Cooley

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On July 22, 2015, the Treasury Department and the IRS published proposed regulations (the "Proposed Regulations") that address the circumstances in which allocations or distributions made by a partnership to a partner that provides services to the partnership will be treated as disguised payments for services. This client alert is geared towards our private investment fund clients who often will implement management fee waiver, or "cashless contribution" arrangements that the Proposed Regulations, issued under Section 707(a)(2)[1], are intended to address. The Proposed Regulations, however, generally apply broadly to persons who provide services to partnerships (or limited liability companies taxed as partnerships).

The Proposed Regulations apply to all arrangements entered into or modified after the date of publication of the final regulations. The Proposed Regulations can be accessed here.

Background

In a standard management fee waiver arrangement, the manager of a private investment fund waives its entitlement to a portion of the management fees payable by the fund in exchange for an increased, "special" allocation of the fund's future profits to the general partner (often the waived fees are credited toward the manager's capital commitment to the fund, and are commonly referred to as "cashless contributions").

The purpose of the technique is two-fold. First, funds and their general partners commonly take the position that a general partner's increased allocations and distributions resulting from the waived management fee represent a distributive share of partnership income, thus converting what would be ordinary income—management fee—into a share of the fund's investment income—often long term capital gains. Second, the technique contains a deferral benefit as management fees are foregone and not paid in exchange for the corresponding taxable allocation of gain in a future year.

There has been some uncertainty in the tax law regarding whether such allocations and distributions should instead be treated as disguised payments for services under the disguised partnership transaction rules in Section 707(a). The Proposed Regulations confirm that certain management fee waiver arrangements will be respected as distributive shares of partnership income (not as disguised payments for services), and advise on the features of such acceptable arrangements; however, the Proposed Regulations also leave open many questions regarding whether fee waiver arrangements commonly used in the investment fund industry are acceptable.

Key takeaways

The Proposed Regulations have been long expected and are long overdue. We address some of the specific features of the Proposed Regulations below; however, the key takeaways for fund managers are as follows:

- More aggressive management fee waiver arrangements are clearly suspect (*e.g.*, those that provide for quarterly elections and allocations, those that use gross income allocations to fill up the general partner's capital account, and those where a management fee waiver is closely timed to a related allocation and distribution of profit to a general partner);
- It is possible that some more "middle-of-the-road" fee waiver arrangements may be subject to challenge, depending on the precise facts and circumstances;
- The IRS is more likely to respect management fee waiver arrangements that include a clawback feature; and
- Management fee waiver arrangements with the following features seem to be acceptable from the IRS's perspective:
    - a binding, irrevocable and clearly communicated waiver of fees executed at least sixty (60) days prior to the period during which the relevant services will be performed;
    - allocations solely out of net income;
    - allocations that are neither highly likely to be available or reasonably determinable based on facts and circumstances at the time of the waiver; and

- a clawback obligation requiring the general partner to return to the partnership distributions in respect of waived fees that exceed the fund's cumulative net profit over its entire term.

The Proposed Regulations

The Proposed Regulations generally apply a facts and circumstances test to management fee waiver arrangements, and identify six non-exclusive factors, to determine whether an arrangement constitutes a disguised payment for services. The most important factor is the determination of whether the arrangement lacks significant entrepreneurial risk. An arrangement that lacks significant entrepreneurial risk constitutes a disguised payment for services, regardless of the application of the remaining five factors to the arrangement. Such an arrangement results in ordinary income to the fund manager, rather than capital gains, as intended.

Whether an arrangement lacks significant entrepreneurial risk generally depends on whether there is a high likelihood that the service provider will receive an allocation regardless of the overall success of the business operation. The Proposed Regulations cite the following factors as indicators of a lack of significant entrepreneurial risk:

1. capped allocations of partnership income if the cap would reasonably be expected to apply in most years,
2. allocations for a fixed number of years under which the service provider's distributive share is reasonably certain,
3. allocations to the fund manager in exchange for waived fees out of gross (rather than net) income,
4. 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, and
5. arrangements in which a service provider either 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.

A management fee waiver arrangement with the features above does not have significant entrepreneurial risk in the IRS's view, and therefore would be recast as the payment of a fee to a fund manager.

The Proposed Regulations consider other secondary factors to determine whether an arrangement constitutes a disguised payment for services, including, among others, whether the arrangement provides for different allocations or distributions with respect to different services received from a single service provider (or certain related service providers) and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly. The facts and circumstances test applies at the time the parties enter into, or modify, the arrangement.

The Proposed Regulations contain several examples that illustrate the application of the facts and circumstances test to management fee waiver arrangements. Reinforcing the factors above, the examples consider:

- the timing of a management fee waiver;
- the existence of a clawback obligation in the event allocations and distributions in respect of a fee waiver arrangement exceed overall partnership net income over the partnership's term; and
- whether allocations are reasonably determinable or highly likely to be available based on all facts and circumstances available at the time of the waiver.

Although the IRS highlighted the importance of including a clawback obligation in management fee waiver arrangements, the Proposed Regulations do not provide any details regarding what the IRS perceives to be a well-structured clawback obligation. The Proposed Regulations do imply, however, that the clawback obligation should be calculated on the basis of net profits over the life of the fund, and that it should be reasonable to anticipate that the general partner is likely to comply with the clawback.

The Proposed Regulations also provide that to the extent allocations and distributions are recast as payments for services, such payments are subject to the deferred compensation rules contained in Sections 409A and 457A.

Conclusions and open questions

Although the examples in the Proposed Regulations establish the broad parameters of an acceptable management fee waiver arrangement, several open questions remain, including:

- Whether the special allocation can be a subset of net income (such as solely out of net long term capital gains);
- Whether a fund with targeted allocations can rely on the Proposed Regulations;
- Whether annual allocations of profit are sufficient to establish significant entrepreneurial risk; and
- Whether there is a distinction to be drawn between venture capital funds (where fund managers generally do not control exits) and private equity funds (where they may).

Due to the lack of specific guidelines in the Proposed Regulations, a prudent taxpayer may be advised to include a clawback feature and the other features of the management fee waiver arrangements the IRS seems to have approved.

We would be happy to discuss with you the impact of the Proposed Regulations on new or existing fund agreements and management fee waiver arrangements. Please contact any member of your Cooley team and we will get started.

NOTES

1. All Section references contained herein refer to the Internal Revenue Code of 1986, as amended, unless otherwise provided.

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