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AUGUST, 2015

IRS TARGETS MANAGEMENT FEE WAIVERS IN PROPOSED REGULATIONS

As expected, the most aggressive waivers may be subject to recharacterization under new rules.

Background

Treasury released long-awaited proposed regulations targeting the most aggressive uses of management fee waivers. Investment funds have used waivers as a tax reduction device, but many investors don't understand the mechanics.

Typical Fund Structure

The "2 and 20" deal

As background, fund organizers almost always structure the fund to be taxable as a partnership under U.S. tax laws. The organizers typically benefit from two payments streams: (1) all right to 2% of the fund's invested capital (the "management fee"), and (2) a share of 20% of fund profits net of expenses (a "profits interest," often though inaccurately referred to as a "carried interest"). For most funds, the general partner contributes 1% of fund capital and holds the 20% profit interest; an affiliated, non-partner entity holds the right to the management fee, which it may periodically waive in exchange for an offsetting increase to the general partner's profits interest.

Consider the following example of a hypothetical $100 million fund with $22 million of profit in a given year. (Further, assume the fund has repaid all capital contributions. The parties are entitled to the amounts in Chart 1:

Chart 1: "Default" arrangement:

Party	Proceeds
Management company	$2M (2% of $100M)
General partner	$4M (20% of $20M)
Limited partners	$16M (80% of $20M)

The management company first receives its 2% management fee, and the partners share in the remaining $20 million of net gain according to the traditional 80/20 split.

Now, compare the parties' proceeds in the event the management company waives its fee for the year:

Chart 2: Fee waiver with offsetting profits interest:

Party	Proceeds
Management company	$0
General partner	$6M ($2M + 20% of $20M)
Limited partners	$16M (80% of $20M)

The limited partners don't experience a change in their economic interest in this example. (Of course, limited partners could benefit from a fee waiver if the fund ultimately lacked sufficient profits to grant the offsetting profits interest.) Instead, the general partner and management company have essentially traded their right to the management fee amount, but due to ownership overlap, no pretax economic change occurs. (Fund sponsors employ special allocation mechanics upon a fee waiver where ownership between the two entities varies in proportion.)

Tax Treatment

The incentive to waive

As illustrated, fund sponsors don't waive fees to alter the economic deal, but do so instead for tax reasons. Under default treatment (Chart 1), the management company is required to report the fee as ordinary income — currently taxed at a maximum rate of 43.4%. With the waiver (Chart 2), the general partner receives the increased profits interest that is potentially taxed as long-term capital gain — currently taxed at a maximum rate of 23.8%.

Often, partnership tax rules are "zero sum" — any change creating a tax benefit to one partner typically creates an equal and offsetting tax detriment to one or more other partners. Without waiver (Chart 1), the limited partners are allocated $17.6 million of capital gain and $1.6 million of loss, which is most likely characterized as an investment expense, subject to deduction limitations (typically deductible only if itemizing, reduced by 2-percent-of-AGI floor, and subject to phase-out of up to 80% for high income taxpayers). Overall the limited partners may owe tax on the entire $17.6 million of capital gain without offset for the fee.

By contrast, the limited partners in a waiver situation (Chart 2) are taxed only on their allocated capital gain of $16 million. In effect, they receive the benefit of the deduction for their portion of the fee by having gain allocated away from them and toward the general partner. So, both fund

sponsors and limited partners (other than tax-exempt partners) benefit from fee waivers in most cases, raising IRS concern. Tax practitioners have advised that more aggressive forms of waiver could be recharacterized by the IRS as either a "guaranteed payment" or a "non-partner" payment — either of which would preclude the preferential tax treatment motivating the waiver.

Proposed Rules

Emphasizing "entrepreneurial risk"

In the proposed regulations (REG-115-452-14), the IRS restates the existing test for treating payments as "non-partner" service payments when: (i) a partner (or would-be partner) performs services for the partnership, (ii) the partnership makes a related (direct or indirect) allocation and distribution to that service provider, and (iii) the transactions are "properly characterized" as occurring between the partnership and a non-partner, when viewed together.

More importantly, the proposed rules provide six factors for determining when an arrangement is "properly characterized" as a disguised service payment. The factors consider whether the service provider:

- Lacks entrepreneurial risk
- Holds a partnership interest for a short term
- Receives the entitlement relatively close in time to providing the services
- Became a partner for tax-motivated reasons
- Is entitled to a small amount of overall partnership profits in relation to the entitlement at issue
- Receives differing amounts with respect to differing services, the services are provided by one person (or related persons), and the terms of the differing amounts are subject to varying levels of entrepreneurial risk

The IRS sourced the first five factors from congressional legislative history, and consistent with Congress's direction, weights the first more heavily. However, the IRS added the sixth factor, which clearly targets fee waivers.

Additionally, the IRS presumes that an arrangement lacks "entrepreneurial risk" if any of five elements are present:

- The entitlement is capped (and the cap is reasonably expected to apply in most years)
- The entitlement is of a relatively certain amount
- The entitlement is computed as an amount of gross income
- An entitlement is "predominantly fixed in amount," is "reasonably determinable," or is "designed to assure that sufficient net profits are highly likely to be available" to fund the entitlement
- The entitlement is related to a service provider's waiver of right to payment, if the waiver is non-binding or fails to timely notify the other parties of the waiver and its terms.

Under these new rules, the IRS could easily challenge many of the more aggressive forms of fee waivers by invoking the fifth factor in instances where the waiver was made late or was structured as a non-binding waiver. By contrast, fund sponsors may continue to use more conservative fee waivers, but this may require introducing real risk of losing the management fee in exchange for potentially lower taxes. (Some believe these new rules may encourage funds to introduce compensation structures closer to a "1 and 25" deal.) However, the IRS could still challenge conservative fee waivers under the new rules by pointing to the "relatively certain amount" factor that presumes lack of entrepreneurial risk, so we'll have to wait to see how this area evolves.

Minimum Allocations

An unexpected change

Also, the IRS made a small but important change to the "guaranteed payment" rules, despite using the "non-partner payment" rules to target fee waivers. The proposed regulations revise an example that effectively changes longstanding position on partner minimum payments. Currently, a partner that is entitled to a distributive share, but subject to a minimum allocation amount, can avoid "guaranteed payment" characterization with respect to the entire allocation, provided the distributive share is enough to clear the hurdle.

The newly proposed rules, however, would impose "guaranteed payment" treatment to the floor amount in all events.