and Partnership Conference

July 18-19, 2019

Austin, TX

Carrying on About Carried Interests

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CARRYING ON ABOUT CARRIED INTERESTS

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INTRODUCTION

Partnership interests issued to individuals solely in exchange for performing past services or a promise to perform future services are referred to as carried interests or profits interests depending on the context.¹ Issuing partnership interests in exchange for services is commonplace and is used by many types of business and investment partnerships to incentivize key partnership service providers and senior management.

Drafting profits interests requires a general understanding of three operating provisions commonly found in a partnership agreement: (i) distribution provisions, (ii) allocation provisions, and (iii) liquidating distribution provisions. Often, a partnership also will provide a provision describing the profits interest and its relevant restrictions.

Federal income tax laws have an enormous influence on how this type of partnership interest is drafted. Achieving the tax treatment sought is important. Tax law determines whether there is a taxable event upon the grant of the partnership interest for services and whether the character of income and gain subsequently allocated to the recipient as cash distributions is taxed as short or long-term capital gain or ordinary income. Accordingly, basic tax principles and relevant rules and regulations are discussed in the body of this paper. More in-depth tax explanations are relegated to the footnotes, including an overview of the recent tax legislation aimed at taxing carried interests.

¹ Any reference to a “partnership” or “partner” in this paper, unless otherwise specified, refers to an entity treated as a partnership for federal tax purposes and to a person treated as a partner for tax purposes, which includes an LLC treated as a partnership and its members. All references in this paper are to the Internal Revenue Code of 1986, as amended (Code) and the income tax regulations promulgated thereunder (Regulations or Tax Regulations).

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First appeared as part of the conference materials for the
28th Annual LLCs, LPs and Partnerships session

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