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Treasury Issues Proposed Regulations Addressing Management Fee Waivers and Other Disguised Payments from Partnerships for Services

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On July 22, 2015, the Treasury Department released proposed regulations regarding disguised payments from partnerships for services (the "Proposed Regulations"). The Proposed Regulations apply to any arrangement between a partnership and a partner that provides services to the partnership in exchange for a partnership interest, including management fee waiver provisions found in many private equity, real estate, and other investment fund agreements. The Proposed Regulations confirm that a partner who receives an interest in a partnership for the performance of services must bear "significant entrepreneurial risk" with respect to the partnership interest if it is to be respected as a profits interest with income recognized through allocations of income from the partnership and not a disguised payment for services taxable as ordinary income for services. A lack of significant entrepreneurial risk will result in such arrangement being recharacterized as a payment for services resulting in ordinary compensation income to the service provider which income could be recognized on the date of the grant of the interest.

The preamble to the Proposed Regulations 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 Revenue Procedures 93-27 and 2001-43 in certain circumstances that the grant of a fee waiver interest is not a taxable event. This may be an indication 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. The preamble also states that the IRS plans to provide additional guidance on profits interests generally when the Proposed Regulations are finalized to exclude profits interest issued in exchange for services for foregoing payment of a substantially fixed amount. It is not clear what additional guidance may be forthcoming. However, based on the examples in the Proposed Regulations, it is not expected that the proposed guidance would change the treatment of traditional carried interest arrangements with meaningful after-tax clawbacks.

Below is a summary of certain provisions contained in the Proposed Regulations. It should be recognized that the proposed rules are unclear in many respects, and will likely be modified and/or clarified before they are finalized. We will post updates as additional guidance is released.

Background on Management Fee Waiver Provisions

Under a typical management fee waiver arrangement, a fund sponsor irrevocably waives its rights to receive management fees from the fund before the beginning of the period for which those fees would otherwise be earned. As part of the arrangement, the capital contribution obligation of the fund sponsor may be reduced on a dollar-for-dollar basis in an amount equal to the waived amount. Amounts that would have been used by the fund to pay the waived management fees are available to the fund as if the fund sponsor had made its full contribution. The fund sponsor receives a profits interest in the fund, entitling it to receive distributions equal to the waived amount as and when distributions would have been made with respect to the deemed contribution, plus a share of future fund profits based on the waived amount treated as a deemed contribution. An alternative fee waiver arrangement does not provide for a reduction in the contribution obligation of the service provider. Rather, after sufficient net profits subsequent to the issuance of the waiver interest is granted have been realized, a special distribution is made ahead of all other distributions with no further participation. The corresponding allocation of net profits to the fund sponsor is frequently limited to items of long-term capital gain and qualified dividend income, thus resulting in the conversion of ordinary income from management fees taxed at a federal income tax rate of 39.6% to long-term capital gains or qualified dividend income taxed at a federal income tax rate of 20%.

Proposed Regulations

Facts and Circumstances Analysis. Under the Proposed Regulations, whether an arrangement should be characterized as a payment for services or a profits interest 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.

Significant Entrepreneurial Risk. The most significant factor in making this determination is the presence or absence of significant entrepreneurial risk. An arrangement without significant entrepreneurial risk will be presumed to be a payment for services. Conversely, an arrangement that has significant entrepreneurial risk will generally not constitute a payment for services unless other factors establish otherwise. Whether an arrangement has or lacks significant entrepreneurial risk 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 significant entrepreneurial risk and will be treated as a disguised payment for services, unless other facts and circumstances establish by clear and convincing evidence that significant entrepreneurial risk is present. The facts and circumstances that create a presumption that significant entrepreneurial risk 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).

Binding Waiver and Notice. The Proposed Regulations effectively require any fee waiver to be binding, irrevocable and made in advance of the taxable year in which the fees would be earned (60 days before the beginning of the year in the examples). In practice, many fee waivers occur immediately prior to a fee computation period, which in some cases is quarterly. The Proposed Regulations require the service provider to notify the partnership and all of its partners of the waiver and its terms.

Fee Waiver Interest to be Issued to Manager/Service Provider. The preamble indicates that the Treasury Department and IRS take the position that issuing a profits interest for services to a person other than the service provider (*e.g.*, certain fee waiver programs have the manager waive the fee and grant the general partner the profits interest) does not qualify for the protection of Revenue Procedures 93-27 and 2001-43.

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 significant entrepreneurial risk prior to the Proposed Regulations being finalized. Moreover, 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. As most fee waivers are made on a quarterly or annual basis rather than at inception of the fund, most existing fee waiver provisions would be subject to the new rules as a modification would occur upon each quarterly or annual election.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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