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Client Alert Commentary

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IRS Issues Proposed Regulations Addressing Management Fee Waivers

Certain arrangements would be recharacterized as ordinary income, rather than as distributive shares of partnership income.

On July 22, 2015, the US Treasury Department and the US Internal Revenue Service (IRS) released proposed regulations (the Proposed Regulations) under Section 707 of the Internal Revenue Code of 1986, as amended (the Code), to provide guidance regarding when arrangements involving the receipt of a partnership interest for services will be treated as a disguised payment for services and not as the right to receive a distributive share of partnership income. An arrangement that is treated as a disguised payment for services under the Proposed Regulations will be treated as a payment for services for all purposes of the Code, with the result that the payment will be taxed as ordinary income and be subject to Code Sections 409A and 457A (as applicable). The Proposed Regulations do not affect traditional forms of carried interest, concluding that they are generally subject to a significant entrepreneurial risk.

In many funds, the persons entitled to receive a management fee from the fund (Managers) have the ability to waive a portion or all of the management fee they are entitled to receive from the fund (the Waived Fee Amount). The general partner (GP) receives a corresponding increased interest in the fund's profits (but not capital), usually equivalent to the interest in the fund that the GP would have received if it had made a capital contribution to the fund equal to the Waived Fee Amount (the Additional Profits Interest). The right to receive distributions from the Additional Profits Interest is normally conditioned on the fund earning economic income or gain after the date the Additional Profits Interest is issued. To avoid constructive receipt of the management fee (and being taxed on the management fee as if received), the waiver must be effective before the management fee is earned or accrued for tax purposes. As a result, the management fee typically is either waived on a periodic basis before the fee accrues or, in some cases, the waiver is "hardwired" into the fund agreement.

Under current law, the treatment of management fee waiver programs for US federal income tax purposes is not always clear. Managers generally take the position that waiver of the management fee does not cause constructive receipt of the management fee, and the Additional Profits Interest is a "profits interest" in the fund under Revenue Procedure 93-27, discussed below.

The Proposed Regulations

Facts and Circumstances Test

The Proposed Regulations apply a facts and circumstances test and provide a non-exclusive list of factors that are relevant to determining when an arrangement is treated as a payment for services. Under the Proposed Regulations, the determination is made at the time the arrangement is entered into or modified. The most important factor in making the determination is whether the arrangement lacks significant entrepreneurial risk. The Proposed Regulations include the following factors that create a presumption that an arrangement lacks significant entrepreneurial risk:

- 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 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 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.

Other factors included in the Proposed Regulations which indicate that the arrangement should be treated as a payment for services include (i) the service provider holds an interest for a short duration and (ii) 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.

Examples

The Proposed Regulations contain six examples to illustrate the difference between an arrangement that is treated as a payment for services and an interest in a partnership that is treated as the right to receive future allocations of income and distributions. Four of the examples focus on management fee waiver structures and illustrate when an arrangement lacks significant entrepreneurial risk. These examples show that where an allocation of income is reasonably determinable and there are highly likely to be available profits to allocate to the service provider, the arrangement will lack significant entrepreneurial risk.

A number of specific principles can be gleaned from the examples. Allocations should be based on net profits, not gross income. The ability of the GP to manipulate the timing of the realization of gains and losses is a significant factor in determining that an arrangement lacks sufficient entrepreneurial risk. It is important that fees are waived irrevocably and in advance of the time they would be earned. However, much is left to be determined on the specific facts and circumstances of each arrangement.

Modifications to Revenue Procedure 93-27

Revenue Procedure 93-27 generally provides that if a person receives a profits interest for the provision of services to or for the benefit of a partnership, the IRS will not treat the receipt of such interest as a taxable event for the partner or the partnership. The Revenue Procedure does not apply if (i) the profits interest relates to a substantially certain and predictable stream of income, (ii) within two years of receipt, the partner disposes of the profits interest, or (iii) the profits interest is a limited partnership interest in a publicly traded partnership. Revenue Procedure 93-27 was issued to provide administrative guidance regarding the tax treatment of the issuance of a profits interest to prevent continued litigation regarding the value of a profits interests. The Preamble to the Proposed Regulations provides that the Treasury Department and the IRS plan to issue a revenue procedure in conjunction with the publication of the

Proposed Regulations in final form, which is expected to provide that the Revenue Procedure will not apply to profits interest issued in connection with management fee waivers or other similar situations.

The Preamble suggests that the IRS intends that Revenue Procedure 93-27 will not apply even to fee waiver arrangements, such as the one described in Example 6 of the Proposed Regulations, that are subject to significant entrepreneurial risk, and are thus not recharacterized as a payment for services under the Proposed Regulations. It is not clear why the IRS intends to take that approach, and how Additional Profits Interests that are not recharacterized under the Proposed Regulations will be treated if not covered by the safe harbor in Revenue Procedure 93-27 given that the Additional Profits Interest will have to be subject to significant entrepreneurial risk to avoid being treated as a payment for services. Given the principle that each partner has only a single undivided interest in a partnership for federal income tax purposes, it is particularly unclear how the IRS intends to treat the issuances of Additional Profits Interests with respect to an existing partnership interest that met the requirements of Revenue Procedure 93-27 when initially issued. By removing Additional Profits Interests that are subject to significant entrepreneurial risk from the safe harbor in Revenue Procedure 93-27, the change presumably makes previous case law relevant again and reintroduces the complex issues surrounding valuation of Additional Profits Interests that were meant to be settled by the issuance of Revenue Procedure 93-27, even in the case of arrangements that pass muster under the Proposed Regulations.

Effective Dates and Transition Rules

The Proposed Regulations apply to all arrangements entered into or modified after the issuance of the final regulations. To the extent that an arrangement permits a service provider to waive all or a portion of its fee for any period subsequent to the date the arrangement is created, the arrangement is considered modified on the date that the fee is waived. In the case of a partnership that provides for multiple fee waivers over its life, it is not clear if the “arrangement” for this purpose is the partnership agreement, or each event under the partnership agreement giving rise to an Additional Profits Interest.

Observations

One key issue that practitioners will need to carefully consider are the implications under other provisions in the Code if an interest structured as a profits interest is recharacterized as an arrangement that is treated as a payment for services. As mentioned above, an arrangement that is treated as a disguised payment for services under the Proposed Regulations will be treated as a payment for services for all purposes of the Code, with the result that the payment can be subject to Section 409A and 457A of the Code. Having payments be subject to those provisions of the Code can result in unintended income inclusion and harsh penalties if the service payments are not structured properly. In addition, given the proposed changes to Revenue Procedure 93-27, it is more important than ever that timely elections be made under Section 83(b) of the Code with respect to interests in a partnership that include the right to receive Additional Profits Interests, if those interest are subject to a “substantial risk of forfeiture.”

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