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Proposed IRS Regulations Target Management Fee Waiver Arrangements

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On July 22, 2015, the Treasury Department and the Internal Revenue Service ("IRS") released proposed regulations (the "Proposed Regulations") regarding disguised payments for services under Section 707(a)(2)(A) of the Internal Revenue Code of 1986, as amended (the "Code"). The Proposed Regulations include anticipated guidance on "fee-waiver" arrangements commonly used by private investment funds, although the Proposed Regulations apply to a wider array of arrangements. In addition, the preamble to the Proposed Regulations contemplates future revisions to existing IRS guidance, further limiting the ability to treat the grant of a "profits interest" to service providers as a non-taxable event.

If finalized in their current form, the rules would characterize certain fee waiver arrangements as disguised compensatory payments for services. Such treatment also could give rise to collateral consequences under other tax rules relating the taxation of current and deferred compensation arrangements under Sections 409A and 457A of the Code.

While the Proposed Regulations are not yet effective, the position of Treasury and the IRS, as stated in the preamble, is that the Proposed Regulations generally reflect current law consistent with congressional intent. Accordingly, the Proposed Regulations should be considered in connection with current and future management fee-waiver and other similar arrangements.

Background

In general, management fee-waiver arrangements are intended to allow a service provider to defer taxable income through the receipt of a "profits interest" in a partnership which subsequently will result in allocations and distributions of a portion of the partnership's underlying income to such service provider in its capacity as a partner. Such allocations and distributions may be taxable to the service provider at a more favorable tax rate, in particular in the case of preferential tax rates applicable to individuals with respect to long term capital gains and qualified dividend income.

Section 707(a)(2)(A) of the Code grants broad anti-avoidance authority to the Treasury Department and IRS to issue regulations to treat certain allocation as compensation income if the arrangement is more properly characterized as a transaction occurring between the partnership and a non-partner. The preamble to the Proposed Regulations emphasizes the legislative history of Section 707(a)(2)(A) of the Code and incorporates several related tests and factors into the Proposed Regulations.

The Proposed Regulations

The Proposed Regulations provide that whether a partnership allocation of income to a service partner constitutes disguised compensation payment for services depends on all of the facts and circumstances. The most important factor in such determination is the presence or absence of "significant entrepreneurial risk" with respect to the service provider relative to the "the overall entrepreneurial risk" of the underlying partnership.

The Proposed Regulations provide that an arrangement that lacks significant entrepreneurial risk is treated as a compensatory payment for services. If such treatment applies, the possible application of the rules under Sections 409A and 457A of the Code, relating to current and deferred compensation arrangements, also should be examined.

The Proposed Regulations provide a non-exclusive list of factors that create a presumption that an arrangement lacks significant entrepreneurial risk and will be treated as a payment for services in the absence of clear and convincing evidence to the contrary:

- Capped allocation of partnership income if the cap is reasonably expected to apply in most years;
- An allocation for one or more years under which the service provider's share of income is reasonably certain;
- An allocation of gross income;
- An allocation (under a formula or otherwise) that is predominantly fixed in amount, is reasonably determinable under all facts and circumstances, or is designed to assure that sufficient net profits are highly likely to be available to make the allocation to the service provider; or
- An arrangement in which a service provider fails to timely waive its right to receive payment for the future performance of services in a binding manner or otherwise to provide appropriate notice regarding such waiver.

The Proposed Regulations also provide a non-exclusive list of additional factors of secondary importance in determining whether or not an arrangement that gives the appearance of significant entrepreneurial risk constitutes a payment for services:

- The service provider holds, or is expected to hold, the partnership interest on a transitory basis or only for a short duration;
- The service provider receives an allocation and distribution in a time frame comparable to the time frame that a non-partner service provider would typically receive payment;
- The service provider became a partner primarily to obtain tax benefits that would not have been available if the services were rendered to the partnership in a third party capacity;

- The value of the service provider’s interest in general and continuing partnership profits is small in relation to the allocation and distribution; or

- The arrangement provides for different allocations or distributions (e.g., carry and fee waiver allocations) with respect to different services, the services are provided by one or more related persons (e.g., a general partner and a management company) and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly.

The weight of any such secondary factor depends on the particular case and the absence of a factor is not necessarily indicative of whether or not an arrangement is treated as a payment for services.

Several examples in the Proposed Regulation consider the so-called “clawback” obligation that is commonly used in private equity fund structures (i.e., an undertaking by the service provider to repay distributions previously received that are not supported by the partnership’s longer-term performance). Those examples suggest that a “clawback” obligation, which is reasonably anticipated to be enforceable, is a helpful factor in supporting the presence of significant entrepreneurial risk. Conversely, it appears that the existence of a clawback undertaking with respect to the general partner’s carried interest and the absence of such obligation with respect to the manager’s fee-waiver arrangement, may support a recast of the manager’s arrangement as a payment for services.

Application of Safe Harbor Revenue Procedures Concerning “Profits Interests”
Existing IRS guidance (Rev. Proc. 93-27, 1993-2 C.B. 343, Rev. Proc. 2001-43, 2001-2 C.B. 191 and Notice 2005-43, 2005-24 I.R.B 1221) provides that, subject to certain exceptions, the grant of a profits interest in a partnership to a service provider is not treated as a taxable event if certain requirements are met. Such favorable treatment requires, among other things, the grant of a partnership interest that qualifies as a “profits interest,” for services to or for the benefit of the partnership, that is not disposed of within two years of such grant.

The preamble to the Proposed Regulations states that the existing profits interest safe harbor does not apply to transactions in which one party provides services and another party receives a seemingly associated allocation and distribution of partnership income or gain, such as when a management company that provides services to a private equity fund waives its fee, while a related party receives a profits interest the value of which approximates the amount of the waived fee.

In addition, the preamble states that when the Proposed Regulations are finalized, additional limiting guidance will be issued with respect to grants of profits interests to service providers. Such guidance will exclude from the favorable safe harbor the issuance of a profits interest for the performance of services in conjunction with the relevant service provider forgoing payment of an amount that is substantially fixed (including a substantially fixed amount determined by formula, such as a fee based on a percentage of partner capital commitments).

Under such new contemplated guidance, the IRS may (and likely will) assert that a profits interest granted pursuant to a management fee waiver arrangement results in the upfront taxable inclusion of compensation income by the service provider (even if the arrangement is respected as an issuance of a profits interest and is not otherwise characterized as disguised compensatory payments pursuant to the other rules set forth in the Proposed Regulations).

Effective Date

While the Proposed Regulations will apply only to arrangements entered into or modified on or after the date final regulations are published in the Federal Register, the position of the Treasury Department and IRS, as stated in the preamble, is that the Proposed Regulations generally reflect the Code and related guidance in relevant legislative history regarding disguised payments for services. As a result, the Treasury Department and IRS may challenge existing fee waiver arrangements prior to the Proposed Regulations being finalized. In addition and importantly, in determining the application of the final regulations to an existing arrangement, an arrangement that permits a service provider to waive all or a portion of its fee at a later date or dates, is considered to be "modified" when the service provider subsequently waives any portion of its fee, thereby subjecting the arrangement to scrutiny under the final regulations.

Conclusion

Given the IRS and Treasury position that the Proposed Regulations generally reflect existing rules under the Code and related guidance in relevant legislative history and that existing arrangements will be treated as being modified upon subsequent waivers of fees, existing and future management fee waiver arrangements should be examined and, when possible, structured in light of the rules set forth in the Proposed Regulations. In addition, careful consideration should be given to the implications of the rules under Sections 409A and 457A of the Code concerning current and deferred compensation arrangements.

If you would like to discuss the Proposed Regulations and their possible impact on existing and/or future management fee-waiver arrangements, please contact one the following members of Bracewell & Giuliani's tax team:

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