Structuring Hedge Fund Manager Compensation: Tax and Economic Considerations

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The idea that compensation should be tied to a measurable performance standard is not a new one. For hedge fund managers, such an approach often takes the form of exceeding a benchmark, such as an S&P index. Many factors will affect the particular form such a relative incentive compensation package will take, complicated by the partnership provisions of the Code governing distributive shares and guaranteed payments.

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The recent turmoil in the financial markets may cause the structure of typical hedge fund manager compensation to be revisited. [1] Investors might look for ways to reduce the amount that fund managers take from their returns. Fund managers may seek ways to earn compensation in down markets. One possible compensation structure that could increase in popularity is compensation tied to a benchmark, also known as relative incentive compensation.

BACKGROUND

Hedge fund managers are usually compensated by their investors in two ways. They are entitled to a management fee, typically 1.5% or 2% per annum of the fund's net asset value. This payment is usually structured as a fee that is paid by the fund to the fund manager on a monthly or quarterly basis. In addition, fund managers are entitled to a percentage, typically 20%, of the net income of the fund every year. [2] This payment may be structured as a fee (referred to as an incentive fee or a performance fee) or an allocation (referred to as an incentive allocation, a performance allocation, or a "carried interest"), as discussed in more detail below. This compensation arrangement is often referred to as "two and twenty."

Occasionally, the fund manager will be entitled to its incentive compensation only if the fund's returns exceed the returns of a specified benchmark (sometimes referred to as a hurdle). For example, a manager of a fund with a healthcare strategy could be entitled to 20% of the portion of the net income of the fund for any year that exceeds the return of the S&P Healthcare Index.

In certain instances, the compensation is structured so that the manager is entitled to incentive compensation even if the fund's returns are negative, as long as the fund outperforms the benchmark. Consider that same fund manager, entitled to incentive

compensation equal to 20% of the fund's outperformance of the benchmark, where the return of the S&P Healthcare Index was -10% (i.e., $1,000 invested in the S&P Healthcare Index at the beginning of that year would be worth $900 at year-end). If the fund's return was -2% (i.e., $1,000 invested in the fund at the beginning of that year would be worth $980 at year-end), the manager would be entitled to 20% of the fund's 8% outperformance of the benchmark (or $16 for every $1,000 invested).

When the fund's return is negative but exceeds the benchmark's return, the typical incentive allocation provisions will not work. An incentive allocation is an allocation by the partnership (the fund) of a portion its net income to the general partner (the fund manager), but if the fund sustains a net loss for the year, there is no net income to allocate to the general partner. There are alternative ways of structuring relative incentive compensation, and a fund manager's choice will depend on both economic and tax considerations.

INCENTIVE ALLOCATION vs. INCENTIVE FEE

Before considering the alternative structures, it is important to review the differences between an incentive allocation and an incentive fee, and the reasons for using one over the other. [3]

Incentive allocation. As noted above, a typical hedge fund is a partnership for U.S. federal income tax purposes. The general partner of a hedge fund is also typically a partnership for U.S. federal income tax purposes, and the individual managers of the fund are usually partners or members of that partnership. The general partner entity is a partner in the hedge fund partnership, and as such is entitled to an allocation of the partnership's income, profits, losses, and expenses. Usually, the general partner will contribute a small amount of capital to the fund, [4] for example, 1% of the assets of the partnership.

The partnership agreement generally provides that income, profits, losses, and expenses are first apportioned among the partners in proportion to capital contributions. The general partner would, in this step, be entitled to 1% of the income, profits, losses, and expenses of the fund. The incentive allocation provisions of the partnership agreement provide, however, that if there is net income in any year, 20% of the net income that is initially apportioned to the limited partners will be allocated instead to the general partner. [5]

Incentive fee. The incentive fee provisions of the partnership agreement provide that if there is net profit in any year, the fund pays a fee to the general partner equal to 20% of such net profit.

Advantages of allocation. From a tax perspective, an incentive allocation is often preferable to an incentive fee for several reasons.

1. Because an incentive allocation is structured as a partnership allocation, the character of the income and profits flows through to the general partner. [6] The general partner may therefore realize a portion of its incentive allocation as long-term capital gain and qualified dividend income taxed at lower rates, instead of as ordinary income taxed at a higher rate. An incentive fee, however, would constitute ordinary income to the general partner.

Bills have been introduced in Congress that generally would treat an incentive allocation as ordinary compensation income derived from the performance of services, overriding the general flow-through treatment based on the characterization of the underlying income. [7] In addition, flow-through treatment may be of limited benefit to the hedge fund manager. Many hedge funds make an election under Section 475(f) pursuant to which all of their investment income is treated as ordinary income in any event. Even if a hedge fund does not make an election under Section 475(f), a significant portion of its income may be either short-term capital gain, due to its short-term trading strategy, or ordinary income, due to the application of Section 1256, the rules applicable to OID obligations, the rules applicable to market discount, or the rules applicable to short sales. [8]

2. An incentive fee is taxable in its entirety on receipt by the general partner. An incentive allocation, however, is a partnership allocation of unrealized as well as realized gains, and the portion of the allocation attributable to unrealized gains is not taxable until the gains are actually realized in a later year.

3. For state tax purposes, an incentive fee might be characterized as business income subject to a higher rate of tax than an incentive allocation, which might be characterized as investment income. [9]

4. An incentive allocation is effectively deductible by the investors without limitation, as the portion of the fund's income attributable to the incentive compensation is never allocated to the limited partners, but is allocated to the general partner in the first instance. An incentive fee, however, will be considered a miscellaneous itemized deduction deductible only under Section 212 (as opposed to Section 162) to the extent that the fund does not actively trade and is considered an "investor," rather than a "trader," for U.S. federal income tax purposes. Miscellaneous itemized deductions are subject to various limitations on deductibility. [10]

In certain situations, however, a fund manager may choose to structure its incentive compensation as an incentive fee.

1. Until recently, a fund manager of an offshore hedge fund treated as a corporation for U.S. tax purposes may have sought to defer all or part of its incentive compensation pursuant to a properly structured deferral plan. Only a fee, but not an allocation (which may otherwise have been made by a "master" fund treated as a partnership for U.S. federal income tax purposes), could have been deferred. Section 457A, enacted on 10/3/08, effectively eliminated the possibility of implementing such a deferral plan.

2. In certain states, tax rates on ordinary income may be lower than rates imposed on capital gains. Fund managers subject to tax in such a state may therefore structure their incentive compensation as an incentive fee rather than an incentive allocation. [11]

3. An incentive fee is simpler to understand, document and administer than an incentive allocation, and therefore may be preferable, in particular if the fund has made a Section 475(f) election and the fund manager is not giving up a character benefit.

ALTERNATIVE RELATIVE INCENTIVE COMPENSATION STRUCTURES

There are several different ways in which a fund manager can structure relative incentive compensation. The structure that a fund manager chooses will depend on both economic and tax considerations. As more fully described below, there is a tension between

obtaining the tax benefits of an allocation and ensuring that the full amount of incentive compensation will be received.

Net Income Allocation in All Cases

Using a structure that provides for a net income allocation in all circumstances is the best from a tax perspective—capital gains and qualified dividends flow through to the general partner, [12] and an investor's deduction of the incentive compensation is not subject to any limitation. Furthermore, there is minimal risk that the allocation will be recharacterized as a fee. Nevertheless, this approach is the least desirable for the fund manager from an economic perspective.

In this structure, the general partner receives an allocation of 20% of the portion of the fund's realized and unrealized net income that exceeds the relevant benchmark return. If the fund's return is positive, the allocation functions like the typical net income incentive allocation. If the fund outperforms the benchmark but sustains a net loss in a given year, however, an incentive allocation cannot be made in that year as there is no net income to allocate pursuant to the incentive allocation provisions.

The fund agreement may provide that the fund will keep track of the shortfall in a memorandum account and that such amount will be rolled over to subsequent years when the fund has net income. If, however, a limited partner withdraws from the fund, and at that time net income is still insufficient to make the incentive allocation, the unrecovered shortfall attributable to that limited partner will be forfeited.

As noted above, this structure should produce the most favorable tax result. At least a portion of the general partner's incentive allocation may flow through as long-term capital gain and qualified dividends [13] and, for the investors, the allocation would have the effect of a full deduction. Although there is a risk that the allocation could be recharacterized as a fee, this risk appears to be minimal. [14]

Nevertheless, because the incentive allocation is at risk if the fund does not have sufficient net profits at the time an investor withdraws from the fund (which is likely to coincide with the fund's not earning a positive return), this structure is unlikely to be acceptable to the fund manager as a business deal matter. [15]

Fee in All Cases

Structuring the compensation package as a fee in all circumstances is the best from an economic perspective but the worst from a tax perspective. The fund pays an incentive fee equal to 20% of the return of the fund over the return of the benchmark in all events, i.e., whether the fund sustains a net gain or a net loss. Even if the fund's return for the year is negative, the fee is paid if the fund outperforms the benchmark.

Economically, then, the fund manager will always receive its compensation if the fund outperforms the benchmark, and there is no risk of forfeiting incentive compensation in down years due to insufficient income. In addition, this structure has the benefit of simplicity. Although certain of the other compensation arrangement structures may provide little economic risk and better tax treatment (if respected), [16] those structures are subject to recharacterization. The fund manager may prefer certainty in outcome, and may wish to avoid the time, expense, and effort of an IRS challenge, especially if structuring the arrangement as an allocation is merely an accommodation for the

investors and the general partner attains little or no benefit (for example, because the fund generates significant short-term capital gains or makes a Section 475(f) election).

From a tax perspective, however, the benefits of an allocation described above are lost if the fee approach is taken. All of the fund manager's incentive compensation is taxed at ordinary income rates on a current basis, and the investors' deductions for the incentive fee may be subject to limitations on deductibility.

Net Income/Gross Income Allocations

From an economic perspective, a structure providing for a net income allocation in up years and a gross income allocation in down years is superior to the arrangement under which the general partner receives a net income allocation in all events. From a tax perspective, this structure (if respected) is superior to an incentive fee. [17] Nevertheless, this structure introduces some economic risk and some tax recharacterization risk.

In this approach, if the fund has net income for the year the general partner receives an allocation of 20% of the portion of the fund's realized and unrealized net income that exceeds the relevant benchmark return. If the fund sustains a net loss in a given year but outperforms the benchmark, *gross* income equal to 20% of the difference between the performance of the fund and the performance of the benchmark is allocated to the general partner. [18]

To the extent gross income is not sufficient to allocate the full incentive compensation earned by the general partner (which may be unlikely), incentive compensation would not be taken in such year. The partnership agreement may provide that the fund will keep track of the shortfall in a memorandum account and that such amount will be rolled over to subsequent years in which the fund has gross income. Once again, however, if a limited partner withdraws from the fund at a time when income—here, gross income—is still insufficient to make the incentive allocation, the incentive compensation attributable to that limited partner will be forfeited.

The tax treatment of a gross income allocation is not clear. There is some risk that in years in which the fund sustains a net loss, the gross income allocation could be recharacterized as a guaranteed payment under Section 707(c) or as a payment to a partner not acting in its capacity as a partner under Section 707(a). In that event, the general partner would treat the incentive compensation as ordinary income and the limited partners would most likely be subject to certain limitations on the deductibility of the incentive compensation as described above. [19] There also is some risk that the entire arrangement could be recharacterized as a fee arrangement even in years in which the fund has net income.

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 or the use of capital 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 263, for purposes of section 162(a) (relating to trade or business expenses)."

If a payment is made to a partner in its capacity as a partner, [20] but such payment is not determined with regard to partnership income, it is a guaranteed payment and is deemed to be made to a nonpartner for certain purposes. If a payment is not determined with regard to partnership net income but is determined based on partnership gross income, is the payment a guaranteed payment?

In *Pratt,* 64 TC 203 (1975), *aff'd in part and rev'd in part* 39 AFTR 2d 77-1258, 550 F2d 1023 (CA-5, 1977), three individuals formed partnerships for the purpose of the purchase, development, and operation of shopping centers. The taxpayers, as general partners, were entitled to a fee equal to a percentage of the gross rentals from the shopping centers. The fees were not paid to the taxpayers but were credited to accounts payable to the taxpayers. The taxpayers, who accounted for their income on the cash method, did not report the fees as income in the years in which they were earned, but the partnerships deducted such fees annually.

The Service claimed that the taxpayers should include the fees in income as distributive shares in the years in which they were earned, while the taxpayers maintained that the fees should be treated as payments under Section 707(a) [21] or Section 707(c). [22] The Tax Court held that a payment based on a partnership's gross income is not determined without regard to the partnership's income, and therefore is not a guaranteed payment under Section 707(c). [23] The court also held that the fees were not Section 707(a) payments, as discussed below.

In response to the Tax Court's decision in *Pratt,* the IRS issued Rev. Rul. 81-300, 1981-2 CB 143, which was based on the same facts as *Pratt.* The IRS disagreed with the Tax Court and reversed the position that it itself took in *Pratt,* concluding that "[a] payment for services determined by reference to an item of gross income will be a guaranteed payment if, on the basis of all of the facts and circumstances, the payment is compensation rather than a share of partnership profits." Factors that the Service considered relevant in making such a determination were the reasonableness of the payment for the services performed and whether the same method of payment would be used to compensate an unrelated third party for the same services. [24]

In 1984, Congress enacted Section 707(a)(2)(A) as part of DRA '84. The legislative history [25] states that the transaction described in Rev. Rul. 81-300 should be treated as a transaction described in Section 707(a), [26] and not as a Section 707(c) guaranteed payment. It is not entirely clear why Congress made this statement, [27] but it could be that Congress agreed with the Tax Court in *Pratt,* and not with the IRS in Rev. Rul. 81-300, that gross income allocations are considered to be determined with regard to partnership income and are therefore not guaranteed payments under Section 707(c). [28]

Although the Service's position is that a gross income allocation is a guaranteed payment, [29] the Tax Court and possibly the legislative history of Section 707(a)(2)(A) support the view that it is not a guaranteed payment. [30] In addition, one might argue that a plain reading of the statute indicates that a gross income allocation is not a guaranteed payment, as the allocation is determined with regard to income of the partnership, albeit gross income, and is therefore not "determined without regard to the income of the partnership." [31]

Even if the IRS were successful in recharacterizing the gross income allocation as a guaranteed payment, it is likely that the gross income allocation would be so recharacterized only in years in which the fund sustained a net loss, not in years in which the fund generated net income. Reg. 1.707-1(c), Example 2, describes a two-person partnership. Partner C is entitled to receive 30% of partnership income, but not less than $10,000. If the partnership had $60,000 income in a particular year, C is entitled to $18,000, all as a distributive share and none as a guaranteed payment. If, however, the partnership had $20,000 of income, C receives the $10,000 minimum. The Regulation concludes that $6,000 is a distributive share and $4,000 is a guaranteed payment.

It appears, then, that even if there is a bona fide guaranteed payment and even if that guaranteed payment is made in the same year as the allocation, the partner's distributive share is not affected. In fact, the example in the Regulations allows as much distributive share as possible and minimizes the guaranteed payment. Even if the hedge fund gross income allocation were treated as a guaranteed payment, such treatment should, following the example in the Regulations, apply only in years in which there is insufficient net income to support characterization as a distributive share, i.e., in years in which the fund sustains a net loss. In years in which the fund has net income, though, the guaranteed payment should be minimized, and the distributive share maximized, so that the allocation should be respected as distributive share to the extent of the fund's net income.

A final argument that may be made in support of the position that a hedge fund gross income allocation is not a Section 707(c) payment is that even if the Service's view in Rev. Rul. 81-300 is correct, the hedge fund gross income allocation is fundamentally different from, and better than, the allocation described in Rev. Rul. 81-300 and in *Pratt.* In the case and Ruling, the general partners were entitled to an allocation calculated based on a certain percentage of the *gross* income of the partnership. In such a situation, it is at least debatable whether such a payment can be considered to be determined with regard to the income of the partnership, given that there is no connection between the allocation and the partnership's net income.

With respect to the hedge fund gross income allocation, however, the amount of the allocation is in fact based on and determined with regard to the *net* income of the partnership. The allocation is made from gross income, but the calculation of the amount of the allocation depends on the net income of the partnership. A stronger case can be made, then, that the hedge fund gross income allocation is made with regard to the income of the partnership.

Section 707(a). Section 707(a)(1) states: "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." Is a general partner of a hedge fund that is entitled to a gross income allocation acting in a capacity other than in its capacity as a partner in the partnership?

In *Pratt,* discussed above, the taxpayers argued that the fees based on gross rentals should be treated as Section 707(a) payments and therefore were not includable in income until actually or constructively received. The Tax Court agreed with the government, though, and held that the payments were not Section 707(a) payments because the taxpayers were acting in their capacities as partners. Their duties were performed pursuant to the partnership agreement and were within the normal scope of the duties of a general partner. [32] The Fifth Circuit affirmed, holding that Section 707(a) covers transactions outside the scope of the partnership, while the general partners' activities in *Pratt* were activities in which the partnership itself was engaged.

On the same day that the IRS issued Rev. Rul. 81-300, however, it also issued Rev. Rul. 81-301, 1981-2 CB 144, which addressed a gross income allocation to the general partner of an investment partnership. The IRS concluded that the gross income allocation was subject to Section 707(a) and taxable to the investment advisor under Section 61 as compensation for services rendered because it was made to the investment advisor in its capacity other than as a partner in the partnership. Factors considered by the Service included:

- The investment advisor provided similar services to others as part of its regular trade or business.
- The investment advisor's management was supervised by directors.
- The investment advisor could be fired with 60 days' notice by a majority vote of directors.
- The investment advisor paid its own expenses.
- The investment advisor was not personally liable to the other partners for losses incurred in the investment of the investment partnership's assets.

Although these 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) in 1984. In *Pratt* and Rev. Rul. 81-301, the Tax Court, the Fifth Circuit, and the IRS made the determination of whether a person was acting in a partner capacity by reference to the nature of the services performed. This view of acting in a partner capacity changed, however, with DRA ’84.

The legislative history [33] provides several factors to consider in determining whether services performed by a partner are performed in the partner's capacity as a partner in the partnership. The most important factor is whether the payment for the services is subject to appreciable risk. [34] In this context, the legislative history notes that short-lived gross income allocations are suspect, but may in limited circumstances be subject to entrepreneurial risk and therefore be respected as distributive shares of partnership income.

The other factors that are listed are whether the partner status of the recipient is transitory, whether the distribution and allocation that are made to the partner are close in time to the partner's performance of services, whether the partner became a partner primarily to obtain tax benefits, and whether the value of the partner's interest in general and continuing partnership profits is small in relation to the allocation in question.

Following the enactment of Section 707(a)(2)(A), the question of whether a partner performs services in its capacity as a partner of the partnership depends primarily on whether the payment for such services is subject to appreciable risk. The nature of the services performed by the partner has become less relevant. [35] Risk takes many forms with respect to a hedge fund gross income allocation:

- There is a substantial risk that the fund manager will not outperform the benchmark.
- There is a risk that gross income will not be sufficient to make the incentive allocation.
- There is a risk the general partner will forfeit the incentive allocation attributable to an investor that withdraws from the fund before sufficient gross income is earned (although this risk is small).

Therefore, the general partner's entitlement to the incentive allocation is subject to entrepreneurial risk. The allocation is not capped at a fixed dollar amount, is not made for a limited time, and is not reasonably determinable. All of these factors, which are mentioned in the discussion of entrepreneurial risk in the legislative history of Section 707(a)(2)(A), indicate that the payment is made to the partner for services performed in its capacity as a partner of the partnership.

In addition, Congress clearly contemplated that certain gross income allocations would be respected as distributive shares of partnership income, as it stated the following in the legislative history: "Although short-lived gross income allocations are particularly suspect

in this regard, gross income allocations may, in very limited instances, represent an entrepreneurial return, classifiable as a distributive share under sec. 704."

The legislative history also states, however, that there are instances when an allocation contingent in amount may be recharacterized as a fee. This generally will be the case only when (1) the partner in question normally performs, has previously performed, or is capable of performing similar services for third parties and (2) the allocation effectively compensates the partner in a manner substantially similar to the manner in which the partner's compensation from a third party normally would be computed.

Although these factors generally may be present with respect to a hedge fund manager's incentive allocation, an example provided by the legislative history is helpful in distinguishing a hedge fund gross income allocation from the allocations intended to be treated as Section 707(a)(2)(A) payments. In the example, a stock broker is admitted as a partner of an investment partnership. The stock broker agrees to effect trades for the partnership without commission, and is entitled to an allocation of gross income that approximates his forgone commissions. It is expected that the partnership will have sufficient gross income to make this allocation.

The amount of the payment to the stock broker is contingent, but is computed by means of a formula that approximates the method for calculating a normal brokerage fee and effectively varies with the amount and value of services rendered, rather than the income of the partnership. The allocation is treated as a fee under Section 707(a)(2)(A) rather than as distributive share. This paradigm case of an allocation recharacterized as a Section 707(a)(2)(A) payment is distinguishable from the hedge fund gross income allocation because the hedge fund gross income allocation is not merely paid out of income, but is based on and calculated by reference to the income of the partnership, and does not vary with the amount of services performed.

Although some commentators state that most gross basis payments probably will be covered by Section 707(a), [36] it would appear that as a practical matter the risk of successful recharacterization is small. The IRS could seek to recharacterize the allocation in net loss years, or in all cases. To recharacterize the allocation in net loss years only, the Service would have to maintain that the general partner is acting in its capacity as a partner in certain years (when the partnership has net income), but not in other years (when the partnership has net loss), which is doubtful.

In addition, recharacterizing the entire arrangement, i.e., arguing that the general partner is not acting in its capacity as a partner at all, seems difficult. The overall economic arrangement blends the gross income allocation (in net loss years) with the net income allocation (in net income years), and certainly entails risk and supports the argument that the general partner is acting in its capacity as a partner.

Net Income/Gross Income Allocations/Guaranteed Payment

A compensation structure providing for a net income allocation in up years and a gross income allocation/guaranteed payment in down years does not contain any economic risk (i.e., no risk of forfeiting incentive compensation in net loss years due to insufficient income). If it is respected, the tax benefits of an allocation are preserved in virtually all situations. [37] Nevertheless, the risk of tax recharacterization is greater than in the "net income allocation in up years; gross income allocation in down years" structure described immediately above.

This arrangement is mechanically the same as the "net income allocation in up years; gross income allocation in down years" structure described above, except that instead of rolling over to subsequent years any shortfall in an incentive allocation due to insufficient gross income, the partnership would make a guaranteed payment of such shortfall to the general partner in the year of the shortfall.

The tax analysis of the gross income allocation is the same as above, except that the existence of the guaranteed payment in the down years creates a greater likelihood than in the "net income allocation in up years; gross income allocation in down years" structure described above that the entire arrangement will be recharacterized as a fee. Because there is no economic risk to the general partner in this structure that it will not receive any compensation to which it is entitled as a result of outperforming the benchmark, it is less likely that the allocations will be respected as the general partner's distributive share of the partnership's income.

The IRS could argue that the payment is computed without regard to income if the fund manager knows it will receive the payment regardless of whether there is sufficient gross income. Moreover, the certainty of payment (if the fund manager outperforms the benchmark) increases the similarity of this arrangement to a third-party arrangement. By contrast, under the "net income allocation in up years; gross income allocation in down years" structure described above, the fund manager may have to wait to receive the payment and may never receive the payment in certain circumstances, which reflects entrepreneurial risk and looks less like a third-party arrangement.

In a variation of this structure, the fund does not make a guaranteed payment of the shortfall to the general partner if gross income is not sufficient. Instead, the fund keeps track of and rolls forward any shortfall until the fund has sufficient gross income to make the allocation, but if an investor withdraws from the fund, the fund pays the shortfall attributable to that investor as a guaranteed payment out of amounts otherwise distributable to the withdrawing partner. This variation is less likely to be recharacterized, as the general partner may have to wait for payment if gross income is not sufficient, which reflects some degree of entrepreneurial risk. This variation in structure still entails significant recharacterization risk, however, because any payment to which the general partner is entitled as a result of outperforming the benchmark is virtually certain to be made.

CONCLUSION

In structuring relative incentive compensation, one must balance the economic and the tax goals of the fund manager, and must carefully consider the risk that an arrangement will be recharacterized for U.S. federal income tax purposes. While a typical net income allocation may not be ideal from a business perspective and an incentive fee may not be satisfactory from a tax perspective, a properly structured gross income allocation may provide the fund manager and the investors with an effective alternative that can be tailored to meet the fund manager's risk profile.

Practice Notes

In structuring relative incentive compensation for a manager of a hedge fund that is entitled to incentive compensation even when the fund's returns are negative (as long as the fund outperforms the benchmark), it may be effective to provide for a net income allocation in up years, and a gross income allocation in down years. To strengthen the position that income earned under such an arrangement should be treated as a

distributive share of partnership income, as opposed to being recharacterized as a fee, it may be helpful if the manager's compensation is subject to risk, and not guaranteed, if there is insufficient gross income to make the full gross income allocation.

1

See, e.g., Johnson and Burgess, "Hedge Funds' Fee Structure Comes Under Scrutiny," The Financial Times Limited, 11/4/08, available at us.ft.com/ftgateway/superpage.ft?news_id=fto110420081544540165.

2

The performance fee or allocation is typically subject to a "high water mark," providing that the fund manager will be entitled to a percentage of the fund's income only to the extent that the fund has recovered any prior losses.

3

The discussion in this section assumes that there is no hurdle or benchmark and ignores the impact of a high water mark.

4

Fund managers often make contributions to the fund for marketing purposes, to indicate that they have "skin in the game." See also note 14, *infra,* indicating that managers also make capital contributions to the fund to solidify their status as partners of the fund for tax purposes.

5

The incentive allocation is typically a percentage of realized and unrealized net income, as determined by generally accepted accounting principles. There is an exception for illiquid investments that are designated as "side pocket" investments, with respect to which the incentive allocation is calculated as a percentage of realized net income.

6

See Sections 702(a) and (b).

7

See H.R. 4213, 111th Cong. (1st Sess., 2009); H.R. 1935, 111th Cong. (1st Sess., 2009). These bills also would subject such income to self-employment tax. See also H.R. 6275, 110th Cong. (2d Sess., 2008); H.R. 2834, 110th Cong. (1st Sess., 2007). In addition, see *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals* and *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals* (both of which include a revenue item entitled "Tax Carried (Profit[s]) Interests As Ordinary Income"); President Obama's fiscal-year 2011 budget proposal released on 2/1/10 and fiscal-year 2010 budget proposal released on 2/26/09 (both of which include a line item that states: "Tax carried interest as ordinary income").

8

See, e.g., Statement of Leon M. Metzger, Former Vice Chairman and Chief Administration Officer of Paloma Partners Management Company, Testimony Before the Full Committee of the House Committee on Ways and Means, 9/6/07, available at waysandmeans.house.gov/Hearings/Testimony.aspx?TID=1810.

9

In addition, an incentive fee, but not an incentive allocation, may be subject to the New York City unincorporated business tax.

10

Miscellaneous itemized deductions may be deducted by an individual taxpayer only to the extent they exceed 2% of AGI (Section 67(a)), are not deductible in computing alternative minimum tax (Section 56(b)(1)(A)(i)), and are subject to further reduction to the extent AGI exceeds a threshold amount (Section 68(a)).

11

See Rosenblum, "Organization of a Private Investment Fund: Basic Operational and Legal Issues," available at www.foleyhoag.com/~/media/Files/Publications/Generic/Org%20Private%20Investment

%20Fund%20%20%20Rosenblum2006%20pdf.ashx.
12

Nevertheless, as described in note 7, *supra,* and the accompanying text, pursuant to proposed legislation an incentive allocation generally would be treated as ordinary compensation income derived from the performance of services, overriding the general flow-through treatment based on the characterization of the underlying income.
13

Id.
14

See, e.g, Rosenblum, *supra* note 11, for a discussion of this risk. To mitigate the risk that the general partner would not be treated as a partner for tax purposes, many advisors recommend that the general partner make a capital contribution to the fund. See, e.g., Weigel, "Private Investment Fund Interests Held by Employees: *Campbell,* Section 83(b) and Other Considerations," Tax Forum No. 543 (6/5/00); Rosenblum, *supra* note 11. Rosenblum also suggests that the investment advisor should receive an actual fee for services, in addition to the carried interest held as a partner. Also, the incentive allocation is a grant of a profits interest in a partnership, which, under current law, should not be a taxable event. See Rev. Proc. 93-27, 1993-2 CB 343, and Rev. Proc. 2001-43, 2001-2 CB 191. See, however, Prop. Reg. 1.83-3(l) and Notice 2005-43, 2005-24 IRB 1221, proposing a safe harbor confirming this treatment if a Section 83(b) election is made and if other conditions are met. See also H.R. 4213, 111th Cong. (1st Sess., 2009) (proposing that the FMV of a partnership interest received in connection with the performance of services is treated as being equal to its liquidation value); H.R. 1935, 111th Cong. (1st Sess., 2009) (same).
15

A variation of this structure that addresses the economic risk inherent in the arrangement provides that if an investor withdraws from the partnership before any incentive allocation attributable to such investor is made to the general partner (due to insufficient net income), a payment (treated as a fee) of any shortfall is made to the general partner out of proceeds otherwise distributable to the withdrawing investor. Making the receipt of the full payment more certain, however, increases the risk that the entire arrangement will be recharacterized as a fee. See the discussion in the text, below.
16

See, for example, the structure described in the text, below, involving a net income allocation in up years and a gross income allocation/guaranteed payment in down years.
17

If the proposed legislation described in note 7 and the accompanying text is enacted, however, some of the benefits of an incentive allocation would be eliminated.
18

A "fund of funds" may not be able to use a gross income allocation because the underlying funds may report income or loss only on a net basis, and may not be willing to make gross income and loss data available.
19

With regard to whether a guaranteed payment under Section 707(c) is deductible under Section 212, see McKee, Nelson, and Whitmire, *Federal Taxation of Partnerships and Partners,* Fourth Edition (Thomson Reuters/WG&L, 2007), ¶14.03[4] ("Because §162(a) applies only to ordinary and necessary expenses paid or incurred in a 'trade or business,' there is literally no statutory basis for deducting guaranteed payments for the use of investment (as distinguished from trade or business) capital. Nevertheless, to avoid a patently unfair result, such payments should be deductible under §212").
20

Regarding whether a payment must be made to a partner in its capacity as a partner in order to qualify as a guaranteed payment, see Willis, Pennell, and Postlewaite, *Partnership Taxation,* Sixth Edition (Thomson Reuters/WG&L, 1996), ¶11.04[1][b]; Postlewaite and Cameron, "Twisting Slowly in the Wind: Guaranteed Payments After the Tax Reform Act of 1984," 40 Tax Lawyer 649 (1987), fn. 144; Klig and Sloan, 712-2nd

T.M. (BNA), *Partnerships—Taxable Income; Allocation of Distributive Shares; Capital Accounts,* fn. 1026.
21

See the text accompanying notes 32 to 36, *infra,* for a discussion of Section 707(a).
22

If the payments were considered made under Section 707(c), the general partners presumably would have challenged the Regulations under Section 707(c), which require a matching of the timing of the income to the partner and the deduction by the partnership. See Postlewaite and Cameron, *supra* note 20, fn. 113.
23

See also Ltr. Rul. 7813001 (following Pratt, gross income allocation will not be treated as a Section 707(a) or 707(c) payment, but as a distributive share to the extent it does not exceed the partnership's net income; no opinion expressed or implied on the tax characterization of such amounts to the extent they exceed the partnership's net income).
24

See also GCM 38067, 8/29/79; GCM 38670, 3/31/81.
25

S. Rep't No. 98-169, 98th Cong., 2d Sess. 230 (1984).
26

See the text accompanying notes 32 to 36, *infra,* for a discussion of Section 707(a).
27

See Postlewaite and Cameron, *supra* note 20, page 681 (Congress redefined the partner capacity issue in terms of risk as opposed to the nature of the services performed); Manning, 711 T.M. (BNA), *Partnerships—Formation and Contributions of Property or Services,* III.C.4. ("Possibly, the concern was the difference in the timing rules").
28

See Banish, "Using Guaranteed Payments to Compensate Service Partners Has Numerous Advantages," 11 J. Partnership Tax'n 115 (Summer 1994), fn. 14.
29

See McKee et al., *supra* note 19, ¶14.01[2], noting that the IRS continues to follow Rev. Rul. 81-300, 1981-2 CB 143, as indicated by TAM 8642003, which cites it with approval.
30

The soundness, from a policy perspective, of the Tax Court's view that a gross income allocation is determined with regard to income of the partnership is the subject of debate among commentators. See, e.g., McKee et al., *supra* note 19, ¶14.03[1][a]; Steinberg, "Fun and Games with Guaranteed Payments," 57 Tax Lawyer 533 (2004). See also the articles cited in Postlewaite and Cameron, *supra* note 20, fn. 127.
31

Postlewaite and Cameron, *supra* note 20, pages 673-674, observe that according to the 1954 legislative history, Section 707(c) should apply to a partner who renders services to the partnership for a "fixed salary, payable without regard to partnership income," indicating that, in determining which payments constitute guaranteed payments, Congress focused on the payment of a fixed amount to the partner. This is clearly not the case with a hedge fund gross income allocation.
32

In dicta, the Tax Court mentioned that it is "far from clear" whether continuing payments were intended to come within Section 707(a), which refers to "transactions" and may be limited only to services performed for a specific transaction.
33

S. Rep. No. 98-169, *supra* note 25, pages 227-230.
34

See Ltr. Rul. 9219002 (applying this factor).
35

See Postlewaite and Cameron, *supra* note 20 (emphasizing this point, suggesting that Congress sought to change the result of Rev. Rul. 81-300 because Section 707(a)(2)(A)

redefined the partner-capacity issue, and proposing that because Section 707(c) is no longer meaningfully distinguishable from Section 707(a), Section 707(c) should be repealed). See also Bittker and Lokken, *Federal Taxation of Income, Estates, and Gifts,* Third Edition (Thomson Reuters/WG&L, 2003), ¶89.1.3 (the distinction made in Pratt between partnership activities and activities outside the scope of the partnership was effectively eliminated by the enactment of Section 707(a)(2)(A)).
36

See Willis et al., *supra* note 20, ¶10.07, fn. 361, and ¶11.04[1][b]. See also ¶10.07[3][g] (noting that because Section 707(a)(2)(A) is hard to apply in the absence of Regulations, the IRS is likely to focus on a gross income allocation when the allocation is used to change the character of income to the recipient or the tax consequences to the partnership and there is little risk that payment will not be made).
37

If, however, the proposed legislation described in note 7, *supra,* and the accompanying text is enacted, some of the benefits of an incentive allocation would be eliminated.

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