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IRS Issues Proposed Regulations Relating to Disguised Payments for Services and Discussing Tax Treatment of Management Fee Waiver Arrangements

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On Wednesday July 22, 2015, the Internal Revenue Service ("IRS") issued Proposed Regulations (REG-115452-14) providing guidance to partnerships and partners as to whether an arrangement between a partnership and a service provider is treated as a disguised payment for services under Section 707(a)(2)(A) of the Internal Revenue Code of 1986, as amended ("IRC"). Characterization of an arrangement as a disguised payment for services could have adverse tax consequences to fund sponsors and/ or their affiliates receiving payments, and could also impact the tax treatment of the partnership and the other partners.

The Proposed Regulations contain conforming changes to the guaranteed payment regulations under IRC Sec. 707(c) as well as a notice of proposed modifications to Revenue Procedure 93-27 (as clarified by Revenue Procedure 2001-43) relating to issuance of interests in partnership profits to service providers.

Key Points

Principally, the Proposed Regulations provide that:

- A partner that receives compensation in the form of an allocation of partnership income or gain for services rendered to a partnership may be treated as receiving a disguised payment of a fee for services.
- Determination of the true character of an arrangement is made on the basis of all the facts and circumstances; the formal characterization of the arrangement between the parties is not binding.
- The most significant factor in determining whether an arrangement constitutes a payment for services is the presence of a significant entrepreneurial risk at the times the parties enter into or modify the arrangement.
- The measure of a significant entrepreneurial risk is assessed on the basis of the service provider's entrepreneurial risk relative to the overall entrepreneurial risk of the partnership.
- Additional profits interests received by sponsors who have waived management fees may not be subject to the safe harbor rules of Revenue Procedure 93-27.
- The IRS may challenge arrangements in place before the effective date of the final regulations.

Background

A partner who provides services to a partnership may receive compensation in the form of a special allocation of partnership income or gain. The tax treatment of such compensation depends on whether a partner acts in a partner or non-partner capacity. Generally, partnership allocations that are made to a partner for services rendered in its capacity as a partner are treated as a distributive share of partnership income,[1] and a corresponding distribution of cash equal to such share is generally tax-free to the partner.[2] The foregoing income allocation and the related distribution of partnership proceeds reduce the other partners' share of partnership taxable income. If a partner engages in a transaction with a partnership in a non-partner capacity, then the payments received are not treated as distributive share of the partnership's income. Accordingly, they do not reduce the other partners' allocable share of taxable income or gain; however, payments of such amount may be capitalized or deducted by the partnership.[3]

Congress was aware that a special allocation and related distribution of partnership income could be used to circumvent the capitalization requirements of IRC Sec. 263. IRC Sec. 707(a)(2)(A) vested the IRS with regulatory authority in order to combat such techniques by providing that allocations and distributions in connection with the performance of services may be re-characterized as payments of ordinary income to a non-partner, in order to reflect the proper economic substance of the arrangement.

Factors indicating an arrangement as a disguised fee for services

The Proposed Regulations provide a mechanism for determining whether a purported allocation between a service provider and a partnership is treated as a disguised payment for services under IRC Sec. 707(a)(2) for all purposes of the Code (including for purposes of calculating the partnership's taxable income that is allocable to the other partners).

The Proposed Regulations utilize a facts and circumstances approach by employing the following six non-exclusive factors that may indicate that an arrangement constitutes (in whole or in part) a payment for services:

- The arrangement lacks significant entrepreneurial risk;
- The service provider holds (or is expected to hold) a transitory partnership interest or a partnership interest for a short duration;
- The service provider receives an allocation of income or gain and distribution of cash in a time frame comparable to the time frame in which a non-partner service provider would typically receive payment;
- The service provider became 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 granted in exchange for services;
- The arrangement provides for different allocations or distributions with respect to different services received, the services are provided either by one person or by persons that are related (under section 707(b) or 267(b)), and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly.

[1] IRC Sec. 702(a), 704(b).

[2] IRC Sec. 731

[3] IRC Sec. 707(a)

Significant entrepreneurial risk is the most critical factor, in that its absence would suffice to conclusively establish the character of the payment as a disguised payment for services. The following factors create a rebuttable presumption that an arrangement lacks significant entrepreneurial risk:

- A 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, or is designed to assure that sufficient net profits are highly likely to be available; 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.

The Proposed Regulations characterize the nature of an arrangement at the times the parties enter into or modify the arrangement, and would apply regardless of whether the service provider receives other allocations and distributions in a partner capacity.

The Proposed Regulations provide some helpful examples illustrating the application of the foregoing rules. In these examples, it appears that the IRS would respect arrangements where, amongst other factors, the General Partner's allocation is based on net profits, the allocation is subject to a clawback obligation of the General Partner over the life the fund and the General Partner is anticipated to comply with such clawback obligation, and the amount of the allocation is not reasonably determinable at the time the arrangement is entered into. Conversely, the IRS proposes that arrangements lack significant entrepreneurial risk where, amongst other factors, the allocation is effected on the basis of gross income that is reasonably determinable on the basis of the fund's investment profile, the amount of the allocation is capped, and such cap is reasonably expected to apply.

Forthcoming Changes in the Treatment of Management Fee Waivers

Asset managers have been employing a strategy of waiving their management fees in return for a corresponding profits interest of equal value. In a typical management fee waiver arrangement, the management company will waive its right to receive a management fee as a consideration for services rendered, and the General Partner (which is usually affiliated with the management company), will receive a corresponding profits interest that is calculated by reference to the waived management fee. Through this strategy, asset managers may effectively convert ordinary income into long-term capital gains, and avoid the imposition of certain employment taxes and, potentially, state and local income taxes otherwise applicable to compensation income.

Obtaining a profits interest is, in turn, beneficial, given that the granting and vesting of a profits interest in a partnership in exchange for services generally is not treated as a taxable event, so long as (i) the profits interest would not be related to a substantially certain and predictable stream of income, and (ii) the profits interest would not be disposed within two years of receipt; see Revenue Procedure 93-27 (as clarified by Revenue Procedure 2001-43). Pursuant to the Preamble to the Proposed Regulations, the Treasury and the IRS have determined that Revenue Procedure 93-27 does not apply with respect to management fee waiver arrangements, because the entity receiving the profits interest (i.e. the general partner) is not the entity providing the services , and because the granting of the profits interest to the general partner in exchange for the waiver of the management fee is tantamount to a disposition of a profits interest by the management company within two years of receipt. Thus, treatment of a partnership interest received in relation to waived management fees would be subject to the analysis described above with respect to whether the holder of the partnership interest has significant entrepreneurial risk. The IRS and the Treasury intend to issue a revenue procedure, in conjunction with the publication of the Proposed Regulations in final form, providing for an exception to the safe harbor rules in Revenue Procedure 93-27; it remains unclear, however, whether such exception will apply retroactively.

Effective Date

The Proposed Regulations are proposed to be effective on the date the final regulations are published in the Federal Register, and are proposed to apply to any arrangement entered into or modified after the date of publication of the final regulations. In the case of management fee waiver arrangements, if a service provider waives all or a portion of its fee after the publication of the regulations in final form, the Proposed Regulations are proposed to apply even if the arrangement was entered before the date of such publication. For all other preexisting arrangements (i.e. those entered into or modified before the date of publication of the final regulations), the Preamble provides that the statute and guidance, including the legislative history of IRC Sec. 707(a)(2)(A), would apply to determine whether a purported allocation is a disguised fee for services. The IRS' position is that the Proposed Regulations reflect the Congressional intent behind the enactment of IRC Sec. 707(a)(2)(A); presumably, the IRS may still challenge preexisting arrangements on the basis of the factors analyzed in the Proposed Regulations that were drawn from the legislative history, including the significant entrepreneurial risk factor.

Conclusion

Though the Proposed Regulations are primarily intended to attack putative allocations to service partners as disguised payments for services, their application may have an adverse effect on the partnership and partners that are not affiliated with the service provider, possibly on a retroactive basis. Sponsors of funds that have waived their management fee should assess the impact of the non-applicability of the safe harbor exception of Revenue Procedure 93-27 with respect to a portion of their profits interest.

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