July 24, 2015

Management Fee Waiver Update: Treasury Issues Proposed Regulations Addressing Disguised Payments from Partnerships for Services

On Wednesday, July 22, 2015, the Treasury Department and the Internal Revenue Service (the "IRS") released proposed regulations on disguised payments from partnerships (including investment funds) for services (the "Proposed Regulations") and also announced their intent to modify existing administrative guidance on profits interests.[1] These Proposed Regulations include anticipated guidance on "fee waiver" arrangements,[2] though they apply more broadly to any arrangement between a partnership and a service-provider partner. The proposals aim, among other things, to ensure that partners who receive interests in partnerships for the performance of services bear "significant entrepreneurial risk" with respect to their partnership interests, and, in some circumstances, recharacterize arrangements as payments for services (which would be treated as ordinary compensation income). The proposed guidance would not change the treatment of classic carried interest arrangements with after-tax clawbacks.

One of the more puzzling aspects of the guidance appears only in the preamble to the Proposed Regulations, which announces that the IRS plans to provide additional guidance on profits interests generally when these Proposed Regulations are finalized. This suggests that the IRS may be reserving the right to treat profits interests granted in respect of waived management fees ("fee waiver interests") as taxable at fair market value upon grant, which may be the value of the waived fees. As a practical matter, we would expect traditional fee waiver programs to be of limited utility if the Treasury Department and IRS intend that fee waiver interests are taxable upon grant, though there may be alternative economic arrangements to consider.

The proposed rules are unclear in many respects, and will likely be refined before being finalized. We will keep our clients informed as the law develops, and will be discussing the application of the proposed rules to particular fee waiver programs with our clients in the coming weeks.

Background on Fee Waiver Programs

A typical fee waiver program may work as follows:

- A fund manager irrevocably waives its rights to receive management fees from an investment fund ("waived amounts") before the beginning of the year in which those fees would otherwise be earned;

- Limited partners in the fund contribute capital to the fund in respect of the waived amounts;
- The fund manager receives a profits interest in the fund, entitling it to receive distributions equal to the capital contributed by the limited partners in respect of the waived amounts, plus the investment return on such capital, but only to the extent that the fund has sufficient net profits to support the distribution. The manager is allocated partnership items out of net profits (which are intended to retain the same character as when received by the partnership and may include long-term capital gain and qualified dividend income) to support the right to distributions.

Proposed Regulations

The Proposed Regulations provide detailed rules to recharacterize arrangements in which a service provider receives allocations and distributions from a partnership as, instead, payments for services. If an arrangement is characterized as a disguised payment for services, it will be treated as a payment for services for all purposes of the Internal Revenue Code of 1986, as amended (the "Code"). The character, timing and amount of any income, deduction or other tax item attributable to these payments will be determined under the provisions of the Code that apply to payments for services, notably including Sections 409A and 457A. As noted above, while the Proposed Regulations address fee waiver programs, their scope is broader and they will be relevant in any situation where a partnership has a service-provider partner.

Facts and Circumstances Analysis. Under the Proposed Regulations, whether an arrangement should be characterized as a payment for services, rather than as partnership allocations and distributions, depends on all of the facts and circumstances at the time the parties enter into or modify the arrangement. The Proposed Regulations provide a non-exclusive list of factors that are relevant in this determination. The most significant factor in making this determination is the presence or absence of significant entrepreneurial risk ("SER"). An arrangement without SER will be treated as a payment for services. Conversely, an arrangement that has SER will generally not constitute a payment for services unless other factors establish otherwise.

Significant Entrepreneurial Risk. Whether an arrangement has or lacks SER is determined based on the service provider's entrepreneurial risk relative to the overall entrepreneurial risk of the partnership. The Proposed Regulations describe certain facts and circumstances that create a presumption that an arrangement lacks SER and will be treated as a disguised payment for services, unless other facts and circumstances establish by clear and convincing evidence that SER is present. The facts and circumstances that create a presumption that SER is lacking are:

- Capped allocations 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 to the service provider;
- An allocation that is predominantly fixed in amount, reasonably determinable under all facts and circumstances, or designed to assure sufficient net profits are highly likely to be available to make the allocation (*e.g.*, because the agreement only allocates net profits from certain periods or transactions and does not depend on the long-term success of the enterprise); and
- An arrangement in which a service provider waives its right to receive payment for future performance of services in a manner that is non-binding or fails to notify the partnership and its partners of the waiver and its terms in a timely manner.

Additional Factors. The Proposed Regulations provide a non-exclusive list of additional factors to consider in determining whether an arrangement is a disguised payment for services, including whether the arrangement provides for different allocations and distributions with respect to related service providers, with significant differences in entrepreneurial risk (*e.g.*, a clawback with respect to carried interest but not with respect to fee waiver interests).

Observations

- *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 Treasury Department and IRS have indicated that they believe that the Proposed Regulations regarding disguised payments for services generally reflect the Code and related guidance in relevant legislative history. Therefore, the Treasury Department and IRS may challenge existing fee waiver arrangements in which the service provider does not have SER prior to the Proposed Regulations being finalized. Importantly, for the purposes of determining whether the final regulations apply to an arrangement, if an arrangement permits a service provider to waive all or a portion of its fee at a later date, the arrangement would be considered to be "modified" on any date that the service provider waives its fee.
- *When Arrangements are Tested.* The Proposed Regulations will be applied to characterize an arrangement at the time the arrangement is entered into or modified. Although not expressly addressed, we expect that the IRS would treat a fee waiver pursuant to preexisting fund agreements as entering into or modifying such an arrangement.
- *Binding Waiver and Notice.* The Proposed Regulations effectively require any fee waiver to be binding, irrevocable and made well in advance of the taxable year in which the fees would

be earned (the examples suggest 60 days), and also require the service provider to notify the partnership and all of its partners of the waiver and its terms in a timely manner.

- *Clawbacks*. Several examples in the Proposed Regulations discuss typical private equity fund clawback arrangements (*i.e.*, the service provider must give back any distributions it receives from the partnership that are not supported by the partnership's net profits over the life of the partnership) and note that these arrangements tend to support a finding of SER where it is reasonable to anticipate that the service provider "could and would" fulfill the clawback obligation. The preamble to the Proposed Regulations also suggests that, while not dispositive, the fact that a general partner's carried interest is subject to a clawback while a fee waiver arrangement with a manager related to the general partner is not subject to a similar clawback may suggest that the manager's arrangement should be treated as a payment for services rather than a partnership interest.

- *Treasury and IRS Believe that the Fee Waiver Interest Should be Issued to Manager/Service Provider*. The preamble indicates that the Treasury Department and IRS believe that issuing a profits interest for services to a person other than the service provider does not qualify for the protection of existing IRS guidance that the grant of certain profits interests is not a taxable event.[3] (There are some existing programs where the manager waives the fees but another entity holds the related profits interest.)

- *Grant of Fee Waiver Interest May Become a Taxable Event*. The preamble states that the Treasury Department and IRS plan to amend existing profits interest "safe harbor" guidance when the Proposed Regulations are finalized, so that fund managers could not rely on guidance that the grant of a fee waiver interest is not a taxable event. The new rule described in the preamble would exclude from this safe harbor a profits interest issued in conjunction with a partner forgoing payment of an amount that is substantially fixed (including where the amount is determined by a formula, such as in the case of management fees based on a percentage of partner capital commitments) for the performance of services, apparently even if the arrangement satisfies the SER and other standards of the Proposed Regulations. This may signal that the IRS might seek to treat a grant of a fee waiver interest as taxable at fair market value, even if the arrangement would not be treated as a disguised payment for services under the Proposed Regulations. As a practical matter, we would expect that traditional fee waiver programs would be of limited utility if the Treasury Department and IRS intend that fee waiver interests would be taxable upon grant, though there may be alternative economic arrangements to consider.

There are many other provisions in the Proposed Regulations, and many details that are not dealt with in this summary. We will keep our clients informed with respect to future developments.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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1 See Disguised Payments for Services, 80 Fed. Reg, 43652 (proposed Jul. 23, 2015). The Proposed Regulations are issued under Section 707(a)(2)(A) of the Code, and the preamble to the Proposed Regulations announces IRS intent to modify Revenue Procedure 93-27.

2 Some refer to fee waiver programs as "management profits interest" or "MPI" programs. These terms are equivalent to fee waiver, and this memorandum uses "fee waiver" throughout.

3 For these purposes, a profits interest is an interest where the holder would not receive any distributions from the partnership if the partnership sold its assets for fair market value and liquidated at the time the interest is granted. (This would, for example, be the case with respect to carried interest issued on the formation of an investment fund.) If the profits interest satisfies the conditions of existing IRS guidance, the holder does not recognize any income on the date of issuance. The profits interest holder will receive allocations of taxable income (and associated rights to cash distributions) when the partnership realizes income. The character of the allocations is determined at the partnership level, which means that profits interest holders may receive allocations of long-term capital gain when the partnership disposes of investments.