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Management Alert

Proposed Treasury Regulations Offer Guidance on Disguised Payments for Services

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Fee waivers by partners for services rendered to their partnerships will now be subject to scrutiny by the Internal Revenue Service (the "IRS"), pursuant to the Treasury Department's notice of proposed rulemaking (the "Notice") issued on July 22, 2015. The Notice contains proposed regulations (the "Proposed Regulations") relating to disguised payments for services under section 707(a)(2)(A) of the Internal Revenue Code (the "Code"). Under the Proposed Regulations, allocations of income to service-providing partners that lack "significant entrepreneurial risk" will be recharacterized as payments for services.

Most notably, arrangements in which a service-providing partner waives its rights to payment for the future performance of services in a manner that is non-binding will be presumed to lack significant entrepreneurial risk. This will make it more difficult for private equity funds to convert fees taxed at high ordinary income rates into gains taxed at lower capital gains rates that often applies to carried interests, unless the partners undertake a "clawback obligation" or otherwise arrange for the allocations to be subject to significant entrepreneurial risk.[1]

In addition, the Notice states that the Treasury intends to revise the current guidance relating to profits interests, to provide that a partnership interest issued in conjunction with a partner forgoing payment of a substantially fixed fee will not be treated as a profits interest.

Background - Code Section 707(a)(2)(A)

In 1984, Congress added section 707(a)(2)(A) to the Code, providing that "under regulations prescribed by the Secretary" certain partnership allocations and distributions related to transfers of property and performance of services between partners and partnerships, should be disregarded and instead be treated as "disguised sales" and "disguised payments for services." While final Treasury Regulations providing rules for implementing the "disguised sales" provision of Code section 707(a)(2)(A) were promulgated in 1992, no regulatory guidance relating to the "disguised payments for services" provision has existed until now.

In the absence of any such regulations, partnership agreements have provided for substantially fixed allocations of income (and associated distributions) to service-providing partners in arrangements that included capped allocations of partnership income, allocations of gross income, and arrangements whereby the allocation and distribution would be in exchange for non-binding waivers of fees. Because no implementing Treasury Regulations have been promulgated, these partnerships have taken the position that such allocations cannot be disregarded under Code section 707(a)(2)(A).

[1] See, e.g., Example 6 in the Proposed Regulations.

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The Proposed Regulations provide the rules which, if finalized, would finally implement the disguised payments for services provisions under Code section 707(a)(2)(A).

The Proposed Regulations

The Proposed Regulations provide a mechanism for determining whether an arrangement is a disguised payment for services. The Proposed Regulations apply both to arrangements relating to services provided by a person in a partner capacity or in anticipation of becoming a partner. The Proposed Regulations, however, merely provide a mechanism for determining when an arrangement is recharacterized as a disguised payment for services. The ultimate tax consequences of such recharacterization is based on other relevant provisions of the Code and judicial doctrines.[2]

While the determination of whether an arrangement is a disguised payment for services depends on all the facts and circumstances (as existing at the time the parties enter into, or modify, the arrangement), the Proposed Regulations provide the following non-exclusive list of six factors that are to be taken into account in making the determination:

1. The arrangement lacks significant entrepreneurial risk (as determined based on the service provider's entrepreneurial risk relative to the overall entrepreneurial risk of the partnership);

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; and

6. 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 time and manner required under applicable law as determined by applying all relevant sections of the Internal Revenue Code to the arrangement.

Of these factors, the most important is whether there is significant entrepreneurial risk in the arrangement. A payment arrangement that lacks significant entrepreneurial risk will be presumed to be a disguised payment for services; an arrangement that has significant entrepreneurial risk will generally not constitute a disguised payment for services, unless the other factors establish otherwise.

The Proposed Regulations set forth the following facts and circumstances that create a presumption that an arrangement lacks significant entrepreneurial risk:

- 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. if the partnership agreement provides for an allocation of net profits from

[2] While the Proposed Regulations do not directly address the issue, the Notice indicates that arrangements which have previously been reasonably characterized as guaranteed payments under Code section 707(c) should not be subject to the disguised payment for services rules.

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specific transactions or accounting periods and this allocation does 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.

Clear and convincing evidence would be needed to rebut the presumption of a lack of significant entrepreneurial risk created by the presence of any of these facts and circumstances.

The Proposed Regulations also contain examples to illustrate the application of these rules, many of which describe fairly common arrangements.

If enacted, the Proposed Regulations would apply to all arrangements entered into or modified after the promulgation of final regulations. To the extent that an arrangement permits a service provider to waive all or a portion of its fee for any period subsequent to the date the arrangement is created, then the arrangement is modified for purposes of this paragraph on the date or dates that the fee is waived.

In addition, the Proposed Regulations provide that in the case of any arrangement entered into or modified before the promulgation of final regulations, the determination of whether the arrangement is a disguised payment for services will be determined based on the statute and the guidance provided in the legislative history. This implies that the IRS may intend to challenge arrangements based on the statute itself, even in the absence of implementing Treasury Regulations.

Changes to the Profits Interest Rules

Rev. Proc. 93-27 provides that, subject to certain exceptions, a profits interest issued for the provision of services will not be treated as a taxable event for the partner or the partnership. Rev. Proc. 2001-43 further provides for circumstances under which a grant of a substantially non-vested profits interest to a service provider will be treated as having been received on the date of grant.

The Notice indicates that Treasury Department plans on making revisions to these safe harbor procedures relating to the issuance of profits interests by a partnership. Specifically, in conjunction with the publication of the Proposed Regulations in final form, the Treasury Department and IRS plan to issue a revenue procedure providing for an additional exception to these safe harbors for a profits interest issued in conjunction with a partner forgoing payment of an amount that is substantially fixed.

The Notice also states that the Treasury Department and IRS are aware of transactions in which a service provider waives a fee while a related party receives an interest in future partnership profits. The Notice states the Treasury Department and IRS have determined that Rev. Proc. 93-27 does not apply to such transactions.

Request for Comments

The Notice invites comments on all aspects of the Proposed Regulations. In particular, the Notice requests comments on (i) whether arrangements could exist which lack significant entrepreneurial risk, but should nevertheless be respected as allocations and distributions of distributive shares of income, (ii) sufficient notification requirements to effectively render a fee waiver binding, and (iii) specific issues and examples with respect to which further guidance would be helpful relating to allocations by a partnership with a targeted capital account agreement to a partner who has an increased right to partnership assets as determined as if the partnership liquidated at the end of the taxable year in the event that the partnership recognized insufficient net income.

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Initial Observations

The Proposed Regulations are designed to close, or at least narrow, a loophole that has allowed payments for services that generate ordinary income to be electively recharacterized as payments in respect of partnership interests, generally "carried interests" issued to service providers, which are intended to generate capital gains. Although carried interests have been the subject of some controversy and numerous legislative proposals, the Proposed Regulations do not affect their treatment *per se*, and they therefore generally remain subject to capital gains treatment. However, because the Proposed Regulations do establish limits on the ability of service providing partners and their partnerships to convert fee income into capital gain income, they indirectly serve to limit the applicability of carried interest treatment to payments made to partners.

The Proposed Regulations establish a "facts and circumstances" test for determining whether an arrangement is a disguised payment for services, and as such there is meaningful uncertainty in how the Proposed Regulations will be applied. Midstream waivers or conversions of payments that would have otherwise been paid as management fees are an easy case, and one that was plainly at the front of the minds of the regulators who wrote the Proposed Regulations. However, economic arrangements between fund managers and their investors can take many shapes and forms -- with a common trade-off point being the balance, from a business perspective, between the manager's lower risk "fee" income and higher risk, carried interest "return" income. Assuming the Proposed Regulations are adopted in their current form, there is a real risk that the IRS will use them to attack carried interests themselves by second-guessing non-abusive arrangements that make business and economic sense to managers and investors.

If you have any questions, please contact your Seyfarth attorney, Steven Meier at *smeier@seyfarth.com*, John Napoli at *jnapoli@seyfarth.com*, or Michael Rosenthal at *mrosenthal@seyfarth.com*.

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