Changes on the Horizon? IRS Announces New Plans to Recharacterize Management Fee Waiver Arrangements

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On July 22, 2015, the IRS released proposed regulations that could limit the utility of “management fee waiver” arrangements (the “Proposed Regulations”). Management fees generally are taxable as compensation income. Typically, management fee waiver arrangements have involved a waiver of a fixed management fee in exchange for the grant of a profits interest in a fund. These arrangements have generally presumed that the grant of the profits interest is not currently taxable and that future distributions on the profits interest could be eligible for capital gain treatment.

Under the Proposed Regulations, fund distributions on these granted interests, in many circumstances, could be treated as disguised payments for services, taxable as compensation income. The IRS also plans to issue separate guidance that would treat the grant of a profits interest in connection with a management fee waiver as a taxable event, potentially even if there is no disguised payment for services under the Proposed Regulations.

Disguised Payment for Services

Consistent with the language of Section 707(a)(2)(A) of the Internal Revenue Code, the Proposed Regulations provide that an arrangement will be treated as a disguised payment for services if (i) a service provider, either in a partner capacity or in anticipation of becoming a partner, performs services to or for the benefit of the partnership, (ii) there is a related allocation (direct or indirect) 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 in a non-partner capacity.

Whether a management fee waiver arrangement is a disguised payment for services hinges on whether the arrangement is more properly viewed as occurring between the partnership and a person acting in a non-partner capacity.

Facts and Circumstances Test

Under the Proposed Regulations, whether an arrangement constitutes a payment for services (in whole or in part) depends on all of the facts and circumstances at the time the parties enter into or modify the arrangement. The Proposed Regulations include a list of six non-exclusive factors that may indicate that an arrangement constitutes a disguised payment for services. Of the six factors, the most important factor is the existence of significant entrepreneurial risk (discussed below). An arrangement that lacks significant entrepreneurial risk constitutes a payment for services. In contrast, an arrangement that has significant entrepreneurial risk generally will not constitute a payment for services, unless the totality of the other relevant factors warrants a different characterization.

The other five non-exclusive factors to be used in determining whether or not an arrangement should be treated as a payment for services are:

1. That the service provider holds, or is expected to hold, a transitory partnership interest or a partnership interest for only a short duration;
2. That 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;
3. That the service provider became a partner primarily to obtain tax benefits which would not have been available if the services were

rendered to the partnership in a third party capacity;

4. That the value of the service provider's interest in general and continuing partnership profits is small in relation to the allocation and distribution; and
5. That the arrangement provides for different allocations or distributions with respect to different services received, where the services are provided either by a single person or by persons that are related, and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly.

The weight given to any one of these five factors, or any other relevant factor other than entrepreneurial risk, depends on the facts and circumstances of the particular case, and the presence or absence of any one or more of these factors is not determinative; rather, these five other factors are to be considered in the aggregate.

Entrepreneurial Risk

As stated, the most important factor in determining whether an arrangement is a disguised payment for services is whether the arrangement lacks significant entrepreneurial risk. Whether an arrangement lacks significant entrepreneurial risk is based on the service provider's entrepreneurial risk relative to the overall entrepreneurial risk of the partnership (*i.e.*, the level of connection between a payment and the success of the payor's business). The Proposed Regulations set forth a list of certain facts and circumstances that create a presumption that an arrangement lacks significant entrepreneurial risk, including:

1. Capped allocations of partnership income, if the cap would reasonably be expected to apply in most years;
2. Allocations for a fixed number of years under which the service provider's distributive share of income is reasonably certain;
3. Allocations of gross income items;
4. An allocation (under a formula or otherwise) that is predominantly fixed in amount, is reasonably determinable under all the 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; and
5. Arrangements in which a service provider either 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 contain a number of examples illustrating the application of the foregoing factors. Several of the examples consider the application of the Proposed Regulations to management fee waiver arrangements. In particular, Examples 5 and 6 illustrate examples of arrangements that exhibit significant entrepreneurial risk and, therefore, do not constitute payments for services. The service provider's arrangement in these examples includes the following facts and circumstances that, taken together at the time the arrangement is entered into, support the existence of significant entrepreneurial risk:

1. The allocation to the service provider is determined out of net profits and is neither highly likely to be available nor reasonably determinable;
2. The allocation is subject to a clawback obligation over the duration of the fund and the service provider is reasonably expected to be able to comply with that obligation; and
3. None of the other factors are present that would favor a characterization of the arrangement as a payment for services.

No Safe Harbor for Profits Interest

Revenue Procedure 93-27 and Revenue Procedure 2001-43 generally provide that the issuance of a profits interest (vested or unvested) to a partner in return for services to or for the benefit of the partnership is not treated as a taxable event for the partner or partnership under certain circumstances. In the preamble to the Proposed Regulations, the IRS announced its intention to issue guidance that would create an exception to this safe harbor for certain management fee waiver arrangements, such as transactions in which one party provides services and another party receives a seemingly associated allocation and distribution of partnership income or gain. This would include arrangements whereby a management company provides services to a fund in exchange for a fee, waives that fee, and then a party related to the management company receives an interest in future partnership profits the value of which approximates the amount of the waived fee.

In addition, the IRS proposes to take the position that the safe harbor does not apply to arrangements where a partnership issues a profits interest in conjunction with a partner (or an associated service provider, such as a management company) waiving a fixed fee for the performance of services. This would make the receipt of a profits interest in connection with a management fee waiver a taxable event, potentially even if there is no disguised payment for services under the Proposed Regulations.

Conclusion

The Proposed Regulations represent a significant development in the area of management fee waiver arrangements. The IRS states that it believes the Proposed Regulations to represent current law, and thus taxpayers with existing management fee waiver arrangements in place, or those contemplating such arrangements, should consult with their Foley Hoag attorney to determine the best course of action.

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