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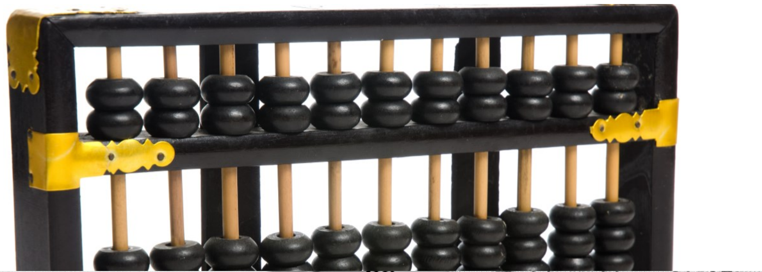

July 2015

Proposed Regulations on Disguised Payments for Services and Management Fee Waivers

In this Issue:

Example 1

Example 2

Example 3 2

Example 4

Example 5 3

Example 6 4

For More Information 5

About Polsinelli's Tax Practice 6

On July 23, 2015, the Internal Revenue Service ("IRS") issued a Notice of Proposed Rulemaking (the "Notice") which proposed Treasury regulations under Section 707(a)(2)(A) of the Internal Revenue Code of 1986, as amended (the "Code"). That section of the Code characterizes certain partnership allocations and distributions as payments for services rather than a distributive share of partnership income under Section 702 of the Code. The Notice proposed the addition of Treasury Regulations Section 1.707-2 and amended Treasury Regulations Section 1.707-1.

The most important consequence to understand about the proposed Treasury regulations is what they do not do. Ordinary carried interest structures with a percentage management fee based on capital commitments are not affected, and binding management fee waivers in exchange for an interest in future net profits over the life of the partnership are also respected and not recharacterized as disguised payments for services under Section 707 (a)(2)(A).

The Notice contains a detailed description of the legislative history of Section 707(a)(2)(A) which provides that an arrangement will be treated as a disguised payment for services if (i) a person (service provider) in a partner capacity performs services to or for the benefit of the partnership; (ii) there is a related direct or indirect allocation and distribution to the service provider; and (iii) the performance of the services and the allocation and distribution when viewed together are properly characterized as a transaction occurring between the partnership and a person acting other than in that person's capacity as a partner. The Notice explains that according to the legislative history of Section 707(a)(2)(A), the most important factor in determining whether a payment is a disguised payment for services is whether the payment is subject to significant entrepreneurial risk as to both the amount and fact of the payment. The Notice quotes the legislative history to the effect that partners receive distributions of profits with respect to the business success of the venture whereas third parties generally receive payments which are not subject to this risk. Other non-exclusive factors may also be considered but they are secondary to the entrepreneurial risk factor. The determination of whether an arrangement will be characterized as a disguised payment for services under the proposed regulations is made at the time this arrangement is entered into and is not retroactively recharacterized.

The proposed regulations list six factors which indicate that an arrangement is a disguised payment for services. However, an arrangement that lacks significant entrepreneurial risk is presumed to be a disguised payment for services, unless the other factors establish otherwise. This is the most important point of the proposed regulations, because partnership allocations of net profits which are not highly likely or reasonably determinable will not ordinarily be treated as disguised payments for services. The other five factors that create a presumption that an allocation of partnership income should be characterized as a payment for services include:

i) Capped allocations

ii) Allocations for one or more years of reasonably certain income

iii) An allocation of gross income

iv) Certain formula allocations predominately fixed in amount

v) Non-binding management fee waivers for future services

Proposed Treasury Regulations Section 1.707-2(d) contains six examples which provide the most helpful guidance of the proposed regulations. In each of the examples, the partnership maintains capital accounts, satisfies the economic effect test of Treasury Regulations Section 1.704-1(b)(2)(ii), and liquidation distributions are made in proportion to capital accounts. In addition, in all cases in which the partnership allocation involved a carried interest, the examples state that the service partner entered into a clawback obligation.

Example 1

Example 1 illustrates a capped allocation of gross income to a partner who is also a service provider. In the example the project is expected to generate $100,000 annually, the service providers normal fee would be $40,000 and he contributes cash equal in value to 25% of the partnership. The service provider will receive a 25% distributive share for the life of the partnership and a special allocation of $20,000 of partnership gross income for the first 2 years of the partnership's operations. The $20,000 payments are treated as disguised payments for services because they are an allocation of gross income and by definition lack significant entrepreneurial risk. In addition, the payments are capped and do not extend for the life of the partnership.

Example 2

Example 2 illustrates a formula allocation of gross income designed to approximate foregone brokerage commissions. The formula for the allocation is based on a normal brokerage fee and varies with the amount and value of the services. The broker also receives a 51% interest in residual profits. Example 2 states that it is reasonably expected that the partnership will have sufficient gross income to make the allocation. The example concludes that since the allocation is from gross income, reasonable, and determinable, it is a disguised payment for services.

Example 3

Example 3 is a more complicated fact pattern involving a general partner, A, which controls the management company, M, which manages the investment partnership. A receives a 10% carried interest in net profits of the

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partnership over its life with a clawback obligation if A receives more than 10% of the aggregate net profits of the partnership. M, the manager, contributes cash for a 1% partnership interest but is entitled to a priority allocation and distribution of net gain from the sale of any one or more assets during any 12 month accounting period in which the partnership has an overall gain. The amount of the priority allocation is intended to approximate the fee that M would normally charge.

Example 3 concludes that A's carried interest in net profits should not be recharacterized as a payment for services since it is based on the net profits over the life of the partnership. It is unclear whether the existence of the clawback obligation in this and the other examples is required for the allocation to be respected as a partnership allocation and not a disguised payment for services.

M's arrangement is recharacterized as a disguised payment for services because the priority allocation and distribution is not based on the net profits of the partnership over its life but over any 12 month period and A, which owns M, controls the timing of recognition of gains and losses. Thus, the combined facts indicate that sufficient profits are likely to be available to make the priority allocation and distribution. A priority allocation from net profits can be treated as a disguised payment for services under certain circumstances where the service provider or a related person can control the realization of net profits during a discrete time period to ensure profits will exist. Presumably, if the priority allocation to M was not over any 12 month period but over the life of the partnership and M had a clawback obligation, the allocation would not have been recharacterized.

Example 3 continues with a priority allocation to M based on the revaluation of partnership assets under Treasury Section 1.704-1(b)(2)(iv)(f) and concludes that this also must be recharacterized as a disguised payment for services since A, the general partner, controls the timing of events that permit a revaluation. The example refers to the specified accounting period and the combined factor of control over the timing of the revaluation as the controlling factors.

Example 4

Example 4 illustrates the effect of a special allocation of net profits over a specified future 12 month taxable year rather than in any 12 month accounting period. The allocation of the net profits will only be made if the partnership has overall net profits. The example states that one or more of the readily tradable securities will be sold for a gain, but it cannot be reasonably predicted whether the partnership will have net profits from its entire portfolio in that 12 month period. Seemingly, the different result is that A, the general partner, cannot indirectly control the existence of net profits or manipulate the taxable year.

Example 5

The first portion of Example 5 describes but does not analyze the typical "2 and 20" structure in which the general partner contributes capital equal to 1% of the capital contributed by the limited partners, receives a 20% interest in net income over the life of the fund and the manager receives an annual fee equal to 2% of the capital committed by the partners. Although not analyzed, the remainder of Example 5 indicates that the carried interest should be respected and the management fee would be treated as a fee paid for services.

Example 5 continues by altering this typical arrangement by providing that A, the general partner, will contribute only nominal capital, and will receive a 20% carried interest in future net profits. M will receive as a fee 1% of the capital committed by the partners. A will also receive an Additional Amount of future net income determined by a formula which is designed to approximate the present value of 1% of the capital commitment of the partners determined annually over the life of the fund. A also undertakes a clawback obligation.

Example 5 concludes that the Additional Amount qualifies as a partnership interest because it is based on the net profits of the partnership over its life. The example also relies on the clawback obligation for its conclusion. Thus, a formula for allocating net profits which is designed to equal a service fee will not be recharacterized as long as it represents a significant entrepreneurial risk. Therefore, the Additional Amount must be an allocation of net profits over the life of the partnership. The purpose of the Additional Allocation is irrelevant for purposes of characterizing it as a disguised payment for services.

Example 6

Example 6 may be the most salient part of the proposed regulations because it approves a management fee waiver in a typical 20% carried interest and 2% management fee structure. In Example 6, the general partner, A, contributes 1% of the capital contributed by the limited partners and is entitled to a 20% interest in future partnership net income and gains over the life of the partnership. M, controlled by A, is entitled to an annual management fee equal to 2% of the capital committed by the partners. M, may waive all or a portion of its annual management fee by giving notice to the partnership 60 days prior to the partnership taxable year for which the fee is payable. The waiver is irrevocable for the fee payable with respect to the year of the waiver. In exchange for the management fee waiver, M receives an Additional Interest in the future partnership net income and gains designed to approximate the present value of the fee waived. Both A and M enter into a clawback obligation.

Example 6 concludes that neither the 20% carried interest granted to A or the Additional Interest issued to M on the waiver of its management fee are disguised payments for services. Similar to the other examples, Example 6 indicates both the carried interest and the Additional Interest do not lack significant entrepreneurial risk because both allocations are based on the net profits of the partnership over its life.

Example 6 also stresses the clawback obligation of both A and M.

Example 6 provides a clear guideline on how management fee waivers must be structured. Notice of this waiver must be given by the service provider before the commencement of the relevant taxable year of the partnership, and the waiver must be irrevocable for the fee payable in that year. The allocation and distribution of the Additional Interest can be structured to approximate the present value of the waived fee indicating motive is not relevant. The Additional Interest must be an interest in net profits of the partnership over the life of the partnership.

The facts of Example 6 state that the partnership satisfies the economic effect requirements and liquidates in accordance with capital accounts. In that regard, Example 6 requires that the capital accounts of the partners must be revalued immediately prior to the grant of the Additional Interest to M.

The proposed regulations will be effective for all arrangement entered into after they are published as final Treasury regulations. For arrangements entered into before that date, there is an "in terrorem" provision that states such arrangements will be governed by the statutory language of Section 707(a)(2)(A) and the legislative history. Since the Notice discusses in detail the legislative history supporting the proposed regulations, taxpayers ignore the proposed regulations at their peril. In other words, the proposed regulations could be viewed as effective immediately.

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For More Information

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