CLIENT MEMORANDUM

New Proposed Tax Regulations Regarding Private Equity Management Fee Waivers

August 3, 2015

AUTHORS

James R. Brown | **Anthony J. Carbone** | **Hillel N. Jacobson** | **Joseph A. Riley**

On July 22, 2015, the U.S. Department of the Treasury and the Internal Revenue Service proposed new partnership tax regulations addressing payments and allocations of income for services.[1] These proposed regulations, released under section 707(a)(2)(A) of the Internal Revenue Code (the "Code"), would affect, among other things, the treatment of certain management fee waiver structures used by private equity funds.

Under certain management fee waiver structures, the advisor to the private equity fund waives some or all of its fees in exchange for future fund profits generally up to the amount that would have been received if the waived fee had been actually paid to the advisor and then reinvested by the advisor into the fund. The result of the structure is that these profits, if realized, would be taxable to the advisor at the rates applicable to investment income when the income is recognized by the fund. Also, such amounts would not be a management fee deduction to investors.

Whether an arrangement constitutes a payment for services under the proposed regulations generally depends on whether there is "significant entrepreneurial risk." The preamble to the proposed regulations notes that the Congressional intent was to distinguish between advisors that extract the profits of the fund based on the business success of the fund,

---

[1] See the previous Willkie Farr & Gallagher LLP Client Memorandum, "N.Y. Attorney General Investigates Private Equity Management Fee Waivers" (Sept. 4, 2012), available here.

compared to advisors that receive payments for their services that are not subject to this risk. Accordingly, the proposed regulations provide specific examples of circumstances in which there is a high likelihood that the advisor will receive income regardless of the overall success of the fund. However, the proposed regulations are clear that the analysis is one of facts and circumstances, as described in more detail below. Investment advisors should therefore consider reviewing their existing management fee waiver structures in light of the analysis set forth in the proposed regulations and they should further consider whether any amounts recharacterized as payments for services could be subject to the deferred compensation rules in section 409A or 457A of the Code.

The Proposed Regulations

The proposed regulations provide six factors for determining whether or not the profits received as a result of the waived management fee should be characterized as payment for services. As discussed above, the most important factor in determining whether or not an arrangement constitutes a payment for services is that the allocation and distribution is subject to significant entrepreneurial risk. Under the proposed regulations, an advisor's clawback obligation at the end of the fund that is based on the fund's overall profitability is evidence of significant entrepreneurial risk. In addition, in determining whether the advisor's entrepreneurial risk is "significant," the advisor's entrepreneurial risk should be measured against the fund's entrepreneurial risk, not some absolute level of entrepreneurial risk. An arrangement that lacks significant entrepreneurial risk constitutes a disguised payment for services.

The proposed regulations indicate that certain facts and circumstances create a presumption that an arrangement lacks significant entrepreneurial risk (unless other facts and circumstances establish the presence of significant entrepreneurial risk by clear and convincing evidence), specifically if the management fee waiver structure provides for:

(i) capped allocations of fund income if the cap is reasonably expected to apply in most years,

(ii) an allocation for one or more years under which the advisor's share of income is reasonably certain,

(iii) an allocation of gross income,

(iv) an allocation (under a formula or otherwise) that is predominately fixed in amount, is reasonably determinable under all the facts and circumstances, or is designed to assure that sufficient net profits are highly likely to be available to make the allocation to the advisor, or

(v) an arrangement in which an advisor waives its right to receive payment for the future performance of services in a manner that is nonbinding or fails to timely notify the fund (and the partners in the fund) of the waiver and its terms.

An example in the proposed regulations finds that an allocation to an advisor does not have significant entrepreneurial risk if (i) the allocation is an allocation of net profit from any 12-month accounting period in which the fund has net gain; (ii) the fund invests in illiquid investment assets and the sale of the assets is controlled by persons related to the advisor; and (iii) the advisor does not have a clawback obligation.

The proposed regulations include five additional factors that indicate that the profits received as a result of the waived management fee are disguised payments for services. These factors are nonexclusive and are of secondary importance to the significant entrepreneurial risk factor in performing the analysis. These factors are:

(i) that the advisor holds, or is expected to hold, a transitory interest in the fund or an interest in the fund for only a short duration,

(ii) that the advisor receives an allocation and distribution in a time frame comparable to the time frame in which a nonpartner service provider would typically receive payment,

(iii) that the advisor became a partner in the fund primarily to obtain tax benefits that would not have been available if the services were rendered to the fund in a third-party capacity,

(iv) that the value of the advisor's interest in general and continuing fund profits is small in relation to the allocation and distribution, and

(v) if the arrangement provides for different allocations or distributions with respect to different services received, where the services are provided either by a single person or by related persons (for purposes of section 707(b) or 267(b) of the Code), and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly.

The proposed regulations would be effective on the date the final regulations are published in the Federal Register and would apply to any arrangement entered into or modified on or after the date of publication of the final regulations. However, the proposed regulations note that for transactions that predate the date the final regulations are published in the Federal Register, section 707(a)(2)(A) and the guidance provided by the legislative history to that section apply. Note that Treasury and the IRS believe that the proposed regulations reflect the legislative intent in the statute and legislative history and it is possible that they may apply the substance of these regulations before they are finalized.

Impacts on IRS Revenue Procedure 93-27

IRS Revenue Procedure 93-27 provides that when a partner in a partnership receives a profits interest in the partnership for the provision of services, if the arrangement comes within a safe harbor, the receipt of such interest will not be a taxable event for the partner or the partnership. One of the requirements of the safe harbor is that the partner does not dispose of the profits interest within two years of receipt. The preamble to the proposed regulations provides that Treasury and the IRS have determined that a transaction in which an advisor of a fund waives its service fee and a party related to the advisor receives future fund profits does not come under the safe harbor in Revenue Procedure 93-27 because the transaction would not satisfy the requirement that receipt of a profits interest be for the provision of services to or for the benefit of the partnership in a partner capacity or in anticipation of being a partner, and because the advisor's constructive transfer of the profits interest to the related party would constitute a disposal of the profits interest.

In addition, Treasury and the IRS intend to issue a revenue procedure providing for an additional exception to the safe harbor in Revenue Procedure 93-27 in the case of a profit interest issued in conjunction with a partner forgoing payment of an amount for the performance of services that is substantially fixed (including a substantially fixed amount determined by formula, such as a fee based on a percentage of partner capital commitments).

If you have any questions regarding this memorandum, please contact James R. Brown (212 728-8287; jbrown@willkie.com), Anthony J. Carbone (212 728-8291; acarbone@willkie.com), Hillel N. Jacobson (212 728-8655; hjacobson@willkie.com), Joseph A. Riley (212 728-8715; jriley@willkie.com) or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is an international law firm with offices in New York, Washington, Houston, Paris, London, Frankfurt, Brussels, Milan and Rome. The firm is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our fax number is (212) 728-8111. Our website is located at www.willkie.com.

August 3, 2015