Report No. 1330

**NEW YORK STATE BAR ASSOCIATION**

**TAX SECTION**

# REPORT ON THE PROPOSED REGULATIONS ON DISGUISED PAYMENTS FOR SERVICES

**NOVEMBER 13, 2015**

TABLE OF CONTENTS

**Page**

## INTRODUCTION

This report[1] of the Tax Section of the New York State Bar Association provides comments on the notice of proposed rulemaking issued by the Internal Revenue Service on July 23, 2015, which contains proposed regulations concerning disguised payments for services under Section 707(a)(2)(A), proposed conforming modifications to the regulations governing guaranteed payments under Section 707(c) (the proposals collectively, the "Proposed Regulations") and statements regarding the interpretation of and planned modifications to Revenue Procedure 93-27 relating to issuance of partnership profits interests to service providers.[2]

We commend the IRS and the Treasury for their efforts to provide guidance in these areas. The 1984 legislative history of Section 707(a)(2)(A)[3] provides meaningful direction for when Congress intended Section 707(a)(2)(A) to apply. Although they depart from the legislative history in certain respects, 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. The Proposed Regulations also address a separate issue, discussed below, relating to guaranteed payments.

---

1 The principal author of this report is John Hart. Significant contributions were made by Michael Schler, David Schnabel, David Sicular and Eric Sloan. Helpful comments were received from Andy Braiterman, Jonathan Brenner, Jonathan Brose, James Brown, Peter Connors, Simcha David, Dwight Ellis, Phillip Gall, Patrick Gallagher, Marcy Geller, Stephen Land, Andrew Needham, Amanda Nussbaum, Peter Schuur, David Shapiro, Linda Swartz and Kirk Wallace. The assistance of Michael Badain is gratefully acknowledged. This report reflects solely the views of the Tax Section of the New York State Bar Association ("NYSBA") and not those of the NYSBA Executive Committee or the House of Delegates.

2 REG-115452-14, 80 Fed. Reg. 43,652 (July 23, 2015). All "Section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" references are to the Treasury Regulations promulgated under the Code.

3 See H.R. Rep. No. 98-432, at 1216-21 (1984); S. Prt. No. 98-169, at 223-32 (1984); H.R. Rep. No 98-861 (1984), at 859-62; see also Staff of Joint Comm. on Taxation, General Explanation of H.R. 4170 (1984), at 223-33.

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 these arrangements are a significant focus of this 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 investments funds and urge the Internal Revenue Service (the "IRS") and the Treasury to keep this in mind as they finalize the rules.

In this report, we make recommendations in areas where revisions to the new rules could be considered to provide clarification, to reflect the legislative history more closely or to avoid unintended results. We also include recommendations regarding the proposed conforming change to the Section 707(c) regulations and the statements regarding Revenue Procedure 93-27.

This report is divided into five parts. Part I provides as background a general description of existing fee waiver arrangements. Part II provides a summary of our recommendations. Part III provides a summary of current law. Part IV provides a summary of the Proposed Regulations and statements regarding Revenue Procedure 93-27. Part V contains a detailed discussion of our recommendations.

## I. GENERAL DESCRIPTION OF EXISTING FEE WAIVER ARRANGEMENTS

Given the focus on fee waiver arrangements, we thought it would be useful to outline our understanding as to how these arrangements typically work. In private investment funds, the general partner or an affiliated manager (referred to collectively herein as a "sponsor") might, absent these arrangements be entitled to receive a fee for investment management services under a formula that applies a percentage (such as 2%) to capital commitments of investors and/or capital invested, subject to various adjustments. Although the specific terms of these arrangements vary widely, three aspects of the various alternatives are briefly described below.

Elective versus Hard-Wired Arrangements. In funds providing for these arrangements, the sponsor may be permitted to elect either at the inception of the partnership's activities (referred to herein as "one-time election" arrangements) or from time to time during the term of the partnership (referred to herein as "periodic arrangements") not to receive some or all of the fees otherwise payable in the future and instead to receive an interest in profits of the partnership. In other arrangements, the agreements simply provide for a lower fee amount that is not subject to adjustments relating to the profits interest and additional profits interest when the parties sign them and no election is available to the sponsor (referred to herein as "hard-wired" arrangements). These arrangements are discussed below at V.G.2.

Fixed Amount versus Variable Amount. There are two common alternative formats for measuring what the sponsor is entitled to receive. In the first, which can be referred to as a fixed amount format, the future fee is reduced and the sponsor receives a right to partnership profits equal to that fixed amount, provided the partnership has at least that amount of profits. In the second alternative, which can be referred to as a variable amount format, the future fee is reduced and the sponsor becomes entitled to receive an amount from the partnership equal to what the sponsor would have received had it invested amounts in such investments equal to the reduction in fees. Thus, if a $100 fee reduction related to a specific investment under the variable amount format, and the investment was eventually sold for 90% of its cost, the sponsor would be tentatively entitled to $90. On the other hand, if the investment were sold for 110% of cost, the sponsor would be tentatively entitled to $110. The right to receive any amount (whether $90 or $110 in the foregoing example), however, would be subject to the requirement that the partnership have sufficient profits ($90 or $110 in the example); the sponsor receives a distribution of the tentative entitlement amount only to the extent the partnership has profits available to allocate to the sponsor. So in either format, the sponsor's profits interest is subject to the possibility the relevant investment will be sold at a loss and the possibility the partnership will not have sufficient profits. In our experience, variable arrangements are far more common.

Various Ways to Define "Profits". Partnerships providing for those arrangements generally intend for them to be treated as partnership profits interests for tax purposes, but different partnerships may define "profits" for that purpose in different ways that have different degrees of economic risk. The lowest level of economic risk would be to consider the profit requirement to be met if the partnership has an item of gross income at any time in an amount sufficient to cover the intended allocation. Alternatively, the interest would be subject to greater economic risk if net income over the life of the partnership is required, and (if distributions are made before the liquidation of the partnership) either (a) unrealized gains or losses are taken into account or (b) a repayment (a "clawback") is required if subsequent losses cause cumulative net profits to be inadequate. Alternatively, "profit" could be defined to include solely profit from the specific investment to which the fee reduction had been allocated. Of course, other ways to define profits are possible as well, and arrangements all across the economic risk spectrum have been used.

For tax purposes, the character of a fee would be ordinary income and the inclusion in income would occur when the fee was paid or accrued. The character of the allocated amounts under the profits interest would flow through from the partnership level and could be long-term capital gain in whole or in part. Such amounts would often be allocated in a later year than when a fee would have been paid or accrued. The issuance of a profits interest to a sponsor, therefore, often has the effect of converting ordinary income into long-term capital gain and of deferring income recognition, in both cases as compared to payment of a fee to the sponsor.

The Proposals appear to reflect two types of concerns relating to fee waiver arrangements. The first, reflected in the proposed changes to Revenue Procedure 93-27, is that the IRS and the Treasury have concluded a valuation safe harbor of $0 is inappropriate where the recipient had, and waived, the right to receive a fixed or formula fee. The second, reflected in the Proposed Regulations, is that the IRS has understandably expressed concern that some arrangements of this type may not in fact subject the sponsor to any meaningful enough economic risk so as to justify treatment of the arrangement in accordance with its form as an allocation of partnership profits.

## II. SUMMARY OF PRINCIPAL RECOMMENDATIONS

1. Our recommendation with respect to the proposed change to Example 2 of Treas. Reg. §1.707-1(c) ("Example 2") 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.

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 IRS 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 IRS decides to retain the phrase in some form, the IRS 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)(l)(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 IRS 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 Rev. Proc. 93-27 to make it inapplicable to waiver arrangements. We would, however, make the following observations:

a. The IRS should reconsider its statements about interests issued to affiliates.

b. The IRS 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 IRS continue work on its compensatory partnership interest project as a priority project.

## III. SUMMARY OF CURRENT LAW

### A. Section 707(a)(2) and Legislative History

Section 707(a)(2) was passed as part of the Tax Reform Act of 1984. Section 707(a)(2)(A) provides that, under regulations prescribed by the Secretary, if:

(i) a partner performs services for a partnership or transfers property to a partnership,

(ii) there is a related direct or indirect allocation and distribution to such partner, and

(iii) the performance of such services (or such transfer) and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership,

> such allocation and distribution shall be treated as a transaction [between the partnership and one who is not a partner].

The legislative history of Section 707(a)(2)(A) states that the provision is not intended to:

> apply in every instance in which a partner acquires an interest in a partnership and also performs services . . . . In particular, the committee does not intend to . . . apply this new provision in cases in which a partner receives an allocation (or an increased allocation) for an extended period to reflect his contribution of . . . services to the partnership provided the facts and circumstances indicate that the partner is receiving the allocation in his capacity as a partner. . . . In prescribing… regulations, the Treasury should be mindful that the committee is concerned with transactions that work to avoid capitalization requirements or other rules and restrictions governing direct payments and not with non-abusive allocations that reflect the various economic contributions of the partners.[4]

This language suggests that a core original purpose of Section 707(a)(2)(A) was to function as an anti-abuse rule to prevent avoidance of capitalization or other rules.

The legislative history lists five factors that "should be considered in determining whether [a service] partner is receiving the putative allocation and distribution in his capacity as a partner."[5] The first factor listed in the legislative history, which the legislative history states is the most important factor, is whether the payment "is subject to an appreciable risk as to amount." The legislative history explains,

> . . . An allocation and distribution provided for a service partner . . . which subjects the partner to significant entrepreneurial risk as to both the amount and the fact of payment generally should be recognized as a distributive share and a partnership distribution, while an allocation and distribution … which involves limited risk as to amount and payment should generally be treated as a fee under sec. 707(a).[6]

The legislative history then lists the four other factors to consider:

---

4 S. Prt. No. 169 (hereinafter "Senate Report"), at 226 (1984).

5 Id., at 227. The Senate Report provides a sixth factor which relates to purported allocations and distributions for property.

6 Id.

> The second factor is whether the partner status of the recipient is transitory. Transitory partner status suggests that a payment is a fee or is in return for property....
>
> The third factor is whether the distribution and allocation that are made to the partner are close in time to the partner's performance of services for or transfers of property to the partnership. In the case of continuing arrangements, the time at which income will be allocated to the partner may be a factor indicating that an allocation is, in fact, a disguised payment. For example, an allocation close in time to the performance of services, or the transfer of property, is more likely to be related to the services or property….
>
> The fourth factor is whether, under all the facts and circumstances, it appears that the recipient became a partner primarily to obtain tax benefits for himself or the partnership if he had rendered services to the partnership in a third party capacity…
>
> The fifth factor…is whether the value of the recipient's interest in general and continuing partnership profits is small in relation to the allocation in question. This is especially significant if the allocation for services is for a limited period of time.[7]

The Senate Report also states: "The committee anticipates that the Secretary may describe other factors that are relevant in evaluating whether a purported allocation and distribution should be respected."[8]

The legislative history further explains that Section 707(a)(2)(A) is generally intended to apply to an allocation that is contingent as to amount only in certain limited situations. Specifically, the legislative history provides:

> There may be instances in which allocation/distribution arrangements that are contingent in amount may nevertheless be recharacterized as fees. Generally, these situations should arise *only* when (1) the partner in question normally performs, has previously performed, or is capable of performing similar services for third parties; and (2) the partnership agreement provides for an allocation and distribution to such partner that effectively

[7] Id., at 227, 228.

[8] Id., at 228.

> compensates him in a manner substantially similar to the manner in which the partner's compensation from third parties normally would be computed.[9]

B. Section 707(c)

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.  Current Example 2 of that regulation provides:

> Partner C in the CD partnership is to receive 30 percent of partnership income as determined before taking into account any guaranteed payments, but not less than $10,000. The income of the partnership is $60,000, and C is entitled to $18,000 (30 percent of $60,000) as his distributive share. No part of this amount is a guaranteed payment. However, if the partnership had income of $20,000 instead of $60,000, $6,000 (30 percent of $20,000) would be partner C's distributive share, and the remaining $4,000 payable to C would be a guaranteed payment.

Thus, current Example 2 of Treas. Reg. §1.707-1(c) adopts a wait and see approach for arrangements that allocate a percentage of income to a partner, subject to a minimum. Guaranteed payment treatment applies only to the extent the minimum affects the amount paid to the partner.

C. Revenue Procedure 93-27

Treas. Reg. §1.721-1(b)(1) provides that the receipt of a partnership capital interest for services provided to the partnership is taxable as compensation. Revenue Procedure 93-27 (the "Revenue Procedure") was issued in response to uncertainty over whether a profits interest in a partnership issued to a service provider is similarly taxable.  The Revenue Procedure provides a safe harbor under which the IRS would not treat a profits interest (determined on a liquidation basis) issued to a partner in

---

[9] Senate Report, at 229 (emphasis added); see also Staff of Joint Comm. on Taxation, at 230.

exchange for services rendered to or for the benefit of a partnership in such partner's capacity as a partner as a taxable event to either the partner or the partnership.[10] The Revenue Procedure lists three exceptions; in these cases the safe harbor is not available: (i) if the profits interest relates to a substantially certain and predictable stream of income (such as income from high-quality securities), (ii) if the partner disposes of the profits interest within two years or (iii) if the profits interest represents a limited partner interest in a publicly traded partnership.[11]

## IV. SUMMARY OF PROPOSED CHANGES

### A. Proposed Regulations

#### 1. Treas. Reg. §1.707-1(c) – Guaranteed Payments

The Proposed Regulations would reverse the current rule of Example 2 so that the minimum amount guaranteed to be received by the partner is always treated as a guaranteed payment. Under the Proposed Regulations, Example 2 is modified to read as follows:

> Partner C in the CD partnership is to receive 30 percent of partnership income, but not less than $10,000. The income of the partnership is $60,000, and C is entitled to $18,000 (30 percent of $60,000). Of this amount, $10,000 is a guaranteed payment to C. The $10,000 guaranteed payment reduces the partnership's net income to $50,000 of which C receives $8,000 as C's distributive share.

#### 2. Prop. Treas. Reg. §1.707-2 – Disguised Payments for Services

The Proposed Regulations provide that whether an arrangement constitutes a payment for services depends on the facts and circumstances. They provide

---

[10] Rev. Proc. 93-27, 1993-2 CB 343 (June 9, 1993).

[11] Rev. Proc. 2001-43, 2001-2 CB 191 (Aug. 2, 2001) provides guidance on the treatment of a grant of a substantially nonvested partnership interest to a service provider if the requirements of Revenue Procedure 93-27 and certain other requirements are met.

a non-exclusive list of six factors that "may indicate" an arrangement constitutes a disguised payment for services. The first factor is the absence of significant entrepreneurial risk, which is in effect a super factor under the Proposed Regulations. An arrangement that lacks significant entrepreneurial risk in effect automatically constitutes a disguised payment for services without regard to other facts and circumstances. The Proposed Regulations explain that whether an arrangement lacks significant entrepreneurial risk is based on the service provider's entrepreneurial risk relative to the overall entrepreneurial risk of the overall enterprise.[12] The Proposed Regulations set forth five factors that presumptively cause an arrangement to lack significant entrepreneurial risk (and thus treated as a payment for services to the service provider) unless other facts and circumstances establish the presence of significant entrepreneurial risk by clear and convincing evidence. These factors are:

(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 (under a formula or otherwise) 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 (e.g. if the partnership agreement provides for an allocation of net profits from specific transactions or accounting periods and this allocation does not depend on the long-term future success of the enterprise); or

(v) An arrangement in which a service provider waives its right to receive payment for the future performance of services in a manner

[12] Prop. Treas. Reg. §1.707-2(c)(1).

> that is non-binding or fails to timely notify the partnership and its partners of the waiver and its terms.[13]

The Proposed Regulations then list five other factors that indicate an arrangement may constitute a disguised payment for services. The first four (but not the fifth) of these are based on language in the legislative history.

> (1) The service provider holds, or is expected to hold, a transitory partnership interest or a partnership interest for only a short duration;[14]
>
> (2) The service provider receives an allocation and distribution in a time frame comparable to the time frame that a non-partner service provider would typically receive payment;[15]
>
> (3) The service provider 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;[16] and
>
> (4) The value of the service provider's interest in general and continuing partnership profits is small in relation to the allocation and distribution;[17]
>
> (5) The arrangement provides for different allocations or distributions with respect to different services received, the services are provided either by one person or by persons that are related, and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly.[18]

The Proposed Regulations also include examples of the application of the new rules provided in Prop. Treas. Reg. §1.707-2(b) and (c). Several of these examples are described and discussed below.

B. <u>Proposed Changes to Revenue Procedure 93-27</u>

---

[13] Prop. Treas. Reg. §1.707-2(c)(1)(i)-(v).

[14] Prop. Treas. Reg. §1.707-2(c)(2).

[15] Prop. Treas. Reg. §1.707-2(c)(3).

[16] Prop. Treas. Reg. §1.707-2(c)(4).

[17] Prop. Treas. Reg. §1.707-2(c)(5).

[18] Prop. Treas. Reg. §1.707-2(c)(6).

As discussed above, Revenue Procedure 93-27 provides a safe harbor under which a person receiving a partnership profits interest will not be treated as taxable on receipt of such interest except in three limited circumstances. The Preamble to the Proposed Regulations (the "Preamble") indicates the Treasury and the IRS have determined Revenue Procedure 93-27, as currently in effect, 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. The Preamble also states the Treasury and the IRS intend to issue a new revenue procedure excluding from the Revenue Procedure 93-27 safe harbor a profits interest issued in conjunction with a partner forgoing payment of an amount that is substantially fixed, including a Section 707(c) guaranteed payment or a non-partner payment under Section 707(a).

## V. DISCUSSION

### A. Example 2 of Prop. Treas. Reg. §1.707-1(c)

Proposed new Example 2 would reverse current law by providing that when a partnership agreement provides that a partner is to receive the greater of a percentage of the partnership's income and a fixed sum, the fixed sum is treated as a guaranteed payment even if the partner receives more than the fixed sum because the percentage of income exceeds the fixed sum. Both current Example 2 and the proposed modification of the example appear to apply to guaranteed payments for both services and use of capital.

The proposed new rule has some common sense appeal in that the minimum amount is payable without regard to income of the partnership. However, the approach of the current regulation perhaps reflects the principle that, absent compelling policy considerations, partner sharing of partnership profits should be viewed as such rather than as wages or interest or otherwise as payments between third parties. It is also unclear whether partnerships are relying on the current rules in ways the IRS might consider problematic.

The Preamble indicates the view of the IRS and the Treasury that Congress's emphasis on entrepreneurial risk and the principle that a Section 704(b) allocation must have significant entrepreneurial risk requires the change to existing regulations under Section 707(c). We would note, however, that Example 2 was in place when Congress amended Section 707(a)(2)(A), and nowhere in the legislative history to the Section 707(a)(2)(A) changes is there any mention of Congress having a concern with Example 2. Moreover, it is not immediately apparent why a change to Section 707(a)(2)(A) requires any change to regulations under Section 707(c). The two Code sections apply to different categories of partnership items (payments of income versus payments without regard to income) and to partners acting in different capacities (non-partner versus partner).

Under the new Example 2, parties seeking guaranteed payment treatment could provide for a guaranteed fixed payment amount that was well below expected allocation levels (and thus not viewed by the parties as meaningful) and thereby achieve treatment of the fixed amount as a guaranteed payment even if (as expected) the actual payment in fact exceeded the guaranteed minimum; affording such opportunities to taxpayers may be an unintended consequence of the proposed rules. The IRS should consider whether the current version of Example 2, which favors allocation treatment, might be more appropriate than the proposed new version in such cases. For example, a

U.S. citizen living abroad seeking to exclude income under Section 911 might be entitled to the higher of a percentage of partnership net income and a guaranteed minimum that is much lower than the expected amount produced by the percentage allocation. Under the new rule, the individual would be able to rely on the minimum to qualify for the Section 911 exclusion even though the minimum is not meaningful.[19] Similarly, such a provision for a partnership engaged in a U.S. service business might allow the parties to treat a foreign-based nonresident alien partner as having foreign source income, which would generally not be subject to U.S. federal income tax.[20]

An anti-abuse rule could be added under which an allocation structured as the greater of a percentage and a minimum would be analyzed on a wait-and-see basis, as under current Example 2, if the minimum was highly likely to be irrelevant or was added primarily for tax avoidance reasons. The IRS might also consider excluding from the rule of new Example 2 (and applying the former wait-and-see rule to) certain arrangements such as those between a partnership where capital is not a material income-producing factor and a service partner who is involved in the general activities of the partnership on an ongoing basis (similar to the carve out from Section 707(a)(2)(A) described below at V.B.2). The IRS should also consider revising Example 2 to make

---

[19] Miller v. Comm'r, 52 T.C. 752 (1969) (law firm partner living abroad received a guaranteed payment from the partnership; the guaranteed payment was compensation for purposes of Section 911 and therefore not included in gross income), acq. 1972-2 CB 2; Carey v. U.S., 427 F.2d 763 (Ct. C1. 1970) (fixed payment to accounting firm partner living abroad was a guaranteed payment under Section 707(c) and therefore excluded from the partner's income under Section 911).

[20] Such foreign sourcing of income would be based on treating the guaranteed payment for services as having a source in the place where the services were performed. See Section 862(a)(3); Philip Stoffregen, Kenneth Harris, and Francis Wirth, "Partners and Partnerships – International Tax Aspects," 910 Tax Mgmt. (BNA) Foreign Income, at A-43 (June 1, 2015). In that event, if guaranteed payment treatment applied, the other partners generally would be entitled to a (foreign source) deduction for the guaranteed payment and would report the corresponding income.

clear the $60,000 income of Partnership CD is net income, which seems to be implicit in the reference to net income in the last sentence.

It is perhaps even less clear that a change in the rules for disguised payments for services should affect rules that govern whether amounts paid with respect to a capital investment should be treated as an allocation or as a guaranteed payment. (**Principal Recommendation (1(a)).**) Indeed, since the Proposed Regulations were released, government officials have acknowledged that in making the proposed change, their focus was on services, not capital.[21] The issues in this area are quite complex and the law is quite unclear. Even if new Example 2 is retained, we believe that its application to guaranteed payments for capital should be considered further. For example, if the return on a preferred partnership interest is structured as an allocation but calls for any return that is accrued and unpaid on redemption to be payable in all events on redemption, and at a given time the accrued and unpaid return exceeds all equity capital of the partnership, additional returns of the preferred interest will only be paid if the partnership generates income or gain, which suggests such additional returns should not be viewed as guaranteed payments. But that would require the characterization to be determined (or changed) after the issuance of the preferred, while the new proposed rule seems to contemplate the interest being characterized at issuance.

In addition, treatment of a partnership interest that is entitled to a preferred allocation and distribution as instead being a guaranteed payment could accelerate the income (and corresponding deduction) resulting from the guaranteed payment as compared to when the underlying income is earned and could cause income recognition

[21] See Amy S. Elliot, Fee Waiver Regs May Change Guaranteed Payment Example, TAX NOTES, Nov. 2, 2015, at 607; Amy S. Elliot, Disguised Fee Waiver Regs Could Affect PTPs in 2 Ways, TAX NOTES, Oct. 26, 2015, at 473.

to the service partner, and loss recognition to the partnership, even where the corresponding amount is never paid. Converting an allocation into an income inclusion and deduction may have additional consequences, as deductions may be subject to limitations (such as under Section 212). Even if there is a perceived need to apply a new approach in the services area, the new Example 2 approach could be limited to services and not made applicable to payments for the use of capital. Given that neither the Preamble nor the Proposed Regulations include any discussion about payments for the use of capital, if the revised Example 2 is in fact intended to apply to use of capital payments, it would be helpful if the Preamble to the final regulations could shed light on the purpose of the change as it applies to such payments.

In any event, because it clearly changes the rule in the prior regulations, to the extent the new rule of Example 2 is retained, the final regulations should provide an effective date for this modification to Example 2. We believe that one reasonable approach could be to apply the new rule to arrangements entered into or modified after the date final regulations are published. (**Principal Recommendation (1(b))**.)

B. Prop. Treas. Reg. §1.707-2(c) -- General Comments

1. Background

Prop. Treas. Reg. §1.707-2(c) provides that the "most significant factor is significant entrepreneurial risk," and that "[a]n arrangement that lacks significant entrepreneurial risk constitutes a payment for services."[22] The formulation in the legislative history is somewhat different, stating that the "first, and generally the most important, factor is whether the payment is subject to *an appreciable risk* as to

[22] Prop. Treas. Reg. §1.707-2(c).

amount."[23] The legislative history then adds that a payment subject to significant entrepreneurial risk as to both the amount and fact of payment generally should be respected as an allocation and distribution, while an allocation and distribution that has "limited risk as to amount and payment" should generally be treated as a fee.[24] (Some have noted that the legislative history does not actually say that the absence of significant entrepreneurial risk *would* necessarily cause the arrangement to be a payment for services.) However, it is not clear whether the proposed regulations intended, by using the phrase "significant entrepreneurial risk" as the standard, to adopt a different standard than the "an appreciable risk as to amount" standard provided by the legislative history. It would be helpful for the preamble to the final regulations to clarify this point.

The Proposed Regulations set forth a list of factors that create presumptions that an arrangement will fail unless the taxpayer can show significant entrepreneurial risk by clear and convincing evidence. Although the legislative history anticipates the IRS may describe other factors than those listed in the legislative history, it has no presumptions other than identifying "an appreciable risk as to amount" as the most important factor. Two of the proposed presumption factors vary to some extent from the legislative history. First, the Proposed Regulations treat a gross income allocation as establishing an unfavorable presumption, whereas the legislative history generally treats gross income allocations as a problem only if the amount is reasonably certain. Second, the Proposed Regulations treat an allocation predominantly fixed in amount as establishing the presumption that the purported allocation is actually a payment for services without regard to the likelihood of the allocation, whereas the

---

[23] Senate Report, at 227 (emphasis added).

[24] Id.

legislative history generally focuses on fixed or limited allocations where the fixed amount or limit is likely to apply. The Proposed Regulations also do not include a rule similar to the contingent amount rule from the legislative history.[25]

2. Carve Out Certain Partnerships

Given the potential for complexity and unintentionally harsh or favorable consequences arising from Section 707(a)(2)(A), it might be useful to consider excluding from Section 707(a)(2)(A) allocations in partnerships in which capital is not a material income-producing factor where the partner receiving the allocation is involved in the general activities of the partnership on an ongoing basis. We believe that such situations present little potential for abusive tax planning of the type at which Section 707(a)(2)(A) and the Proposed Regulations are aimed. Such an exemption would, for example, permit a professional services firm to create a minimum allocation of net income for a given service partner (for example, for an initial period after the individual becomes a partner). If Section 707(a)(2)(A) applied, Sections 409A and 457A could create harsh consequences to a partner,[26] and rules for source and character of income might lead to favorable or unfavorable surprises for partnerships with cross-border activities and partners resident in a country other than the country in which much of the partnership's income arises.[27]

---

25 See *supra* note 9 and accompanying text.

26 Sections 409A and 457A subject certain deferred compensation arrangements to interest and additional income tax but do not apply to partnership allocations.

27 For example, application of Section 707(a)(2)(A) to a payment received by a partner in a foreign country could cause the income to have a foreign source and not be considered effectively connected with a U.S. trade or business ("ECI"), while an allocation of income could be treated as U.S. source ECI.

### 3. Bifurcation of Partnership Interests

Both the legislative history and the Proposed Regulations contemplate that Section 707(a)(2)(A) may apply to either all or a portion of an allocation to a partner. Notably, in each example in the legislative history in which Section 707(a)(2)(A) applied to only a portion of the service provider's interest in the partnership, the partnership interest in question had a pro rata component received in exchange for cash and a single specialized allocation received in exchange for services.[28] In those cases, it was easy to isolate the allocation for services and to test only that allocation under Section 707(a)(2)(A). The Proposed Regulations include a number of similar examples in which there are two clearly identifiable sets of allocations: one issued in exchange for services and one issued in exchange for a cash investment by the service partner. Example 5 of the Proposed Regulations is the only example in which a service partner receives two types of allocations in exchange for services. In that example, many of the relevant features of the two types were similar so that bifurcation did not affect the result.[29] It is not entirely clear, however, whether (or how) to apply the Proposed Regulations to individual components of a single integrated allocation received by the same partner in exchange for the same services.

Individual layers within an integrated set of allocations almost necessarily involve differing levels of entrepreneurial risk. For example, suppose that on the sale of a business whose value was $900 upon formation, the first $100 of gain is allocated to a

[28] See Senate Report, at 228-30.

[29] In Example 5, the general partner received both a 20% carried interest and an "additional interest." Although not entirely clear, it seems as though both types of interests were established upon the formation of the partnership, could be satisfied only from net income over the life of the fund and were subject to a clawback.

service partner and the remaining profit is allocated 90% to a capital partner and 10% to the service partner. This is a simplified version of an arrangement sometimes referred to as a "catch up" profits interest that is commonly used in a wide range of partnerships that conduct operating businesses, including many partnerships that are not private equity or other types of investment funds. Under the Proposed Regulations, it appears the service partner's right to the first $100 (to "catch up" to a 10% share of the sales proceeds) could be analyzed separately from the service partner's right to be allocated 10% of the residual profits.

Or consider a real estate partnership in which a service provider invests no capital and a capital partner invests $100, where the service partner has a profits interest at one level (for example, 10% with other 90% allocated to the capital partner) until the capital partner has received a specified return on capital (for example, 9% per annum), and has a higher profits interest (for example, 20%) thereafter. The 90/10 layer produces a maximum allocation under a fixed formula (1% of capital per annum). Again, it appears that this layer could be analyzed separately under the Proposed Regulations.

These are common and entirely commercial arrangements, yet every partnership with a service partner entitled to fixed or formula amounts in individual layers of the waterfall could have Section 707(a)(2)(A) payments if the layers are analyzed separately and the first layer was likely to be exceeded. (Indeed, the first layer will always be more likely to be achieved than later layers, so the sixth factor of the Proposed Regulations would always seem to be present in any complex arrangement (at least where the different layers are considered to be for different services).) Bifurcation could thus lead to the odd result that a partner, in performing the same services, would do so partly in a partner capacity and partly in a non-partner capacity. We believe that it seems sensible and consistent with the legislative history for the final regulations not to require bifurcation of individual layers of an integrated waterfall. (**Principal Recommendation (2)**.)

We would recommend that an integrated waterfall be defined so that, if a layer of an allocation waterfall allocates a category of net income to both a service partner and one or more capital partners and if the service partner is then entitled to all or a portion of an additional layer of allocations of the same category of net income after a specified target amount of net income has been allocated in the first layer, the two layers of allocation to the service partner would be integrated. That approach would cause the layers in the second example above to be integrated. An anti-abuse rule could be provided so that neither (1) provisions to allocate income to a partner that are not expected to result in allocations of substantial income to the partner nor (2) allocation provisions determined to have a principal purpose to avoid Section 707(a)(2)(A) would receive the benefit of this proposed integration of waterfall layers.

In addition, if a layer of an allocation waterfall allocates a category of net income disproportionately to capital partners, and the next layer allocates the same category of net income disproportionately to the service partner to equalize the partners' cumulative returns in proportion to subsequent sharing levels between capital and service partners, the layers of allocation to the service partner should be integrated. That approach would allow allocations that catch up the service partner to prior allocations of income to the capital partner to be integrated with additional allocations to the service partner, consistent with the statement in the Preamble that such catchup allocations should generally be respected.[30]

The first example in this section does not meet either of those criteria. Many of our members believe that the first example is also a sympathetic case for integration. Others, however, disagree, noting that its economic terms bear some similarity to the economics of certain fee waiver arrangements, while recognizing that there are differences, such as that the service provider's allocation depends on there being a gain on the ultimate sale of the business in which the partnership invests. In addition, of course, the arrangement described in the first example is not actually a private equity fee waiver, and it may also be the case that the Proposed Regulations do not intend to attack private equity fee waiver based on a bifurcation argument. We have not (yet) been able to come up with a rule that shields the first example from bifurcation without allowing fee-waiver type arrangements also potentially to avoid bifurcation. We urge the IRS and the Treasury to consider whether examples such as the first example should be caught by rules designed to attack fee waiver arrangements on the basis of bifurcation.

C. Significant Entrepreneurial Risk

1. Clause (iv)

Prop. Treas. Reg. §1.707-2(c)(1)(iv) provides that significant entrepreneurial risk is presumed to be absent if an allocation:

> 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 (e.g. if the partnership agreement provides for an allocation of net profits from specific transactions or accounting periods and this allocation does not depend on the long-term future success of the enterprise)[.]

[30] 80 Fed. Reg. at 43,655.

We have a number of questions about this clause and believe it requires further consideration. The language of the first factor in clause (iv), "predominantly fixed in amount", differs somewhat from the legislative history and other provisions of the Proposed Regulations by the use of the word "predominantly," which expands the scope of the factor beyond allocations that are fixed, capped or limited. Clause (i) of Prop. Treas. Reg. §1.707-2(c)(1) separately provides that an arrangement is presumptively treated as a disguised payment to a service provider when the arrangement provides for "capped allocations of partnership income if the cap is reasonably expected to apply in most years." Perhaps the "predominantly fixed in amount" factor is unnecessary in light of the "capped allocation" provision or should also be limited to cases where the fixed component is "reasonably expected to apply" in a similar way to clause (i). Moreover, the factor appears to give rise to the presumption that significant entrepreneurial risk is absent for an allocation that is predominantly fixed in amount, even if the allocation is not highly likely to be paid. The case where the amount is highly likely to be paid is already covered by the third factor (see the discussion below under "Reasonably Certain"). As discussed below, given the sentence structure of clause (iv), it is at least possible such an interpretation was not intended.

If the final regulations retain the "predominantly fixed" presumption factor in some form, additional guidance on the meaning of "predominantly fixed in amount" would be helpful. (**Principal Recommendation (3)**.) In particular, we do not believe a profits interest should be regarded as predominantly fixed merely because it reflects a hypothetical investment of a specific amount. Such an allocation is not fixed merely because one of the inputs to the formula for making the allocation is a specific amount.

The third factor of clause (iv) ("highly likely to be available") also seems susceptible of interpretations that may be unintended. The factor presumes insufficient risk if net income is highly likely to be available to make the allocation, but it is not limited to fixed or targeted amounts that are highly likely to be exceeded. For example, if a partnership divides all profits 90% to a capital partner and 10% to a service partner, the presumption would appear to apply if the possibility of a single dollar of profit were considered highly likely. It would make more sense to us if the drafting were revised as follows:

> is predominantly fixed in amount *or* is reasonably determinable under all the facts and circumstances, *and* is designed to assure that sufficient net profits are highly likely to be available to make an allocation to the service provider at least equal to the fixed component of the allocation or to the "reasonably determinable" amount (e.g. if the partnership agreement provides for an allocation of net profits from specific transactions or accounting periods and this allocation does not depend on the long-term future success of the enterprise)[.]

Alternatively, it would seem as though the factor should require a fixed or formula amount that is highly likely to be exceeded. Without these additional criteria, this factor could be viewed as circular or else close to tautological.

2. Reasonably Certain

In addition to the issues in clause (iv) of Prop. Treas. Reg. § 1.707-2(c)(1) noted above, the provisions of Prop. Treas. Reg. §1.707-2(c)(1) use multiple standards that are very similar; the IRS should consider a unified standard for all such provisions to reduce confusion. Prop. Treas. Reg. §1.707-2(c)(1)(ii) creates a presumption of no significant entrepreneurial risk if the service provider's share of income is *reasonably* *certain*; Prop. Treas. Reg. §1.707-2(c)(1)(iv) creates the same presumption if the allocation is *reasonably determinable* under the facts and circumstances or if it is *highly likely* that sufficient net profits will be available to pay the allocation. Instead of using three alternative formulations of very similar standards, taxpayers may find it less confusing if Prop. Treas. Reg. §1.707-2(c)(1)(ii) and -(iv) were consolidated to provide that no significant entrepreneurial risk exists when the fact and amount of payment are reasonably certain, which could include an allocation that is made if there is any income in any period (as opposed to a one-year or longer period specified in advance) or from any asset (as opposed to an asset or subset of assets or activities specified in advance), as discussed below.

3. Life of the Partnership; Overall Results of Partnership

Prop. Treas. Reg. §1.707-2(c)(1) states the general rule that whether an arrangement lacks significant entrepreneurial risk is based on the service provider's entrepreneurial risk relative to the overall entrepreneurial risk of the partnership. The general concept here seems appropriate, but it is unclear whether that statement (or the parenthetical in presumption (iv) discussed above) means that an allocation for less than the entire life of the partnership or one that is linked solely to one asset or activity or a subset of assets or activities of the partnership, rather than all assets or activities of the partnerships, may be inherently problematic (although as discussed below, one of the examples in the Proposed Regulations blesses an allocation based on a single year's results).

We believe that an allocation should not automatically be treated as a disguised payment for services merely because it is based on (1) a period of at least 12 months that is shorter than the life of the partnership and/or (2) an asset or activity or subset of assets or activities of the partnership that are less than all of the assets or activities of the partnership, so long as the time period, asset(s) or activity(ies) are specified in advance and are being used for measurement for a business reason. (**<u>Principal Recommendation (4)</u>**.) Example 4 of Prop. Treas. Reg. §1.707-2(d) blesses a profits interest based on net profit from a single specified year but under the facts of the example the partnership owns only marketable securities and the profit calculation is based on all assets of the partnership (as well as having a Section 475 election in place). As discussed below, the same treatment should apply in appropriate cases even if the allocation relates to assets that are non-public securities or to only a single asset or subset of assets of the partnership (and where no Section 475 election applies). One possible approach could be to revise the current general rule to provide that whether an arrangement lacks significant entrepreneurial risk is based on the service partner's entrepreneurial risk relative to the overall entrepreneurial risk of the partnership for the period or assets or activities to which the arrangement relates.

We acknowledge that there are a number of situations involving subsets of partnership assets or shorter periods that are inappropriate. For example, if an allocation to a service provider allows the partnership to "cherry pick" periods with net income to fund the provider's allocation after the arrangement is in place, even if other periods have losses, such arrangement may be abusive and should be considered to have a factor favoring disguised payment for services treatment. On the other hand, when the service provider receives a distribution only from net income earned over a one-year or longer period and the period is determined in advance when the lower fee is set and for a business reason, there would seem to be little potential for abuse, even if the partnership agreement lacks a clawback provision (discussed below), at least where the net income for the period includes unrealized gain and loss as well as recognized income, gain and loss. Likewise, allowing the service provider to cherry pick assets after the arrangement is in place for the purpose of deciding which assets generate net income to be allocated to the partner may be abusive where it serves to make it likely income will be available to cover the service partner's allocation. On the other hand, providing that an allocation will be from net income of an asset or subset of assets or activities of the partnership specified in advance (when the lower fee is set or when the asset is acquired) and for a business reason does not seem to create a similar potential for abuse, and should not create a disguised payment for services.[31]

The examples in the Proposed Regulations could be viewed as implying that a clawback is required at least where another profits interest in the same partnership is subject to a clawback. However, requiring a partnership agreement to have a clawback provision to avoid treating allocations to a service provider as a disguised payment for services would seem to attach too much importance to a specific commercial term. Many partnerships provide for profits interests with no clawback or deficit restoration obligation or impose such an obligation on some but not all partners. In some cases, a clawback may be illogical or unwanted, such as where the partnership is intended to continue indefinitely. Even if other profits interests are subject to a clawback provision, the absence of a clawback may not be abusive where the arrangement depends on

---

[31] For example, a partner may perform services relating to some assets and not others and have a greater interest in the relevant assets and a lower or no interest in the other assets. No reason is apparent for treating such a partner as automatically flunking the "significant entrepreneurial risk" test because the partner's risk differs from that of the partnership as a whole.

cumulative net income over a period of one year or more determined in advance. In other words, a partner without a clawback may be subject to entrepreneurial risk. Based on our own experiences, we question whether a sponsor in the real world would manipulate arrangements that lack a clawback to optimize its profits interest (in light of fiduciary concerns, the desire to enhance returns for track record presentations in subsequent fundraising, etc.). Such concerns would be further reduced it there is a requirement to mark to market the relevant investments that remain unsold at the end of the measurement period and take into account the unrealized gain or loss inherent in such investments would seem to address any such concern, which would also give limited partners the ability to contest the sponsor's entitlement to the allocation. Concern about a sponsor using an artificially high valuation for nontraded assets could be further allayed by requiring the sponsor to use the same valuations as those that are included in periodic reports to investors or are used to determine redemption prices, and by requiring special scrutiny if assets are sold at significantly lower prices shortly after the valuation date.

Regardless of how the rules treat allocations based on periods shorter than the life of the partnership or subsets of partnership assets, we believe an allocation should not fail to have significant entrepreneurial risk merely because certain expenses are excluded from the calculation, provided the exclusion is for a business reason. For example, overall net income for the service partner's allocation might omit certain expenses as part of the commercial arrangement (such as fees paid to the service partner itself for services provided to the partnership).

4. Proposed Additional Examples

We believe that it would be useful for the final regulations to include additional examples that contain somewhat common factual details as to arrangements that would pass muster under the proposed regulations. We propose two such examples below at V.E.5. It would be helpful to provide a safe harbor or an example to make clear that the following situations would be respected as allocations and distributions. The first situation would be a hard-wired interest issued to the sponsor where the amount of allocable profit equals the distributions that would be received from a hypothetical investment (similar to the variable amount format described in Part I of this report), subject to a requirement that the partnership have sufficient overall net income to allocate to the sponsor, and subject to an enforceable clawback, where the allocation and payment of an amount (net of any such clawback) at least equal to the amount of such hypothetical investment is not reasonably certain. The second situation would be an additional hard-wired interest issued to the sponsor where the amount of allocable profits equals a distribution that would be received from a hypothetical investment in a particular investment, subject to a requirement that the specific investment produce sufficient profit to allocate to the sponsor. The second safe harbor could require that any interim distributions in respect of that investment be subject to a clawback if the investment was subsequently sold at a loss, and that allocation and payment of an amount (net of any such clawback) at least equal to the hypothetical investment amount not be reasonably certain.

### 5. Gross Income

Prop. Treas. Reg. §1.707-2(c)(1)(iii) creates a presumption that no significant entrepreneurial risk exists when an allocation of gross income is made. The presence of an allocation based on gross income, particularly when coupled with other bad facts, such as a cap, understandably would be viewed with some suspicion. The legislative history acknowledges that very concern, indicating that gross income allocations may "in very limited circumstances" represent an entrepreneurial return. But the legislative history also provides that gross income allocations are respected if the allocations "represent an entrepreneurial return" and the amount that will be paid is uncertain (assuming that the service provider does not perform similar services for third parties where the service provider's compensation is on a basis intended to replicated the third-party charge).[32] In addition, the legislative history includes an example (Example 1) in which a capped but speculative gross income allocation is respected.

We have two suggestions relating to the proposed rules for gross income allocations. First, we recommend that the IRS consider in the final regulations generally treating gross income allocations as a factor for the IRS to consider rather than as a basis for presuming the lack of significant entrepreneurial risk. If that recommendation is followed, a presumption might still be appropriate for certain types of gross income allocations, such as those described in the legislative history that replicate what the service provider charges third parties. Gross income allocations that are fixed or capped might also fall within other presumptions. Second, the final regulations should provide that net gain from an asset sale, even if technically included in "gross income" under the

[32] Senate Report, at 227, 229-30.

Code, should not be treated as gross income that triggers the presumption. The gross income allocations in the legislative history involved gross income that was highly likely to be earned, such as rent or interest. Net gain from an asset sale is not generally highly likely to be earned at the outset and is thus in the nature of net profit.[33] A service provider should be entitled to an allocation from net gain of an asset sale without treating the allocation as triggering a presumption that the allocation is in fact a payment for services. (**Principal Recommendation (5)**.)

6. Notice to Partners

Prop. Treas. Reg. §1.707-2(c)(1)(v) creates a presumption that no significant entrepreneurial risk exists if the waiver is nonbinding or the service provider fails to timely notify the partnership and its partners of the waiver and its terms. We agree the waiver must be binding and agree a notice requirement helps ensure the waiver is in fact binding and clear. In some circumstances, however, it may be impractical or unduly burdensome for the service provider to provide notice to all partners, as the identity of some partners may be unknown or the cost of providing such notice may be substantial. The Preamble appears to recognize that fact and specifically requests suggestions regarding fee waiver requirements that sufficiently bind the service provider and are administrable by the partnership and its partners. While waivers may become less frequent after changes to the Revenue Procedure are made, we believe that for any waivers that are made, it should be sufficient that (i) the waiver is made before the end of the prior taxable year (eliminating any potential implication from Example 5 that the

[33] Under Treas. Reg. §1.61-6(a), gain realized on the sale or exchange of property is included in "gross income" under Section 61, but is clearly defined as the excess of amount realized over cost or other basis.

waiver must be made at least 60 days before the end of the taxable year), (ii) is made in a writing (which may be electronic) that states that the waiver is irrevocable and is made, and (iii) is made to a committee of limited partner representatives or a similar subset of partners in a widely held partnership. (**Principal Recommendation (6)**.) We believe such an approach would result in sufficient relevant partners knowing about the waiver and its terms so as to further the ostensible purpose of the notice rule (binding and clear notice) while avoiding the potential for footfaults.

D. Prop. Treas. Reg. §1.707-2(c) -- Other Factors

1. Different Interests for Different Services

Prop. Treas. Reg. §1.707-2(c)(6) focuses on an arrangement involving different services that are provided by the same or related persons, and the terms of the differing allocations or distributions held by the same or related persons are subject to levels of entrepreneurial risk that vary significantly. The IRS should consider whether this factor, which was not mentioned in the legislative history, is necessary or helpful. Section 707(a)(2) does not and should not require that each allocation has the highest possible level of entrepreneurial risk. Whether an allocation is abusive or not should not depend on whether the partner holding the interest also holds another profits interest (either directly or through an affiliate) with different terms and a different amount of risk. If a service partner held a simple ratable profits interest in a partnership and a related service partner held a separate profits interest in the same partnership that was subordinated to a preferred return to a capital partner, Prop. Treas. Reg. §1.707-2(c)(6) would provide that the lower risk profits interest (the first service partner's interest) has a factor favoring treatment as a disguised payment for services because of the presence of another profits interest with higher risk (the related service partner's interest). If there were no higher risk profit interest, however, the lower risk profits interest would probably not raise any questions. We are concerned that the existence of this factor could lead to excessive challenges of nonabusive commercial arrangements on audit. Likewise, if a partnership provides a no-risk profits interest to a service partner and has no other profits interest outstanding, the no-risk interest is still abusive. (**<u>Principal Recommendation (7)</u>**.) Note that if Principal Recommendation (4) above regarding single assets or subsets of assets is adopted, absent a change or elimination of Prop. Treas. Reg. §1.707-2(c)(6), one or more allocations within all such arrangements would seemingly have a bad factor (for example, because the risk for one asset would be more or less than the risk for all assets, but not exactly the same), which seems inappropriate.

2. <u>Interests Held by Affiliate</u>

Whether or not the Final Regulations omit the factor described by Prop. Treas. Reg. §1.707-2(c) (6), as discussed above, we believe Prop. Treas. Reg. §1.707-2(c)(5) should be modified to take into account interests held by affiliates. Prop. Treas. Reg. §1.707-2(c)(5) provides that a factor in favor of treatment as a payment for services exists when the value of the service provider's interest in general and continuing partnership profits is small in relation to the allocation and distribution. Prop. Treas. Reg. §1.707-2(c)(6), discussed above, in effect penalizes an entity by taking into account interests held by a related service provider. Under that provision, if an affiliate related to a partner has a higher risk interest, the partner has a factor favoring disguised payment treatment for the partner's interest. If the factor described by Prop. Treas. Reg. §1.707-2(c)(6) is retained, the final regulations should be consistent and give the service provider the benefit of interests held by a related entity for purposes of determining if the service provider has a sufficiently substantial partnership interest apart from the potentially abusive interest being tested under Prop. Treas. Reg. §1.707-2(c)(5). (**Principal Recommendation (8)**.) We believe that change would be appropriate even if Prop. Treas. Reg. §1.707-2(c)(6) is deleted, as the presence of a general and continuing interest held by an affiliate would seem to negate the adverse inference about the tested interest on which this factor focuses in the same way as if the interests were held by the same person.

E. Prop. Treas. Reg. §1.707-2(d) – Examples

1. Allocations Reflecting Interest in Partnership

The Proposed Regulations provide a series of examples in Prop. Treas. Reg. §1.707-2(d). The discussion below suggests some changes to the existing examples and some new examples that could be considered to provide further clarification of the application of the rules. But as a threshold matter, one general point should be considered: all of the examples in the Proposed Regulations specify that the partnerships agreements provide for liquidating distributions in accordance with capital accounts and allocations that have economic effect under Treas. Reg. §1.704-(b)(2)(ii). We believe the same rules should apply to partnerships whose allocations are valid under Section 704, even if they do not involve liquidations in accordance with capital accounts, so we recommend that the final regulations clarify that a partnership agreement need not provide for liquidating distributions to be made in accordance with capital account balances. (**<u>Principal Recommendation (9)</u>**.)[34]

2. <u>Comments on Example 3</u>

Example 3 of Prop. Treas. Reg. §1.707-2(d) describes a relationship between M, a service provider, ABC, an investment partnership holding investment assets that are not readily tradable, and A, a company that is the general partner of ABC and controls M. As part of the partnership agreement, M 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 for which ABC has overall net income. This allocation is intended to approximate the fee that M would have otherwise received for its services. A is allocated 10% of any net profits or losses earned by ABC over the life of the partnership, subject to a clawback obligation. Example 3 states that M's priority allocation is highly likely to be available and reasonably determinable as to amount based on all the facts and circumstances, singling out A's ability to control the timing of asset dispositions as a factor leading to such conclusion. The example concludes that A's arrangement has significant entrepreneurial risk because (i) the allocation to A is of net profits earned over the life of the partnership, (ii) the allocation is subject to a clawback and (iii) the allocation is neither reasonably determinable nor highly likely to be

[34] See New York State Bar Association Tax Section, Report on Partnership Target Allocations (Sept. 23, 2010) for discussion about the growing use of "target allocations" as an alternative method for allocating a partnership's items of income and loss among its members. Furthermore, in 2004, the IRS proposed regulations concerning proper allocation of creditable foreign tax expenditures ("CFTEs") for partnerships. T.D. 9121, I.R.B. 2004-20. The proposed regulations provided a safe harbor under which partnership allocations of CFTEs would be deemed in accordance with the partners' interests in the partnership. One requirement to use the proposed safe harbor was that the partnership agreement had to provide for liquidating distributions in accordance with capital account balances. When the regulations were finalized in 2006, the safe harbor no longer required liquidation in accordance with capital accounts; the regulations merely required the allocations to be proportionate to the distributive shares of income to which the CFTEs related. T.D. 9292, I.R.B. 2006-47.

available, and that the arrangement is not a disguised payment for services. It concludes that M's arrangement lacks significant entrepreneurial risk because (i) the priority allocation is an allocation from any 12-month accounting period in which the partnership has net gain and therefore does not depend on the overall success of the enterprise and (ii) the timing of recognition of gains and losses is controlled by A, who is related to M, and that the arrangement provides for a disguised payment of services.

It would appear the conclusion regarding M may reflect governmental concern that arrangements are more susceptible to manipulation where the profits interest recipient controls the timing or realization of income and the integrity of the arrangement is not protected either by a clawback or by taking into account unrealized gains and losses. Some of us question whether this concern may be overstated, as control by a profits interest holder over the timing of sales does not necessarily mean that sales will be manipulated to maximize the allocation being tested. The sponsor owes fiduciary duties to other partners and has an incentive to maximize long-term investment returns to enhance marketing of future funds and otherwise improve standing with investors. Those duties and incentives should generally deter the sponsor from manipulating the timing of sales at the expense of the overall success of the partnership. Moreover, the illiquid nature of many private investments would also impede attempts to manipulate the timing of sales. However, as noted above, we acknowledge that the IRS and Treasury may feel that greater safeguards are needed in this context, and that taking into account net unrealized loss may be appropriate to address those concerns.

Clause (iv) of Example 3 changes the facts to allow ABC to fund the priority allocation to M from the revaluation of partnership assets pursuant to Treas. Reg.

§1.704-1(b)(2)(iv)(f). It concludes that because the valuation of the assets is controlled by A and M's profits may be determined by reference to a specific accounting period, the arrangement lacks significant entrepreneurial risk and is a disguised payment for services.

Because clause (iv) of Example 3 adds a bad fact (the partnership can fund M's priority allocation from any revaluation of partnership assets pursuant to Treas. Reg. §1.704-1(b)(2)(iv)(f) as well as from what appears to be realized net profit in any 12-month period) to an arrangement that already is treated as a disguised payment for services, the conclusion that the arrangement with an additional bad fact is also treated as a disguised payment for services is unsurprising. The example is presumably intended to highlight the fact that valuations of nontraded assets on the occurrence of any bookup event (such as a redemption or issuance of interests) may be particularly susceptible to manipulation. If so, the IRS may wish to revise the example or provide a new example to make that point.[35]

3. Comments on Example 4

Example 4 of Prop. Treas. Reg. §1.707-2(d) provides the same facts as Example 3, except ABC's investment assets are readily tradable securities for which A has validly made a mark-to-market election under Section 475. Additionally, M is entitled to receive a special allocation and distribution based on partnership net gain attributable to a specified future 12-month taxable year, and it cannot reasonably be predicted whether the partnership will have net profits with respect to its entire portfolio in that specified taxable year. The example concludes that there is significant

[35] We would also point out, as noted above, any concern about a sponsor using artificially high valuations for nontraded assets could be addressed by requiring use of the same valuations as are used in periodic reports to investors or to determine redemption prices and by imposing special scrutiny where subsequent sales occur shortly after the valuation at significantly lower prices.

entrepreneurial risk because (i) the special allocation is allocable out of net profits, (ii) the partnership assets have a readily ascertainable market value determined at the close of each year and (iii) it cannot reasonably be predicted whether the partnership will have net profits with respect to its entire portfolio for the year to which the special allocation would relate, and thus the arrangement does not constitute a payment for services.

As noted above, Example 4 describes an investment partnership that has made a mark-to-market election under Section 475(f)(1). In our experience private investment funds using mark-to-market book accounting (which would be many hedge funds but not most other private investment funds) often do not make a Section 475 election. We believe it would be reasonable to respect allocations made pursuant to book market-to-market accounting for an annual or longer specified regular interval, provided they are subject to a "high-water mark," meaning any net losses incurred before the testing period must first be covered by net profits in the testing period (measured at the end of such period) before the profits interest begins to share. Such arrangements are not generally subject to a clawback, reflecting the commercial reality that investors are protected by the mark-to-market and do not need a clawback. Perhaps the example could be revised to reflect such an arrangement. We also believe it would be helpful to address the case of mark-to-market book accounting applied to less than all of the partnership's assets where net unrealized gains and losses are taken into account. In any event, it would be helpful if the IRS could clarify the relevance of the Section 475 election to the analysis set forth in the example.

4. Example 5

In Example 5 of Prop. Treas. Reg. §1.707-2(d), A is a general partner of investment partnership ABC, and A has delegated the management function to M, a company controlled by A. The example states that comparable funds to ABC commonly require the general partner to contribute capital in an amount equal to 1% of the limited partners' capital contributions, provide the general partner with an interest in 20% of future partnership net income and gains (measured over the life of the fund) and pay the fund manager an amount equal to 2% of capital committed by the partners. ABC's partnership agreement provides that A only contributes nominal capital, M receives an annual amount equal to 1% of committed capital, and A receives an interest in 20% of future partnership net income and gains (measured over the life of the fund, and subject to a clawback). A is also granted an additional interest in future partnership net income and gains, intended to represent the present value of 1% of committed capital.[36] The example provides that there is significant entrepreneurial risk because (i) the allocation to A is of net profits, (ii) the allocation is subject to a clawback and (iii) the allocation is neither reasonably determinable nor highly likely to be available, and thus the arrangement is not a payment for services.

Example 5 refers to the fact that funds "comparable" to the investment fund being analyzed (i) "commonly require" the general partner to contribute capital equal to 1% of the capital committed by the limited partners, (ii) provide the general partner with a profits interest equal to 20% of future partnership income and (iii) pay the fund manager a fee equal to 2% of committed capital. In reality, actual fee and profit

[36] We are not aware of any investment funds that create additional interests in future profits based on such a present value calculation.

sharing arrangements among private investment funds vary widely as to fee percentage, the base on which the fee is calculated and other terms. As a result, it may be difficult for a fund to determine the precise compensation arrangements for comparable funds. In addition, we are not sure why the fee arrangements of comparable funds is important to the analysis in the example, and would suggest that it be removed in the final regulations.

5. Suggested Additional Examples

a. Whole Fund Variable Amount Management Profits Interest

The IRS should consider adding in the final version of Prop. Treas. Reg. §1.707-2(d), as Example 7, the following example.[37] A is a general partner in newly formed partnership ABC, an investment fund. A is responsible for providing management services to ABC. ABC's partnership agreement provides that A must contribute capital in an amount equal to 1% of the capital contributed by the limited partners, that A is entitled to an interest in 20% of future partnership net income and gains as measured over the life of the fund, and that A is entitled to receive an annual fee in an amount equal to 0.8% of capital committed by the partners. The partnership agreement provides A is entitled to an interest in partnership profits corresponding to 0.7% of the partnership's investment amount and 0.7% of future partnership net income and gains (the "Additional Interest"). The Additional Interest relates to investments by the partnership under a protocol not subject to change by A. Under the protocol, A shares in distributions from each such investment as if the sponsor had invested capital in that investment equal to an additional 0.7% of the partnership's investment amount, but A's

[37] We note that this example is consistent with Example 5, and may simply represent a further fleshing out of the facts of that example, but we believe the additional detail will provide helpful guidance to taxpayers.

allocations are limited to overall partnership net realized income or gain for year of sale of an investment less any cumulative overall partnership net realized losses in prior years. (Thus A's distribution from that investment, before considering the limit described above, may be less than or greater than the initial deemed capital amount allocable to that investment.) A's profits interest is subject to clawback for losses in subsequent years, and A's Additional Interest is subject to such a clawback as well. The allocation and payment (net of such a clawback) of an amount at least equal to the deemed investment amount is not reasonably certain. The example would conclude that A's arrangements do not constitute a disguised payment for services and should be respected.

b. Investment-by-Investment Management Profits Interest

The IRS should also consider adding in the final version of Prop. Treas. Reg. §1.707-2(d), as Example 8, the following example, which would provide an alternative method to establish that an arrangement should not constitute a disguised payment for services. The facts are the same as in Example 7, except A's allocation from each investment is limited to income from that investment, rather than the limit based on overall net income described in Example 7. In addition, there would be a clawback at the time of sale of the investment if (1) A had received any distribution of income on the additional interest with respect to such investment, (2) the sale was at a loss and (3) the loss resulted in an insufficient amount of income being available to cover the prior allocation of income (but there would be no other clawback required). The allocation and payment (net of any such clawback) of an amount at least equal to the deemed capital amount is not reasonably certain. The example would conclude A's arrangements do not constitute a disguised payment for services and should be respected.

F. Prop. Treas. Reg. §1.707-9 – Effective Date

Prop. Treas. Reg. §1.707-9(a)(1) provides that, in general, Prop. Treas. Reg. §1.707-2 applies to all arrangements entered into or modified after the date of publication of the final regulations. This is a sensible effective date rule. It might be helpful for the effective date rule to clarify that modification of an arrangement does not include modifications to a partnership agreement or other agreement pursuant to which such arrangement is provided, if the modification does not affect allocations or distributions from such arrangement.

G. Revenue Procedure 93-27

1. Different Entity Holds Profits Interest

The Preamble indicates that the IRS and the Treasury believe that the safe harbor created by the Revenue Procedure does not apply to an arrangement in which the fee entity provides services but the profits interest is held by an affiliate of the fee entity, rather than by the fee entity itself.[38] The Preamble provides two reasons for this position: first, that the profits interest is not issued for the provision of services to or for the benefit of the partnership in a partner capacity or in anticipation of becoming a partner (the "provision of services test"), and second, the fee entity should be viewed as having initially received the profits interest and then as having transferred that interest to its affiliate within two years (the "two-year test").[39]

We would suggest that the IRS reconsider this position for two reasons. (**Principal Recommendation (10(a)).**) First, in most cases of which we are aware, those

[38] 80 Fed. Reg. at 43,656. An IRS official has stated publicly the statement in the Preamble is not technically a modification of Rev. Proc. 93-27 but is instead the government's interpretation of the revenue procedure.

[39] Id.

structures may not truly involve any transfers of the ultimate indirect ownership of the profits interest. Most typically, the ultimate individuals who receive the profits interests are in fact the same people who would have received the waived fee (either as owners of the fee earning entity or as employee compensation). In many cases, what motivates the sponsor to form one entity to earn fees and a separate entity to earn investment returns are state or local tax concerns having nothing to do with federal income tax planning or objectives.

In addition, even if the interest is viewed as issued first to the fee entity and then transferred to a separate entity, the ownership of the profits interest by a separate entity would not seem to violate the principle intended to be protected by the two-year test. The purpose of the two-year rule is presumably to exclude a profits interest that can be more readily valued based on the facts of the transfer within that period.[40] Thus, a third-party sale within two years for a cash price might be considered to provide an objective basis to conclude that the interest could have been reasonably valued when issued, and would also provide information about that value. But a constructive transfer to an affiliate for no consideration sheds no light on the value of the interest, or the ease with which it could have been valued, when issued. Particularly in light of the tension between the annual accounting principle and the two-year rule, it may be appropriate to limit the two-year rule to cases such as third-party cash sales that establish a clear value and thus further the underlying policy. More generally, it may be useful to revise the

[40] See, e.g., Diamond v. Comm'r, 492 F.2d 286 (7th Cir. 1974) ("[I]t is clear that a partner who receives only an interest in future profits of the partnership as compensation for services is not required to report the receipt of his partnership interest as taxable income. The rationale is twofold. In the first place, the present value of a right to participate in future profits is usually too conjectural to be subject to valuation…" (internal citation omitted)).

two-year rule to exclude affiliate transfers, gifts and other transfers that do not establish a clear value.

2. Exclude Profits Interests Where Payments Forgone

The Preamble indicates that the IRS plans to issue a new revenue procedure adding an additional exception to Revenue Procedure 93-27 to exclude from the safe harbor profits interests issued in conjunction with a partner forgoing payment of a substantially fixed amount.[41] Presumably, the rationale for this additional exception is that the forgone amount provides clear information about the value of the profits interest.[42] Some of our members would note that uncertainty about value may remain, however, as the profits interest is subject to some type of profits contingency while the fee is not and it may be unclear when investments will be made to which the profits interest relates. Moreover, a sponsor may choose to forego fees and instead rely on a profits interest to improve relations with investors or improve investment returns to assist future fundraising or for other commercial reasons. But, our consensus view is that we do not object to the change.

If clear valuation is the basis for the change, we recommend that the amended Revenue Procedure make it clear that the exception will not apply to hard-wired arrangements (those where the lower fee and additional profits interests are provided for when the documents are signed). (**Principal Recommendation (10(b))**.) In that case, there is no fixed contractual right to a particular amount and thus there is no clear way to

41 80 Fed. Reg. at 43,656.

42 Cf. Philadelphia Park Amusement Co. v. U.S., 126 F.Supp. 184 (Ct. Cl. 1954).

determine the value of the "forgone" fee that the sponsor might have received had it negotiated a different deal.[43]

3. Compensatory Profits Interest Regulations

Whatever changes the IRS and the Treasury may decide to make to the Revenue Procedure, it is important not to lose sight of the complexities and uncertainties that await in circumstances where the safe harbor does not apply. Even if the safe harbor does not apply, some parties may nevertheless treat the receipt of such interests as nontaxable in reliance on Campbell[44] and other authorities, while other parties may treat the receipt of such interests as taxable and as giving rise to a corresponding deduction. In the latter case, it is not clear what is the best way to account for the corresponding deduction, how to avoid double inclusion of income to the holder and how to reconcile the arrangements with our current capital accounts system. Some parties may attempt to mitigate the income inclusion by allocating some or all of the deductions to the service partner, although such an allocation may or may not be valid, and Sections 409A, 457A and 212 and other limits on deductions may make the inclusion and deduction less than pain-free. A revenue procedure modifying Revenue Procedure 93-27 is probably not the best place for the IRS to spell out what happens if a compensatory partnership interest is included in the service partner's income in an amount in excess of its liquidation entitlement, as that seems like a broader topic more appropriately handled through the

43 Perhaps one could argue a separate profits interest is issued for each investment, but the agreement to pay fees at the lower level is reached at inception when the actual fee amounts that will be payable in the future may not be easy to determine, and the only compensatory award of the profits interest also occurs at inception, all of which seems inconsistent with a determination that compensatory transfers are occurring as each investment is made.

44 Campbell v. Comm'r, 943 F.2d 815 (8th Cir. 1991).

regulations.[45] We urge the IRS and the Treasury to make those regulations a priority. (**Principal Recommendation (10(c)).**)

H. Preamble: Allocation Implies Distribution

Section 707(a)(2)(A)(ii) requires both an increased allocation and an increased distribution as a prerequisite to the IRS treating the arrangement as a payment for services. At one point the Preamble expresses the view that an income allocation correlates with an increased distribution right, justifying the assumption that the distribution should be treated as having been provided for.[46] The Preamble also notes the desirability of characterizing arrangements initially rather than retroactively, with which we agree.[47] However, the partnership agreement may provide for an allocation of income at a time when a corresponding distribution is not made. The partnership agreement might also provide that subsequent losses (or certain subsequent losses) are to be allocated to the service provider before the entitlement to a distribution is established, thereby potentially subjecting the right to receive the distribution to significant entrepreneurial risk. It would be helpful if the final regulations clarified that when analyzing an arrangement when it is created, risks associated with both the allocation and the distribution components should be considered together in evaluating the arrangement.

---

[45] The New York State Bar Association Tax Section submitted an extensive report on proposed regulations and a proposed revenue procedure issued on May 20, 2005. The report enumerates and discusses some of the myriad complexities and uncertainties associated with compensatory transfers of partnership profits interests and other partnership interest. New York State Bar Association Tax Section, Report on the Proposed Regulations and Revenue Procedure Relating to Partnership Equity Transferred in Connection with the Performance of Services (Oct. 23, 2005).

[46] 80 Fed. Reg. at 43,654.

[47] Id.