Q4 2017

Privcap/ Report

# The Tax Consequences of GP Restructurings

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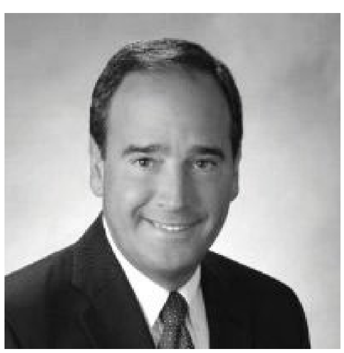

**Tom Lenz**
Partner, Tax Services,
RSM US LLP

**Privcap: We're talking about the tax impacts of GP restructurings. What are the typical circumstances for a restructuring?**

**David Guin, Withersworldwide:** The first one, perhaps the most common one, is a recutting of the economics among employees of the fund managers. That can happen because you have new people coming in and you have people leaving. But it's usually the same group of people recutting the economics among themselves. In that regard, one of the things you should be concerned about, especially if you bring new people in, is to be sure you are keeping a count of what we call "profits interests."

We're just going through this with a client now, where they're bringing a new person into their fund management complex and we're having to structure it so that he's not getting any current value by bringing him into the fund. So we're having to high loft the current value in the GP in making sure he's not participating in that. Otherwise, he would get taxed on the current value of the interest he was receiving without having to pay for it.

We're also seeing an increasing number of GP rollups. In a GP rollup, you typically have a firm that has a big distribution network and they're going out to smaller fund managers to

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become part of their network. That requires a restructuring of the holdings of the GP.

Finally, we do see some cash-out restructurings. That happens primarily when you have a senior person at the firm who decides they're going to retire. This requires a restructuring usually because the firm needs to either generate the cash to pay them out or to recut the economics of the GP so that the person who is exiting the firm gets the appropriate value of the GP as of the time they left.

**In considering these transactions, what are the biggest concerns your clients have or the biggest questions you get about doing these transactions in a tax-efficient manner?**

**Tom Lenz, RSM:** There's valuation issues, of course. But with respect to the profits interest, there's a big issue regarding the person's status as either an employee or a partner. As far as the IRS is concerned, you cannot have dual status as an employee and a partner. That's probably one of the bigger issues.

Then, the other issue is the taxability of profits interest in general. There's this notion out there that profits interests aren't taxable; that's not necessarily true.

Profits interest theoretically would be taxable, but there's this IRS revenue procedure that says, effectively, "These interests are just too hard to be valued, so therefore, as a matter of convenience, as long as the partner has zero value upon issuance from a liquidation standpoint or from a waterfall, we're going to say that interest has a zero value." Theoretically, it's taxable to that partner, but it has zero value, so the partner has no income. One of the requirements to have this procedure applied is [that] the general partner would then need to hold onto their interest for at least two years.

So if there's a disposition within two years of a profits interest being granted, then you're no longer under the safe harbor. We see this tripped up a lot, where someone transfers a profits interest and it's within this two-year period. Now, all of a sudden, they're not within this safe harbor, so therefore you would go back to when that profits interest was issued, and you have to figure out whether the interest did, in fact, have value.

**What are some of the valuation issues you see, Lindsay?**

**Lindsay Hill, RSM:** There are two key concepts to keep in mind in a restructuring: What will this restructuring impact and where do we need to understand the value? Within the fund structure, there are different areas where we have value: It might be in the GP interest or the carried interest or in the LP or in the underlying management company.

In the context of valuation, that management company is the operating entity; it's where we're getting the management fee revenue. It's the expenses and it's the investment in the company. Traditional valuation methodologies often apply, even though, obviously, the GP interest is a significant value and the LPs are important as well. But you need to keep in mind what the subject of the valuation is and make sure you're addressing that valuation appropriately.

Regarding profits interests—as it was mentioned, it's not necessarily a taxable event upon the grant date. The profits interests give you a right to appreciation in value of the company. But one thing from a valuation perspective that I like to point out—at least to the people who are receiving these profits interests—is that it's important that you do have an appropriate value on that underlying interest of the profits interest, so that the holder of it is getting the appreciation value. If that hurdle per se is set too high, then they're not really gaining from that appreciation. And if it's too low, there's kind of a beneficial notion there.

It's really significant that you understand the terms of the profits interest, the hurdles and the vesting provisions.

**David, in what restructurings are key man clauses important to look at, and in what case is investor consent necessary?**

**Guin:** One thing we're always looking at when we're doing a GP restructuring are the key man provisions. Often they're not a problem. A key man provision in fund documents will normally identify one or more individuals, and it'll be structured in one of two ways: Either it'll say that those one or two individuals need

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–David Guin, Withersworldwide

to be making the investment decisions for the fund, or it will say that they need to be devoting substantially all of their time and attention to it. So as you're bringing people in and out of the management companies, you need to be looking at the key man provisions and determining whether what you're doing would trigger them.

A lot of the key man provisions you see in fund documents today do allow the fund manager to substitute new people, often with the consent of an LP committee. The LP advisor committee is something that can usually be worked around, but if you're thinking about a GP restructuring and you do have any key man provisions in your fund documents, be sure to look at them.

Another issue that often comes up is whether investor consent is required. As you may be aware, if the fund manager is an SEC-registered investment advisor, there's a provision in the Investors Act that says you cannot transfer a contract without client consent. And the SEC has taken the position that a change in control of the fund manager constitutes an assignment of the contract if you actually have a change in the management in control of the fund manager.

For example, you could be transferring interests from an individual to a trust for that individual and transferring more than 50 percent of the ownership of the fund manager, but because the same people would be running the fund, it wouldn't really be a change that required investor consent. However, if you are in a GP rollup where you're offering control of the fund manager to the entity that's doing the rollup, those are the types of things that would constitute an assignment of the underlying investing management agreement between the fund and the fund management company.

The way this has been looked at has changed substantially over my time in practicing law. Early on in my practice, people generally took the view that the general partner—i.e., the fund manager—could consent to its assignment on its own. That's much less common today.

Even if the documents don't specifically require it, in my experience, if there's going to be a change in control of the investment manager, people are often going out to the LPs to seek consent to the transfer so that they're sure they're not violating this provision—the investment advisor act.

**What do people involved in a GP restructuring need to understand about how to handle guaranteed payments for tax planning?**

**Lenz:** From an investment standpoint, the one thing with guaranteed payment is, again, the situation where you have a preferred return that is senior to someone else's capital in the partnership and whereby you may have phantom income, even though the entity itself that you're investing in is not profitable.

**Mathew Talcoff, RSM:** We are seeing more and more funds set up tiered structures which may help their employees who are obtaining a new interest, where they don't want to have to deal with some of the issues of being considered a partner in the operating entity such as with guaranteed payments and different rules with respect to how they pay their estimated taxes.

**Guin:** From a legal standpoint, we've seen some of that as well. We're seeing a lot of our clients go to, rather than treating people as partners, they are giving them a contractual right that looks more like a phantom equity right rather than actually making them a partner. ■

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