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CLIENT
MEMORANDUM

N.Y. ATTORNEY GENERAL INVESTIGATES PRIVATE EQUITY MANAGEMENT FEE WAIVERS

As reported in the press over the weekend, the New York Attorney General's Office is investigating the so-called "management fee waiver structure" used by many advisors to private equity funds and has already issued subpoenas to a number of private equity fund managers. The investigation highlights the need of private equity fund managers to carefully review their fund documents and tax strategies.

Under the management fee waiver structure, the advisor waives some or all of its fees in exchange for future fund profits up to the amount that would have been received if the waived fee were actually invested in the fund. If structured and implemented properly these profits, if realized, should be taxed to the advisor at the lower rates applicable to investment income while both deferring such income until recognized by the fund and allowing individual fund investors to avoid the limitations that apply to deductions for management fees.

This tax strategy developed out of the same rules that allow the advisor's "carried interest" to be treated as investment income from the fund (i.e., as capital gains, assuming the fund produces capital gains), which is principally a federal tax benefit and permits income to be deferred from the time the fees would have been paid until the time the fund recognizes investment income. In New York City, however, the strategy also avoids the unincorporated business tax, and it generally avoids New York state income tax for the advisor's nonresident members. Although the New York investigation necessarily concerns only the New York tax treatment of the strategy, it has received national attention because the strategy's validity under New York tax law depends almost entirely on its validity under federal tax law.

Most tax advisors generally view the relevant federal law as strongly favoring taxpayers, though over the last 15 years the strategy has involved many variations and evolved differently among private equity firms. A few commentators in the press have characterized some of these variations as being more "aggressive" than others.

In this context, "aggressiveness" generally refers to features of the strategy indicating that (1) the advisor could have actually taken the waived amount at the time of the waiver or (2) the ultimate receipt of the waived amount is not really subject to investment risk because it is not payable exclusively from *future* profits (e.g., some of the profits are "pre-baked" at the time of the waiver). Assessing levels of aggressiveness generally depends on when the waiver is made relative to when the fee would otherwise be paid, how the waiver is applied in respect of investments made by the fund (e.g., the extent to which the advisor can "cherry pick" investments) and whether and to what extent profits from investments in respect of which the waiver was not applied can be utilized to recover losses (or the lack of profits) from investments to which the waiver was applied (including even from investments made before the waiver date).

To our knowledge, however, all of the strategy's commonly used variations require waiver before the tax year in which the fee would otherwise be paid and preclude the advisor from receiving anything in the absence of future profits from fund investments, as clearly measured for the period starting after the waiver date. Under federal law, those two conditions are the clear touchstones of the strategy's validity. For those taxpayers who generally adhere to these conditions, we would not expect that the investigation ultimately would result in tax adjustments. For funds that elect to defer the management fee at a time close to when the fee would otherwise be paid (e.g., in the same tax year as payment) or allow the potential for the advisor to receive profits from investments made prior to the waiver, there may be incremental risk, depending on the focus of the investigation and the specific manner in which the arrangements are structured.

It is important to note that under the same proposed federal legislation that would tax carried interest as ordinary income, the income from the management fee waiver structure would also be taxed as ordinary income. For this reason, if such proposed legislation becomes more likely to be passed, private equity fund advisors should consider strategies for avoiding the application of the legislation at least to the value of the waiver structure that accrued prior to the waiver date.

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