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Treasury Department and IRS Release Proposed Regulations on Management Fee Waivers

On July 22, 2015, the Treasury Department and the IRS released proposed regulations regarding fee-waiver arrangements commonly used by private investment funds. If finalized, the new rules would recharacterize certain partnership interests received in connection with fee waivers (“waived-fee interests”) as disguised compensation arrangements that result in ordinary income.

In the government’s view, the proposed rules, though not yet effective, generally reflect current law and congressional intent. In preamble language, the government also states that an existing administrative safe harbor treating certain grants of “profits interests” as nontaxable events will be interpreted and revised to exclude waived-fee interests. As a result, even if a waived-fee interest is not deemed to be a disguised compensation arrangement, the government may take the position that it is taxable on receipt.

Taken together, these are significant developments that may adversely affect many existing fee-waiver arrangements, with collateral consequences under other tax rules governing the taxation of current and deferred compensation.

Background

An example of a fee-waiver arrangement may involve (1) an advance waiver by a management company of its right to a portion of fees payable by the investment fund for future services; and (2) the receipt by the fund’s general partner of a waived-fee interest in future profits, calculated by reference to the amount of the waived fee and in certain cases the performance of one or more investments. The additional waived-fee interest is intended to be a “profits interest” for tax purposes that is nontaxable on receipt and that generates payments whose tax character is based on the related profits (typically capital gains, dividends, and interest), and the manager is intended not to realize ordinary income on a current basis in connection with the grant.

The Proposed Regulations

A facts-and-circumstances test applies under the proposed regulations to determine whether a waived-fee interest is recast as a disguised compensation arrangement that generates payments taxable as ordinary income. The key factor is whether the waived-fee interest arrangement “lacks significant entrepreneurial risk” relative to “the overall entrepreneurial risk” of an investment in the relevant fund. If there is a disguised compensation arrangement, managers will need to consider whether the potentially punitive executive compensation “anti-deferral” rules of Code Sections 409A and 457A apply.

The proposed regulations provide a non-exclusive list of factors that presumptively cause a waived-fee interest arrangement to lack sufficient entrepreneurial risk, including:

- A right of the waived-fee interest recipient to receive an allocation of a capped amount of profits (e.g., an amount that approximates the amount of foregone fees), where the cap is reasonably expected to be met in most years.
- An allocation of gross (not net) profits to the waived-fee interest recipient.
- A right of the waived-fee interest recipient to receive allocations of net profits from specific transactions or specific accounting periods that do not depend on the long-term success of the investment fund.

- Arrangements where the fee waiver is not binding or not made in advance of the period with respect to which the relevant management fees would accrue or where partners are not timely notified of the waiver. The proposed regulations suggest that it is sufficient to deliver notice 60 days prior to the year for which the fee would otherwise be payable.

It often will not be clear whether a particular arrangement runs afoul of these presumptions. The proposed regulations do not, for example, clearly indicate whether there is sufficient “entrepreneurial risk” where, as is common, the amount allocable in respect of the waived-fee interest is tied to the amount of distributions the recipient would have received if it had invested an amount of capital equal to the waived fee amount in a specific transaction. The proposed regulations suggest that taxpayers may demonstrate the presence of sufficient “entrepreneurial risk” if the waived-fee interest is subject to a clawback obligation at the end of the investment fund’s life based on the fund’s overall profitability, but there is scant guidance on the details of qualifying clawback arrangements.

Existing Guidance on Profits Interests

Since 1993, the government has provided a safe harbor to the effect that the issuance of a “profits interest” in return for services to or for the benefit of a partnership is not a taxable event provided certain tests are satisfied, including that the partner not dispose of the interest within two years. However, in the preamble to the proposed regulations, the government asserts that where a management company waives a fee and a different party (such as the general partner) receives a waived-fee interest, the favorable 1993 safe harbor does not apply. This line of reasoning may also implicate structures where a “special limited partner” (and not a general partner) is entitled to receive carried interest distributions. The government also states that it intends to issue guidance to the effect that the safe harbor does not apply to the grant of a waived-fee interest to the management company waiving the fee. Accordingly, the government may begin to assert in examinations that, even if a waived-fee interest is not a disguised compensation arrangement, the receipt of the waived-fee interest is a taxable event. This position would reflect a dramatic departure from current practice and could significantly alter the intended treatment of fee-waiver arrangements.

If you have any questions with respect to these developments, please contact a member of Ropes & Gray’s [tax](#) or [benefits](#) practice groups.