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Management Fee Waivers

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Management Fee Waivers Generally

- The key economic incentives for sponsors of a private equity fund are to earn management fees and a profit participation on the fund's investments (*i.e.*, the carried interest).
- Management fees are typically taxed to the sponsors as ordinary income and, as of this writing, the carried interest is generally taxed as long term capital gains (since the carried interest retains the character of the income earned by the fund which is, typically, long-term capital gains).
- ***For years, sponsors of private equity funds have employed a strategy of waiving their management fees in return for a priority profits allocation (e.g., an additional carried interest) when the fund earns income, including long-term capital gain income. By doing so, the sponsors effectively convert ordinary income into long-term capital gains.***
- The purpose of this presentation is to: (i) provide typical management fee waiver provisions for the fund limited partnership agreements; and (ii) discuss how the IRS will likely issue guidance that could re-characterize the fee waivers back into ordinary income.

Management Fee Waivers – LPA Provisions

Defined Terms

- “Waived Fee Amount” means on any date, the amount of any Management Fee payable on or prior to such date that has been waived in accordance with section [XX].
- “Adjusted Net Income” means, with respect to any Waived Fee Amount and solely for purposes of determining amounts to be distributed under Section [XX] (note: the section referencing the special distributions attributable to the Waived Fee Amount), on any date, the portion, if any, of Net Income corresponding to Distributable Cash on such date remaining if such Net Income is recalculated, assuming that the respective Book Values of all Partnership assets is deemed to have been adjusted to reflect their respective Fair Market Values on the Waiver Effective Date for such Waived Fee Amount.
- “Remaining Waived Fee Amount” means, on any date, the amount, if any, equal to the positive excess of: (a) all Waived Fee Amounts created on or prior to such date over (b) the aggregate amount of distributions to the Special Limited Partner prior to such date pursuant to section [XX].

Management Fee Waivers – LPA Provisions

Defined Terms

- “LP Percentage” means, with respect to any Limited Partner and any Portfolio Investment, the percentage corresponding to the ratio of such Limited Partner’s Percentage Interest with respect to such Portfolio Investment over the total Percentage Interests of all Limited Partners with respect to such Portfolio Investment.
- “Management Fee Portion” means, with respect to distributions on any date attributable to any Portfolio Investment, the aggregate amount that would be distributable on such date under section [XX] to a Limited Partner whose Capital Commitment had equaled the aggregate Waived Fee Amount on such date (other than amounts so distributable to such Limited Partner under section [XX] (note: return of capital contributions provision) but without giving effect to any reapportionment to the General Partner under section [XX] (note: GP catch-up and carried interest provisions).

Management Fee Waivers – LPA Provisions

Waiver Provisions

- Management Fee Waiver. The Manager shall have the option, in its sole discretion, to waive the payment to it of all or any portion of the Management Fee otherwise payable on any date, such option to be exercised by an irrevocable written notice to such effect to the General Partner at least two Business Days prior to the earlier of (A) the first day of the Fiscal Year of the Partnership in which such payment date occurs or (B) the first day of any prior such Fiscal Year prior to such Fiscal Year but commencing subsequent to the applicable notice of waiver. Capital Contributions applied to the payment of Management Fees, including amounts that would have been applied to the payment of Management Fees but for a waiver of such payment under this section [XX], shall not reduce the Remaining Capital Commitment of any Partner. In the event a Waived Fee Amount is established pursuant to the foregoing provisions of this section [XX], the Manager (or its designee) shall execute and deliver to the General Partner a signature page to this Agreement and upon such delivery, the Manager (or such designee) shall become the special limited partner of the Partnership (the “Special Limited Partner”) and, as such, the Special Limited Partner shall be entitled to receive distributions of Distributable Cash calculated by reference to the Waived Fee Amount under section [XX] and corresponding allocations under section [XX], but shall not by reason of being the Special Limited Partner have a Capital Commitment or a Voting Interest or be required to make Capital Contributions.

Management Fee Waivers – LPA Provisions

Special Distributions

Special Distributions in Respect of Waived Management Fees. In the event that, prior to any distributions of Distributable Cash subject to section [XX] [Note 1], a positive Waived Fee Amount has been established, then the application of section [XX] [Note 1] to the portion of such distribution apportioned to any Limited Partner shall, solely to the extent such Distributable Cash corresponds to Adjusted Net Income determined on such date by reference to the related Waived Fee Amount, be modified by the following:

(i) First, before any distribution to such Limited Partner pursuant to section [XX] [Note 2], amounts otherwise so distributable shall instead be distributed to the Special Limited Partner until the amount so distributed to the Special Limited Partner under this section [XX] relating to such Limited Partner equals the product at the time of any Remaining Waived Fee Amount and such Limited Partner's LP Percentage; and

(ii) Second, after all distributions to such Limited Partner at the time required under section [XX] [Note 2] but before any distribution to such Limited Partner pursuant to section [XX] [Note 3], amounts otherwise so distributable shall instead be distributed to the Special Limited Partner until the amount so distributed to the Special Limited Partner under this section [XX] relating to such Limited Partner equals the product such Limited Partner's LP Percentage and the Management Fee Portion with respect to such Portfolio Investment.

Note 1 -- This reference is to the section attributable to distributions of Available Cash from Portfolio Investments generally.

Note 2 -- This reference is to the section requiring distributions attributable to a return of capital contributions, including a return of capital contributions used to fund investments and also capital contributions used to fund expenses.

Note 3 -- This reference is to the section requiring distributions attributable to the preferred return payable to the investors.

IRS Re-characterization of Fee Waivers

- In the 2012 presidential election, Mitt Romney's nomination brought national attention to Bain Capital's strategy of waiving management fees in order to convert the taxation of such income from ordinary into long-term capital gains.
- Since 2012 and to date, the IRS has not successfully challenged fee waivers.
- **However, the IRS recently proposed Treasury Regulations pursuant to IRC 707(a)(2)(A) that would eliminate fee waivers and the conversion of ordinary income into capital gain.**

IRC 707(a)(2)(A)

Transactions that are characterized under IRC 707 typically result in ordinary income treatment to the payee and a reduction in income to the partnership regardless of whether the payments by the partnership to the partner are intended to be treated as distributive share of income. Section 707(a) provides as follows:

Section 707: Transactions between partner and partnership

(a) Partner not acting in capacity as partner.

(1) In general. If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner.

(2) Treatment of payments to partners for property or services. **Under regulations prescribed by the Secretary** – (A) If (i) a partner performs services for a partnership . . . (ii) there is a related direct or indirect allocation or distribution to such partner, and (iii) the performance of such services (or such transfer) and the allocation and distribution, when viewed together, are properly characterized as a transaction as occurring between the partnership and a partner acting other than in his capacity as a member of the partnership, such allocation and distribution shall be treated as a transaction described in paragraph (1).

Proposed Regulations Under IRC 707(a)(2)(A)

- On July 22, 2015, the IRS issued proposed regulations under IRC 707(a)(2)(A) indicating the circumstances under which payments made by a partnership will be a disguised payment for services. The proposed regulations provide that such analysis is based upon the facts and circumstances of the arrangement. The proposed regulations then provide for six non-exhaustive factors that may indicate a disguised payment for services. They are as follows:
 - Lack of Significant Entrepreneurial Risk
 - Timing of Allocation and Distribution
 - Transitory Partnership Interest
 - Obtaining Tax Benefit
 - Relative Size of the Partnership Interest
 - Different Allocations and Distributions for Different Services

The following slides will provide some detailed information about each of the factors referenced above.

Proposed Regulations Under 707(a)(2)(A)

- Lack of Significant Entrepreneurial Risk: The most important factor in determining whether an arrangement is a disguised payment for services is whether the service provider's allocation and distribution is subject to "significant entrepreneurial risk." The determination of whether an arrangement lacks significant entrepreneurial risk is based upon the service provider's risk relative to the overall entrepreneurial risk of the partnership. The following factors create a presumption that an arrangement lacks significant entrepreneurial risk:
 - Capped allocations of income if the cap is reasonably expected to apply in most years.
 - An allocation for one or more years under which the service provider's share of income is reasonably certain.
 - An allocation of "gross" income rather than an allocation of income on a "net" basis.
 - An allocation that is predominantly fixed in amount, is reasonably determinable under all the facts and circumstances or is designed to ensure that sufficient net profits are highly likely to be available to make the allocation to the service provider.
 - An arrangement in which a service provider waives its right to receive payment for future services in a manner that is non-binding or fails to notify the partnership and its partners of the waiver or its terms.

Proposed Regulations Under 707(a)(2)(A)

- Timing of Allocation and Distribution: The service provider receives an allocation and distribution in a time frame comparable to the time frame that non-partner service provider would typically receive payment for services.
- Transitory Partnership Interest: The service provider holds or is expected to hold a transitory partnership interest or a partnership for only a short period of time.
- Obtaining Tax Benefits: The service provider became a partner primarily to obtain tax benefits that would not have been available if the services were rendered to the partnership in a non-party third party capacity.
- Relative Size of Partnership Interest: The value of the service provider's interest in general and continuing partnership profits is small in relation to the allocation and distribution.
- Different Allocations and Distributions for Different Services: The arrangement provides for different allocations or distributions with respect to different services rendered, where the services are provided either by a single person or related persons and the terms of differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly.

Proposed Changes to Rev.Proc. 93-27

- Revenue Procedure 93-27 provides a safe harbor to the taxation of the service provider upon the receipt of profits interests in connection with the performance of services. The safe harbor currently provides that the receipt of a profits interest in return for the performance of services will not be taxable unless either: (i) the profits interest relates to a substantially certain and predictable stream of income from partnership assets; (ii) the partner disposes of the profits interest within 2 years of receipt; or (iii) the relevant partnership is a publicly-traded partnership.
- In structuring management fee waivers, taxpayers have generally relied on the Rev.Proc. 93-27 safe harbor to take the position that receipt of a profits interests in exchange for the waiver of the management fee is not a taxable event.
- The IRS intends to create another exception to the safe harbor under Rev.Proc. 930-27. The proposed exception would apply to a profits interest issued in conjunction with a partner waiving payment of an amount that is substantially fixed for the performance of services, including fees based upon a percentage of capital commitments. The exception would apply even if service provider had a significant entrepreneurial risk.

Examples Under Proposed Regulations

- The Proposed Regulations contain several examples of management fee waivers, including examples where, if the regulations are finalized in such form, the IRS will respect the waivers. The common elements of the examples where the waivers will be respected are as follows:
 - Cumulative Net Income: allocations and distributions in respect of the waiver interest are made out (and only to the extent of) cumulative net income and gain over the life of the fund.
 - Clawback: the partner receiving the allocations and distributions in respect of the waiver interest agrees to return to the fund any distributions that ultimately are not supported by allocations of cumulative net income or gain, and it is reasonable to believe that the partner will be able to (and actually will) satisfy the clawback obligation.
 - Waiver Requirements:
 - Waiver is irrevocable
 - Advance notice of the waiver is made to all partners in the fund
 - Waiver occurs prior to the fund's first investment or at least before the taxable year in which the fees are due

Practical Solutions for Management Fee Waivers

- Solutions for New Funds:
 - Include a waiver that is based upon cumulative net profits over the life of the fund. Do not have special allocations of income or gain for the amount of the waived fees on an annual basis.
 - Include a clawback provision in the waiver provisions of the limited partnership agreement.
 - Allocations and distributions should be made to the party entitled to receive the management fees. Do not give the management company flexibility to designate which party (e.g. the general partner of the fund) is entitled to the allocation and distribution.
 - Provide for an upfront waiver to comply with the profits interest safe harbor under potential changes to Rev.Proc. 93-27.
- Solutions for Existing Funds: Sponsors should amend the limited partnership agreement to:
 - Hardwire any discretionary waivers.
 - Amend the allocation and distribution provisions so that the waiver is based upon cumulative net profits over the life of the fund.
 - Include a clawback provision with respect to the distributions attributable to the waiver.
 - Allocations and distributions should be made to the party entitled to receive the management fees. Do not give the management company flexibility to designate which party (e.g. the general partner of the fund) is entitled to the allocation and distribution.

Other Jurisdictions

- Fee waiver structures are not effective in other jurisdictions.
- For example, the UK introduced the disguised management fee income rules in 2015, which effectively prevented the use of fee waiver, fee diversion, etc.
- International funds will need to check the position in countries applicable to them.

Further information

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