AN ALERT FROM THE BDO PRIVATE EQUITY AND TRANSACTION ADVISORY SERVICE PRACTICES

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SUBJECT

PROPOSED REGULATIONS ADDRESSING DISGUISED PAYMENTS FOR SERVICES LIKELY TO IMPACT MANAGEMENT FEE WAIVER ARRANGEMENTS

SUMMARY

Proposed Regulations under Internal Revenue Code ("IRC") Section 707(a)(2) issued on July 22, 2015 (Prop. Reg. Section 1.707-2) prescribe rules for characterizing an arrangement between a partnership and its partners as a disguised payment for services. If finalized, the regulations are likely to affect the tax consequences of many "management fee waiver" and "cashless contribution" arrangements common to the private equity, hedge fund and venture capital industries.

The proposed regulations contain two examples specifically focused on management fee waiver arrangements. In each example, the IRS concludes that the arrangements do not constitute a disguised payment for services under Section 707(a). However, the determinations rely on the existence of "significant entrepreneurial risk" within the arrangements. Many management fee waiver arrangements, as currently structured, may not satisfy this requirement.

Treasury also indicated that it intends to issue a revenue procedure providing an additional exception to the existing profits interest safe harbor under Revenue Procedure 93-27. The proposed modification would limit applicability of the safe harbor contained in Rev. Proc. 93-27 such that the safe harbor would not apply to situations where a profits interest is issued in conjunction with a partner forgoing payment of an amount that is substantially fixed for the performance of services. Additionally, the IRS has indicated that the existing the safe harbor would not apply to issuance of a profits interest to a party related to a service provider in exchange for the service provider waiving its fees.

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The proposed regulations would be effective on the date the final regulations are published in the Federal Register. However, in the case of any arrangement entered into or modified before the final regulations are published, the IRS indicated it will determine whether an arrangement is a disguised payment for services on the basis of the statute and legislative history. The IRS's position is that the proposed regulations generally reflect Congressional intent as to which arrangements are appropriately treated as disguised payments for services.

BDO OBSERVATIONS & NEXT STEPS

The proposed regulations and modifications to Rev. Proc. 93-27 are in large part a response to management fee waiver arrangements common in the private equity, hedge fund, and venture capital industries. In a typical fee waiver, a partner (or an affiliate of the partner) of an investment fund will waive its right to receive a fixed fee for investment management services and instead receive an interest in fund profits and corresponding distributions. If such a waiver is effective for income tax purposes, the partner may be able to defer recognition of income and convert its ordinary fee income into capital gains. The proposals provide guidance on the economic risk needed in order to achieve this tradeoff.

Taxpayers subject to these rules, e.g., fund managers and investment managers, should review existing management fee waiver arrangements and evaluate the potential impact of these proposed rules. To the extent existing arrangements lack significant entrepreneurial risk under the proposed rules, taxpayer's may want to consider modifying such agreements. Further, as taxpayers enter into new management fee waiver arrangements it is advisable to structure such arrangements in conformity with the proposed rules.

APPLICATION AND TIMING OF THE PROPOSED REGULATIONS

Under the proposed regulations, an arrangement otherwise characterized as an allocation and distribution will be treated as a disguised payment for services under IRC Section 707(a) if:

(i) A person (the "Service Provider"), either in a partner capacity or in anticipation of becoming a partner, performs services to or for the benefit of a partnership;

(ii) There is a related direct or indirect allocation and distribution to such Service Provider; and

(iii) The performance of such 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 determination is made at the time the arrangement is entered into or modified and without regard to whether the terms of the arrangement require the allocation and distribution to occur in the same taxable year. An arrangement that is treated as a payment for services under these rules is treated as a payment for services for all purposes of the Internal Revenue Code. The amount paid to a person in consideration for services under these rules is treated as a payment for services provided to the partnership, and, when appropriate, the partnership must capitalize these amounts (or otherwise treat such amounts in a manner consistent with their recharacterization). The partnership must also treat the arrangement as a payment to a non-partner in determining the remaining partners' shares of taxable income or loss.

The inclusion of income by the service provider and deduction (if applicable) by the partnership of amounts paid pursuant to an arrangement that is characterized as a payment for services under IRC Section 707(a) is taken into account in the taxable year as required under applicable law by applying all relevant sections of the Internal Revenue Code, including for example, sections 409A and 457A (as applicable), to the allocation and distribution when they occur (or are deemed to occur under all other provisions of the Internal Revenue Code).

FACTORS CONSIDERED UNDER THE PROPOSED REGULATIONS

Whether an arrangement constitutes a payment for services (in whole or in part) depends on all of the facts and circumstances. The proposed regulations provide a non-exclusive list of factors that may indicate that an arrangement constitutes a payment for services. The presence or absence of a factor is based on all of the facts and circumstances at the time the parties enter into the arrangement (or if the parties modify the arrangement, at the time of the modification).

An arrangement that lacks significant entrepreneurial risk constitutes a payment for services. An arrangement that has significant entrepreneurial risk will generally not constitute a payment for services unless other factors establish otherwise. For purposes of applying the proposed regulations, the weight to be given to any particular factor, other than entrepreneurial risk, depends on the particular case and the absence of a factor is not necessarily indicative of whether or not an arrangement is treated as a payment for services.

(1) The arrangement lacks significant entrepreneurial risk. 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. Facts and circumstances described below 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.

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.

MANAGEMENT FEE WAIVER EXAMPLES

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 includes the following facts and circumstances that taken together support the existence of significant entrepreneurial risk:

(1) The allocation to the service provider is determined out of net profits;

(2) The allocation is neither highly likely to be available nor reasonably determinable based on all facts and circumstances available at the time of the arrangement;

(3) The service provider undertakes a clawback obligation and is reasonably expected to be able to comply with that obligation; and

(4) The facts and circumstances do not otherwise suggest that the arrangement is properly characterized as a payment for services.

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.

MODIFICATIONS TO REVENUE PROCEDURE 93-27

In addition to the proposed regulations, Treasury announced plans to issue a revenue procedure providing for an additional exception to the safe harbor in Rev. Proc. 93-27. Rev. Proc. 93-27 provides that in certain circumstances if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of becoming a partner, the IRS will not treat the receipt of such interest as a taxable event for the partner or the partnership. 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, including a guaranteed payment under IRC Section 707(c) or a payment in a non-partner capacity under IRC Section 707(a).

The preamble also states Treasury's conclusion that transactions in which one party provides services, and another party receives a seemingly associated allocation and distribution of partnership income or gain does not meet the requirements of Rev. Proc. 93-27. 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 receipt of an interest in partnership profits in this case would not 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 as required under Rev. Proc. 93-27. The service provider would also be considered to have effectively disposed of the partnership interest (through a constructive transfer to the related party) within two years of receipt which is prohibited by the revenue procedure.