Understanding Targeted Allocations (PowerPoint)

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Proposed Regulations on Management Fee Waivers

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Introduction

• On July 22, 2015, the Treasury Department and the IRS released proposed regulations that would, if adopted, substantially curtail the use of management fee waivers. Generally, the regulations would characterize many of these arrangements as disguised payments for services.

• While the proposed regulations are aimed at management fee waivers, the scope of the proposed regulations is broad and could affect the taxation of certain grants of profits interests more generally.

• The regulations are proposed to be effective when final regulations are published. However, the preamble to the proposed regulations states that pending publication of final regulations, the position of the Treasury Department and the IRS is that the proposed regulations generally reflect Congressional intent as to which arrangements are appropriately treated as disguised payments for services.
Private equity funds (including venture capital funds) are pools of capital that make investments in private companies ("Portfolio Companies"). The majority are structured as limited partnerships (some are structured as LLCs).

The fund sponsors are the general partners ("GPs") and the investors (typically institutional investors or high net worth investors) are the limited partners.

The GP typically receives three sources of income from the fund:

- A 20% (or perhaps higher) share of overall profits (the "Carried Interest")
- A right to share in profits and losses from the fund based on the GP’s required capital contribution (typically 1% but often at least 3% of overall capital contributions) (the "Capital Interest")
- A management fee (typically 2% of capital commitments). This is often received by a separate management company owned by the same persons (the "Principals") that own the GP.
The market has evolved to require the GP to increase its Capital Interest or “skin in the game.”

Typically the GP would receive a management fee pay ordinary income tax on that income, and then use after tax income to make its capital contributions with respect to their Capital Interests. This was tax inefficient and very often could lead to cash flow issues for the GP and the Principals.

As a result, parties started implementing the management fee waiver mechanism. The basic idea is the GP (or the management company) waives all or a portion of the management fee in exchange for a special allocation of the fund’s future profits. The GP’s cash commitment with respect to the Capital Interest is reduced by the amount of the waived fee. This effectively allows the GP to make capital contributions on a pre tax basis. Moreover, the allocation typically is of long term capital gain (or qualified dividend income), so the GP converts ordinary income into long term capital gain.
Two most common forms are of management fee waivers are:

- Pure management fee waivers pursuant to which the special profit allocation cannot exceed the amount of the waiver management fee. For example, if the GP waives $1 million of management fees, it eventually will receive a special allocation of profits capped at $1 million.

- “Cashless contributions” pursuant to which the amount of waived management fee is treated as a deemed investment by the GP in the fund relating to a particular Portfolio Company. This deemed investment has the potential to earn the same return (or suffer the same loss) as cash investments made by the Limited Partners in such Portfolio Company. For example, assume the $1 million in the prior example is deemed invested in Portfolio Company A. The GP would receive future profits (if available) equal to (a) the $1 million deemed investment plus or minus (b) the profits and losses deemed earned by the GP from its investment in Portfolio Company A.
The theory supporting the management fee waiver arrangement is that the waiver results in a bona fide allocation because the right to be allocated sufficient profits (and receive corresponding distributions) is subject to significant entrepreneurial risk. Note that if there are not sufficient profits, the GP will not receive its waived management fee (and the profits or losses thereon in the case of a cashless contribution).

IRC Section 707(a)(2)(A) attempts to distinguish between bona fide partnership allocations and disguised payments for services. In particular, if a partner performs services for a partnership, there is a related allocation and distribution to such partner, and the performance of services and the related allocation and distribution are properly treated as a disguised payment for services, then the transaction is treated as such. The legislative history to IRC Section 707(a)(2) says that the most important factor in determining whether the transaction would be respected as an allocation or treated as a disguised payment for services is whether the payment is subject to significant entrepreneurial risk.
Perceived Abuses of Management Fee Waiver

• GPs were structuring the waiver to maximize the likelihood that there would be sufficient profits to match the future allocation. Examples include:
  – Allocations made solely out of gross income
  – A special allocation of profits earned by the fund in a particular tax year, even if the fund did not earn profits on an overall basis.

• For example, assume the GP waives a $1 million management fee on formation of the fund. Assume the fund loses $1 million per year in each of years 1 through 3. In year 4 the fund makes $1 million in profit, which is specially allocated on a priority basis to the GP. Overall, the fund has lost $2 million, but is able to allocate $1 million of profits to the GP solely in respect of year 4.
  – These practices generally meant there was little economic risk that the future allocation would not be paid. As discussed below, the proposed regulations address these and other perceived abuses.
The carried interest and the management fee waiver mechanism each is a form of “profits interest.” A profits interest entitles its holder to future profits and appreciation in partnership assets. For example, if an existing partnership worth $100 grants a service provider a 10% profits interest, and the partnership sells its assets for $100, the service receives gets $0.

The tax treatment of a profits interest is addressed in Revenue Procedure 93-27. Generally, under Rev. Proc. 93-27, the service provider is not taxed on receipt of the profits interest issued in exchange for services performed or to be performed to or for the benefit of a partnership. The service partner is treated as a partner, and if the partnership ultimately realizes long term capital gain on sale of its assets, the service provider is taxed at favorable long term capital gains rates.

Revenue Procedure 93-27 does not apply if:

- the profits interest relates to a substantially certain and predictable stream of income from partnership assets;
- within two years of receipt, the partner disposes of the profits interest; or
- the profits interest is a limited partnership interest in a publicly traded partnership.

As discussed below, the preamble to the proposed regulations proposes to issue a new exception from Rev. Proc. 93-27 where the profits interest is issued in connection with a partner foregoing payment of a substantially fixed amount. The preamble also says the IRS intends to deny the safe harbor in other common situations (e.g. where one party waives the management fee and a related party receives the allocation). While these exceptions are focused on the management fee waiver arrangements, they potentially have broader application.
The Proposed Regulations
In determining whether a fee waiver arrangement will be treated as a disguised payment for services, in whole or in part, the Proposed Regulations adopt a facts and circumstances test.

Under this test, if a fee waiver lacks significant entrepreneurial risk ("SER"), the fee waiver will be taxed as an ordinary income payment for services to the recipient.

On the other hand, if there is real economic risk as to the amount of any future allocation, then the arrangement, as a general matter, may have SER and the prospect of future capital gain treatment.
The Proposed Regulations adopt a new six non-exclusive factor test to determine whether an arrangement constitutes a disguised payment for services.

- The first of the six factors – SER – is accorded the most weight in the analysis.
- As a result, arrangements without SER essentially automatically qualify as disguised payments for services as opposed to distributive shares of income.
- Whether an arrangement lacks SER is based on the service provider’s entrepreneurial risk relative to the overall entrepreneurial risk of the partnership.
**Significant Entrepreneurial Risk ("SER")**

- Certain arrangements are presumed to lack SER because they are highly likely to provide the service provider with an income allocation regardless of the overall success of the business operation:
  - Capped allocations where the cap is reasonably expected to be reached
  - Allocations for a fixed number of years
  - Allocations of gross income items
  - Certain allocations predominantly fixed in amount and reasonably determinable
  - Certain arrangements where the service provider waives rights to a payment for future services

- Arrangements suggesting that a SER exists:
  - Future allocation is based on net profits
  - Future allocation is subject to a clawback obligation
  - Recipient is reasonably likely to comply fully with any repayment responsibilities
  - Future allocation is not certain to be available nor reasonably determinable at the time of the arrangement
**Significant Entrepreneurial Risk ("SER")**

- **“Catch-up” Allocations**
  - A “catch-up” allocation is a disproportionate allocation of income or gain to a service provider to “catch the service provider up” to a proportionate capital account position.
  - For example, a service provider may receive a 10% profits interest with a $0 capital account and allocations of 100% of future gain until the service provider’s capital account ultimately equals 10% of the capital accounts of all partners.
  - Preamble to Proposed Regulations states that catch-up allocations generally will not lack SER.

- **Treatment of “Greater-of” Situations**
  - Under existing regulations, if a partner is entitled to an allocation of the greater of 30% of partnership income or a minimum guaranteed amount, the entire allocation qualifies as a distributive share of income if it exceeds the minimum guaranteed amount.
  - The Proposed Regulations will change this result by providing that the entire minimum guaranteed amount is treated as a guaranteed payment regardless of whether the minimum guaranteed amount is reached.
Secondary Factors

• The Proposed Regulations also provide additional factors of secondary importance in determining whether an arrangement constitutes a payment for services.
• The weight given to each of these factors depends on the particular case and the absence of a particular factor is not determinative.
• Additional Factors of Secondary Importance include:
  – Transitory holdings of a partnership interest
  – Time frame for allocation and distribution mirrors the time frame within which a non-partner service provider would typically receive payment
  – Service provider becomes a partner primarily to obtain tax benefits which otherwise would not be available
  – Value of service provider’s interest in continuing profits is small in relation to the allocation and distribution
  – Certain arrangements providing for (i) different allocations or distributions for different services received where (ii) the services have differing levels of entrepreneurial risk and are provided by the same person or related parties
The Preamble to the Proposed Regulations states that the IRS is likely to issue new guidance for applying Rev. Proc. 93-27.

Specifically, the new guidance will add a fourth exception for profits interests issued in connection with a partner foregoing a payment.

In addition, the new guidance is likely to remove from the safe harbor under Rev. Proc. 93-27 all profits interests where one party provides services and a related party receives a seemingly associated profits interest.

For example, if a management company providing services for a fee waives the fee while a related party receives a profits interest the value of which approximates the amount of the waived fee, Rev. Proc. 93-27 is likely to not apply in the future.
Examples
An investment partnership acquires a portfolio of assets that are neither readily tradable nor readily valued. M performs services for which a fee would normally be charged. Instead of receiving a fee, M contributes $500,000 for (i) a 1% interest in partnership capital and profits and (ii) a priority allocation and distribution of net income from a sale during any 12 month period in which the partnership has overall net gain in an amount intended to approximate the charge for M’s services.

The GP, who controls M directs partnership operations, causes the partnership to buy and sell assets during any period; and controls the timing of distributions.

GP will be allocated 10% of any net profits and losses of the partnership earned over the life of the partnership. A clawback obligation is in effect and GP is expected to comply fully with repayment obligations.
Proposed Regulations (Example 3)

- M’s arrangement is treated as a disguised payment for services as opposed to a distributive share of partnership income because (i) the amount of net income that will be allocated to M is highly likely to be available and reasonably determinable based on all the facts and circumstances at the time of partnership formation; and (ii) the allocation to M does not depend on the overall success of the partnership.

- GP’s arrangement, however, will qualify as a distributive share of income and will not be recharacterized as a disguised payment for services.

- The GP’s arrangement has SER because the allocation is out of net profits earned over the life of the partnership and subject to a clawback obligation with which the GP is reasonably expected to comply.
Proposed Regulations (Example 6)

- GP in ABC partnership is responsible for providing services to ABC but has delegated its responsibilities to M (a company controlled by GP). GP is entitled to 20% of future ABC net income and gains measured over ABC’s life. Amount is neither highly likely to be available nor reasonably determinable based on facts & circumstances available upon ABC’s formation. GP undertakes a clawback obligation and is expected that GP could & would comply fully with any such repayment obligations.

- M is entitled to 2% annual fee from committed capital. If M waives irrevocably its annual fee 60 days before the beginning of the partnership taxable year, ABC will issue to M a profits interest for the year in the amount of the estimated value of the fee. Amount of net income or gains allocable to M is neither highly likely to be available nor reasonably determinable based on facts and circumstances of ABC.
Proposed Regulations (Example 6): Analysis

• Do the facts and circumstances suggest the presence or absence of SER?

• The allocations to A and M do not presumptively lack SER under the proposed regulations.

• M waives the right to a fee before the period begins, the allocations are based on net profits, the allocations are subject to a clawback obligation over the fund’s life and A and M are expected to comply fully with this obligation, and the allocations are neither reasonably determinable nor highly likely to be available.

• Accordingly, arrangements have SER qualify as distributive shares of income as opposed to disguised payments for services.
In a surprising move, the Treasury and the IRS also addressed issues with preferred interests and targeted capital account arrangements in the Preamble to the Proposed Regulations.

In short, the Preamble seems to express a tentative view and requests comments on the treatment of preferred interests in certain targeted capital account arrangements where the preferred returns attributable to those interests for the year exceed partnership net income for the year.

For example, if the preferred return allocable to a preferred interest holder equals $10 while the net income of the partnership equals only $8, is the additional $2 of preferred return over and above net income ignored, treated as an allocation of gross income or treated as a guaranteed payment?

Note that this issue does not arise if the partnership liquidates based on partner capital accounts.
Effective Date

• The Proposed Regulations are not effective until the final regulations are published and would apply only to arrangements entered into or modified on or after such date.

• Nevertheless, the Preamble provides that “pending the publication of final regulations, the position of the Treasury Department and the IRS is that the proposed regulations generally reflect Congressional intent as to which arrangements are appropriately treated as disguised payments for services.

• Will the IRS begin reviewing arrangements through the lens of these Proposed Regulations despite their stated effective date or are the Proposed Regulations intended only to create a “chilling effect”?

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