IRS Studying Fee Waivers

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The IRS isn't waiting for direction from Congress on the taxation of carried interest and is proceeding on a tangential issue — the treatment of fee waivers — which it has determined is "fair game," Clifford Warren, special counsel in the IRS Office of Associate Chief Counsel (Passthroughs and Special Industries), said April 30.

"Fee waivers is something that we are in fact studying at this point," Warren said at a Practising Law Institute seminar in Chicago. "There's a spectrum, and we're trying to figure out what's good and what's bad," Warren told Tax Analysts, adding that while some fee waivers might work perfectly well, it's not clear that all of them fall within the safe harbor in Rev. Proc. 93-27, 1993-2 C.B. 343. That safe harbor requires that the recipient act as a partner and not dispose of the interest within two years.

Management fee waivers allow private equity and hedge fund managers to forgo their fixed management fee (commonly 2 percent) in exchange for a profits interest — a carried interest — to take advantage of deferral and preferential capital gains tax rates. Warren said some fee waivers may implicate section 707(a)(2)(A), which would treat the service provider as acting in a non-partner capacity. (Prior analysis: *Tax Notes*, Apr. 8, 2013, p. 107.)

Prospects for Carried Interest

At a panel on the final (T.D. 9612) and proposed (REG-106918-08) noncompensatory partnership option regulations, Joy Spies, branch 1 senior technician reviewer, IRS Office of Associate Chief Counsel (Passthroughs and Special Industries), said the Service is waiting to see what happens with carried interest legislation before it resumes work on 2005 proposed regulations (REG-105346-03) concerning the tax treatment of compensatory partnership interests.

Glenn Dance of Ernst & Young LLP said some on Capitol Hill have cited the IRS's administrative policy of not taxing the issuance of a profits interest under Rev. Proc. 93-27 as one of the reasons for the favorable tax treatment of carried interest. He asked Spies for reassurance that the IRS is not reconsidering that policy.

Rev. Proc. 93-27 and Rev. Proc. 2001-43, 2001-2 C.B. 191, continue to represent the IRS's position, Spies said.

Warren said some believe that if the carried interest legislation is "out there again and again and again, it's going to be enacted." But he said the proposed legislation is complex. "It tries to do something in subchapter K that's unnatural," he said. The complexity is necessary to prevent taxpayers from avoiding the provision by using tiers, borrowing capital from the limited partners, using derivatives, or simply selling the partnership interest before the carry is earned, he said.

As for the prospects that carried interest legislation will be passed soon, Warren said, "It could get lost in major tax reform . . . or it could be the centerpiece of major tax reform. We don't know."

Back-End Profits Interest

Bahar A. Schippel of Snell & Wilmer LLP discussed a planning strategy that may enable a partnership to compensate a service provider with a profits interest that entitles him to more than just a flat percentage of future profits. Under the strategy, the service provider receives a profits interest that entitles him to catch up to a pro rata share of existing capital, but only to the extent that there are future profits — without requiring allocations of ordinary income or withholding for those future profits. If the service provider is treated as a partner all along, the back-end payment will be entitled to capital gains treatment and won't trigger tax upfront, she said.

> ***'It could get lost in major tax reform or it could be the centerpiece of major tax reform. We don't know,' Warren said of carried interest legislation.***

Schippel said that under the planning strategy, the service provider takes a profits interest that entitles him to receive, for example, 5 percent of future profits and a catch-up allocation that pays a share of profits equal to 5 percent of existing capital, but only in a liquidity event. That is done by allocating to the service provider's capital account 100 percent of the interim book-up gain, if any, or profits upon the sale of the business until he is made whole, she said. Warren pointed out that that could mean the service provider may not receive a Schedule K-1 until the partnership is sold.

"There are varying levels of thought as to whether the IRS would buy into that," Schippel said. "I personally believe that given that the employee is actually taking a risk that the business will have to actually grow in value, there's a good position to take that the strategy does work."

Julie A. Divola of Pillsbury Winthrop Shaw Pittman LLP said the planning strategy raises two questions: whether the allocation of book-up gain only has substantial economic effect and whether the interest is really a profits interest. "All you're doing is letting it trigger sometime in the future on a revaluation event," she said. "You've deferred your ability to be taxed until the end. It's a timing

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thing, and I think the issue is whether it has substantial economic effect.''

Schippel said she would give the employee not only 5 percent of the future growth in the business, but also a share of annual operating income that ideally is equivalent to the employee's back-end participation. ''But if not, at least something that's more than de minimis,'' she added. ''That makes the person a partner in the meanwhile. You want to become a partner. You don't want to just say, 'Hey, look, there's a sale. We'll give you a bonus.'''

''There's substantial economic effect, because the day you promised this to the [service provider], it had absolutely zero value, so its liquidation value was in fact zero. There was substantial risk that the value may not actually go up,'' Schippel said. ■

IRS TO AMEND RULES ON BOTTOM-DOLLAR GUARANTEES

The IRS may issue proposed regulations to limit the ability of a partner to assume a so-called bottom-dollar loan guarantee, according to Clifford Warren, special counsel in the IRS Office of Associate Chief Counsel (Passthroughs and Special Industries).

Under a bottom-dollar loan guarantee, a partner guarantees only the least risky portion of the debt — the last dollar or dollars. The lender is still at risk for the first loss on the loan, and the partner is considered to bear the economic risk of loss for the debt. Reg. sections 1.704-2(m) and 1.737-4(b) approve some tax-motivated and bottom guarantees.

''We are working on proposed regulations that will try and get at guarantees and indemnities that don't have sufficient commercial substance and are really tax avoidance'' by treating those guarantees and indemnities as nonrecourse, Warren said May 1 at a Practising Law Institute seminar in Chicago. The guidance will seek to make the distinction using ''fairly objective criteria,'' he said, noting that a near-final draft of the guidance is being circulated but that it's unclear when it might be released.

Real Estate Roundtable President Jeffrey D. DeBoer in a March 13 letter to the IRS and Treasury urged them not to issue guidance that would disregard a bottom guarantee, arguing that it would be inconsistent with ''the undeniable fact that the bottom guarantor is exposed to more economic risk than other non-guaranteeing partners.'' (Prior coverage: *Tax Notes*, Jan. 28, 2013, p. 423.)

The guidance, which involves the disguised sale rules under sections 707 and 752, will address the extent to which a partner may be required to have net worth in order to be allocated liabilities. Under reg. section 1.752-2(b)(6), a partner's net worth — that is, whether it's thinly capitalized — isn't a factor in determining whether the partner bears economic risk of loss subject to an antiabuse rule. Because the assumption that a partner will satisfy the obligation regardless of net worth is in the regulations and not the statute, the IRS is looking at it, Warren said.

Warren said taxpayers shouldn't worry that the guidance will trigger recapture upon issuance, adding that the regulations will be proposed, open for comment, and contain a prospective effective date and possible transition relief. ■

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