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KIRKLANDPEN
Private Equity Newsletter

July 24, 2015

IRS Issues Proposed Regulations on Management Fee Waivers

PENpoints

The proposed regulations, if finalized in their current form, would likely curtail the use of certain elements common in existing fee waiver arrangements.

On July 22, Treasury and the IRS (collectively, "IRS") issued new proposed regulations addressing private equity ("PE") fund management fee waivers and similar arrangements in which a service provider (e.g., a PE fund manager) receives an interest in future partnership profits in lieu of receiving a current fixed payment for services. The objective of the proposed regulations is to determine whether such a profit allocation made as part of a fee waiver arrangement should be respected as a true allocation of partnership profits (which, for a PE fund, typically consists primarily of long-term capital gains and qualified dividends) or whether the arrangement should be re-characterized as a disguised fee taxable to the fund manager as ordinary income.

The proposed regulations, if finalized in their current form, would be more anti-taxpayer than IRS officials previously suggested[1] and are likely to be controversial. There is a 90-day comment period for the proposed regulations, which then may be revised prior to finalization. However, if finalized in their current form, they could adversely affect certain longstanding and widely used management fee waiver practices that fund managers and their advisors generally have viewed as consistent with existing tax law and guidance.

Traditional Management Fee Waiver Arrangements

Although there are many permutations, in a typical management fee waiver arrangement the fund manager foregoes a portion of the management fees otherwise payable to it by the fund in exchange for an additional allocation of the fund's future profits (primarily long-term capital gains and qualified dividends), if any. Such an election to waive fees may be made at the fund's inception and/or periodically during the fund's life.

In some arrangements, the waived fee amount is treated as an investment by the fund manager that earns a positive or negative return identical to actual cash invested in the fund. In other arrangements, the future allocation of fund profits is capped at the amount of the waived fee.

Importance of Entrepreneurial Risk

The proposed regulations specify certain factors that IRS believes must be considered in determining whether a fee waiver arrangement should be respected or re-characterized. The most important factor is whether the arrangement has "significant entrepreneurial risk." Under the proposed regulations, an arrangement lacking significant entrepreneurial risk would automatically be re-characterized as a fee subject to ordinary income treatment. The proposed regulations state that "significant entrepreneurial risk" is presumed not to exist where one or more of the following elements are present:

- the arrangement is "highly likely" to result in profits for the fund manager at least equal to the waived fee amount (as an example of this, the regulations cite "an allocation of net profits from specific transactions or accounting periods [that] . . . does not depend on the long-term future success of the enterprise");[2]
- the special profit allocation is capped (e.g., limited to the amount of fees waived);
- the special profit allocation applies in one or more years in which the service provider's share of income is reasonably certain;
- the special profit allocation consists of gross income items (i.e., is not contingent on the fund having net profit in any year); or
- the waiver election is "non-binding" on the service provider or the service provider fails to timely notify the partnership and the other partners of the waiver and its terms.

The proposed regulations indicate that the presumption created by any of these factors can potentially be

INSIDE KIRKLANDPEN

Upcoming Events 4

rebutted by "clear and convincing evidence," but do not provide specific examples of such evidence.

Other Factors

Other factors that the proposed regulations identify as problematic include:

- the arrangement provides for different allocations or distributions with respect to different services received — for example, a 20% allocation of profits for services performed by the fund manager in consideration for the carried interest, and a much smaller allocation of profits under the fee waiver arrangement (which the regulations seem to suggest relates to a different set of services);
- the services are provided either by one person (such as a general partner or management entity) or by related persons (such as a fund general partner and a separate management company controlled by the same individuals);
- the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly (apparently referring to a situation in which the special profit allocation under a fee waiver arrangement is viewed as having less entrepreneurial risk than the risk associated with a separate carried interest or capital allocation); and
- the PE fund manager controls the timing of fund asset dispositions (and thus the realization of gains and losses) and periodic fund asset valuations (used in determining gains accruing after the date of a particular fee waiver).

Proposed Regulation Example 3

The proposed regulations include examples of arrangements that IRS views as either "good" or "bad" based on the foregoing factors, among others. Example 3 includes certain features that are common in a PE fund fee waiver arrangement, including an any-12-month measurement period (such as the any-taxable-year period often used in a PE fund fee waiver arrangement) for calculating profits that can be allocated under the arrangement. In the example, the proposed regulations conclude that the overall arrangement lacks "significant entrepreneurial risk" and therefore should be treated as a disguised fee for services, based in part on an assumption that the fund manager has the ability to control the timing of asset dispositions. Additionally, the example indicates that IRS views an any-12-month profit measurement period as providing the fund manager with substantial certainty that sufficient profits can be made available in one or more such periods, even when analyzed at the time of the partnership's initial formation.

Other examples indicate that an arrangement is less likely to be re-characterized where (i) the fee waiver occurs upon formation of the partnership, (ii) the profit allocation is based on cumulative net profit calculated over the life of the fund (rather than net profit or even gross profit for any 12-month period), and/or (iii) the manager's special profit distributions are subject to clawback if insufficient profits are generated over the partnership's life.

Future Guidance May Preclude Reliance on Profits Interest "Safe Harbor"

In addition to characterizing fee waiver arrangements as either valid profit allocations or disguised fees, the preamble to the proposed regulations also indicates IRS's intent to issue additional guidance that may preclude some (or possibly all) fee waiver profits interests from qualifying for the so-called "safe harbor" under IRS Revenue Procedures 93-27 and 2001-43. Under those long-standing Revenue Procedures, IRS treats profits interests satisfying certain conditions as having zero value when issued (and thus being nontaxable to the recipient).

The full implications of this future guidance are unclear at this time. However, IRS could potentially seek to use this future guidance to tax fee waiver-related profits interests upon their issuance based on an estimated value for such interests at such time (rather than on their liquidation value of zero), even if the arrangement complies with the principles of the proposed regulations. Whether such a position would prevail if reviewed by a court is not clear, given that case law prior to the Revenue Procedures generally held that the value of many partnership profits interests is not readily ascertainable.

Effective Date

The regulations will apply to a fee waiver arrangement entered into or modified on or after the date the regulations are finalized. For a "periodic" waiver approach (i.e., where the total amount to be waived over the life of the fund is not specified at fund inception), it appears that the final regulations would apply to each

periodic fee waiver occurring after the regulations' effective date (even if the fund's partnership agreement was executed well before the effective date).

However, the regulatory preamble indicates that IRS believes the principles embodied by the proposed regulations reflect "congressional intent" and current law. Accordingly, IRS may seek on audit to apply similar arguments and theories even to partnership agreements executed or management fees waived before the regulations are finalized. Whether such an audit position (for a period before there were final regulations) would prevail if reviewed by a court is unclear. Many practitioners believe that the legislative history underlying the applicable tax statute is materially more taxpayer favorable than the principles set forth in the proposed regulations.

Conclusion

In light of this new guidance, as well as the complexity of fee waiver strategies generally, fund managers should consult experienced counsel (i) before implementing a new fee waiver strategy and (ii) to determine the proposed regulations' implications for existing fee waiver arrangements.

We intend to submit extensive comments to IRS on the proposed regulations.

1 See *KirklandPEN* dated May 29, 2013 and *KirklandPEN* dated June 9, 2014, for coverage of previous IRS statements concerning fee waiver arrangements, which suggested that well-designed fee waiver arrangements would be respected.

2 In one of the examples, the regulations cite (apparently as a bad factor) that the "priority allocation and distribution . . . [are] intended to approximate the fee that would normally be charged for the services . . ."

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PENnotes

Structuring and Negotiating LBOs
San Francisco, CA
September 10, 2015
New York, NY
September 24, 2015
Chicago, IL
October 1, 2015

This biennial event, chaired by Kirkland partner Jack Levin, focuses on the legal, tax, structuring and practical negotiating aspects of buyouts and other complex private equity deal-doing. More information to follow.

PLI Hot Topics in Mergers & Acquisitions 2015
Chicago, IL
September 16, 2015
New York, NY
October 2, 2015

An expert faculty of lawyers, general counsel, regulators and investment bankers will explore the state of M&A and trends for the year ahead. Kirkland partners Scott Falk and Sarkis Jebejian are co-chairs of the event. Click here for more information.

Deal Dynamics
Chicago, IL
September 17, 2015

Kirkland & Ellis and Major, Lindsey & Africa are hosting a breakfast CLE discussion for general counsel and M&A and securities counsel from the greater-Chicagoland area to highlight certain challenges and opportunities in the acquisition and integration of private targets by public companies. Kirkland partner Kevin Morris will moderate the panel discussion. More information to follow.

Securities Filings 2015: Practical Guidance in a Changing Environment
Chicago, IL
November 12-13, 2015

This program will analyze in detail the principal forms used for filings with the SEC under the Securities Act of 1933, and the Securities Exchange Act of 1934, with particular emphasis on the mechanics of and timing for assembling particular filings. Recent legislation and SEC rule changes affecting disclosure obligations, in particular those resulting from the JOBS Act, will be woven within the topics covered. Kirkland partner Carol Anne Huff will speak at the event. Click here for more information.

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