

The Internal Revenue Service (IRS) is considering two matters that are likely to be of considerable interest to managers of private equity funds, hedge funds and real estate funds – the tax treatment of management fee waivers and whether individuals can be employees and partners of the same partnership entity at the same time for tax purposes.

Management Fee Waivers

According to a recent report by BNA Tax, Clifford Warren, special counsel to the IRS office of Associate Chief Counsel (Passthroughs and Special Industries), has told practitioners at two recent conferences that proposed Treasury regulations addressing management fee waivers are expected to be released in the next few months. Warren was quoted at Practising Law Institute (PLI) programs in Chicago and New York this spring that the IRS has a good working draft of the proposed regulations that have been “reviewed in final form internally.”

In the most common type of management fee waiver, a fund manager waives the right to receive management or other service fees in lieu of making capital contributions that the manager may otherwise be required to make. The fee waiver may defer recognition of income and result in capital gain rather than ordinary income. Fee waivers are common in private equity funds, while less common in hedge funds and real estate partnerships.

Warren has suggested that fee waiver arrangements are drawing regulatory attention because tax practitioners and their fund clients have pushed the boundaries of permissible negotiated arrangements. The BNA reported that Warren told the New York PLI audience, “There’s a wide spectrum of fee waiver practices out there, and it’s not always clear how they work.”

While proposed regulations do not have the force of law unless and until they are finalized, Warren cautioned the New York PLI audience that fund managers should be wary of being too aggressive before the proposed regulations come out because existing tax rules could be used to curb current fee waiver abuses. During both PLI presentations, Warren observed the need for fund managers to have entrepreneurial risk, but it is not clear how that requirement may fit into the proposed regulations. He indicated that the proposed regulations will include examples.

It should be noted that last year, Warren told groups that the regulations would not be limited to covering management fee waivers and that they would include “conversion-type allocations and distributions” as well.

Employee-Partners

The IRS is also continuing to look at the issue of whether an individual can be a partner and an employee of a pass-through entity at the same time, a status barred by 1969 guidance (Revenue Ruling 69-184). Tax lawyers and accountants have been urging the IRS for years to reconsider the position, arguing that there is no detriment to the Treasury if regular compensation income paid to an employee-partner is treated as wages subject to withholding. Such treatment would make it easier for less sophisticated employee-partners, who could have trouble handling estimated tax payments on their own. The IRS has asked practitioners for a complete analysis of a change, including its possible impact on pension rules, fringe benefit rules and self-employment tax calculations.

A number of legislative tax reform proposals seek to break service partner compensation into two parts – regular compensation, which would be taxed as wages, and equity return, which would not. The equity return would not be subject to the self-employment tax. One of the proposals presented to the IRS for possible regulatory action seeks to avoid making changes to the Social Security and Medicare tax bases. Under that proposal, an employee-partner who is treated as receiving wages would continue to be liable for self-employment tax on the portion of his or her distributive share of partnership income that would be considered self-employment income under current law.

We will continue to monitor IRS action on the above two issues and will send out future client alerts with any new developments. In the meantime, if you have questions or would like to discuss the issues above, please do not hesitate to contact us.

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