Fund Management Fee Waivers Under Attack

By Peter A. Glicklich and Heath Martin

On July 23, 2015, the IRS published proposed regulations under Code Sec. 707(a)(2)(A)[1] that recharacterize certain allocations and distributions to a partner as disguised payments for services provided by the partner (the "Proposed Regulations").[2] The Proposed Regulations reflect the IRS's long-standing lack of comfort with the so-called management fee waiver arrangements often utilized by investment funds to reduce taxes on profits paid to investment fund professionals. While the Proposed Regulations—which are to be effective prospectively after they are finalized—are expected to have only a limited impact on foreign investors and fund managers, the impact on U.S. managers of all funds could be material.

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Background

A "management fee waiver," as described in the Proposed Regulations, is an arrangement in which the company that manages a fund's investments waives a portion of its management fee and, in exchange, the fund grants a priority profits interest to the entity that acts as the general partner of the fund. The general partner entity is usually indirectly owned by the same persons who control the management company, and accordingly the ultimate recipient of the management fee and the priority profits interest is often the same. The main difference between the two arrangements is that the management fee is generally characterized as ordinary income, whereas the holder of a profits interest in a fund structured as a partnership often receives an allocation of capital gain instead. Therefore, a management fee waiver can be a simple and form-driven mechanism for investment fund professionals to convert ordinary income into capital gain.

According to the preamble to the Proposed Regulations, the only downside to one of these arrangements is that, at least theoretically, there is some risk that the fund will not produce enough profit to pay distributions to the general partners with respect to the priority profits interest. In such a case, the management company would have waived its right to a portion of its fee without having the fee effectively paid back as a distribution with respect to the profits interest. In many cases, however, the risk that the waived fee will be lost is negligible.

The Proposed Regulations imply that some funds use special structuring techniques to reduce the risk that the waived fee will be lost while continuing to access a tax benefit through offsetting allocations. For instance, a fund could have the priority profits interest paid out of gross income, before deducting expenses, or the profits interest could be paid from a successful exit from an investment without offset for any losses. Unsurprisingly, the degree to which payments with respect to a profits interest are subject to a "significant entrepreneurial risk" is a major factor upon which the Proposed Regulations base the recharacterization of such payments as payments in respect of services.

Possible Cross-Border Impact

As described further below, the effect of the Proposed Regulations in the cross-border context can be even harsher than in purely domestic structures. A non-U.S. person who is a partner in a partnership that sells property generally receives allocations of foreign-source gain as a result,[3] whereas if that partnership performs services in the United States, the non-U.S. partner generally receives an allocation of U.S.-source ordinary income. Since a non-U.S. partner generally pays U.S. federal income tax on U.S.-source income, but not foreign-source income, non-U.S. partners may be able to escape U.S. federal tax entirely on an interest structured as a profits interest instead of a management fee under a typical management fee waiver arrangement.

Fund managers and their tax advisors will attempt to find fund structures that preserve the benefits of management fee waivers without running afoul of the Proposed Regulations or falling outside of the safe harbor of Rev. Proc. 93-27.

If a payment on a profits interest is recharacterized as a payment for services conducted within the United States, however, that payment may be taxed as ordinary income at a rate of up to 39.6 percent. If the recharacterization of the general partner's profit interest as income from services results in the general partner entity being considered to be engaged in a U.S. trade or business, even more of the general partner's income could become subject to the taxing jurisdiction of the United States.

If the partnership is not providing services in the United States, however, a recharacterization of a management fee waiver may have no adverse impact on a non-U.S. partner, despite the approach of the Proposed Regulations.

The effect of the Proposed Regulations on non-U.S. investors does not seem significant. Allocations with respect to a profits interest reduce the amounts of income and gain available for allocation to limited partners. If those amounts are recharacterized as compensation to the general partner, then the allocations to limited partners will still be reduced by a corresponding deduction.[4] Accordingly, a recharacterization of such allocations should not affect amounts allocated or distributed to limited partners.

Details of the Proposed Regulations

Code Sec.707(a)(2)(A) provides that, under IRS regulations, a transaction between a partnership and a partner will be characterized as between the partnership and a person who is not a partner, if "a partner performs services for a partnership or transfers property to a partnership, there is a related direct or indirect allocation and distribution to such partner, and the performance of such services (or such transfer) and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership." The Proposed Regulations provide a mechanism for determining when this standard is met.

Generally, under the Proposed Regulations, the question of whether a particular arrangement is a disguised payment for services depends on all the facts and circumstances. The Proposed Regulations provide that the following six circumstances, if present, weigh in favor of finding that a particular arrangement constitutes a payment for services (although the Proposed Regulations also provide that this list of factors is nonexclusive):

1. The arrangement lacks significant entrepreneurial risk.
2. The service provider holds, or is expected to hold, a transitory interest in the partnership or a partnership interest of only a short duration.
3. The service provider receives an allocation and distribution in a time frame comparable to the time frame that a nonpartner 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.
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 who are related and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly.

According to the Proposed Regulations, the first of these factors, whether an allocation and distribution to a partner is subject to "significant entrepreneurial risk," is to be given the most weight. Accordingly, an arrangement that lacks significant entrepreneurial risk constitutes payment for services, and an arrangement that has significant entrepreneurial risk generally does not constitute payment for services, unless the other factors establish otherwise.[5]

The Proposed Regulations provide additional guidance for evaluating this first and most important factor. Generally, a determination of whether a particular arrangement lacks significant entrepreneurial risk is based on the service provider's entrepreneurial risk in comparison to the overall entrepreneurial risk of the partnership. The Proposed Regulations list the following five features of an arrangement as characteristics of an arrangement *lacking significant entrepreneurial risk*:

1. a capped allocation of partnership income, if the cap is reasonably expected to apply in most years;
2. an allocation in one or more years under which the service provider's share of income is reasonably certain;
3. an allocation of gross income;
4. an allocation that is predominantly fixed in amount, is reasonably determinable 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. an arrangement in which a service provider waives its right to receive payment for the future performance of services in a manner that is nonbinding or fails to timely notify the partnership and its partners of the waiver and its terms.

Finally, the Proposed Regulations include six examples that illustrate the application of all of these factors to particular sets of facts. Most of these examples describe arrangements involving an investment fund that is obligated to pay management fees to a management company that is related to the general partner of the fund.

Generally, the examples show that an arrangement is comparatively more likely to be respected by the IRS if allocations are based on *net* profits over the life of the fund *and* distributions are subject to a "clawback" obligation. On the other hand, an arrangement is more likely to be recharacterized as a payment for services if allocations are based on the fund's gross income or net income during a particular period or if the allocations are capped.

For instance, Example 3 discusses a management company that holds a one-percent interest in a fund that entitles the management company to receive a priority allocation of gain from the sale of fund assets within a 12-month accounting period in an amount intended to approximate a normal management fee. The general partner of the fund controls the management company and, in addition, directs all of the operations of the fund, including decisions regarding when to buy or sell assets and when to make distributions, to the management company. The general partner is entitled to 10 percent of the fund's profits but is subject to a "clawback" obligation in the event that the fund distributes too much to the general partner.

Example 3 concludes that the arrangement with respect to the management company is a disguised payment for services because the arrangement lacks significant entrepreneurial risk. This conclusion is based on the fact that the priority allocation to the management company is based on the fund's gains during a particular 12-month accounting period and not on the overall success of the enterprise, and moreover the general partner, a party related to the management company, is in control of when and how those gains are realized.

In contrast, Example 3 concludes that the arrangement with respect to the general partner is *not* a disguised payment for services because the arrangement creates significant entrepreneurial risk for the general partner in that the allocation to the general partner is based on the profits over the life of the fund and is backed up by a clawback obligation. Accordingly, the allocation is not considered reasonably determinable or highly likely to be available and is therefore subject to significant entrepreneurial risk. Therefore, the general partner's profits interest is not recharacterized as a payment for services.

Related Guidance

In addition to the analysis based on significant entrepreneurial risk as embodied in the factors described above, the preamble to the Proposed Regulations describes additional guidance that will be issued in this area in the future. As noted above, a management fee waiver arrangement involves the issuance of additional profits interests to the general partner of a fund in exchange for a waiver by an affiliated management company of its management fee. The characterization of the grant of a profits interest in a partnership as the transfer of an equity interest instead of a payment of compensation has been the subject of a long history of case law and other historical IRS guidance.[6] Taxpayers such as fund managers and general partners of funds have relied on a safe harbor in Rev. Proc. 93-27,[7] the IRS's seminal pronouncement on this issue, to claim that the grant of a profits interest in a fund is not a taxable event.

This safe harbor provides that the receipt of a profits interest is not taxable as long as: (i) the profits interest does not relate to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (ii) the partner does not dispose of the profits interest within two years of its receipt; and (iii) the profits interest is not a limited partnership interest in a publicly traded partnership.[8]

The preamble to the Proposed Regulations states that the safe harbor in Rev. Proc. 93-27 does not apply to transactions where one party provides services and another party receives a seemingly associated allocation and distribution of partnership income or gain because such an arrangement is really a grant of a profits interest to the service provider immediately followed by a transfer of the interest to another party in violation of the second requirement in the Rev. Proc. 93-27 safe harbor. The IRS believes that such transactions include a standard management fee waiver arrangement, where the general partner of a fund receives a profits interest in exchange for the management company's waiver of fees. In addition, the IRS plans to issue a revenue procedure providing an exception to the Rev. Proc. 93-27 safe harbor—under this forthcoming exception, an interest in a partnership that is issued in conjunction with a partner forgoing a right to a substantially fixed payment will no longer be eligible for the safe harbor.

It is important to note that this forthcoming guidance is separate from the rules regarding significant entrepreneurial risk and the applicable factors described above. If a profits interest issued in exchange for services does not qualify for the safe harbor provided in Rev. Proc. 93-27, then the taxation of that grant of an interest will depend on an uncertain body of case law. The IRS is likely to argue that the case law applies regardless of whether the interest lacks significant entrepreneurial risk. Under the case law, a transfer of a profits interest with a determinable value in exchange for services can be treated as compensation.

The Proposed Regulations and the forthcoming guidance announced in its preamble attack management fee waiver arrangements on two fronts: through the facts-and-circumstances test that applies to arrangements involving a partner that provides services to a partnership, and through the guidance concerning the safe harbor in Rev. Proc. 93-27, which applies generally to grants of a profits interest in exchange for services. These provisions are likely to provide an effective tool for the IRS to combat a tax strategy that, until now, has provided a relatively easy device for managers and general partners of investment funds to shield a significant amount of income from U.S. federal income tax.

The Proposed Regulations will generally be effective on the date the corresponding final regulations are published in the Federal Register. However, since the IRS has taken a position on existing law in the preamble to the Proposed Regulations, *i.e.,* that the profits interest safe harbor of Rev. Proc. 93-27 does not apply to situations where a service provider and recipient of the profits interest are different persons, there is no legal reason why the IRS cannot advance that position against existing arrangements.

Further Consideration of Cross-Border Issues

Generally, non-U.S. persons who are not engaged in a trade or business within the United States are only taxed by the United States on their U.S.-source income. Accordingly, the U.S. federal income taxation of non-U.S. service providers depends on the source (as determined under U.S. federal income tax rules) of their services income. For U.S. federal income tax purposes, the source of services income is the location where the services are performed.[9] In the case of services provided by an entity classified as a partnership for U.S. federal tax purposes, the resulting income is sourced at the partnership level.[10] Accordingly, if a partnership performs services within the United States, the income allocated to the partners should be U.S.-source income, regardless of whether the partners provided services within the United States.[11]

Unlike income from services, gains from the sale of personal property are generally sourced according to the residence of the seller,[12] so non-U.S. taxpayers are generally not subject to U.S. federal income tax with respect to gains on the sale of personal property located in the United States, including stock in a portfolio company or other securities. Two major exceptions to this rule are relevant to cross-border investment funds. First, gains that are effectively connected to a U.S. trade or business are taxed on a net basis at graduated tax rates, much like the income of a U.S. taxpayer. Second, gains from the sale of U.S. real property interests are taxable to non-U.S. taxpayers as if they were effectively connected to a U.S. trade or business, regardless of whether the non-U.S. taxpayer is actually engaged in such a business.

Generally, the source of income realized by a partnership is sourced with reference to the residence of the partnership. Gains from the sale of property by a partnership, however, are sourced at the partner level.[13] Accordingly, as noted above, a non-U.S. partner in a partnership that provides services within the United States receives an allocation of U.S.-source services income regardless of whether the non-U.S. partner was ever physically present in the United States. On the other hand, a non-U.S. partner in a partnership that sells personal property in the United States generally receives an allocation of foreign-source gain, which is not subject to U.S. federal income tax unless the gain is effectively connected to a U.S. trade or business, the gain is from the sale of a U.S. real property interest or some other exception applies.

As suggested above, the impact of the Proposed Regulations (and the position on Rev. Proc. 93-27 taken in the preamble) can be especially harsh in the cross-border context if a fund manager would be taxable on service fees but not on an allocation from an underlying partnership. For non-U.S. general partners, the new rules could have the effect of converting income that was previously not taxable in the United States at all into compensation income that is fully taxable in the United States. Moreover, if allocations and distributions from a fund to a general partner are recharacterized into payments for services, then the general partner of fund could be considered to be engaged in any U.S. trade or business that the fund is engaged in. In such a case, other income of the general partner could be subject to U.S. federal income tax as well.

Investment funds that implement management fee waiver arrangements are not likely to have non-U.S. general partners. However, since most investment fund structures use a flow-through entity as the general partner, the new rules are likely to affect non-U.S. individuals or entities that are holders of indirect interests in a general partner entity and, accordingly, the fund itself.

A non-U.S. individual who holds direct or indirect interests in a general partner entity that is classified as a flow-through entity for U.S. federal tax purposes receives taxable allocations that reflect items of income, gain, loss and deduction that originate in the corresponding investment fund. If the general partner has received a profits interest in the fund as part of a management fee waiver arrangement, then income allocations with respect to that profits interest will flow up to the non-U.S. individual. If most of the income of the fund takes the form of gains from the sale of the fund's investments (and not U.S. real property interests or income effectively connected to a U.S. trade or business), then the fund allocations that flow up to the non-U.S. individual will retain their characterization as foreign-source gain from the sale of personal property.

Under applicable provisions of the Code, gains from the sale of personal property are generally treated as foreign-source income when realized by a non-U.S. person, and non-U.S. persons who are not engaged in a U.S. trade or business are only taxed by the United States on U.S.-source income. The net effect is that a non-U.S. person with a direct or indirect interest in the general partner of a fund can receive income from the fund with respect to that general partnership interest free of U.S. federal income tax (other than gains with respect to real property located within the United States, which are taxed under FIRPTA or gains that are effectively connected to a U.S. trade or business).

If, as provided in the Proposed Regulations, allocations and distributions from a fund with respect to a profits interest are recharacterized as income in respect of services, then the non-U.S. partner is no longer sheltered from U.S. taxation. As described above, services income, unlike gain from the sale of property, is sourced based on the location where the relevant services are performed. Accordingly, if the general partner of the fund is treated as performing services within the United States, then the resulting allocations of income to the non-U.S. partner will be U.S.-source services income, which is taxable at ordinary income rates up to 39.6 percent.

If the general partner is treated as a service provider, then it is likely to also be treated as engaged in a U.S. trade or business. In such a case, the U.S. trade or business is attributed up to the ultimate owners of the interests in the general partner entity, including any non-U.S. individuals. Moreover, if a general partner entity is engaged in a U.S. trade or business, then it is possible that its assets will be treated as held in connection with that trade or business, and accordingly, other income of the general partner, and not just income with respect to the priority profits interest, may be treated as effectively connected with that trade or business. Effectively, the general partner entity is no longer a passive investor in the fund, but a second management company.

If the IRS were successful in asserting these positions, then the non-U.S. holder of an indirect interest in the fund's general partner would no longer enjoy distributions with respect to that interest free of U.S. federal income tax.[14] In fact, if the general partner is treated as engaged in a U.S. trade or business, all of the non-U.S. individual's income relating to his or her interest in the general partner entity could end up being either services income or income effectively connected with a U.S. trade or business—all of which is taxed in the United States.

Some relief may be available if the non-U.S. person qualifies for the provisions of a tax treaty between the United States and the non-U.S. person's home country. For instance, such tax treaties usually require non-U.S. service providers to be present in the United States for a minimum number of days before they can be taxed on U.S.-source services income and provide that non-U.S. persons are not treated as being engaged in a U.S. trade or business unless they have a permanent establishment in the United States. The availability of these provisions is subject to other limitations, however, and each tax treaty implements these provisions differently.

The effect of the Proposed Regulations on non-U.S. fund managers may be severe. The impact of the Proposed Regulations on foreign investors, however, is more difficult to evaluate. Investors are generally indifferent with regard to management fee waiver arrangements from a tax perspective because the amount remaining for investors is the same regardless of whether fees are paid directly to the management company or whether fees are paid to the general partner as a priority distribution of profits. Accordingly, there may be no significant tax effects of fee waivers to non-U.S. investors.[15]

Conclusion

Fund managers and their tax advisors will attempt to find fund structures that preserve the benefits of management fee waivers without running afoul of the Proposed Regulations or falling outside of the safe harbor of Rev. Proc. 93-27. The new guidance, however, represents a major land grab by the IRS. A facts-and-circumstances approach like the one used in the Proposed Regulations provides little guidance to taxpayers while maximizing the IRS's ability to apply the related rules to new structures. Any limits on the potential recharacterization of partnership allocations and distributions into services income under the new rules will have to be hammered out in additional guidance and, possibly, in the courts.

In addition, the IRS's use of the preamble of the Proposed Regulations as a way to reinterpret existing guidance may disqualify already existing arrangements from reliance on the Rev. Proc. 93-27 safe harbor. Ordinarily, the public would be given an opportunity to comment on such a significant re-interpretation of existing law, and effective dates would be set to give taxpayers notice and the ability to restructure their affairs. In this case, the IRS has dispensed with such procedures.

Ultimately, the Proposed Regulations reveal how aggressive the IRS has become in pursuing arrangements that it believes to be abusive. The effects on non-U.S. partners of general partner entities underscore the level of this aggression. Such partners are faced with what could be a 180-degree shift in their U.S. federal tax liability with respect to their interests in an investment fund.

ENDNOTES

1 References to Code Sec. in this article refer to sections of the U.S. Internal Revenue Code of 1986, as amended (or, the "Code").

2 REG–115452–42, 80 FR 43,652 (July 23, 2015).

3 If the underlying property is a U.S. real property interest or if the partnership is engaged in a U.S. trade or business, then the non-U.S. partner should receive an allocation of income that is effectively connected to a U.S. trade or business, which is taxed on a net basis at graduated rates. In addition, other provisions of the Code may cause gain from the sale of property to be U.S.-source income instead of foreign-source income.

4 The Proposed Regulations provide rules for determining when a particular arrangement is recharacterized a disguised payment for services, but, surprisingly, little detail is provided regarding the effects of such recharacterization. For instance, no guidance is given regarding whether, in the investment fund context, a disguised payment for services would be a deductible compensation expense or whether it would be an investment expense subject to the two-percent floor for miscellaneous itemized deductions. If a non-U.S. limited partner is otherwise subject to U.S. federal income tax, a recharacterization under the Proposed Regulations could lead to deductions that are not subject to the two-percent floor, which would represent a tax benefit for such a limited partner.

5 According to the Proposed Regulations, the weight to be given to the 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 recharacterized as a payment for services.

6 *See, e.g.*, Rev. Proc. 2001-43, 2001-2 CB 191; Rev. Proc. 93-27, 1993-2 CB 343; *W.G. Campbell*, CA-8, 91-2 USTC ¶50,420, 943 F2d 815 ; *S. Diamond*, CA-7, 74-1 USTC ¶9306, 492 F2d 286.

7 Rev. Proc. 93-27, 1993-2 CB 343.

8 Rev. Proc. 93-27, 1993-2 CB 343, at §4.02.

9 Code Sec. 861(a)(3). Many tax treaties provide some relief from this rule for eligible service providers. For instance, under the U.S.–Canada tax treaty, a Canadian service provider is not taxed by the United States on compensation for services performed in the United States if (i) the amount of that income does not exceed $10,000, or (ii) the service provider is not present in the United States for more than 183 days in an applicable 12-month period and the compensation is not paid by or on behalf of a resident of the United States or borne by a Canadian resident's permanent establishment in the United States.

10 *See* Code Sec. 875(1).

11 *See* Rev. Rul. 67-158, 1967-1 CB 188.

12 Code Sec. 865.

13 Code Sec. 865(i)(5).

14 Assuming that the fund does not hold U.S. real property interests or is otherwise engaged in a U.S. trade or business.

15 But *see* the discussion of miscellaneous itemized deductions in endnote 4, above.