

## Introduction

On July 22, 2015, the US Department of the Treasury and Internal Revenue Service (IRS) issued a long-awaited [notice of proposed rulemaking](#) (Notice) on “disguised payments for services.” The proposed regulations (Proposed Regulations) and introductory language (“preamble”) provide rules for determining whether an arrangement will be treated as a disguised payment for services as opposed to an allocation of a distributive share of income. This recharacterization could have several consequences, including converting capital gain into ordinary income for the recipient, requiring a partnership to capitalize a payment and changing the timing of income or deductions. In addition, the IRS indicates that it intends to amend Rev. Proc. 93-27, which allows a recipient of a “profits interests” in a partnership to avoid recognition of income upon the receipt of the interest if certain conditions are met. The Notice has significant implications for arrangements sometimes found in investment partnership arrangements, including management fee waivers and carried interests provided to recipients that do not provide services to the partnership.

The Notice states that new regulations will apply to arrangements entered into or modified after regulations are issued in final form and that, pending final regulations, the determination of whether a payment is a disguised payment for services is made on the basis of the statute and the legislative history. The Notice includes a statement that essentially warns taxpayers that **the Proposed Regulations are effective immediately and possibly retroactively**: “Pending the publication of final regulations, the position of the Treasury Department and the IRS is that the proposed regulations generally reflect Congressional intent as to which arrangements are appropriately treated as disguised payments for services.”

The Notice seeks comments on the Proposed Regulations and provides an opportunity to request a public hearing. Comments and requests for a public hearing must be received by October 21, 2015.

This publication focuses on two places where the Notice may have a large impact on transaction structuring and may leave those who have formed or invested in partnerships that appear to violate the new guidance wondering what steps to take – management fee waiver provisions and profit interests (including carried interests) that are issued to a partner that is not a service provider. We begin with a description of the general scope of the Proposed Regulations.

## General Rules Regarding Disguised Payments for Services

The Notice focuses on whether certain payments or rights received for services should be characterized under section 707(a)(2)(A) of the Internal Revenue Code as payments received by a partner other than in its capacity as a partner (i.e., as “disguised payments for services”) as opposed to distributive shares of income. In general, payments received in a capacity other than as a partner would

constitute ordinary income to the recipient and the partnership would deduct or capitalize the payments based on how the payments would be characterized if made to a third party (i.e., deducted, capitalized subject to amortization, capitalized without ability to amortize, or not deducted by reason of rules prohibiting deductions for certain types of expenditures, such as those for fines, penalties or lobbying). If a partner is treated as receiving distributions as distributive shares, the income allocated to the partners would be determined based on the character of the income to the partnership (such as capital gain, interest income, passive income or regular ordinary income).

The Proposed Regulations provide that an arrangement will be treated as a disguised payment for services if:

- A person (service provider), either in a partner capacity or in anticipation of becoming a partner, performs services to or for the benefit of the partnership;
- There is a related direct or indirect allocation and distribution to the service provider; and
- 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 state that whether an arrangement constitutes a disguised payment for services “depends on all of the facts and circumstances” and is determined at the time the arrangement is entered into or modified. The Proposed Regulations include six nonexclusive factors for determining whether an arrangement constitutes a disguised payment for services.

The most important factor is “significant entrepreneurial risk.” An arrangement that has significant entrepreneurial risk “will generally not constitute a payment for services unless other factors establish otherwise.” The Proposed Regulations list five facts and circumstances “that create a presumption that an arrangement lacks significant entrepreneurial risk”:

- Capped allocation of partnership income if the cap is reasonably expected to apply in most years;
- An allocation for one or more years under which the service provider’s share of income is reasonably certain;
- An allocation of gross income;
- 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 make the allocation to the service provider; or
- An arrangement in which a service provider waives its right to receive payments 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.

The final presumption is expected to draw comments from partnerships with management fee waivers in place. Existing fee waiver provisions may have clear requirements for making legally binding elections, but may not require that election be timely communicated to each of the partners. Following the publication of the Notice, we can expect that fee waivers will include a requirement that all partners be notified, but it would seem unfair to penalize a partnership for failing to include such a requirement before the Notice was published.

The five less significant factors for determining whether an arrangement is a disguised payment for services are:

- Whether the service provider holds or is expected to hold a transitory partnership interest or an interest for only a short duration;
- Whether 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;
- Whether 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;
- Whether the value of the service provider's interest in general and continuing partnership profits is small in relation to the allocation and distribution; and
- Whether "[t]he 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."

In discussing the final factor, the preamble observes that the absence of a "clawback" obligation could create a lower level of economic risk for a service provider that might contribute to an arrangement being a disguised payment for services. We expect that some commenters on the Notice will challenge the somewhat simplistic discussion of the clawback and seek greater clarification on when the absence of a clawback obligation may be problematic.

The proposed regulations provide six detailed examples to illustrate the application of the rules. One can glean from the examples that, as a general rule, an arrangement will not be a disguised payment for services if the service provider receives a real interest in the profits and losses of the partnership or in distributions based on the profits and losses of the partnership, and the amount of the profits and losses or distributions are not highly predictable.

## Management Fee Waivers

The Notice's discussion of management fee waivers is attracting significant attention. In a typical management fee waiver situation, a person who is providing management or investment advice services to a partnership and who would be entitled to a fee waives the fee in exchange for an interest in partnership profits or distributions. Management fee waivers typically result in the deferral of the recognition of income by the service provider and sometimes convert what would otherwise be ordinary income to capital gain.

In some arrangements, the amount of the waived fee is treated as a capital contribution solely for purposes of determining whether the promoters of the partnership are meeting their capital commitment requirements and calculating percentage interests in distribution. The waived fee is not added to service provider's capital account.

In more aggressive fee waiver arrangements, an investment manager may waive fees after the rights to receive the fees have accrued and/or in exchange for a priority special allocation of gross income that is computed in a manner which approximates the forgone fee or commission.

The Proposed Regulations allow for management fee waivers that are structured to comply with the rules by creating significant entrepreneurial risk. The Notice describes the applicable provisions as follows:

Several of the examples consider arrangements in which a partner agrees to forgo fees for services and also receives 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 before the period begins 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 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 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. 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.

The Proposed Regulations target the aggressive management fee waiver arrangements in which service providers receive, in lieu of management fees or commissions, a special allocation of gross income that is computed in a manner which approximates the forgone fee or commission.

Although the Proposed Regulations clearly approve of properly structured management fee waivers, the Notice includes language that may raise questions about the direction in which the IRS and Treasury are headed. The Notice states that the IRS plans to issue a revenue procedure providing an additional exception to the safe harbor in Rev. Proc. 93-27: “The additional exception will 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.” This statement has created some confusion as to whether the exception will cover all arrangements in which a partner forgoes receiving a payment or just arrangements that do not comport with the final regulations when published. We expect that IRS and Treasury officials will clarify their intent when they speak about the Notice at trade association meetings and educational conferences.

As noted above, the Proposed Regulations describe general principles for determining whether arrangements will be treated as disguised payments for services and then illustrate those principles with examples. The examples can sometimes be confusing because they set forth facts that are not essential to a conclusion. In Example 6, a partnership agreement permits a general partner to waive all or a portion of its fee for any year if it provides written notice to the limited partners at least 60 days prior to the commencement of the partnership taxable year for which the fee is payable. Neither the preamble nor the Proposed Regulations require a 60-day advanced notice for a management fee waiver to be effective. The preamble refers to fees being waived before the period begins through a waiver that is binding, irrevocable and clearly communicated to the other partners. The Proposed Regulations identify as an adverse factor “an arrangement in which a service provider waives its right to receive payment for 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.” Therefore, the Proposed Regulations appear to be looking for an unambiguous and binding waiver made before the right to receive a fee begins to accrue, rather than to a waiver notice that is provided a particular number of days in advance.

The Notice cautions that a management fee waiver that is characterized as a payment for services may cause a payment not to comply with the deferred compensation rules under sections 409A or 457A of the Code.

## Targeted Capital Account Allocations and Management Fees

The Notice invites comment on an issue that sometimes arises in connection with fee waivers in partnership agreements that allocate profit and loss using what are referred to as “targeted capital accounts.” The Notice states that “[s]ome taxpayers have expressed uncertainty whether a partnership with a targeted capital account agreement must allocate income or a guaranteed payment to a partner who has an increased right to partnership assets determined as if the partnership liquidated at the end of the year even in the event that the partnership recognizes no, or insufficient, net income.”

This situation can easily arise if a partnership agreement provides that all distributions will be made in accordance with “percentage interests” and a partner’s percentage interest is determined based

on the relative amount of cash the partner contributed with a waived management fee being treated as the equivalent of a cash contribution for purposes of determining percentage interests. If the partnership had no profit and loss during a year (which could easily be the case if it invested in start-up corporate businesses) and the partnership liquidated at the end of the year and sold all of its assets for tax-book value, some of the proceeds would be distributed to the partner who waived management fees even though the partner had no capital account associated with the waived fees. If the partnership had income, the income would be allocated to cause the capital account of the partner who waived the fee to equal the amount of the hypothetical distribution. The Notice invites comment on what should happen if the partnership does not have any partnership level net income to allocate.

If the Treasury and IRS were to conclude that the partnership must treat the fee-waiver partner as either receiving a “guaranteed payment” or an allocation of gross income with a corresponding loss allocated to others, the benefit of management fee waivers would be eliminated in many cases.

## Profits Interests That Are Not Issued to the Service Provider

The Notice states that the IRS is “aware of 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.”

The Notice states that the IRS has determined that the “profits interests” provisions of Rev. Proc. 93-27 do not apply to such structures because “they would 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 because the service provider would effectively have disposed of the partnership interest (through a constructive transfer to the related party) within two years of receipt.” Disposition of a partnership interest received for services within two years of receipt take the profits interest outside of the safe harbor provided by Rev. Proc. 93-27.

This interpretation creates problems for non-service providers who were relying on the profits interest exception to avoid immediate recognition of gain on the fair market value of an interest received. In some fund arrangements, a “special limited partner” that provides no services to a partnership makes a capital contribution and receives rights to allocations and distributions commensurate with the contribution and an additional carried interest – an additional return based on the success of the overall enterprise that other partners do not receive. The Notice appears to be attacking this type of arrangement even if the owners of the special limited partner are providing services to the fund through another entity.

Under the IRS position reflected in the Notice, the actual service provider could be viewed as receiving the carried interest rights (and, therefore, be required to include the value of the rights in gross income when issued) and then transferring the rights to the non-service provider in a transaction that may or may not result in a corresponding deduction. The tax treatment of the non-service provider may depend on its relationship with the service provider.

## Next Steps

Fund sponsors, general partners, fund managers and partnerships should consider whether their past or planned arrangements could constitute disguised payments for services under the Proposed Regulations or preamble, and whether possible new exceptions to the profits interest safe harbor could affect planned arrangements. If the Notice presents issues, fund sponsors and general partners should consider revisions in future arrangements to minimize the risk of problems as well as commenting on the Notice. Lawyers in our Tax Strategy & Benefits Practice can help assess the risks associated with the Notice, counsel on consequences of existing arrangements that do not comply with the spirit of the Notice, advise on how to structure future arrangements so as to comply with the Proposed Regulations and prepare comments on the Proposed Regulations.

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