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IRS Proposes Changes to the Taxation of Fee Waivers and Possibly Other Transactions in Which Partners Provide Services

IRS Proposals Would Re-characterize Partnership Income from Some Fee Waiver Arrangements (and Potentially Other Transactions) as Service Income

SUMMARY

The IRS issued proposed regulations that would address when a partnership allocation and distribution in exchange for services will be re-characterized as a disguised fee. Although the proposed regulations appear to apply to all disguised payments for services, the proposed regulations directly address fee waivers, which are commonly used by private equity funds and venture capital funds. The IRS also announced that it intends to remove profits interests received in exchange for waived fees from an existing safe harbor under which the receipt of certain profits interests is not currently taxable. In contrast to fee waivers, the proposed regulations appear to leave more common carried interests (particularly those subject to clawbacks) generally untouched.

While final regulations will apply only prospectively, the IRS's position is that the proposed regulations reflect congressional intent as to which arrangements are appropriately treated as disguised payments for services. Consequently, the IRS may seek to apply the substance of the proposed regulations to existing arrangements.

PROPOSED REGULATIONS

A partner often provides services to a partnership in exchange for a partnership interest. Section 707(a)(2)(A) is intended to distinguish whether the partner receives the related allocation and distribution from the partnership in a partner capacity (*i.e.*, as a distributive share of partnership income and partnership distribution, which in some cases may be taxed as capital gain) or a non-partner capacity (*i.e.*, as a payment for services, which is generally taxed as ordinary income). However, the statute itself does nothing more than restate the inquiry. In particular, the statute provides that if a partner performs services for a partnership and receives a related allocation and distribution, then the transaction will be treated as a non-partner transaction if the transaction is "properly characterized" as a non-partner transaction.

While Section 707(a)(2)(A) authorizes the IRS to prescribe regulations, the IRS had refrained from exercising that authority for over thirty years.[1] During that time, the only available guidance was the statute's legislative history.[2]

At the outset, the proposed regulations track the statute and provide that an arrangement will be treated as a disguised payment for services if: (1) a person performs services to or for the benefit of a partnership; (2) there is a related direct or indirect allocation and distribution from the partnership to the service provider; and (3) when viewed together, the services, allocation, and distribution are properly characterized as a transaction occurring between the partnership and a non-partner.[3] While determining proper characterization under the third prong depends on all of the facts and circumstances, the proposed regulations follow the legislative history's approach and identify six specific (albeit nonexclusive) factors to consider in making that determination. The first five factors generally track the legislative history, while the sixth factor is new.

A. SIGNIFICANT ENTREPRENEURIAL RISK

Under the proposed regulations, the first and most important factor to consider in determining the proper characterization of an arrangement is whether the allocation and distribution subject the service provider to "significant entrepreneurial risk."[4] While an arrangement that has significant entrepreneurial risk will generally be recognized as a distributive share, the analysis must also consider the other five factors that the proposed regulations identify. In contrast, if an arrangement lacks significant entrepreneurial risk, then the arrangement necessarily constitutes a disguised payment for services and, consequently, there is no

1 Section 707(a)(2)(A) was enacted as part of the Deficit Reduction Act of 1984. *See* P.L. 98-369, § 73, 98 Stat. 494, 591.

2 S. Rep. No. 98-169, at 223-32 (1984).

3 Prop. Treas. Reg. § 1.707-2(b)(1).

4 Prop. Treas. Reg. § 1.707-2(c).

need to consider the other factors.[5] However, the IRS requests comments on whether there are any circumstances under which an allocation that lacks significant entrepreneurial risk should nevertheless be respected as a distributive share.

The proposed regulations measure a service provider's entrepreneurial risk relative to the overall entrepreneurial risk of the partnership, rather than by reference to some absolute level of entrepreneurial risk.[6] For example, a service provider who receives an allocation and distribution from a partnership engaged in a low-risk business will generally be subject to a similarly low level of risk. In contrast, a service provider who receives an allocation and distribution from a partnership engaged in a high-risk business will generally be subject to a similarly high level of risk. Nevertheless, the preamble to the proposed regulations is clear that, under the appropriate circumstances, significant entrepreneurial risk could exist with respect to the allocation from the low-risk partnership (subject to the other considerations outlined in the proposed regulations) but not with respect to the allocation from the high-risk partnership.[7]

The preamble explains that certain arrangements create a high likelihood that a service provider will receive an allocation regardless of the partnership's long-term business success. However, the proposed regulations go beyond the legislative history in providing that these arrangements create a rebuttable presumption that significant entrepreneurial risk is lacking. To overcome the presumption established by the proposed regulations, a taxpayer must show facts and circumstances that establish significant entrepreneurial risk by "clear and convincing evidence." The proposed regulations list the following arrangements as creating a presumption against significant entrepreneurial risk:

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 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 satisfy the allocation; and
5. Arrangements 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.[8]

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5 *Id.*

6 Prop. Treas. Reg. § 1.707-2(c)(1).

7 *See* Disguised Payments for Services, 80 Fed. Reg. 43,652, 43,654 (proposed July 23, 2015) [hereinafter, IRS Notice].

8 Prop. Treas. Reg. § 1.707-2(c)(1).

Regarding the "designed to assure" component of the fourth category, allocations of net profits from specific accounting periods (*e.g.*, quarterly) or specific transactions that do not depend on the partnership's long-term success may increase the likelihood that sufficient profits will be available to satisfy the allocation. The same is true for allocations measured over any partnership accounting period of twelve months or less if the service provider (or a related party) (1) has discretion to determine the value of hard-to-value partnership assets or (2) controls entities in which the partnership invests, including controlling the timing and amount of distributions by those controlled entities.[9]

The fifth type of arrangement aims directly at fee-waiver structures where a service provider waives fees in exchange for a share of future partnership income and gains (generally equal to the amount of the waived fees). The "Fee Waivers" section below discusses the application of the proposed regulations to fee waivers in more detail.

B. OTHER FACTORS

The proposed regulations also identify five other factors to consider in determining the proper characterization of an arrangement. The preamble refers to these other factors as being of "secondary importance" in the sense that they are relevant only if an arrangement clears the initial hurdle of having significant entrepreneurial risk.[10] The weight given to each secondary factor depends on the particular case, and no one factor is necessarily determinative. The five secondary factors are as follows:

1. Whether the service provider holds, or is expected to hold, a transitory partnership interest or a partnership interest for only a short duration;
2. Whether the service provider receives an allocation and distribution in a time frame comparable to the time frame in which a non-partner service provider would typically receive payment;
3. Whether the service provider became a partner primarily to obtain tax benefits which would have been unavailable if the service provider had provided services to the partnership in a third-party capacity;[11]
4. Whether the value of the service provider's interest in general and continuing partnership profits is small in relation to the allocation and distribution being evaluated; and
5. Whether (a) services are provided either by one person or by persons that are related under Sections 707(b) or 267(b) (such as a general partner and a management company that are under common ownership), (b) the arrangement provides for different allocations or distributions with respect to different services (such as general management and oversight by a general partner and investment advice or other management services by a

9 IRS Notice at 43,655.

10 *Id.*

11 Neither the proposed regulations nor the accompanying preamble make clear whether this factor is limited to tax benefits for the service provider or could instead encompass tax benefits for the other partners.

> related management company), and (c) the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly.[12]

While the first four factors in this list track the legislative history, the last one is new. To illustrate the last factor, the preamble posits a situation in which a general partner and a related management company both provide services to a partnership in exchange for a share of future net profits. The general partner agrees to a "clawback" that requires the general partner to repay distributions that exceed the general partner's share of net profits over the life of the partnership. In contrast, the management company does not agree to a clawback.

The preamble explains that the absence of a clawback creates "a significantly lower level of economic risk" for the management company than for the general partner.[13] Coupled with the fact that the general partner and the management company are related and both provide services to the partnership, this hypothetical fact pattern satisfies the fifth factor and, therefore, weighs in favor of treating the management company's allocation and distribution as a disguised fee for services. Notably, while the preamble discusses clawbacks in the context of the five secondary factors, the examples in the proposed regulations suggest that clawbacks are equally relevant in evaluating the first factor: whether a service provider has significant entrepreneurial risk.[14]

C. NO ACTUAL DISTRIBUTION REQUIRED

The proposed regulations provide that an arrangement must be characterized as a disguised fee for services or a distributive share and partnership distribution when the arrangement is entered into (or modified).[15] To facilitate this construct, the preamble interprets Section 707(a)(2)(A) in a manner that seems contrary to the statute's plain language.

Section 707(a)(2)(A) applies only if there is both an allocation and a distribution to the service provider. Nevertheless, the preamble takes the position that an actual distribution is not required to re-characterize an allocation as a disguised fee for services.[16] The preamble reasons that because a partnership allocation correlates with an increased distribution right, an arrangement that provides for a partnership allocation should be treated as also providing for an associated distribution.

The preamble justifies this approach by appealing to administrative convenience. If the analysis requires an actual distribution, and that actual distribution does not occur until years after the related allocation, then taxpayers and the IRS would be forced to take a wait-and-see approach under which an allocation

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12 Prop. Treas. Reg. § 1.707-2(c)(2) to (6).

13 IRS Notice at 43,655-56.

14 *See* Prop. Treas. Reg. § 1.707-2(d), ex. 3, 5, & 6.

15 Prop. Treas. Reg. § 1.707-2(b)(2)(i).

16 IRS Notice at 43,654.

might be retroactively re-characterized years later. The IRS believes that such retroactive re-characterization is administratively difficult. Consequently, the proposed regulations characterize an arrangement when it is entered into (or modified), regardless of when (or if) the service provider receives a distribution from the partnership.

D. INVESTMENT PARTNERSHIPS

The proposed regulations contain several examples that illustrate the significant-entrepreneurial-risk concept.[17] Two of those examples consider common structures in which a general partner and a related management company provide services to an investment partnership that holds a portfolio of investment assets.[18] The examples assume that the general partner receives an allocation of net profits over the life of the partnership and agrees to a clawback. The general partner has significant entrepreneurial risk because the tested allocation is (1) of net profits earned over the life of the partnership, (2) subject to a clawback, and (3) neither reasonably determinable nor highly likely to be available.

With respect to the management company, the examples consider a variety of different facts and circumstances. One example assumes the management company is entitled to receive a priority allocation of the partnership's net gain during any year in which the partnership has overall net gain and in an amount intended to approximate the fee that the management company would normally charge for its services. The related general partner controls when the partnership buys and sells assets.

The example makes two observations with respect to the management company's priority allocation. *First*, the priority allocation does not depend on the overall success of the partnership over its life but instead requires net profits only in any given year. *Second*, the general partner, an entity related to the management company, controls the timing of asset dispositions and, therefore, the timing of gains or losses. The example concludes that, taken together, those facts indicate that the allocation is reasonably determinable and that sufficient net profits are highly likely to be available to satisfy the priority allocation. As a result, the allocation is presumed to lack significant entrepreneurial risk.

The example then builds on this fact pattern by assuming that (1) the partnership's investment assets are not readily tradable on an established securities market, (2) the partnership can fund the management company's priority allocation by revaluing—as opposed to actually disposing of—partnership assets, and (3) the general partner controls the amount and timing of such revaluations. These additional facts also cause the allocation to be reasonably determinable or to ensure that sufficient net profits are highly likely to be available to satisfy the priority allocation. As a result, the allocation is presumed to lack significant entrepreneurial risk.

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17 Surprisingly, none of the examples in the proposed regulations applies any of the secondary factors that the proposed regulations identify.

18 *See* Prop. Treas. Reg. § 1.707-2(d), ex. 3 & 4.

Finally, another example changes the fact pattern by assuming instead that (1) the partnership's investment assets are publicly traded, (2) the partnership is a trader (rather than an investor) that has elected to mark-to-market all of the partnership's securities each year for tax purposes,[19] and (3) the management company is entitled to receive a priority allocation of the partnership's net gain attributable to a particular future year (as opposed to any future year). Although it is expected that one or more of the partnership's assets will be sold for a gain, it cannot reasonably be predicted whether the partnership will have net profits with respect to its entire portfolio in the specified year. The example concludes that under these facts, the priority allocation is neither reasonably determinable nor highly likely to be available. For that reason, the arrangement is *not* presumed to lack significant entrepreneurial risk. This example appears, therefore, to limit the proposed regulations' sweep.

E. FEE WAIVERS

Another two examples explicitly consider fee-waiver structures where a service provider waives service fees in exchange for a share of future partnership profits.[20] The IRS added fee-waiver guidance to the IRS's 2013-2014 priority guidance plan[21] and has recently disclosed active work on a proposed regulation project.[22] In evaluating whether an allocation received in exchange for a fee waiver is a disguised fee for services, the examples focus on the manner in which the service provider (1) waives its fees and (2) is entitled to share in future partnership profits.

Regarding the waiver, recall that the proposed regulations identify a non-binding, untimely, or uncommunicated fee waiver as an arrangement creating a presumption that entrepreneurial risk is lacking. In contrast, the examples contemplate fee waivers that are binding, irrevocable, and clearly communicated to the other partners. In particular, one example considers a "hard-wired" waiver (*i.e.*, where a lower management fee is established upon formation of a partnership in exchange for a priority allocation of partnership profits) while another example considers an annual waiver mechanism that allows the service provider to waive some or all of its fees for any year by providing written notice at least sixty days before the start of the year in which the fee would otherwise be paid. The examples conclude that the waivers support the existence of significant entrepreneurial risk. However, the preamble also requests comments regarding fee-waiver requirements that sufficiently bind the waiving service provider and that are administrable by the partnership and its partners.

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19 *See* I.R.C. § 475(f).

20 *See* Prop. Treas. Reg. § 1.707-2(d), ex. 5 & 6.

21 Internal Revenue Service, 2013-2014 Priority Guidance Plan 21 (Aug. 9, 2013).

22 *See, e.g.*, Michael Bologna, *Fee Waiver Guidance 'Very Far Along,' Likely to Come Out Soon, IRS Attorney Says*, 83 DTR G-3 (Apr. 29, 2015); Jaime Arora, *Assumption of Risk a Major Factor in Fee Waiver Guidance*, 2014 TNT 105-7 (June 2, 2014); Amy S. Elliot, *Fee Waiver Guidance Will Likely Come as Regs*, 2014 TNT 83-2 (Apr. 30, 2014).

Regarding the service provider's share in partnership profits, the examples consider an allocation that is (1) of net (rather than gross) profits, (2) neither reasonably determinable nor highly likely to be available, and (3) subject to a clawback over the life of the fund. The examples also assume that the service provider would and could comply with any obligations that arose under the clawback. Both examples conclude that, taken together, these facts support the existence of significant entrepreneurial risk.

The preamble makes clear that the presence of each fact described in the fee-waiver examples is not necessarily required to determine that Section 707(a)(2)(A) does not apply to an arrangement. "However, the absence of certain facts, such as a failure to measure future profits over at least a 12-month period, may suggest that an arrangement constitutes a fee for services."[23]

F. OTHER IMPLICATIONS

The proposed regulations clearly focus on fee waivers and so may impact private equity funds and venture capital funds more than other partnerships, such as hedge funds which typically do not use fee waivers. Nevertheless, the extent to which the IRS intends the proposed regulations to apply in other common partnership structures is unclear. For example, it is unclear whether the proposed regulations target situations in which a general partner is allocated a preferred amount of net income to permit the general partner to fund its expenses.

Additionally, examples in the proposed regulations suggest that a clawback is strong evidence of significant entrepreneurial risk. Absent the presence of other negative factors, however, a standard incentive allocation without an accompanying clawback can presumably still have significant entrepreneurial risk when all of the facts and circumstances are considered. In this regard, the proposed regulations do not appear to impact standard carried interest allocations. Following public comment, the final regulations may resolve some of this uncertainty.

Finally, an arrangement that is treated as a disguised payment for services under the proposed regulations must be treated as a payment for services for all federal income tax purposes.[24] This includes, for example, Sections 409A and 457A, which relate to deferred compensation.[25]

G. EFFECTIVE DATE

The proposed regulations would be effective on the date final regulations are published in the Federal Register and would apply prospectively to any arrangement entered into (or modified) on or after that

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[23] IRS Notice at 43,656.

[24] Prop. Treas. Reg. § 1.707-2(b)(2)(i).

[25] While not addressed in the proposed regulations, re-characterizing a service provider's allocation and distribution as a disguised payment for services might affect the other partners in the partnership. For example, deductions attributable to a re-characterized payment for services may be subject to limitations on miscellaneous itemized deductions applicable to individuals and trusts.

date.[26] For this purpose, an arrangement is modified on any date that a service provider waives a fee.[27] For example, a fee-waiver structure that allows a service provider to waive fees on an annual basis would be considered modified—and, therefore, subject to the final regulations—each time the service provider makes a waiver.

In contrast, the proposed regulations do not apply to any arrangement entered into (or modified) before final regulations are published in the Federal Register.[28] Rather, the determination of whether such an arrangement is a disguised payment for services must be made on the basis of Section 707(a)(2)(A) and its legislative history. Nevertheless, pending publication of final regulations, the IRS's position is that the proposed regulations reflect congressional intent as to which arrangements are appropriately treated as disguised payments for services.[29] Consequently, the IRS may seek to apply the substance of the proposed regulations to existing arrangements.

FORTHCOMING CHANGES TO REV. PROC. 93-27

Rev. Proc. 93-27 provides that if a person receives a profits interest in exchange for providing services to or for the benefit of a partnership and in a partner capacity or in anticipation of becoming a partner, then the IRS will not treat the receipt of such interest as a taxable event.[30] In conjunction with publishing final regulations, the IRS plans to issue a revenue procedure providing an exception to the Rev. Proc. 93-27 safe harbor for profits interests issued in connection with fee-waiver transactions.[31] As a result, even if an allocation and distribution attributable to a profits interest avoid re-characterization under the Section 707(a)(2)(A) regulations, the IRS could still attempt to tax the service provider's *receipt* of the profits interest on the ground that the profits interest has a determinable value. In that event, taxpayers will have to rely on a patchwork of case law to defend against current taxation.

Additionally, the IRS has determined that Rev. Proc. 93-27 does not apply to transactions in which one party provides services and another party receives a seemingly associated allocation and distribution of partnership income or gain. Consequently, the IRS will take the position that Rev. Proc. 93-27 does not apply when, for example, a management company waives a management fee while 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.[32] It is unclear whether this change in IRS position would apply in the

[26] Prop. Treas. Reg. § 1.707-9(a).

[27] *Id.*

[28] Prop. Treas. Reg. § 1.707-9(b).

[29] IRS Notice at 43,657.

[30] 1993-2 C.B. 343.

[31] IRS Notice at 43,656.

[32] *Id.*

common situation in which the general partner receives a management fee (which is treated as a fee for services) and another entity related to the general partner is admitted to the partnership with a partnership interest entitled to a disproportionate share of partnership profits (*i.e.*, a carried interest).

CONCLUSION

While clearly attempting to curtail fee waivers, the proposed regulations stop short of prohibiting them altogether. Rather, the examples provide a roadmap for structuring a fee-waiver profits interest that the IRS will respect as a partnership distributive share. However, despite the fact that fee-waiver profits interests may technically still be feasible, the economic arrangements that the proposed regulations require may foreclose such profits interests as a practical matter. This is particularly true given the uncertainty created by removing fee-waiver profits interests from the Rev. Proc. 93-27 safe harbor. Moreover, while clearly intended to address fee waivers, the proposed regulations may also affect other common partnership structures. Although final regulations will be prospective only, taxpayers should take note of the guideposts in the proposed regulations and adjust existing transactions where appropriate.

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