

Management Fee Offsets – A Trap for Foreign Investors?

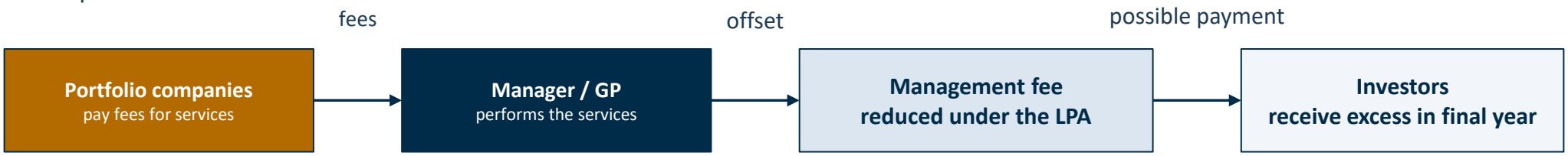
U.S. tax risks when unused fee offsets are paid out to investors

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How Management Fee Offsets Work

Portfolio companies pay fees for services performed by the manager. Under the typical LPA, offset provisions reduce current or future management fees. At wind-up, an unused balance may become payable to the LPs. An LP may be required to opt in or out, sometimes at subscription.



Over the life of the fund — illustrative timing

Years 1–5

Investment period

Management fee on committed capital. Offsets are absorbed against the current charge.

Years 6–10

Step-down

Management fee falls. Offsets may exceed the current charge and carry forward against later management fees.

Year 10+

Wind-down

Little or no management fee remains. An unused balance may become payable under the LPA, often at termination.

What the LPA does with a residual balance at the end

Lapses

Offsets apply only "to the extent of" management fees and the LPA is silent on a residual, so the balance simply expires. More typical of pre-ILPA standard documents.

Paid to investors – the current standard

The ILPA model LPA pays the residual to LPs at termination, with an LP opt-out. Actual LPAs vary: the payer (fund or GP/manager), the election mechanics and any cap at fees previously borne.

Credited to a successor fund

Uncommon. Needs express terms and benefits only investors who re-up; others are left in the 'lapses' case.

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For a Direct LP the Decision Tree is Straightforward

Unless the payment is reported as ECI, take it. If it is reported as ECI, the questions are whether you file U.S. returns anyway, whether the $$ is worth the tax return effort and potential recurring admin, and whether you can still waive.

Refund – not taxable income

WHAT IT IS

Your own management fees coming back: a price reduction on a service the fund bought, not income. Strongest where the payout is capped at fees paid allocated to you.

WHAT YOU NET

100%. No withholding, no U.S. return triggered.

Take it

Ask for the basis in writing before accepting.

Taxable income, but not ECI

WHAT IT IS

U.S.-source income to you, outside any U.S. business of the fund: the manager earned the portfolio-company fees and passes an excess through (FDAP income).

WHAT YOU NET

70% (after 30% withholding), or up to 100% with a treaty claim. Generally, no U.S. return if the withholding was right.

Take it

A refund claim for over-withholding does require a return.

ECI – a U.S. service business

WHAT IT IS

The payout treated as the fund's share of fees for services performed in the U.S., which puts the fund – and every partner – in a U.S. business. Sponsors seldom report it that way, but the LPA's carve-out of offset payments from its no-USTB covenant shows they cannot rule it out.

WHAT YOU NET

Cash less 21–37% withholding, plus a U.S. return (federal, often state); UBTI for a tax-exempt investor. A non-filer that files for this one item has put the fund's U.S. business on record and invited questions about earlier years.

Take it if a U.S. return is acceptable

Already filing: usually yes. No-filing policy: waive – secure the election at subscription.

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Who Should Take the Money – and Who Should Not

Investor	Recommendation	Why
Non-U.S. institution seeking no U.S. filing obligation	Take a refund or FDAP payment: neither needs a return. If it would be reported as ECI, waive – with the election secured at subscription, before the rights become fixed.	A small payment can buy a U.S. filing obligation. The sponsor's reporting does not bind the IRS.
Non-U.S. investor already filing	Usually take it. Price the extra federal and state tax, and possible branch profits tax for a corporate.	An existing return makes the extra cost small; it does not make the tax go away.
Treaty-country investor	Take a refund or FDAP payment; treaty relief may apply to FDAP income. If the sponsor reports ECI, do not count on the treaty.	A treaty can reduce or remove the tax on income; it does not remove a U.S. filing obligation once the fund is in a U.S. business.
Sovereign / Section 892 investor	Waive unless a separate §892 review clears it.	Commercial activity attributed to a controlled entity can put its whole exemption at risk.
Tax-exempt investor (U.S. or qualifying foreign)	A refund is fine. A share of service fees is UBTI: weigh the tax and filing cost against the payment, and keep an early opt-out.	Eligible foreign exempts are taxed the same way on U.S.-source UBTI; foreign private foundations also face a 4% excise on U.S.-source dividends and interest.
Non-treaty corporate or home-country taxpayer	Take a refund or FDAP payment (30% withheld, no return). If reported as ECI, compare the after-tax amount with waiving and check the home-country credit.	ECI adds a U.S. return, state tax and possibly branch profits tax.
Fund of funds	One election binds every underlying investor. Decide the policy before subscription and get the sponsor's reporting analysis before answering (Example 3).	Investors who file cannot decide for those who must not; split elections need contractual support.

A foreign tax-exempt organization is assumed able to document its U.S. exempt status (IRS determination letter or opinion of U.S. counsel); otherwise it is treated as an ordinary foreign investor.



Example 1 – A Swiss Pension Fund

Illustration (federal tax): a Swiss pension fund, treated as a foreign trust, holds 5% of a USD 1bn U.S. fund. Its share of a USD 4m excess payout is USD 200,000. It has never filed a U.S. return. Treaty eligibility is assumed.

If you take it – reported as ECI

Gross	200,000
Withholding at 37%	(74,000)
Treaty relief at source	none
Federal compliance*	(7,500)
State compliance*	(2,500)
Net cash after withholding	**≈ 116,000**

Assumes the sponsor reports the payout as ECI and the fund is treated as being in a U.S. service business through a U.S. permanent establishment, which each partner shares. For a no-filing investor the return, not the 74,000, may be the decisive issue.

If you take it – as a refund

Gross	200,000
Current gross income	0
Withholding	0
U.S. return	none
Net cash	**200,000**

The preferred result: substantiate a true recovery of fees or expenses and their prior tax treatment. A cap supports the position but does not establish it. No withholding, no return.

If you waive upfront

Cash accepted	0
Withholding	0
U.S. return	none
Net cash	**0**

For a firm no-filing mandate where treatment is unresolved: no cash, no withholding, no return. The election must remove the entitlement and allocations in advance; declining cash later is not enough. A waiver removes the final payment and its allocation.

**USD 10,000 compliance costs are illustrative; state tax, if any, is additional. The refund and waiver columns assume the fund's activities do not put it in a U.S. business. A non-income refund needs no treaty; if the payment is income but not ECI, the treaty's other-income article should give 0% at source.*

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If Waiving Payment – Timing is Key

An opt-out is strongest before payment rights and related income allocations become fixed. Declining cash later can leave the tax behind. Negotiate the election before committing to the investment.

1 → 2 → 3

Subscription / side letter

Waive here

Check the subscription's opt-in/opt-out, default and irrevocability. For a no-filing mandate, secure a prospective election removing the payment entitlement and related allocations. Avoid control over waived funds. Do not assume a later notice or election window.

Negotiated notice window

Possibly still in time

Negotiated side letter example: no upfront irrevocable election and GP uses commercially reasonable efforts to provide at least 10 Business Days' advance written notice of offset payment which investor can waive.

Payment notice

Probably too late

A fixed right alone is not constructive receipt. The risk is high when cash is available without substantial restrictions. Check the full LPA: a prepayment election may follow the relevant tax event.

What the case law supports

An outright refusal differs from accepting income or directing it to someone else. Timing, entitlement, control and the partnership allocations all matter. No authority makes every prepayment opt-out safe.

Cash is not the only thing

LPAs may deem partners paid for other contractual purposes; that is not a tax allocation. If the allocation rules assign taxable income despite an opt-out, declining cash does not remove it. A direct GP payment needs its own characterization. And no waiver takes a partner out of a U.S. business the fund itself is in.

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Example 2 – A Wind-Down Notice

A PE Fund wind-down notice offers a foreign corporate LP an offset-fee opt-out of USD 100,000. Assume the recipient is a foreign corporation with no applicable U.S. income tax treaty.

WHAT THE NOTICE SAYS

- Offset fees of USD 5 million exceed remaining fund expenses; the excess will be used to "refund Fund expenses previously paid".
- The Fund intends to take the position that these amounts are not UBTI or ECI, but please consult your tax advisor.
- LP's share: USD 100,000. Irrevocable opt-out by a stated date; otherwise paid in the final liquidating distribution.

THE GAP TO CLOSE BEFORE ACCEPTING

- The intended non-ECI/non-UBTI treatment supports a recovery position. It is not a commitment and does not specify the tax-form entries.
- Confirm the legal recovery basis, source and any income allocations. Calling it a cash distribution does not change what it represents.
- Recommendation: take a refund or FDAP payment with matching reporting. If the sponsor reports ECI, compare tax and filing cost with a timely opt-out.

Federal Outcomes for the non-treaty corporation

Refund – not income

Assumed genuine recovery with no current gross income and no separate filing trigger: no withholding or return from this receipt. Net USD 100,000.

Taxable, but not ECI (FDAP)

30% = USD 30,000 withheld. Net USD 70,000 and no U.S. return if the withholding is right; a refund claim for over-withholding does require one. Treaty may eliminate 30% tax.

ECI – tax plus a U.S. return

21% = USD 21,000 before deductions, plus a U.S. corporate return and a possible 30% branch profits tax on, roughly, the after-tax amount (relief on winding up the U.S. business needs an investor-wide review; another ECI-producing fund can prevent it). Net USD 79,000 before BPT; ≈ 55,300 with it.

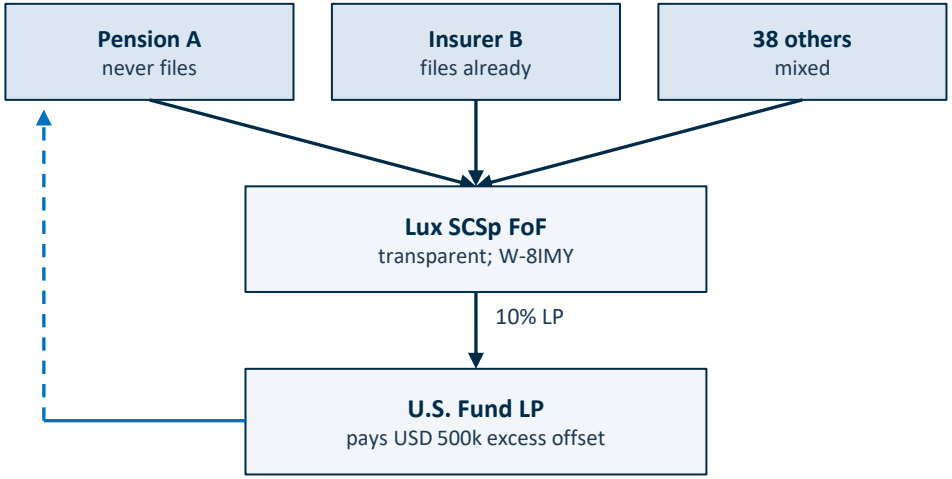
Ask before accepting: paid gross or withheld, and at what rate? What character, source and allocations support the position? Which tax forms will show it, and how?

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Example 3 – The Fund-of-Funds Decides for Everyone

For a direct LP the choice is easy; a FoF makes it for everyone behind it. A Luxembourg SCSp FoF with 40 European investors holds 10% of a U.S. fund; FoF and U.S. fund are transparent for U.S. tax. At wind-down the U.S. fund proposes an excess-offset payout – the FoF's 10% share is USD 500,000 – reported as ECI.



One FoF election can affect 40 investors

- The FoF receives the notice and makes the response. Underlying investors may never see it.
- ECI and filing obligations pass through transparent tiers. Look-through withholding depends on the FoF's documentation; without it the fund withholds at the highest rate. The FoF has its own compliance duties.
- A split election needs contractual and tax support. Separate cash payments do not resolve existing income allocations.

What the FoF should do

- Default: where a no-ECI/no-filing mandate controls, preserve or exercise the opt-out unless supported treatment protects that mandate.
- Get the sponsor's payment, allocation and reporting analysis before responding. Investors already filing cannot decide the issue for protected investors.
- Negotiate separate elections or tax-effective sleeves if the amounts justify them. Do not assume one FoF election can be split after income is earned.
- Disclose the FoF's election policy and decision authority before subscription. Escalate conflicts before the deadline.

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Eight Due Diligence Questions for the GP

1. For whose account are portfolio-company fees collected – the manager's or the fund's? Does the no-USTB covenant carve out offset payments?
2. How do unused offsets carry against later fund fees? What happens to the residual at wind-up: forfeiture, payment or a permitted successor-fund credit?
3. What legal character and source support the payment, and how will you report and withhold? Can the intended treatment and change-notice commitment go in writing?
4. Is there a cap tied to prior management fees or GP Share paid in respect of this LP? How are excess organisational expenses treated?
5. Who pays the LP directly? Does the LPA's "as if received" rule affect tax allocations, and what do its exceptions do?
6. Must I opt in or out at subscription? What are the default, deadline and revocability? Is a later election available before rights and allocations become fixed?
7. Do fund personnel take paid board seats, break-up fees or co-investment fees in the fund's name?
8. For a FoF with mixed investor constraints, can separate elections or sleeves work under the documents and tax allocations?

Rule of thumb: decide at subscription, in writing, and make the sponsor's reporting position part of the deal. The cheapest fee-offset dollar is the one whose facts – cap, payer, reporting – you fixed before it was earned; and a fund that charges its portfolio companies no fees has nothing to offset.

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Also Worth Considering – Clawbacks and Other Traps

A genuine carry clawback

- A GP clawback generally corrects carried-interest economics rather than compensating the LP for services.
- Trace the repayment through the underlying allocations, including any ECI, UBTI or sovereign commercial income.
- A cash repayment does not automatically rewrite prior-year allocations or settle character and basis.
- Netting does not settle the fee question: an excess-offset payout netted against a clawback still needs its own characterization.
- Practical step: ask the sponsor to separate the carry correction from fee/expense recoveries in its calculation and reporting.

Other inadvertent routes to ECI, UBTI or filings

Break-up fees paid to the fund

Fund receipts can have different character and source. Distinguish service fees from damages, capital-gain items and expense reimbursements.

Director and monitoring fees paid to the fund

Board seats held by fund personnel with fees paid to the fund: services income at the fund level.

Co-investment deal fees

An LP earning fees for U.S. services from sourcing or working a deal can create its own business-income issue.

Loan origination

A U.S. manager's lending or financing activity can be attributed to the fund; the Tax Court said so in 2023.

FIRPTA surprise

A company is a U.S. real property holding company if U.S. real estate is half or more of its real estate plus business assets, by value. Share sales can then face FIRPTA, subject to exceptions such as qualified foreign pension funds.

Secondaries

If gain on the LP interest would be ECI, the buyer withholds 10% of the amount realized, debt relief included, unless a certification or exception applies.

Subscription lines (tax exempts)

Borrowing can create debt-financed UBTI. Check the investor and real-estate exceptions.

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Disclaimer

This presentation provides general information and does not constitute legal or tax advice or an opinion on a particular investment. Fund terms, activities and investor status determine the result. Examples are illustrative, and stated cost assumptions are not estimates. Obtain advice before making an election.

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