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Memorandum

Proposed IRS Regulations Target Private Equity Management Fee Waiver Arrangements

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Introduction

On July 22, 2015, the Internal Revenue Service ("IRS") and Treasury Department released proposed regulations regarding disguised payments for services under section 707(a)(2)(A) of the Internal Revenue Code of 1986, as amended (the "Code"). The proposed regulations, if finalized, could treat participants in common private equity fund management fee waiver arrangements as receiving compensatory payments for services rather than allocations of the fund partnership's underlying income. The preamble to the proposed regulations also describes certain modifications to existing IRS safe harbors relating to the issuance of partnership profits interests. The regulations are proposed to be effective on the publication date of the final regulations. However, in the preamble to the proposed regulations, the IRS states its position that the regulations generally reflect Congressional intent with respect to existing law.

Section 707(a)(2)(A) – General Rule

Section 707(a)(2)(A) of the Code is an anti-abuse rule that grants authority to the Treasury Department and IRS to issue regulations that would treat partnership income allocated and distributed to partners with respect to services as compensation income if the arrangement is more properly characterized as a transaction occurring between the partnership and a non-partner. In the legislative history to this provision, Congress identified "significant entrepreneurial risk" as the most important factor in determining whether a partnership allocation and distribution to a service partner is properly characterized as a partnership allocation or a disguised payment for services, although other factors are also relevant.

Management Fee Waiver Arrangements Covered by the Proposed Regulations

The proposed regulations provide that whether a partnership allocation of income to a service partner constitutes a disguised compensatory payment depends on all of the facts and circumstances.

The most important factor in the analysis under the proposed regulations is whether the arrangement subjects the service partner to significant entrepreneurial risk relative to the overall entrepreneurial risk of the partnership. The proposed regulations provide that an arrangement that lacks significant entrepreneurial risk is treated as a compensatory payment for services. The following factors create a presumption that an arrangement lacks significant entrepreneurial risk in the absence of clear and convincing evidence to the contrary: (i) capped allocations of partnership income if the cap is reasonably expected to apply in most years; (ii) an allocation for one or more years under which the service provider's share of income is reasonably certain; (iii) an allocation of gross income; (iv) an allocation 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; or (v) 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 partners of the waiver and its terms.

In addition to lack of significant entrepreneurial risk, the proposed regulations provide the following non-exclusive list of other factors that may indicate a partnership allocation to a service provider is properly characterized as a compensatory payment: (i) the service partner holds, or is expected to hold, the partnership interest on a transitory basis or for a short duration; (ii) the service partner receives an allocation and distribution in a time frame comparable to the time frame that a non-partner service provider would typically receive payment; (iii) the service partner 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; (iv) the value of the service partner's interest in general and continuing partnership profits is small in relation to the allocation and distribution; and (v) the arrangement provides for different allocations or distributions (e.g., carry and fee waiver allocations) with respect to different services received, the services are provided by one person or related persons (e.g., a general partner and a management company), and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly.

The proposed regulations provide several examples of the application of the regulations, including one example that describes some terms of common private equity management fee waiver arrangements. In one example, a management entity provides services to a private investment partnership and is entitled to receive a priority allocation and distribution of net gain from the sale of any one or more assets during any 12-month accounting period in which the partnership has overall net gain. The priority allocation is intended to approximate the management fee that would normally be charged for the management services. The general partner of the private investment partnership is an affiliate of the management entity and controls the timing of asset purchases and sales and distributions. Under the facts of the example, the amount of partnership net income or gain available to be allocated to the management entity is assumed to be highly likely to be available and reasonably determinable based on facts available on formation of the

partnership, including the general partner's ability to control the timing of asset purchases and sales and distributions. The example concludes that the arrangement is a disguised payment for services taxable as compensation income.

Modification to Profits Interest Safe Harbor

The preamble to the proposed regulations describes the Treasury Department and IRS position that existing IRS safe harbors regarding partnership profits interests do not apply to some management fee waiver arrangements. Existing IRS Revenue Procedures provide that service partners may receive a profits interests in a partnership without current taxation provided the grant meets certain requirements, including that the receipt of the profits interest be for the provision of services to or for the benefit of the partnership and that the profits interest not be disposed of within two years of receipt. The preamble to the proposed regulations states that the existing profits interest safe harbor does not apply to transactions in which one party provides services and another party receives a seemingly associated allocation and distribution of partnership income or gain, such as when a management company that provides services to a private equity fund waives its fee, while a related party receives a profits interest the value of which approximates the amount of the waived fee. Although the scope and application of the IRS and Treasury position is not clear, the additional guidance will need to be considered in connection with future grants of profits interests as part of management fee waiver arrangements and otherwise if the party that is receiving the allocation is not identical to the party that is waiving the fee.

In addition, the preamble describes new guidance that will be issued after the proposed regulations are finalized. This new guidance will provide an exception to the profits interests safe harbors for profits interests issued in conjunction with a partner forgoing payment of an amount that is substantially fixed for the performance of services. With this change, even a management fee waiver arrangement that is not recast under the final version of the proposed regulations may not be eligible for the current profits interest safe harbor. Thus, the IRS may assert that profits interests granted pursuant to such a management fee waiver arrangement may result in the upfront inclusion of compensation income by the recipient.

Conclusion

The proposed regulations are broadly formulated and leave many open questions. In determining whether allocations to service providers are properly treated as compensation income, the proposed regulations provide a facts and circumstances analysis the application of which is uncertain in the context of real-world highly-complex private equity fund arrangements. Although the proposed regulations will not be effective until they are published in final form, private equity fund sponsors should proceed cautiously in light of the stated IRS position that the proposed regulations are an interpretation of current law rather than a prospective change.

Pending further guidance, we recommend that private equity fund clients:

- Review current management fee waiver arrangements to determine how such arrangements should be administered given the factors identified in the proposed regulations as indicative of disguised payments for services.
- Consider whether management fee waiver arrangements should be used for new funds and for future investments made by existing funds.
- Review the structure and terms of prospective management fee waiver arrangements in light of the proposed regulations.

We will continue to monitor developments regarding the proposed regulations, which remain subject to change, including any future related IRS notices.

For further information regarding the proposed regulations, please contact one of the following members of Simpson Thacher's Tax Department.

NEW YORK CITY

John Creed
+1-212-455-3485
jcreed@stblaw.com

Marcy Geller
+1-212-455-3543
mgeller@stblaw.com

Jonathan Goldstein
+1-212-455-2048
jgoldstein@stblaw.com

John Hart
+1-212-455-2830
jhart@stblaw.com

Nancy Mehlman
+1-212-455-2328
nmehlman@stblaw.com

PALO ALTO

Katharine Moir
+1-650-251-5035
kmoir@stblaw.com

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UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
600 Travis Street, Suite 5400
Houston, TX 77002
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3919 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Seoul
West Tower, Mirae Asset Center 1
26 Eulji-ro 5-gil, Jung-gu
Seoul 100-210
Korea
+82-2-6030-3800

Tokyo
Ark Hills Sengokuyama Mori
Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000