IRS Proposes Regulations Addressing Profits Interests, Investment Fund Fee Waiver Arrangements

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On July 23, 2015, the Internal Revenue Service (IRS) and the Treasury Department proposed regulations that address the tax treatment of certain partnership interests issued in exchange for services. Of particular note, the proposed regulations would in some circumstances recharacterize payments made by partnerships to service-provider partners as payments for services rather than as a distribution of partnership profits. In addition, the proposed regulations would treat certain fee waiver arrangements commonly used by investment fund managers as disguised payments for services rather than as the tax-free issuance of a compensatory "profits interest."

The IRS and Treasury have taken the position that the proposed regulations reflect Congress' intent regarding which arrangements are properly treated as disguised payments for services and, thus, may apply even in the absence of final regulations. In addition, in the preamble to the proposed regulations, the IRS and Treasury announced that it plans to issue additional guidance excepting certain arrangements from the existing safe harbors governing the issuance of profits interests. Accordingly, partnerships that issue compensatory partnership interests to service providers or utilize fee waiver arrangements should assess their arrangements carefully in light of the proposed regulations and anticipated guidance on profits interests.

Compensatory Partnership Interests and Distributions to Service Partners

Under existing IRS guidance, a partnership's grant of a "profits interest" in exchange for the provision of services to or for the benefit of the partnership generally is not taxable to the recipient service provider so long as, among other requirements, the profits interest entitles the service provider to only share in the future profits of the partnership and the future appreciation in the value of the partnership's assets. In addition, allocations and distributions made by the partnership to the service provider partner with respect to the profits interest generally are treated as distributive shares of the partnership's income, not as compensation income. As a result, the character of that income for tax purposes as ordinary or capital in the hands of the partnership passes through to the service-provider partner.

The proposed regulations introduce a "facts and circumstances" test to determine whether an arrangement with a service provider will be treated as a disguised payment for services rather than as an equity distribution by a partnership with respect to a profits interest. Generally, the test is intended to determine whether the service provider's right to receive an allocation and associated distribution is subject to significant entrepreneurial risk of the partnership's business, which indicates that the payment should be respected as a distribution with respect to partnership equity, or whether the arrangement is designed to ensure that the service-provider partner receives an agreed-upon amount, which indicates that the payment should be viewed as a disguised payment for services. Of particular note, the proposed regulations provide that certain types of arrangements are presumed to lack significant entrepreneurial risk and thus constitute a disguised payment for services unless the facts and circumstances establish otherwise through clear and convincing evidence: (i) capped allocations of partnership income that are reasonably expected to apply in most years, (ii) allocations for a set period of years where the service provider's share of income is reasonably certain, (iii) allocations designed to assure that sufficient net profits are highly likely to be available to make the allocation to the service provider, such as allocations limited to specific limited time periods or transactions and that do not depend on the longer-term success of the partnership's business, and (iv) allocations of gross income.

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In addition, the proposed regulations contain several examples that illustrate the application of the facts and circumstances test to a variety of fact patterns involving investment funds. In general, the examples show that a service provider generally will be treated as being subject to significant entrepreneurial risk where: (i) the service provider receives an allocation of net income measured over the life of the partnership, (ii) the amount of the partnership's income is not reasonably determinable nor highly likely to be available, and (iii) the service provider is subject to a "clawback" obligation, and it is reasonable to determine that the service provider could and would comply with that obligation.

Of particular relevance to hedge funds, the examples confirm that the amount of a partnership's income will not be considered reasonably determinable or highly likely to be available merely because the partnership's assets consist of marketable securities, so long as the allocation to the service provider is based on there being net profits with respect to the partnership's entire portfolio and it cannot be reasonably predicted whether such an overall net profit will be realized during the relevant period.

On the other hand, the examples show that a service provider generally may not be treated as being subject to significant entrepreneurial risk where: (i) the allocation is a priority allocation based on the income earned by the partnership during a specific and limited period of time (the example involves a 12-month accounting period), and (ii) a party related to the service provider that holds the profits interest (such as a related investment manager) has the power to sell or revalue the assets of the partnership in order to ensure there is sufficient net profit to make the allocation to the service provider. The preamble to the proposed regulations notes that the presence of each fact described in the examples is not necessarily required to determine that an arrangement is not disguised payment for services, and certain examples do reach favorable conclusions without the presence of a particular fact.

Helpfully, the preamble to the proposed regulations clarifies that "catch-up" allocations typically will not cause an arrangement to be treated as a disguised payment for services absent other factors indicating that the service-provider partner is not subject to entrepreneurial risk with respect to the allocation. Catch-up allocations are a common feature of private equity fund waterfalls under which, after the investors have received their priority return, the general partner receives a priority allocation of fund profits until an agreed-upon profit split between the investors and general partner is reached. It would seem that other arrangements involving priority allocations also generally should not be recharacterized under the proposed regulations as payments for services — for example, priority allocations of profits to partners that receive compensatory profits interests intended to quickly equalize their capital account balances with those of the other partners. However, partnerships that utilize such arrangements should review whether other factors are present that may implicate a presumption that the service partner is not subject to significant entrepreneurial risk, such as gross income allocations or allocations linked to specific limited time periods or transactions that do not depend on the overall success of the partnership's business.

Fee Waiver Arrangements

The proposed regulations also address fee waiver arrangements used by many private equity funds under which the fund manager may waive its rights to receive management fees otherwise owed by the fund while it, or an affiliate acting as the general partner of the fund, receives an additional profits interest in the fund. As a threshold matter, in order for a fee waiver arrangement to be respected under the proposed regulations as a tax-free grant of a profits interest, the service provider generally must waive its right to receive the fees before the relevant period to which the fee relates in a manner that is binding and irrevocable. In addition, the allocations made with respect to the profits interest must still be analyzed under the facts and circumstances test to determine whether the service provider is subject to significant entrepreneurial risk.

Notably, the preamble to the proposed regulations states that the IRS and Treasury believe that the existing safe harbor that permits the tax-free grant of profits interests in exchange for the provision of services to the partnership does not apply in situations where one party provides the services and another party receives an associated allocation or distribution of partnership income or gain. According to the IRS and Treasury, this type of arrangement does not meet the requirement under the safe harbor that the party that receives the interest in partnership profits also be the party that provides the services to the partnership. Private equity and hedge funds that utilize separate partnerships to provide management services to their funds and to serve as the general partner of their funds should consider the impact of this position on their fee waiver arrangements.

Furthermore, the IRS and Treasury stated in the preamble to the proposed regulations that they plan to issue guidance excepting from the profits interest safe harbor arrangements where a profits interest is issued in conjunction with a partner foregoing a "substantially fixed" payment for services. Accordingly, a fee waiver arrangement that does not comply with the new guidance could result in both the grant of the additional profits interest as well as the allocation of income with respect to the profits interest being treated as compensation income subject to tax as ordinary income to the recipient service provider.

The full text of the proposed regulations is available at http://www.gpo.gov/fdsys/pkg/FR-2015-07-23/pdf/2015-17828.pdf.