

# Passthrough Partner

---

## Disguised Payment for Services in a Capacity Other Than That of a Partner

*By J. Leigh Griffith*

**P**roposed regulations (the “Proposed Regulations”)<sup>1</sup> were recently issued to flesh out an anti-abuse rule for Code Sec. 707(a) found in Code Sec. 707(a)(2)(A),<sup>2</sup> modify Rev. Proc. 93-27<sup>3</sup> and Rev. Proc. 2001-43<sup>4</sup> and modify the interpretation of Code Sec. 707(c). While the Proposed Regulations are to apply prospectively to arrangements entered into or modified on or after the date of publication of the final regulations, it is important to note that the preamble to the Proposed Regulations states, “the determination of whether an arrangement is a disguised payment for services under section 707(a)(2)(A) is made on the basis of the statute and the guidance provided regarding that provision in the legislative history of [such section].”<sup>5</sup> As discussed herein, this means that much of the analysis of the Proposed Regulations is subject to current and retroactive application. The Proposed Regulations do not describe the consequences of characterizing an arrangement for the payment of services that are controlled by applicable law.

### Background

---

Under the Code, an allocation or distribution between a partnership and a partner can be characterized in one of three ways: (i) a distributive share under Code Sec. 704(b), the right to which may qualify as a “profits interest” as defined in Rev. Proc. 93-27 as clarified by Rev. Proc. 2001-43; (ii) a guaranteed payment under Code Sec. 707(c); or (iii) a transaction in which a partner has rendered services to the partnership in a capacity as other than a partner under Code Sec. 707(a).<sup>6</sup> Each of these characterizations has potentially different tax ramifications, and there is certainly a tension among these alternatives as they all involve a service provider providing services to a partnership and receiving an allocation and distribution. Indeed, the same service provider may be providing different services that are each subject to a different characterization. The determination of which characterization is appropriate involves conflicting concerns. In the author’s view, there will be many cases where the relationship may be reasonably classified in two different characterizations, and the subjective nature of the determination is fraught with the opportunity for disputes. The Proposed Regulations attempt to stack the deck in favor of the IRS by injecting a “clear and convincing evidence” standard to overcome a presumption that an arrangement is a disguised payment



**J. LEIGH GRIFFITH** is a Partner at Waller Lansden Dortch & Davis, LLP, in Nashville, Tennessee.

for services.<sup>7</sup> The determination as to whether an arrangement has sufficient “entrepreneurial risk” at times will not be clear and the application of the secondary factors even more so. The author believes that if the characterization of the partnership is reasonable under the facts and circumstances and is consistently applied, the characterization of the partnership should control; that is, however, not what the Proposed Regulations provide.

## Disguised Payments for Services in a Capacity Other Than That of a Partner

The Proposed Regulations provide that an arrangement will be treated as a disguised payment for services by a service provider in a capacity other than that as a partner if:

1. a person (service provider), either in a partner capacity or in anticipation of becoming a partner, performs services (directly or through its delegate) to or for the benefit of a partnership;
2. there is a related direct or indirect allocation and distribution to such service provider; and
3. the performance of such services and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a person acting other than in that person’s capacity as a partner.<sup>8</sup>

In accordance with the 1984 legislative history of Code

*The broad language in the preamble concerning the disassociation of the distribution requirement from the allocation for the application of Code Sec. 707(a)(2)(A) is troubling.*

Sec. 707(a)(2)(A), the Proposed Regulations use a facts-and-circumstances test to determine whether a specific arrangement should be treated as a payment for services as opposed to a distributive share. The legislative history includes five nonexclusive factors<sup>9</sup> to be considered. The Proposed Regulations list the legislative history factors as the first five factors to be considered and add a sixth factor that is aimed at the management fee waiver arrangements now commonly used by private equity and venture capital funds. The six factors identified in the Proposed Regulations,<sup>10</sup> starting with the most important, follow:

1. **Significant Entrepreneurial Risk.**<sup>11</sup> This first factor, whether the service provider bears significant entrepreneurial risk as to both the amount and fact of payment, is the most important.<sup>12</sup> An arrangement that lacks such risk almost certainly will be treated as a payment for services in a capacity other than that of a partner.<sup>13</sup> Whether a significant entrepreneurial risk exists will be determined by comparing the service provider’s entrepreneurial risk to that of the overall entrepreneurial risk of the partnership.<sup>14</sup> All else equal, this permits a service provider to be treated as providing services as a partner in ventures that do not have a high risk (such as investing in high-quality debt securities or ownership of real estate under a triple net lease) and not simply higher risk ventures such as venture capital, private equity or operating a small closely held business. In the view of Congress (as well as the Proposed Regulations) significant entrepreneurial risk is the most important factor as “[p]artners extract the profits of the partnership with reference to the business success of the venture, while third parties generally receive payments which are not subject to this risk.”<sup>15</sup>

The Proposed Regulations then list five unweighted factors (or facts and circumstances) that create a presumption that an arrangement lacks significant entrepreneurial risk and indicates the classification will be that of a payment for services unless other facts and circumstances establish the presence of significant entrepreneurial risk by clear and convincing evidence. The existence of one or more of these factors can lead to the conclusion the arrangement is disguised compensation. These five unweighted factors are<sup>16</sup>:

- 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 predominately fixed in amount, is reasonably determinable under all 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 ([for example], 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 that is nonbinding or fails to timely notify the partnership and its partners of the waiver of its terms.

Factors two through six as set forth below are characterized as secondary factors. The absence of such a factor is not necessarily indicative of whether or not an arrangement is treated as a payment for services:

2. **Transitory Partnership Interest.** “The service provider holds or is expected to hold a transitory partnership interest or a partnership interest for only a short duration.”<sup>17</sup>
3. **Timing of Allocation and Related Distribution.** The allocation and distribution to the service provider is made in a time frame comparable to the time frame in which “a non-partner service provider would typically receive payment.”<sup>18</sup>
4. **Primary Purpose to Obtain U.S. Tax Benefits.** “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.”<sup>19</sup>
5. **Partnership Interest Small in Comparison to Allocation and Distribution.** “The value of the service provider’s interest in general and continuing partnership profits is small in relation to the allocation and distribution.”<sup>20</sup>
6. **Related Parties and Different Allocations and Distributions with Respect to Different Services.** “The arrangement provides for different allocations or distributions with respect to different services received” when services are performed by the same or related persons,<sup>21</sup> “and terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly.”<sup>22</sup>

If a service provider’s interest is recharacterized as a disguised payment for services versus a partner’s allocation and distribution and the service partner has no other interest that qualifies the service partner as a partner, the service provider will not be considered to be a partner. If this causes no partnership to exist because the service provider was the second partner of an otherwise two-partner partnership, the service provider is deemed to be providing services to the other person, and there is no partnership.<sup>23</sup>

The Proposed Regulations provide six examples to illustrate the application of the above factors.<sup>24</sup> These examples with a bit of editorial commentary follow:

**Example 1.** ABC partnership is formed to construct and rent a building. A, an architect, contributes 25 percent of the equity cash and does not charge an architectural fee (normal fee would be \$40,000)

for services and receives a 25-percent interest in the partnership and a special allocation of \$20,000 of gross income for the first two years of operations. The building is projected to generate \$100,000 of gross income annually. The 25-percent equity is deemed to be a partnership interest and is respected. The special allocation and distribution of \$20,000 a year for the first two years is not. The rationale of the Proposed Regulations is the special allocation to A is a capped amount and reasonably expected to apply<sup>25</sup> and the special allocation is out of gross income.<sup>26</sup> Strangely, at least to the author, the second factor of an allocation for one or more years in which the service provider’s share of income is reasonably certain<sup>27</sup> was not cited in the example’s analysis.

*The fact that the Proposed Regulations when finalized will be of broader application than merely to private equity and venture capital partnerships needs to be understood.*

**Example 2.** A, a stock broker, contributes 51 percent of the partnership capital of partnership ABC and receives a 51-percent interest in residual partnership profits and losses and agrees to effect trades for the partnership. A also agrees to forego normal brokerage commissions and has a special allocation of gross income computed in a manner that approximates the foregone commissions. The example cites “[t]he special allocation to A is computed by means of a formula similar to a normal brokerage fee and varies with the value and amount of services rendered rather than with the income of the partnership.”<sup>28</sup> It is also stated that the partnership is reasonably expected to have the gross income to make this allocation. While the 51-percent interest is respected and A is a partner, the special allocation is found to be disguised compensation for services because it is reasonably certain there will be sufficient gross income to make the allocation. The example refers to Proposed Reg. §1.707-2(c)(1)(iii) and (iv) but does not discuss the specific application of (iv) as the statement of facts essentially concluded this factor existed by virtue of the formula being similar to a normal brokerage fee and approximates the foregone commissions. The example states the allocation does not depend on the

long-term future success of the enterprise, but it may not even depend on the short-term success of the enterprise. The author assumes the formula is tied to specific transactions by being computed “similar to a normal brokerage fee.” The example would be more useful if it fleshed out how the formula resulted in a fixed amount. In addition, the example states the amount is “reasonably determinable.” The author is unclear as to what “reasonably determinable” means unless it means the formula results in an amount similar to a normal brokerage fee that varies with the value and amount of services provided. A little more insight with respect to this example in the finalization of the Proposed Regulations would be welcome. Presumably, Example 2 stands for the proposition that allocations based on measured activity that is conducted in the ordinary course of business with standard rates coupled with a gross-income allocation (or presumably a highly likely net-profits allocation without a clawback obligation) will not constitute an allocation and distribution.

**Example 3.** Example 3 is a base example with two variations. This example involves a real world common fact pattern. New partnership ABC is created in which A is the general partner of ABC and controls M. M contributes cash in exchange for a one-percent partnership interest in the capital and profits of the partnership and has a priority allocation and distribution of net gain from the sale of one or more assets during any 12-month accounting period in which the partnership has an overall net gain. Per the example, the allocation and distribution is intended to approximate the fee that would normally be charged for the services M performs. The example states the amount of partnership net income or gains that will be allocable to M under the ABC partnership agreement is highly likely to be available and reasonably determinable<sup>29</sup> based on all facts and circumstances upon formation of the partnership. A will be allocated 10 percent of the overall net amount of partnership profits computed over the life of the partnership with a clawback obligation if too much has been allocated and distributed to A.

In the first variation, the investments of the partnership are not marketable. The general partner, A, directs all operations of the partnership consistent with the partnership agreement including causing ABC to purchase or sell assets during any accounting period, and A controls the timing of any distributions to M.

In the example, the IRS concludes although A apparently did not contribute capital, the 10-percent allocation of net profits earned over the life of the partnership with the clawback obligation is neither reasonably determinable nor highly likely to be available.<sup>30</sup> M’s allocation, on the other hand, is deemed to be disguised compensation in a capacity other than that of a partner. Given the nature of the assets and A’s ability to control the timing of asset dispositions, the amount of partnership net income or gain allocable to M is highly likely to be available and reasonably determinable based on facts and circumstances at formation. Specifically, the priority allocation to M is an allocation of net profit from any 12-month accounting period in which the partnership has net gain and does not depend on the overall success of the enterprise. The ability of A to control the timing of recognition of gain or loss in combination with the other facts indicates the allocation is reasonably determinable, and sufficient profits are highly likely to be available to make the priority allocation to M. As a result, the allocation presumptively lacks significant entrepreneurial risk.

The second variation has the same facts except the partnership can fund M’s priority allocation and distribution of net gain from the revaluation of the partnership’s difficult to value assets pursuant to Reg. §1.704-1(b)(2)(iv)(f). A controls the valuation of the difficult to value assets. This fact taken in combination with the partnership’s determination of partnership profits for calculating M’s distribution by reference to a specific accounting period causes the allocation, in the IRS’s view, to be either reasonably determinable under the facts and circumstances or to ensure that net profits are highly likely to be available to make the priority allocation to the service provider with the result M’s allocation is disguised compensation.

The preamble indicates that the opportunity for a related party to control the valuation of the assets and controlling events that affect valuations (such as timing of announcements that affect the value of the assets<sup>31</sup>) may lead to a higher likelihood that sufficient net profits will be available to make the allocation.<sup>32</sup> Similarly, in discussing Example 4 in the preamble,<sup>33</sup> the IRS asserts that the affiliate controls the entities in which the partnership invests, including the timing and amount of distributions (although it notes that the valuation and the control of the portfolio companies does not necessarily establish the absence of

significant entrepreneurial risk).<sup>34</sup> The author struggles to understand how: (i) the amount of partnership net income is highly likely to be available, and (ii) reasonably determinable. Perhaps, this riddle is solved with the additional assumption of the example that it is intended that the allocation and distribution will approximate the fee that would normally be charged.

**Example 4.** This is another variation of Example 3, except the investment assets are securities traded on an established securities market, and ABC is in the trade or business of trading securities and has validly elected to mark-to-market under Code Sec. 475(f)(1). In addition, M is entitled to receive its special priority allocation of net profits (based on the annual mark-to-market and actual sales) and distribution of partnership net gain attributable to a specified future 12-month tax year. Although it can reasonably be expected that the partnership will be able to sell one or more assets for a gain, it cannot reasonably be predicted whether the partnership will have net profits with respect to its entire portfolio in that 12-month tax year. In this case, the IRS concludes that net profits of the entire portfolio for any year to which a special allocation would relate is neither reasonably determinable nor highly likely to be available. Thus, the arrangement does not lack significant entrepreneurial risk, and the arrangement is a distribution and allocation to a partner.

The contrast between Example 3's second variation and Example 4 appears to be based on the notion that the general partner will disregard its fiduciary duties to its partners when making decisions concerning valuation and perhaps the timing of sales. Overstated values over time will have a tendency to harm the general partner and its controlling owner's reputation even if legal action for a breach of fiduciary duty and good faith dealings is not initiated. Investors do pay attention. The sequence of dispositions of assets and distributions from portfolio companies may increase the likelihood of a profit in a given year and the allocation for that year, but over the life of the allocation and distribution the portfolio companies either perform or do not perform and that risk is substantial.<sup>35</sup> The facts and circumstances in looking at the specific general partner, its affiliates and a pattern of past conduct may lead to such conclusion. A blanket determination that the affiliated general partner and manager in a fund investing in nontraded assets with an allocation based on net profits creates a presumption there is a lack of

significant entrepreneurial risk, however, appears to be thin if the allocation and distribution is more than a relatively small amount where minor "fudging" can provide the expected distribution. Does the potential to "play games" to produce an artificial net profit for a year or two, as suggested in Example 3 variation one, justify the determination that over the life of the partnership the allocation lacks significant economic risk as to both the amount and the fact of payment? Does the opportunity to produce an artificial profit based on selected sales make the service provider's share of income reasonably certain? Is the implicit ability to pick the twelve month period as opposed to a fixed fiscal year from day one a major element of the analysis?

*Popular press is appropriately focused on the investment partnerships, but the potential ramifications are much broader.*

**Example 5.** This example involves an investment partnership. The example states that the customary arrangement is for A, the general partner of newly formed ABC, to contribute one percent of the capital of the partnership and to receive a 20-percent carried interest measured over the life of the fund and pay the fund manager an amount equal to two percent of the capital contributed by the partners. ABC has a different agreement. A contributes nominal capital to ABC, and ABC will pay M (a management entity controlled by A) an amount equal to one percent of the capital contributed by the partners, and A receives 20 percent of future-partnership net income and gains as measured over the life of the partnership and an "additional interest" of partnership net income and gains determined by a formula that is approximately equal to the present value of one percent of capital committed by the partners determined annually over the life of the fund. A agrees to a clawback obligation.<sup>36</sup> In the example, the IRS concludes, "[t]he arrangement with respect to A creates significant entrepreneurial risk under paragraph (c)(1) of this section because the allocation to A is of net profits, the allocation is subject to a clawback obligation over the life of the fund and it is reasonable to anticipate that A could and would comply with this obligation, and the allocation is neither reasonably determinable nor highly likely to be available."<sup>37</sup>

This example indicates that even when the allocation and distribution are intended to replace a normal fee, if the allocation is from net profits and subject to a clawback obligation, significant entrepreneurial risk is present. The intent to avoid a fee and instead receive an allocation and distribution does not control if in fact there is entrepreneurial risk.

**Example 6.** In this example, A, the general partner of ABC limited partnership investment fund is responsible for providing management services to the partnership. It delegates this responsibility to its controlled affiliate M. A contributes one percent of the capital contributed by the limited partners, is entitled to an interest in 20 percent of the partnership net income and gains measured over the life of the fund and has a clawback obligation. M is entitled to an annual fee equal to two percent of the capital contributed by the partners. A's 20-percent interest is neither highly likely to be available nor reasonably determinable. The partnership agreement permits M to waive all or a portion of its fee for any year if M provides written notice to the limited partners of ABC at least 60 days prior to the commencement of the partnership tax year for which the fee is payable. If M waives its fee, it will receive an interest determined by formula in subsequent partnership net income and gains, which the example labels as "additional interest." At the time such interest is issued, the partnership will revalue partner capital accounts under Reg. §1.704-1(b)(2)(iv)(f), and the agreement requires that liquidating distributions are made in accordance with capital account balances. The parties intend the estimated present value of the additional interest approximates the estimated value of the fee that was waived and has a clawback provision. The IRS determines that in this case the amount of net income and gains allocable to M is neither highly likely to be available nor reasonably determinable since its allocations and distributions are based on net profits over the life of the partnership, and both are subject to a clawback provision.

## Profits Interest

The preamble indicated that when the Proposed Regulations are adopted the IRS will modify Rev. Proc. 93-27 as clarified by Rev. Proc. 2001-43 to add an exception for profits interests issued in conjunction with a partner forgoing payment of a substantially fixed amount, including a formula amount such as a fee based on a percentage of partner capital commitments, including a guaranteed

payment under Code Sec. 707(c) or a payment in a non-partner capacity under Code Sec. 707(a).<sup>38</sup>

In addition, it appears that the IRS has become aware of a large number of funds in which the affiliated management entity waived its right to payment (sometimes after amounts were substantially earned), and the affiliated general partner (or other entity controlling the fund) received a "profits interest."<sup>39</sup> The preamble states:

The Treasury Department and the IRS have determined that Rev. Proc. 93-27 does not apply to such transactions because they would not satisfy the requirement that receipt of an interest in partnership profits be for the provision of services to or for the benefit of the partnership in a partner capacity or in anticipation of being a partner, and because the service provider would effectively have disposed of the partnership interest (through a constructive transfer to the related party) within two years of receipt.<sup>40</sup>

Falling outside the safe harbor will then bring into play valuation issues. However, since the partnership interest is presumably in exchange for the waiver of the fee, valuation should not be difficult. It will likely be the present value of the fee. This will not conflict with case law.<sup>41</sup> This statement in the preamble should be a warning to partnerships with such allocations that an IRS examining agent is likely to raise the issue.

## Guaranteed Payments Under Code Sec. 707(c)

The preamble also states that Rev. Rul. 66-95<sup>42</sup> and Rev. Rul. 69-180<sup>43</sup> will become obsolete as of the date the Proposed Regulations are finalized and published in the FR.<sup>44</sup> These revenue rulings provide for a tiering or ordering approach when there is a combination of an allocation and distribution and a guaranteed payment. Under these revenue rulings, when a partner is entitled to a percentage of the net profits but not less than a specified dollar amount, the Code Sec. 707(c) guaranteed payment in a specific year will only be the amount, if any, to which the service provider is entitled that exceeds the percentage allocation. The affirmative reversal of the tiering is found in the Proposed Regulations' amendment of Reg. §1.707-1(c) by adding a second example. This amendment provides the Code Sec. 707(c) guaranteed payment is first and that only the amount received above such guaranteed amount will be a Code Sec. 704(b) allocation and distribution. This change is very significant

in investment partnerships with recurring significant capital gains and is clearly aimed at private equity and venture capital funds where capital gains are their primary income. However, the ramifications go far beyond investment partnerships and impact all of the partners in an affected partnership—even “regular” partnerships with service providers. In any year that the partnership’s ordinary income is low but the capital gains are high (such as the year of a liquidity event or years in which substantial Code Sec. 1231 assets are sold), the partners with guaranteed payments will not participate in the capital gains with respect to the guaranteed payment portion even though their profits allocation is a multiple of the minimum payment they were entitled to. While capital gains may not be a frequent event for a “regular” partnership, the service provider with a guaranteed payment may feel the tax pain of all ordinary earned income versus a mix of capital gain and ordinary income a few times over his or her career. However, unlike a Code Sec. 707(a) recharacterization, this change does not distort the economic arrangement of the partners (just the character of the income of the service partner).

## Obsolescence of Rev. Rul. 81-300

The Proposed Regulations obsoleted Rev. Rul. 81-300<sup>45</sup> as of July 23, 2015, when they were issued.<sup>46</sup> This revenue ruling held that an allocation of items of gross income constituted a guaranteed payment. Congress in the legislative history of the Tax Reform Act of 1984 specifically overruled Rev. Rul. 81-300 and concluded that the payment described therein should be a Code Sec. 707(a) payment.<sup>47</sup> Thirty years later, the IRS has now obsoleted the offending ruling. Therefore, gross income allocations can be Code Sec. 707(a) allocations and distributions. However, as described herein, the IRS generally believes that such allocations, without a clawback obligation, will not have entrepreneurial risk.

## “Targeted Capital Account Agreements”

In the request for comments for public hearing the IRS stated:

Some taxpayers have expressed uncertainty whether a partnership with a targeted capital account agreement must allocate income or a *guaranteed payment* to a partner who has an increased right to partnership assets determined as if the partnership liquidated at the end of the year even in the event

that the partnership recognizes no, or insufficient, net income. (Emphasis added.)<sup>48</sup>

The answer and the concept of “guaranteed payment” in the question have caught the author off-guard. The provided answer does not really answer the question:

The Treasury Department and the IRS generally believe that existing rules under §§1.704-1(b)(2)(ii) and 1.707-1(c) address this circumstance by requiring partner capital accounts to reflect the partner’s distribution rights as if the partnership liquidated at the end of the tax year but request comments on specific issues and examples with respect to which further guidance would be helpful.<sup>49</sup>

The fact this question is raised in the preamble troubles the author as it may raise serious questions about the advisability of using targeted capital accounts in many partnerships in which book-ups are expected.

## Discussion and Observations

### Overview

The author does not believe the Proposed Regulations are intended to or will impact the basic profits interests awarded to service partners who do not contribute capital with a percentage interest in the net profits of the partnership and who receive allocations and distributions each year over the life of the partnership with some portion of the operating cash flow held by the partnership to accumulate capital in the ordinary course. Such an allocation should not have any of the six characteristics found in Proposed Reg. §1.707-2(c)(1)-(6). Unfortunately, all of the examples with carried interests involve investment partnerships and appear to have a clawback obligation.<sup>50</sup> Example 1 does not have a basic carried interest; Example 2 does not have a basic carried interest; Examples 3 and 4 have a basic carried interest (20 percent) but each with an express clawback obligation; Example 5 has a 20-percent carried interest and an additional interest, but the wording and placing of the clawback is not completely clear whether the clawback applies to just the additional interest or both interests and Example 6 has an express clawback associated with its 20-percent carried interest. The Proposed Regulations are clear that a clawback obligation is not the litmus test although a clawback seems to assure there is economic risk. It would be useful if the final regulations had an example of a basic carried interest covering income and gain as it arises over the life of the partnership without a clawback obligation.

## Management Fee Waivers

The preamble makes it clear that the IRS position is that management fee waivers whereby the management company waives its fee and the general partner or other affiliate receives an interest in the partnership is not within the safe harbor of Rev. Proc. 93-27.<sup>51</sup> In addition, the preamble states the IRS intends to add another exception to the safe harbor applying to partners foregoing an amount that is substantially fixed (including a substantially fixed amount determined by formula, such as a fee based on a percentage of partner capital commitments) for the performance of services, including a guaranteed payment under Code Sec. 707(c)<sup>52</sup> or a payment in a nonpartner capacity under Code Sec. 707(a).<sup>53</sup> One commentator has concluded that the forthcoming exception will create a valuation issue of fee waivers even when the service provider and recipient of the partnership interest are the same “even if those interests are hard-wired at inception of a partnership and presumably subject to a clawback obligation.”<sup>54</sup> Because of the common use of management fee waivers in private equity and similar funds, this change and the anticipated change have received a fair amount of press. However, these sorts of waivers are largely limited to such funds and are not used by “main street” partnerships.

## Compensation for Service Not Characterized Under Code Sec. 707(a) or 707(c) is a Code Sec. 704(b) Allocation and Distribution

The Proposed Regulations make it clear that allocations under an arrangement between the service provider and the partnership to which neither Code Sec. 707(a) nor 707(c) apply are distributive shares under Code Sec. 704(b).<sup>55</sup>

## Relationship Between Code Secs. 707(a)(2) and 704(c)

Prior to the issuance of the Proposed Regulations, it was unclear how the IRS viewed the distinction between Code Secs. 707(a) and 707(c), with some commentators feeling that Code Sec. 707(a)(2) effectively subsumed Code Sec. 707(c). With the Proposed Regulations, the Treasury and the IRS have concluded that Code Sec. 707(a)(2) applies to arrangements in which distributions to the service provider depend on an allocation of an item of income and Code Sec. 707(c) applies to amounts whose payments are unrelated to partnership income.<sup>56</sup> The working relationship between the two subsections has been reconciled. Code Sec. 707(a) relationships are

treated as compensation for all purposes while Code Sec. 707(c) relationships are only treated as compensation for purposes of Code Sec. 61(a) relating to gross income and Code Sec. 162(a) relating to trade or business expense. For all other purposes, a guaranteed payment is considered as a partner’s distributive share of ordinary income.<sup>57</sup>

## Is There an Implicit Continuation of the Premise That a Partner Cannot Also Be an Employee of the Same Partnership?

The Proposed Regulations do not characterize the relationship of the service provider to the partnership with respect to Code Sec. 707(a) as that of an employee or independent contractor. The preamble states that taxpayers should look to relevant authorities to determine the status of the service provider as an independent contractor or employee<sup>58</sup> and cites Rev. Rul. 69-184.<sup>59</sup> Unfortunately, the revenue ruling takes the position that a service provider cannot be both a partner and an employee (dual status) of the same partnership.<sup>60</sup> As a matter of policy, many believe that this position is outdated and does not reflect the development of limited liability companies whereby middle management and even some rank and file employees have been awarded membership interests in the limited liability company. Often these service providers are not providing services in the capacity as a partner nor are they independent contractors. Is the concept that a Code Sec. 707(c) guaranteed payment may be recharacterized as nonpartner compensation an avenue for permitting a dual status partner with the guaranteed payment being characterized as employee compensation? The current re-evaluation of Code Sec. 707(a) and (c) presents an excellent opportunity for the Treasury and the IRS to review their position on dual status. Middle management and below that have a small profits interest should not be forced into the burden of the self-employed tax returns and the responsibility of quarterly payments.

## Gross Income Allocations

By obsoleting Rev. Rul. 81-300, the IRS acknowledges that a gross-income allocation is not a guaranteed payment under Code Sec. 707(c). Under the Proposed Regulations, allocations of gross income are highly suspect and presumptively lack significant entrepreneurial risk. Indeed, the preamble notes that the legislative history of the Tax Reform Act of 1984 concluded that the allocation of gross income in that ruling was not a Code Sec. 707(c) guaranteed payment but rather a Code Sec. 707(a) payment.<sup>61</sup>

## Allocation and No Distribution but Still Code Sec. 707(a) Disguised Payment?

Although the Proposed Regulation properly uses the statutory phrase “allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a person acting other than in that person’s capacity as a partner,”<sup>62</sup> the preamble seems to substantially diminish if not eliminate the distribution requirement when it states:

Although section 707(a)(2)(A)(ii) requires both an allocation and a distribution to the service provider, the Treasury Department and the IRS believe that a premise of section 704(b) is that an income allocation correlates with an increased distribution right, justifying the assumption that an arrangement that provides for an income allocation should be treated as also providing for an associated distribution for purposes of applying section 707(a)(2)(A).<sup>63</sup>

The regulatory embodiment is apparently found Proposed Reg. §1.704-2(a)(2)(i) wherein it does not require that the allocation and distribution occur in the same tax year. There is no guidance as to the length of time that the distribution can be disassociated from the allocation and the provision of services and still be deemed an “associated distribution.” Generally, third parties will not provide services without being paid relatively proximate to the time services are rendered. To the extent the Proposed Regulation means that a reasonable period after the end of a tax year for computations and distributions/payments to be made for services performed in the later part of the tax year, the Proposed Regulations would be consistent with the concept of related distribution. If the Proposed Regulation envisions some long-term additions to what would be a capital account if the service provider was a partner, it is much harder to see. While the scope of this “disassociation” of “associated” remains unclear to the author, the IRS appears to be invoking the grant of regulatory authority provided to the Secretary to identify transactions involving disguised payments for services under Code Sec. 707(a)(2)(A).<sup>64</sup>

The author believes that the Code generally requires an associated distribution in a time frame similar to that which a third-party nonpartner would require for compensation for services. A characteristic of a partner would be to maintain a capital account into which income and gain attributable to the partner’s interest is credited and often some of which is retained. This should be a factor that would indicate the service provider is acting in

partner capacity as opposed to a capacity of a nonpartner. This is not a deferral of income recognition by a service provider classified as a partner by the partnership as the timing of payment is irrelevant. The service provider will recognize income and gain each year it is recognized by the partnership. A substantial period between services and the distribution of substantially all of the amount the service provider is entitled to is a partner characteristic.

## Twelve-Month Period May or May Not Be an Adequate Time for Entrepreneurial Risk

The Proposed Regulations in Example 4 provide that a 12-month tax year is an adequate period for measuring entrepreneurial risk for purposes of a specific but ongoing allocation and distribution. However, in Example 3, the statement is made, “[t]he priority allocation to M is an allocation of net profit from any 12-month accounting period in which the partnership has net gain, and thus it does not depend on the overall success of the enterprise.”<sup>65</sup> Is the time period distinction any 12-month accounting period versus a 12-month tax year? The 12-month tax year is fixed in advance, and therefore, the period is not subject to manipulation, whereas any 12-month accounting period may be manipulated. A floating 12-month period appears to be a negative indicator. The time period over which net profits are measured that is sufficiently long to have no presumption of lack of entrepreneurial risk is of critical importance if a clawback provision is not applicable. It would be useful if the final regulations gave comfort that in the absence of unusual circumstances the use of a tax year as the ongoing measuring period for net profit allocations and distributions is consistent with significant entrepreneurial risk.

## Clawback Provision Is a Bright Line for Significant Economic Risk

The Proposed Regulations clearly demonstrate that an allocation and distribution interest in net income over the life of the partnership with a clawback requirement for a solvent service provider has significant economic risk. The Proposed Regulations also make it clear that a clawback obligation can be net of reasonable allowances for tax payments made with respect to the partnership interest being tested.<sup>66</sup>

In the private equity and venture capital world, clawback obligations are common. In the main street partnerships that are not investment funds and even in some smaller investment funds, the clawback of amounts previously allocated and distributed to the service provider does not appear to

be the general rule, and often the service provider would be unable to honor a clawback if one were to occur. While the presence of a clawback obligation is not an absolute requirement, it appears that a net income allocation with a clawback will almost always (if not always) have significant entrepreneurial risk. It is troubling that no example expressly has a carried interest recognized with entrepreneurial risk that does not have a clawback obligation.

### **Although the Determination of Whether a Code Sec. 707(a) Allocation and Distribution Is to Be Made Based on the Facts at the Time the Arrangement Is Entered into, Subsequent Audits Have the Benefit of Hindsight**

Although the determination as to whether an arrangement is properly characterized as a payment for services is based on the facts at the time the arrangement is entered into or modified, the issue may come up on a later audit. Successful enterprises often look easy in hindsight and various amounts appear highly certain and reasonably determinable. In the context of a large liquidity event, a recharacterization of a substantial allocation and distribution as a Code Sec. 707(a) payment can be dramatic. The effect on the service provider may be going from a 20-percent long-term capital gains tax to a 39.6-percent rate plus uncapped Social Security taxes. If the deduction is a business expense, the partners receive a tax benefit. They have an ordinary deduction and capital gains if both occur in the same tax year. However, as discussed below, problems for the other partners can also emerge if the compensation is capitalized into retained assets, if part of the compensation is found to be excessive and nondeductible, and/or if the deduction occurs in a later year.

### **The Overlay of Capitalized Compensation to Code Sec. 707(a) Distributions**

As discussed above, the Code Sec. 707(a) distributions/payments are considered compensation for all purposes. If the services provided by the service provider are such that the compensation must be capitalized, there is obviously no deduction. If all assets or partnership interests are not sold in such year, the negative tax ramification may be very serious. Any capitalized basis that is spread among the various remaining assets increases the immediate gain to the partners on the assets or business sold. There is no allocation to the service provider with respect to such amounts where there would have been had such amounts been treated as an allocation and distribution.

### **The Overlay of Reasonable Compensation to Code Sec. 707(a) Payments**

The Proposed Regulations state that an arrangement that is treated as a payment for services is treated as a payment for all purposes of the Code including the timing of deductions, capitalization, *etc.*<sup>67</sup> The partnership is also required to treat the arrangement as a payment to a nonpartner in determining the remaining partners' shares of taxable income or loss.<sup>68</sup> If a person receiving an allocable share of allocations and distributions is deemed to have disguised compensation, what happens if the share is excessive to the services being rendered and therefore does not represent an ordinary and necessary business expense?<sup>69</sup> Presumably, the excess is simply a nondeductible expense. The ramifications of a nondeductible expense not only include no deduction but also a reduction in basis. The ramification becomes most acute in the year of a liquidity event, as the amounts are likely to be very large. The remaining partners will have 100 percent of the gain from the liquidity event but no tax benefit for the excessive compensation, whereas if the service provider was recognized as a partner with respect to the allocation and distribution, such amounts would be taxed to the service provider and not to the other partners.

### **Timing of Distribution or Payment Is Critical**

If the allocation and distribution in a liquidity event is recharacterized as a Code Sec. 707(a) payment, the deduction (assuming it is a deductible expense) for a cash basis partnership may not be properly taken until payment. On a year-end closing, the failure to immediately distribute/pay the service provider may cause the deduction (or perhaps basis increase) to fall in a subsequent year. This mismatch can be expensive for the partners.

### **Obsolescence of Rev. Rul. 66-95 and Rev. Rul. 69-180 and New Example 2 of Reg. §1.707-1(c)**

Although the Proposed Regulations' amendment and obsolescence of these revenue rulings are an effort by the IRS aimed at the private equity and venture fund managers enjoying capital gains versus ordinary income, noninvestment partnerships often have a mix of capital providers and service providers that may be caught in the net. The service providers often have a base compensation (guaranteed payment) or supplemental payments if the share of net profits and distributions is less than an agreed upon amount. Sometimes, the arrangement is guaranteed payment followed by

a participation in the allocation of income and gain for the year. In such cases, the reversal of the tiering order of the regulations is irrelevant. However, if the arrangement provides that if an allocation and distribution of net profits does not equal to a minimum dollar amount in a given year, the shortfall (*i.e.*, the difference between the minimum annual amount and the allocation and amount distributed) will be paid. Until the Proposed Regulations are finalized and Rev. Rul. 66-95 and Rev. Rul. 69-180 are obsoleted, the service partner receives an allocation of partnership income gain and loss of whatever character in accordance with the partner's interest, and only the excess is a guaranteed payment. The portion of the allocation that is not characterized as a guaranteed payment will have the service provider's share of income, gain and loss items of the partnership—including a share of the deduction of the guaranteed payment expense if such is deductible. The entire guaranteed payment to the service partner is ordinary earned income. After the Proposed Regulations are finalized and the revenue rulings obsoleted, amounts up to the minimum threshold will be considered a guaranteed payment and ordinary earned income. Only the amounts in excess of such minimum will constitute an allocation and distribution. Generally, the income of an operating partnership for a given year is largely ordinary operating income, and if the service partner's share of such ordinary income is equal to or greater than the guaranteed payment, this reversal in the tiering is somewhat irrelevant if the whole guaranteed payment is deductible. However, if the service partner's otherwise share of ordinary self-employment items of income is less than the full guaranteed payment, the tax position of the partners will change. The service partner will have more ordinary self-employment income, and the other partners will have less ordinary income,<sup>70</sup> or if the partnership's income and gain for the tax period is all capital gain, the other partners will have a share of the ordinary deduction plus their percentage of capital gain. In the capital gain scenario with a deductible guaranteed payment, the tax cost to the service provider may be offset by a tax benefit to the other partners. If the activity of the service provider requires capitalization, the reversal of the tiering will cause the service provider to have more self-employment income,

and the allocation to the other partners will not change. It is important to keep in mind that: (i) the recipient of a guaranteed payment is a partner, and (ii) a guaranteed payment is a distribution under Code Sec. 704(b) so the nontax economics of the partners do not change.

## Conclusion

The IRS has taken aim at private equity, venture capital and other partnerships that previously have been able to successfully provide services and largely receive capital gain treatment in a manner objectionable to the IRS. The provisions, perhaps with the exception of the wavier provisions,<sup>71</sup> potentially have application to all partnerships and partners providing services to the partnership without contributing a proportionate amount of capital. Depending on how examining agents actually apply the factors and make the subjective determinations, partners in many main street partnerships may find themselves classified (or attempting to be classified) as receiving allocations and distributions in a capacity other than that of a partner. The lack of an example containing a profits interest without a clawback obligation having significant entrepreneurial risk is also troubling. The broad language in the preamble concerning the disassociation of the distribution requirement from the allocation for the application of Code Sec. 707(a)(2)(A) is also troubling.<sup>72</sup> For operating partnerships, this may not be a big deal during normal operations, but when a liquidity event occurs it will be. Partners need to understand the application of the new tiering rule under Code Sec. 707(c) to their situation after the Proposed Regulations are finalized. While this is not a tax life-changing event, it will be irritating. The IRS raising the question of guaranteed payments in the context of complying with targeted capital accounts is worrisome. The fact that the Proposed Regulations when finalized will be of broader application than merely to private equity and venture capital partnerships needs to be understood. Popular press is appropriately focused on the investment partnerships, but the potential ramifications are much broader.

## ENDNOTES

<sup>1</sup> 80 FR 43,652–61 (July 23, 2015).

<sup>2</sup> Code Sec. 707(a)(2)(A) was added by the Tax Reform Act of 1984, in part to prevent partners from circumventing the capitalization requirements of Code Secs. 263 and 709 by structuring payments for services as allocations of partnership income under Code Sec. 704. H.R. REP. NO. 98-432, pt. 2, at 1216–21 (1984); 1 S. COMM. ON FINANCE, 98TH CONG., DEFICIT REDUCTION ACT

OF 1984 EXPLANATION OF PROVISIONS 223-32 (Comm. Print 1984).

<sup>3</sup> Rev. Proc. 93-27, 1993-2 CB 343.

<sup>4</sup> Rev. Proc. 2001-43, 2001-2 CB 191.

<sup>5</sup> 80 FR at 43,657.

<sup>6</sup> 80 FR at 43,652.

<sup>7</sup> Proposed Reg. §1.707-2(c)(1).

<sup>8</sup> Proposed Reg. §1.707-2(b)(1).

<sup>9</sup> H.R. REP. NO. 98-432, pt. 2, at 1219-20; S.

COMM. ON FINANCE, 98TH CONG., *supra* note 2, at 227–28.

<sup>10</sup> Proposed Reg. §1.707-2(c).

<sup>11</sup> Proposed Reg. §1.707-2(c)(1).

<sup>12</sup> Proposed Reg. §1.707(c) ("The most important factor is significant entrepreneurial risk as set forth in paragraph (c)(1) of this section.")

<sup>13</sup> The preamble to the Proposed Regulations states:

The Treasury Department and the IRS have concluded that the presence of significant entrepreneurial risk in an arrangement is necessary for the arrangement to be treated as occurring between a partnership and a partner acting in a partner capacity. Nonetheless, the Treasury Department and the IRS request comments on, and examples of, whether arrangements could exist that should be treated as a distributive share under section 704(b) despite the absence of significant entrepreneurial risk.

80 FR at 43,657.

<sup>14</sup> Proposed Reg. §1.707-2(c)(1).

<sup>15</sup> S. COMM. ON FINANCE, 98TH CONG., *supra* note 2, at 227.

<sup>16</sup> Proposed Reg. §1.707-2(c)(1)(i)-(iv).

<sup>17</sup> Proposed Reg. §1.707-2(c)(2).

<sup>18</sup> Proposed Reg. §1.707-2(c)(3). As discussed in "Discussion and Observations—Allocation and No Distribution but Still a Code Sec. 707(a) Disguised Payment," *infra*, the Proposed Regulations morph this timing requirement by interpreting the allocation correlates with an increased distribution right and therefore should be treated as also providing for an associated distribution for purposes of applying Code Sec. 707(a)(2)(A) even if the correlated distribution itself is not contemporaneous to the allocation. 80 FR at 43,652. This appears to be inconsistent with the timing factor as provided in the legislative history. See S. COMM. ON FINANCE, 98TH CONG., *supra* note 2, at 227.

<sup>19</sup> Proposed Reg. §1.707(c)(4).

<sup>20</sup> Proposed Reg. §1.707(c)(5).

<sup>21</sup> Proposed Reg. §1.707-2(c)(6) defines related persons by reference to Code Sec. 707(b) or 267(b).

<sup>22</sup> Proposed Reg. §1.707-2(c)(6). Example 5 of Proposed Reg. §1.707-2(d) provides an example of a general partner receiving a 20-percent allocation and distribution subject to a clawback obligation and a related management company receiving an amount of partnership income not subject to a clawback obligation. The example concludes that the management company received disguised compensation as opposed to a partnership allocation and distribution.

<sup>23</sup> Proposed Reg. §1.707-2(b)(3).

<sup>24</sup> Proposed Reg. §1.707-2(d).

<sup>25</sup> Proposed Reg. §1.707-2(c)(1)(i).

<sup>26</sup> Proposed Reg. §1.707-2(c)(1)(iii).

<sup>27</sup> Proposed Reg. §1.707-2(c)(2)(ii).

<sup>28</sup> Proposed Reg. §1.707-2(d), Example 2.

<sup>29</sup> How an allocation of net income is reasonably determinable in a scenario whereby the

general partner has to manipulate the timing of profitable sales is unclear to the author.

<sup>30</sup> Presumably, the partnership intended this to be a profits interest, but Rev. Proc. 93-27 is not discussed in the Proposed Regulations, and the preamble does not discuss it in the context of this example.

<sup>31</sup> The reference to a related party's ability to control the timing of an announcement impacting valuation indicates the drafters had in mind a partnership that controls or has extensive influence over its portfolio entities.

<sup>32</sup> 80 FR at 43,655.

<sup>33</sup> The author believes the preamble refers to Example 4 when it should be referring to Example 3. Presumably, since the portfolio companies in Example 4 are publicly traded, the partnership may not control the portfolio companies to the extent it controls the distributions, and certainly with SEC requirements the ability to control timing of announcements is reduced.

<sup>34</sup> 80 FR at 43,655.

<sup>35</sup> Proposed Reg. §1.707-2(c)(2) *infra* requires that an allocation for one or more years under which the service provider's share of income is reasonably certain.

<sup>36</sup> See "Discussion and Observations—Overview," *infra* (commenting that it is unclear whether the clawback applies only to the additional interest or both interests).

<sup>37</sup> Proposed Reg. §1.704-2(d), Example 5.

<sup>38</sup> 80 FR at 43,656.

<sup>39</sup> According to Lee Sheppard, the fee and profits interest structure involving a general partner and a separate management company is a tax plan to avoid the four percent New York City unincorporated business income tax. See Lee Sheppard, *The IRS' Zinger on Partnership Profits Interest Receipt*, 2015 TNT 148-1, Aug. 3, 2015.

<sup>40</sup> 80 FR 43,656.

<sup>41</sup> See *S. Diamond*, 56 TC 530, Dec. 30, 838 (1971), *aff'd*, CA-7, 74-1 ustr ¶9306, 492 F2d 286.

<sup>42</sup> Rev. Rul. 66-95, 1966-1 CB 169.

<sup>43</sup> Rev. Rul. 69-180, 1969-1 CB 183.

<sup>44</sup> 80 FR at 43,657.

<sup>45</sup> Rev. Rul. 81-300, 1981-2 CB 143.

<sup>46</sup> 80 FR at 43,657.

<sup>47</sup> 80 FR at 43,653.

<sup>48</sup> 80 FR at 43,657.

<sup>49</sup> *Id.*

<sup>50</sup> Proposed Reg. §1.707-2(d), Example 1.

<sup>51</sup> 80 FR at 43,656.

<sup>52</sup> The concept that a Code Sec. 707(c) guaranteed payment could be recharacterized as compensation to a non-partner was a bit

surprising to the author. Does this offer a potential opportunity for the treatment of persons holding small membership interests in an LLC to be treated as employees with respect to such payment?

<sup>53</sup> 80 FR at 43,656.

<sup>54</sup> *PwC Provides Overview of IRS's Proposed Fee Waiver Rules*, TAX ANALYSTS, Doc 2015-17480 (July 27, 2015).

<sup>55</sup> 80 FR at 43,654.

<sup>56</sup> 80 FR at 43,653.

<sup>57</sup> Reg. §1.707-1(c); 80 FR at 43,654.

<sup>58</sup> 80 FR at 43,654.

<sup>59</sup> Rev. Rul. 69-184, 1969-1 CB 256.

<sup>60</sup> The author is the chairman of a multidisciplinary task force of the ABA Section of Taxation that is preparing a white paper for possible submission to the Treasury and the IRS concerning the ability of service providers to be treated as employees and partners of the same partnership. The widespread use of small profits interests given to middle management and long-term employees who are ill equipped for the lack of withholding and the more complicated tax returns of self-employed individuals. The frequency in which tax preparers are assisting businesses to issue W-2s and K-1s is making this a systemic problem and has moved this issue to the forefront.

<sup>61</sup> 80 FR 43,653.

<sup>62</sup> Proposed Reg. §1.707-2(b)(1)(iii).

<sup>63</sup> 80 FR at 43,654.

<sup>64</sup> See 80 FR 43,653.

<sup>65</sup> Proposed Reg. §1.707-2(d), Example 3.

<sup>66</sup> Proposed Reg. §1.707-2(d), Example 2.

<sup>67</sup> Proposed Reg. §1.707-2(b)(2).

<sup>68</sup> *Id.*

<sup>69</sup> If the anticipated Code Sec. 707(a) share to the service provider is more than reasonable compensation, is that an indication that the services are being provided in the capacity as a partner?

<sup>70</sup> This assumes the guaranteed payment is an ordinary and necessary business expense fully deductible under Code Sec. 162(a) and is not subject to capitalization.

<sup>71</sup> While the waiver provisions are not limited to investment partnerships, the author cannot recall seeing waivers in any other partnership with the possible exception of very distressed real estate partnerships in which some fees were waived for additional interest in turnaround situations that had more than entrepreneurial risk.

<sup>72</sup> 80 FR 43,653.

This article is reprinted with the publisher's permission from the TAXES The Tax Magazine®, a monthly journal published by Wolters Kluwer. Copying or distribution without the publisher's permission is prohibited. To subscribe to the TAXES The Tax Magazine® or other Wolters Kluwer Journals please call 800 449 8114 or visit CCHGroup.com. All views expressed in the articles and columns are those of the author and not necessarily those of Wolters Kluwer.