Tax

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Proposed Regulations Target Management Fee Waivers

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In the Federal Register for July 23, 2015, the Treasury Department published proposed regulations regarding the circumstances under which partnership allocations and distributions will be treated as disguised payments for services. These proposed regulations are aimed at attempts by investment fund managers to convert ordinary, management fee income into tax-favored long-term capital gains through the use of management fee waivers.

The proposed regulations draw heavily on the legislative history to Internal Revenue Code section 707(a)(2)(A), enacted as part of the Deficit Reduction Act of 1984 (P.L. 98-369), which provides that allocations and distributions to a partner by a partnership will be disregarded and instead treated as disguised payments for services if the performance of such services and the related direct or indirect allocation and distribution, taken together, are properly characterized as a transaction between the partnership and a partner acting other than in his capacity as a member of the partnership.

The proposed regulations list six non-exclusive factors that indicate an arrangement constitutes a disguised payment for services (the first five of which are contained in the legislative history to section 707(a)(2)(A)).

- The arrangement lacks significant entrepreneurial risk. This is the most important factor and is accorded the greatest weight. An arrangement lacking significant entrepreneurial risk constitutes a payment for services while an arrangement that has significant entrepreneurial risk will not generally constitute a payment for services.
- The service provider holds, or is expected to hold, a transitory partnership interest or a partnership interest for only 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 becomes 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.
- The arrangement provides for different allocations or distributions with respect to different services received, the services are provided either by one person or related persons, and the terms of the differing allocations or distributions are subject to significantly varying levels of entrepreneurial risk.

The following situations create a presumption that an arrangement lacks significant entrepreneurial risk and will be treated as a disguised payment for services unless other facts and circumstances establish the presence of significant entrepreneurial risk by clear and convincing evidence.

- 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.
- An allocation under a formula or otherwise that is predominantly fixed in amount, is reasonably determinable, 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).
- 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 notify the partnership and its partners of the waiver and its terms on a timely basis.

The rules in the proposed regulations would be effective for arrangements entered into or modified after the date of publication of final regulations in the Federal Register. A fee waiver for a period subsequent to the date an arrangement is created is treated as a modification of the arrangement on the date of the waiver. However, Treasury and the IRS believe the proposed regulations generally reflect Congressional intent as to which arrangements are appropriately treated as disguised payments for services; accordingly, there is concern that Treasury and the IRS may attempt to apply the principles of the proposed regulations on a retroactive basis.

The Notice of Proposed Rulemaking indicates that when the proposed regulations are adopted as final regulations, the IRS intends to publish a Revenue Procedure adding an additional exception to the safe harbor of Revenue Procedure 93-27 (which specifies circumstances under which receipt by a person of a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of becoming a partner will not be treated as a taxable event for the partner or the partnership). That additional exception will cover circumstances, and the safe harbor will not apply, where a profits interest is issued in conjunction with a partner foregoing payment of an amount for the performance of services that is substantially fixed (including by reference to a formula, such as a fee based on partnership capital commitments). The Notice of Proposed Rulemaking also states that the proposed Revenue Procedure in Notice 2005-43 (which is to supersede Revenue Procedure 93-27 if regulations proposed in 2005 relating to the transfer of partnership equity in connection with the performance of services are ultimately adopted in final form) will contain a similar exception. See our June 2005 publication, *Treasury Revisits Guidance on Partnership Interests Exchanged for Services*. As a result of these changes, profits interests issued in connection with fee waiver arrangements would lose their protection under the existing safe harbor guidance and apparently could be challenged by the IRS under pre-safe harbor case law—

even where the profits interest would otherwise avoid characterization as a disguised payment for services under the proposed regulations.

The Notice of Proposed Rulemaking also contains language regarding the Treasury and the IRS view as to when targeted capital account allocations will be considered to have substantial economic effect. In practice, most partnership agreements utilizing targeted capital account allocations require allocations of net income or net loss in a manner resulting in capital account balances "as nearly as possible" equal to amounts that would be distributed to partners were the partnership to liquidate at the end of the particular taxable period, and only require allocations of gross income to achieve this capital account true-up for the year of the partnership's liquidation. The Notice of Proposed Rulemaking suggests that Treasury and the IRS believe resort to gross income allocations to achieve the true-up is required on an annual basis.

Available Material

- July 23, 2015 Notice of Proposed Rulemaking, disguised payment for services.
- Revenue Procedure 93-27, profits interest safe harbor.
- Revenue Procedure 2001-43, unvested profits interests.
- May 24, 2005 Notice of Proposed Rulemaking, partnership equity for services.
- Notice 2005-43.

The information presented is only of a general nature, intended simply as background material, is current only as of its indicated date, omits many details and special rules, and accordingly cannot be regarded as legal or tax advice.

If you have any questions about the content of this alert, please contact one of the authors, the Pillsbury attorney with whom you regularly work, or one of the attorneys below.

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