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November 13, 2015

The Honorable Mark Mazur
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The Honorable William J. Wilkins
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1111 Constitution Avenue, NW
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Re: Report #1330 on the Proposed Regulations on
Disguised Payment for Services

Dear Messrs. Mazur, Koskinen and Wilkins:

I am pleased to submit the attached report of the Tax Section of the New York State Bar Association. The report provides comments on the notice of proposed rulemaking issued on July 23, 2015, which contains proposed regulations concerning disguised payments for services under Section 707(a)(2)(A) and proposed conforming changes to the regulations governing guaranteed payments under Section 707(c) (the "Proposed Regulations") and statements regarding the interpretation of and planned changes to Revenue Procedure 93-27 relating to issuance of partnership profits interests to service providers.

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We understand that the proposals are in large part a response to arrangements involving profits interests issued to service partners in private investment funds, which are sometimes referred to as “management profits interests” or “management fee waiver” interests, and those arrangements are a significant focus of the report. We note, however, that the proposals, especially the Proposed Regulations, will apply to a far wider range of arrangements, many of which do not involve fee waiver or indeed investment funds and urge the Internal Revenue Service and the Treasury to keep this in mind as they finalize the rules.

Section 707(a)(2)(A) provides that, when a partner performs services for a partnership other than as a partner, any allocations and distributions related to such performance are treated as a transaction between the partnership and one who is not a partner. The Proposed Regulations provide guidelines for determining when such allocations and distributions should be treated as a disguised payment for services and not a transaction between a partnership and its partner.

Section 707(c) and Treas. Reg. §1.707-1(c) provide that payments made by a partnership to a partner for services or use of capital are considered as made to a person who is not a partner, to the extent such payments are determined without regard to the income of the partnership. The Proposed Regulations would change Example 2 of that regulation regarding the treatment of guaranteed minimum amounts to a partner otherwise entitled to a share of partnership income.

Revenue Procedure 93-27 provides a safe harbor under which a profits interest issued to a partner for services is not treated as a taxable event to either the partner or the partnership, except in certain circumstances. The proposed guidance indicates the Internal Revenue Service and the Treasury (1) have determined Revenue Procedure 93-27 does not apply to certain issuances of profits interests to an affiliate of an entity waiving its entitlement to fees and (2) intend to issue a new revenue procedure excluding from the Revenue Procedure 93-27 safe harbor certain issuances of profits interests connected to a partner forgoing fee payments.

We commend the Internal Revenue Service and the Treasury for their efforts to provide guidance in these areas. The Proposed Regulations generally adopt an approach consistent with what Congress intended, and together with statements relating to Revenue Procedure 93-27 reflect a thoughtful approach to address aggressive practices in a complex area.

In this report, we make recommendations in areas where revisions to the Proposed Regulations could be considered to provide clarification, to reflect the legislative history more closely or to avoid unintended results. We also include recommendations relating to Revenue Procedure 93-27.

As discussed in the report, our principal recommendations are as follows:

1. Our recommendation with respect to the proposed change to Example 2 of Treas. Reg. §1.707-1(c) relating to guaranteed payments has two parts: (a) the scope of the change should be revisited, in particular whether it should apply both to payments for use of capital and to payments for services or should be limited to payments for services, and (b) the final regulations should provide an effective date for any change that is ultimately made.

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2. The final regulations generally should not require a bifurcation of separate layers of an integrated waterfall allocation and separate analysis of the individual layers.

3. The Internal Revenue Service should consider modifying clause (iv) of Prop. Treas. Reg. §1.707-2(c)(1) either to remove the “predominantly fixed in amount” factor or to limit the factor to cases where at least the fixed amount is reasonably expected to be allocated and paid to the service partner. If the Internal Revenue Service decides to retain the phrase in some form, it should provide guidance on the meaning of “predominantly fixed in amount.”

4. The final regulations should provide that an allocation of net income to a service provider over a period less than the life of the partnership (such as 12 months or more), or an allocation made with respect to a single partnership asset or subset of assets, may be consistent with the presence of significant entrepreneurial risk, so long as the time period or asset (or subset of assets) is identified in advance when the arrangement is set, the allocation is being used for measurement for a business reason and the entrepreneurial risk of the arrangement is significant relative to the overall entrepreneurial risk of the partnership for the period or assets in question.

5. The final regulations should clarify that net gain from an asset sale should not fall within the presumption set forth in Prop. Treas. Reg. §1.707-2(c)(1)(iii) (which sets forth a presumption that allocations of gross income lack significant entrepreneurial risk).

6. Prop. Treas. Reg. §1.707-2(c)(1)(v) should be modified to allow partnerships with numerous partners to provide notice of the arrangement to specified subsets of partners, rather than all partners.

7. The Internal Revenue Service should consider eliminating Prop. Treas. Reg. §1.707-2(c)(6), which introduces a new factor to be considered in determining whether an arrangement should be treated as a disguised payment for services: provision of different services by the same person or related persons who receive different allocations with different risk levels for the different services.

8. Particularly if the final regulations retain the factor described in Principal Recommendation (7), Prop. Treas. Reg. §1.707-2(c)(5), which compares the interest being tested with the partner’s general and continuing interest in the partnership, should be revised so that it also takes into account interests held by an affiliate.

9. The final regulations should clarify that a partnership agreement need not provide for liquidating distributions to be made in accordance with capital account balances for the grant of an interest in a partnership to meet the significant entrepreneurial risk and other requirements of the Proposed Regulations.

10. We do not object to the proposed narrowing of Revenue Procedure 93-27 to make it inapplicable to waiver arrangements. We would, however, make the following observations:

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(a) The Internal Revenue Service should reconsider its statements about interests issued to affiliates.

(b) The Internal Revenue Service should consider clarifying that the change does not affect “hard-wired” arrangements, that is, arrangements that are built into the documents signed by the parties and are not subject to any election by the general partner or manager.

(c) Because eliminating the applicability of the safe harbor does not state a substantive rule of taxation and because there are a number of difficult issues raised by compensatory partnership interests that are subject to up-front taxation, we recommend that the Internal Revenue Service continue work on its compensatory partnership interest project as a priority project.

We appreciate your consideration of our recommendations. If you have any questions or comments regarding this report, please feel free to contact us, and we will be glad to discuss or assist in any way.

Respectfully Submitted,

David R. Sicular
Chair

Enclosure

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