CLIENT ALERT

IRS Proposes Rules Curbing Fee Waivers

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On July 22, 2015, the IRS proposed regulations that, if and when finalized, will adversely affect many fee waiver and similar arrangements traditionally used by private equity funds to convert fee-based ordinary income to tax-preferred capital gains. The IRS has taken a dim view of such arrangements for several years, and the proposed regulations further crystallize the IRS' position.

Under these proposed rules, a carried interest received by a management company or general partner in exchange for a waived management fee may be taxable on receipt or recharacterized as ordinary income when realized. Importantly, even though the proposed regulations are not effective until finalized, the IRS has indicated that it views the proposed regulations as reflective of current law, indicating that fund sponsors can expect that the IRS may apply these positions in audits with respect to waived fees. To be clear, the proposed regulations should not affect the tax treatment for carried interests in general or the tax treatment of fee waivers that are not related to a priority allocation and distribution to the general partner (*i.e.*, waivers or reductions of fees granted in side letters or to affiliates of general partners).

Background

In many fund structures, the general partner (or its management company affiliate) is entitled to receive carried interest and a management fee. Under many limited partnership agreements, the general partner reserves the right to waive its management fee in exchange for an additional special carried interest. In some cases, this fee waiver is hard-wired such that the general partner is not paid a fee but rather has rights to priority allocations and distributions since fund inception. The profits of private equity funds are generally capital gains taxable at more favorable rates than ordinary income.

Proposed Regulations – The Good, the Bad, and the Ugly

The IRS proposed regulations provide that, in certain cases, an allocation of profits will be treated as a disguised payment for services, taxable as ordinary income, and subject to the deferred compensation rules of Code sections 409A and 457A. While six factors are considered in making this determination, the most important factor is whether the recipient of the carried interest has "significant entrepreneurial risk." In other words, in exchange for capital gains treatment, a general partner must give up the relative certainty of receiving the amount. Furthermore, if the general partner's regular carried interest is subject to a clawback, the proposed regulations suggest that any carried interest received in lieu of a management fee must also be subject to a clawback.

The IRS has illustrated these rules with several examples. In the "bad" example, an investment manager is entitled to a priority allocation and distribution of net gain from the sale of any asset during any 12-month accounting period in which the partnership has overall net gain. The priority allocation is intended to approximate the fees that would normally be charged for the management services. The general partner of the fund, which controls the manager, is able to control the fund's sale of assets as well as the timing of distributions. Given the nature of the assets in which the fund will invest, the IRS concludes in the example that the amount of gains allocable to the manager is highly likely to be available and reasonably determinable upon formation of the partnership. The general partner has a carried interest of 10 percent based on the profits of the fund over its life. While the general partner's carried interest is subject to a clawback, the priority allocations and distributions are not. The IRS concludes in the example that the general partner's carried interest is subject to entrepreneurial risk but the manager's allocation is a disguised payment for services and taxable as to ordinary income. Importantly, the example did not involve a fee waiver, but rather recharacterized a priority allocation built into the fund agreements.

In the "good" example provided by the IRS, the investment manager has a right to a two percent investment fee, but can waive that fee for a year at least 60 days before the year begins. If the manager waives the fee, the manager receives a carried interest intended to have a present value approximately equal to the waived fee. However, the amount of net income or gain allocable to the manager is neither highly likely to be available nor reasonably determinable based on the facts and circumstances at the time of the waiver. Furthermore, the manager agrees to a clawback obligation with respect to the carried interest received in lieu of the management fee.

However, even in this "good" example, the general partner may not realize the anticipated benefits of a carried interest received in lieu of a management fee. The preamble to the proposed regulations also provides that the IRS intends to change the "profits" interest safe harbor when it finalizes the regulations discussed above. Under this safe harbor, a properly structured carried interest is generally deemed to have zero value for tax purposes on the date of grant. As a result, the recipient does not have taxable ordinary income upon receipt of a carried interest. The IRS proposes to change the safe harbor so that it would not apply to a carried interest received in exchange for a waived fee. That is, even if a carried interest is respected as an equity interest and is not recharacterized as a disguised fee, the carried interest may not be eligible for the profits interest safe harbor. In that case, the IRS presumably could assert that the management company should be taxable upon receipt of the carried interest, based on the value at the time of grant.

Takeaways

Fee waivers have been under heightened scrutiny for several years. While the proposed regulations leave a number of questions unanswered, the IRS does make clear that when carried interests are subject to sufficient "entrepreneurial risk," they may pass muster. Nevertheless, once the regulations are finalized, the IRS' position may be that a carried interest received in exchange for a fee waiver still must be taxed on grant. Thus, these regulations when finalized will significantly curtail the economic value of traditional fee waivers.

The proposed regulations may be found here.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.