Recent Developments & Observations

Fee Waiver Proposed Regulations and Catch-up Allocations

By Bahar A. Schippel

On August 10, 2015, the IRS and Treasury issued proposed regulations[1] (the "Proposed Regulations") relating to disguised payments for services under Code Sec. 707(a)(2)(A), mainly to combat certain perceived abuses by fund managers relating to fee waivers. The Proposed Regulations provide guidance regarding when an arrangement between a partnership and one or more of its partners will be treated as a disguised payment for services and are not limited to fee waivers. This column will address certain aspects of the Proposed Regulations, specifically, whether certain common arrangements between a partnership and its service provider partners may be treated as a disguised payment for services.

Situation 1: Assume A and B form a partnership to manufacture medical devices and each contributes $40 to the partnership. A and B do not have expertise in managing a company, so they hire C as their CEO. As a start-up, the partnership is low on cash, so A and B promise C a 20-percent interest in the partnership to make up for a below-market salary. C expects to receive a full 20-percent share of the proceeds in a sale transaction. For obvious reasons, A and B wish to reduce the tax impact to C of the grant of the equity to him, while being able to provide him with capital gains on the sale of his equity. A "profits interest" would achieve such goals,[2] but in order to qualify as a profits interest, C's 20-percent interest in the partnership must have a zero liquidation value at the time of grant. The solution, if C is willing to take some risk, is to subordinate C's distribution rights to A and B's $80 in capital contributions, but to give him a catch-up distribution of $20, so that as long as the partnership sells for $100 or more, he will be entitled to a full 20 percent of the total proceeds. A, B and C agree to the following distribution priorities: (i) Tranche 1: A and B are entitled to a return of their $80; (ii) Tranche 2: C is entitled to $20; and (iii) Tranche 3: Any proceeds remaining will be distributed 40/40/20 to A, B and C. Since A and B are entitled to a priority distribution of their capital contributions, under these facts, C's interest should qualify as a profits interests under Rev. Proc. 93-27 and therefore achieve the above-stated tax goals. This column will explore whether the Proposed Regulations would treat the $20 of Tranche 2 income allocation, at the time such allocation is made to C, as a disguised fee for services.

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Situation 2: Assume D and E form a partnership to acquire real estate for investment purposes in the Phoenix, Arizona, metropolitan area. D has substantial resources and is willing to contribute $100 to the partnership. E has limited resources but has substantial expertise in the Phoenix real estate market. D and E agree to the following distribution priorities: (i) Tranche 1: D is entitled to a return of his $100 plus a 10-percent preferred return; (ii) Tranche 2: E is entitled to an amount equal to the preferred return received by D; and (iii) Tranche 3: Any proceeds remaining will be distributed equally to D and E. As in Situation 1, this column will explore whether the Proposed Regulations would treat the allocation relating to the Tranche 2 distribution, at the time such allocation is made, as a disguised fee for services.

The Proposed Regulations provide guidance regarding when an arrangement between a partnership and one or more of its partners will be treated as a disguised payment for services and are not limited to fee waivers.

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To understand the Proposed Regulations, an understanding of fee waivers is helpful. A fund manager in a typical fund may be compensated for its services through what is often referred to as a "two and twenty" structure, where the "two" represents a fixed annual fee, based on investor contributions or assets under management (the "Fixed Fee") and the "twenty" represents the carried interest percentage of the fund manager in the fund (the "Carried Interest").[3] The Fixed Fee generally pays for the administrative overhead costs of the fund manager, while the Carried Interest is intended to align the interest of the fund manager with the investors, such that the more profitable the fund turns out to be, the more valuable the Carried Interest will be. If a fund is profitable, the Carried Interest may substantially exceed what the fund manager could have charged as a fixed fee, but if the fund is not successful, including by reason of economic circumstances beyond the fund manager's control, the Fixed Fee component by itself may represent a less than fair market value for the services of the fund manager. Thus, in essence, a degree of risk justifies the potential for high rewards. Carried Interests receive favorable tax treatment, which includes taxation at preferential capital gains rates (to the extent that the investors are entitled to capital gains on their returns). By contrast, the Fixed Fee is taxed as ordinary income. Proposed legislation to tax Carried Interests as ordinary income is frequently revisited on the Hill, as many view it unfair to allow fund managers to receive what may amount to a considerable portion of their compensation at favorable capital gains rates. This column will not, however, address the many proposals for Carried Interest legislation.

Many funds require that the fund manager has a stake in the fund, and it is typical to require the fund manager to make capital contributions to the fund equal to one percent of the total capital raised by the fund. In large funds, this one-percent requirement may be difficult to meet, especially for young fund managers. To enable fund managers to meet their one-percent contribution requirement and/or to provide for favorable tax treatment on the Fixed Fee, the concept of "fee waivers" began to surface in the fund industry. Thus, a fund manager may forego some or all of its Fixed Fee *in lieu* of an additional Carried Interest, with the additional Carried Interest typically being fixed in an amount equal to the foregone fee (the "Carry Converted Fee"). Often times, the fund manager is able to waive its right to the Fixed Fee in exchange for the Carry Converted Fee through a unilateral election (the "Waiver Election") that is not subject to the approval of the investors. In addition, depending on the risk tolerance of the fund manager, the Waiver Election may be a one-time election applicable for the life of the fund, or, as is more common, the Waiver Election may be made on an annual or more frequent basis with respect to the Fixed Fee for such period. Further, although the Carried Interest is typically based on the fund's overall performance, and subject to a claw back if paid in excess prior to the final settlement of the fund, it is common for the Carry Converted Fee to be paid out of a single profitable fund transaction, and not subject to claw back, regardless of the fund's overall performance otherwise. The Carry Converted Fee is thus relatively risk-free, especially where the fund manager can control the timing of the Waiver Election. Fund managers take the position that the Carry Converted Fee receives the same tax treatment as a Carried Interest. The IRS and the Treasury disagree.

The Proposed Regulations treat the typical fee waiver arrangement involving the Carry Converted Fee as a disguised fee for services. Under the Proposed Regulations, an arrangement will be treated as a disguised payment for services if (i) a partner, directly or through its delegate, performs services to or for the benefit of the partnership; (ii) there is a related direct or indirect allocation and

distribution to partner; 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 other than in that person's capacity as a partner.

The Proposed Regulations provide a mechanism for determining whether or not an arrangement is treated as a disguised payment for services under Code Sec. 707(a)(2)(A). Whether an arrangement constitutes a payment for services depends on all of the facts and circumstances. There are six nonexclusive factors that may indicate that an arrangement constitutes a disguised payment for services. The first of these six factors is whether the allocation and related distribution are subject to significant entrepreneurial risk and are accorded more weight than the other factors. Thus, arrangements that lack significant entrepreneurial risk are treated as disguised payments for services. The weight given to each of the other five factors depends on the particular case, and the absence of a particular factor (other than significant entrepreneurial risk) is not necessarily determinative of whether an arrangement is treated as a payment for services. The other five factors are as follows:

(1) The service provider holds, or is expected to hold, a transitory partnership interest or a partnership interest for only a short duration.
(2) The service provider receives an allocation and distribution in a time frame comparable to the time frame that a nonpartner service provider would typically receive payment.
(3) 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.
(4) The value of the service provider's interest in general and continuing partnership profits is small in relation to the allocation and distribution.
(5) 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 Code Sec. 707(b) or 267(b) and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly.

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. Reg. §1.707-2(c)(1)(i) through (v) of the Proposed Regulations set forth arrangements that presumptively lack significant entrepreneurial risk. These arrangements are presumed to result in an absence of significant entrepreneurial risk (and therefore, a disguised payment for services) unless other facts and circumstances can establish the presence of significant entrepreneurial risk by clear and convincing evidence. The Proposed Regulations include examples that generally describe facts and circumstances in which there is a high likelihood that the service provider will receive an allocation regardless of the overall success of the business operation, including *any one* of the following: (i) capped allocations of partnership income if the cap would reasonably be expected to apply in most years; (ii) allocations for a fixed number of years under which the service provider's distributive share of income is reasonably certain; (iii) allocations of gross income items; (iv) 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 (for example, if the partnership agreement provides for an allocation of net profits from specific transactions or accounting periods and this allocation does not depend on the overall success of the enterprise); and (v) arrangements in which a service provider either waives its right to receive payment for the future performance of services in a manner that is nonbinding or fails to timely notify the partnership and its partners of the waiver and its terms.

Applying the factors in the Proposed Regulations to Situations 1 and 2 described above, are the allocations and the related distributions for Tranche 2 amounts to C and E susceptible to being re-characterized as fees for services? In both situations, the Tranche 2 allocations are capped in amount. In Situation 1, the amount, $20, is fixed and determinable at the outset. In Situation 2, the amount of Tranche 2 will vary based on the distribution date, but it is possible that such amount may be reasonably determinable based on the partnership's business plan. In other words, if the partnership's business plan is to hold the real estate for five years and then sell, then the amount of E's Tranche 2 allocation can be reasonably determined. As stated above, the Proposed Regulations set forth arrangements that presumptively lack significant entrepreneurial risk, and one of these factors is an allocation (under a formula or otherwise) that is predominantly fixed in amount. Fortunately, however, the Preamble to the Proposed Regulations states that:

> [C]ertain priority allocations that are intended to equalize a service provider's return with priority allocations already allocated to investing partners over the life of the partnership (commonly known as

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> "catch-up allocations") typically will not fall within the types of allocations covered by the … example [provided in the Proposed Regulations] and will not lack significant entrepreneurial risk, although all of the facts and circumstances are considered in making that determination.

Since other facts and circumstances will have to be considered, what might such facts and circumstances include? The Preamble to the Proposed Regulations states that "[o]ne fact is that the value of partnership assets is not easily ascertainable and the partnership agreement allows the service provider or a related party in connection with a revaluation to control the determination of asset values, … " In Situation 1, assume that in addition to providing the CEO with a 20-percent interest in the partnership, the partnership also creates a five-percent equity pool, permitting the CEO to grant profits interests to the partnership's management team. Under existing Code Sec. 704(b) regulations, the grant of an interest in a partnership in exchange for money or for services is a revaluation event.[4] If the CEO grants profits interests to his management team at a time when the value of the partnership has increased, that will create revaluation book gain (the "Revaluation Gain") under the Code Sec. 704(b) regulations. Presumably, consistent with the CEO's right to a priority distribution with respect to Tranche 2, such revaluation gain would be allocated to the CEO as required by the Code Sec. 704(b) regulations. Do the combination of the following factors—(i) the Tranche 2 amount is fixed, (ii) the CEO is able to control the timing of the grant of the profits interests and therefore the timing of the revaluation and (iii) the partnership's assets are hard to value—mean that when the revaluation occurs, the CEO is deemed to have received a disguised fee for his services? It is this author's understanding, based on discussions with IRS officials involved in drafting the Proposed Regulations, that the Proposed Regulations did not intend to reach this result. The overweighing factor is that, at the time of the issuance of the CEO's interests, there is significant risk that he will not receive some or all of the Tranche 2 distribution amount. Even if the CEO is allocated the Revaluation Gain, as a result of A and B's priority distribution rights, it is unlikely that the CEO will receive any Tranche 2 distributions until the business is sold. Thus, regardless of the fact that the CEO may be able to control the timing of the revaluation and the related allocation of Revaluation Gain to himself, he cannot be assured of any distributions until the business as a whole is profitable. Curiously, however, the Proposed Regulations place the emphasis on the allocation itself, regardless of the risk that the allocation will result in a corresponding distribution. The Preamble to the Proposed Regulations states as follows:

> Although section 707(a)(2)(A)(ii) requires both an allocation and a distribution to the service provider, the Treasury Department and the IRS believe that a premise of section 704(b) is that an income allocation correlates with an increased distribution right, justifying the assumption that an arrangement that provides for an income allocation should be treated as also providing for an associated distribution for purposes of applying section 707(a)(2)(A). The Treasury Department and the IRS considered that some arrangements provide for distributions in a later year, and that those later distributions may be subject to independent risk. However, the Treasury Department and the IRS believe that recharacterizing an arrangement retroactively is administratively difficult. Thus, the proposed regulations characterize the nature of an arrangement when the arrangement is entered into (or modified) regardless of when income is allocated and when money or property is distributed. The proposed regulations apply to both one-time transactions and continuing arrangements.

In this case, although the CEO may be able to manipulate the timing of the revaluation event and the amount of the Revaluation Gain, the CEO's ability to receive any Tranche 2 distributions will depend squarely on the amount of true economic gain resulting from the sale of the partnership. Thus, it would seem inappropriate to require the CEO to recognize fee income at the time of the revaluation. Yet, the Proposed Regulations could be read to imply such result. To the extent that the IRS and Treasury did not intend to cause service partners to recognize fee income under these circumstances, it would be helpful for the final regulations, when they are issued, to include an example or other clarifying language to negate such inference. If the service provider is able to manipulate the timing of both the allocation *and* the distribution in a manner so as to remove entrepreneurial risk, then only should such an arrangement be subject to re-characterization as fee income.

ENDNOTES

[1] IRB 2015-32, REG–115452–14.

[2] *See* Rev. Proc. 93-27, 1993-2 CB 343.

[3] Depending on the type of fund or the economic conditions, the fixed fee and/or the carry percentage may vary.

[4] *See* Reg. §1.704-1(b)(2)(iv)(f).

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