Journal of Taxation and Regulation of Financial Institutions

Management Fee Waivers: The Current State of Play

Private equity fund management fee waivers are once again on the radar, on the heels of recent comments by IRS officials that the agency is contemplating issuing new guidance and the First Circuit's decision in Sun Capital. If effective, the waiver converts a fund manager's ordinary income for services into a future profits interest in the fund that yields income taxed at capital gains rates, so the industry has much at stake as this debate heats up. This article looks at recent developments in fee waiver arrangements and analyzes the arguments that the IRS is likely to consider.

SABA ASHRAF AND ALYSON K. PIRIO

Fee waivers have garnered a lot of attention since 2007. While used in a variety of partnership transactions, their use by managers of private equity funds[1] has received the most attention. Mechanically, fee waivers can be broken down into two steps: under Step 1, a partner (or manager in the case of a private equity fund) that is entitled to a fee for services rendered to the partnership (the fund in the case of private equity funds) waives its right to the fees prior to the time the services are rendered. Under Step 2, the partner (or manager) receives a profits interest in the partnership (or the private equity fund) in exchange for the services.

This waiver, if effective, converts what otherwise would have been ordinary income (currently taxed to individuals at a rate of 39.6 percent), into capital gain (currently taxed to individuals at a rate of 20 percent[2]). Private equity fund managers argue that they have exchanged a fixed amount due to them for a claim for future profits of the partnership and, since this future profits interest is subject to economic risk, taxation at capital gains rates is appropriate. However, depending on the underlying facts relating to the nature and timing of the waiver, the allocation and distribution pursuant to the profits interest actually may have little economic risk.

As the Internal Revenue Service (IRS) contemplates the issuance of new guidance regarding fee waivers, an examination of the recent developments in this area and the application of existing law is timely. This article first describes management fee waiver arrangements in the private equity context, and also highlights recent developments in New York state and pronouncements by the IRS. Next, the article examines the key tax issues related to fee waivers, including whether (1) the underlying income of most funds is in fact capital gain or ordinary income, (2) the issuance of a profits interest in exchange for the fee waiver is tax-free pursuant to Revenue Procedure 93-27,[3] and (3) the allocation and distribution pursuant to the profits interest are in substance payments made for services to the manager in a non-partner capacity pursuant to Section 707(a)(2)(A).[4]

[1] We use the term private equity generally to encompass a variety of funds, including venture capital, buyout, and growth funds. The common fact in each of these funds is that they acquire the stock of the portfolio companies for investment, and intend for most of their income to be capital gain.

[2] The current long-term capital gains tax rate for individuals is 20 percent. An additional 3.8 percent net investment income tax would apply to the capital gains. Similarly, while the highest individual income tax rate is currently 39.6 percent, the management fees would be subject to employment taxes, generally at a rate of 3.8 percent applying to the uncapped portion. See infra text accompanying notes 19-21.

[3] 1993-2 CB 343.

[4] All references in the text to Sections are to the Internal Revenue Code of 1986, as amended (the "IRC"), unless otherwise specifically indicated.

Saba Ashraf is a partner in and leader of, and Alyson K. Pirio is an associate in, the tax practice group of McKenna, Long & Aldridge LLP. The authors thank Andy Immerman for his comments on an earlier draft of this article. The authors may be contacted by email, respectively, at sashraf@mckennalong.com and apirio@mckennalong.com.

FEE WAIVER ARRANGEMENTS IN THE PRIVATE EQUITY FUND CONTEXT

Typical Fund Structure. A private equity fund is most commonly formed as a limited partnership or other pass-through entity treated as a partnership for U.S. federal income tax purposes.[5] The fund receives capital contributions from investing limited partners, which it then it invests in portfolio companies. The fund holds the portfolio companies as capital assets—i.e., for investment, with the goal of appreciation in value over time.[6] Accordingly, most of the underlying income of the fund is capital gain.[7]

The fund is typically organized and managed by a group of individuals that contribute a relatively small amount of capital to the fund, oftentimes 1 percent of the total capital contributions, and provide investment expertise in selecting, managing, and disposing of fund assets.[8] The fund's manager receives a "carried interest" or profits interest in the fund. A carried interest is a right to receive a percentage of fund profits without an obligation to contribute to the capital of the fund. A carried interest would not give the manager a right to partnership assets on liquidation of the partnership immediately after the carried interest grant.[9] Generally the grant of a partnership profits interest for services is a non-taxable event.[10]

Income from a carried interest is long-term capital gain to the extent that it is attributable to gains realized by the fund from portfolio companies that are capital assets held for more than one year.[11]

In addition to a carried interest, a fund manager commonly receives a management fee, calculated as a percentage of fund assets, as compensation for the services it performs. The combination of a management fee and a carried interest has been referred to as "two and twenty," referring to the practice of providing the manager a fee equal to 2 percent of capital and a carried interest equal to 20 percent of overall partnership profits.[12]

Bifurcated Interests. Often, fund organizers bifurcate their interests in the fund in order to minimize local taxes.[13] The general partner (typically a pass-through entity) receives the carried interest and a separate management company is formed (typically as a limited liability company (LLC) or other pass-through entity) that receives the 2 percent management fee.[14] In these bifurcated structures, the general partner does not actively engage in any activities, and the management company and the general partner typically have completely or largely overlapping interests. See Figure 1.

As mentioned above, the first step in a fee waiver arrangement is that the management company waives its right to its management fee before it has performed the services. Management fees are typically paid semi-annually or quarterly, and are paid in arrears (i.e., at the end of the period for which services are provided). Some managers waive the right to receive all of their fees at the time the fund is formed; others decide whether to waive the fee each year or quarter. Either way, the waiver is done prior to the time the related services are performed. Under Step 2, the general partner of the fund receives an additional profits interest in lieu of the management fee. As a result of this two-step process, the management fee that would have been ordinary income is exchanged for a future profits interest that is mostly capital gain.

Allocation of Proceeds. Distribution waterfalls in fund partnership agreements establish the priority of

[5] Joint Committee on Taxation Report, Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Sept. 4, 2007, JCX-62-07 (Part I) and JCX-63-07 (Part II) (hereinafter "2007 Joint Committee Report"); see also Andrew W. Needham, 735 BNA Tax Management Portfolio Private Equity Funds, VII.C.3. at A-15.

[6] See discussion infra, under the subheading "Trade or Business/Fund Gain as Capital Gain."

[7] By way of background, a partnership is not subject to federal income tax. Instead, its income, gains, losses, deductions, and credits are parsed out according to their character among the categories listed in Section 702(a). Each partner then reports his "distributive share" of the items in each of these categories on his personal income tax return. William S. McKee, William F. Nelson & Robert L. Whitmire, *Federal Taxation of Partnership and Partners*, ¶ 11.01(1) (4th ed. 2007 & Supp. 2013).

[8] 2007 Joint Committee Report, supra note 5.

[9] Id.

[10] See Rev. Proc. 93-27, 1993-2 CB 343, and Rev. Proc. 2001-43, 2001-2 CB 191 and discussed infra, under the subheading "Revenue Procedure 93-27."

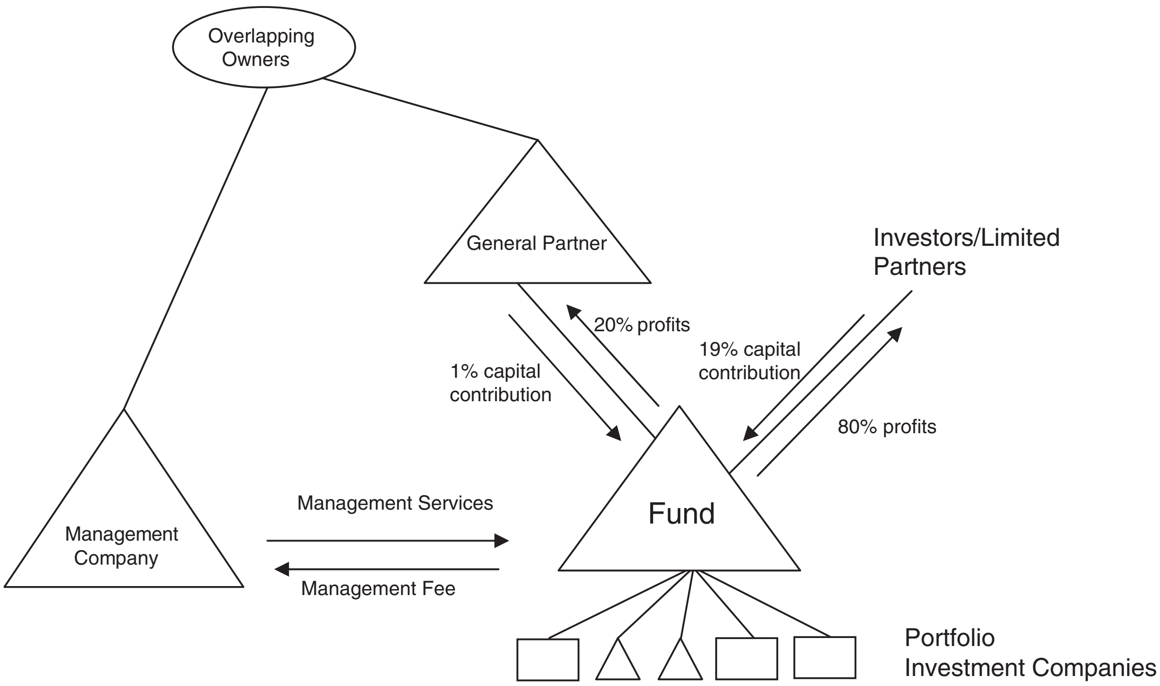
[11] 2007 Joint Committee Report, supra note 5.

[12] Id.

[13] For example, this bifurcated structure can impact the amount that is subject to New York City's unincorporated business tax. The unincorporated business tax generally applies to every individual or unincorporated entity carrying on a trade or business in New York City. However, there is an exemption from the tax for activities that constitute trading for one's own account and partial exemption for an unincorporated entity that is primarily engaged in trading for its own account. Therefore, the carried interest is bifurcated from the management fee because the general partner can generally claim that it is primarily engaged in self-trading (i.e., trading or investment of the assets in the fund) and not subject to the unincorporated business tax. The management fee is, however, subject to the unincorporated business tax. Cara Griffith, "The Questionable Legality of New York City's Proposed UBT Audit Position," Tax Notes, Feb. 27, 2012, p. 713.

[14] The management company also may provide some management services to some of the portfolio investment companies.

Figure 1: Bifurcated Interests in Fund



the distribution of proceeds from investments to the fund investors and the general partner. The additional profits interest issued in the lieu of the management fee differs somewhat in timing and priority in the distribution waterfall from the regular carried interest that the general partner receives. Typically, distributions related to a regular profits interest are placed near the end of the waterfall. By contrast, distributions related to the additional profits interest received by the general partner are near the top of the waterfall—sometimes even above the return of the capital contributions of the investors. Therefore, the amount and timing of the profit allocation is much more certain than that of the regular profits interest.

Other factors that can make the additional profits interest issued in lieu of a management fee more certain than the ordinary carried interest include that the additional profits interest:

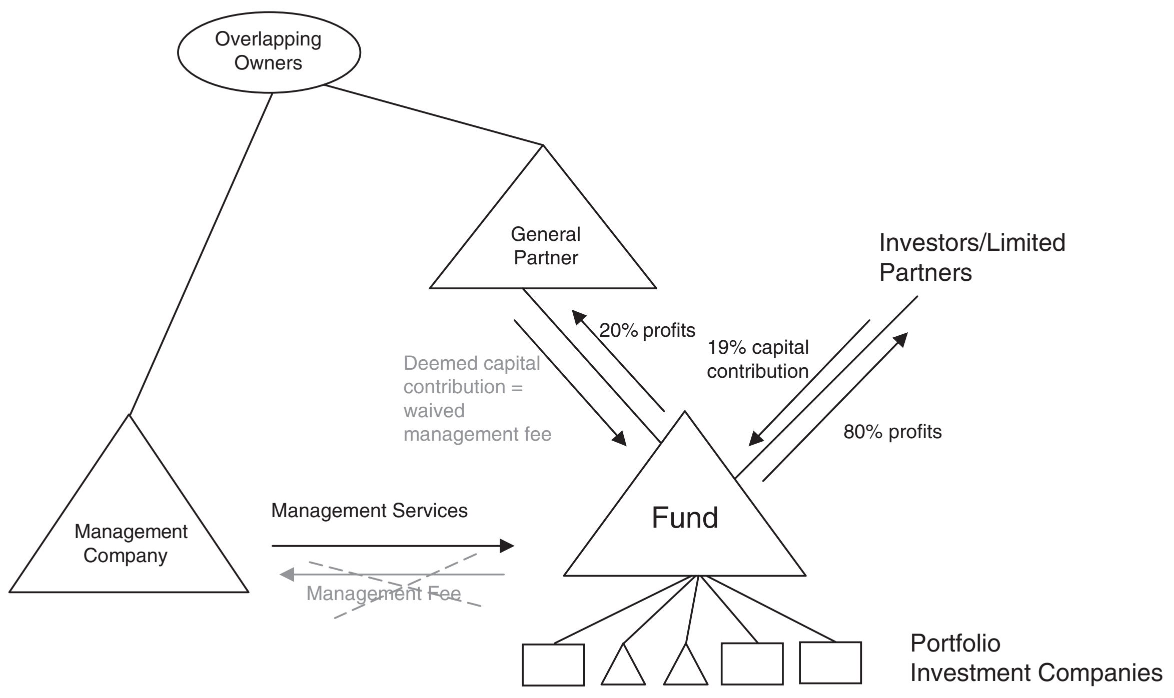
- Is frequently paid from gross income of the fund, while the carried interest is generally paid from net income;
- May be paid out of quarterly gross income rather than annual gross income; and
- Is, in many circumstances, not subject to a clawback, unlike the carried interest.

In the private equity context, rather than simply waiving management fees for an additional profit allocation equal to the management fee, the fee is often waived in exchange for a reduction of the amount of the capital contribution required from the general partner. For example, assume the general partner's capital contribution is $1 million. Instead of making the capital contribution, the management company will waive its management fee in the amount of $1 million, and in lieu of it receive a notional or deemed capital contribution of $1 million. The allocation provisions of the fund's partnership agreement will allocate profits to the general partner until it has been allocated this $1 million. See Figure 2. The allocated profits will be capital gain. The follow-on distribution of attendant cash by the fund will be tax-free.[15]

Although not very common in our experience, at times certain partnerships do not make the distribution to the management company out of cash flow related to the future profit allocation (i.e., proceeds attendant to the sale of a portfolio investment). Instead,

[15] The profit allocation will increase the basis a partner has in its partnership interest. IRC § 705(a)(1)(A). A distribution of cash will result in taxable income only to the extent it exceeds the tax basis of the distributee partner. IRC § 731(a)(1).

Figure 2: Fee Waived in Exchange for Reduced Capital Contribution



the distribution is made out of loan proceeds or cash that the fund partnership has from other sources.

TAX BENEFITS OF WAIVERS

The first and most important benefit of fee waivers is to convert income that would have been taxed as ordinary income to the manager into income taxed as capital gain. It is important to note that in regard to this and each of the other benefits of the waiver, managers seek to achieve these benefits with as little deviation as possible from the parties' original arrangement with respect to the management fees. In other words, the goal is not simply to achieve capital gain treatment, but to do so while maintaining the timing and risk that would have existed if the waiver had not taken place.

A second benefit relates to the time value of money. In order to fund its $1 million capital contribution, the manager would be required to pay that amount to the fund upon formation. Use of the waiver gives the manager an opportunity to satisfy its capital contribution without contributing any up-front money—and allows the manager to put its $1 million to other uses.

A third benefit is the deferral of income. Rather than receiving the management fee in the year earned and recognizing the income in that year, the waiver defers income to the year in which the gains related to the additional carried interest are realized by the manager.[16] That said, the timing benefit is only meaningful if the deferral is for a significant period of time. If, as described above, an underlying goal is to keep the risk and timing as close as possible to that of the management fee, the deferral will not be for a very long period of time.

A fourth benefit relates to the deductibility of the management fee by the fund's investors. A U.S. individual investor in a fund generally receives a deduction for his share of the management fees paid by the fund to the manager. However, this Section 212 deduction is subject to the limits on miscellaneous itemized deductions under Sections 67[17] and 68.[18]

[16] Gregg D. Polsky, "Private Equity Management Fee Conversions," 122 Tax Notes 743 (Feb. 9, 2009).

[17] IRC § 67 provides that miscellaneous itemized deductions can only be deducted to the extent that, in the aggregate, they exceed 2 percent of adjusted gross income.

[18] IRC § 68 reduces itemized deductions by the lesser of 80 percent of itemized deductions and 3 percent of the amount by which a taxpayer's adjusted gross income exceeds an applicable amount (currently $300,000 for joint filers) (the Pease limitation).

Further, the fee is nondeductible for tax-exempt and non-U.S. investors, because they are not subject to U.S. tax. However, the conversion of the management fee to additional carried interests results in additional capital gain being shifted from the investors to the general partner. For investors subject to tax, this provides an immediate offset against their gains, with the effect of a full tax deduction. This gives fund investors an incentive to acquiesce to the waiver.

A fifth benefit is that in some jurisdictions, there is an advantage in converting ordinary income, which may be subject to additional taxes (for example, the New York City unincorporated business tax) into capital gain. (This is concept is discussed further below in regard to the investigations conducted by the New York Attorney General's office.)

Another benefit of waivers is no longer as significant as it once was. Prior to 2013, fee waiver arrangements converted income that was subject to self-employment taxes (i.e., management fees taxed as ordinary income) into a profits interest not subject to employment taxes.[19] However, the January 2013 imposition of the net investment income tax (NIIT) pursuant to Section 1411 may have thwarted this goal. Now, income that is not subject to self-employment tax (SET) may be subject to the NIIT at 3.8 percent—a rate intended to approximate the current rate of employment taxes that apply to an uncapped amount of wages or net earnings from self-employment.[20] Therefore, there is generally no rate differential between the payment of the SET above the threshold amount and payment of the NIIT. It is possible that the Medicare component of SET will increase in the future and there will not be a corresponding increase in the NIIT.[21] This would create a rate differential that benefits the management fee waiver arrangement. It is unclear, however, how likely that would be.

PRIVATE EQUITY FUND FEE WAIVERS IN THE NEWS

Fee waivers have been in the news regularly for the past several years. Some key players in the private equity industry, including Bain Capital LLC and Apollo Global Management, have been identified as using them.[22] KKR & Co. reportedly used the strategy from 2007 until 2009, when it became a public company.[23] Many attribute the use of fee waiver arrangements by these funds to the IRS's silence on this issue, which the funds viewed as a green light. Ed Kleinbard, a professor at the USC School of Law and a former chief of staff of Congress's Joint Committee on Taxation, said some firms "seemed to have interpreted the silence of the IRS as acquiescence, which is not correct, but the IRS failed to enforce the rules in this area."[24] Mr. Kleinbard went on to say that "[f]irms ended up taking positions that I think went beyond what the law permitted. . . . But the IRS failed to do its job of litigating those issues. Had they done so, a lot of these structures, including possibly Bain's, would have been disallowed."[25]

In mid-2012, New York Attorney General Eric Schneiderman issued subpoenas to several private equity funds as part of a larger investigation focusing on the use of management fee waiver arrangements.[26] At first glance, it is difficult to understand why he would conduct such an investigation, as there is no rate differential between ordinary income and capital gains in New York. Many suspect that the state was concerned with the deferral of income that is a natural result of such arrangements.[27] That said, because most fee waiver arrangements try to interfere as little as possible with the economic arrangement that existed prior to the waiver, any income deferral is likely only short-term. The real concern may have been the possible avoidance of state income tax on the waiver amounts. Conversion of management fees from ordinary income to capital gain generally prevents such amount from being subject to the New York City unincorporated business tax, and nonresident members do not pay New York state income tax on such amounts.[28] Finally, it has been suggested that

---

19 See Polsky, supra note 16.

20 The general Medicare component of SET is 2.9 percent in 2013, but starting in 2012, the SET applies to self-employment income over a "threshold amount" ($250,00 for a joint return, $125,000 for a married taxpayer filing separately, and $200,000 for a single return) at a rate of 3.8 percent. The old-age, survivors, and disability insurance (OASDI) component of employment taxes is 12.4 percent; however, it is subject to a wage cap of $113,700.

21 From a historical perspective, this is similar to what was done in 1986, when the long-term capital gains tax rate was reduced to equal the income tax rate. It was just a matter of time before the ordinary income tax rate increased, thereby again creating a rate differential.

22 Reed Albergotti, Mark Maremont & Gregory Zuckerman, "New York Probes Private-Equity Tax Practices" (Wall Street Journal, Sept. 3, 2012), available at http://online.wsj.com/news/articles/SB10000872396390443571904577629831800831466.

23 Id.

24 Id., quoting Mr. Kleinbard.

25 Id.

26 Nicholas Confessore, Julie Creswell & David Kocieniewski, "Inquiry on Tax Strategy Adds to Scrutiny of Finance Firms" (N.Y. Times, Sept. 1, 2012), available at http://www.nytimes.com/2012/09/02/business/inquiry-on-tax-strategy-adds-to-scrutiny-of-finance-firms.html?pagewanted=all&_r=0.

27 Lee Sheppard, "Mitt Romney Tax Clarifications" (Forbes, Sept. 11, 2012), available at http://www.forbes.com/sites/leesheppard/2012/09/11/mitt-romney-tax-clarifications/.

28 Supra note 13.

managers might have been treating the additional carried interest as a nontaxable distribution of capital for New York state tax purposes.[29]

Although the New York state investigation appears to have lost momentum, it called into question the validity of the tax strategy behind the management fee waiver arrangement and has people in the industry wondering whether there will be additional federal or state level scrutiny of such arrangements in the future.

CURRENT IRS PERSPECTIVE AND POSSIBLE NEW GUIDANCE

If federal tax law is changed so that income from carried interests is taxed as ordinary income, management fee waivers would be moot. But whatever Congress may do, in statements made on April 30, 2013, Clifford Warren, Special Counsel in the IRS Office of Associate Chief Counsel (Passthroughs and Special Industries), indicated that the IRS may take action regarding management fee waiver arrangements.[30] And who can blame the IRS for not waiting for Congress to act? At this point, claims that Congress will reform carried interests taxation ring hollow.[31]

Although the New York state investigation appears to have lost momentum, it called into question the validity of the tax strategy behind the management fee waiver arrangement and has people in the industry wondering whether there will be additional federal or state level scrutiny.

According to Mr. Warren, the characterization of management fee waivers is "fair game" and fee waivers are "something that [the IRS is] in fact studying."[32] Despite the IRS's concern with certain fee waiver arrangements, he said, "[t]here's a spectrum, and we're trying to figure out what's good and what's bad,"[33] and it is unlikely the IRS will make all management fee waiver arrangements "strictly forbidden."[34] Rather, whether a fee waiver is on the permissible end of the spectrum will be based on a facts-and-circumstances analysis. Arrangements on the "bad" end of the spectrum may include those that (1) do not fall within the Revenue Procedure 93-27 safe harbor (which, as discussed below, requires the recipient be a partner and hold the interest for at least two years) and (2) those where the service provider would be treated as acting in a non-partner capacity under Section 707(a)(2)(A).[35] For example, if a private equity fund manager that contractually waived its right to a fixed management fee for the first year on the day of the fund's formation in exchange for a profits interest that it will receive only if there is sufficient net gain on all of the assets at the end of the fund's life, that would be permissible. But an arrangement involving a waiver where the timing of the waiver was unclear because it merely appeared in an internal memorandum or an accounting entry and where, soon after the waiver, the manager received a gross income allocation and related distribution, which it reported as capital gain, would not pass muster.[36] In addition to the timing issues in the second example, the IRS is also concerned the related parties in these arrangements can play fast and loose with the documentation.

The examples above are at the far ends of the spectrum; we don't know whether the IRS will provide additional guidance on other arrangements deemed permissible—or any specific guidance regarding management fee waivers at all. However, according to the IRS, if it comes, such guidance could be in the form of a revenue ruling, or audit guidelines designed to challenge arrangements at the bad end of the spectrum.[37]

---

[29] Eric Kroh, "Investigation Brings Management Fee Waivers Under Scrutiny," Tax Notes, Sept. 10, 2012, p. 1250.

[30] Amy S. Elliott, "IRS Studying Fee Waivers," Tax Notes, May 6, 2013, p. 599. Although the IRS comments suggest that there will not be a wholesale disallowance of management fee waiver arrangements, the Senate Finance Committee appears to be considering other ideas. On June 7, 2013, the Committee released the eighth in a series of discussion papers on tax reform; at the top of the list for reforming compensation, it suggests reforming the treatment of carried interest and other partnership interests received in whole or in part in exchange for services. This paper included a suggestion that the conversion of management fees into "partnership shares taxed at capital gains rates" be disallowed. Senate Finance Committee Staff Tax Reform Options for Discussion, Types of Income and Business Equities, June 6, 2013.

[31] Sheldon I. Banoff of Katten Muchin Rosenman LLP perhaps said it best in discussing long-awaited carried interest legislation: "unless and until it becomes real, I think it's been a little bit like the little boy who cried wolf." Amy S. Elliott, "IRS Amplifies Its Views on Management Fee Waivers," Tax Notes, May 27, 2013, p. 999.

[32] Elliott, supra note 30.

[33] Id.

[34] Id.

[35] Id.

[36] Id.

[37] Id. As noted, the IRS has concerns that some funds may not keep clear books and records reflecting when a waiver takes place and how much appreciation was inherent in their portfolio investments at the time the profits interest was issued. This may explain why the IRS is considering audits rather than legislation to address these situations.

In keeping with Mr. Warren's statements, during a September 24, 2013, meeting of the Passthroughs and Real Estate Committee of the District of Columbia Bar Taxation Section, Craig Gerson, attorney-advisor for the Treasury Office of Tax and Legislative Counsel, advised that the Office of Tax and Legislative Counsel hopes to provide guidance that will brighten the line between management fee waivers that are structured correctly and those that are not.[38] Mr. Gerson said two variables that the government may address are (1) the timing of when the waiver occurs, and (2) the likelihood that profit is available to pay the general partner in lieu of the fee.[39]

ANALYSIS OF KEY TAX ISSUES

Trade or Business / Fund Gain as Capital Gain. Until the *Sun Capital*[40] decision, it was generally taken as a given that private equity funds were not engaged in a trade or business and, therefore, the gain on the sale of their portfolio investments was capital gain.[41] In order for a fee waiver to convert ordinary income into capital gain, the fund in which the profits interest is issued must have capital gains that it can pass through to its partners. If the underlying income of a partnership is ordinary income, then a major incentive for engaging in a management fee waiver is taken away, and the frequency with which such waiver arrangements are implemented (and for that matter, carried interests in general issued) would significantly decrease.[42]

Sun Capital. In *Sun Capital*, the First Circuit Court of Appeals held that a private equity fund was not merely a passive investor in one of its portfolio companies, but rather that it could be in a "trade or business" for purposes of withdrawal liability under the Multiemployer Pension Plan Amendments Act (MPPAA).[43] Some have expressed concern that *Sun Capital* puts into question whether the income attributable to the carried interest in a private equity fund is capital gain.[44]

In *Sun Capital*, two limited partnership private equity funds (the "Sun Funds") formed a limited liability company to invest in Scott Brass, Inc. As is typical in private equity arrangements, general partners of the Sun Funds oversaw the funds and received an annual fee of 2 percent of the total capital commitments plus a percentage of the Sun Funds' profits from investments. Sometime after the Sun Funds' investment, Scott Brass stopped making contributions to its multiemployer pension fund, and became liable for withdrawal liability. Approximately one year thereafter, an involuntary Chapter 11 bankruptcy was brought against Scott Brass. The pension fund sought

In *Sun Capital*, the First Circuit Court of Appeals held that a private equity fund was not merely a passive investor in one of its portfolio companies, but rather that it could be in a "trade or business."

[38] Amy S. Elliott, "New Guidance Will Clarify the Treatment of Fee Waivers," Tax Notes, Sept. 30, 2013, p. 1499.

[39] Id.

[40] Sun Capital Partners III, LP, et. al. v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129 (1st Cir. 2013).

[41] Steven M. Rosenthal & Andrew W. Needham, "Taxing PE Funds and Their Partners: A Debate on Current Law," Tax Notes, June 10, 2013, p. 1327; see James H. Lokey, Jr. & Donald E. Rocap, "Selected Tax Issues in Structuring Private Equity Funds," 631 PLI/Tax 9 (2004) § 1.05[5]; Peter J. Elias, "Effect of the New Medicare Tax on U.S. Investors in Hedge Funds," Tax Notes, Feb. 25, 2013, p.965 at n.15, stating:

> U.S. tax law has long distinguished between investment funds that are considered to be traders and those considered to be investors or non-traders. The principal difference, for tax law purposes, is that a trader fund (because of active trading) is deemed to be engaged in an active trade or business, whereas a non-trader fund is not. In general, an investment fund will be considered a trader for this purpose if the fund's trading activities are frequent and substantial, and if the fund generally seeks profits from short-term market swings rather than long-term appreciation. See, e.g., Boatner v. Commissioner, T.C. Memo. 1997-379, aff'd, 164 F.3d 629 (9th Cir. 1998) (taxpayer deemed to be a trader when trading activities were "frequent, regular and continuous"). By contrast, an investor or non-trader is one who purchases and sells securities with the principal purpose of realizing investment income in the form of dividends, interest, and gains from appreciation in value over a relatively longer holding period. See, e.g., Higgins v. Commissioner, 312 U.S. 212 (1941); King v. Commissioner, 89 T.C. 445 (1987).

[42] This may be the reason, for example, that developers that are partners in traditional real estate development partnerships (that typically generate ordinary income) do not waive their development fees for a profits interest in the real estate development partnership.

[43] *Sun Capital*, 724 F.3d at 133. The First Circuit reversed the decision of the United States District Court for the District of Massachusetts, which had held that the Sun Funds were not trades or businesses because they did not have any offices or employees, and they did not make or sell goods or report income other than investment income on their tax returns. Additionally, the Sun Funds were not engaged in the management activities of the general partner.

[44] Amy S. Elliott, "Panelists Agree Fee Offsets Are Problematic, But Disagree on Sun Capital's Significance," Tax Notes, Oct. 7, 2013, p. 16.

to collect the unfunded benefits of Scott Brass from the Sun Funds and the Sun Funds sought a declaratory judgment that they were not liable under the MPPAA for the payment of withdrawal liability.

By way of background, the MPPAA requires employers that withdraw from a multiemployer plan to pay their proportionate share of the pension fund's vested but unfunded benefits. In order for withdrawal liability to be imposed on an organization other than the one obligated to the pension fund, the organization must be a trade or business.[45] The Sun Funds asserted, among other arguments, that they were not a trade or business and so they had no liability.

The phrase "trade or business" is not defined in either the relevant provision of the MPPAA or Treasury Regulations. The First Circuit considered two seminal Supreme Court cases addressing U.S. trade or business.[46] In *Higgins v. Commissioner*,[47] the taxpayer had numerous investments in real estate, stocks, and bonds and spent time overseeing these investments. The Supreme Court held that merely keeping records and collecting interest and dividends from securities through managerial attention to those investments is not sufficient to constitute carrying on a trade or business no matter how large the estate or continuous the work.[48] In *Whipple v. Commissioner*,[49] the Supreme Court held that full-time service to a corporation was not in and of itself a trade or business and, therefore, did not permit a full deduction of a worthless loan by the corporation as a business bad debt. The Court went on to state, "furnishing management and other services to corporations for a reward not different from that flowing to an investor in those corporations is not a trade or business."[50]

The First Circuit noted that the definitions of trade or business found in *Whipple* and *Higgins* are not controlling for MPPAA purposes, and did not find its determination that the Sun Funds could be in a trade or business to be inconsistent with them. The First Circuit emphasized that (1) unlike the taxpayer in *Higgins*, the Sun Funds (through affiliated entities) participated in the management of Scott Brass[51] and (2) unlike the taxpayer in *Whipple*, the Sun Funds received a direct economic benefit for such management, above and beyond that received by an investor.[52]

In concluding that one of the Sun Funds was engaged in a trade or business, the circuit court placed its greatest emphasis on the fact that the fund undertook activities related to Scott Brass's business and received a direct economic benefit *in addition* to that of an investor.[53] The court noted that "active involvement in management under the [management] agreements provided a direct economic benefit to at least Sun Fund IV that an ordinary, passive investor would not derive: an offset against the management fees it otherwise would have paid its general partner for managing the investment"[54] in Scott Brass. Fee offset arrangements such as the one used by the Sun Fund are a strategy employed by funds that have tax-exempt and foreign investors to protect such investors from certain types of income that would be taxable to them.[55] Specifically, in *Sun Capital*, Scott Brass made

[45] MPPAA § 402(a); 29 U.S.C.A. § 1301(b)(1); Employee Retirement Income Security Act of 1974, § 4203(a), 29 U.S.C.A. § 1383(a).

[46] The court also considered a 2007 appeals letter from the Pension Benefit Guaranty Corporation (PBGC) addressing what constitutes a trade or business in the single-employer pension plan context. The appeals letter held that a private equity fund was in a trade or business because its controlling stake in the portfolio company allowed it to exercise control over the company through its general partner. *Sun Capital,* 724 F.3d at 138. The PBGC reached this conclusion after applying a two-prong test that it apparently derived from Comm'r v. Groetzinger, 480 U.S. 23 (1987). The two-prongs are: (1) whether the private equity fund was engaged in an activity with the primary purpose of income or profit, and (2) whether it conducted its activity with continuity and regularity. *Groetzinger*, 480 U.S. at 35. The First Circuit stated that the 2007 PBGC appeal letter is owed no more than *Skidmore* deference.

[47] 312 U.S. 212 (1941).

[48] Id. at 218.

[49] 373 U.S. 193 (1963).

[50] Id. at 203.

[51] *Sun Capital*, 724 F.3d at 145-46. See infra notes 53 and 54 and accompanying text.

[52] Id.

[53] Id. at 142. Other factors it considered included that (1) the Sun Funds' investments in portfolio companies are for the general purpose of making a profit and (2) the profits are made from the sale of stock of the portfolio company at a gain.

[54] Id. at 143.

[55] If a fund renders management services to its portfolio companies in exchange for fees, its tax-exempt investors have unrelated business taxable income, and its foreign investors have effectively connected income—which the tax-exempt and foreign investors would like to avoid. The fees related to the services may be significant, however, and many funds are hesitant to not receive them. Andrew Needham explains:

> To protect the tax-exempt and foreign investors, therefore, the sponsor will usually adopt some form of prophylactic strategy to purge "bad income" from the fund. The most common of these strategies is to separate, both under the fund agreement and in practice, the activities of the fund manager as a provider of investment advisory services from the activities of the fund as a passive investor. As is so often the case, however, this effort to delineate the activities of the two entities to achieve a tax objective tends to conflict with the primary non-tax objective of the fund investors, which is to maximize portfolio returns. In the typical fund, therefore, although the fund manager will capture 100% of most categories of fee income, the fund investors will receive some form of compensating adjustment to the periodic management fee.

Andrew W. Needham, 735 BNA Tax Management Portfolio Private Equity Funds, VII.C.3. at A-47.

payments of greater than $186,000 to the general partner of one of the Sun Funds; this amount offset the fee that the Sun Fund had to pay to the general partner.[56] The court found that this offset was not the result of ordinary investment activity.

The pension fund also put forth the additional argument that the Sun Funds were in the trade or business of developing, promoting, and selling companies. However, the First Circuit did not address the argument because it was presented to the court too late.[57] Finally, the court noted that the definition of trade or business did not have to be uniform across different areas of tax law, and, more importantly, that its decision was strictly limited to the ERISA context.

Potential Implications. Where does *Sun Capital* leave us? Although *Sun Capital* specifically limited itself to the issue of a trade or business for purposes of withdrawal liability under the MPPAA, a broad interpretation of the holding could suggest that where the general partner or other agent of the fund is performing services for the portfolio investment companies, the fund may be deemed to be engaged in the trade or business of the portfolio company itself or that of providing managerial services.

Two aspects of the *Sun Capital* decision are somewhat puzzling. First, the First Circuit noted that the Sun Funds, through affiliated entities, participated in the management of Scott Brass. The fact that a general partner or a management company is providing services to a portfolio company should not result in the *fund* being treated as providing those services to the portfolio company. Activities of agents should be attributed to a principal only when performed on behalf of a principal. Unless the general partner or management company is performing the services *on behalf of the fund*, the fund should not be treated as engaged in those activities.[58] Second, while it is clear the Sun Fund was receiving an economic benefit because of the fee offset, it did not itself engage in any activities to earn such services. If no actual services are performed by the fund or an agent on its behalf, then it is difficult to reach the conclusion that the fund is engaged in a trade or business. Perhaps the thought process of the court was as follows: Even though the fund did not directly perform any activities for Scott Brass, its agents (the general partner and the management company) did. It is appropriate to deem the general partner and management company to be agents of the fund in performing services for Scott Brass because, effectively, the fund received the approximately $186,000 for its services from Scott Brass, and then assigned it over to its agents.

That said, even if the broad interpretation that where a general partner of a fund is performing services for the portfolio investment companies, the fund may be deemed to be engaged in a trade or business is accepted, this should not mean that the fund's gain on the sale of its portfolio companies is ordinary income rather than capital gain. Even if the fund is said to be engaged in these trades or businesses, unless it can be shown that the purchase price being paid on the sale of the portfolio companies is essentially a payment to the fund for the managerial services it may have performed for the portfolio companies, the gain should be capital gain.[59]

Employees of LLCs and corporations are commonly given equity interests as performance incentives.

The fact that a general partner or a management company is providing services to a portfolio company should not result in the fund being treated as providing those services to the portfolio company. Activities of agents should be attributed to a principal only when performed on behalf of a principal.

It is generally accepted that such employees' gains on the sale of the LLC or corporation are capital gains. That the portfolio company receives services from the employee does not mean that a portion of the gain on the sale of the employee's investment in the company is converted into fees for the services. The return the employee receives on the sale of its investment is no different that the return that any investor would receive. Analogously, even if—based on the *Sun Capital* rationale—it is concluded that the typical private equity fund is engaged in the business of its portfolio company, or of managing the portfolio company, this should not convert the fund's gain on the sale of its portfolio investments into ordinary income.

If, on the other hand, a fund is in the trade or business of promoting its portfolio investments for sale to customers in the ordinary course of business, then the First Circuit has left open the possibility that the gain may be ordinary income rather than capital gain. Theoretically, on this particular set of facts, it may be possible to show that the gain on the sale represents

[56] *Sun Capital*, 724 F.3d at 143.

[57] Id. at n.26. The Court noted that "[t]he 'developing business enterprises for resale' theory was not presented to the district court nor in the opening briefs to us. Whatever the merit of the theory, our decision does not engage in an analysis of it."

[58] See generally Rosenthal & Needham, supra note 41.

[59] See *Whipple*, supra note 49; *Higgins*, supra note 47.

not appreciation of value in assets held for investment, but rather a payment wholly or in part for the promotion services. However, with respect to most private equity funds, the facts simply do not support that the funds are in the business of promotion. The private equity funds serve as vehicles to collect the capital of the investors and invest that capital in portfolio companies. They do not have an intent to resell the portfolio companies as part of an ordinary business.[60] The fact that the private equity fund receives some investment management services, whether it be from its general partner or a third party, does not mean that the fund is holding its portfolio companies as something other than investments. We do not suggest that there could never exist such a set of facts. We simply note that it is not common for the fund, either directly or through its agents, to engage in the promotion of companies for sale on a regular basis.

Even Treasury seems to be reluctant, for now, to embrace the argument that based on Sun Capital, private equity funds can be said to be engaged in the trade or business of selling its portfolio companies for sale to customers in the ordinary course of business.

Even Treasury seems to be reluctant, for now, to embrace the argument that, based on *Sun Capital*, private equity funds can be said to be engaged in the trade or business of selling its portfolio companies for sale to customers in the ordinary course of business.[61] The remainder of this article assumes that the gains generated by the portfolio companies are in fact capital gains, and moves on to examine whether there are other bases on which fee waivers could be unsuccessful in converting ordinary income to capital gain.

The Revenue Procedure 93-27 Safe Harbor. A key basis for concluding that fee waivers successfully convert ordinary income to capital gains is that the issuance of the profits interest in lieu of the fee is tax-free. As discussed earlier, management fee waivers involve a two-step construct. Under Step 1, the management company waives a right to receive the fee it would receive upon the performance of management services. Step 2 involves receiving a profits interest in exchange for the performance of services.

Step 1 should not result in any taxable income to the manager. A basic rule of taxation is that if income or compensation has already been earned, and the taxpayer has the right to the income, then the taxpayer cannot turn her back on the compensation and avoid the taxable income.[62] On the flip side, if compensation is waived prior to the time that it is earned or there is a right to it, then there should not be taxable income.

The receipt of a new profits interest under Step 2 is intended to be tax free. Under Revenue Procedure 93-27, if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity, the IRS will not treat the receipt of such an interest as a taxable event of the partner or the partnership, unless one of three exceptions applies:

1. The profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease;
2. Within two years of receipt, the partner disposes of the profits interest; or
3. The profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of Section 7704(b).[63]

[60] Rosenthal & Needham, supra note 41 (Needham's comments generally). See also Ivan Mitev, "*Sun Capital*: Trade or Business Armageddon Talk" (Fund-Taxation.com, Aug. 9, 2013), available at http://fund-taxation.com/sun-capital-trade-or-business-armageddon-talk ("[a]s a practical matter, it is also difficult to argue that a private equity fund, which is inherently an investment vehicle, should be taxed as a developer or promoter of companies.").

[61] Andrew Velarde, "Treasury Official, Practitioners Discuss *Sun Capital*," Tax Notes, Sept. 9, 2013, p. 1066.

[62] See Hamilton Nat'l Bank of Chattanooga v. Comm'r, 29 BTA 63, 67 (1933) ("A taxpayer may not deliberately turn his back upon income. . . ."). See also Treas. Reg. § 1.451-1(a) ("Under [the accrual] method of accounting, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the services are completed. . . . Under the cash receipts and disbursements method of accounting, such an amount is includible in gross income when actually or constructively received."); Treas. Reg. § 1.451-2(a) ("Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.")

[63] In 2001, Rev. Proc. 2001-43, 2001-2 CB 191, was issued to clarify that when a partnership grants a profits interest for services, the appropriate time to determine whether there is a realization event for tax purposes is the time of issuance, even if, at that time, the interest is substantially nonvested. In addition, proposed regulations relating to profits interests were issued in 2005. REG-105346-03. Notice 2005-43, 2005-1 CB 1221 (May 24, 2005). Prop. Reg. § 1.83-3(l)(i) (providing that IRC § 83 principles will control the tax consequences of the issuance of either a capital or profits interest in a partnership). The proposed regulations reach the same results as Rev. Procs. 93-27 and 2001-43, but require jumping through some hoops to get there. The proposed regulations have not been finalized, and given the length of time that has passed since their issuance, it is unclear that they will be finalized. This article does not address their application to fee waivers.

These exceptions "attempt to isolate for further review and possible litigation those interests that are easily valued at or about the time of receipt."[64]

The first Revenue Procedure 93-27exception, a profits interest relating to a substantially certain and predictable stream of income, may raise issues in the fee waiver context. One reason cited for why waivers are not effective is that, in practice, there is no economic risk associated with the future profits interest.[65] Unlike traditional profits interests issued by funds, which are typically the last rung in the distribution waterfall, a profits interest issued in place of management fees typically appears near the top, in some instances, even prior to the repayment of the capital contributions of the investors. The higher a distribution is in the waterfall, the greater the certainty that the payment will be made by the fund. Depending on the quality of the portfolio investments that the fund has made, the income required to pay the top tiers of the waterfall could arguably be substantially certain and predictable. That said, it likely is not as certain and predictable as the income stream from high quality debt securities, or high-quality net leases. Therefore, it is unclear whether the first exception will apply.

If the profits to be paid in place of the management fees come out of fund gains that were accrued by the fund at the time the fee was waived, but not realized until after the waiver, then there is a stronger argument that the profits interest falls within the first exception.[66] However, note that Revenue Procedure 93-27 refers to a "substantially certain and predictable *stream* of income from partnership assets." It is unclear whether a one-time predictable payment of income, as opposed to a predictable stream of income, would fall within the first exception described above. Given that the exceptions to Revenue Procedure 93-27 are aimed at excluding situations where the profits interest is capable of easily being valued, it should not matter whether the predictable income of the partnership is a one-time event or a stream of income. That said, however, a literal reading requires a "stream" of income in order to be excepted.

The second exception to the application of Revenue Procedure 93-27 is the disposition of the profits interest by the partner within two years of its receipt. In a typical fund the contractual arrangement to receive the management fee is between the management company and the fund (see Figure 2 on page 8), whereas immediately after the waiver, the profits interest is issued to the general partner. In addition to the usual two steps involved in a fee waiver, in the private equity context involving bifurcated interests, there is an implied third step: after the waiver of the management fee and the receipt of a profits interest, the management company transfers (or is deemed to transfer) this profits interest to the general partner. Specifically, upon receipt of the profits interest, the management company is deemed to distribute the interest to its members. Assuming completely overlapping ownership between the management company and the general partner, immediately thereafter, the members of the general partner entity are deemed to contribute this profits interest to the general partner. Assuming completely overlapping ownership, the distribution and the contribution should be tax-free.[67]

Technically, because the transfer (or the deemed transfer) of the profits interest by the management company to the general partner takes place within two years of the receipt of the profits interest, the situation where the management company is a separate entity from the general partner would seem to fall squarely within the second exception to Revenue Procedure 93-27. However, some commentators note that this is a technical argument and that there appears to be no policy reason why the manager's decision to bifurcate should influence whether the Revenue Procedure 93-27 safe harbor applies.[68] (As discussed earlier, separating the management company from the general partner is generally done for state or local tax planning purposes. Many funds do not have this as a feature of their structure. Thus, this issue would not arise for them.)

As the discussion above illustrates, although there are many situations in which Revenue Procedure 93-27 may apply to the issuance of profits interests in lieu of fees, there may be circumstances where the safe harbor does not apply. In these situations, we are left with the confusing general body of case law as to

[64] McKee et al., supra note 7, at ¶ 5.02(7).

[65] See Lee A. Sheppard, "From the Archives: Carried Away: Management Fee Conversion," Tax Notes, Aug. 13, 2007, p. 532.

[66] The allocation of profits that accrued prior to the time the fee was waived raises the question of whether the interest issued to a partner was a capital interest as opposed to a profits interest. A profits interest entitles a partner to only future profits, and nothing on liquidation of the partnership. If a general partner is entitled to a payment immediately after the issuance of a profits interest upon a hypothetical liquidation of the fund, then the general partner may have been issued a capital interest. See Lokey, Jr. & Rocap, supra note 41.

[67] See IRC § 731, 721.

[68] Polsky, supra note 16.

the taxation of profits interests that existed prior to the issuance of this revenue procedure.[69]

Section 707(c). Section 707(c) states:

> to the extent determined without regard to the income of the partnership, payments to a partner for services . . . shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and, subject to section 162, for purposes of section 162(a) (relating to trade or business expenses).

In its recent statements, curiously, the IRS has not mentioned Section 707(c) when discussing its renewed interest in "getting at" management fee waiver arrangements.

Pre TRA-84. To understand the IRS's current position, a review of the relevant historic case law is helpful. The seminal case addressing nonpartner capacity prior to the Tax Reform Act of 1984[70] (TRA-84) is *Pratt v. Commissioner*.[71] In *Pratt*, three individuals formed partnerships to purchase, develop, and operate shopping centers. In return for these services, the partners received a fee equal to a percentage of gross rental from the shopping center. The partners maintained that the fees should be treated as payments under Section 707(a) or 707(c), and reported the fees in the year received rather than the year earned. The IRS asserted that the partners, cash basis taxpayers, should include the fee income as distributive shares in the years in which they were earned.

The Tax Court held that the fees were not Section 707(a) payments because the partners were performing "basic duties of their partnership business pursuant to the partnership agreement" and were acting "within the normal scope of their duties as general partners."[72] It found that the fees were properly treated as a distributive share of partnership income and were includable in the partner's gross income for the years in which the services were rendered and not in the years when the payments were ultimately received. On appeal, the Fifth Circuit affirmed the Tax Court's decision, finding the partners performed the managerial services in their capacities as partners. Both the Tax Court and the Fifth Circuit focused their "partner capacity" analysis on an evaluation of the "nature of the services" when compared to the activities in which the partnership was engaged.

In response to *Pratt*, the IRS issued Revenue Ruling 81-300,[73] which was based on facts very similar to *Pratt*'s. The IRS agreed with *Pratt* that the partners in their capacities as partners rendered the managerial services, and thus Section 707(c) applied. It said

> the term "guaranteed payment" should not be limited to fixed amounts. A payment for services determined by reference to an item of gross income will be a guaranteed payment, if based on all of the facts and circumstances, the payment is compensation rather than a share of profits. . . . It is the position of the [IRS] that in *Pratt* the management fees were guaranteed payments under Section 707(c) of the Code.[74]

---

[69] Rev. Proc. 93-27 describes the case law that existed immediately prior to its issuance:

> Under section 1.721-1(b)(1) of the Income Tax Regulations, the receipt of a partnership capital interest for services provided to or for the benefit of the partnership is taxable as compensation. On the other hand, the issue of whether the receipt of a partnership profits interest for services is taxable has been the subject of litigation. Most recently, in Campbell v. Commissioner, 943 F.2d 815 (8th Cir. 1991), the Eighth Circuit in dictum suggested that the taxpayer's receipt of a partnership profits interest received for services was not taxable, but decided the case on valuation. Other courts have determined that in certain circumstances the receipt of a partnership profits interest for services is a taxable event under section 83 of the Internal Revenue Code. See, e.g., Campbell v. Commissioner, T.C.M. 1990-236, rev'd, 943 F.2d 815 (8th Cir. 1991); St. John v. United States, No. 82-1134 (C.D. Ill. Nov. 16, 1983). The courts have also found that typically the profits interest received has speculative or no determinable value at the time of receipt. See Campbell, 943 F.2d at 823; St. John. In Diamond v. Commissioner, 56 T.C. 530 (1971), aff 'd, 492 F.2d 286 (7th Cir. 1974), however, the court assumed that the interest received by the taxpayer was a partnership profits interest and found the value of the interest was readily determinable. In that case, the interest was sold soon after receipt.

[70] P.L. 99-514).

[71] 64 TC 203 (1975), aff'd in part and rev'd in part, 550 F2d 1023 (5th Cir. 1977).

[72] Pratt, 64 TC at 211-212. The Tax Court also held that a payment based on a partnership's gross income is not a guaranteed payment under Section 707(c) because it was computed as a percentage of "gross income" of the partnership (as discussed below).

[73] 1981-2 CB 143.

[74] Id. The IRS simultaneously issued Rev. Rul. 81-301, 1981-2 CB 144. This involved a partner/advisor that rendered services to an investment partnership and was allocated 10 percent of the daily gross income of the partnership in return. The services were substantially the same as the services it rendered as an independent contractor or agent to persons other than its partners. The IRS ruled that IRC § 707(a) applied to the services because: (i) the adviser provided similar services to others as part of its regular trade or business, (ii) its services to the partnership were supervised by the directors of the partnership, (iii) the partner/advisor could be relieved of its duties and right to compensation at any time by a majority vote of the directors, (iv) the partner/advisor paid its own expenses and was not personally liable to the other partners for any losses incurred in the investment and reinvestment services that he provided.

Post-TRA-84. Curiously, the legislative history of TRA-84, addressing Section 707(a)(2)(A) (discussed further below) states that

> Congress intended that [Section 707(a)(2)(A)] lead to the conclusions contained in [Rev. Rul. 81-300], except that the transaction described in Rev. Rul. 81-300 would be treated as a transaction described in section 707(a) (rather than section 707(c)).[75]

It is not clear why Congress did not agree with the IRS position that Section 707(c) applies to such allocations. It could be that Congress agreed with the Tax Court in the *Pratt* decision.[76]

The IRS currently appears inclined not to use Section 707(c) as the basis for asserting that management fee waivers result in ordinary income. Perhaps it is because of the position Congress took in enacting TRA-84, or perhaps it thinks Revenue Procedure 93-27 and Section 707(a)(2) provide sufficient ammunition.[77] Therefore, we focus our attention on Section 707(a)(2)(A).

Section 707(a)(2)(A). In recent statements, IRS representatives have repeatedly asserted Section 707(a)(2)(A) as a possible basis for fee waivers resulting in ordinary income. Added to the Code as a part of TRA-84, Section 707(a)(2)(A) provides, in relevant part, that under Treasury regulations, if:

> (1) a partner performs services for a partnership,
> (2) there is a related direct or indirect partnership allocation and distribution to the partner, and
> (3) when viewed together, the performance of such services and the allocation/distribution are properly characterized as a transaction between the partnership and a partner acting in a non-partner capacity, the transaction is to be treated as a transaction between the partnership and a person who is not a partner.[78]

Where Section 707(a)(2)(A) applies, the amount paid to the partner is treated as a payment for services rather than a distributive share of partnership income whose character is determined at the partnership level.

Prior to its amendment by TRA-84, Section 707(a) simply provided that partners engaging in transactions with a partnership in a nonpartner capacity should be treated as third parties for tax purposes. Generally, services that were closely related to the business of the partnership were found to be services rendered in a partner capacity, and those not closely related were held to be services rendered in a nonpartner capacity.[79] As discussed below, Section 707(a)(2)(A) redefined the determination of whether a partner is acting in its capacity as a partner by focusing on risk, specifically the risk as to the amount and fact surrounding a special allocation, as opposed to the nature of the services.[80]

Although the pre-1984 authorities continue to be relevant in determining whether a payment is treated as a Section 707(a) payment, they became less important with the enactment of Section 707(a)(2)(A).

The IRS currently appears inclined not to use Section 707(c) as the basis for asserting that management fee waivers result in ordinary income.

Treasury has not yet issued regulations pursuant to Code Section 707(a)(2)(A); however, the legislative history provides significant guidance for determining when a partner is acting in a non-partner capacity.

A large aim of Congress in enacting Section 707(a)(2)(A) was to prevent partnerships from effectively obtaining current deductions for payments that would otherwise be required to be capitalized and deducted over a longer period of time.[81] However,

---

[75] Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 226 (1985) [hereinafter "1985 Joint Committee Report"] at 230-231.

[76] See Seth H. Poloner, "Structuring Hedge Fund Manager Compensation: Tax and Economic Considerations," 11 J. Tax'n 304, 308-309 (May 2010), and the authorities cited therein.

[77] See id. for a more in depth discussion of IRC § 707(c).

[78] See IRC § 707(a)(2)(A); 1985 Joint Committee Report, supra note 75.

[79] See Philip F. Postlewaite & David Cameron, "Twisting Slowly in the Wind: Guaranteed Payments After the Tax Reform Act of 1984," 40 Tax Law. 649, 660 (1986-1987).

[80] Id.

[81] A partnership is generally required to capitalize (rather than currently deduct) expenditures that relate to the improvement of property or create an asset the useful life of which extends substantially beyond the end of the taxable year. Similarly, under IRC § 709, a partnership may not currently deduct amounts paid or incurred to organize the partnership. Absent the application of IRC § 707(a)(2)(A), if the organizer of a partnership was also a partner of the partnership, allocations of partnership gross or net income to the organizer and related income distributions to him in payment of his services, could, if respected, have the effect of a current deduction for organizational and syndication fees (because the allocation and related distribution, which in this case were economically indistinguishable from a direct payment, reduced the taxable income allocated to the remaining partners in the year of the allocation. In enacting IRC § 707(a)(2)(A), Congress was concerned that partnerships were being used to circumvent the requirement to capitalize certain expenses by making allocations of income and corresponding distribution in place of direct payments for property or services. See 1985 Joint Committee Report, supra n.75, at 225: "The provision is aimed at preventing a partnership from obtaining an effective deduction for the cost of services rendered that must otherwise be capitalized. S. Rep. No. 169, 98th Cong., 2d Sess. 225 (1984) ('Senate Report'). The effect of the provision is to deny the service provider or the transferor of property the status of a partner, thus denying the partnership the advantage sought." Id.

Congress was also clearly mindful of the potential manipulation by some to characterize income that would otherwise be ordinary as capital gain,[82] and intended for Section 707(a)(2)(A) to address any such potential manipulations.

Congress believed that certain factors should be considered in determining whether a partner receives the putative allocation and distribution in his capacity as a partner.[83] In Technical Advice Memorandum 9219002,[84] in ruling as to whether an allocation of capital gain to a limited partner was a payment within the scope of Section 707(a)(2)(A), the IRS considered this legislative history and analyzed these factors.

Payments Subject to Appreciable Risk. The Joint Committee Report states:

> The first, and generally the most important, factor is whether the payment is subject to an appreciable risk as to amount. Partners extract the profits of the partnership with reference to the business success of the venture, while third parties generally receive payments which are not subject to this risk. Thus, an allocation and distribution provided for a service partner under the partnership agreement which subjects the partner to significant entrepreneurial risk as to both the amount and the fact of payment generally should be recognized as a distributive share and a partnership distribution, while an allocation and distribution provided to a service partner under the partnership agreement which involve limited risk as to the amount and payment should generally be treated as a fee under section 707(a).[85]

Notably, in Technical Advice Memorandum 9219002, the IRS gave great weight to the first factor in ruling that allocations to a partner were in its capacity as a partner. It noted that the allocation was "subject to significant entrepreneurial risk as to both the fact and the amount of the allocation" and that the amount of any appreciation in the assets of the partnership (and resulting allocation) was "highly speculative."[86]

The Joint Committee Report provides two specific examples of limited partner's risk: (1) capped allocation of partnership income (i.e., percentage or fixed dollar amount allocations subject to an annual maximum amount when the parties could reasonably expect the cap to apply in most years); and (2) allocations for a fixed number of years under which the income that will go to the partner is reasonably certain.[87] Similarly, continuing arrangements in which purported allocations and distributions are fixed in amount or reasonably determinable under all the facts and circumstances and which arise in connection with services also shield the purported partner from entrepreneurial risk.[88]

Regarding the existence of appreciable risk when gross income allocations are involved the Joint Committee Report provides:

> Although short-lived [i.e., capped or for a fixed number of years] gross income allocations are particularly suspect in this regard, gross income allocations may, in very limited instances, represent an entrepreneurial return, which is classifiable as a distributive share under section 704.[89]

The first factor is the most important one, and should be carefully analyzed in the private equity context. Fee waivers often involve capped allocations of fund income. Also, unlike the general carried interests issued to most general partners in funds, the allocations related to the fee waivers are not only much higher in the waterfall, but specifically tied to the amount of the management fee, or the reduced capital contribution. Further, fee waivers frequently involve allocations of gross income rather than net income, and sometimes allocations of gross income on a quarterly basis rather than an annual basis. The reality is that most partners engaging in fee waivers want to do so on terms that do not meaningfully alter their right to receive the underlying funds, or subject it to greater risk. The ideal result for most waiver arrangements is one where, if tax considerations are put aside, there is essentially no change to their right to receive the funds. Depending on the general expectations regarding the fund's underlying income, it is quite possible that the waivers would—and should—be treated as not subject to entrepreneurial risk as to fact or amount.

This is not to say that allocations of gross income are never subject to entrepreneurial risk. For example, there certainly may exist the risk that the fund may not have sufficient gross income in a fiscal year or

[82] See 1985 Joint Committee Report, supra note 75, at 224 (in addressing issues under prior law, it notes "if a service-providing partner was allocated a portion of the partnership's capital gains in lieu of a fee, the effect of the allocation/distribution could be to convert ordinary income (compensation for services) into capital gains"); see also Senate Report, supra note 81, at 228.

[83] 1985 Joint Committee Report, supra note 75, at 227.

[84] TAM 9219002 (Jan. 27, 1992).

[85] 1985 Joint Committee Report, supra note 75, at 227.

[86] See supra note 84.

[87] See 1985 Joint Committee Report, supra note 75, at 227-228.

[88] Id. at 228.

[89] Id.

quarter to make the allocation in lieu of the fee. The allocation in the partnership agreement may be structured so as to be required to be allocated to the general partner only once certain hurdles have been achieved. The partnership may have a right to claw back the distributed fee in certain events. The point, however, is that this is a factual determination, and in many circumstances, risk is not present. In these cases, there may be a strong argument that the receipt of the allocation and the related distribution is not subject to entrepreneurial risk.

We note that the situation, described earlier in this article, where certain partnerships make distributions to the manager from cash proceeds prior to and unrelated to the sale of portfolio investments would seem to be a circumstance where there is very little entrepreneurial risk. In such cases, the application of Section 707(a)(2)(A) may be particularly relevant.

Partner Status of Recipient Is Transitory. The second factor is whether the recipient's partner status is transitory. Transitory partner status (which limits the duration of a purported joint undertaking for profit) suggests that a payment is a fee. *"The fact that partner status is continuing, however, is of no particular relevance in establishing that an allocation and distribution are received in an individual's capacity as a partner."*[90] In most cases, partner status of the general partner receiving the additional profits interest will not be transient. While the existence of this factor supports characterization as a fee, its absence appears to be neutral.

Allocation and Distribution Close in Time to Performance of Services. The third factor is whether the allocation and distribution are close in time to the partner's performance of services for the partnership.[91] Such an allocation is more likely to be related to the services. When the income subject to allocation arises over an extended period or is remote in time from the services, the risk of not receiving the payment (the first factor) may also increase.[92]

Generally, allocations of income to general partners in lieu of fee waivers are relatively high up in the waterfall, and are relatively close in time to the performance of the ongoing services. This factor, as applied to many situations, would seem to support characterization as a fee.

Recipient Became Partner Primarily to Get Tax Benefits. The fourth factor is whether, under all the facts and circumstances, the recipient became a partner primarily to obtain tax benefits for himself or the partnership which would not have been available if he had rendered services to the partnership in a third-party capacity. While it certainly could not be said that the general partner became a partner in the fund for the purpose of obtaining a tax benefit, it may be said that the general partner is opting to receive the specific allocation in lieu of a fee waiver (i.e., increasing its profits interest) primarily to obtain tax benefits for himself.

Size of Profits Interest. The fifth factor is whether the value of the partner's interest in the general and continuing partnership profits is small in relation to the allocation in question (thus suggesting that the purported allocation is, in fact, a fee). Typically the general partner's profits interest, not taking into account any profits interest granted in lieu of the management fee, is quite large. *"The fact that the recipient's interest in general and continuing partnership profits is substantial does not, however, suggest that the purported partnership allocation/distribution arrangement should be recognized."*[93]

Transitory partner status (which limits the duration of a purported joint undertaking for profit) suggests that a payment is a fee.

While application of the five factors will yield different results depending on the underlying facts and circumstances, generally, the first (and most important) and the third factors will support that Section 707(a)(2)(A) should apply, and the remaining factors will be neutral.

Illustrative Example. After describing the five factors, the legislative history sets forth two illustrative examples, one of which seems quite relevant to management fee waivers:

> Example 1: A commercial office building constructed by a partnership is projected to generate gross income of at least $100,000 per year indefinitely. Its architect, whose normal fee for such services is $40,000, contributes cash for a 25-percent interest in the partnership and receives both a 25-percent distributive share of net income for the life of the partnership, and an allocation of $20,000 of partnership gross income for the

[90] Id. (emphasis added).

[91] Id.

[92] Id.

[93] Id. (emphasis added).

> first two years of partnership operations after lease-up. The partnership is expected to have sufficient cash available to distribute $20,000 to the architect in each of the first two years, and the agreement requires such a distribution.[94]

The Joint Committee Report concludes that the purported gross income allocation and partnership distribution in this example should be treated as a fee under Section 707(a), rather than as a distributive share, because as to those payments the architect is insulated from the risk of the joint enterprise. Factors which contribute to this conclusion are: (1) the special allocation to the architect is fixed in amount and there is a substantial probability that the partnership will have sufficient gross income and cash to satisfy the allocation/distribution; (2) the distribution relating to the allocation is fairly close in time to the rendering of the services; and (3) it is not unreasonable to conclude from all the facts and circumstances that the architect became a partner primarily for tax reasons.[95]

The Joint Committee Report goes on to note that if the agreement allocates to the architect 20 percent of gross income for the first two years following construction of the building, a question arises as to how likely it is that the architect will receive substantially more or less than his imputed $40,000 fee. In this case, if the building is pre-leased to a high-credit tenant under a lease requiring the lessee to pay rent of $100,000 per year, or if there is a low vacancy rate in the area for comparable space, it is likely that the architect will receive approximately $20,000 per year for the first two years of operations. Therefore, he assumes limited risk as to the amount or payment of the allocation; as a consequence, the allocation/distribution should be treated as a disguised fee. If, on the other hand, the project is a “spec building,” and the architect assumes significant entrepreneurial risk that the partnership will be unable to lease it, the special allocation might (even though a gross income allocation), depending on all the facts and circumstances, properly be treated as a distributive share and a genuine partnership distribution. (The second example is not quite as applicable as Example 1 to the fund situation. Hence, we do not delve into it here.)

The Joint Committee Report example illustrates how factually sensitive the determination is of whether a purported income allocation is in substance a payment subject to Section 707(a)(2)(A). The example suggests that in the private equity context focus should be placed on the probability that the fund will have enough income to make the allocation of the profit in lieu of the fee, whether the amount is fixed, and the expected timing of the distribution in relation to when the fee would have been paid.

While some may view Code Section 707(a)(2)(A) as difficult to apply in the absence of regulations, the five factors cited in the legislative history do provide helpful guidance.

The Joint Committee Report examples illustrate how factually sensitive the determination of whether a purported income allocation is in substance a payment subject to Section 707(a)(2)(A) will be. While situations at one end of the spectrum (up-front waiver prior to the time any services have been performed; limited certainty as to how much and timing of income the fund will generate; and allocations out of net income) appear to not fall within the purview of Section 707(a)(2)(A), many situations that are in a more gray area may do so. Facts and circumstances of each situation have to be weighed and considered. This spectrum analysis is precisely what the IRS has stated it will use to provide greater clarity as to permissible and impermissible fund management fee waiver arrangements. Specifically, two areas that the government has said it may address are: (1) the timing of when the waiver occurs, and (2) the likelihood that profit is available to pay the general partner in lieu of the fee.[96] Both of these factors are relevant to the Section 707(a)(2)(A) analysis.

CONCLUSION

The question of whether management fee waivers successfully convert a fee taxed as ordinary income into a share of the fund's income allocable to a partner under Section 704(b) is highly fact dependent. An examination of the existing case law and legislative history suggests that the waiver will not be successful under certain circumstances. The IRS has expressed that it views the factual situations as landing on a spectrum. While situations at one end of the spectrum (up-front waiver prior to the time any services have been performed; limited certainty as to how much and timing of income the fund will generate; and allocations out of net income) appear to not fall within the purview of Section 707(a)(2)(A) or an exception to Revenue Procedure 93-27, many situations in a more gray area may do so. In order to avoid risk of taxation of the issuance of the profits interest, and risk of characterization as payment for services pursuant to Section 707(a)(2)(A), managers of funds should (1) be mindful of the timing of the waiver, and (2) be willing to subject the receipt of the funds to a certain level of risk. ■

[94] Id. at 229.

[95] Id. at 229-230.

[96] Id.