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IRS rules target common deferral arrangement

TAXING MATTERS
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The IRS has issued proposed regulations regarding disguised payments for services by partnerships. While the proposed rules are focused on a common practice used by private equity funds, they have important implications for all partnerships that make payments to their partners in connection with services.

The regulations are issued under the general provisions of the Internal Revenue Code that allow the IRS to treat partnership allocations as disguised payments for services if that reflects their true economic character. Payments in exchange for services are treated as ordinary income; partnership allocations may qualify for capital gain treatment depending on the nature of the payment. The purpose of the regulations is to ensure that taxpayers pay tax at ordinary income rates on what is really services income.

The rules apply a facts and circumstances test to determining whether an arrangement is a payment for services. The principal factor under this test is whether the service partner bears "significant entrepreneurial risk" with respect to the receipt of the payment relative to the overall entrepreneurial risk of the partnership. If the receipt of the payment is not subject to significant entrepreneurial risk, it is treated as made in exchange for services.

The regulations provide a list of circumstances that, if present, generate a rebuttable presumption that there is not "significant entrepreneurial risk," as well as a list of other factors that may indicate that an allocation is really for services. For example, a cap on the amount of the purported income allocation, which cap is expected to apply, creates a presumption that a payment is for services.

The proposed rules are targeted at a common fee-deferral arrangement used by private equity funds.

To understand these rules, it's useful to go back to the basic economics of private equity funds.

Funds work on the so-called "2 and 20" model. When the partnership sells an investment, the fund sponsor receives 20 percent of any profits generated. The fund sponsor also receives a 2 percent management fee each year in exchange for its services in operating the fund.

The capital gain tax treatment of the 20 percent carry has become a flashpoint for Congressional criticism. The new rules, however, are targeted at a common deferral arrangement with respect to the 2 percent management fee that seeks to transform it from ordinary income to capital gain.

In this arrangement, the manager of a fund waives its management fee and notionally invests it in the fund through an affiliated entity. Payment is only made if the fund generates sufficient profits. There are many variations on this arrangement. For example, the payment may be essentially equivalent to the management fee and earned quickly as a profit is generated, or the waived fee can instead be invested in the fund and paid out as other investors receive their returns.

The proposed regulations contain two examples showing the application of the general rules to a management fee waiver. In the first example, the manager's affiliate receives a priority allocation and distribution for any 12-month period in which the partnership has a net gain that is intended to approximate the normal management fee. The example concludes that the allocation is a disguised payment for services because the allocation lacks significant entrepreneurial risk. Because of the terms, sufficient profits to make the priority allocation are almost certain to be available. Accordingly, the payments are treated as ordinary income.

The regulations contain another example in which a management fee deferral arrangement is respected. In this example, the receipt of payment relating to the deferred fee depends on the overall performance of the fund over its life. Because of this, capital gain treatment is available.

A great deal of commentary has focused on the examples in the proposed regulations, and they are likely to be revised prior to finalization of the regulations. Though the proposed regulations are not effective until finalized, the IRS has stated that it believes they are an interpretation of existing law.

The proposed rules apply not only to private equity funds but also in other areas where an arrangement between a partner and a partnership may be treated as a disguised payment for services.

Payments in exchange for services are treated as ordinary income; partnership allocations may qualify for capital gain treatment depending on the nature of the payment.

For example, they state that a partner will be taxed immediately if the partner receives any interest in the partnership for forgoing an amount payable for performance of services that is substantially fixed, even if the interest is designed so that a partner is not paid unless the partnership is profitable in the future. This modifies a safe harbor that is commonly used by many startup businesses.

Private equity funds using management fee waivers or contemplating such mechanisms should revisit the structure of such arrangements to determine if changes are necessary to avoid ordinary income tax treatment under the proposed regulations.

Other parties making payments to partners that are arguably in exchange for services should review these arrangements carefully for compliance with the proposed regulations.

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