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Private Equity Alert

IRS and Treasury Release Proposed Regulations Addressing Management Fee Waiver Arrangements

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On July 22, 2015, the US Treasury and the IRS released proposed regulations under Section 707 of the Code addressing disguised payments for services. The proposed regulations, when finalized, would limit the use of management fee waiver arrangements that typically involve the sponsor of a private equity fund waiving its right to receive all or a portion of the management fee in exchange for a profits interest in the fund. In addition, the preamble to the proposed regulations indicates that profits interests issued in certain instances will not be protected by Rev. Proc. 93-27 and Rev. Proc. 2001-43, which generally provide a safe harbor that treats the receipt of profits interests as non-taxable.

Effective Date

The proposed regulations, once finalized, will apply to any management fee waiver arrangement entered into (or modified) on or after the date the final regulations are published. For these purposes, each periodic management fee waiver election (e.g., annual) by a sponsor would be viewed as a modification of such management fee waiver arrangement. Arrangements entered into, or modified, prior to the date the regulations are finalized are subject to existing law and legislative history. Notwithstanding the prospective effective date, both the US Treasury and the IRS are of the view that the proposed regulations generally reflect Congressional intent as to existing law.

Significant Entrepreneurial Risk

Whether a management fee waiver arrangement will be treated as a payment for services under the proposed regulations is based on all of the facts and circumstances. While the proposed regulations include a non-exclusive, six-factor list to help make that determination, the most important factor according to the IRS and the US Treasury is whether the allocation and distribution is subject to “significant entrepreneurial risk.” The proposed regulations look to a service provider’s entrepreneurial risk relative to the overall entrepreneurial risk of the partnership to determine if an arrangement meets this standard.

In addition, the proposed regulations identify the following five facts and circumstances that create a presumption that an arrangement lacks significant entrepreneurial risk (which can only be rebutted by clear and convincing evidence to the contrary):

- Capped allocations 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 (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., allocations of net profits from specific accounting periods that do not depend on the long-term future success of the enterprise); or
- 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.

The proposed regulations include six examples to help illustrate the application of these rules to circumstances that the IRS and the US Treasury believe demonstrate the presence or the absence of significant entrepreneurial risk. It is telling that in the two examples that include a clawback obligation the arrangement in each is found to create significant entrepreneurial risk. As a practical matter, if the proposed regulations were finalized as currently drafted, it appears that for an arrangement to satisfy these conditions, it must provide for an allocation and distribution out of net profits determined over the life of the fund, include a clawback obligation, and not provide an allocation that is either "reasonably determinable" in value or "highly likely" to occur.

Profits Interest Safe Harbor – Modifications to Revenue Procedure 93-27

Under Rev. Proc. 93-27, if a person acting in its capacity as a partner (or in anticipation of becoming a partner) receives a profits interest for the provision of services to or for the benefit of the partnership, then the IRS will not treat the receipt (or vesting) of the profits interest as a taxable event for the partner or the partnership. The "safe harbor" does not apply if: (1) the profits interest relates to a substantially certain and predictable stream of income, (2) the partner disposes of the profits interest within two years of receipt, or (3) the profits interest is a limited partnership interest in a publicly traded partnership.

The terms of management fee waiver arrangements can vary significantly. A typical arrangement permits the sponsor to elect on a periodic basis whether to waive a portion of the management fee in exchange for an additional profits interest. Sponsors generally take the position that such profits interests qualify for the safe harbor provided in Rev. Proc. 93-27 (as modified by Rev. Proc. 2001-43).

The preamble to the proposed regulations announces the IRS's current view that the safe harbor does not apply to a common variation of a management fee waiver arrangement where one party who provides services (e.g., the manager) is deemed to immediately transfer a profits interest it receives in connection with a management fee waiver to another party (e.g., the general partner) that ultimately receives an associated allocation and distribution of income or gain. In addition, the preamble provides that the IRS intends to modify the safe harbor to include an additional exception for profits interests "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 . . . ."

The proposed regulations and the modified approach to profits interests announced in the preamble to such regulations would effectively prevent the safe harbor from applying to profits interests issued in connection with many common management fee waiver arrangements. By excluding these profits interests from the safe harbor, many sponsors will need to consider the potential value of such profits interests before waiving future management fees.

Conclusion

The proposed regulations provide new insights and guidance with reference to the types of management fee waiver arrangements that the IRS and the US Treasury view as acceptable, but they also leave open a number of questions as to how certain elements will apply to the types of arrangements that are more common in the marketplace.

Accordingly, until regulations are finalized, sponsors that are considering:

(i) waiving future management fees or implementing new waiver arrangements,

(ii) issuing profits interests to a “special limited partner” (rather than the general partner) or

(iii) transferring profits interests (including to estate planning vehicles) within two years of receipt,

should consider the impact, if any, of the proposed regulations, including the guidance in the preamble that discusses safe harbor disqualification for certain profits interest transfers (or deemed transfers) within two years of issuance. With respect to sponsors that have already waived management fees in certain typical arrangements, regardless of whether or not the waived amounts have been invested, we would expect those sponsors to continue to invest in the same manner that they would have prior to the issuance of the proposed regulations as the investments contemplated by such arrangements do not appear to be within the scope of the proposed regulations.

Please contact us for advice that is specific to your situation. We would be happy to discuss any aspect of the foregoing and its potential impact on your organization.

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