Client Update

Treasury Issues Proposed Regulations on Management Fee "Waiver" Mechanisms

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On July 22, 2015, the U.S. Treasury Department and the U.S. Internal Revenue Service issued proposed regulations (the "Proposed Regulations") relating to disguised payments for services rendered by a partner to a partnership.[1] The Proposed Regulations are issued under section 707 of the Internal Revenue Code, which generally provides that (under regulations issued by the IRS) an allocation and distribution from a partnership to a service partner will be treated as compensation income (rather than a share of profits) if it is properly characterized as a transaction between the partnership and a person acting in a non-partner capacity. The Proposed Regulations in some respects adopt a facts and circumstances test and provide a non-exclusive list of factors to consider when making the determination. However, the Proposed Regulations provide that an arrangement that lacks "significant entrepreneurial risk" will in all cases be recharacterized as a payment for services. While the Proposed Regulations provide significant detail on what facts and circumstances will be considered, they leave many questions unanswered and introduce additional questions that require clarification.

The Proposed Regulations were expected to target management fee "waiver" mechanisms (described below). However, the Proposed Regulations and the preamble to the Proposed Regulations are broader and also implicate other partnership arrangements, such as the "profits interest" safe harbor of Revenue Procedure 93-27. The Proposed Regulations do not appear to modify the tax treatment of carried interest.

MANAGEMENT FEE "WAIVER" MECHANISMS GENERALLY

Management fee "waiver" mechanisms have been used in various forms in the private equity fund area for the past two decades. Although there are many different types of arrangements, they generally involve a reduction in the

1 80 Fed. Reg., 43,652 (proposed Jul. 23, 2015).

management fee payable to the fund's manager (sometimes through a waiver during the term of the partnership of an upcoming management fee, and hence the term "fee waiver") and the receipt of a corresponding profits interest by the manager, the general partner, or another partner. The allocation and distribution of profits to the recipient partner is subject to the fund's generating sufficient profits that are taken into account for this purpose under the fund's partnership agreement. In some mechanisms, the amount received from the profits interest is equal to the reduction in the management fee (if there are sufficient profits). In others, each reduction in the management fee is notionally invested in the fund, and the amount received with respect to a reduction will be more than the reduction if the investment is sold at a gain, and less than the reduction if the investment is sold at a loss.

Many details of the mechanisms differ from fund to fund, including the timing of when the manager can "waive" the fee (*e.g.*, annually or quarterly), and the type and timing of profits from which the recipient partner is provided its allocations and distributions (*e.g.*, gross income vs. net income, book income vs. income from realizations, and the period over which net income is measured). In some mechanisms (often referred to as "hardwired" mechanisms), there is no "waiver" at all. Rather, from the inception of the fund the management fees and the recipient partner's entitlement to allocations and distributions are determined by formulas set out in the partnership agreement.

THE PROPOSED REGULATIONS

Under the Proposed Regulations, the determination of whether an arrangement is a disguised payment for services is made at the time the arrangement is entered into or modified.

The Proposed Regulations provide a non-exclusive list of six factors that determine whether an arrangement constitutes a payment for services. The most important factor is the existence of significant entrepreneurial risk, which is based on the service provider's entrepreneurial risk relative to the overall entrepreneurial risk of the partnership. An arrangement that lacks significant entrepreneurial risk constitutes a payment for services, while an arrangement that has significant entrepreneurial risk will generally not constitute a payment for services unless other factors establish otherwise. Other than entrepreneurial risk, the weight of any particular factor depends on the particular case.[2]

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[2] The secondary factors are:

(1) whether the service partner holds, or is expected to hold, the partnership interest on a transitory basis or for a short duration;

(2) whether the service partner receives an allocation and distribution in a time frame

The Proposed Regulations provide a list of facts and circumstances that create a presumption that an arrangement lacks significant entrepreneurial risk, because these facts create a high likelihood that the service provider will receive an allocation and distribution regardless of the overall success of the business operations. The presumption may only be rebutted with clear and convincing evidence. These factors are:

(i) Capped allocations of partnership income if the cap is reasonably expected to apply in most years;

(ii) Allocations for a fixed number of years under which the service provider's distributive share of income is reasonably certain;

(iii) Allocations of gross income items;

(iv) An allocation (under a formula or otherwise) that is predominantly fixed in amount, is reasonably determinable under all the 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 (*e.g.*, if the partnership agreement provides for an allocation of net profits from specific transactions or accounting periods and this allocation does not depend on the long-term future success of the enterprise); or

(v) An arrangement in which a service provider either waives its right to receive payment for the future performance of services in a manner that is non-binding or fails to timely notify the partnership and its partners of the waiver and its terms.

The Treasury and the IRS provide more guidance on item (iv) above in the preamble. The preamble indicates that certain facts, when coupled with a priority allocation of net income to the service provider that is measured over an accounting period of 12 months or less, create opportunities that will lead to a higher likelihood that sufficient net profits will be available to make the

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comparable to the time frame that a non-partner service provider would typically receive payment;

(3) whether the service partner 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;

(4) whether the value of the service partner's interest in general and continuing partnership profits is small in relation to the allocation and distribution; and

(5) where different services are provided by the same service provider or related providers, whether the level of entrepreneurial risk with respect to allocations and distributions for one service varies significantly as compared to the level of entrepreneurial risk with respect to allocations and distributions for the other service.

allocation. These facts include: (i) the value of the partnership's assets is not easily ascertainable and the service provider or a related party controls the determination of asset values or events that may affect such values, and (ii) the service provider or a related party controls the entities in which the partnership invests.

An arrangement that is treated as a disguised payment for services will be treated as a payment for services for all tax purposes, with the result that the payment will be taxed as compensation and will be subject to sections 409A and 457A of the Code (unless the requirements of those sections are otherwise met).

Effective Date – The Proposed Regulations only apply to arrangements entered into or modified after the date final regulations are issued. If an arrangement permits a service provider to waive its fee after the date the arrangement is entered into, then the arrangement would be considered to be modified on any date that the fee is waived. The preamble also states that it is the position of the Treasury and the IRS that the Proposed Regulations generally reflect Congressional intent, indicating that the principles of the Proposed Regulations may represent their litigation position for arrangements entered into before final regulations are issued.

THE EXAMPLES

The Proposed Regulations provide six examples to demonstrate the application of the proposed rules to certain fact patterns. Because the Proposed Regulations utilize a facts and circumstances test, these examples are critical to understanding the implications of the new rules. We focus our discussion on Example 3, which seems most pertinent to the management fee "waiver" mechanism in a typical private equity fund.

Example 3 involves an investment partnership that will acquire a portfolio of assets that are not readily tradable. In the recital of facts, M is entitled to a priority allocation and distribution of net income during any 12-month accounting period in which the partnership has overall net gain in an amount intended to approximate the fee that would normally be charged for the services M provides. The general partner controls M and directs the operations of the partnership, including causing the partnership to buy and sell assets "during any accounting period." The example states in its recital of the facts that, given the nature of the assets and the general partner's ability to control the timing of asset dispositions, the amount of net income that will be allocated to M is highly likely to be available and reasonably determinable based on all facts and circumstances at the time of the partnership formation. In the analysis, the example discusses the facts and circumstances of M's arrangement, noting that the allocation to M does not depend on the overall success of the partnership, and that the sale of the assets and hence the timing of recognition of gains and losses is controlled by the general partner. The example concludes what had previously been assumed in the facts, that the allocation is reasonably determinable under all the facts and circumstances and that sufficient net profits are highly likely to be available to make the priority allocation, and therefore the arrangement is treated as a payment for services.

Example 3 contains elements common to many private equity funds' management fee "waiver" mechanisms, and therefore is likely to become the object of some scrutiny by practitioners. In particular, it is the only example in which the profits available for the allocation are computed by reference to the net gain during any 12-month accounting period in which the partnership has overall net gain. It is unclear what period of allocations, if any, would be *per se* acceptable other than the life of the partnership (which passes muster in Examples 5 and 6, at least if there is a clawback and it is reasonable to anticipate that the clawback would be complied with).

In Examples 5 and 6, a manager or a related party is entitled to an additional profits interest intended to approximate the fee that would normally be charged for the services the manager provides. In each case the manager's or related party's entitlement is based on future partnership net income and is subject to a clawback obligation. The examples provide in the facts that the amount of net profits that will be allocated to the party is neither highly likely to be available nor reasonably determinable based on all the facts and circumstances. Each example concludes that the arrangement does not constitute a payment for services.

OBSERVATIONS/QUESTIONS

Highly Likely to be Available – One of the key determinations under the Proposed Regulations is whether sufficient net income is highly likely to be available to make the allocation to the service provider under the arrangement. However, there is uncertainty surrounding what facts are necessary to make that determination. The text of the Proposed Regulations indicates that an allocation of net profits from specific transactions or accounting periods that does not depend on the long-term future success of the enterprise is one example. However, Example 4 includes such facts, and yet the Proposed Regulations conclude that the allocation is not highly likely to be available. As discussed above, the preamble provides additional facts that when present may create opportunities that will lead to a *higher* likelihood that sufficient net profits will be available to make an allocation, but does not provide that such facts mean net income is highly likely to be available.

Fixed or Reasonably Determinable Allocation – Another key determination under the Proposed Regulations is whether an allocation is either predominantly fixed in amount or is reasonably determinable under all the facts and circumstances. Again, uncertainty exists with respect to this analysis, as the only guidance provided is through the examples, and no example appears to isolate the issue of whether the arrangement (i) fixes the allocation to an amount intended to approximate the fee that would normally be charged for the services the manager performs (as in Example 3) or (ii) provides the service provider with an interest in subsequent partnership net income with an estimated value equal to the fee waived (as in Examples 5 and 6).

OTHER IMPLICATIONS OF THE PROPOSED REGULATIONS

Traditional Carried Interest – Examples 3, 5 and 6 indicate that traditional carried interest arrangements would not constitute a disguised payment for services.

"Catch-Up" Allocations – The preamble provides that traditional "catch-up" allocations would typically not lack significant entrepreneurial risk, but all of the facts and circumstances would need to be considered.

Profits Interests Safe Harbor – In the preamble, the Treasury and the IRS announced their determination that Revenue Procedure 93-27 (which provides a safe harbor for the receipt of a profits interest not to be treated as a taxable event) does not apply where one party (*e.g.*, the manager) provides services to a partnership in exchange for a fee that can be waived, while a related party (*e.g.*, the general partner) receives an interest in future partnership profits which approximates the amount of the waived fee. In addition, the Treasury and the IRS announced in the preamble their intention to issue a revenue procedure providing an additional exception to the safe harbor in Revenue Procedure 93-27 at the time that final regulations are issued. The exception will apply to a profits interest issued in conjunction with a partner forgoing payment of an amount that is substantially fixed for the performance of services. This exception would seem to apply even to a set of facts, such as Example 6, under which the amount of net profits that will be allocated to the party is neither highly likely to be available nor reasonably determinable. This exception may also preclude profits interest treatment for certain interests received in tax-free rollovers of compensation obligations. If Revenue Procedure 93-27 does not apply to an arrangement, and the receipt of a profits interest is treated as a taxable event, previous case law relating to valuation will again be relevant with respect to such interests.

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These rules are in proposed form and we anticipate the Proposed Regulations will be widely commented on and will likely be refined before being finalized. Please do not hesitate to contact us with any questions.