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Investment management tax alert
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Treasury Department and IRS issue proposed regulations regarding disguised payments by partnerships for services

On July 23, 2015, the Treasury Department ("Treasury") and the Internal Revenue Service (the "IRS") published proposed regulations under section 707(a)(2)(A) (the "proposed regulations") (REG-115452-14) that treat certain arrangements, including private equity fund management fee waiver arrangements, as payments by partnerships for services.

An arrangement that is treated as a payment for services under the proposed regulations will be characterized as ordinary income and will be treated as a payment for services for all purposes of the Code. Thus, the partnership must treat the payments as payments to a non-partner in determining the remaining partners' shares of taxable income or loss.

Issue: Section 707(a)(2)(A)

Section 707(a) addresses arrangements in which a partner engages with the partnership other than in its capacity as a partner. Section 707(a)(2) grants the Secretary of the Treasury broad regulatory authority to identify transactions involving disguised payments for services under section 707(a)(2)(A). This grant of regulatory authority stems from Congress's concern that partnerships and service providers were inappropriately treating payments as allocations and distributions to a partner even when the service provider acted in a capacity other than as a partner.

Congress determined that allocations and distributions that were, in substance, direct payments for services should be treated as a payment of fees rather than as an arrangement for the allocation and distribution of partnership income.

Proposed regulations

The proposed regulations would provide that an arrangement will be treated as a disguised payment for services if -

(1) A person (service provider), either in a partner capacity or in anticipation of being a partner, performs services (directly or through its delegate) to or for the benefit of the partnership;

(2) There is a related direct or indirect partnership allocation and distribution to the service provider; and

(3) The performance of the services (prong 1) and the allocation and distribution (prong 2), 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.

Under the proposed regulations, there are six factors that would be used to determine whether a transaction is properly characterized as a fee for services.

(1) The first and most important factor is whether the payment is subject to significant entrepreneurial risk as to both the amount and fact of payment. The following five facts and circumstances create 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.

(2) The service provider holds, or is expected to hold, a transitory partnership interest or a partnership interest for only a short duration.

(3) 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.

(4) 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.

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

(6) 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), and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly.

Under the proposed regulations, allocations pursuant to an arrangement between a partnership and a service provider to which sections 707(a) and 707(c) do not apply would be treated as a distributive share under section 704(b).

Management fee waivers under the proposed regulations

The proposed regulations contain a number of examples illustrating the application of these regulations to arrangements that contain certain facts and circumstances that Treasury and the IRS believe demonstrate the existence or absence of significant entrepreneurial risk.

Several of the examples consider arrangements in which a partner agrees to forgo fees for services and, in lieu of the fees, receive a share of future partnership income and gains. The examples consider the application of section

707(a)(2)(A) based on the manner in which the service provider (i) forgoes its right to receive fees and (ii) is entitled to share in future partnership income and gains.

In Examples 5 and 6, the service provider forgoes the right to receive fees in a manner that supports the existence of significant entrepreneurial risk by forgoing its right to receive fees in connection with the fund's formation and by executing a waiver that is binding, irrevocable, and clearly communicated to the other partners. Similarly, the service provider's arrangement in these examples include the following facts and circumstances that, according to the regulations, taken together support the existence of significant entrepreneurial risk: the allocation to the service provider is determined out of net profits and is neither highly likely to be available nor reasonably determinable based on all facts and circumstances available at the time of the arrangement, and the service provider undertakes a clawback obligation and is reasonably expected to be able to comply with that obligation.

The preamble to the proposed regulations (the "Preamble") states that the presence of each fact described in these examples is not necessarily required to determine that section 707(a)(2)(A) does not apply to an arrangement. The absence of certain facts, however, 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.

Proposed changes to profits interests revenue procedures

Rev. Proc. 93-27, clarified by Rev. Proc. 2001-43, provides that the receipt of a partnership profits interest is not a taxable event so long as the person receives the interest either as a partner or in anticipation of becoming one. Rev. Proc. 93-27 does not apply, however, if the partnership is a publicly traded partnership, generates a substantially certain and predictable stream of income, or a partner disposes of the profits interest within two years of its receipt.

According to the Preamble, Treasury and the IRS 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. For example, a management company that provides services to a fund in exchange for a fee may waive that 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.

According to the Preamble, the government believes that these transactions do not satisfy the requirement that receipt of an interest in partnership profits be for the provision of services to or for the benefit of the partnership in a partner capacity or in anticipation of being a partner, and the service provider may be viewed as having disposed of the partnership interest (through a constructive transfer to the related party) within two years of receipt.

In addition, the Preamble states that Treasury and the IRS plan to issue a revenue procedure providing an additional exception to the safe harbor in Rev. Proc. 93-27 in connection with finalizing the Proposed Regulations. The additional exception would apply to a profits interest issued in conjunction with a partner forgoing payment of an amount that is substantially fixed (including a substantially fixed amount determined by formula, such as a fee based on a percentage of partner capital commitments) for the performance of services, including a guaranteed payment under section 707(c) or a payment in a non-partner capacity under section 707(a). As drafted, profits interests received as part of a fee waiver would not qualify as a profits interest under Rev. Proc. 93-27. Presumably, taxpayers would be required to determine the value of such an interest or argue that the receipt of such an interest is not taxable under case law.

Effective date

The proposed regulations would be effective on the date the final regulations are published in the Federal Register and would apply to any arrangement entered into or modified on or after the date of publication of the final regulations.

Regarding arrangements entered into or modified before the proposed regulations are finalized, the determination of whether those arrangements are disguised payments for services under section 707(a)(2)(A) will be made under the Code and the legislative history of section 707(a)(2)(A). The position of Treasury and the IRS is that the proposed regulations generally reflect Congressional intent.

Contacts

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