Client Alert

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IRS Proposes New Regulations on Carried Interests and Fee Waivers as Disguised Compensation

The Internal Revenue Service recently proposed new guidelines that, under certain circumstances, would recharacterize carried and other service-related equity interests in partnerships (which for tax purposes includes limited liability companies) as disguised payments for services. If a partnership interest granted to a service provider is recharacterized as disguised compensation, then the service-related partnership interest disappears for tax purposes and the service provider is no longer treated as an equity owner (*i.e.,* a partner or member) with respect to the service-related partnership interest. As a result, partnership allocations and distributions made on the service-related partnership interest to the service provider become ordinary compensation income (even if the partnership's underlying income consists of capital gains), potentially subject to FICA and other employment-related tax provisions.

Taking an overall "facts and circumstances" approach, the proposed regulations view the presence or absence of "significant entrepreneurial risk" (which itself is also determined in light of the overall facts and circumstances) as the overriding indicator of whether a service-related partnership interest is a disguised compensation arrangement. If a service-related partnership interest carries "significant entrepreneurial risk," the partnership interest will generally not be treated as a disguised compensation arrangement, unless the presence of other compensation-related factors indicates otherwise (*e.g.,* transitory or short-term equity ownership, allocations and distributions tied to the types of services rendered or made over periods comparable to those over which non-partner service providers would typically receive payment, and a small continuing interest in overall partnership profits).

In contrast, a service-related partnership interest without "significant entrepreneurial risk" is deemed to be a disguised compensation arrangement, regardless of the degree to which other compensation-related factors may or may not be present. The presence of any one of the following five factors creates a presumption that no "significant entrepreneurial risk" exists: (1) a cap on allocations if the cap is reasonably expected to apply in most years, (2) an allocation for one or more years if the service provider's income share is reasonably certain, (3) an allocation of gross income, (4) an allocation that is either (A) fixed in

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amount, (B) reasonably determinable, or (C) designed to assure that sufficient net profits are highly likely to be available for the service provider (such as a profit share for a specific transaction or accounting period that is not tied to the long-term success of the enterprise) or (5) a fee waiver that is either (A) non-binding or (B) is not disclosed timely to the partnership and its partners. By way of an example discussing the grant of a partnership interest to an investment manager in lieu of a management fee, the proposed regulations indicate that an irrevocable fee waiver made and disclosed to the investment fund's limited partners at least 60 days prior to the start of the period for which the management fee would otherwise have been payable does not cause the partnership interest to lack "significant entrepreneurial risk."

Although purportedly intended to address fee waivers in the investment fund context, the scope of the proposed regulations is not so limited and may affect tax planning for carried interests in partnerships engaged in real estate and other active businesses. As shown in the included examples, the proposed regulations conclude that "significant entrepreneurial risk" exists when a carried interest's participation in partnership allocations and distributions is tied to and limited by the partnership's overall lifetime profitability (combined with a corresponding "clawback" obligation). However, the proposed regulations fail to give any negative guidance on when a carried interest lacks "significant entrepreneurial risk." So, when deciding to accept a carried or other partnership interest, service providers should consider carefully the extent to which any deviation from the terms of the example partnership interests increases the probability that the partnership interest will be found to lack "significant entrepreneurial" risk" (*e.g.,* by omitting the lifetime profit limitation and/or any clawback obligation).

The proposed regulations are intended to apply only to partnership arrangements entered into or modified after the date on which the regulations are issued in final form. However, the IRS views the proposed regulations as a clarification of existing law, hinting that it may seek to apply the principles set forth in the proposed regulations to pre-existing partnership arrangements.

For more information on the IRS guidelines regarding carried partnership interests, please contact the Olshan attorney with whom you regularly work or Mark A. Limardo to discuss any of these matters.

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