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In this report, Jewett explores the tax treatment of the crystallization of a carried interest, its effects on the holder's carried interest, and technical aspects of the taxation of carried interests.

This report was originally presented to the Tax Club.

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I. Introduction

The tax treatment of so-called carried interests in partnerships[1] is of considerable importance to fund managers and real estate developers and has been the subject of frequent criticism by lawmakers and tax reform advocates in the past decade. A carried interest or promote generally is an interest received by a general partner, sponsor, manager, employee, or other service provider in the future profits of an entity treated as a partnership for federal income tax purposes that is received in exchange for services provided by the recipient rather than in exchange for a contribution of capital. In its simplest form, a carried interest gives the holder the right to share in future profits of the partnership only to the extent that the value of the partnership's assets has increased, and often only after the other partners have received their capital back. Recipients of

[1] In this discussion, the term "partnership" refers to any entity that is treated as a partnership for federal income tax purposes.

carried interests often benefit from (1) being able to exclude the value of the interest from taxable income when granted based on its qualification as a profits interest for tax purposes; and (2) being taxed on most, if not all, of their share of the partnership's income at capital gain tax rates in spite of the compensatory nature of the grant of the interest.

The Tax Cuts and Jobs Act, signed into law December 22, 2017, contained a new section 1061, which was designed to limit the favorable tax treatment afforded to some recipients of carried interests. This report discusses how that legislation has changed the tax treatment of carried interests. Nevertheless, meaningful tax benefits still exist for carried interest recipients. It is important to note that the tax treatment of carried interest will likely be subject to further change. President Biden's administration has proposed eliminating carried interest holders' ability to be eligible for favorable capital gains rates on their share of partnership income and eliminating the favorable tax rates applicable to capital gains more generally. On September 15, 2021, the House Ways and Means Committee approved a variety of tax reform proposals that are to be acted on by the House as part of Build Back Better Act (H.R. 5376) reconciliation legislation, including a proposal to significantly change section 1061. It is uncertain what if any changes to the taxation of carried interests will ultimately be enacted.

This report is not intended to examine whether the tax treatment of carried interests is appropriate, because that has been discussed in great detail in countless articles, news stories, and interviews. Instead, the discussion focuses on some technical aspects of the taxation of carried interests. In particular, this report examines the tax treatment of the crystallization of a carried interest — a feature that gives the holder the right to restructure the carried interest to capture its increased value at a future date by converting it into a straight-percentage partnership interest, based on the value of the partnership's property at the time of the crystallization. Even though crystallization is an increasingly common right granted to the holder of a carried interest in real estate joint ventures and open-ended fund structures, there are many areas in which the tax treatment of this right and its exercise is uncertain.

Although profits interests in partnerships are issued in a variety of contexts, this discussion primarily focuses on the treatment of carried interests directly issued to a general partner or manager by investment funds and real estate joint ventures as profits interests. Several other interesting and complicated tax issues raised by profits interests issued in the context of operating partnerships and long-term incentive plans — including those concerning vesting new grants when the partnership has meaningful activity and appreciation of assets, tiered compensatory partnership arrangements, and forfeiture of profits interests — are beyond the scope of this report. That is because the focus of this report is on crystallization, which typically occurs only in the context of investment funds and real estate joint ventures. Accordingly, when this report refers to "carried interests," it is not referring to any profits interest in a partnership but is more narrowly focused on interests intended to qualify as profits interests in investment funds and real estate joint ventures.

To provide a foundation for the discussion of carried interests and crystallization, this report first discusses the general tax treatment of a profits interest. If a partnership interest granted to a service provider qualifies as a profits interest, the IRS permits the holder to treat the interest as having no initial value, such that no taxable income is recognized by the holder on the receipt of that interest. The holder of a profits interest is taxed in the same manner as any other partner on his or her distributive share of the partnership's income, gain, loss, deduction, and credit based on the nature of income generated by the partnership. Accordingly, if the partnership generates capital gain rather than ordinary income, the holder will be taxed on that income at a favorable rate (generally 20 percent for long-term capital gains) as opposed to the rates applicable to ordinary income or short-term capital gain for individuals (now 37 percent).

This report then examines how section 1061 alters the tax treatment of some profits interests. Under section 1061, any capital gain recognized by a holder of a carried interest on the sale of an applicable partnership interest (that is, a compensatory interest in an investment partnership) or on the sale of an asset held by an applicable partnership is treated as short-term capital gain if the interest or underlying assets were held for three years or less, rather than the one-year holding period generally required to achieve long-term capital gain treatment.

The discussion then turns to various ways that a carried interest is structured economically and analyzes how those alternative promote structures are thought to comport with the requirements to be treated as profits interests. It then considers the tax consequences of a crystallization and the tax treatment of the holder of a crystallized partnership interest going forward. Finally, this report examines the application of section 1061 to a crystallized partnership interest, particularly in light of recently issued final regulations under section 1061, which provide some guidance.

Despite the widespread use of crystallization structures in the real estate and private investment fund sectors, there has been surprisingly little written about the tax treatment of crystallization. Accordingly, this report seeks to provide an introduction to these structures from a tax perspective.

II. Taxation of a Profits Interest

The taxation of an interest granted to a partner in exchange for services rendered was historically uncertain. Under the general nonrecognition rules applicable to a partnership, no gain or loss is recognized by a partnership or any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.[2] This nonrecognition rule, as suggested by its plain language, applies when property — but not services — is contributed to a partnership in exchange for an interest in the partnership.

An interest received in exchange for services provided may constitute a capital interest, a profits interest, or a combination of both. Under regulations promulgated under the general nonrecognition rules of section 721, to the extent that any of the partners gives up any part of their right to be repaid their contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply.[3] The interest in the partnership capital so transferred is a capital interest and constitutes income to the recipient service partner.[4] The amount of that income is the fair market value of the interest in partnership capital transferred.[5] The FMV is determined either at the time the capital is transferred for past services or at the time the services have been rendered if the transfer is conditioned on the completion of the recipient's future services.[6] When that income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the recipient partner's right to withdraw or otherwise dispose of that capital interest.[7]

The regulations distinguish the transfer of a capital interest from the transfer of a share in partnership profits in exchange for services rendered, but they do not provide guidance on the taxation of a profits interest. The taxation of a profits interest had been subject to litigation until the IRS's issuance of further guidance. Under the IRS guidance, the receipt of a profits interest generally is not treated as a taxable event for a partner or a partnership if the partner receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner. The profits interest holder is taxed in the same manner as any other partner and subject to tax on his or her distributive share of the partnership's income, gain, loss, deduction, and credit based on the nature of income generated by the partnership.

A. *Diamond*

In one of the early cases to address the tax treatment of a profits interest, *Diamond*,[8] the court

[2] Section 721(a).

[3] Reg. section 1.721-1(b)(1).

[4] *Id.*

[5] *Id.*

[6] *Id.*

[7] *Id.*

[8] *Diamond v. Commissioner*, 492 F.2d 286 (7th Cir. 1974), *aff'g* 56 T.C. 530 (1971).

held that a profits interest is taxable compensation. Philip Kargman, who had a right to purchase an office building, asked Sol Diamond to secure a mortgage loan for the acquisition of the building. Diamond and Kargman agreed that Diamond would be entitled to a 60 percent share of profits or losses from the venture if he successfully arranged financing. Diamond successfully obtained financing, and Diamond and Kargman entered into a joint venture agreement in December 1961. The agreement provided that they would associate as joint venturers for 24 years (the life of the mortgage) unless there was an earlier termination by agreement or sale; that Kargman would advance all cash needed beyond the mortgage proceeds; that profits and losses of their venture would be divided 40 percent to Kargman and 60 percent to Diamond; and that in the event of a sale, the proceeds would be distributed first to repay the capital contributed by Kargman, and net profits thereafter would be divided 40 percent to Kargman and 60 percent to Diamond. In February 1962 Kargman and Diamond purchased the office building.

Soon thereafter, in March 1962, Diamond sold his interest to Kargman for $40,000, and Kargman in turn sold it to another person. Diamond claimed that no tax consequences resulted from the receipt of his interest in the partnership, and he reported the $40,000 sale proceeds as short-term capital gain. Essentially, Diamond claimed the partnership interest he received was not a capital interest subject to taxation upon receipt but a profits interest instead.

The Tax Court disagreed and held that Diamond received the interest as taxable compensation for the services he performed securing the mortgage loan, and it valued the interest at $40,000, as evidenced by the sale. The Seventh Circuit, affirming the Tax Court's findings, stated that no statute or regulation "expressly and particularly prescribe[d] the income tax effect, or absence of one, at the moment a partner receives a profit-share in return for services."[9] The Seventh Circuit examined commentaries, judicial interpretation, legislative history, and administrative interpretation and found no support for not treating a profit share with determinable market value received in return for services as compensation.

B. *Campbell*

The issue of taxation of profits interest was raised again in *Campbell*,[10] and the appellate court in that case reached a different conclusion. William Campbell was employed by a group of business entities, including some real estate brokerage and consulting firms, engaged in the formation and syndication of limited partnerships. Campbell was responsible for sourcing real properties for acquisition, negotiating the terms of and obtaining financing for the acquisition, organizing partnerships to carry out the acquisition, and preparing offering materials in connection with the syndication of those partnerships. In exchange for his services, Campbell received 15 percent of the proceeds from each syndication and special limited partnership interests to share in the profits of the partnerships that he helped form and finance.

The Tax Court, following the conclusion in *Diamond*, agreed with the IRS that the partnership interests were taxable upon receipt by Campbell. Campbell, on the other hand, argued that he received profits interests as a service partner and that the receipt was not a taxable event. Alternatively, he argued that the interests he received did not have value at the time of receipt, and thus he should not be taxed.

The Eighth Circuit agreed with Campbell that the partnership interests he received had only speculative value, and it essentially based its reversal of the Tax Court's holding on that ground. In reaching its conclusion, the Eighth Circuit also distinguished the facts in *Campbell* from those in *Diamond*. The court said that Diamond was likely granted the profits interest in an employee capacity (and did not intend to remain a partner) and received money representing the value of his services. Campbell, however, was unlikely to obtain immediate returns from the partnership interests, and those

[9] *Id.*, 492 F.2d at 288.

[10] *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991), *rev'g* T.C. Memo. 1990-162.

interests were not transferable. Although the Eighth Circuit did not explicitly hold that a profits interest should not be taxable upon receipt, it did cast doubt on the Tax Court's holding that Campbell's profits interests were taxable upon receipt.

C. Rev. Proc. 93-27

Rev. Proc. 93-27, 1993-2 C.B. 343, was the first published guidance in which the IRS explained how a partnership profits interest received in return for services provided to, or for the benefit of, a partnership is to be treated for tax purposes.

The revenue procedure defines a profits interest as a partnership interest other than a capital interest. A capital interest is defined as an interest that would give the holder a share of the proceeds if the partnership's assets were sold at FMV and then the proceeds were distributed in a complete liquidation of the partnership, a determination generally made at the time of receipt of the partnership interest.

The revenue procedure provides a safe harbor under which the receipt of a profits interest is not treated as a taxable event. Under the safe harbor, subject to three exceptions, if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, the IRS will not treat the receipt of that interest as a taxable event for the partner or the partnership.

The safe harbor does not apply in the following three situations: (1) if the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (2) if within two years of receipt, the partner disposes of the profits interest; or (3) if the profits interest is a limited partnership interest in a publicly traded partnership within the meaning of section 7704(b).

D. Rev. Proc. 2001-43

The IRS later issued Rev. Proc. 2001-43, 2001-2 C.B. 191, to clarify Rev. Proc. 93-27. Rev. Proc. 2001-43 provides guidance on the treatment of profits interests that are substantially nonvested at the time of issuance.

Rev. Proc. 2001-43 clarifies that the determination of whether an interest granted is a capital interest or a profits interest is made at the time of receipt, even if, at that time, the interest is substantially nonvested within the meaning of reg. section 1.83-3(b). Accordingly, if a grant of a profits interest meets the safe harbor provided in Rev. Proc. 93-27, the IRS will not treat the grant of the interest or the event that causes the interest to become substantially vested as a taxable event for the partner or the partnership if: (1) the partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant, and the service provider takes into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest; (2) upon the grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise) for the FMV of the interest; and (3) all other conditions of Rev. Proc. 93-27 are satisfied.

Rev. Proc. 2001-43 further provides that the service partner to whom the revenue procedure applies does not need to file an election under section 83(b).

E. Proposed Regulations

In 2005 the IRS issued proposed regulations[11] addressing the treatment of partnership interests and other instruments granted in connection with the performance of services. The proposed regulations provide that a partnership and all its partners may elect a safe harbor under which the FMV of a partnership interest that is transferred in connection with the performance of services is treated as being equal to the liquidation value of that interest.[12] As long as the recipient would not be entitled to receive anything on a hypothetical liquidation of the partnership under a hypothetical liquidation as of the date of grant, the receipt of a profits interest should not be a taxable event under the proposed regulations. The proposed regulations apply section 83 to all

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[11] REG-105346-03.

[12] Prop. reg. section 1.83-3(l)(1).

the partnership interests transferred without distinguishing between partnership capital interests and partnership profits interests.[13] As a result, most practitioners recommend that recipients of a profits interest file a protective section 83(b) election, despite the guidance in Rev. Proc. 2001-43, particularly if the interest is subject to a vesting schedule. The proposed regulations also address the timing and allocation of a partnership's deduction as well as valuation rules for compensatory partnership interests transferred in connection with services performed.

In conjunction with the proposed regulations, the IRS issued Notice 2005-43, 2005-1 C.B. 1221, which contains a proposed revenue procedure that, when finalized, will obsolete Rev. Proc. 93-27 and Rev. Proc. 2001-43. The proposed revenue procedure provides additional rules for the elective safe harbor to treat the FMV of a partnership interest transferred in connection with services performed as being equal to the liquidation value of the interest. For this purpose, liquidation value is determined without regard to any lapse restriction, and it means the amount of cash that the recipient of the partnership interest would receive if, immediately after the transfer, the partnership sold all its assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) for cash equal to the FMV of those assets and then liquidated. The proposed revenue procedure also addresses several technical issues concerning the tax treatment of nonvested partnership interests, including forfeiture allocations.

III. Section 1061

Although section 1061 has altered the tax treatment of carried interests in investment partnerships, it has not significantly changed the practice of issuing carried interests as an alternative to making compensatory payments to service providers. Importantly, section 1061 does not change the federal income tax consequences associated with the nonrecognition of income upon the grant of a profits interest to a service provider. Instead, section 1061 generally requires that the service provider hold the interest for over three years to be eligible to claim long-term capital gain on the sale of that interest, and it applies a similar holding period requirement for sales of assets by partnerships in which a service provider holds a carried interest. For private equity funds and real estate partnerships, these rules rarely end up adversely affecting service providers in practice because holding periods for interests in and assets of these funds and ventures typically exceed three years; for real estate ventures, the gain is typically eligible for special treatment under section 1231. In the hedge fund context, section 1061 is also not of great significance because most of a hedge fund's investments do not generate long-term capital gain. Accordingly, section 1061 has become more of a compliance and administrative burden for investment funds rather than a meaningful disincentive to issue carried interests to service providers.

The following is a summary of the rules of section 1061, as interpreted by final regulations issued by Treasury on January 7, 2021.[14] This does not purport to be an exhaustive discussion of all the nuances of section 1061 but instead is intended to provide a high-level overview of how the rules work. There is considerable complexity in the application of these rules, particularly in the context of tiered-partnership arrangements with service and non-service providers owning interests in the same entities.

A. Basic Rules

Section 1061(a) provides that gain "with respect to" an "applicable partnership interest" is treated as short-term capital gain if the gain relates to an interest or asset that has been held for three years or less. Accordingly, if the holder of an API disposes of that interest within three years, the gain on that disposition will generally be treated as short-term capital gain. Similarly, a holder of an API will not be eligible for long-term

[13] Reg. section 1.721-1(b)(1) and prop. reg. section 1.83-3(e).

[14] T.D. 9945. The final regulations generally apply to tax years beginning on or after the date they are published in the *Federal Register*, and they will therefore apply to taxpayers with a calendar tax year beginning January 1, 2022. Taxpayers are allowed to apply the final regulations before that date if they are applied consistently. Reg. section 1.1061-1(b), -2(c), -3(f)(1), -4(d), -5(g), and -6(e).

capital gain treatment on the sale of an asset held by the issuing partnership for three years or under, regardless of the holder's holding period for the API.[15] Further, service providers holding an interest in an entity that holds an API are subject to the three-year holding period requirements. Finally, property distributed to the holder of an API by the partnership continues to be subject to the three-year holding period requirement of section 1061. That requirement alters the general one-year holding period requirement for gain recognized on sales of assets and partnership interests to be eligible for long-term capital gain treatment. Under current law, short-term capital gain is subject to tax at ordinary income rates.

An API generally is an interest in a partnership received in connection with the performance of substantial services in an "applicable trade or business" for the partnership (or a related person).[16] An applicable trade or business consists of a business that is regularly, continuously, and substantially conducted in connection with raising or returning capital and that either invests in or develops "specified assets."[17] Specified assets generally include stocks and securities; commodities; real estate held for rental or investment; cash or cash equivalents; and some options, derivatives, or partnership interests in connection with any of the aforementioned assets.[18] Accordingly, in light of these definitions, section 1061 applies primarily to carried interests in hedge, real estate, and private equity funds, and in real estate joint ventures.

The following simple scenarios illustrate the mechanics of how the rules of section 1061 operate.

Example 1: A partner (P) holds a carried interest in a private equity fund for two years and then sells the partnership interest. Previously, P would have recognized long-term capital gain. However, under section 1061(a), this gain is recharacterized as short-term capital gain.

Example 2: P has held the carried interest in a private equity fund for four years. However, the fund has held Asset X for only two years, and the partnership now sells Asset X. P would recognize capital gain in the amount of his proportionate share of the partnership gain. Section 1061(a) would apply to P's gain on his partnership interest and accordingly recharacterize P's share of the partnership's gain as short-term capital gain.

Example 3: As in Example 1, P has held the carried interest for two years, and the partnership has held Asset X for four years. The partnership now sells Asset X and recognizes gain. P's share of that gain would not be recharacterized, and it would be treated as long-term capital gain.

Example 4: As in Example 2, P has held the carried interest for four years, but the partnership has held Asset X for only two years. P now sells his partnership interest to an unrelated party, and the partnership continues to own Asset X. Subject to an antiabuse rule, section 1061(a) does not apply to this transaction because the gain recognized by P on the partnership interest is the gain on the sale of that interest, and the asset being sold is the partnership interest itself, which has been held for over three years. Thus, P would recognize long-term capital gain.

B. Some Carried Interests Excluded

Some exceptions to the application of section 1061 may be available. An API held by a corporation (not including an S corporation or a passive foreign investment company for which the shareholder has a qualifying electing fund election) is not subject to these rules.[19] There is a narrow exception for an interest transferred to a person in connection with substantial services performed as an employee of another entity that is conducting services that are not an applicable trade or business if that person provides services only to that entity (that is, a portfolio company).[20] Also, an interest in a partnership acquired by

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[15] The final regulations include an antiabuse rule that is applicable only when, at the time of disposition of an applicable partnership interest held for over three years, (1) the partnership interest would have a holding period of three years or less if the holding period of that partnership interest were determined by excluding any period before which third-party investors have capital commitments to the partnership, or (2) a transaction or series of transactions has taken place with a principal purpose of avoiding potential gain recharacterization under section 1061(a). Reg. section 1.1061-4(a)(3)(i)(A).

[16] Section 1061(c)(1).

[17] Section 1061(c)(2).

[18] Section 1061(c)(3).

[19] Section 1061(c)(4)(A).

[20] Section 1061(c)(1).

taxable purchase for FMV is not an API if (1) the purchaser is not a related party to the seller; (2) the purchaser is not related to any person who provided, provides, or will provide services to the target partnership or any lower-tier partnership; and (3) the purchaser did not, does not, and does not anticipate providing services to the target partnership or a lower-tier partnership.[21]

An exception to the application of section 1061 is carved out for capital gains and losses allocated to a holder of a capital interest in an applicable partnership when the right to share in profits is commensurate with the holder's capital contributions.[22] There has been significant uncertainty about the circumstances in which this capital interest exception applies. Under the final regulations, for an allocation to qualify as an allocation for a capital interest, the allocation to the holder for its interest must be determined and calculated in a similar manner as the allocations for capital interests held by similarly situated unrelated partners who do not provide services and who have made significant aggregate capital contributions.[23] A capital interest allocation to a holder of an API is treated as having been made in a similar manner if the allocation and distribution rights for the capital contributed by a holder of an API to which the holder's capital interest allocation relates are reasonably consistent with the allocation and distribution rights for capital contributed by unrelated partners who do not provide services and have made significant aggregate capital contributions (that is, 5 percent or more of total contributed capital).[24] The similar manner test may be applied on an investment-by-investment basis or on the basis of allocations made to a particular class of interests.[25] Although the final regulations made several additional helpful clarifications, many questions remain, particularly regarding the application of the similar manner test. Note that the final regulations generally disqualify from capital interest treatment partnership interests acquired in exchange for capital that is borrowed by the contributing partner from the partnership, another partner, or any persons related to the partnership or other partners.[26]

The final regulations provide that gain that has been allocated to a holder of an API will be treated as having been contributed in exchange for a capital interest to the extent those amounts are reinvested (either as a result of an actual distribution and recontribution or the retention of such by the partnership).[27] However, there had been significant uncertainty about whether unrealized gains that were allocated to the capital account of a holder of an API as a result of a book-up or other revaluation event could be treated as capital of the holder for purposes of the capital interest exception. If allocations of unrealized gains allowed the holder of an API to qualify for the capital interest exception, future allocations regarding the capital interest would not be subject to section 1061. The final regulations clarify that gains must be realized before the holder of an API receives credit for purposes of the capital interest exception, and therefore, a fund manager cannot get capital account credit for unrealized gains.[28] The application of these rules in the context of a crystallization event are discussed later in this report.

C. Certain Exclusions

Importantly, the final regulations have specified that some items of gain and loss may not be recharacterized as short term. Section 1231 gain or loss, which applies to gain or loss from the sale of real estate and other property used in a trade or business, is treated as long-term capital gain and is not subject to recharacterization under section 1061.[29] This is a significant benefit to real estate fund service providers because most of the gain recognized by those individuals is subject to section 1231. Section 1256 gain or loss subject to a mark-to-market regime (generally gain from

[21] Reg. section 1.1061-3(d).

[22] Section 1061(c)(4)(B).

[23] Reg. section 1.1061-3(c)(3)(i).

[24] Reg. section 1.1061-3(c)(3)(ii).

[25] *Id.*

[26] Reg. section 1.1061-3(c)(3)(v)(A).

[27] Reg. section 1.1061-3(c)(3)(iii).

[28] Reg. section 1.1061-2(a)(1)(ii).

[29] Reg. section 1.1061-4(b)(7)(i).

specified futures and options contracts) is excluded.[30] Qualified dividends under section 1(h)(11)(B) are excluded.[31] Further, other capital gains and losses characterized as long term or short term without regard to the holding period rules in section 1222, including gains and losses under the mixed straddle rules in section 1092(b), are excluded.[32]

D. Related-Party Transfers

Special rules regarding transfers of API to persons related to the transferor apply. Section 1061(d) generally provides that if a taxpayer directly or indirectly transfers any API that has been held for three years or less to a person related to the taxpayer (generally defined to include a taxpayer's family members as well as persons including entities that perform or have performed services for the applicable partnership), the transfer is taxable. The final regulations provide important guidance and clarify that section 1061(d) does not accelerate gain on a transfer and that it applies only to recharacterize gain on transfers in which gain is recognized.[33] However, while section 1061(d) does not trigger the recognition of gain in otherwise tax-free transfers, such as contributions to partnerships or transfers that are often used in estate planning, any future realized gains on those transferred partnership interests would remain subject to potential section 1061 recharacterization.

E. Carry Waivers

Following the enactment of section 1061, many fund sponsors have added a concept known as a carry waiver to their fund agreements whereby the sponsor would waive its right to allocations and distributions on its carried interest to the extent that the gain is from the sale of capital assets held for three years or less. The fund sponsor then would have the right to receive in the future allocations and distributions of gain from the sale of capital assets held for over three years. The preamble to the proposed regulations under section 1061 contained a warning about carry waivers: "Similar arrangements may not be respected and may be challenged under section 707(a)(2)(A), sections 1.701-2 and 1.704-1(b)(2)(iii), and/or the substance over form or economic substance doctrines." Notably, the final regulations contain no further statements about carry waivers, although it is unclear whether anything can be inferred from that regarding the IRS's position on carry waivers. Presumably, carry waivers would be subject to an analysis similar to the one in the proposed regulations regarding management fee waivers.[34]

IV. Structure of Carried Interests

Carried interests are structured in a variety of ways. This discussion provides a summary of some of the more common carried interest structures and the circumstances in which they arise, and it notes some variations on the structures. Rather than delve into the tax allocations associated with the interests, this discussion primarily focuses on the economic entitlements of the interests and the implications for qualification as a profits interest for tax purposes. Because allocations in investment funds and real estate joint ventures typically are distribution-driven targeted allocations,[35] it seems more appropriate to focus on the economic entitlements. Moreover, the tax considerations associated with structuring profits have been well covered elsewhere.[36]

This discussion makes several simplifying assumptions for illustrative purposes. To begin with, it assumes that the structures involve a partnership with a general partner that has not made any capital contributions but has solely received a carried interest in connection with its

[30] Reg. section 1.1061-4(b)(7)(ii).

[31] Reg. section 1.1061-4(b)(7)(iii).

[32] Reg. section 1.1061-4(b)(7)(iv).

[33] Reg. section 1.1061-5(a).

[34] *See* REG-115452-14 (regulations proposed in July 2015 under section 707(a)(2)(A) on disguised payments for services).

[35] Under a targeted allocation method, tax items are allocated to cause the capital accounts of the partners to equal, as much as possible, specified capital account targets. Typically, the target capital account of each partner will be the amount the partner would receive on a hypothetical liquidation of the partnership based on the book values as of the end of the applicable tax period taking into account certain adjustments.

[36] For an excellent discussion of the history of profits interests and the tax treatment and structuring of profits interests, see Afshin Beyzaee, "Practical Considerations for Issuing Profits Interests, Part 1," *Tax Notes*, June 9, 2014, p. 1157; and Beyzaee, "Practical Considerations for Issuing Profits Interests, Part 2," *Tax Notes*, June 16, 2014, p. 1277.

performance of services and that the limited partners all have made capital contributions. However, it is common for the general partner or an affiliate to contribute a small percentage of the capital of the partnership, and the general partner or affiliate generally will be entitled to distributions in a similar manner to the limited partners. This discussion also assumes that the general partner receives its carried interest when the partnership is formed rather than after the partnership has been in existence and its assets have appreciated in value. Although this assumption is generally appropriate for a direct holder of a carried interest, it is common for the general partner to issue profits interests to individuals who provide services to the underlying partnership over time.[37] Also, this discussion assumes that the carried interest does not run afoul of the following requirements in Rev. Proc. 93-27: (1) the carried interest is not granted for a "substantially certain and predictable stream of income from partnership assets"; (2) the recipient does not dispose of the profits interest within two years of receipt; and (3) the interest is not a limited partnership interest in a PTP.

A. Basic Carried Interest Structure

In many funds and joint ventures, the distribution waterfall effectively ensures that the holder of a carried interest is entitled to treat the interest as a profits interest. This is because the partnership agreement requires that distributions including liquidating distributions be made first to the partners contributing capital until they have received all their capital back before the holder of the carried interest is entitled to receive any distributions. A typical distribution waterfall in a partnership agreement with a basic carried interest structure would have to provide for distributions to be made to the partners as follows:

1. 100 percent to the limited partners until each limited partner receives an amount equal to the capital he or she has contributed (generally in proportion to the partner's so-called percentage interest);
2. 100 percent to the limited partners until each limited partner has received distributions in an amount equal to an 8 percent preferred return per year (the return may be structured as a preferred return or an internal rate of return);
3. 80 percent to the general partner and 20 percent to the limited partners until the general partner has received an amount of distributions equal to 20 percent of the distributions made to the general partner and the limited partners under Tier 2 and this Tier 3; and
4. thereafter, 20 percent to the general partner and 80 percent to the limited partners.

There are many variations on this waterfall. For example, there may be multiple distribution tiers, with each tier providing for an increased percentage of cash flow being distributed to the general partner until a specified rate of return for that tier has been achieved.[38] The general partner may be entitled to receive as much as 40 percent or 50 percent of the cash flow in the final tier. Rates of return can be calculated in various ways. The general partner's share of cash flow after capital has returned may vary. Other variations that can affect the profits interest analysis are discussed later.

In this carried interest structure, the carried interest is granted when the partnership is formed. At that time, if there were a hypothetical liquidation of the partnership immediately after it was formed and the limited partners had contributed capital, the general partner would be entitled to no distributions based on the distribution waterfall. As a result, it is quite clear that the carried interest should qualify as a profits interest under the applicable IRS guidance.

[37] When profits interests are granted in an existing partnership, there is often an embedded limitation on the right of the recipient to receive distributions until after a "distribution threshold" is reached equal to the value of the partnership as of the date that the interest is granted in order to prevent the grantee from being able to share in the existing value of the partnership's assets. There is significant variation regarding how this limitation is implemented.

[38] For example, 25 percent of proceeds to the promote partner and the remainder divided based on percentage interests until a 14 percent return per year is reached — at which point the next tier is reached.

B. American-Style Waterfall

In a distribution waterfall commonly referred to as an American-style waterfall, distributions are typically made to the limited partners and general partner on an investment-by-investment basis, separately distributing the profits from each investment. The American-style waterfall distributes fund profits on the basis of each portfolio investment's performance, with distributions to investors and the sponsor after each investment exit. The following provides an example of how net proceeds from a sale or recapitalization of a portfolio investment are divided among investors and the general partner:

1. 100 percent to the limited partners until each limited partner has received an amount equal to its capital contributions (including related expenses) for the portfolio investment giving rise to the distributions;
2. 100 percent to the limited partners until each limited partner has received an amount equal to all prior unreturned capital contributions for previously liquidated investments and investments that have been written down or written off (including related expenses);
3. 100 percent to the limited partners until each has received distributions equal to its capital contributions for fund expenses (including management fees and organizational expenses);
4. 100 percent to the limited partners until each has received a preferred return on all amounts described in tiers 1 through 3;
5. 80 percent to the general partner and 20 percent to the limited partners until the general partner has received 20 percent of the total distributions of profits previously under Tier 4 (that is, of the preferred return) and this Tier 5;
6. thereafter, 20 percent to the sponsor and 80 percent to the investor.

Under this type of waterfall, if there were a hypothetical liquidation of the partnership immediately after it was formed, and if the limited partners had contributed capital and that capital was used to make investments, the general partner would be entitled to no distributions based on the distribution waterfall because on the sale of each investment, the limited partners would receive a return of their capital. However, in practice, the general partner can receive distributions under this waterfall before the limited partners receive all their capital back and even if the partnership never has any net profits but simply has one successful investment. This raises a potential risk that the IRS could view this arrangement as not completely complying with the spirit of Rev. Proc. 93-27's hypothetical liquidation test. Note, however, that the feature of the second tier of the waterfall requiring distributions to the limited partners of unreturned capital for previously sold investments (that is, investments sold at a loss) and written-down investments should somewhat mitigate this risk or at least suggest a good-faith effort at preventing the general partner from sharing in capital contributed by the limited partners.

Moreover, many partnerships contain a callback provision required by limited partners to ensure that their expected economic arrangement is not adversely affected by this American-style waterfall. The clawback typically applies when the general partner has received carried interest and either the investors have not received their specified preferred return on their total contributions to the fund through that point in time or the total carried interest paid to the general partner to that point exceeds 20 percent of the aggregate profits of the fund. The general partner will pay the investors the greater of (1) the amount of carried interest the general partner has received in excess of 20 percent of the aggregate profits of the fund; or (2) the amount required to provide the investors their preferred return, but usually, for amounts provided in both (1) and (2), never more than the aggregate amount of carried interest the general partner has actually received, net of the taxes it has paid on that carried interest. The clawback could occur solely at the end of the partnership's life or could be imposed on an interim basis and be accompanied by a requirement that a percentage of the distributions to the general partner be put in an escrow account. The clawback provision should provide additional support for characterizing the carried interest as a profits interest, given that the general partner over the life of the fund cannot receive distributions on the capital contributed by the limited partners (ignoring the retention of cash to pay taxes on income allocated for the previously overdistributed amounts).

C. Accelerated Distribution Feature

The general partner may want to be treated as if it had contributed its pro rata share of capital and would like to be entitled to receive distributions in an amount equal to a fixed percentage of all cash flow distributed. This can be accomplished through a catch-up mechanism under which the general partner is entitled to a priority distribution. The catch-up mechanism can vary in terms of timing and risk.

One way to structure the catch-up mechanism would be to replace the third tier in the distribution waterfall in Section IV.A above with a provision providing that 100 percent of distributable cash would be distributed to the general partner until it received an amount equal to its pro rata share of the amounts distributed to the limited partners in the first and second tiers of the waterfall. Although this is much more favorable to the general partner, it should not adversely affect the qualification of the carried interest as a profits interest because the general partner's entitlement to distributions does not begin until after the limited partners have received their capital back.

It is also possible to structure a carried interest in a manner that entitles the general partner to be treated as if it had made capital contributions for purposes of the distribution waterfall. However, this type of arrangement should be respected as a profits interest only if the recipient of the carried interest is entitled to receive only distributions that constitute profits of the partnership.

Using management fee waivers as an example, in a typical management fee waiver arrangement, the general partner of an investment fund is permitted to satisfy all or a portion of its capital commitment to the fund with deemed capital contributions. In connection with the deemed contributions, there is a reduction in the management or other fees payable by the fund to the manager that is an affiliate of the general partner. The general partner is entitled to a priority allocation of subsequent net profits of the fund, if and when they occur, equal to the amount of its deemed capital contributions to the fund. The general partner is then entitled to receive distributions in the same manner as the other limited partners, including distributions equal to its deemed capital contributions.

There are various ways practitioners can gain assurance that the interest granted in connection with the management fee waiver can qualify as a profits interest. For example, fund agreements often contain a special clawback provision under which, if the limited partners have not received cumulative distributions as of the end of the fund's life equal to the capital they contributed, the general partner or affiliate would need to return a sufficient amount of distributions it has received to the fund to allow the fund to make distributions to the limited partners in an amount at least equal to their capital contributed. Because clawback arrangements are common in fund partnership agreements in which there is an American-style distribution waterfall (discussed earlier), this feature should be familiar.

The partnership agreement could contain a provision that adjusts the partnership's distribution waterfall by providing a mechanism that requires that distributions to the general partner for the interest received in exchange for the fee waiver not exceed the amount of available profits (as determined by the general partner) that would cause the holder's interest to fail to qualify as a profits interest. Although this provision is commonly seen in connection with management fee waivers, there is some uncertainty about how to apply it in practice. And if the recipient or an affiliate has the sole discretion to make determinations regarding this provision, which is typically the case, there is some risk that the IRS may not respect this savings provision.

The IRS has viewed management fee waiver structures with significant scrutiny. In July 2015 Treasury and the IRS issued proposed regulations on disguised payments for services.[39] The proposed regulations were intended to address management fee waivers and similar economic arrangements, particularly those that lack significant entrepreneurial risk. They are

[39]REG-115452-14, 80 F.R. 43652 (proposed July 23, 2015).

especially focused on items such as the timing of waiver agreements, the character of items allocated, allocation methods, and allocation frequency and timing. The proposed regulations will apply to arrangements entered into or modified on or after the date the final regulations are published. Final regulations have not yet been issued because the project was on hold in part because of the Trump administration's regulatory executive orders. However, based on reports in tax publications, the IRS views the proposed regulations as reflecting the legislative history of the rules addressing profits interests, and it appears to be following them in audits of existing arrangements.[40] Accordingly, although these types of catch-up partnerships can be structured in a way that qualifies them as profits interests, there is a risk that the arrangements will be recharacterized as compensation, particularly if they contain features that the proposed regulations have identified as indicative of the recipient not bearing significant entrepreneurial risk.

D. Multiple Waterfalls

It is fairly common in investment fund and real estate joint venture agreements to have different distribution waterfalls for operating cash flows (for example, interest, dividends, rents, and other forms of operating profit) and proceeds from a capital event (that is, income resulting from the sale or other disposition of a fund's underlying investments). The waterfalls may differ in terms of the timing of distributions or economic entitlements of the general partner and limited partners. Often, a general partner is permitted to receive carried interest from distributions of current income (but not distributions of disposition proceeds) even if investors have not recovered any of their capital contributions. The distribution waterfall for capital proceeds follows the basic carried interest structure described earlier but takes into account distributions made under the operating cash waterfall.

Practitioners often get comfortable with the carried interest in this type of bifurcated waterfall qualifying as a profits interest, even though the general partner is entitled to share in distributions before the limited partners get their capital back, because the hypothetical liquidation construct is focused on distributions of proceeds from the sale of assets and reflects distributions of income. Moreover, distributions of operating cash flow (that is, income exceeding expenses) implicitly constitute profits. However, if there is current cash flow but the assets of the partnership are depreciating, it may be that the general partner is receiving distributions that effectively constitute capital that the limited partners have contributed. Again, the presence of a clawback if the general partner ultimately receives distributions exceeding the intended arrangement may remove some of the pressure on the tax analysis, as it serves as a limitation on the general partner receiving distributions when the limited partners have not received their capital back.

E. Hedge Fund/Open-Ended Fund Model

Carried interest arrangements in hedge funds are structured differently than in private equity funds or joint ventures. Because of the more liquid nature of a hedge fund's investments, the indefinite life of the fund, and the investors' ability to enter and exit the fund without regular intervals, the investors' economics are based on the net asset value (NAV) of the fund, which is the amount by which the value of the fund's assets exceed the amount of its liabilities as of a particular measurement date. Inherent in this arrangement is that unrealized gains and losses significantly affect the economics. The NAV determines the amount that new limited partners pay for their interests, the amount that existing limited partners receive on redemption, the relative interests of the limited partner, and the amount of management fees paid. The economic structure affects the nature of the carried interest because the general partner's entitlements to receive distributions depend on increases to the NAV.

Other open-ended funds, such as real estate and infrastructure funds, often have carried interest structures that are more like what is used by hedge funds, although it is not uncommon for

[40] *See, e.g.*, Eric Yauch, "Fee Waiver Regs on Back Burner, but IRS Enforcement Continues," *Tax Notes*, May 7, 2018, p. 894.

the fund sponsor's compensation to be solely fee-based, particularly when the strategy is focused on yield rather than asset appreciation. For these funds, given the more illiquid nature of the investments as compared with hedge funds, there are greater valuation challenges, and the measurement period for determining the general partner's entitlement to receive a carried interest may be longer (often three years). However, there is significant variation in terms of the carried interest structure for these funds. For example, the carried interest may be based solely on realized performance or solely on annual cash distributions that exceed a hurdle. For purposes of this discussion, I focus more on the hedge fund model because there is more uniformity, but the same concepts should be applicable to other open-ended funds that adopt carried interest structures.

The mechanics of the carried interest in hedge funds typically operate as follows: The general partner receives a partnership interest that entitles it to an incentive allocation, which is a percentage, typically 20 percent, of the fund's annual increase in NAV above any loss recovery account balance for each investor. An incentive allocation is typically made at the end of the year but also may be made to an investor upon that investor's full or partial redemption from the fund to ensure that the redeemed investor properly bears its share of the allocation. Because different investors invest in the fund at different times and at different valuations, the incentive allocations for each investor could differ.

Hedge funds typically provide a loss recovery mechanism. This mechanism is intended to ensure that the general partner can receive an incentive allocation only for new profits. If the fund incurs a loss, the manager has to recover those losses before it can receive an incentive allocation. To accomplish this, a high-water mark is established immediately after the allocation of the incentive allocation. As a result, an incentive allocation can be taken only on the profits above the high-water mark. The high-water mark is the fund's highest historical NAV such that if there is a loss in a year after a high-water mark being achieved, the fund's NAV has to increase sufficiently to recover the prior loss and then exceed the high-water mark. In some funds, however, the high-water mark may ignore losses incurred several years before the year of measurement. Because investors may join a hedge fund at different times, it is necessary to track high-water marks for each investor.

The fund may also have to meet a performance hurdle before the general partner is authorized to take incentive allocations on any net capital appreciation. This hurdle may be (1) a soft hurdle (in which an incentive allocation is paid on the entire appreciation if the hurdle is met) or (2) a hard hurdle (in which an incentive allocation is paid only on appreciation above the hurdle). Performance hurdles in hedge funds are analogous to the preferred return in private equity funds in that they ensure that limited partners receive some amount in excess of their capital before the general partner receives its share of fund profits.

When an incentive allocation is made, the amount of that allocation for each investor is subtracted from the investor's capital account and is added to the general partner's capital account[41] (that shift being the allocation's crystallization). Once its incentive allocation is crystallized, the general partner is not required to return that amount and may withdraw it from the fund. If not withdrawn, at the end of subsequent accounting periods, the general partner's partnership percentage and corresponding allocations of the fund's net gain or loss will be calculated including the crystallized incentive allocation. Notably, few (if any) hedge funds claw back any portion of the general partner's share of the earlier gains to recover future losses.

Because an incentive allocation is made only when there has been an appreciation in the NAV of the fund in excess of some threshold, the carried interest would seem to be a profits interest almost by definition. If there were a hypothetical liquidation of the fund immediately after it was formed, initial capital was contributed, and the carried interest was granted, the general partner would be entitled to no incentive allocation at that time because there would be no appreciation in the value of the fund's assets, thereby satisfying

[41] Note that the term "capital accounts" for this purpose is not necessarily the same as a section 704(b) book capital account because this capital account is adjusted on a periodic basis to reflect a partner's share of unrecognized gains and losses.

the requirements of Rev. Proc. 93-27. As a result, there should be little risk associated with its qualification as a profits interest.

However, the fund's assets could appreciate significantly in value in some years, drop in value in other years, and never reach the fund's initial NAV. And the general partner would still be entitled to an incentive allocation even though the fund had no aggregate profits over the indefinite life of the fund. As a result, if viewed over the life of the fund, the general partner was entitled to receive distributions of the limited partners' capital even though, in any given year, the general partner never had the right to share in anything other than profits. There is something a bit disconcerting about this possibility despite the incentive allocation's technical compliance with the requirements of Rev. Proc. 93-27.

V. Rationale for a Crystallization

A crystallization allows the sponsor to recognize the economic entitlements associated with a carried interest when a partnership's assets have appreciated in the absence of a capital event. Instead of calculating and paying the sponsor's promote on the basis of actual cash generated, the promote is calculated (and sometimes paid) upon the occurrence of a specified event that corresponds with the creation of value but does not necessarily generate cash for distribution. Crystallization of the carried interest allows the sponsor to be compensated for increases in value resulting from the sponsor's services, regardless of when a liquidity event occurs and without risk that the ultimate performance of the investment might change after the services are provided.

For sponsors — particularly those of ventures or funds in which there is a strategy to hold a property post-development for a long period, with limited opportunities for liquidity — crystallization of the promote may be attractive. Sponsor entities often need to create an incentive for key service providers, who may be less motivated if the prospect of receiving distributions on their share of the carried interest is likely to occur only in the distant future. There may be better alignment of interests between the sponsor and the investor if the sponsor has a mechanism to receive its share of the unrealized profits its efforts have helped to generate soon after those efforts have been undertaken. Further, by crystallizing the promote when the sponsor has performed most of its services, the sponsor's compensation may more accurately reflect the value the sponsor actually brought to the project, without subsequent fluctuations in value that may be unrelated to the activities of the sponsor. However, the sponsor effectively has forsaken future upside, other than on account of its adjusted interest, in exchange for crystallizing the promote early.

Crystallization can also be attractive for limited partners. As discussed, it has the benefit of giving sponsors an incentive to maximize the value of properties in the development stage, when sponsors have the greatest involvement. It also has the benefit of potentially limiting the extent to which sponsors share in future appreciation of the partnership assets, which allows the limited partners the opportunity for potentially greater returns.

VI. Mechanics of a Crystallization

A crystallization allows the holder of a carried interest to lock in the increased value of the partnership's assets by converting the promote into a straight-percentage partnership interest, based on the value of the partnership's property at the time of the crystallization.[42] It is common for the partners to agree on a specific future date at which the promote partner may elect to trigger a crystallization, such as the five-year anniversary of the partnership formation or the leasing and stabilization of a development property. The triggering event may be mandatory, or the general partner may have discretion on a particular date or window of time after an event to elect to crystallize its interest. Upon the occurrence of this event and a subsequent crystallization election, the partners would calculate the amount to which the profits interest would be entitled on a hypothetical sale of the partnership's property and immediate liquidation of the partnership, and they would express that amount as a percentage of the total proceeds of the hypothetical liquidation (the crystallized percentage).

[42]The Appendix provides an example of a crystallization provision.

There are various ways the partnership's assets can be valued in these arrangements. The value may be based on valuations conducted by the general partner or a third-party appraiser engaged by the general partner. There may be third parties that offer indications of interest and indicative pricing. There may be contemporaneous sales of partnership interests that establish a value. The parties may reduce the hypothetical sale proceeds for potential transaction costs and assume that the proceeds will first be used to repay liabilities (although what is considered a liability for this purpose is subject to negotiation). The partnership agreements containing crystallization features vary significantly in terms of mechanics for establishing valuations.

The general partner's rights regarding its crystallized interest will also vary. The general partner may have the right to cause the limited partners to purchase all or a portion of its crystallized interest. Alternatively, the general partner may have the right to cause the partnership to redeem all or a portion of its interest for cash at the time of crystallization or at some point in the future. The ability to receive cash currently may be important to the general partner and the individuals with an indirect carried interest, even though they may recognize gain in connection with the redemption to the extent that the distribution exceeds the general partner's tax basis in the partnership. The cash to redeem the partner's interest may come through operating cash flow, contributions by limited partners, sales of assets, or borrowing.

Alternatively, the general partner can elect to retain the crystallized interest, in which case the general partner and limited partners would share in distributions in proportion to their crystallized percentages. As a result, after crystallization, any future increases or decreases in value of the partnership's assets are divided based on the crystallized percentages, with no special sharing of additional profits. The partnership's distribution waterfall effectively is revised to reflect the simplified structure. The general partner in substance is left with a capital interest in the partnership, at least from an economic perspective.

The following is an example of how crystallization might work in a real estate joint venture.

Example 5: Assume that limited partners contribute $1 million to a joint venture that has a distribution waterfall as described in Section IV.A. The partnership borrows $2 million and develops the property. The general partner has the right to elect to crystallize its interest once the property has been fully developed, which is five years after the venture is entered into. The general partner makes the election to crystallize its interest. At that time, the property is worth $5 million. On a hypothetical liquidation, after the debt is repaid from the sales proceeds, the remaining $3 million would be distributed as follows: $1 million to the general partner; and of the remaining $2 million, $400,000 (20 percent) to the general partner and $1.6 million (80 percent) to the limited partners. If the general partner elects to not take any distributions in connection with the crystallization, the general partner's and limited partners' percentage interests in the partnership would be 13.3 percent and 86.7 percent, respectively. However, if the general partner elects to have a distribution equal to 50 percent of the amount it would be entitled to receive on a hypothetical distribution, the general partner's and limited partners' percentage interests in the partnership would be 92.8 percent and 7.2 percent, respectively.

Note that crystallization of the carried interest in a real estate joint venture is conceptually similar to the incentive allocation paid to the general partner in open-ended hedge funds, in which the carried interest is computed and paid on the basis of periodic determinations of the NAV of the fund's investments rather than the proceeds of asset dispositions. It is also similar to how holders of carried interests in open-ended real estate and infrastructure funds are able to get liquidity despite the long-term holding periods for the assets in those funds.

VII. Tax Treatment of Crystallization

A. Treatment as a Nonrecognition Event

Most practitioners take the position that a crystallization is not an event in which taxable gain (or loss) would be recognized. The rationale is that unlike a so-called capital shift — in which one partner effectively transfers a portion of his interest in the capital of the partnership to another partner, which would be treated as a sale of a portion of that partner's interest to the other partner — in a crystallization, the partners already are entitled to the value of the partnership's assets in the crystallized percentages and would receive those amounts upon a hypothetical asset sale and liquidation. As a result, the crystallization is merely adjusting how profits will be shared.

There is nothing in the code or regulations, and no guidance from the IRS, that explicitly addresses the tax treatment of crystallizations of carried interests. There is actually minimal guidance on how to treat any adjustment of partners' interests in the partnership, whether occurring as a result of the exercise of an option, the agreement of partners, or an automatic event built into the partnership agreement. As a result, in analyzing the tax treatment of crystallizations, one should consider general principles of subchapter K and the tax treatment of economically equivalent transactions.

When partners and partnerships wish to change how they share gain associated with unrealized appreciation in partnership assets, partnership tax experts have often questioned whether existing partners may agree to that change without causing a taxable capital shift. As noted earlier, reg. section 1.721-1(b)(1) provides guidance on when a taxable capital shift occurs, stating:

> To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred for services constitutes income to the partner under section 61.

However, according to a leading treatise on partnership taxation, "it seems quite clear that no taxable shift results" in connection with a recapitalization of a partnership, even when the manner in which the partners are sharing in unrealized appreciation in the partnership's assets is being changed.[43]

In my view, which for the avoidance of doubt has no real significance, one of the elegant features of subchapter K is that, subject to various antiabuse provisions, it allows partners to structure their relationships with each other and with the partnership as mutually agreed, with the tax consequences of those agreements being recognized over time through various basis and capital account adjustments rather than resulting in immediate taxation. As noted in an extraordinary article that offers a lot of insight into the tax considerations associated with partnership-ownership realignments, when subchapter K was enacted, the legislative history made it clear that "the principal objectives [of subchapter K] have been simplicity, flexibility, and equity as between partners."[44] There are countless ways in which subchapter K embodies those principles, including allowing contributions and distributions of property to generally be nonrecognition events, allowing for special allocations of items of income and loss, and generally respecting the desired economic arrangements of partners. Given the simplicity and flexibility that subchapter K seems to encourage, it would seem inappropriate for a simple shifting of how future partnership profits are shared to result in a recognition event, absent a specific provision to the contrary.

Under section 1001, an exchange of property is generally subject to tax unless an exception applies. Because a crystallization is merely an adjustment to the contractual arrangement among the partners, there is certainly an argument that it does not give rise to an exchange for purposes of section 1001 because there is no actual property being exchanged. However, in connection with a crystallization, arguably there could be a deemed exchange and, in some situations, deemed exchanges have been treated

[43]William McKee, William Nelson, and Robert Whitmire, *Federal Taxation of Partnerships and Partners*, para. 12.04[1] (2007). In making this statement, the treatise cites LTR 9821051.

[44]Sheldon I. Banoff, "Partnership Ownership Realignments Via Partnership Reallocations, Legal Status Changes, Recapitalizations, and Conversions: What Are the Tax Consequences?" 83 *Taxes* 105 (2005) (citing S. Rep. 1622; H.R. Rep. 1337).

as actual exchanges for purposes of section 1001. For example, regulations issued under section 1001 address the situation in which a modification of the terms of a debt instrument results in a deemed exchange.[45] The IRS has indicated through published guidance that it believes a conversion of one type of partnership interest into an interest with different rights involves a deemed exchange of property. That published guidance is discussed later.

An exchange of property generally results in a recognition of taxable gain or loss under section 1001 to the extent the amount received for the exchanged property is different from the transferor's basis in that property, unless there is an applicable nonrecognition provision in the code. If a crystallization is deemed to result in an exchange of property, in the context of partnerships, it would seem as though there are a variety of ways that nonrecognition provisions, particularly sections 721 and 731, could apply.

For example, in a construct embraced by the applicable IRS guidance (discussed later), the partners could be viewed as contributing their existing partnership interests to the partnership in exchange for new partnership interests. Subject to rules applicable to potential shifts in partnership liabilities, the contribution of partnership interests to the partnership in exchange for the new partnership interests should be tax free under section 721, and the distribution of the new partnership interests generally should be tax free under section 731.

In a slightly different construct, the partnership could be deemed to make an in-kind distribution of its assets to the general partner in redemption of its economic interest. Later, the general partner could be deemed to contribute those assets to the partnership in exchange for a new interest with its crystallized percentage. In general, ignoring potential disguised sale and hot asset issues, an actual distribution of assets would be nontaxable under section 731, and an actual contribution of assets would be nontaxable under section 721. In substance, a crystallization has the same economic effect without the complication of transferring portions of assets, given the practical restrictions associated with doing so.

Similarly, crystallization may be viewed as occurring through a deemed in-kind distribution of the partnership's assets in a deemed liquidation of the partnership, followed by a deemed contribution by the partners into a new straight-percentage partnership (although that partnership likely would be treated as a continuation of the existing one for tax purposes). Some partnership agreements with crystallization provisions actually contain provisions under which the partners agree to treat the transaction as a deemed distribution of all the partnership's assets to the partners in liquidation followed by a deemed contribution by the partners of those assets to a partnership. The general result of this approach is that the tax treatment of a crystallization would be that of contributions and distributions, which generally should be nontaxable for the general partner, the other partners, and the partnership under sections 721 and 731.

B. Applicable Guidance

Although there is relatively limited guidance on the tax consequences when partners adjust their economic interests in a partnership, the guidance that has been provided is helpful and generally concludes that those adjustments generally should be nonrecognition transactions. The relevant guidance addresses agreements to adjust sharing of partnership profits and losses, conversions of partnership interests from one type of interest into a different type of interest, recapitalizations of all partnership interests, and changes in the profit and capital sharing of a general partner's interest. In general, this authority has treated the adjustments as deemed exchanges involving a contribution of the existing interest for a new interest in a transaction that generally is tax free under section 721 or treats the adjustments as a nonrecognition event under other authority.

[45] *See* reg. section 1.1001-3.

1. *Lipke.*

Lipke[46] is the only authority addressing the application of section 761(c) that provides that a partnership agreement includes any modifications of the partnership agreement made before or at the time prescribed by law for filing the partnership return for the tax year (not including extensions). In *Lipke*, the Tax Court interpreted sections 704 and 761 in holding that changes to the partners' sharing ratios are permissible as long as the change is made in accordance with section 761(c) and the change is not attributable to a variation under section 706 — such as when a partner sells part of his partnership interest, is partially redeemed, or makes an additional capital contribution. The Tax Court held that absent a variation under section 706, such as a capital contribution, the partnership's changes "constituted nothing more than a readjustment of partnership items among existing partners which, by itself, is permissible," and it did not treat the adjustments as a recognition event.

2. Rev. Rul. 84-52.

In Rev. Rul. 84-52, 1984-1 C.B. 157, the IRS ruled that no gain or loss is realized as a consequence of the conversion of a partner's interest in a general partnership into that of a limited partner in a limited partnership. Each partner's interest in profits, losses, and capital remained the same after the conversion, although it did not appear that this fact was relevant to the IRS's conclusion. Rather than analyzing the transaction as an exchange of partnership interests, Rev. Rul. 84-52 treats the transaction as a distribution of a new partnership interest to the converting partners in exchange for a contribution of their old interests to the partnership under section 721. The revenue ruling then concludes that no gain or loss should be recognized by any converting partner unless the change in status results in a reduction in his share of partnership liabilities of sufficient magnitude to create a deemed distribution of money under section 752(b) that exceeds the adjusted basis of his partnership interest. Similarly, the revenue ruling determined that the adjusted basis of a converting partner is not affected by the conversion unless it changes his share of partnership liabilities. Further, the revenue ruling determined that there should be no change in a converting partner's holding period for his partnership interest under section 1223(1). Finally, although no longer applicable under current law, the IRS concluded that there was no technical termination of the partnership under section 708(b)(1)(B). Note that the treatment adopted by the IRS in Rev. Rul. 84-52 suggests that the conversion should be treated as a realization event rather than a nonevent, albeit generally a nonrecognition event under section 721.[47]

Similarly, in Rev. Rul. 95-37, 1995-1 C.B. 130, and Rev. Rul. 95-55, 1995-2 C.B. 313, the IRS ruled that the conversion of an interest in a partnership to an interest in a limited liability company and limited liability partnership, respectively, is subject to the same treatment as provided in Rev. Rul. 84-52. In LTR 201745005, relying on the same analysis as was used in Rev. Rul. 84-52, the IRS ruled that the conversion of an LLC to a limited partnership will not result in recognition of income, gain, or loss. Several other rulings on applicable partnership conversions have reached the same conclusion as Rev. Rul. 84-52.[48] Note, however, that the IRS has reached the conclusion in a couple of instances while citing Revenue Ruling 84-52 that there was no exchange of partnership interests.[49]

One curious aspect of Rev. Rul. 84-52 and some of the subsequent rulings is that there seems to be some inconsistency between the characterization of the restructuring as a contribution of existing interests in exchange for new partnership interests subject to section 721 and some of the IRS's analysis of the tax consequences of the conversion transactions. For example, in Rev. Rul. 95-37, the IRS concluded that section 706(c)(2)(A), which provided that the tax year of a partnership closes for any partner who sells or exchanges the partner's entire

[46] *Lipke v. Commissioner*, 81 T.C. 689 (1983).

[47] For an excellent discussion of partnership continuations generally and the conversion rulings in particular, see Phillip Gall, "Nothing From Something: Partnership Continuations Under Section 708(a)," University of Chicago Federal Tax Conference (2016).

[48] *See, e.g.*, LTR 9350013, LTR 9226035, LTR 8904061, and LTR 8542044.

[49] *See* LTR 8448060 and LTR 8448062.

interest in the partnership, was not implicated by the conversion, even though the IRS found there to be a deemed contribution of existing interests in exchange for new interests. Rev. Rul. 84-52 contains a similarly curious interpretation regarding the technical termination rules of section 708(b)(1)(B).[50] Moreover, as discussed later in this report, there are many issues not addressed in these rulings that could be implicated if the conversions were treated as actual contributions of existing interests in exchange for the restructured interests. It is almost as though the IRS is using the construct of contribution of existing partnership interests in exchange for restructured interests to arrive at general nonrecognition treatment while ignoring that construct in applying other provisions of subchapter K that are implicated in an actual exchange of partnership interests. Oddly, the IRS arguably reaches the right answer in its conclusions (or lack of raising issues), but the logic is inconsistent.

3. LTR 200345007.

In LTR 200345007, the IRS reached a similar conclusion as it had in Rev. Rul. 84-52 regarding an LLC that had only one class of shares outstanding and converted those shares into different classes having differing rights, preferences, privileges, and restrictions. The IRS ruled that the members were not required to recognize gain or loss on the exchange of their old shares for the new ones, subject to potential consequences from shifts in liabilities. Moreover, the letter ruling concluded that holders of the new shares could exchange them for other differing interests without having to recognize gain or loss. The IRS cited sections 721, 741, and 1001 as well as Rev. Rul. 84-52 in its analysis. Nonetheless, the IRS did not explicitly state that it was treating the conversion at issue as an exchange of property.[51]

4. ILM 201517006.

The position that a promote crystallization generally is not a recognition event is also supported by ILM 201517006. That internal legal memorandum analyzed whether a restructuring of a general partner's interest in a PTP was taxable. The general partner owned a straight-percentage capital interest and a profits interest that was not publicly traded. The restructuring occurred when the profits interest had accrued significant value, and the holder effectively converted that interest into common units and a new and less valuable profits interest. The IRS concluded that this was a nontaxable readjustment of partnership items under section 761, with no changes in the effective economic ownership of the partnership as of that point in time.

In support of that conclusion, the IRS cited *Lipke* for the proposition that year-end reallocations of profits or losses, even though retroactive, are permissible among existing partners if additional capital is not contributed. The IRS further noted that Rev. Rul. 84-52 concluded that the conversion of general partnership interests into limited partnership interests will not cause partners to recognize gain but did not treat the transaction as a deemed contribution of existing interests in exchange for modified partnership interests.

ILM 201517006 certainly supports the position that a crystallization generally should be a nontaxable event. However, two specific aspects of the memorandum involve facts that are not present in many partnership crystallizations: (1) the partnership was a PTP (for which there are specific rules regarding the holding period under reg. section 1.1223-3(c)(2)(i) based on the fact that different units in a PTP can be more specifically identified than interests in a non-publicly traded partnership); and (2) the partner's corporate parent contributed cash to the partnership immediately before the restructuring such that there was a book-up event. Although it is unclear whether the IRS's conclusion would apply in the absence of either of those factors, it seems reasonable to extend the rationale of the memorandum to broader circumstances.

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[50] *See* Gall, *supra* note 47. *See also* Monte A. Jackel and Robert J. Crnkovich, "Partnership Conversions: Making Something Out of Nothing," *Tax Notes*, July 20, 2009, p. 275.

[51] Similarly, in LTR 8238066, the IRS ruled that the conversion of general partnership interests into limited partnership interests with a reduced interest in the partnership's profits "will not constitute a sale or exchange of such interests." *See also* LTR 9821051 (change to economic arrangement of partners by amendment "will not result in the realization of income").

C. Other Tax Consequences

Although it would appear that changes to partners' interests in partnership profits such as those that occur in connection with a crystallization generally should be tax free, there are several situations in which other provisions in subchapter K could apply to cause gain or loss recognition or otherwise affect basis and capital accounts. The extent to which these provisions could be applicable should depend in part on the construct used to analyze the crystallization. Notably, the tax considerations associated with recapitalizations beyond the basic issue of whether they are recognition transactions have been thoughtfully discussed elsewhere, but it is relevant to the discussion of crystallization to take these considerations into account.[52]

1. Changes in allocations.

It should be unsurprising that allocations of profits and losses and items of income, gain, loss, deduction, and credit will change in connection with a crystallization. Because the way in which distributions are made going forward will change, tax and book allocations should follow. Similarly, allocations of losses necessarily will change because the general partner will bear the economic detriment of any decline in value of the partnership's assets.

There are many situations in which allocations must be made in a particular way under the applicable regulations based on how other partnership items are shared. For example, the partnership's reallocation of profits also can affect allocations of nonrecourse deductions among the partners. The regulations provide generally that nonrecourse deductions may be allocated in a manner that is reasonably consistent with allocations that have substantial economic effect on some other significant partnership item attributable to the property securing the nonrecourse debt.[53] For example, before the crystallization, the partners may have shared nonrecourse deductions based on an 80-20 percent split of residual profits, whereas after the crystallization, they may share in nonrecourse deductions based on their crystallized percentages.

Allocations of tax credits and recapture cannot have substantial economic effect and therefore must be allocated in accordance with the partners' interests in the partnership as of the time the credit or recapture obligation arises.[54] However, if a partnership expenditure that gives rise to a tax credit in a partnership tax year also gives rise to valid allocations of partnership loss or deduction (or other downward capital account adjustments) for that year, the partners' interests in the partnership for that credit shall be in the same proportion as those partners' respective distributive shares of that loss or deduction (and adjustments). In both cases, the allocations for tax credits and recapture may shift as the way in which the partners will be sharing in profits and losses going forward will shift.

Also, as discussed later, assuming that there is a contemporaneous book-up or one soon thereafter, the partners will be subject to section 704(c) on their shares of items of built-in gain at the time of the crystallization. In general, this will require the service-providing partner to be allocated tax items to take into account the disproportionate amount by which his tax basis for the partnership's assets is lower than his share of the FMV of those assets.

2. Liability shifting.

It seems appropriate and necessary to take into account the consequences of changes to a partner's share of partnership liabilities when considering the tax consequences of a crystallization. In allocating a partnership's nonrecourse debt among the partners under section 752, a partner's share of the debt equals the sum of the partner's share of (1) partnership minimum gain, (2) section 704(c) minimum gain, and (3) excess nonrecourse debt of the partnership as determined in accordance with the "partner's share of profits," as provided in reg. section 1.752-3(a)(3). Because a crystallization necessarily will change how a partner's share of profits is determined, there likely would be a change in how nonrecourse liabilities are allocated.

[52] *See* Jeffrey Erickson, "Recapitalizations of Partnerships: General Issues Under Subchapter K," Tax Management Memorandum (Mar. 22, 2004); and Banoff, *supra* note 44.

[53] Reg. section 1.704-2(e)(2).

[54] Reg. section 1.704-1(b)(4)(ii).

The applicable guidance from the IRS indicates that under section 721, a change in how partners share profits is a deemed exchange that will not result in the recognition of gain or loss under section 741 or 1001, except to the extent that section 731 requires gain to be recognized from a deemed distribution of cash under section 752(b). Any shift in liabilities could cause the partners to recognize gain under section 731 to the extent that the amount of liabilities that are reallocated exceeds the tax basis of the partner experiencing the reduction in allocated liabilities. Presumably, the amount of any liability shift should be determined by comparing the partners' shares of liabilities before and after the crystallization.[55]

A shift in liabilities could trigger the disguised sale of property rules under section 707(b), which treat shifts in liabilities as potential proceeds from the sale of the property contributed to the partnership. If the partnership has borrowed funds within the two years before the crystallization on the deemed contribution of property by each partner to the partnership under the exchange approach adopted by the relevant IRS guidance, the partners conceivably could be deemed to contribute property subject to liabilities that are not qualified liabilities. How the disguised sale rules would work mechanically is unclear. In a situation in which there is no actual property contribution and the application of the rules is uncertain, it seems inappropriate for the disguised sale rules to apply. However, there is no guidance on this point.

3. Disguised sale of partnership interests.

As counterintuitive as it might seem, a crystallization might be treated as a disguised sale of a partnership interest under section 707(a)(2)(B) if there is a related contribution of cash by one or more partners to the partnership. The risk seems significantly greater and more appropriate if there is a corresponding cash distribution to the carried interest partner in redemption of a portion or all its crystallized interest. However, the risk could also be present in connection with crystallization of an interest in a hedge fund or other open-ended fund in which there are periodic capital contributions being made by new or existing partners, and the general partner has the right to receive distributions on its crystallized interest.

Section 707(a)(2)(B) gives Treasury authority to treat some transactions involving contributions of cash by specified partners and distributions of cash or property to other partners as disguised sales of partnership interests. Section 707(a)(2)(B) provides that those transfers could be treated as disguised sales of partnership interests under regulations prescribed by Treasury if:

> (i) there is a direct or indirect transfer of money or other property by a partner to a partnership,
>
> (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and
>
> (iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property.

Regulations on disguised sales of partnership interests have yet to be issued, although regulations had been proposed but were later withdrawn.[56] Even though regulations have not been issued, one arguably should consider the potential application of the statute, the principles in the proposed regulations, and other guidance.[57] Note that some practitioners have argued that section 707(a)(2)(B) cannot be invoked by the IRS in the absence of implementing Treasury regulations.[58] However, that does not appear to be the view of Treasury and the IRS.[59]

[55]Reg. section 1.752-1(f).

[56]The regulations (REG-149519-03) were proposed November 26, 2004, and withdrawn January 21, 2009. *See* Announcement 2009-4, 2009-8 IRB 597.

[57]The IRS has ruled that some contributions and distributions should be treated as disguised sales of partnership interests. *See* TAM 200037005 and FSA 200024001. For contrary authority, see *Communications Satellite Corp. v. United States*, 625 F.2d 997 (Ct. Cl. 1980); and *Jupiter Corp. v. United States*, 2 Cl. Ct. 58 (1983).

[58]*See, e.g.*, Samuel Grilli, "Can the IRS Currently Contend That Here Has Been a Disguised Sale of a Partnership Interest?" 123 *J. Tax'n* 289 (2015); Richard M. Lipton, "Can There Be a Disguised Sale of Partnership Interests?" 4 *J. Passthrough Entities* 5 (Jan./Feb. 2001); Blake D. Rubin and Andrea Macintosh Whiteway, "New Developments in Disguised Sales of Partnership Interests," 3 *J. Passthrough Entities* 8 (Nov./Dec. 2000).

[59]*See, e.g.*, Yauch, "Revamped Disguised Sale Rules Are in Draft Form, IRS Says," *Tax Notes Federal*, Feb. 8, 2021, p. 1007.

Theoretically, the IRS could view a crystallization as a disguised sale of a partnership interest in light of the potential deemed contribution of existing partnership interests and a deemed distribution of "new" partnership interests. However, the application of these rules in this context makes little sense. The carried interest partner is receiving a partnership interest with the same economic value as the interest exchanged based on a hypothetical liquidation analysis and is retaining that interest. The carried interest partner is not receiving any of the cash contributed. Moreover, the crystallization is occurring either automatically or under the exercise of an option, neither of which is typically a realization event.

However, if there is an actual redemption of all or a portion of the crystallized interest of the partner previously holding the carried interest, the potential application of the disguised sale of partnership rules seems somewhat more compelling. In that instance, if the limited partners contribute cash and, shortly thereafter, the general partner receives a distribution of cash in redemption of a portion of its crystallized interest, there is a risk that the combined contribution and distribution could be viewed as part of an integrated transaction. For funds in which there would regularly be periodic contributions of cash by new or existing investors in the ordinary course, the risk of integration seems less likely, particularly given that all dispositions of interests in the fund are carried out through redemptions. However, in joint ventures in which there is a single limited partner, there may be reasonable arguments to treat the cash contribution followed by redemption as a disguised sale. While the form of redemptions has generally been respected, the tax benefits of treating the transaction as a partial redemption (for example, basis recovery) are potentially meaningful for the general partner and could be challenged under section 707(a)(2)(B).

4. Mixing bowl and similar rules.

Theoretically, a crystallization could implicate the anti-mixing-bowl rules of sections 704(c)(1)(B) and 737 and similar provisions. Sections 704(c)(1)(B) and 737 can trigger gain when a partner contributes appreciated property to a partnership and there is a related distribution of property to the contributing or noncontributing partners. Section 704(c)(1)(B) applies if contributed property is distributed to another partner within two years of the contribution. If a distribution is subject to section 704(c)(1)(B), the contributing partner is required to recognize gain or loss to the extent of the gain or loss that would be allocated to the contributing partner under section 704(c) had the contributed property been sold for its FMV. While application of section 704(c)(1)(B) primarily affects the contributor of the distributed property, the distributee partner may also be affected because the basis of the distributed property would be adjusted immediately before its distribution.[60] Under section 737, if a partnership makes a distribution of property to a property-contributing partner within seven years of the contribution, the distribution triggers gain (but not loss) to the extent of the lesser of (1) the excess of the FMV of the distributed property over the redeemed partner's basis in its partnership interest (reduced, but not below zero, by any distributed money) or (2) the amount of pre-contribution gain.[61]

Similar rules are implicated under section 731(c). Section 731(c) is designed to prevent some distributions of marketable securities from qualifying as tax-free distributions under section 731(a). Under section 731(c), if there is a distribution of marketable securities, the securities are treated as cash rather than property so that if the amount of marketable securities distributed exceeds the tax basis of the distributee partner, there will be gain recognition.

Despite the seemingly inappropriate application of these rules to a crystallization, it is possible that the deemed contribution of an existing appreciated partnership interest under the construct adopted by the IRS in the rulings discussed above or even a hypothetical distribution and recontribution of assets under alternative constructs should be treated as a contribution for purposes of the anti-mixing-bowl rules. However, because there is no actual

[60] Section 704(c)(1)(B)(iii).

[61] Section 737(a).

contribution, as a purely technical matter, it would seem as though sections 704(c)(1)(B) and 737 should be inapplicable. The abusive situations targeted by the anti-mixing-bowl rules are not implicated here because none of the partners are trying to effectively dispose of an interest in appreciated property acquired outside the partnership. It would seem to be a misconstrued extension to apply the anti-mixing-bowl rules in these circumstances.

5. Ancillary tax issues.

Although a thorough discussion is beyond the scope of this report, a variety of other partnership tax provisions could be implicated in connection with a crystallization, particularly if the crystallization is treated as a transfer of partnership interests. For example, various aspects of section 706 — including how to allocate tax items for a year in which there has been a transfer of a partnership interest and the rules for determining the partnership's tax year — could be affected.[62] The PTP rules under section 7704 and various technical aspects of the regulations under section 7704 may need to be considered if a crystallization is treated as a transfer of a partnership interest. Various recapture rules or rules allowing previously suspended losses could be applicable.

The sale of a partner's interest before 2018 could cause a technical termination of the partnership under section 708(b)(1)(B) if 50 percent or more of the total interests in partnership capital and profits was sold within a 12-month period. For transfers on or after January 1, 2018, however, section 708(b)(1)(B) is no longer applicable to sales because the TCJA repealed this provision. Notably, some IRS rulings described earlier suggest that a technical termination is not triggered, presumably under the theory that no sale or exchange of a partnership interest has occurred.

Under section 721(b), gain realized on a contribution of property to a partnership is ineligible for tax-free treatment if the partnership would be an "investment company" within the meaning of that term provided in the regulations under section 351(e), if the partnership were incorporated. Although section 721(b) likely would be inapplicable because, in connection with a crystallization, each partner would be transferring identical assets (an interest in the existing partnership), if other assets are contributed to the continuing partnership, those contributions could be taken into account in determining whether the partners could be subject to tax under section 721(b).

Similarly, under section 721(c), despite the application of section 721(a), a U.S. person will realize gain when that person contributes section 721(c) property to a section 721(c) partnership. Section 721(c) property is, generally, appreciated property. A section 721(c) partnership is a partnership in which the U.S. person and one or more related foreign persons own at least 50 percent of the partnership interests. Section 721(c) provides an exception for partnerships that adopt a gain deferral method, which generally requires the partnership to, among other things, use the remedial allocation method for the contributed property. Theoretically, section 721(c) could be applicable to a crystallization, although it would take a very aggressive promote structure under which the general partner would end up with 50 percent or more of the profits of the partnership to even implicate these rules. Moreover, the application of section 721(c) in the context of a crystallization would be somewhat absurd.

D. Book-Ups

One of the thornier issues with crystallizations is whether the crystallization can be treated as a permissible book-up event under which each partner's book capital account is increased to reflect the current value of his share of partnership assets. As a technical matter, adjustments to the manner in which partners share in profits of the partnership is specified by the regulations as an event in which partners can restate their capital accounts. However, it is fairly common for partnerships to treat the reallocation as a book-up event despite the technical challenges.

When particular events occur to alter the economic arrangements among partners, a revaluation provision allows the partners' capital

[62] Reg. section 1.706-1(b)(4)(ii).

accounts to be increased or decreased to reflect the current value of the partnership's assets.[63] The book-up will cause a restatement of the partners' capital accounts as if the partnership had sold its assets for their FMV with the resulting gains (and losses) allocated to the preexisting partners under the terms of the partnership agreement. If the interests in the partnership change — for example, as a result of a new partner buying into the partnership based on the FMV of partnership assets and not historic capital contribution value, without an adjustment to the partners' capital accounts — the relative capital accounts may not reflect the actual economic deal among the partners. Moreover, there could be adverse tax implications for the partners if there is not a revaluation of the capital accounts when there is a change in the economic arrangements of the partners.

In the context of a crystallization, if the capital accounts are not booked up, the service-providing partner could be adversely affected economically, or the capital-contributing partners may be adversely affected from a tax perspective, depending on how the partnership agreement is drafted. If the partnership agreement provides that liquidating distributions are made in accordance with positive capital account balances, the service-providing partner's book capital account would not accurately reflect the value of his interests. His rights to liquidating distributions would not accurately reflect the post-crystallization economic arrangement (that is, the service provider would not have received the benefit of the pre-crystallization appreciation in the value of the partnership because that unrealized appreciation would not be reflected in his capital account). As a result, if there were a liquidation of the partnership, and if there were insufficient profits allocated to that partner before in connection with the liquidation, the service-providing partner may receive fewer distributions in liquidation than he would have if the capital accounts had been booked up.

Conversely, if there is no book-up, appropriate tax allocations to take into account the partners' relative interests in the built-in gain or loss of the partnership's assets may not be made. A book-up preserves the preexisting appreciation of the partners as built-in gain in the existing partnership assets as if those partners had contributed those assets to the partnership. Thus, the amount of the book-up in each asset is treated as an amount in which the tax basis of an asset differs from its FMV under section 704(c) to be allocated, when recognized, to the partners based on their shares of pre-crystallization appreciation under the principles of section 704(c), which generally apply when a partner contributes appreciated property to a partnership to properly allocate pre-contribution gain to that partner. Practitioners refer to these allocations as reverse section 704(c) allocations. If there is no book-up, the service-providing partner may not be allocated a sufficient amount of built-in gain when a particular asset is sold because the tax gain would be allocated in proportion to book gain rather than allocated disproportionately to the service-providing partner, who has a disproportionate amount of built-in gain. While this may merely be a timing issue, there could be character mismatches or loss limitations applicable on liquidation when the non-service-providing partners would otherwise be able to claim losses on the prior allocations in excess of their shares of gain.

Under the applicable regulations, a revaluation of partnership assets is permitted when the following events occur[64]:

1. the contribution of money or other property to the partnership by a new or existing partner in consideration for an interest;
2. the liquidation of the partnership or a distribution of money or other property to a retiring or continuing partner as consideration for an interest;
3. the grant of an interest in the partnership as consideration for the provision of services for the benefit of the partnership by an existing or new partner;
4. the issuance by the partnership of a noncompensatory option; and

[63] Reg. section 1.704-1(b)(2)(iv)(f).

[64] Reg. section 1.704-1(b)(2)(iv)(f).

5. under generally accepted industry accounting practices, if substantially all of the partnership's property consists of stock, securities, commodities, options, warrants, futures, or other instruments that are readily tradable on an established market.

The regulations state that only on the occurrence of one of these five events may a partnership increase or decrease the capital accounts of the partners to reflect a revaluation of the partnership assets. In practice, there is a difference of opinion among practitioners about whether a crystallization itself is sufficient to trigger a book-up or whether the partners must undertake an additional specific act (such as contributing additional capital) to trigger a book-up under the applicable regulations. I understand that some practitioners treat the crystallization itself as a book-up event, notwithstanding the lack of clear guidance in the regulations.[65] Other practitioners are uncomfortable with this approach and would wait until one of the enumerated book-up events occurs. At a minimum, partnership agreements often state that a book-up event is intended at the time of crystallization.

Proposed regulations under section 751(b), issued in November 2014, would add two more elective revaluation events: (1) agreements to change (other than a de minimis change) the manner in which the partners share any item or class of items of income, gain, loss, deduction, or credit of the partnership under the partnership agreement; and (2) a revaluation by either an upper-tier partnership or a lower-tier partnership.[66] Although not entirely clear from the language used in the proposed regulations, the first of these events seemingly would cover a crystallization, given that it is an agreement that changes the method for sharing future tax items from the manner in which existing unrealized items are shared. It certainly would be helpful to have clarification on this issue.

E. Profits Interest Characterization

For the same reasons described above when considering whether the structure of carried interest in hedge funds and other open-ended funds can qualify as a profits interest, it would seem that the existence of a crystallization feature should not itself disqualify a carried interest from profits interest treatment. If there were a hypothetical liquidation of a partnership in which a service provider received a carried interest immediately after the partnership was formed and initial capital was contributed, the service provider would not be entitled to any distributions at that time because there would be no appreciation in value of the partnership's assets. Under the basic distribution waterfall, the service provider would not be entitled to receive anything until after the other partners received their capital back. As a result, the interest of the service-providing partner would seem to meet the basic requirements of Rev. Proc. 93-27.

Because a crystallization adjusts the way that partners share in profits going forward based on the economic entitlements of the partners under a hypothetical liquidation of the partnership on the crystallization date, any such adjustment would be based on an appreciation of value of the partnership's assets. The crystallization does effectively convert what had been a profits interest into a capital interest, but it only does so to the extent of unrealized appreciation. It would seem difficult to argue that a subsequent recapitalization involving an interest that was clearly a profits interest when granted should cause the profits interest to no longer qualify.

However, there is the possibility that the partnership's assets depreciate significantly in value after the crystallization event and that the capital-contributing partners do not get their capital returned based on the post-crystallization waterfall. The service-providing partner would be entitled to receive distributions under the post-crystallization waterfall despite the partnership's having had no aggregate profits. As a result, if viewed over the life of the partnership, the service-providing partner would be entitled to received distributions of the other partners'

[65] *See, e.g.*, Banoff, *supra* note 44 ("It is assumed that in the real world (not the tax world), the partners will restate their capital accounts if there is unrealized gain or loss, even though the reallocation is not an event described in Treas. Reg. section 1.704-1(b)(2)(iv), and the profit and loss reallocations will be based on the partners' modified interests solely in future profits and losses.").

[66] REG-151416-06.

"capital" even though at the time of crystallization, the service-providing partner only received a capital interest for a portion of the partnership's unrealized profits at that time. As with many of the carried interest structures described above, this possibility does suggest that the crystallization right gives the holder something more than a mere right to share in future profits of the partnership. Nevertheless, the presence of a crystallization right should not cause the interest to run afoul of the IRS guidance under Rev. Proc. 93-27.

VIII. Tax Treatment on Sale of Interest

A. In General

In general, section 1222 provides that long-term capital gain is gain from the sale of a capital asset held for over one year. This applies both to the sale of capital assets held by a partnership for over one year and to the sale of a partnership interest held by the partner for over one year. However, as discussed earlier, this general rule was modified by the TCJA, which introduced a new section 1061 that provides a special rule for profits interests. Under section 1061, any capital gain on "applicable partnership interests" held by a taxpayer is treated as short-term capital gain if the partnership interests or underlying assets being sold are held for three years or under, rather than one year or under.

B. Holding Period Consequences

If a crystallization generally is treated as a nontaxable event, the question arises whether crystallization should have any effect on the holding period for an API. There are several different ways that a crystallization event could affect a service provider's holding period for its API. The potential section 1061 implications of a crystallization could differ depending on whether the crystallized interest is received for realized or unrealized gains. Interestingly, the New York State Bar Association was divided on which approach should be adopted when making recommendations in response to proposed regulations under section 1061.[67]

1. Not an API.

Upon crystallization, a "new" straight-percentage partnership interest is received. It could be argued that this new percentage interest is not an API and that the entire partnership interest should be governed by the standard one-year holding period rules. The argument is that the new interest is received not for services provided but rather in exchange for a deemed contribution of the existing profits interest. Under this approach, a partner with a carried interest could effectively avoid the provisions of section 1061 by converting his profits interest to a capital interest, even if that conversion occurred before the end of the three-year holding period and the crystallization itself would not result in any gain being recognized on the reallocation of profits.

Some arguments could support that treatment. First, one could argue that this is the precise result that could occur if the crystallization were in fact carried out through in-kind distribution of partnership property followed by a contribution of that property to a new partnership. The property contributed would have built-in gain, but the partner would receive a standard capital interest in exchange for this value and would be subject only to the default one-year holding period under section 1221. Second, in crystallizing the interest, the promote partner has effectively given up any special rights to share disproportionately in future profits of the partnership. There are economic consequences to the partners going forward, and this economic substance should mitigate any suggestion that a crystallization was designed only to achieve a favorable tax result. One additional note is that if the post-crystallization interest were treated as a new capital interest, it would presumably have to be held for the standard one year after receipt to be eligible for long-term capital gain, which could actually be more onerous in scenarios in which the profits interest had already been held for three years before crystallization and would already

[67] NYSBA Tax Section, "Report on Proposed Regulations Under Section 1061," Rep. No. 1442, at 22, 43 (Oct. 5, 2020).

have qualified for long-term capital gain treatment.

2. All or a portion of the crystallized interest is an API.

An alternative position is that the newly crystallized interest is effectively the same interest as the profits interest — but with some future economics readjusted — and therefore continues to be an API. In this case, the holding period would "tack" (that is, the partner would still need to hold the interest for a total of three years) because the profits interest was an API on receipt. The three-year holding period would begin as of the initial grant of the interest, such that the pre-crystallization and post-crystallization periods would count together toward this three-year requirement. This approach is consistent with the general nonrecognition treatment of the crystallization.

Note, however, that this treatment would seem inappropriate to the extent that the crystallized interest is received for realized gains. For example, if a hedge fund general partner's carried interest is crystallized annually and the increase in its capital account includes allocations for realized gains as well as increase attributable to unrealized gains, only the portion of its crystallized interest attributable to unrealized gains should be treated as an API subject to section 1061. To the extent that it receives an interest for realized gains (that is, the fund does not distribute but instead reinvests those proceeds), the general partner should be treated as though it had received an actual distribution of the proceeds and contributed the cash to the fund for a capital interest. If this bifurcated approach is followed, the general partner would only be subject to a three-year holding period for new investments and a tacked holding period for its partnership interest to the extent that its crystallized interest is received in connection with unrealized appreciation.

Regarding a crystallized interest received for assets that have not yet been sold, the rationale for treating that interest as an API is that section 1061(a)(1) applies to long-term capital gains "with respect to" that API, and those gains continue to be "with respect to" an API until they are realized. Moreover, until that appreciation is recognized and taxed, those amounts should not actually be treated as part of the general partner's capital. This can be differentiated from a situation in which the fund recognizes sale proceeds and those proceeds could in fact be distributed to and contributed by the general partner.

Note that the complexity of tracking which component of a partner's interest is an API versus a capital interest and allocating subsequently recognized gains to the different types of interests could be considerable, particularly if there are annual crystallization events over the life of a fund.

3. New API.

Theoretically, the newly crystallized interest could be treated as a new API with a new three-year holding period starting as of the date of crystallization. It seems difficult to argue that the crystallized interest is a new interest and received for services, because the existing profits interest is being exchanged for the post-crystallization interest. Nevertheless, it is a possibility, albeit clearly the wrong approach.

The final regulations adopted the bifurcated approach discussed above in which a crystallized interest received for assets that have not yet been sold is treated as an API with a tacked holding period, and a crystallized interest received for assets that have been sold is treated as a capital interest. Under the final regulations, a partnership interest will be treated as having been contributed in exchange for a capital interest to the extent that realized amounts are reinvested (either as a result of an actual distribution and recontribution to, or the retention of those amounts by, the partnership).[68] However, the final regulations clarify that gains must be realized before the holder of an API receives credit for purposes of the capital interest exception, and therefore, a fund manager cannot get credit for unrealized gains. As a result, unrealized gains that are allocated to the capital account of a holder of an API as a result of a book-up or other revaluation event are not eligible for treatment as a deemed contribution in exchange for a capital interest.

Notably, the final regulations only address the reinvestment of "API gains" (that is, long-term capital gains, as determined under one-year

[68] Reg. section 1.1061-3(c)(3)(iii).

holding period rules) by a service provider in a partnership resulting either from an actual distribution and recontribution of the API gain or the retention of the API gain by the partnership. However, the rule in the final regulations treating the interest received for the reinvestment of those gains as eligible for capital interest treatment does not appear to apply to taxable items recognized for a partnership asset, such as short-term capital gains, dividends, or interest income. Hopefully, this will be addressed in subsequent guidance from Treasury or the IRS.

IX. Conclusion

Although the "favorable" tax treatment provided to recipients of carried interests may soon be coming to an end in light of the strong political pressure to tax any income derived from a carried interest at ordinary income rates, carried interest structures are still an important incentive compensation technique for fund managers and sponsors. The crystallization of a carried interest, which is a feature that provides the holder of a carried interest with the right to restructure the interest to capture the increased value of the interest at a future date by converting the interest into a straight-percentage partnership interest, has become common in many carried interest structures. However, the tax treatment of a crystallization and its effects on the holder's carried interest have received little discussion in the tax literature. This report seeks to offer some thoughts on these issues.

As discussed, in light of the authority applicable to other types of partnership recapitalizations, it would appear that a crystallization should generally be treated as a nonrecognition event, subject to potential gain recognition for liability shifting. Although there are a variety of partnership antiabuse rules, such as the rules applicable to a disguised sale of property or partnership interests and the anti-mixing-bowl rules, it seems inappropriate for those rules to apply in connection with a simple adjustment to the sharing of future profits. Even though a crystallization is not technically a book-up event (although proposed regulations, if finalized, would appear to add it to the list of permissible book-up events), in many instances it will be important to adjust the partners' capital accounts in connection with a crystallization to ensure that the partners receive the appropriate economic and tax treatment following a crystallization. Further, a crystallization should not itself disqualify an interest that is otherwise treated as a profits interest for tax purposes, even though after a crystallization, the carried interest holder could receive distributions that effectively constitute a portion of the other partners' capital.

The final regulations under section 1061 have provided guidance on how a crystallization should affect a carried interest for purposes of section 1061, essentially adopting a bifurcated approach when a crystallized interest received for assets that have not yet been sold is treated as an API with a tacked holding period, and a crystallized interest received for assets that have been sold is treated as a capital interest. However, some aspects of how these rules will apply, particularly in terms of how they apply to other types of income recognized by a partnership, remain unclear.

X. Appendix

Carried Interest Crystallization.

(a) During (x) the Initial Carried Interest Crystallization Period or (y) if Manager does not deliver a Carried Interest Crystallization Notice during the Initial Carried Interest Crystallization Period, the Second Carried Interest Crystallization Period, Manager shall have the one-time right by written notice to Investor given during the applicable Carried Interest Crystallization Period (the "Carried Interest Crystallization Notice"), to elect (which election, except as set forth in subsection (c), shall be irrevocable) to convert its Promote Interest into additional Company Interests in the Company (an "Interest Crystallization") in accordance with the terms of this section. If Manager issues a Carried Interest Crystallization Notice and on the date such Carried Interest Crystallization Notice is issued the Subsidiary Property Owner has entered into a binding or nonbinding letter of intent or term sheet for a Financing of the Project that is intended to close within one hundred eighty (180) days following the date of such Carried Interest Crystallization Notice (such Financing, the "Subject Financing"), then Manager shall have the right to include in such

Carried Interest Crystallization Notice an election (such election, a "Partial Cash Crystallization Election") to receive, to the extent there are sufficient Net Proceeds of a Capital Transaction from the closing of the Subject Financing, a cash payment equal to a percentage (which percentage (i) shall be specified in such Carried Interest Crystallization Notice and (ii) shall be equal to or less than fifty percent (50 percent)) (such percentage, the "Cash Crystallization Percentage") of the Deemed Carried Interest Distribution Amount and to convert the remainder of the Deemed Carried Interest Distribution Amount into additional Company Interests in the Company (a "Partial Interest Crystallization"). If Manager does not make a Partial Cash Crystallization Election in the Carried Interest Crystallization Notice, then Manager's right to make a Partial Cash Crystallization Election pursuant to this *subsection (a)* shall be deemed waived and Manager shall have no further rights to make a Partial Cash Crystallization Election.

(b) If Manager issues a Carried Interest Crystallization Notice during the Carried Interest Crystallization Period:

(i) The Stipulated Fair Market Value shall be determined as set forth in *Exhibit [ ]*; provided, however, (i) if Manager has made a Partial Cash Crystallization Election and has not subsequently delivered a 100 percent Interest Crystallization Notice, then (x) if the Company receives a copy of the appraisal commissioned by the lender of the Subject Financing (the "Financing Appraisal") prior to the Subject Financing Outside Date, the Stipulated Fair Market Value shall be determined based on the Financing Appraisal and (y) if the Financing Appraisal is not received prior to the Subject Financing Outside Date, the Stipulated Fair Market Value shall be determined as set forth in *Exhibit [ ]* or (ii) if Manager has made a Partial Cash Crystallization Election and subsequently delivered a 100 percent Interest Crystallization Notice, then the Stipulated Fair Market Value shall be determined as set forth in *Exhibit [ ]*.

(ii) On the Interest Crystallization Effective Date, Managing Member shall calculate (or cause to be calculated), subject to approval by Investor, the Carried Interest Distributions that would be received by Manager upon a Hypothetical Liquidating Distribution (such amount, the "Deemed Carried Interest Distribution Amount"); and

(iii) Subject to *subsection (c)*, on the Interest Crystallization Effective Date, (A) Investor's Percentage Interest shall be automatically adjusted to equal (x) if Manager has (i) not made a Partial Cash Crystallization Election or (ii) made a Partial Cash Crystallization Election but subsequently timely delivered a 100 percent Interest Crystallization Notice, the Investor Fully Converted Percentage Interest or (y) if Manager has made a Partial Cash Crystallization Election and has not subsequently delivered a 100 percent Interest Crystallization Notice, the Investor Partially Converted Percentage Interest, (B) Manager's Percentage Interest shall be automatically adjusted to equal (x) if Manager has (i) not made a Partial Cash Crystallization Election or (ii) made a Partial Cash Crystallization Election but subsequently timely delivered a 100 percent Interest Crystallization Notice, the Manager Fully Converted Percentage Interest or (y) if Manager has made a Partial Cash Crystallization Election and has not subsequently delivered a 100 percent Interest Crystallization Notice, the Manager Partially Converted Percentage Interest, (C) Manager's Percentage Interest shall be automatically adjusted to equal (x) if Manager has (i) not made a Partial Cash Crystallization Election or (ii) made a Partial Cash Crystallization Election but subsequently timely delivered a 100 percent Interest Crystallization Notice, the Manager Fully Converted Percentage Interest or (y) if Manager has made a Partial Cash Crystallization Election and has not subsequently delivered a 100 percent Interest Crystallization Notice, the Manager Partially Converted Percentage

Interest (an example of the calculation set forth in the foregoing clauses (A), (B), and (C) is attached hereto as *Exhibit [ ]*), (D) if Manager has made a Partial Cash Crystallization Election and has not subsequently delivered a 100 percent Interest Crystallization Notice, the Company shall redeem a portion of Manager's Promote Interest in exchange for the Company distributing the Partial Cash Crystallization Redemption Amount to Manager (the "Redemption"), (E) the Manager Promote Interest shall be deemed extinguished and all future distributions of Net Cash Flow and Net Proceeds of a Capital Transaction shall be distributed to the Members in proportion to their respective Percentage Interests, as adjusted in accordance with the terms of this *section [ ]*, (F) all allocations of Profits and Losses shall be made to the Members in proportion to their respective revised Percentage Interests, (G) the Manager Members and Investor shall execute an acknowledgment of contribution and extinguishment substantially in the form attached hereto as *Exhibit [ ]*, and (H) the Members intend that (i) the conversion of Manager's Promote Interest pursuant to an Interest Crystallization or a Partial Interest Crystallization shall not be treated, for federal income tax purposes, as an event that would cause the recognition of taxable gain, (ii) at or about the time of such Interest Crystallization or Partial Interest Crystallization, as applicable, the Capital Accounts of Investor and Manager shall be adjusted in the nature of a "book-up" so as to be in proportion to their respective Percentage Interests, and (iii) subsequent allocations of income, gain, loss, and deduction with respect to such asset shall take into account any variation between the adjusted basis of such asset for federal income tax purposes and its Gross Asset Value in the same manner as under Code section 704(c) and the Treasury Regulations thereunder, using such methods with respect to allocations relating to the Property as determined by Investor in its sole discretion.

(c) In the event that Manager has made a Partial Cash Crystallization Election and the Subject Financing is not consummated by the Subsidiary Property Owner within one hundred eighty (180) days following the date of the delivery of the Carried Interest Crystallization Notice (such date, the "Subject Financing Outside Date"), then Manager shall have the right by delivery of written notice to Investor within five (5) days following the Subject Financing Outside Date to withdraw the Carried Interest Crystallization Notice (such notice, a "Redemption Withdrawal Notice") or elect to have Manager's entire Promote Interest converted into additional Company Interests in the Company in accordance with the procedures set forth in *subsection [ ]*(such notice, a "100 percent Interest Crystallization Notice"). If Manager shall fail to deliver a Redemption Withdrawal Notice or 100 percent Interest Crystallization Notice within five (5) days following the Subject Financing Outside Date, then Manager shall be deemed to have delivered a Redemption Withdrawal Notice. If Manager delivers or is deemed to deliver a Redemption Withdrawal Notice, then Manager shall have the right to deliver a new Carried Interest Crystallization Notice during the Carried Interest Crystallization Period. Notwithstanding anything to the contrary contained in this Agreement, the Members hereby agree that, notwithstanding the fact that Manager may have made a Partial Cash Crystallization Election, no Member shall be under any obligation to consent to causing the Company to cause the Subsidiary Property Owner to enter into the Subject Financing or any other Financing and the terms of the Subject Financing and any other Financing shall be subject to the approval of each Member in its sole and absolute discretion and no Member shall be under any obligation to ensure that the Net Proceeds of a Capital Transaction resulting from the closing of the Subject Financing or any other Financing are sufficient to effectuate the Partial Cash Crystallization. For the avoidance of doubt, in no event shall any Member be obligated to make any Additional Capital Contribution to pay the Partial Cash Crystallization Redemption Amount. For purposes of clarity, in the event that

(i) Manager has made a Partial Cash Crystallization Election, (ii) the Subject Financing or any other Financing is approved by the Members in accordance with the terms hereof and consummated by the Subsidiary Property Owner on or prior to the Subject Financing Outside Date, and (iii) Net Proceeds of a Capital Transaction resulting from the closing of such Subject Financing or other Financing are sufficient to effectuate the Partial Cash Crystallization, then the Partial Cash Crystallization Redemption Amount shall be paid to Manager notwithstanding any other provision of this Agreement and any additional Net Proceeds of a Capital Transaction resulting from the closing of such Subject Financing or other Financing shall be distributed to the Members in accordance with their respective Percentage Interests, as adjusted in accordance with this *section*.

(d) Upon completion of the Interest Crystallization or the Partial Interest Crystallization, as applicable, in accordance with the provisions of this *section*, the Manager's Promote Interest shall be deemed extinguished and all future distributions of Net Cash Flow and Net Proceeds of a Capital Transaction shall be distributed to the Members in accordance with their respective Percentage Interests, as adjusted in accordance with this *section*.

(e) Notwithstanding anything to the contrary herein, each Member shall pay its own attorney fees and expenses in connection with the extinguishment of the Manager Promote Interest pursuant to this *section*.

(f) Notwithstanding anything to the contrary contained in this Agreement, Manager shall not be permitted to exercise its rights pursuant to this *section [ ]* from and after the delivery of a notice of Material Default by Investor to the Manager Members (unless it is determined in any arbitration proceeding that no Material Default has occurred).

(g) If Manager does not deliver a Carried Interest Crystallization Notice during the Carried Interest Crystallization Period, then Manager's right to cause an Interest Crystallization pursuant to this *section* shall be deemed waived and Manager shall have no further rights pursuant to this *section*.

(h) Any disputes as to the determination of the Deemed Carried Interest Distribution Amount, the Investor 100 percent Interest Crystallization Conversion Percentage, the Investor Partial Interest Crystallization Conversion Percentage, the Manager Investor 100 percent Interest Crystallization Conversion Percentage, the Manager Investor Partial Interest Crystallization Conversion Percentage, the Manager 100 percent Interest Crystallization Conversion Percentage, or the Manager Partial Interest Crystallization Conversion Percentage under this *section* shall be resolved by expedited arbitration in accordance with the terms of *section [ ]* and such determination shall be binding on the Members. ■