

Client Alert

August 2015

Treatment of Partnership Interests as Disguised Payments for Services

On July 22, 2015, the U.S. Treasury Department (“Treasury”) and the Internal Revenue Service (“IRS”) proposed regulations that could impact partnership interests issued in exchange for management fee waivers or to service providers generally. The proposed regulations would treat the receipt of what purports to be a profits interest in a partnership as a disguised payment for services in certain circumstances. If a purported profits interest is recharacterized in that manner, its receipt will give rise to immediate ordinary income for the service provider and will be treated as a payment for services for all purposes of the Internal Revenue Code (“Code”). Although the proposed regulations technically will not be effective for arrangements entered into before the date that the regulations are finalized, Treasury and the IRS view the proposed regulations generally as reflecting existing law and legislative history. Accordingly, partnerships should consider the proposed regulations in connection with any future issuance of profits interests and examine current practices to determine whether any changes are warranted.

Significant Entrepreneurial Risk

In determining whether a purported profits interest issued to a service provider will be respected as a partnership interest, the most important factor is whether the payment is subject to “significant entrepreneurial risk.” A payment is not subject to “significant entrepreneurial risk” when there is a high likelihood the service provider will receive its allocation regardless of the overall success of the partnership as a whole. The following facts and circumstances indicate a lack of significant entrepreneurial risk: (i) capped allocations of income if the cap would reasonably be expected to apply in most years; (ii) allocations for a fixed number of years where the share of partnership income is reasonably certain; (iii) allocations of gross income items; (iv) allocations that are predominantly fixed in amount (through a formula or otherwise), are reasonably determinable, or are designed to assure that sufficient net profits are highly likely to be available (e.g., allocations of net profits from specific transactions or accounting periods that do not depend on the long-term future success of the enterprise); and (v) fee waivers that are non-binding or for which timely notice is not given to the partnership. The proposed regulations contain several examples of arrangements that have or do not have significant entrepreneurial risk.

Modification of Revenue Procedure 93-27

Revenue Procedure (“Rev. Proc.”) 93-27 provides a safe harbor for certain issuances of profits interests that will not be treated as taxable events for the partner or the partnership. Rev. Proc. 93-27 does not apply if (i) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, (ii) within two years of receipt, the partner disposes of the interest, or (iii) the partnership is a “publicly traded partnership” under the Code. The preamble to the proposed regulations indicates that Treasury and the IRS have determined that the provision of services by one party coupled with the receipt of a profits interest by a related party does not satisfy Rev. Proc. 93-27. In addition, the preamble indicates that Treasury and the IRS will add an additional exception to Rev. Proc. 93-27 to exclude situations where the profits interest is issued in conjunction with the partner forgoing payment of an amount that is substantially fixed (such as a fee based on a percentage of partner capital).

commitments) for the performance of services. Outside of the safe harbor, recipients would be required to determine whether the value of the profits interest at the time of issuance was entirely speculative or whether the interest had some value that would be required to be included in income.

Takeaways

Based on the proposed regulations, partnerships issuing partnership interests to service providers should consider the following:

- Profits interests that allocate the partnership's overall net income or net capital gain, rather than income from particular assets, are more likely to be respected.
- Profits interests that depend on the partnership's income over the life of the partnership (perhaps even including a clawback) are more likely to be respected.
- Profits interests that allocate gain based on actual sales are more likely to be respected than allocations based on revaluations of non-traded property.
- Profits interests that are based on allocations of gross income are presumed to lack significant entrepreneurial risk unless there is clear and convincing evidence to the contrary.
- Fee waivers that apply for a full year or more and that are communicated in writing prior to the start of the year are more likely to be respected.
- In connection with a fee waiver, profits interests issued to the service provider waiving the fee, rather than an affiliate of the service provider, are more likely to satisfy Rev. Proc. 93-27 (although even this may not satisfy the safe harbor if the additional exception noted above is added).

We note that the proposed regulations focus on partnership interests issued to service providers and do not address partnership interests issued to investors. Please contact one of the attorneys listed in this alert for more information about the proposed regulations.

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