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IRS issues proposed regulations for 'contentious' carried interest

Carried interest has always been a point of contention with the IRS. On July 23, the IRS issued proposed regulations in an attempt to close one aspect that it has always viewed as abusive.

Carried interest is a common vehicle used to compensate a service partner (an individual/entity) for setting up and managing an investment. This usually includes raising capital from investors, identifying and securing the investment, and often the operation of the property. The service partner may or may not invest its own cash for a capital interest, but regardless of a capital investment the service partner still has the upside of the carried interest it receives in the partnership for setting up the deal. Like other partners in the partnership, the carried interest would be taxed on the appreciation of the investment at capital gain rates as low as 20 percent for federal income tax purposes (the current federal rate for long-term capital gains).

Common in these types of arrangements are the payments of fees to the service partner that relate to the acquisition and/or management of the investment. These fees are generally paid without regard to the success of the investment, and constitute ordinary income that can be taxed up to the maximum rate of 39.6 percent and will be taxed when earned.

Often in the operating agreements of these types of investments, there are clauses that allow for fee waivers. These fee waivers allow for the conversion of the fee, which would be taxable now, into a preferred distribution in the future. In essence, these clauses allow the service partner to convert their ordinary income taxable now to likely capital gain on a preferred distribution in the future.

Bryan Adam
Senior tax manager, Anton Collins Mitchell LLP, Denver

■ **How do the proposed regulations impact fee waivers?** The proposed regulations have various factors that are considered in determining if there is a "disguised payment" for services but are primarily focused on whether the arrangement has "entrepreneurial risk." If the arrangement does not have "entrepreneurial risk," then the fee waiver will be ignored and will be deemed a "disguised payment" for services taxable to the service partner at ordinary income rates when earned.

The regulations specifically state the following presume a lack of entrepreneurial risk: 1) capped allocations of partnership income if the cap is reasonably expected to apply; 2) an allocation for one or more years under which the service provider's share of income is reasonably certain; 3) an allocation of gross income; 4) an allocation that is predominantly fixed in amount; or 5) an arrangement in which a service provider waives its right to receive a payment for the future performance of services in a manner that is nonbinding.

In essence, the "entrepreneurial risk" boils down to two tests: 1) how the fee is waived and 2) how the future profits allocations are structured. To satisfy the first test, the fee needs to be waived in writing, in advance of the fee being earned, and be irrevocable by the partner.

To satisfy the second test, the service partner needs to truly be at risk of loss – meaning there can't be allocations that are fixed or allocations that are reasonably certain to occur. In addition, the allocations of income can't be capped to the service partner, if the cap is reasonably expected to occur in most years.

There are numerous examples that illustrate how the IRS views these arrangements and "entrepreneurial risk." Following is Example 1 from the proposed regulations for illustration purposes:

Example (1). Partnership ABC constructed a building that is projected to generate $100,000 of gross income annually. A, an architect, performs services for partnership ABC for which A's normal fee would be $40,000 and contributes cash in an amount equal to the value of a 25 percent interest in the partnership. In exchange, A will receive a 25 percent distributive share for the life of the partnership and a special allocation of $20,000 of partnership gross income for the first two years of the partnership's operations.

Under the above example the service partner fails to have "entrepreneurial risk" based on the fact that the special allocation of income in the first two years is reasonably certain to occur, the allocation is made out of gross income, and the allocation is capped. This would result in the fee being taxable as ordinary income to the service partner in the year it was earned.

Since the regulations are proposed, there is a 90-day comment period from the date of publication, July 23, 2015. The Treasury Department and the IRS are requesting comments on whether there are arrangements that could exist that do not have "entrepreneurial risk" but shouldn't be re-characterized as "disguised payments" for services. In addition, they are requesting comments on what is sufficient notification of a fee waiver. Comments can be submitted to the IRS by regular or electronic mail by Oct. 21, 2015.

■ **So how does a service partner proceed?** Assuming that these proposed regulations stay in their current form, the key takeaway is that the income allocation to the service partner must be based on the success of the deal. The allocations should be based on net income and there should be a real risk of loss to the service partner. The risk of fee waivers being re-characterized as a "disguised payment" for services may be minimized if the arrangement is properly planned for and the service partner is willing to accept the risk of loss should the investment fail to perform.

A focus on proactive planning, analysis of operating agreements with fee waiver provisions and smart deal structuring may mitigate the potentially detrimental impacts and leave the service partner in the best possible position.▲