Proposed Regulations Issued On Management Fee Waivers

Client Alert

July 24, 2015

On July 22, 2015, the U.S. Department of the Treasury and U.S. Internal Revenue Service issued proposed Treasury Regulations under Section 707(a)(2)(A) of the Internal Revenue Code of 1986, as amended, addressing management fee waiver arrangements.[1] Under the Proposed Regulations, certain management fee waiver arrangements will be treated as disguised payments for services for U.S. federal income tax purposes, resulting in ordinary income treatment (and possibly significant penalties under deferred compensation rules). The Proposed Regulations also cover additional matters that are beyond the scope of this client alert.

While the Proposed Regulations are not technically effective unless and until the date final regulations are published, the Treasury Department and IRS believe that the Proposed Regulations generally reflect current law. In other words, the government's position is that the core principles outlined in the Proposed Regulations apply under current law.[2]

Management Fee Waiver Arrangements

In a typical management fee waiver arrangement, the general partner of a private investment fund (owned by the fund managers) is permitted to satisfy all or a portion of its capital commitment to the fund with "deemed" capital contributions, and the fund managers similarly are deemed to satisfy all or a portion of their capital contribution obligations to the general partner. In connection with the deemed contribution, there is a reduction in the management fee payable by the fund (where the fee is payable either to the general partner or to a management company owned by one or more of the owners of the general partner of the fund).

The general partner is entitled to a priority allocation of subsequent net profits of the fund, if and when they occur, equal to the amount of its deemed capital contributions to the fund. If such priority profit allocation includes net long-term capital gain or qualified dividend income, the fund's general partner (and its partners) would be subject to tax at the lower U.S. federal capital gains tax rate as compared to the higher ordinary income tax rate that otherwise would have applied to the waived management fee. The priority allocation may also result in deferral of the tax that would have been due if management fees had not been waived.

Analysis of Management Fee Waiver Arrangements Under Proposed Regulations

The Proposed Regulations provide that whether an arrangement between a partner and a partnership constitutes a payment for services depends on all of the facts and circumstances, and identifies six non-exclusive factors to consider. The most important factor is the entrepreneurial risk of the arrangement -- an arrangement that lacks significant entrepreneurial risk is treated as a payment for services without regard to any other factor.[3] The five other factors identified by the Proposed Regulations that are indicative of a disguised payment for services:

(i) the service provider holds, or is expected to hold, a transitory partnership interest or a partnership interest for only a short duration;

(ii) 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;

(iii) 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;

(iv) the value of the service provider's interest in general and continuing partnership profits is small in relation to the allocation and distribution; and

(v) 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 Sections 707(b) or 267(b) of the Internal Revenue Code, and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly.[4]

Significant Entrepreneurial Risk

As noted above, the Proposed Regulations treat a management fee waiver arrangement that lacks significant entrepreneurial risk as a payment for services. An arrangement that has significant entrepreneurial risk generally will not constitute a payment for services, unless other factors establish otherwise. Whether an arrangement lacks significant entrepreneurial risk is based on the service provider's entrepreneurial risk relative to the overall entrepreneurial risk of the fund. [5]

Under the Proposed Regulations, each of the following facts and circumstances creates a presumption that an arrangement lacks significant entrepreneurial risk and will be treated as a disguised payment for services unless other facts and circumstances establish the presence of significant entrepreneurial risk by clear and convincing evidence:

(i) capped allocations of partnership income if the cap is reasonably expected to apply in most years;

(ii) an allocation for one or more years under which the service provider's share of income is reasonably certain;

(iii) an allocation of gross income;

(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 (*e.g.*, 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 long-term future success of the enterprise); or

(v) 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.[6]

Examples in Proposed Regulations

The Proposed Regulations include examples of management fee waiver arrangements that presumptively lack significant entrepreneurial risk and those that do have significant entrepreneurial risk.

A management fee waiver arrangement was determined to presumptively lack significant entrepreneurial risk where the priority allocation in respect of the management fee waiver arrangement was an allocation of net profit from any 12-month accounting period in which the partnership had net gain (as a result, the allocation did not depend on the overall success of the enterprise). In this example, the sale of assets by the partnership (and hence the timing of recognition of gains and losses) was controlled by the general partner of the partnership, a company related to the service provider receiving the priority allocation of profit in respect of the management fee waiver arrangement.[7]

By contrast, a management fee waiver arrangement was determined to have significant entrepreneurial risk where the interest consisted of future partnership net income and gains, the allocation was subject to a clawback obligation to the extent that, over the life of the fund, the share of future partnership net income and gain was in excess of the fund's net profit, it was reasonably anticipated that the clawback obligation could and would be complied with, and the allocation was neither reasonably determinable nor highly likely to be available. There were no additional facts and circumstances suggesting that the arrangement was properly characterized as a payment for services.[8]

Certain Transactions Not Within IRS Revenue Procedure 93-27

The receipt of a "profits interest" that is covered by IRS Revenue Procedure 93-27 is not a taxable event. The preamble to the Proposed Regulations includes a statement that the Treasury Department and IRS have determined certain transactions in which one party provides services and another party receives an associated allocation and distribution of partnership income or gain are not treated as the grant of a "profits interest" that satisfies the requirements of IRS Revenue Procedure 93-27.[9] For example, the IRS Revenue Procedure would not apply where a management company that provides services to a fund in exchange for a fee waives that fee, and 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.[10] This determination by the Treasury Department and IRS leaves open the possibility of challenging the valuation and taxation of the receipt of such a partnership interest.

Next Steps

Fund managers should review any potential or existing management fee waiver arrangements in light of the Proposed Regulations. The Proposed Regulations mandate no gross income allocations and the examples strongly suggest that the management fee waiver arrangement should be economically at risk – and supported by an enforceable return obligation – to the extent amounts received by reason of the fee waiver exceeds the cumulative net profits over the life of the fund. Accordingly, fund managers should consider structuring their arrangements to conform with these guidelines.

If you would like to discuss the Proposed Regulations or management fee waiver arrangements generally, including the impact on existing arrangements, please contact any of the lawyers listed on this alert or the member of the Proskauer Tax Group with whom you normally consult on these matters.

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[1] The Proposed Regulations can be found here.

[2] *See* Preamble to Proposed Regulations.

[3] Proposed Treasury Regulation Section 1.707-2(c).

[4] Proposed Treasury Regulation Section 1.707-2(c)(2)-(6).

[5] Proposed Treasury Regulation Section 1.707-2(c)(1).

[6] Proposed Treasury Regulation Section 1.707-2(c)(1)(i)-(v).

[7] Proposed Treasury Regulation Section 1.707-2(d), Example 3.

[8] Proposed Treasury Regulation Section 1.707-2(d), Example 5.

[9] *See* Preamble to Proposed Regulations.

[10] *Id*.