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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-115452-14]

RIN 1545-BM12

Disguised Payments for Services

AGENCY: Internal Revenue Service (IRS), Treasury

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to disguised payments for services under section 707(a)(2)(A) of the Internal Revenue Code. The proposed regulations provide guidance to partnerships and their partners regarding when an arrangement will be treated as a disguised payment for services. This document also proposes conforming modifications to the regulations governing guaranteed payments under section 707(c). Additionally, this document provides notice of proposed modifications to Rev. Procs. 93-27 and 2001-43 relating to the issuance of interests in partnership profits to service providers.

DATES: Written and electronic comments and requests for a public hearing must be received by **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG-115452-14), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-115452-14), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC, or sent electronically, via the Federal eRulemaking Portal at <http://www.regulations.gov> (indicate IRS and REG-115452-14).

FOR FURTHER INFORMATION CONTACT: Concerning submissions of comments, Oluwafunmilayo (Funmi) Taylor (202) 517-6901; concerning the proposed regulations, Jaclyn M. Goldberg (202) 317-6850 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Generally, under the statutory framework of Subchapter K of the Code, an allocation or distribution between a partnership and a partner for the provision of services can be treated in one of three ways: (1) a distributive share under section 704(b); (2) a guaranteed payment under section 707(c); or (3) as a transaction in which a partner has rendered services to the partnership in its capacity as other than a partner under section 707(a).

Distributive Share Treatment

Partnership allocations that are determined with regard to partnership income and that are made to a partner for services rendered by the partner in its capacity as a partner are generally treated as distributive shares of partnership income, taxable under the general rules of sections 702, 703, and 704. In some cases, the right to a

distributive share may qualify as a profits interest defined in Rev. Proc. 93-27, 1993-2 C.B. 343. Rev. Proc. 93-27, clarified by Rev. Proc. 2001-43, 2001-2 C.B. 191, provides guidance on the treatment of the receipt of a profits interest for services provided to or for the benefit of the partnership.

Arrangements subject to sections 707(c) or 707(a)(1).

In 1954, Congress added section 707 to the Code to clarify transactions between a partner and a partnership. Section 707(a) addresses arrangements in which a partner engages with the partnership other than in its capacity as a partner. The legislative history to section 707(a) provides the general rule that a partner who engages in a transaction with the partnership, other than in its capacity as a partner is treated as though it were not a partner. The provision was intended to apply to the sale of property by the partner to the partnership, the purchase of property by the partner from the partnership, and the rendering of services by the partner to the partnership or by the partnership to the partner. H.R. Rep. No. 1337, 83d Cong., 2d Sess. 227 (1954) (House Report); S. Rep. No. 1622, 83d Cong., 2d Sess. 387 (1954) (Senate Report).

Congress simultaneously added section 707(c) to address payments to partners of the partnership acting in their partner capacity. Section 707(c) provides that to the extent determined without regard to the income of the partnership, payment to a partner for services shall be considered as made to a person who is not a partner, but only for purposes of sections 61(a) and 162(a). The Senate Report and the House Report provide that a fixed salary, payable without regard to partnership income, to a partner who renders services to the partnership is a guaranteed payment. The amount of the payment shall be included in the partner's gross income, and shall not be considered a

distributive share of income or gain. A partner who is guaranteed a minimum annual amount for its services shall be treated as receiving a fixed payment in that amount.

House Report at 227; Senate Report at 387.

In 1956, the Treasury Department and the IRS issued additional guidance under §1.707-1 relating to a partner not acting in its capacity as a partner under section 707(a) and to guaranteed payments under section 707(c). See TD 6175. However, it remained unclear when a partner's services to the partnership were rendered in a non-partner capacity under section 707(a) rather than in a partner capacity under section 707(c).

In 1975, the Tax Court distinguished sections 707(a) and 707(c) payments in *Pratt v. Commissioner*, 64 T.C. 204 (1975), aff'd in part, rev'd in part, 550 F.2d 1023 (5th Cir. 1977). In *Pratt*, the general partners in two limited partnerships formed to purchase, develop, and operate two shopping centers received a fixed percentage of gross rentals in exchange for the performance of managerial services. The Tax Court held that these payments were not guaranteed payments under section 707(c) because they were computed based on a percentage of gross rental income and therefore were not paid without regard to partnership income. The Tax Court further held that section 707(a) did not apply because the general partners performed managerial duties in their partner capacities in accordance with their basic duties under the partnership agreement. On appeal, the Fifth Circuit affirmed the Tax Court's decision. The Fifth Circuit reasoned that Congress enacted section 707(a) to apply to partners who perform services for the partnership that are outside the scope of the partnership's activities. The Court indicated that if the partner performs services that the partnership itself

provides, then the compensation to the service provider is merely a rearrangement among the partners of their distributive shares in the partnership income.

In response to the decision in *Pratt*, the Treasury Department and the IRS issued Rev. Rul. 81-300, 1981-2 C.B. 143 and Rev. Rul. 81-301, 1981-2 C.B. 144 to clarify the treatment of transactions under sections 707(a) and 707(c). As in the *Pratt* case, Rev. Rul. 81-300 considers a partnership formed to purchase, develop, and operate a shopping center. The partnership agreement required the general partners to contribute their time, managerial abilities, and best efforts to the partnership. In return for these services, the general partners received a fee equal to five percent of the partnership's gross rental income. The ruling concluded that the taxpayers performed managerial services in their capacities as general partners, and characterized the management fees as guaranteed payments under section 707(c). The ruling provides that, although guaranteed payments under section 707(c) frequently involve a fixed amount, they are not limited to fixed amounts. Thus, the ruling concluded that a payment for services determined by reference to an item of gross income will be a guaranteed payment if, on the basis of all facts and circumstances, the payment is compensation rather than a share of profits.

Rev. Rul. 81-301 describes a limited partnership which has two classes of general partners. The first class of general partner (director general partners) had complete control over the management, conduct, and operation of partnership activities. The second class of general partner (adviser general partner) rendered to the partnership services that were substantially the same as those that the adviser general partner rendered to other persons as an independent contractor. The adviser general

partner received 10 percent of daily gross income in exchange for the management services it provided to the partnership. Rev. Rul. 81-301 held that the adviser general partner received its gross income allocation in a nonpartner capacity under section 707(a) because the adviser general partner provided similar services to other parties, was subject to removal by the director general partners, was not personally liable to the other partners for any losses, and its management was supervised by the director general partners.

Enactment of Section 707(a)(2)(A)

Congress revisited the scope of section 707(a) in 1984, in part to prevent partners from circumventing the capitalization requirements of sections 263 and 709 by structuring payments for services as allocations of partnership income under section 704. H.R. Rep. No. 432 (Pt. 2), 98th Cong., 2d Sess. 1216-21 (1984) (H.R. Rep.); S. Pt. No. 169 (Vol. 1), 98th Cong., 2d Sess. 223-32 (1984) (S. Pt.). Congress specifically addressed the holdings in Rev. Rul. 81-300 and Rev. Rul. 81-301, affirming Rev. Rul. 81-301 and concluding that the payment in Rev. Rul. 81-300 should be recharacterized as a section 707(a) payment. S. Pt. at 230. Accordingly, the Treasury Department and the IRS are obsoleting Rev. Rul. 81-300 and request comments on whether it should be reissued with modified facts.

Congress also added an anti-abuse rule to section 707(a) relating to payments to partner service providers. Section 707(a)(2)(A) provides that if a partner performs services for a partnership and receives a related direct or indirect allocation and distribution, and the performance of services and allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the

partnership and a partner acting other than in its capacity as a partner, the transaction will be treated as occurring between the partnership and one who is not a partner under section 707(a)(1). See section 73 of the Tax Reform Act of 1984 (the 1984 Act). The Treasury Department and the IRS have concluded that section 707(a)(2) applies to arrangements in which distributions to the service provider depend on an allocation of an item of income, and section 707(c) applies to amounts whose payments are unrelated to partnership income.

Section 707(a)(2) grants the Secretary broad regulatory authority to identify transactions involving disguised payments for services under section 707(a)(2)(A). This grant of regulatory authority stems from Congress's concern that partnerships and service providers were inappropriately treating payments as allocations and distributions to a partner even when the service provider acted in a capacity other than as a partner. S. Prt. at 225. Congress determined that allocations and distributions that were, in substance, direct payments for services should be treated as a payment of fees rather than as an arrangement for the allocation and distribution of partnership income. H.R. Rep. at 1218; S. Prt. at 225. Congress differentiated these arrangements from situations in which a partner receives an allocation (or increased allocation) for an extended period to reflect its contribution of property or services to the partnership, such that the partner receives the allocation in its capacity as a partner. In balancing these potentially conflicting concerns, Congress anticipated that the regulations would take five factors into account in determining whether a service provider would receive its putative allocation and distribution in its capacity as a partner. H.R. Rep. at 1219-20; S. Prt. at 227.

Congress identified as its first and most important factor whether the payment is subject to significant entrepreneurial risk as to both the amount and fact of payment. In explaining why entrepreneurial risk is the most important factor, Congress provides that “[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.” S. Prt. at 227. An arrangement for an allocation and distribution to a service provider which involves limited risk as to amount and payment is treated as a fee under section 707(a)(2)(A). Congress specified examples of allocations that presumptively limit a partner’s risk, including (i) capped allocations of income, (ii) allocations for a fixed number of years under which the income that will go to the partner is reasonably certain, (iii) continuing arrangements in which purported allocations and distributions are fixed in amount or reasonably determinable under all facts and circumstances, and (iv) allocations of gross income items.

An arrangement in which an allocation and distribution to a service provider are subject to significant entrepreneurial risk as to amount will generally be recognized as a distributive share, although other factors are also relevant. The legislative history to section 707(a)(2)(A) includes the following examples of factors that could bear on this determination: (i) whether the partner status of the recipient is transitory; (ii) whether the allocation and distribution that are made to the partner are close in time to the partner’s performance of services; (iii) whether the facts and circumstances indicate that the recipient became a partner primarily to obtain tax benefits for itself or the partnership that would not otherwise have been available; and (iv) whether the value of the

recipient's interest in general and in continuing partnership profits is small in relation to the allocation in question.

Explanation of Provisions

Section 1.707-1 sets forth general rules on the operation of section 707. Section 1.707-2 is titled "Disguised payments for services" and is currently reserved. Sections 1.707-3 through 1.707-7 provide guidance regarding transactions involving disguised sales under section 707(a)(2)(B). These proposed regulations are issued under § 1.707-2 and provide guidance regarding transactions involving disguised payments for services under section 707(a)(2)(A). The effective date of the proposed regulations is provided under § 1.707-9.

I. General Rules Regarding Disguised Payments for Services

A. Scope

Consistent with the language of section 707(a)(2)(A), § 1.707-2(b) of the proposed regulations provides that an arrangement will be treated as a disguised payment for services if (i) a person (service provider), either in a partner capacity or in anticipation of being a partner, performs services (directly or through its delegate) to or for the benefit of the partnership; (ii) there is a related direct or indirect allocation and distribution to the service provider; and (iii) the performance of the 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.

The proposed regulations provide a mechanism for determining whether or not an arrangement is treated as a disguised payment for services under section

707(a)(2)(A). An arrangement that is treated as a disguised payment for services under these proposed regulations will be treated as a payment for services for all purposes of the Code. Thus, the partnership must treat the payments as payments to a non-partner in determining the remaining partners' shares of taxable income or loss. Where appropriate, the partnership must capitalize the payments or otherwise treat them in a manner consistent with the recharacterization.

The consequence of characterizing an arrangement as a payment for services is otherwise beyond the scope of these regulations. For example, the proposed regulations do not address the timing of inclusion by the service provider or the timing of a deduction by the partnership other than to provide that each is taken into account as provided for under applicable law by applying all relevant sections of the Code and all relevant judicial doctrines. Further, if an arrangement is subject to section 707(a), taxpayers should look to relevant authorities to determine the status of the service provider as an independent contractor or employee. See, generally, Rev. Rul. 69-184, 1969-1 C.B. 256. The Treasury Department and the IRS believe that section 707(a)(2)(A) generally should not apply to arrangements that the partnership has reasonably characterized as a guaranteed payment under section 707(c).

Allocations pursuant to an arrangement between a partnership and a service provider to which sections 707(a) and 707(c) do not apply will be treated as a distributive share under section 704(b). Rev. Proc. 93-27 and Rev. Proc. 2001-43 may apply to such an arrangement if the specific requirements of those Revenue Procedures are also satisfied. The Treasury Department and the IRS intend to modify the exceptions set forth in those revenue procedures to include an additional exception for

profits interests issued in conjunction with a partner forgoing payment of a substantially fixed amount. This exception is discussed in part IV of the Explanation of Provisions section of this preamble.

B. Application and Timing

These proposed regulations apply to a service provider who purports to be a partner even if applying the regulations causes the service provider to be treated as a person who is not a partner. S. Prt. at 227. Further, the proposed regulations may apply even if their application results in a determination that no partnership exists. The regulations also apply to a special allocation and distribution received in exchange for services by a service provider who receives other allocations and distributions in a partner capacity under section 704(b).

The proposed regulations characterize the nature of an arrangement at the time at which the parties enter into or modify the arrangement. 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). The Treasury Department and the IRS considered that some arrangements provide for distributions in a later year, and that those later distributions may be subject to independent risk. However, the Treasury Department and the IRS believe that recharacterizing an arrangement retroactively is administratively difficult. Thus, the proposed regulations characterize the nature of an arrangement when the

arrangement is entered into (or modified) regardless of when income is allocated and when money or property is distributed. The proposed regulations apply to both one-time transactions and continuing arrangements. S. Prt. at 226.

II. Factors Considered

Whether an arrangement constitutes a payment for services (in whole or in part) depends on all of the facts and circumstances. The proposed regulations include six non-exclusive factors that may indicate that an arrangement constitutes a disguised payment for services. Of these factors, the first five factors generally track the facts and circumstances identified as relevant in the legislative history for purposes of applying section 707(a)(2)(A). The proposed regulations also add a sixth factor not specifically identified by Congress. The first of these six factors, the existence of significant entrepreneurial risk, is accorded more weight than the other factors, and arrangements that lack significant entrepreneurial risk are treated as disguised payments for services. The weight given to each of the other five factors depends on the particular case, and the absence of a particular factor (other than significant entrepreneurial risk) is not necessarily determinative of whether an arrangement is treated as a payment for services.

A. Significant Entrepreneurial Risk

As described in the Background section of this preamble, Congress indicated that the most important factor in determining whether or not an arrangement constitutes a payment for services is that the allocation and distribution is subject to significant entrepreneurial risk. S. Prt. at 227. Congress noted that partners extract the profits of

the partnership based on the business success of the venture, while third parties generally receive payments that are not subject to this risk. *Id.*

The proposed regulations reflect Congress's view that this factor is most important. Under the proposed regulations, an arrangement that lacks significant entrepreneurial risk constitutes a disguised payment for services. An arrangement in which allocations and distributions to the service provider are subject to significant entrepreneurial risk will generally be recognized as a distributive share but the ultimate determination depends on the totality of the facts and circumstances. The Treasury Department and the IRS request comments on whether allocations to service providers that lack significant entrepreneurial risk could be characterized as distributive shares under section 704(b) in any circumstances.

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. For example, a service provider who receives a percentage of net profits in each of a partnership that invests in high-quality debt instruments and a partnership that invests in volatile or unproven businesses may have significant entrepreneurial risk with respect to both interests.

Section 1.707-2(c)(1)(i) through (v) of the proposed regulations set forth arrangements that presumptively lack significant entrepreneurial risk. These arrangements are presumed to result in an absence of significant entrepreneurial risk (and therefore, a disguised payment for services) unless other facts and circumstances can establish the presence of significant entrepreneurial risk by clear and convincing evidence. These examples generally describe facts and circumstances in which there

is a high likelihood that the service provider will receive an allocation regardless of the overall success of the business operation, including (i) capped allocations of partnership income if the cap would reasonably be expected to apply in most years, (ii) allocations for a fixed number of years under which the service provider's distributive share of income is reasonably certain, (iii) allocations of gross income items, (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 (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 overall success of the enterprise), and (v) arrangements in which a service provider either waives its right to receive payment for the future performance of services in a manner that is non-binding or fails to timely notify the partnership and its partners of the waiver and its terms.

With respect to the fourth example, the presence of certain facts, when coupled with a priority allocation to the service provider that is measured over any accounting period of the partnership of 12 months or less, may create opportunities that will lead to a higher likelihood that sufficient net profits will be available to make the allocation. One fact is that the value of partnership assets is not easily ascertainable and the partnership agreement allows the service provider or a related party in connection with a revaluation to control the determination of asset values, including by controlling events that may affect those values (such as timing of announcements that affect the value of the assets). (See Example 3(iv).) Another fact is that the service provider or a related

party controls the entities in which the partnership invests, including controlling the timing and amount of distributions by those controlled entities. (These two facts by themselves do not, however, necessarily establish the absence of significant entrepreneurial risk.) By contrast, certain priority allocations that are intended to equalize a service provider's return with priority allocations already allocated to investing partners over the life of the partnership (commonly known as "catch-up allocations") typically will not fall within the types of allocations covered by the fourth example and will not lack significant entrepreneurial risk, although all of the facts and circumstances are considered in making that determination.

With respect to the fifth example, the Treasury Department and the IRS request suggestions regarding fee waiver requirements that sufficiently bind the waiving service provider and that are administrable by the partnership and its partners.

Congress's emphasis on entrepreneurial risk requires changes to existing regulations under section 707(c). Specifically, Example 2 of § 1.707-1(c) provides that if a partner is entitled to an allocation of the greater of 30 percent of partnership income or a minimum guaranteed amount, and the income allocation exceeds the minimum guaranteed amount, then the entire income allocation is treated as a distributive share under section 704(b). Example 2 also provides that if the income allocation is less than the guaranteed amount, then the partner is treated as receiving a distributive share to the extent of the income allocation and a guaranteed payment to the extent that the minimum guaranteed payment exceeds the income allocation. The treatment of the arrangements in Example 2 is inconsistent with the concept that an allocation must be subject to significant entrepreneurial risk to be treated as a distributive share under

section 704(b). Accordingly, the proposed regulations modify Example 2 to provide that the entire minimum amount is treated as a guaranteed payment under section 707(c) regardless of the amount of the income allocation. Rev. Rul. 66-95, 1966-1 C.B. 169, and Rev. Rul. 69-180, 1969-1 C.B. 183, are also inconsistent with these proposed regulations. The Treasury Department and the IRS intend to obsolete Rev. Rul. 66-95 and revise Rev. Rul. 69-180, when these regulations are published in final form.

B. Secondary factors

Section 1.707-2(c)(2) through (6) describes additional factors of secondary importance in determining whether or not an arrangement that gives the appearance of significant entrepreneurial risk constitutes a payment for services. The weight given to each of the other factors depends on the particular case, and the absence of a particular factor is not necessarily determinative of whether an arrangement is treated as a payment for services. Four of these factors, described by Congress in the legislative history to section 707(a)(2)(A), are (i) that the service provider holds, or is expected to hold, a transitory partnership interest or a partnership interest for only a short duration, (ii) that 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, (iii) that the service provider became a partner primarily to obtain tax benefits which would not have been available if the services were rendered to the partnership in a third party capacity, and (iv) that the value of the service provider's interest in general and continuing partnership profits is small in relation to the allocation and distribution.

To these four factors, the proposed regulations add a fifth factor. The fifth factor is present if the arrangement provides for different allocations or distributions with respect to different services received, where the services are provided either by a single person or by persons that are related under sections 707(b) or 267(b), and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly. For example, assume that a partnership receives services from both its general partner and from a management company that is related to the general partner under section 707(b). Both the general partner and the management company receive a share in future partnership net profits in exchange for their services. The general partner is entitled to an allocation of 20 percent of net profits and undertakes an enforceable obligation to repay any amounts distributed pursuant to its interest (reduced by reasonable allowance for tax payments made on the general partner's allocable shares of partnership income and gain) that exceed 20 percent of the overall net amount of partnership profits computed over the partnership's life and it is reasonable to anticipate that the general partner can and will comply fully with this obligation. The proposed regulations refer to this type of obligation and similar obligations, as a "clawback obligation." In contrast, the management company is entitled to a preferred amount of net income that, once paid, is not subject to a clawback obligation. Because the general partner and the management company are service providers that are related parties under section 707(b), and because the terms of the allocations and distributions to the management company create a significantly lower level of economic risk than the terms for the general partner, the management company's arrangement

might properly be treated as a disguised payment for services (depending on all other facts and circumstances, including amount of entrepreneurial risk).

III. Examples

Section 1.707-2(d) of the proposed regulations contains a number of examples illustrating the application of the factors described in § 1.707-2(c). The examples illustrate the application of these regulations to arrangements that contain certain facts and circumstances that the Treasury Department and the IRS believe demonstrate the existence or absence of significant entrepreneurial risk.

Several of the examples consider arrangements in which a partner agrees to forgo fees for services and also receives a share of future partnership income and gains. The examples consider the application of section 707(a)(2)(A) based on the manner in which the service provider (i) forgoes its right to receive fees, and (ii) is entitled to share in future partnership income and gains. In Examples 5 and 6, the service provider forgoes the right to receive fees in a manner that supports the existence of significant entrepreneurial risk by forgoing its right to receive fees before the period begins and by executing a waiver that is binding, irrevocable, and clearly communicated to the other partners. Similarly, the service provider's arrangement in these examples include the following facts and circumstances that taken together support the existence of significant entrepreneurial risk: the allocation to the service provider is determined out of net profits and is neither highly likely to be available nor reasonably determinable based on all facts and circumstances available at the time of the arrangement, and the service provider undertakes a clawback obligation and is reasonably expected to be able to comply with that obligation. The presence of each

fact described in these examples is not necessarily required to determine that section 707(a)(2)(A) does not apply to an arrangement. However, the absence of certain facts, such as a failure to measure future profits over at least a 12-month period, may suggest that an arrangement constitutes a fee for services.

The proposed regulations also contain examples that consider arrangements to which section 707(a)(2)(A) applies. Example 1 concludes that an arrangement in which a service provider receives a capped amount of partnership allocations and distributions and the cap is likely to apply provides for a disguised payment for services under section 707(a)(2)(A). In Example 3(iii), a service provider is entitled to a share of future partnership net profits, the partnership can allocate net profits from specific transactions or accounting periods, those allocations do not depend on the long-term future success of the enterprise, and a party that is related to the service provider controls the timing of purchases, sales, and distributions. The example concludes that under these facts, the arrangement lacks significant entrepreneurial risk and provides for a disguised payment for services. Example 4 considers similar facts, but assumes that the partnership's assets are publicly traded and are marked-to-market under section 475(f)(1). Under these facts, the example concludes that the arrangement has significant entrepreneurial risk, and thus that section 707(a)(2)(A) does not apply.

IV. Safe Harbor Revenue Procedures

Rev. Proc. 93-27 provides that in certain circumstances if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of becoming a partner, the IRS will not treat the receipt of such interest as a taxable event for the partner or the partnership. The

revenue procedure does not apply if (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (2) within two years of receipt, the partner disposes of the profits interest; or (3) the profits interest is a limited partnership interest in a “publicly traded partnership” within the meaning of section 7704(b).

Rev. Proc. 2001-43 provides that, for purposes of Rev. Proc. 93-27, if a partnership grants a substantially nonvested profits interest in the partnership to a service provider, the service provider will be treated as receiving the interest on the date of its grant, provided that: (i) the partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant, and the service provider takes into account the distributive share of partnership income, gain, loss, deduction and credit associated with that interest in computing the service provider’s income tax liability for the entire period during which the service provider has the interest; (ii) upon the grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest; and (iii) all other conditions of Rev. Proc. 93-27 are satisfied.

The Treasury Department and the IRS are aware of transactions in which one party provides services and another party receives a seemingly associated allocation and distribution of partnership income or gain. For example, a management company that provides services to a fund in exchange for a fee may waive that fee, while a party related to the management company receives an interest in future partnership profits

the value of which approximates the amount of the waived fee. 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.

Further, the Treasury Department and the IRS plan to issue a revenue procedure providing an additional exception to the safe harbor in Rev. Proc. 93-27 in conjunction with the publication of these regulations in final form. The additional exception will apply to a profits interest issued in conjunction with a partner forgoing payment of 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 section 707(c) or a payment in a non-partner capacity under section 707(a).

In conjunction with the issuance of proposed regulations (REG-105346-03; 70 FR 29675-01; 2005-1 C.B. 1244) relating to the tax treatment of certain transfers of partnership equity in connection with the performance of services, the Treasury Department and the IRS issued Notice 2005-43, 2005-24 I.R.B. 1221. Notice 2005-43 includes a proposed revenue procedure regarding partnership interests transferred in connection with the performance of services. In the event that the proposed revenue procedure provided for in Notice 2005-43 is finalized, it will include the additional exception referenced.

Effective Dates

The proposed regulations would be effective on the date the final regulations are published in the **Federal Register** and would apply to any arrangement entered into or modified on or after the date of publication of the final regulations. In the case of any arrangement entered into or modified before the final regulations are published in the **Federal Register**, 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 section 707(a)(2)(A). Pending the publication of final regulations, the position of the Treasury Department and the IRS is that the proposed regulations generally reflect Congressional intent as to which arrangements are appropriately treated as disguised payments for services.

Effect on Other Documents

The following publication is obsolete as of **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**:

Rev. Rul. 81-300 (1981-2 C.B. 143).

The following publications will be obsolete as of the date of a Treasury decision adopting these rules as final regulations in the **Federal Register**:

Rev. Rul. 66-95 (1966-1 C.B. 169); and

Rev. Rul. 69-180 (1969-1 C.B. 183).

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive

Order 13563. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

The Treasury Department and the IRS invite public comment on these proposed regulations. The legislative history supporting section 707(a)(2)(A) indicates that an arrangement that lacks significant entrepreneurial risk is generally treated as a disguised payment for services. 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. In addition, the Treasury Department and the IRS request comments on sufficient notification requirements to effectively render a fee waiver binding upon the service provider and the partnership.

The Treasury Department and the IRS have become aware that some partnerships that assert reliance on § 1.704-1(b)(2)(ii)(i) (the economic effect equivalence rule) have expressed uncertainty on the proper treatment of partners who

receive an increased right to share in partnership property upon a partnership liquidation without respect to the partnership's net income. These partnerships typically set forth each partner's distribution rights upon a liquidation of the partnership and require the partnership to allocate net income annually in a manner that causes partners' capital accounts to match partnership distribution rights to the extent possible. Such agreements are commonly referred to as "targeted capital account agreements." 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. 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 taxable year, but request comments on specific issues and examples with respect to which further guidance would be helpful. No inference is intended as to whether and when targeted capital account agreements could satisfy the economic effect equivalence rule.

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The Treasury Department and the IRS request comments on all aspects of the proposed regulations. All comments will be available for public inspection and copying upon request. A public hearing will be scheduled if requested in writing by any person that timely submits

written or electronic comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these proposed regulations is Jaclyn M. Goldberg of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). However, other personnel from the Internal Revenue Service and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendment to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1-- INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.707-0 also issued under 26 U.S.C. 707(a).

Section 1.707-2 also issued under 26 U.S.C. 707(a).

Section 1.707-9 also issued under 26 U.S.C. 707(a). * * *

Section 1.736-1 also issued under 26 U.S.C. 736(a). * * *

Par. 2. Section 1.707-0 is amended by revising § 1.707-2 to read as

follows:

§ 1.707-0. Table of contents.

* * * * *

§ 1.707-2. Disguised payments for services.

- (a) In general.
- (b) Elements necessary to characterize arrangements as disguised payments for services.
 - (1) In general.
 - (2) Application and timing.
 - (i) Timing and effect of the determination.
 - (ii) Timing of inclusion.
 - (3) Application of disguised payment rules.
- (c) Factors considered.
- (d) Examples.

* * * * *

Par. 3. Section 1.707-1 is amended by adding a sentence at the end of paragraph (a) and revising paragraph (c) Example 2 to read as follows.

§ 1.707-1. Transactions between partner and partnership.

- (a) * * * For arrangements pursuant to which a purported partner performs services for a partnership and the partner receives a related direct or indirect allocation

and distribution from the partnership, see § 1.707-2 to determine whether the arrangement should be treated as a disguised payment for services.

(c) * * *

Example 2. 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.

* * * * *

Par. 4. Section 1.707-2 is added to read as follows:

§ 1.707-2 Disguised payments for services.

(a) In general. This section prescribes rules for characterizing arrangements as disguised payments for services. Paragraph (b) of this section outlines the elements necessary to characterize an arrangement as a payment for services, and it provides operational rules regarding application and timing of this section. Paragraph (c) of this section identifies the factors that weigh in the determination of whether an arrangement includes the elements described in paragraph (b) of this section that make it appropriate to characterize the arrangement as a payment for services. Paragraph (d) of this section provides examples applying these rules to determine whether an arrangement is a payment for services.

(b) Elements necessary to characterize arrangements as disguised payments for services--(1) In general. An arrangement will be treated as a disguised payment for services if--

(i) 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;

(ii) There is a related direct or indirect allocation and distribution to such service provider; and

(iii) 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.

(2) Application and timing--(i) Timing and effect of the determination. Whether an arrangement is properly characterized as a payment for services is determined at the time the arrangement is entered into or modified and without regard to whether the terms of the arrangement require the allocation and distribution to occur in the same taxable year. An arrangement that is treated as a payment for services under this paragraph (b) is treated as a payment for services for all purposes of the Internal Revenue Code, including for example, sections 61, 409A, and 457A (as applicable). The amount paid to a person in consideration for services under this section is treated as a payment for services provided to the partnership, and, when appropriate, the partnership must capitalize these amounts (or otherwise treat such amounts in a manner consistent with their recharacterization). The partnership must also treat the

arrangement as a payment to a non-partner in determining the remaining partners' shares of taxable income or loss.

(ii) Timing of inclusion. The inclusion of income by the service provider and deduction (if applicable) by the partnership of amounts paid pursuant to an arrangement that is characterized as a payment for services under paragraph (b)(1) of this section is taken into account in the taxable year as required under applicable law by applying all relevant sections of the Internal Revenue Code, including for example, sections 409A and 457A (as applicable), to the allocation and distribution when they occur (or are deemed to occur under all other provisions of the Internal Revenue Code).

(3) Application of disguised payment rules. If a person purports to provide services to a partnership in a capacity as a partner or in anticipation of becoming a partner, the rules of this section apply for purposes of determining whether the services were provided in exchange for a disguised payment, even if it is determined after applying the rules of this section that the service provider is not a partner. If after applying the rules of this section, no partnership exists as a result of the service provider failing to become a partner under the arrangement, then the service provider is treated as having provided services directly to the other purported partner.

(c) Factors considered. Whether an arrangement constitutes a payment for services (in whole or in part) depends on all of the facts and circumstances. Paragraphs (c)(1) through (6) of this section provide a non-exclusive list of factors that may indicate that an arrangement constitutes in whole or in part a payment for services. The presence or absence of a factor is based on all of the facts and circumstances at the time the parties enter into the arrangement (or if the parties modify the arrangement,

at the time of the modification). The most important factor is significant entrepreneurial risk as set forth in paragraph (c)(1) of this section. An arrangement that lacks significant entrepreneurial risk constitutes a payment for services. An arrangement that has significant entrepreneurial risk will generally not constitute a payment for services unless other factors establish otherwise. For purposes of making determinations under this paragraph (c), the weight to be given to any particular factor, other than entrepreneurial risk, depends on the particular case and the absence of a factor is not necessarily indicative of whether or not an arrangement is treated as a payment for services.

(1) The arrangement lacks significant entrepreneurial risk. 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. Paragraphs (c)(1)(i) through (v) of this section provide facts and circumstances that create a presumption that an arrangement lacks significant entrepreneurial risk and will be treated as a disguised payment for services unless other facts and circumstances establish the presence of significant entrepreneurial risk by clear and convincing evidence:

(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 that is non-binding or fails to timely notify the partnership and its partners of the waiver and its terms.

(2) The service provider holds, or is expected to hold, a transitory partnership interest or a partnership interest for only a short duration.

(3) 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.

(4) 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.

(5) The value of the service provider's interest in general and continuing partnership profits is small in relation to the allocation and distribution.

(6) 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 under sections 707(b) or 267(b), and the terms of the differing

allocations or distributions are subject to levels of entrepreneurial risk that vary significantly.

(d) Examples. The following examples illustrate the application of this section:

Example 1. Partnership ABC constructed a building that is projected to generate \$100,000 of gross income annually. A, an architect, performs services for partnership ABC for which A's normal fee would be \$40,000 and contributes cash in an amount equal to the value of a 25 percent interest in the partnership. In exchange, A will receive a 25 percent distributive share for the life of the partnership and a special allocation of \$20,000 of partnership gross income for the first two years of partnership's operations. The ABC partnership agreement satisfies the requirements for economic effect contained in § 1.704-1(b)(2)(ii), including requiring that liquidating distributions are made in accordance with the partners' positive capital account balances. Under paragraph (c) of this section, whether the arrangement is treated as a payment for services depends on the facts and circumstances. The special allocation to A is a capped amount and the cap is reasonably expected to apply. The special allocation is also made out of gross income. Under paragraphs (c)(1)(i) and (iii) of this section, the capped allocations of income and gross income allocations described are presumed to lack significant entrepreneurial risk. No additional facts and circumstances establish otherwise by clear and convincing evidence. Thus, the allocation lacks significant entrepreneurial risk. Accordingly, the arrangement provides for a disguised payment for services as of the date that A and ABC enter into the arrangement and, pursuant to paragraph (b)(2)(ii) of this section, should be included in income by A in the time and

manner required under applicable law as determined by applying all relevant sections of the Internal Revenue Code to the arrangement.

Example 2. A, a stock broker, agrees to effect trades for Partnership ABC without the normal brokerage commission. A contributes 51 percent of partnership capital and in exchange, receives a 51 percent interest in residual partnership profits and losses. In addition, A receives a special allocation of gross income that is computed in a manner which approximates its foregone commissions. The 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. It is reasonably expected that Partnership ABC will have sufficient gross income to make this allocation. The ABC partnership agreement satisfies the requirements for economic effect contained in § 1.704-1(b)(2)(ii), including requiring that liquidating distributions are made in accordance with the partners' positive capital account balances. Under paragraph (c) of this section, whether the arrangement is treated as a payment for services depends on the facts and circumstances. Under paragraphs (c)(1)(iii) and (iv) of this section, because the allocation is an allocation of gross income and is reasonably determinable under the facts and circumstances, it is presumed to lack significant entrepreneurial risk. No additional facts and circumstances establish otherwise by clear and convincing evidence. Thus, the allocation lacks significant entrepreneurial risk. Accordingly, the arrangement provides for a disguised payment for services as of the date that A and ABC enter into the arrangement and, pursuant to paragraph (b)(2)(ii) of this section, should be included in income by A in the

time and manner required under applicable law as determined by applying all relevant sections of the Internal Revenue Code to the arrangement.

Example 3. (i) M performs services for which a fee would normally be charged to new partnership ABC, an investment partnership that will acquire a portfolio of investment assets that are not readily tradable on an established securities market. M will also contribute \$500,000 in exchange for a one percent interest in ABC's capital and profits. In addition to M's one percent interest, 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 in which the partnership has overall net gain in an amount intended to approximate the fee that would normally be charged for the services M performs. A, a company that controls M, is the general partner of ABC and directs all operations of the partnership consistent with the partnership agreement, including causing ABC to purchase or sell an asset during any accounting period. A also controls the timing of distributions to M including distributions arising from M's priority allocation. Given the nature of the assets in which ABC will invest and A's ability to control the timing of asset dispositions, 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 based on all facts and circumstances available upon formation of the partnership. A will be allocated 10 percent of any net profits or net losses of ABC earned over the life of the partnership. A undertakes an enforceable obligation to repay any amounts allocated and distributed pursuant to this interest (reduced by reasonable allowances for tax payments made on A's allocable shares of partnership income and

gain) that exceed 10 percent of the overall net amount of partnership profits computed over the life of the partnership (a “clawback obligation”). It is reasonable to anticipate that A could and would comply fully with any repayment responsibilities that arise pursuant to this obligation. The ABC partnership agreement satisfies the requirements for economic effect contained in § 1.704-1(b)(2)(ii), including requiring that liquidating distributions are made in accordance with the partners’ positive capital account balances.

(ii) Under paragraph (c) of this section, whether A’s arrangement is treated as a payment for services in directing ABC’s operations depends on the facts and circumstances. The most important factor in this facts and circumstances determination is the presence or absence of significant entrepreneurial risk. The 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 earned over the life of the partnership, the allocation is subject to a clawback obligation 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. Additionally, other relevant factors do not establish that the arrangement should be treated as a payment for services. Thus, the arrangement with respect to A does not constitute a payment for services for purposes of paragraph (b)(1) of this section.

(iii) Under paragraph (c) of this section, whether M’s arrangement is treated as a payment for services depends on the facts and circumstances. The most important

factor in this facts and circumstances determination is the presence or absence of entrepreneurial risk. 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 thus it does not depend on the overall success of the enterprise. Moreover, the sale of the assets by ABC, and hence the timing of recognition of gains and losses, is controlled by A, a company related to M. Taken in combination, the facts indicate that the allocation is reasonably determinable under all the facts and circumstances and that sufficient net profits are highly likely to be available to make the priority allocation to the service provider. As a result, the allocation presumptively lacks significant entrepreneurial risk. No additional facts and circumstances establish otherwise by clear and convincing evidence. Accordingly, the arrangement provides for a disguised payment for services as of the date M and ABC enter into the arrangement and, pursuant to paragraph (b)(2)(ii) of this section, should be included in income by M in the time and manner required under applicable law as determined by applying all relevant sections of the Internal Revenue Code to the arrangement.

(iv) Assume the facts are the same as paragraph (i) of this example, except that the partnership can also fund M's priority allocation and distribution of net gain from the revaluation of any partnership assets pursuant to § 1.704-1(b)(2)(iv)(f). As the general partner of ABC, A controls the timing of events that permit revaluation of partnership assets and assigns values to those assets for purposes of the revaluation. Under paragraph (c) of this section, whether M's arrangement is treated as a payment for services depends on the facts and circumstances. The most important factor in this

facts and circumstances determination is the presence or absence of entrepreneurial risk. Under this arrangement, the valuation of the assets is controlled by A, a company related to M, and the assets of the company are difficult to value. This fact, taken in combination with the partnership's determination of M's profits by reference to a specified accounting period, causes the allocation to be reasonably determinable under all 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. No additional facts and circumstances establish otherwise by clear and convincing evidence. Accordingly, the arrangement provides for a disguised payment for services as of the date M and ABC enter into the arrangement and, pursuant to paragraph (b)(2)(ii) of this section, should be included in income by M in time and manner required under applicable law as determined by applying all relevant sections of the Internal Revenue Code to the arrangement.

Example 4. (i) The facts are the same as in Example 3, except that ABC's investment assets are securities that are readily tradable on an established securities market, and ABC is in the trade or business of trading in securities and has validly elected to mark-to-market under section 475(f)(1). In addition, M is entitled to receive a special allocation and distribution of partnership net gain attributable to a specified future 12-month taxable year. Although it is expected that one or more of the partnership's assets will be sold 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 taxable year.

(ii) Under paragraph (c) of this section, whether the arrangement is treated as a payment for services depends on the facts and circumstances. The most important factor in this facts and circumstances determination is the presence or absence of entrepreneurial risk. The special allocation to M is allocable out of net profits, the partnership assets have a readily ascertainable market value that is determined at the close of each taxable year, and 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. Accordingly, the special allocation is neither reasonably determinable nor highly likely to be available because the partnership assets have a readily ascertainable fair market value that is determined at the beginning of the year and at the end of the year. Thus, the arrangement does not lack significant entrepreneurial risk under paragraph (c)(1) of this section. Additionally, the facts and circumstances do not establish the presence of other factors that would suggest that the arrangement is properly characterized as a payment for services. Accordingly, the arrangement does not constitute a payment for services under paragraph (b)(1) of this section.

Example 5. (i) A is a general partner in newly-formed partnership ABC, an investment fund. A is responsible for providing management services to ABC, but has delegated that management function to M, a company controlled by A. Funds that are comparable to ABC commonly require the general partner to contribute capital in an amount equal to one percent of the capital contributed by the limited partners, provide

the general partner with an interest in 20 percent of future partnership net income and gains as measured over the life of the fund, and pay the fund manager annually an amount equal to two percent of capital committed by the partners.

(ii) Upon formation of ABC, the partners of ABC execute a partnership agreement with terms that differ from those commonly agreed upon by other comparable funds. The ABC partnership agreement provides that A will contribute nominal capital to ABC, that ABC will annually pay M an amount equal to one percent of capital committed by the partners, and that A will receive an interest in 20 percent of future partnership net income and gains as measured over the life of the fund. A will also receive an additional interest in future partnership net income and gains determined by a formula (the "Additional Interest"). The parties intend that the estimated present value of the Additional Interest approximately equals the present value of one percent of capital committed by the partners determined annually over the life of the fund. However, the amount of net profits that will be allocable to A under the Additional Interest is neither highly likely to be available nor reasonably determinable based on all facts and circumstances available upon formation of the partnership. A undertakes a clawback obligation, and it is reasonable to anticipate that A could and would comply fully with any repayment responsibilities that arise pursuant to this obligation. The ABC partnership agreement satisfies the requirements for economic effect contained in § 1.704-1(b)(2)(ii), including requiring that liquidating distributions are made in accordance with the partners' positive capital account balances.

(iii) Under paragraph (c) of this section, whether the arrangement relating to the Additional Interest is treated as a payment for services depends on the facts and circumstances. The most important factor in this facts and circumstances determination is the presence or absence of significant entrepreneurial risk. The 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. Additionally, the facts and circumstances do not establish the presence of other factors that would suggest that the arrangement is properly characterized as a payment for services. Accordingly, the arrangement does not constitute a payment for services under paragraph (b)(1) of this section.

Example 6. (i) A is a general partner in limited partnership ABC, an investment fund. A is responsible for providing management services to ABC, but has delegated that management function to M, a company controlled by A. The ABC partnership agreement provides that A must contribute capital in an amount equal to one percent of the capital contributed by the limited partners, that A is entitled to an interest in 20 percent of future partnership net income and gains as measured over the life of the fund, and that M is entitled to receive an annual fee in an amount equal to two percent of capital committed by the partners. The amount of partnership net income or gains that will be allocable to A under the ABC partnership agreement is neither highly likely to be available nor reasonably determinable based on all facts and circumstances

available upon formation of the partnership. A also undertakes a clawback obligation, and it is reasonable to anticipate that A could and would comply fully with any repayment responsibilities that arise pursuant to this obligation.

(ii) ABC's partnership agreement also permits M (as A's appointed delegate) to waive all or a portion of its fee for any year if it provides written notice to the limited partners of ABC at least 60 days prior to the commencement of the partnership taxable year for which the fee is payable. If M elects to waive irrevocably its fee pursuant to this provision, the partnership will, immediately following the commencement of the partnership taxable year for which the fee would have been payable, issue to M an interest determined by a formula in subsequent partnership net income and gains (the "Additional Interest"). The parties intend that the estimated present value of the Additional Interest approximately equals the estimated present value of the fee that was waived. However, the amount of net income or gains that will be allocable to M is neither highly likely to be available nor reasonably determinable based on all facts and circumstances available at the time of the waiver of the partnership. The ABC partnership agreement satisfies the requirements for economic effect contained in § 1.704-1(b)(2)(ii), including requiring that liquidating distributions are made in accordance with the partners' positive capital account balances. The partnership agreement also requires ABC to maintain capital accounts pursuant to § 1.704-1(b)(2)(iv) and to revalue partner capital accounts under § 1.704-1(b)(2)(iv)(f) immediately prior to the issuance of the partnership interest to M. M undertakes a clawback obligation, and it is reasonable

to anticipate that M could and would comply fully with any repayment responsibilities that arise pursuant to this obligation.

(iii) Under paragraph (c) of this section, whether the arrangements relating to A's 20 percent interest in future partnership net income and gains and M's Additional Interest are treated as payment for services depends on the facts and circumstances. The most important factor in this facts and circumstances determination is the presence or absence of significant entrepreneurial risk. The allocations to A and M do not presumptively lack significant entrepreneurial risk under paragraph (c)(1) of this section because the allocations are based on net profits, the allocations are subject to a clawback obligation over the life of the fund and it is reasonable to anticipate that A and M could and would comply with this obligation, and the allocations are neither reasonably determinable nor highly likely to be available. Additionally, the facts and circumstances do not establish the presence of other factors that would suggest that the arrangement is properly characterized as a payment for services. Accordingly, the arrangements do not constitute payment for services under paragraph (b)(1) of this section.

Par. 5. Section 1.707-9 is amended by:

- a. Redesignating paragraph (b) as paragraph (c);
- b. Redesignating paragraph (a) as paragraph (b); and
- c. Adding new paragraph (a).

The addition reads as follows:

§ 1.707-9. Effective dates and transitional rules.

(a) Section 1.707-2--(1) In general. Section 1.707-2 applies to all arrangements entered into or modified after the date of publication of the Treasury decision adopting that section as final regulations in the **Federal Register**. To the extent that an arrangement permits a service provider to waive all or a portion of its fee for any period subsequent to the date the arrangement is created, then the arrangement is modified for purposes of this paragraph on the date or dates that the fee is waived.

(2) Arrangements entered into or modified before final regulations are published in the Federal Register. In the case of any arrangement entered into or modified that occurs on or before final regulations are published in the **Federal Register**, the determination of whether the arrangement is a disguised fee for services under section 707(a)(2)(A) is to be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 73 of the Tax Reform Act of 1984 (Pub. L. 98-369, 98 Stat. 494). See H.R. Rep. No. 861, 98th Cong., 2d Sess. 859-2 (1984); S. Prt. No. 169 (Vol. I), 98th Cong., 2d Sess. 223-32 (1984); H.R. Rep. No. 432 (Pt. 2), 98th Cong., 2d Sess. 1216-21 (1984).

* * * * *

Par. 6. Section 1.736-1 is amended by adding a sentence at the end of paragraph (a)(1)(i) to read as follows:

§ 1.736-1. Payments to a retiring partner or a deceased partner's successor in interest.

(a) * * *

(1)(i) * * * Section 736 does not apply to arrangements treated as disguised payments for services under § 1.707-2.

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John Dalrymple,
Deputy Commissioner for Services and Enforcement.

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