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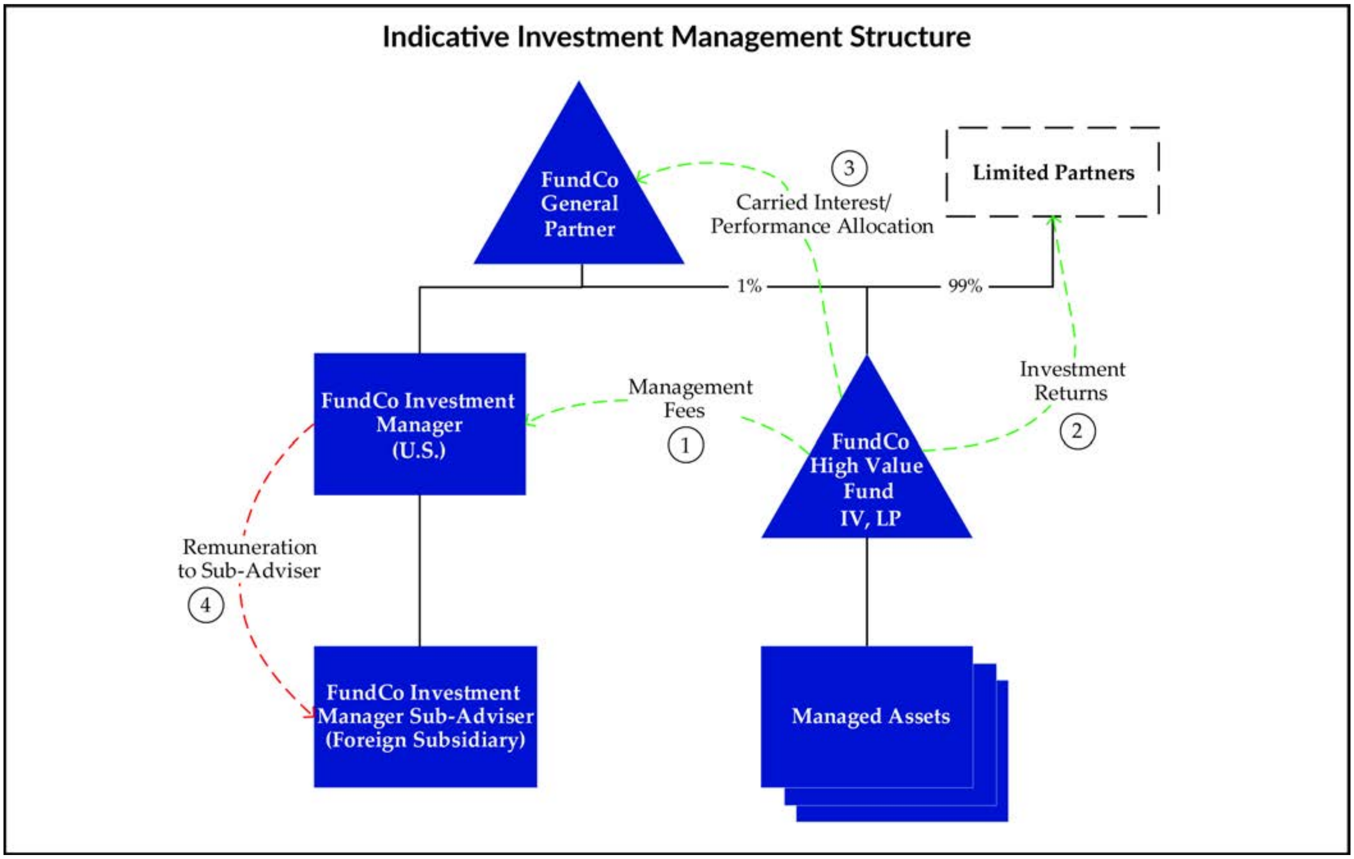
In this article, Taylor and Hunt explain asset management companies' options for remunerating sub-advisers and the preferred structure's effect on transfer pricing method selection.

Sub-advisory functions performed within an asset manager legal entity structure have historically been rewarded through a range of applicable transfer pricing methods. Typically, the chosen method, which has a significant impact on the relevant entity's profit and losses, will be determined through a review of its role in the asset manager's value chain. Carried interest or a performance allocation is a typical remuneration component for a general partner (GP) of some alternative investment classes (for example, private equity funds and hedge funds). Other parties within the fund structure may also receive a carried interest or performance allocation. This article considers the intersection of carried interest, performance allocation, and transfer pricing policies for sub-advisers, including relative to other forms of compensation earned by key members of a typical investment fund structure.

Alternative Investment Structures

Alternative asset managers are generally compensated through management fees, paid by investment funds (and ultimately by the investors, or limited partners) to the management company, either directly or through the GP. GPs are ultimately responsible for the investment decisions executed by a fund, including hiring investment managers, delegating investment decisions to those managers, and overseeing their activities and performance. Management fees are usually calculated as a percentage of assets under management or of committed capital, with the aim of covering costs incurred in delivering asset management services to the investment fund and generating a profit margin.

Also, GPs typically contribute 1 to 3 percent of the capital invested in a fund, with the remainder contributed by the limited partners. While the GPs' capital ownership in the fund provides additional motivation to make investment decisions in the best interests of all investors, GPs are often further incentivized by carried interest or performance allocation received from the investment fund (separate to any management fee) in the event the fund's return exceeds a specified hurdle rate. In private equity, carried interest is typically generated and distributed at the time of exit from one of or all the investments within the fund, while more liquid investment funds (like many hedge funds) may calculate any performance allocation owed based on net asset value on an annual basis and reallocate both realized and unrealized gain within the fund. The split between management fee and carried interest



or performance allocation is often described as "2 and 20," with management fees calculated as 2 percent of assets under management, and carried interest or performance allocation equal to 20 percent of investment returns beyond the hurdle rate. Actual rates will vary by fund.

From a tax perspective, management fees earned by the GP or management company are typically considered (and taxed as) ordinary income. This is also the case for any added performance fees, which are typically structured as profit and loss revenue of the asset manager (and more traditionally seen in the context of hedge funds). Conversely, carried interest from a private equity fund is usually considered capital gains by the relevant jurisdiction, often attracting favorable tax treatment as compared with ordinary income (performance allocation from a hedge fund may be eligible for capital gains treatment but is often taxed at the same tax rates as, or is otherwise treated as, ordinary income). The incremental return of carried interest or performance allocation typically attaches to the investment of the GP into the fund, hence generating consideration as growth in the value of the investment (capital) rather than a fee for services performed by the manager. Individuals, even those not associated with the GP, can also earn carried interest or performance allocation at the discretion of the manager or GP.

The figure depicts a typical alternative investment management remuneration structure.

In the figure, carried interest or performance allocation is seen flowing from the investment fund to the GP as flow 3 while the management fees flow from the investment fund to the investment manager in flow 1. The overall management fees are usually not viewed as raising transfer pricing issues because they are agreed to by unrelated investors, for example, disclosed in limited partner agreements. However, investment managers may have foreign related parties, acting as sub-advisers, assisting in the selection and recommendation of investments in a specific jurisdiction, or for a specific asset class. The remuneration to a sub-adviser performing investment advisory services (that is, a split of the overall management fees), seen as flow 4 in the figure, is subject to transfer pricing regulations of the jurisdictions.

Transfer pricing considers the appropriate remuneration for services between related parties across international or state borders, and whether the remuneration matches what would be agreed upon between third parties applying the arm's-length standard. Typical intercompany services in the asset management industry often include the provision of management or headquarter services, investor referral services, and (as discussed above) delegated sub-advisory services. There may also be related parties performing back-office or other functions to assist in management of the assets.

Sub-advisory functions, like all functions, are priced with reference to their importance to the value chain of the business. Sub-advisory services can include a broad range of activities, typically delegated from the central investment management entity or head office to regional affiliates. They may be routine in nature, perhaps without the ability to conclude investments (just provide research or make nonbinding recommendations), or more high value, for example teams able to unilaterally commit significant capital of the fund without review or approval. The spectrum of delegated sub-advisory functions, as with all transfer pricing analyses, predicates the most supportable transfer pricing method. A more routine sub-advisory role might be properly compensated through a cost-plus mechanism, while a higher degree of responsibility for the sub-adviser could draw remuneration in the form of a split of management fee revenues (or even some measure of overall profits).

If a sub-adviser or its employees perform any of the following functions, it may indicate that its role is not routine in nature, and that it is contributing to the value added functions of the asset manager:

- making investment recommendations that are not subject to further scrutiny;
- participating in the investment committee;
- acting in a collaborative or approval role for investments outside the specific remit of the sub-adviser (the group's strategy is executed in a collaborative fashion involving the sub-adviser and investment manager on equal footings); or
- employing individuals who are separately entitled to a portion of the carried interest or performance allocation earned by the GP, or have an equity stake in the GP or a separate investment vehicle receiving carried interest or performance allocation.

A split of management fees, if determined to be the correct transfer pricing method, could be based on a percentage of the assets for which a sub-adviser has a significant level of management responsibility (similar to how an asset manager as a whole generates revenue from clients). Comparability rules dictate that all forms of compensation are considered when determining the arm's-length pricing for sub-advisory functions, including any performance fees paid to the GP or investment manager. If a sub-adviser performs the types of value added functions described above over part of or all the investment portfolio, any performance fee paid to the investment manager may be included in amounts to be shared with the sub-adviser.

Given that carried interest or performance allocation is typically characterized as an enhanced return on investment, most transfer pricing specialists have historically considered this income stream to fall outside the scope of transfer pricing — distinct from ordinary income, including performance fee or management fee income, and not includable within the income items used to derive subsequent downstream transfer pricing returns. Carried interest or performance allocation is generally not part of traditional revenue as defined within the profit and loss — typically the starting point for transfer pricing.

Transfer pricing returns need to reflect the value that an entity contributes to its organization. For taxpayers looking to defend a routine return for a given function (for example, a cost-plus return for a sub-adviser), care will have to be paid to demonstrate that the functions performed in the relevant entities are distinct from those generating the group's high-value returns. If individuals within an entity perform high-value functions, for example, those typically performed by individuals rewarded by an asset manager with carried interest or performance allocation, it could be questioned whether that entity should be entitled to an income stream higher than a pure routine return. More broadly, earning or being entitled to carried interest or performance allocation could be taken by tax authorities as an indication of an entity's importance within the group value chain.

Conclusion

The treatment of investment sub-advisers, and the potential inclusion of carried interest within their returns from a transfer pricing perspective, is an area of increasing complexity for transfer pricing. Historic notions that sub-advisers could or should always receive a routine return are no longer without challenge. There are a number of factors to consider, such as roles of sub-adviser employees on investment committees, de facto decision-making, and seniority and compensation structure of the sub-adviser (including carried interest for its employees) that potentially make a routine returns method harder to support without appropriate documentation and facts. This can be particularly so if sub-advisory functions are not clearly subordinate to a broader investment management or decision-making role at the investment manager level.

If transfer pricing of carried interest or performance allocation is warranted or required, applicable tax rules would need to be carefully considered to determine the mechanism for transmitting a portion of the carried interest or performance allocation to the sub-adviser. It would be important to consider any taxation mismatches between income inclusion and deductibility when carried interest or performance allocation amounts may, under the applicable transfer pricing method, be transferred, directly or indirectly, to the sub-adviser. This is a topic that will be covered in a subsequent article.

Adequate and compliant transfer pricing documentation should be maintained in each operational jurisdiction outlining the value chain of the respective sub-adviser, the decision-making protocols, the role of any non-domestic investment committee, the ultimate intercompany remuneration methods applied, and the economic analysis supporting those remuneration methods.[1] ■

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[1] The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only, and does not necessarily represent the views or professional advice of KPMG LLP.