

IRS Unlikely to Seek to Prohibit PE Fund Management Fee Waivers

PENpoints

Recent statements by a senior IRS representative indicate that the IRS is likely to challenge management fee waiver arrangements in only limited circumstances.

Over the past year, both the IRS and the New York Attorney General have announced that they were “studying” PE fund management fee waiver strategies. However, the New York examination appears to have moved to the back burner in recent months, and statements last week by a senior IRS representative indicate that the IRS is likely to challenge management fee waiver arrangements in only limited circumstances.

In a typical management fee waiver arrangement, the general partner of a private investment fund agrees to forego management fees in exchange for a special allocation out of the fund’s future profits (frequently out of long-term capital gain). The technique has many possible variations — which the IRS views as a spectrum — some of which work “well” to convert management fee income into long-term capital gain and some of which do not.

Because determining whether a fee waiver arrangement complies with current tax law depends so heavily on the facts and circumstances of each particular case, the IRS is not likely to issue regulations or other guidance addressing fee waiver arrangements generally. Rather, the IRS is likely to (1) utilize the audit process to scrutinize a PE fund’s fee waiver arrangement to determine the extent to which the arrangement subjects the general partner’s special profit allocation to genuine economic risk, and (2) challenge an arrangement that falls on the aggressive end of the spectrum. According to the IRS representative, the IRS has not yet reached any firm conclusions, but may have greater concern about a waiver executed shortly before the applicable fee was due to be paid in exchange for an allocation out of the fund’s next available gross profit where the facts suggest

that the gain out of which the waived amount was to be paid already was “built-in” at the time of the fee waiver (i.e., where the fund assets already had appreciated enough to ensure the waived amount would be paid).

Management fee waiver strategies also would be affected if legislation were enacted to mandate the taxation of investment fund carried interest as ordinary income. Under current tax law, the profit allocated to a fund general partner with respect to both its carried interest and a successful fee waiver strategy is taxed on a flow-through basis and typically consists largely of long-term capital gain. As noted in previous *KirklandPENs*, legislative proposals to change carried interest taxation have been circulating since 2007, and are again included in the Obama administration’s fiscal 2014 budget proposals.¹ If such legislation were enacted, fund manager carried interests, and also fee waiver profit allocations, would generally be taxed as ordinary income rather than as capital gain.

In light of these developments, as well as the complexity of fee waiver strategies generally, fund managers should consult experienced counsel before implementing a new fee waiver strategy and to ensure that existing strategies are designed to withstand potential scrutiny and adapt to possible future changes in tax law.

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¹ See *KirklandPEN* dated [April 15, 2013](#) for prior coverage of the carried interest proposal in the 2014 Obama administration budget, and *KirklandPENs* dated [June 17, 2010](#) and [May 21, 2010](#) for prior coverage of carried interest legislation generally.

If you have any questions about the matters addressed in this *KirklandPEN*, please contact the following Kirkland authors or your regular Kirkland contact.

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Appraisal Rights – The Next Frontier in Deal Litigation?

Appraisal, or dissenters' rights, long an M&A afterthought, have recently attracted more attention as a result of largely unrelated factors giving plaintiffs incentives to pursue a post-merger appraisal claim. While deal counsel typically address the theoretical applicability of appraisal rights where relevant, a number of developments in recent years have contributed to

these rights becoming a potential new frontier in deal risk and litigation. Although it is too early to predict whether appraisal cases will see a true surge, current market conditions and developments regarding dissenters' rights suggest that these rights may merit a reappraisal. To read more about this development, see our recent [M&A Update](#).

New Budget Proposal Could Mean Sweeping Changes in Wind Energy Tax Credits

Private equity firms that invest in the energy industry should take note of new guidance from the IRS relating to tax credits for renewable energy projects and related changes in the Obama Administration's pro-

posed budget to wind and other alternative energy production tax credits. To learn more, see our recent [Kirkland Alert](#).

Setting the Record (Date) Straight

Setting the "record date" in a merger creates a frozen list of stockholders as of a specified date who are entitled to receive notice of, and to vote at, a stockholders' meeting to approve the merger. A tactical approach to the timing of the record date can have strategic implications on the prospects for a deal's success, while the failure to comply with the rules relating to setting a

record date could cause a significant delay in holding the vote, leaving the door open for a topping bidder or dissident stockholder to emerge or gather support. As a result, it is important that dealmakers understand the basic mechanics and rules of setting a record date and the tactical repercussions of the record date construct. To learn more, see our recent [M&A Update](#).

PENnotes

Private Equity Forum (Fourteenth Annual)
New York, New York
July 8 - 9, 2013

The Practising Law Institute will host its “Private Equity Forum (Fourteenth Annual)” on July 8-9 in New York. A distinguished panel of experts will discuss the basics of the private equity practice from fund formation to private equity M&A. Kirkland partner John O’Neil will participate in a panel discussion about the regulatory issues that must be considered when raising a private equity fund. Click [here](#) for more information or to register for this event

5th Annual TMA Western Regional Conference
Laguna Beach, California
July 17 - 19, 2013

Partner Samantha Good will be a featured panelist at the 5th Annual Turnaround Management Association (TMA) Western Regional Conference on July 17-19 in Laguna Beach, California. Samantha’s panel will discuss “Contrasting Restructurings of Large vs. Middle Market Companies.” The panel will provide a contrast between various cases, from small cap restructurings to mega-size restructurings, from the perspectives of the various constituents involved in such cases, as well as thoughts on the current restructuring market and near-term outlook. To register, click [here](#).

Structuring and Negotiating LBOs
Chicago, September 12, 2013
New York, September 19, 2013
San Francisco, September 27, 2013

This biennial event, chaired by partner Jack S. Levin, focuses on the legal, tax, structuring and practical negotiating aspects of buyouts and other complex private equity deal-doing. Registration details to come.

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Private Equity Practice at Kirkland & Ellis

Kirkland & Ellis' nearly 400 private equity attorneys have handled leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 400 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Private Equity Group of the Year" in 2012 and 2013 by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. In addition, Kirkland was awarded "Best M&A Firm in the United States" at *World Finance's* 2012 Legal Awards and was honored as the "Private Equity Team of the Year" at the 2011 *IFLR Americas Awards*.

The Firm was ranked as the #1 law firm for both Global and U.S. Buyouts by deal volume in Mergermarket's *League Tables of Legal Advisors to Global M&A for Full Year 2011 and 2012*, and has consistently received top rankings among law firms in Private Equity by Chambers & Partners, *The Legal 500*, the Practical Law Company and *IFLR*, among others.

The Lawyer magazine has recognized Kirkland as one of its "Transatlantic Elite" every year since 2008, having noted that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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