

# Proposed Treasury Regulations Would Affect Management Fee Waiver Arrangements

The U.S. Treasury Department and the Internal Revenue Service (the "IRS") recently released proposed regulations (the "Proposed Regulations") that, if enacted, would set forth guidelines for determining whether certain partnership allocations should be recharacterized as payments for services. The preamble to the Proposed Regulations also announced that the IRS intends to limit the application of certain guidance under which grants of partnership profits interests are not treated as taxable events to the recipient of the partnership interest, or the partnership.

The Proposed Regulations would apply to all arrangements under which a service provider performs services that benefit a partnership, and receive a related direct or indirect allocation and distribution from the partnership. However, the Proposed Regulations focus particularly on arrangements whereby an investment fund manager receives a partnership profits interest in lieu of receiving management fees.

The Proposed Regulations set out various factors for determining whether allocations and distributions in lieu of waived management fees will be recharacterized as compensation, and include various examples. The primary factor in the determination will be whether the partnership profits interest granted to the service provider reflects significant entrepreneurial risk relative to the overall entrepreneurial risk of the partnership, and the Proposed Regulations provide indicia that create a rebuttable presumption the partnership interest lacks significant entrepreneurial risk.<sup>1</sup>

## The examples in the Proposed Regulations highlight that:

- An arrangement whereby waived management fees may be recovered out of net gain from the sale of any one or more assets during any accounting period, or out of "book ups" in the value of partnership assets, will likely be recharacterized as compensation, in circumstances where the partnership invests in illiquid assets, and the fund manager or an affiliate controls

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<sup>1</sup> Once such indicia is 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 partnership, including the timing of asset dispositions, "book ups" and other events affecting the value of the partnership assets.

- An arrangement whereby waived management fees may be recovered only out of net profits realized over the life of the partnership, and any distribution of waived management fees made during the life of the partnership is subject to a "clawback" to the extent there is insufficient profits over the life of the partnership, normally will not be recharacterized as compensation.

The preamble to the Proposed Regulations states the position of the IRS that arrangements whereby an investment fund manager waives management fees, but a separate, related entity receives the corresponding profits interest, will not qualify for the safe harbor in Rev. Proc. 93-27, under which grants of partnership profits interests made to a service provider will not be treated as a taxable event to the service provider or to the partnership. This position is based on the limitation in Rev. Proc. 93-27 that the service provider not dispose of the partnership profits interest within two years of receipt, and the position of the IRS that the grant of the partnership profits interest to a related entity is a deemed disposition.

The preamble to the Proposed Regulations also announces that a new limitation will be added under which Rev. Proc. 93-27 will not apply to a profits interest granted in conjunction with a partner foregoing payment of a substantially fixed or determinable amount for the performance of services. In circumstances where Rev. Proc. 93-27 does not apply, there nevertheless may be an argument that a service provider receiving a partnership profits interest with only speculative value at the time of grant (or at the time of subsequent vesting if a Section 83(b) election is not made) should be treated as having no compensation income.

The Proposed Regulations would apply to arrangements entered into or modified on or after the date of publication of final regulations. For this purpose, it is likely that waivers of management fees effected after the publication of final regulations would be treated as modifications that cause the relevant management fee waiver provisions to be subject to the final regulations. The preamble to the Proposed Regulations also states that pending the publication of final regulations, the IRS takes the position that the Proposed Regulations generally reflect the manner in which Congress intends the existing statutory provisions regarding disguised payments for services, to be applied. Accordingly, existing management fee waiver arrangements that would be recharacterized under the proposed regulations may be challenged by the IRS notwithstanding that the Proposed Regulations have not been finalized, or that the relevant arrangements are excluded from final regulations by reason of the effective date provisions.

It will be important for investment fund managers having existing management fee waiver arrangements, or that are contemplating such arrangements, consider the effect of the Proposed Regulations and the positions of the IRS announced in the preamble to the Proposed Regulations.

This memorandum provides general information and does not constitute legal advice for any specific person or situation. Questions concerning issues addressed in this memorandum should be addressed to:

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