The Honorable Mark W. Everson  
Commissioner of Internal Revenue  
Internal Revenue Service  
Room 5226  
1111 Constitution Avenue, NW  
Washington, DC 20224

Re: Comments on the Application of Section 409A to Transactions Involving Partnerships

Dear Commissioner Everson:

Enclosed are comments on the application of Section 409A to transactions involving partnerships. These comments represent the individual views of those members who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

Sincerely,

Kenneth W. Gideon  
Chair, Section of Taxation

Enclosure

cc: Carol Gold, Director – TEGE Employee Plans, IRS  
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COMMENTS REGARDING THE APPLICATION OF SECTION 409A OF THE INTERNAL REVENUE CODE TO TRANSACTIONS INVOLVING PARTNERSHIPS

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by individual members of the Employee Benefits Committee and the Partnerships and LLCs Committee of the Section of Taxation. Principal responsibility was exercised by Kurt L.P. Lawson. Substantive contributions were made by Stephan G. Bachelder, Paul Carman, William H. Caudill, Edward A. Razim, Charles B. Temkin, and Bryan L. Tyson. The comments were reviewed by Wayne R. Luepker, Chair of the Executive Compensation Subcommittee. Greta E. Cowart, Vice Chair, and Priscilla E. Ryan, Chair of the Section’s Employee Benefits Committee; by T. David Cowart of the Section’s Committee on Government Submissions; and by Thomas A. Jorgensen, Council Director for the Employee Benefits Committee.

Although many of the members of the Section of Taxation who participated in preparing these comments have clients who would be affected by the federal tax principles addressed by these comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

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Date: May 20, 2005
I. EXECUTIVE SUMMARY

The following comments relate to the application of Section 409A of the Internal Revenue Code of 1986, as amended, to transactions involving partnerships.

Our recommendations are as follows:

1. We recommend that Section 409A not apply to transactions between a partnership and a partner acting in his or her capacity as a partner that are treated as allocations of income under Sections 702 and 704 or distributions under Section 731.

2. We recommend that transactions that are treated under Section 707(a) as transactions between partnerships and partners not acting in their capacity as partners be subject to Section 409A in the same way and under the same circumstances as such transactions would be if they did not involve partners. Under this recommendation whether a transaction is treated as one between a partnership and a partner not acting in his or her capacity as a partner is to be determined under the principles of existing law, not principles developed solely for purposes of applying Section 409A. Further, we recommend that if a transaction is recharacterized under Section 707(a)(2)(A) as one between a partnership and a partner not acting in his or her capacity as a partner, the recharacterization not be given retroactive effect under Section 409A if the parties had a reasonable basis for believing that Section 707(a) did not apply.

3. We recommend that Section 409A not apply to guaranteed payments for services that are treated as transactions between a partnership and a non-partner solely for purposes of Section 61(a) and, subject to Section 263, Section 162(a).

4. We recommend that Section 409A not apply to payments made in liquidation of the interest of a retiring or deceased partner, regardless of whether they are Section 736(b) payments or Section 736(a) payments, and regardless of whether the Section 736(a) payments are guaranteed payments. We recommend that the same treatment apply to payments to terminated partners that are excluded from self-employment tax under Section 1402(a)(10).

5. We recommend that options to purchase partnership interests be treated the same as nonqualified stock options under Section 409A.

6. We recommend that appreciation rights with respect to partnership interests be treated the same as stock appreciation rights (“SARs”) under Section 409A. We agree with other commentators who recommend that the exemption for SARs from the definition of deferred compensation in Notice 2005-1 not require that stock subject to the SAR be publicly traded, and recommend that the same approach be taken for UARs.

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1 All references to “Sections” refer to the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise noted.
7. We recommend that transfers of partnership interests be treated the same as transfers of corporate stock under Section 409A, i.e., as not involving a deferral of compensation for purposes of that section. In the case of transfers of profits interests, we believe there is no need to limit this exception to transfers that are treated under applicable guidance as not resulting in inclusion of income by the service-provider. We further recommend that regulations or a notice (“Regulations”) make clear that changes in a partner’s share of partnership income, unrealized appreciation, and capital from year to year, to the extent they might otherwise be viewed as new transfers of partnership interests, are likewise exempt.

8. We recommend that the substitution, assumption or modification of a partnership option or other equity award pursuant to a merger, acquisition, reorganization or similar transaction not be treated as the grant of a new option or other equity award or a change in the form of payment for purposes of Section 409A if (i) such substitution, assumption or modification is not subject to the discretion of the award recipients, (ii) the terms of the substitution, assumption or modification are determined solely by the partnership or jointly by the partnership and other parties to the transaction or by operation of law and (iii) similar terms apply to all award recipients.

9. We recommend that Section 409A(a)(2)(A)(v) be interpreted to allow distributions upon a change in ownership or effective control of a partnership.

Although the terms “partner” and “partnership” are used throughout these comments, such terms are intended to apply, and they should be read as applying, to all persons and entities that are treated as partners and partnerships for tax purposes under the Code (such as members of LLCs and the LLCs themselves if they do not elect to be treated as corporations for tax purposes), regardless of how they are treated under state law. Publicly traded partnerships that are taxed as corporations have many characteristics that make them more similar to nonpublicly traded partnerships than true corporations. However, these comments do not address these issues from the standpoint of publicly traded partnerships and thus these recommendations may not be appropriate in some circumstances for those entities.
A partnership generally is treated as an entity that is separate from its partners for purposes of calculating partnership income.\(^2\) Thus, under Section 703 the character of each item of partnership income and loss generally is determined at the partnership level,\(^3\) and each item is reflected in partnership income according to the method of accounting adopted by the partnership. However, after the partnership’s income is calculated, it generally is treated as an aggregate of its partners, i.e., as a conduit through which the income must pass.\(^4\) Thus, the partnership itself is not subject to tax. Instead, under Section 702 each partner is taxed on his or her distributive share of partnership income, without regard to when or even whether the income is ever distributed.\(^5\) Consistent with this, under Section 731 when the income is eventually distributed by the partnership it is not subject to tax a second time unless it exceeds the amount previously included in income by the recipient (plus the recipient’s own contributions to the partnership and his or her share of any debt).

Partnership income is determined on the basis of the partnership’s tax year. Under Section 706 each partner’s distributive share of partnership income is included in the partner’s income in the partner’s tax year in which or with which the partnership’s tax year ends. This rule applies regardless of the method of accounting otherwise used by the partner, or when the income actually is distributed by the partnership. In general, a partnership is required to have a majority interest tax year, i.e., a tax year based upon the tax year of its principal partners or the tax year that provides the least aggregate deferral.\(^6\)

Subject to certain limitations designed primarily to prevent abuse, partners have considerable freedom under Section 704 to determine, via the partnership agreement, how to allocate partnership income to reflect the relative contributions of each partner, as well as when to distribute that income consistent with the needs of the business.

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\(^3\) See, e.g., Podell v. Commissioner, 55 T.C. 429 (1970) (income from the sale of property that was inventory to the partnership but would have been a capital asset in the hands of the partner treated as ordinary income). Congress has added provisions to the Code to prevent taxpayers from abusing this rule, e.g., Code §§ 724 & 751, but these provisions are exceptions from the general rule.

\(^4\) “However, a partnership is under subchapter K, as it was prior to the enactment of the 1954 Code, not a separate taxable entity subject to Federal income tax but the partners must include their distributive share of the partnership profits or losses in their income in computing their Federal income tax. Secs. 701 and 702. These provisions of subchapter K considered in the light of its legislative history show that whether the partnership is for a specific purpose considered as an aggregate of its partners or an entity is governed by the statutory provisions with the aggregate treatment prevailing as under prior law except where the statute provides otherwise.” 64 T.C. 203, 209 (1975), aff’d, 550 F.2d 1023 (5th Cir. 1977).

\(^5\) See Basye, 410 U.S. at 453-54; Treas. Reg. § 1.702-1(a).

\(^6\) Code § 706(b); Treas. Reg. § 1.706-1(b)(2).
Each partner in a partnership usually has a capital account. The capital account generally determines the amount of the partnership’s assets the partner would receive if the partnership were liquidated. Typically, a partner’s capital account is increased by the value of any property that the partner contributes to the partnership, by whatever portion of their own capital interests the other partners transfer to the partner, by the partner’s share of the unrealized appreciation of partnership assets (determined on “book-up” events such as the admission of new partners), and by whatever portion of the partner’s distributive share of partnership income has not yet been distributed to the partner. Partners entitled to large distributive shares of partnership income often also have large capital accounts, but there is no requirement that the percentage interests for income and for capital be the same.\(^7\) Similarly, partners with large capital accounts typically are entitled to large shares of the unrealized appreciation of partnership assets, but there is no requirement that they be proportional.

Section 409A generally requires that all amounts deferred under a nonqualified deferred compensation plan after December 31, 2004, on behalf of a service-provider be included in the service-provider’s gross income to the extent that they are not subject to a substantial risk of forfeiture unless the plan complies, both in form and in operation, with certain rules regarding the timing of deferral elections and the timing of payouts and payout elections. If these rules are violated, the amounts included in income also are subject to an additional 20% income tax, and the service-provider is required to pay interest at the IRS underpayment rate plus 1% on the under-payment that would have occurred if the amounts had been included in income when first deferred or, if later, when they were not subject to a substantial risk of forfeiture.

According to Notice 2005-1,\(^8\) compensation generally is subject to a substantial risk of forfeiture for purposes of Section 409A if the service-provider’s “entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial.” For this purpose, “a condition related to a purpose of the compensation must relate to the service provider’s performance for the service recipient or the service recipient’s business activities or organizational goals (for example, the attainment of a prescribed level of earnings, equity value or a liquidity event).”

Section 409A defines a “nonqualified deferred compensation plan” as any plan that provides for the deferral of compensation (other than certain enumerated exceptions). Notice 2005-1 states that a plan provides for the deferral of compensation if it gives a service-provider a “legally binding right” during a taxable year to compensation that (i) has not been “actually or constructively received and included in gross income” and (ii) pursuant to the terms of the plan (a) is “payable to (or on behalf of) the service provider in a later year” and (b) is not required to be “actually or constructively received” by the service-provider within 2½ months after the end of the tax year of the service-provider in which it is no longer subject to a substantial risk of forfeiture (or, if later, 2½ months after the end of the tax year of the service-recipient in which it

\(^7\) By contrast, the income and capital interests of S corporations must be the same. See Code §§ 1361 et seq.

\(^8\) 2005-2 I.R.B. 274.

{THE APPLICATION OF SECTION 409A TO TRANSACTIONS INVOLVING PARTNERSHIPS;1}
is no longer subject to a substantial risk of forfeiture). Neither Section 409A nor Notice 2005-1 defines “compensation” for this purpose.

Notice 2005-1 states that Section 409A generally applies to nonqualified deferred compensation plans for independent contractors, including partners, as well as nonqualified deferred compensation plans for employees. However, it states that, until additional guidance is issued, taxpayers may treat grants of partnership interests, and options and appreciation rights with respect to partnership interests, in the same way as transfers of corporate stock, stock options and SARs for this purpose. The Notice also specifically provides that the issuance of a profits interest in exchange for services that is properly treated under existing guidance as not resulting in inclusion of income by the service-provider at the time of issuance is not treated as a deferral of compensation. In addition, it provides that until additional guidance is issued, arrangements described in Section 736 (payments to terminated partners), other than those excluded from self-employment tax under Section 1402(a)(10), are exempt from Section 409A. Finally, it makes a comment susceptible to multiple interpretations that Section 409A “may” apply to payments covered by Section 707(a)(1) (partner not acting in capacity as partner) “if such payments otherwise would constitute a deferral of compensation under a nonqualified deferred compensation plan.”

Notice 2005-1 asks for comments on the application of Section 409A to arrangements involving partners and partnerships, specifically with respect to the applicability of Section 409A to arrangements subject to Section 736, whether there should be a distinction between payments subject to subsections (a) and (b) of Section 736, the coordination of the timing rules of Treasury Regulation § 1.736-1(b)(5) with Section 409A, and whether there should be special rules in applying Section 409A in the case of transactions treated as transactions with a non-partner under Section 707(a)(2)(A).

We address these and other issues raised by Section 409A and Notice 2005-1 below.

A. Transactions between partnerships and partners acting in their capacity as partners

1. Summary

The system for taxing partners and partnerships outlined above gives partners virtually no opportunity to defer tax on amounts they earn as partners. Moreover, even when a partner provides services to a partnership, generally none of the partner’s share of partnership income is considered compensation income, and the partner is not entitled to any additional amount as

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9 Notice 2005-1 excludes from the definition of deferred compensation most grants of restricted stock, grants of stock options that are not in the money when they are granted, and stock-settled SARs with respect to publicly traded stock that are not in the money when they are granted.

10 The SECA tax system is similar. It treats a general partner’s entire distributive share of partnership income as “net income from self-employment”. Code § 1402(a); Treas. Reg. § 1.1402(c)-1. It makes no attempt to determine what portion of that is compensation for the partner’s own services. It does not treat any portion of a limited partner’s distributive share of
compensation for those services. Usually the only time that a partner receives compensation in his or her capacity as a partner is when the partnership itself receives compensation, the character of which is passed through to the partner, although in that case what the partner receives is not compensation for his or her own services, but rather a share of compensation received for services performed by the partnership as a whole.

Nevertheless, the broad definition of the term deferral of compensation in Notice 2005-1, and the lack of any definition of the term compensation, have created concern that Section 409A might apply to many common transactions between partnerships and partners acting in their capacity as partners. As noted above, according to Notice 2005-1 a deferral of compensation occurs whenever a service-provider has a “legally binding right” during a taxable year to compensation that will be “actually or constructively received” more than 2½ months after the end of the year in which it vests. Conceivably this could mean that, if a partnership agreement does not require all of the partnership’s income for a year to be distributed within 2½ months after the end of the year, the income will be treated as “deferred” even though the partners were taxed on the income in the prior year, and that, if any of the partners provides services to the partnership, some or all of their income will be treated as “deferred compensation” and subject to Section 409A. If that were to happen, the partnership would have to modify its partnership agreement to permit distributions to those partners only at the times permitted by Section 409A. Amendments to the partnership agreement dealing with the timing of distributions might be viewed as deferral elections that would have to be made before the services giving rise to the distributions were performed, or as accelerations of payments that would violate Section 409A.

Conceivably, these rules also could mean that, if the tax year of a partnership is different from that of a partner, and therefore each of the partnership’s tax years is overlapped by two of the partner’s tax years, Section 409A will apply to income earned early in a partnership’s tax year, during the partner’s first overlapping tax year, merely because it will not be included in the partner’s taxable income until the end of the partner’s next tax year. It is not clear how a violation of Section 409A could be avoided in that case short of changing one or both of the parties’ tax years.

Taken to an extreme, these rules could even mean that, any time a partnership agreement promised a service partner some benefit in the future—a share of partnership income, a share of unrealized appreciation on partnership assets, or an increase in the partner’s capital account—this could be viewed as deferred compensation.

2. Recommendation

We recommend that Section 409A not apply to transactions between a partnership and a partner acting in his or her capacity as a partner that are treated as allocations of income under partnership income as net income from self-employment unless it is a guaranteed payment (discussed below). Code § 1402(a)(13).

11 U.P.A. § 18(f). See, e.g., Koenig v. Huber, 87 S.D. 507, 210 N.W.2d 825 (1973) (profits of a partnership divided based upon agreed profit shares without regard to the fact that one partner provided more services than the other).
Sections 702 and 704 or distributions under Section 731. (This recommendation does not cover payments subject to Section 736, which are discussed in Section D. below).

3. Explanation

Our reasons for making this recommendation are set forth below.

a. Inconsistency with system for taxing partnership income

Treating a portion of a service partner’s distributive share of partnership income as compensation for the partner’s services to the partnership would lead to one of two results, both of which are inconsistent with the existing system for taxing partnership income. One result would be to treat as compensation all of the partner’s distributive share of partnership income. However, compensation is ordinary income; whereas a partner’s distributive share of partnership income includes the partner’s distributive share of each class or item of partnership income, gain, loss, deduction, or credit. That fact does not change simply because the partner is providing services to the partnership. Treating the partner’s distributive share as compensation solely for purposes of Section 409A is a possibility, of course, but in our view an artificial and result-driven one that is inconsistent with the spirit of the partnership allocation rules. Furthermore, service partners often make other contributions to the partnership, necessitating some rule for determining how much of the partner’s distributive share should be treated as compensation in any given year. Another result would be to treat as compensation only that portion of the partner’s distributive share that otherwise would be treated as compensation (i.e., the partner’s distributive share of the compensation received by the partnership as compensation for the partnership’s services). However, in that case there would

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12 Code § 61(a)(1); Koss v. Commissioner, 57 T.C.M. (CCH) 882, aff’d, 908 F.2d 962 (3d Cir. 1990).
14 See, e.g., Pratt, 64 T.C. at 209-210 (recharacterizing amounts that were paid to the general partners for services as a portion of their distributive shares of partnership income). Under the particular facts of the case, the Treasury later ruled that the payments should have been treated as a guaranteed payments. Rev. Rul. 81-300, 1981-2 C.B. 143. The authors of the Senate Finance Committee Report on the Tax Reform Act of 1984 appeared to believe that Section 707(a)(2)(A) would cause the particular payment in question in Pratt to be treated as a Section 707(a) payment. Staff of Senate Committee on Finance, 98th Cong., 2nd Sess., Deficit Reduction Act of 1984, 230 (Comm. Print No. 98-169, 1984). However, neither Rev. Rul. 81-300 nor the Finance Committee explanation questioned the court’s conclusion that if the payments were not Section 707(c) payments or Section 707(a) payments, then the payments represented a portion of the general partner’s distributive shares of partnership profit. The Finance Committee explanation, in fact, observes in Example 1 that if the architect in the example (who contributed architectural services to the partnership) had assumed significant entrepreneurial risk, then, depending upon all the facts and circumstances, allocations and distributions to the architect might appropriately be treated as distributive shares and partnership distributions. Similarly, in PLR 8642003 and PLR 7939005 the Internal Revenue Service (“IRS”) ruled that amounts paid to service partners were, in whole or in part, distributions of the recipient partner’s share of the net income of the partnership.
be no correlation between the amount of the compensation and the amount or value of the partner’s services. Thus, for example, service partners in capital-intensive businesses would be treated far differently than service partners in labor-intensive businesses.

Treating any portion of a partner’s distributive share of partnership income, or distributions of that income, as deferred compensation subject to Section 409A would lead to one of these two results, both of which are inconsistent with the existing system for taxing partnership income. As noted above, subjecting a partner’s distributive share of partnership income to Section 409A potentially would limit the timing of partnership amendments and distributions, which would be inconsistent with the flexibility that is a hallmark of the partnership structure, and interfere with a partnership’s ability to base distributions on business concerns and the actual inflows and outflows of cash. Failure to comply with Section 409A could subject a partner’s share of partnership income to tax in an earlier tax year than required under the partnership rules, for no compelling reason because no significant deferral of compensation is even possible under the regular partnership rules.\textsuperscript{15}

b. Inconsistency with technical requirements of Section 409A and Notice 2005-1

It is not at all clear that transactions between partnerships and partners acting in their capacity as partners even come within the definition of a “nonqualified deferred compensation plan” in Section 409A in the first place. As noted above, it is not clear when if ever partners receive “compensation” for their services to the partnership. Other technical problems exist as well.

Notice 2005-1 requires the existence of a “legally binding right” to compensation that is payable in a later year. The income to which a partner has a right under the partnership agreement is contingent on the success of the business. Under Notice 2005-1, that alone apparently is not enough to preclude the existence of a “legally binding right”. However, the dynamics of partnerships, and the fact that, unlike other business entities, service partnerships typically don’t accumulate significant reserves, make it uncommon for active partners to receive a share of annual income in any given year that is out of proportion to the role they actually played in generating it in that year, e.g., as a delayed reward for services they performed in some prior year. Income like this is more like current income than deferred compensation, even if the partner received some kind of right or claim to the income in a prior year (for example, if the partnership agreement that the partner signed years ago said that his distributive share of partnership income would increase over time in some fashion). Furthermore, partnership allocations in service partnerships typically are subject to amendment by a vote of the partners, meaning that any “right” that a partner possesses typically is less certain or fixed than a similar right possessed by a corporate executive.

\textsuperscript{15} There is a kind of limited mismatch between the tax years of a partner and the partnership that is expressly permitted by the Code and regulations, potentially without producing either a matching deduction or any contemporaneous reduction of income for other partners, but that rare exception does not justify extending the reach of Section 409A generally to partnerships.
Moreover, even if the “legally binding right” requirement were satisfied, the right would be subject to a substantial risk of forfeiture until the partnership income was, in fact, earned. Notice 2005-1 says that compensation is subject to a substantial risk of forfeiture if it is contingent on the attainment of a prescribed level of earnings or equity value. Income that is contingent on whether the partnership earns it is just as much at risk as income that is contingent on one of these events.

Situations sometimes arise in which an active partner’s right to a share of partnership income appears to have been deferred from a prior year. For example, many real estate development partnerships give their service partners a “carried interest” (also called a “carry” or “promote”). Generally, the carry entitles the service partner to a certain percentage of profits after the other partners have received a return of their capital and frequently a return on that capital. However, situations like these involve a division of income from a single venture that happens to extend over several years, and the intent is to reward some partners only if the venture generates sufficient returns, not to defer their income. Also, new service partners sometimes receive disproportionately large shares of unrealized appreciation on partnership assets, in order to bring their capital accounts more in line with those of other partners. This often takes several years, which can cause it to look like a deferred reward for the partner’s services. However, such spreading typically only results from the lack of sufficient appreciation to achieve the desired balancing result in the first year.

Treating income like this as compensation subject to Section 409A would, moreover, be unworkable, because taxpayers would have to determine exactly when a partnership’s income became certain enough of being earned that partners’ rights to shares of it became vested, and come up with a way of measuring it potentially long before it even was recognized for tax purposes.

Of course, as noted above, a partner’s distributive share of partnership income can qualify, technically, as deferred compensation under Notice 2005-1 even if it clearly is being given to the partner on account of his or her current services if there is enough of a difference between the tax year of the partner and the tax year of the partnership. However, we believe that the limited period of deferral that is permitted in that case, and the restrictions on a partnership’s choice of tax year that already exist in the law in order to limit such deferrals, are more than enough reason not to trigger Section 409A.

Similarly, Notice 2005-1 provides that compensation is not deferred once it has been “actually or constructively received and included in gross income”. The constructive receipt principles that apply to corporate executives are irrelevant in determining when partners are subject to tax on their distributive share of partnership income. However, if anything, the existing rules subject partners to tax even earlier than would be required under the constructive receipt principles. It would be consistent with the purposes of Section 409A to treat a partner for this purpose as having actually or constructively received his or her share of partnership income when it is included in the partner’s income under Section 702.
c. Inconsistency with exemption for grants of partnership interests

We think it would be illogical if grants of partnership interests (as recognized by Notice 2005-1) were exempt from Section 409A, but many of the transactions that are the natural result of receiving such an interest and operating as a partner were subject to Section 409A.

d. Limited abuse potential

The abuses that led to the enactment of Section 409A are less likely to occur in the partnership context. As noted above, the system for taxing partners and partnerships gives partners virtually no opportunity to defer tax on amounts they earn as partners. Furthermore, since all of the income of a partnership for a given year must be allocated among the partners, a “deferral” of income by one partner to a subsequent year would require that some other partner or partners would be currently taxed on the amount deferred even if they did not actually receive an increase in their draw from the partnership. In fact, such a deferral by one partner would not be effective for tax purposes if it did not shift the tax burden to the other partner or partners, since the regulations under Section 704 already effectively prohibit inter-year trade-offs where they result in a reduction of the partners’ tax liability. Consequently, because partners are dealing with each other, they cannot benefit themselves in the aggregate. This is unlike the case of the executives of a company who may be able to benefit themselves at the expense of the shareholders; in a service partnership context, the partners’ roles are akin to both shareholders and executives of a corporation. In addition, partners are more likely than corporate executives to be liable for the partnership’s debts, and thus it is harder for partners who receive payments on the eve of bankruptcy (like the Enron executives) to keep those payments. Most state laws prohibit distributions even to limited partners if they would cause the partnership’s liabilities to exceed its debts.16

e. Additional consideration for partnerships that use the accrual method

As noted above, under Section 703 each item of partnership income and loss is reflected in partnership income according to the method of accounting adopted by the partnership, and under Section 706 each partner’s distributive share of partnership income is included in the partner’s income in the partner’s tax year in which or with which the partnership’s tax year ends regardless of the method of accounting otherwise used by the partner for the partner’s distributive share. Thus, if a partnership uses the accrual method, effectively every partner in the partnership uses the accrual method. Notice 2005-1 says that Section 409A does not apply to arrangements between taxpayers all of whom use the accrual method of accounting. We believe that Section 409A therefore should not apply to any transactions between a partnership that uses the accrual method and partners acting in their capacity as partners.

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B. Transactions between partnerships and partners not acting in their capacity as partners (Section 707(a) transactions)

1. Summary

Section 707 provides special rules for transactions between partnerships and their partners. Section 707(a) applies to transactions between a partnership and partners not acting in their capacity as partners. It covers payments for services as well as payments for property. Transactions subject to Section 707(a) are treated as transactions with one who is not a partner and thus are subject to the non-partnership provisions of the Code.

The legislative history of Section 707(a) lists six questions relevant to determining whether a partner engages in a transaction in his or her capacity as a partner: (i) was the payment at issue subject to significant entrepreneurial risk, (ii) was the partner’s partnership status transitory, (iii) did the partner become a partner primarily for tax benefits, (iv) how close in time were the transaction and the payment for it, (v) was the size of the partner’s interest in the partnership small in relation to the payment, and (vi) was the payment a disguised sale of property.\(^{17}\) The relevant regulation states that “In all cases, the substance of the transaction will govern rather than its form."\(^{18}\)

Section 707(a)(2)(A) provides that a payment for services can be recharacterized as a transaction with a partner not acting in his or her capacity as a partner where:

(i) . . . a partner performs services for a partnership . . ., (ii) there is a related direct or indirect allocation and distribution to such partner, 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 partner acting other than in his or her capacity as a member of the partnership . . . .\(^{19}\)

2. Recommendation

We recommend that transactions that are treated under Section 707(a) as transactions between partnerships and partners not acting in their capacity as partners be subject to Section 409A in the same way and under the same circumstances as such transactions would be if they did not involve the partnership. Under this recommendation, whether a transaction is treated as one between a partnership and a partner not acting in his or her capacity as a partner is to be determined under the principles of existing law, not principles developed solely for purposes of applying Section 409A. Further, we recommend that if a transaction is recharacterized under Section 707(a)(2)(A) as one between a partnership and a partner not acting in his or her capacity

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\(^{17}\) Staff of Senate Committee on Finance, 98th Cong., 2nd Sess., Deficit Reduction Act of 1984, 227-29 (Comm. Print No. 98-169, 1984).

\(^{18}\) Treas. Reg. § 1.707-1(a) (last sentence).

\(^{19}\) Section 707(a)(2)(A).
as a partner, the recharacterization would not be given retroactive effect under Section 409A if the parties had a reasonable basis for believing that Section 707(a) did not apply.

3. **Explanation**

   We see no reason to use different principles to determine whether a transaction is one between a partnership and a partner not acting in his or her capacity as a partner for purposes of Section 409A than for purposes of Subchapter K. Those principles are well developed and are designed to ensure that the tax treatment of the parties is based on the substance rather than merely the form of the transaction. In that regard, we think that the principles of Section 707(a) are quite consistent with the purposes of Section 409A. Furthermore, given the fact-specific nature of the determination, any meaningful guidance issued under Section 409A probably would have an influence under Subchapter K as well.

   Similarly, given the fact-specific nature of the determination, we think it would be unfair to apply Section 409A to a transaction between a partnership and a partner which is retroactively recharacterized under Section 707(a)(2)(A), because at the time of recharacterization it is no longer possible to comply with Section 409A, as long as the parties reasonably believed that Section 707(a) did not apply at the time of the transaction. Retroactively recharacterizing a transaction as one between a partnership and a partner not acting in a capacity as a partner for purposes of Subchapter K can be burdensome and expensive, but doing it for purposes of Section 409A can be devastating. We are not in a position to suggest exactly when parties should be viewed as having a reasonable belief that Section 707(a) does not apply for this purpose. However, we would be pleased to work with the Treasury and IRS to develop guidelines that would minimize the potential for abuse.

C. **Guaranteed payments (Section 707(c) transactions)**

   1. **Summary**

   Section 707(c) treats payments to a partner for services or for the use of capital that are determined without regard to partnership income as payments to a non-partner, but “only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses).” In all other respects the transaction is treated as one between the partnership and a partner and subject to all of the usual partnership rules. Thus, according to the regulations:

   Guaranteed payments do not constitute an interest in partnership profits for purposes of sections 706(b)(3), 707(b), and 708(b). For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner’s distributive share of ordinary income. Thus, a partner who receives guaranteed payments for a period during which he is absent from work because of personal injuries or sickness is not entitled to exclude such payments from his gross income under section 105(d). Similarly, a partner who receives guaranteed
payments is not regarded as an employee of the partnership for the purposes of withholding of tax at source, deferred compensation plans, etc.\(^\text{20}\)

Consistent with the limited scope of Section 707(c), a partner includes guaranteed payments in income at the same time as the rest of his or her distributive share of partnership income, namely in the tax year within which or with which ends the partnership tax year in which the partnership deducted the payments according to its method of accounting.\(^\text{21}\)

2. Recommendation

We recommend that Section 409A not apply to guaranteed payments, which are treated as transactions between a partnership and a non-partner solely for purposes of Section 61(a) and, subject to Section 263, Section 162(a).

3. Explanation

Most of the reasons listed in Section A. above for not applying Section 409A to transactions (other than guaranteed payments) between a partnership and a partner acting in his or her capacity as a partner also are relevant to guaranteed payments that are treated as transactions between a partnership and a non-partner solely for purposes of Section 61(a) and, subject to Section 263, Section 162(a).

Thus, for example, treating guaranteed payments as deferred compensation subject to Section 409A is likely to lead to results that are inconsistent with the existing system for taxing partnership income, including Section 707(c) itself. One result would be to limit the timing of partnership amendments and distributions (in an attempt to comply with Section 409A), which would be inconsistent with the flexibility that is a hallmark of the partnership structure, and interfere with a partnership’s ability to base distributions on business concerns and the actual inflow of cash. Another result could be to tax a partner’s share of partnership income to him in an earlier tax year than required under the partnership rules (because of a violation of Section 409A), for no compelling reason because even in the case of a guaranteed payment no significant deferral of tax is possible. Furthermore, since many partnerships use the cash method of accounting (unlike corporations, which typically are required to use the accrual method), in many cases the tax would be imposed long before the other partners were allowed to deduct the payment. For example, consider the following hypotheticals:

\(^{20}\) Treas. Reg. § 1.707-1(c).
\(^{21}\) Id. The Tax Court in Pratt explained that “It should be noted that such payments, whether for services or for the use of capital, will be includible in the recipient’s return for the taxable year with or within which the partnership year in which the payment was made, or accrued, ends. [citing legislative history of Section 707(c)] This language leaves no doubt that Congress intended to foreclose the possibility that a partnership might accrue salary and interest expenses, which expenses would reduce each partner’s distributive share of net partnership income or increase his loss therefrom, while the salaried partner might never receive the payments and therefore never include the amounts in income.” 64 T.C. at 213.
Individuals A, B and C created ABC, a cash-method calendar year partnership, to operate a retail business. All three have contributed capital to ABC, and all three provide services in running the store. All are one-third owners (sharing equally all income, deductions and distributions), except that A, who has children in college, is given a guaranteed minimum distribution of $100,000 per year. If ABC has distributable income of $300,000, A’s regular one-third share is $100,000, and none of it is subject to Section 707(c). However, if ABC has only $240,000 of distributable income, A will have $20,000 of income subject to Section 707(c) ($100,000 minus one-third of $240,000). What if A, not wanting to drain ABC’s assets and subject the business (his business) to financial risk, agrees to defer the guaranteed payment until the business has a “good year”? The application of Section 409A could mean that A must either insist on a distribution of his full guaranteed amount (in order to avoid a “deferral of compensation” within the meaning of that section) or risk having to pay tax with money he does not have, plus interest and penalties, with no corresponding deduction for B and C, if the requirements of that section cannot be satisfied (for example, because having a “good year” is not a permitted distribution event). We do not think Congress intended Section 409A to have this result.

Assume ABC starts out with no guaranteed payments, A’s children being young at the time. In June of Year X, with a child about to start college, A agrees to take a reduced percentage of 24% (B and C will now have 38% apiece), in order to have a $100,000 per year guarantee for the next four years. This could be an election to defer compensation in violation of Section 409A(a)(4). If the business produces $417,000 of distributable profits in those years, his guarantee becomes irrelevant for 707(c) purposes, so 409A would presumably not apply. However, if ABC has a bad year, earning only $280,000, his prior “election” could then result in a violation of 409A with respect to $32,800 dollars of guaranteed income. We think this is an illogical result.

These odd results are not mandated by Section 707(c). Quite the opposite: As noted above, Section 707(c) treats guaranteed payments as transactions between a partnership and a non-partner solely for purposes of Section 61(a) and, subject to Section 263, Section 162(a). Congress had the opportunity to add a reference to Section 409A, but it did not do so. The reference to Section 61(a) in the statute could be read as a reference to any provision of the Code that determines whether an amount is includible in gross income. However, as noted above, the regulations do not read it that broadly.\(^\text{22}\) Moreover, if Section 409A applies at all it determines when, not whether, an amount is includible in gross income. Such timing rules even more clearly are not picked up by Section 707(c): According to the regulations, a partner must include guaranteed payments in income in his or her taxable year within or with which ends the partnership’s taxable year in which the partnership deducted the payments according to its own method of accounting, regardless of when the partner actually or constructively receives them. In part in recognition of this, as noted above the regulations under Section 707(c) specifically say

that “a partner who receives guaranteed payments is not regarded as an employee of the partnership for the purposes of . . . deferred compensation plans.”

Moreover, it is not at all clear that a promise of guaranteed payments is included within the definition of a “nonqualified deferred compensation plan” in Section 409A. While guaranteed payments do not depend directly on the amount of partnership income, typically they are at risk if the partnership does not have enough income or assets to make them. In the case of a service partner, the existence of that income or assets often depends in part on the partner’s own efforts. This raises the same issue as above as to whether a promise to make such payments can fairly be considered a “legally binding right” that accrued in a prior year (or, if the promise constitutes a legally binding right, whether the promise can fairly be considered vested until sufficient partnership income or assets are actually earned or otherwise available, unless the partnership’s income is unusually steady or the amount of the guaranteed payment is quite small or the available assets provide adequate assurance). Although similar situations arise in the corporate context, the concern about fairness is greater in the partnership context because partnerships tend to accumulate less reserves, have less predictable incomes, and have incomes that (because many partnerships are small) tend to depend more on the contributions of each individual partner. These are some of the same concerns that have led the IRS to ignore transfers of profits interests in partnerships as either transfers of property under Section 83 or nonqualified deferred compensation arrangements under Section 409A.

The other reasons listed in Section A. above (relating to the unfair use of a constructive receipt standard in Notice 2005-1, the inconsistency between applying Section 409A in this context and the exception for grants of partnership interests, and an additional concern in the case of partnerships that use the accrual method) are just as relevant to guaranteed payments as they are to other allocations of partnership income.

D. Payments to terminated partners (Section 736 payments)

1. Summary

Section 736 deals with certain payments made in liquidation of the interest of a retiring or deceased partner. “Retire” does not have the same connotation here as it does in the employment context, where it generally only refers to a termination of employment by an employee who is over normal retirement age and intends to stop working. A partner “retires” for this purpose when he or she ceases to be a partner under local law.23 Thus, Section 736 applies to virtually any payment to a terminated partner.

There are two main types of Section 736 payments. Section 736(b) payments are payments made in exchange for the partner’s interest in partnership property. Section 736(a) payments are payments not made in exchange for the partner’s interest in partnership property. Section 736(a) payments are treated as a distributive share of partnership income to the extent they are determined with regard to the income of the partnership; otherwise, they are treated as guaranteed payments. Section 736(b) payments are treated as distributions and, under Section

731, such distributions are subject to tax only to the extent they exceed the partner’s adjusted basis in his or her partnership interest. Under Section 741, any such gain generally is capital gain. (Special rules apply, however, to the extent the distributions are attributable to the partner’s interest in substantially appreciated inventory or unrealized receivables that are not eligible for the special rule in Section 736(b)(2), discussed below.)

The interests of the terminated partner and the remaining partners with respect to the characterization of payments to the terminated partner are adverse, because Section 736(a) payments are taxable to the terminated partner and give rise to a concomitant deduction or an equivalent reduction in the distributive shares of the remaining partners, whereas Section 736(b) payments are not taxable to the extent they do not exceed the terminated partner’s basis in his or her partnership interest (and are capital gain to the extent they do), and do not give rise to a deduction or its equivalent for the remaining partners. Consequently, the parties’ characterization of such payments generally is respected.

A partnership’s assets include fixed assets as well as inventory, unrealized receivables and goodwill. Nevertheless, Section 736(b)(2) treats payments to certain partners for unrealized receivables, and for goodwill unless otherwise provided in the partnership agreement, as Section 736(a) payments instead of Section 736(b) payments. Section 736(b)(2) was amended in 1993 to apply only if capital is not a material income-producing factor for the partnership and the terminated partner was a general partner.

Certain payments to terminated partners excluded from self-employment tax under Section 1402(a)(10). To qualify, (i) the payments must be made on a periodic basis pursuant to a written plan that provides for payments on account of retirement to partners generally or to a class or classes of partners to continue at least until the partner’s death, (ii) the partner to whom the payments are made must not have rendered any service with respect to any trade or business carried on by the partnership during the taxable year of the partnership that ends within or with the taxable year of the partner and in which the payment was received, (iii) no obligation must

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24 See Code § 751. Section 751(c) defines “unrealized receivables” to include most categories of ordinary income producing property, including recapture income.

25 See Treas. Reg. § 1.736-1(b)(1); cf. Treas. Reg. § 1.736-1(b)(5)(iii) (parties’ allocation of annual payments between Section 736(a) payments and Section 736(b) payments will be respected only if the total amount allocated to Section 736(b) payments for property does not exceed the fair market value of the partner’s share of the property as of his or her termination date).

26 But only to the extent they exceed the partner’s share of the partnership’s basis in those assets, if any. See Treas. Reg. § 1.736-1(b)(2).

27 The legislative history explains that “[b]y treating a payment for unstated goodwill and unrealized receivables as a guaranteed payment or distributive share, present law in effect permits a deduction for an amount that would otherwise constitute a capital expenditure. This treatment does not measure partnership income properly. . . . It is recognized, however, that general partners in service partnerships do not ordinarily value goodwill in liquidating partners. Accordingly, such partners may continue to receive the special rule of present law.” H.R. Rep. No. 103-111, at 782 (1993).
exist from the other partners to the retired partner except with respect to retirement payments under the plan or rights such as benefits payable on account of sickness, accident, hospitalization, medical expenses, or death, and (iv) the retired partner’s share of the capital of the partnership must have been paid to him in full before the close of the partnership’s taxable year referred to in clause (ii).

To qualify as payments on account of retirement, the payments must constitute bona fide retirement income, which according to the regulations generally is measured by, and based on, such factors as years of service and compensation received.

Because Section 736 payments (including payments subject to Section 1402(a)(10)) are made after a partner ceases to be a partner under state law, and ceases to participate in the business of the partnership, there is a concern that in the case of a service partner they could be considered payments of deferred compensation under Section 409A, if the specific exception in Notice 2005-1 were eliminated or modified.

2. Recommendation

We recommend that Section 409A not apply to payments made in liquidation of the interest of a retiring or deceased partner, regardless of whether they are Section 736(b) payments or Section 736(a) payments, and regardless of whether the Section 736(a) payments are guaranteed payments. We recommend that the same treatment apply to payments to terminated partners that are excluded from self-employment tax under Section 1402(a)(10).

3. Explanation

a. Section 736(b) payments

Section 736(b) payments are in the nature of payments for property, not services, and we recommend that Section 409A not be construed to apply to them.

b. Section 736(a) payments

Most of the reasons listed in Sections A. and C. above for not applying Section 409A to distributive share payments and guaranteed payments to active partners also are relevant to Section 736(a) payments, which are in every respect identical to those payments except that they are made to inactive or former partners. For example, compliance with Section 409A potentially would interfere with a partnership’s ability to vary the timing of the payments on business concerns and the actual inflow of cash, a practice that is quite common and, we believe, completely nonabusive.

The only reason listed above that is not as relevant is the observation that the dynamics of partnerships makes it uncommon for partners to receive a share of annual income that is out of proportion to the role they actually played in generating it. Obviously, in the case of a terminated partner, the partner frequently is receiving a share of income that he or she did not directly help to generate.

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28 Code § 1402(a)(10); Treas. Reg. § 1.1402(a)-17.
However, it does not follow that the payments are deferred compensation. In many cases, they are for unrealized receivables or goodwill and are subject to Section 736(a) (even though unrealized receivables or goodwill are really just types of property) solely by virtue of Section 736(b)(2)(A). Furthermore, treating payments for unrealized receivables as deferred compensation makes no sense to us because the reason the payments are deferred is that the partnership’s clients have not yet paid the amounts they owe, not that the parties have engineered an arrangement to defer the partner’s compensation. As Kent Mason points out in his November 5, 2004 comment, the situation is analogous to that of a sole proprietor who winds up his or her business but continues to receive compensation from clients after the end of the year as they pay off outstanding bills. Finally, in the case of an accrual-method partnership, the receivables generally already have been subject to tax (and thus the payments are tax-free). As a result, the fact that the payments are deferred does not result in any deferral of tax.

Treating payments for goodwill as deferred compensation is inappropriate because goodwill is an asset of the partnership as a whole, reflecting its value as a going concern, which can and does exist even when all of the partners were fully compensated for their services on an annual basis. Payments for goodwill are, in substance, payments for property regardless of how they might be treated under Section 736(b). We think this treatment should be extended even to situations where there is no asset reflected for goodwill on the partnership’s balance sheets, or no specific allocation to goodwill is made, as long as the goodwill actually exists and the allocation could have been made. We agree with Kent Mason’s observation that “Often, the formulas used to determine amounts paid to departing partners are intended in an approximate way to compensate departing partners for both accounts receivable and goodwill. In many cases, neither component is separately identified or measured, but whatever is not paid for accounts receivable is being paid for goodwill.”

For example, consider a physician retiring from a general partnership engaged in the practice of medicine. The physician is a 20% partner. She has practiced in this partnership for 20 years. Capital assets (other than goodwill) are not a material income-producing factor. The practice has been appraised at a value of $1,000,000. The partners agree that retiring partners should be paid the value of their interest in the enterprise, so the partnership agreement provides that a retiring partner will be paid an amount equal to the partnership’s appraised value multiplied by the retiring physician’s percentage interest. However, in order to capture the deduction, the partnership agreement does not refer to the payment for “goodwill.” Much of the retirement payments will be Section 707(c) guaranteed payments, but this does not make them compensation for services. The physician was fully compensated for her services on an annual basis. The payments instead reflect the enterprise value she has helped to create as a partner. Application of Section 409A seems wholly inappropriate.

We think that the same arguments apply to payments subject to Section 1402(a)(10), which likewise tend to be viewed by the parties as payments for the terminated partner’s interest in the goodwill and similar intangible assets of the partnership, and likewise remain subject to the same business risks as other partnership income (regardless of whether they are calculated as a percentage of that income) and potentially even reduction via an amendment to the partnership agreement. We also think it is important that the purpose of Section 1402(a)(10) is to make the
tax treatment of payments subject to that section more similar to the tax treatment of payments from a tax-qualified plan, which are exempt from Section 409A, and that the requirements of Section 1402(a)(10), e.g., the requirement that payments be made on a periodic basis until the partner’s death, make it significantly more difficult if not impossible for partners to exercise the level of control over the timing of that income that Congress appears to have been most concerned about in enacting Section 409A.

E. Options to purchase partnership interests

1. Summary

According to the legislative history of Section 409A and Notice 2005-1, an option on employer stock with an exercise price that is not less than the fair market value of the underlying stock on the date of grant does not provide for a deferral of compensation and thus is not subject to the requirements of Section 409A if it does not include a deferral feature beyond the feature that the option holder has the right to exercise the option in the future. Notice 2005-1 describes this as “consistent with” the more general exception for transfers subject to Section 83. However, because a discounted option also would be subject to Section 83, the real rationale for the exception seems instead to be that a stock option granted at fair market value gives the recipient nothing more than an uncertain potential for future compensation, at least some portion of which is, moreover, attributable to the recipient’s own future efforts.

As noted above, Notice 2005-1 also says that, until additional guidance is issued, taxpayers may treat grants of partnership interests, and options and appreciation rights with respect to partnership interests, in the same way as transfers of corporate stock, stock options and SARs for this purpose.

2. Recommendation

We recommend that options to purchase partnership interests be treated the same as nonqualified stock options under Section 409A.

3. Explanation

The logic underlying the exemption for nonqualified stock options applies equally well to options with respect to partnership interests. Furthermore, treating options to purchase partnership interests the same as nonqualified stock options under Section 409A will bring much-needed simplification to an already complex area (taxation of partnership options and other equity grants) that has been made even more complex by the passage of Section 409A.

F. Appreciation rights with respect to partnership interests

1. Summary

According to Notice 2005-1, an SAR does not provide for a deferral of compensation and thus is not subject to the requirements of Section 409A if it is based on the fair market value of the underlying stock on the date of grant, the stock is publicly traded, the SAR is settled in stock, and the SAR does not include any feature for the deferral of compensation other than the deferral of recognition of income until the right is exercised. Notice 2005-1 also exempts SARs granted pursuant to a plan in effect on or before October 3, 2004, even if the stock is not publicly traded or the SARs are cash-settled. Notice 2005-1 explains that “under certain conditions, [SARs] yield economically equivalent results to nonstatutory stock options exercised in a cashless transaction,” although because they also can function like deferred compensation arrangements additional restrictions are needed to prevent “abuse or intentional circumvention of the purposes of § 409A.” Notice 2005-1 expressed particular concern about the “valuation of the underlying stock where the value is not established by and in an established securities market.”

As noted above, Notice 2005-1 says that, until additional guidance is issued, taxpayers may treat grants of partnership interests, and options and appreciation rights with respect to partnership interests, in the same way as transfers of corporate stock, stock options and SARs.

2. Recommendation

We recommend that appreciation rights with respect to partnership interests (“unit appreciation rights” or “UARs”) be treated the same as SARs under Section 409A. We agree with other commentators who recommend that the exemption for SARs from the definition of deferred compensation in Notice 2005-1 not require that stock subject to the SAR be publicly traded, and recommend that the same approach be taken for UARs.

3. Explanation

UARs are not common. It usually is easier to give service-providers actual partnership capital or profits interests. Nevertheless we think that the reasons listed in Section E. above for treating options to purchase partnership interests the same as nonqualified stock options under Section 409A also justify treating UARs the same as SARs under that section.

It is unfair to treat SARs that are economically equivalent to fair market value stock options as deferred compensation for purposes of Section 409A solely because the underlying stock is not publicly traded. Private companies use SARs for a variety of bona fide business reasons, e.g., to avoid securities law complications and prevent ownership dilution. For the same reasons, we recommend that partnership interests that are subject to UARs not be required to be publicly traded in order for the UARs to avoid treatment as deferred compensation under Section 409A.
G. Restricted partnership interests

1. Summary

Notice 2005-1 refers to an “exception covering transfers of restricted property” subject to Section 83 as follows:

[i]f a service-provider receives property from, or pursuant to, a plan maintained by a service recipient, there is no deferral of compensation merely because the value of the property is not includible in income (under Section 83) in the year of receipt by reason of the property being nontransferable and subject to a substantial risk of forfeiture, or is includible in income (under Section 83) solely due to a valid election under Section 83(b).

Notice 2005-1 does not provide an express rationale for this exception, although presumably it is based on a recognition that a transfer of property represents current rather than deferred compensation. Consistent with this view, Notice 2005-1 also warns that “a plan under which a service provider obtains a legally binding right to receive property . . . in a future year may provide for the deferral of compensation and, accordingly, may constitute a nonqualified deferred compensation plan.”

As noted above, Notice 2005-1 provides that, until additional guidance is issued, taxpayers may treat grants of partnership interests, and options and appreciation rights with respect to partnership interests, in the same way as transfers of corporate stock, stock options and SARs for this purpose. The Notice further provides that—

until additional guidance is issued, for purposes of § 409A, taxpayers may treat an issuance of a profits interest in connection with the performance of services that is properly treated under applicable guidance as not resulting in inclusion of income by the service-provider at the time of issuance, as also not resulting in the deferral of compensation. Similarly, until additional guidance is issued, for purposes of § 409A, taxpayers may treat an issuance of a capital interest in connection with the performance of services in the same manner as an issuance of stock.

2. Recommendation

We recommend that transfers of partnership interests be treated the same as transfers of corporate stock under Section 409A, i.e., as not involving a deferral of compensation for purposes of that section. In the case of transfers of profits interests, there is no need to limit this exception to transfers that are treated under applicable guidance (i.e., Rev. Procs. 93-27 and 2001-43) as not resulting in inclusion of income by the service-provider. Whether further recommend that Regulations make clear that changes in a partner’s share of partnership income, unrealized appreciation and capital from year to year, to the extent they might otherwise be viewed as new transfers of partnership interests, are likewise exempt.
3. Explanation

The logic underlying the exception for transfers of corporate stock in exchange for services applies equally well to transfers of partnership interests in exchange for services. It is not completely clear under current law whether or under what circumstances such transfers are subject to Section 83 or Section 721, but the tax consequences to the service-provider are generally the same in either case.30

This logic is not undercut by the fact that the service-provider might receive some current value from the transfer. Indeed, in the case of a capital interest, as in the case of a transfer of corporate stock, that is inevitable. Thus, we see no reason why the exception should be limited in the case of profits interests to transfers that are treated under Revenue Procedures 93-27 and 2001-43 as not resulting in inclusion of income by the service-provider. To the extent any such transfer would result in the recognition of income under Revenue Procedure 93-27, that portion could be subject to Section 409A.

By analogy to transfers of corporate stock, it might be appropriate under some circumstances to treat a legally binding right to receive a capital interest in a future year as a kind of deferred compensation. We believe that such treatment could, conceivably, even extend to a promise made to an existing partner that capital will be shifted from other partners to him or her in a future year, because such transfers can have the same effect as initial grants of capital interests. However, such treatment would be inappropriate in the case of a transfer of a profits interest or a promise of a share of partnership income or unrealized appreciation on partnership assets in the future because the thing being promised in that case has only speculative value, and that value will depend in part on services performed by the service-provider after the transfer occurs.

H. Substitutions through mergers or other combinations

We agree with the recommendation made by other members of the Employee Benefits Committee of the American Bar Association Section of Taxation in the Comments on Code Section 409A Regarding its Impact on Business Transactions, dated April 15, 2005, that a substitution, assumption or modification of an option or other equity award pursuant to a merger, acquisition, joint venture or similar transaction not be treated as the grant of new deferred compensation or a change in form of payment for purposes of Section 409A, and think that the same principle should apply in the partnership context. Thus, we recommend that the substitution, assumption or modification of a partnership option or other equity award pursuant to a merger, acquisition, reorganization or similar transaction involving a partnership not be treated as the grant of a new option or other equity award or a change in the form of payment for purposes of Section 409A if (i) such substitution, assumption or modification is not subject to the

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30 Compare Treas. Reg. §§ 1.721-1(b)(1) & 1.83-1(a)(1). The tax consequences for the partnership are somewhat less clear, but most likely the transfer results in a deduction either because it is treated as a guaranteed payment or because it is treated as a deemed cash payment equal to the fair market value of the services followed by a contribution of the cash to the partnership in exchange for the capital interest. See Treas. Reg. § 1.721-1(b)(2).
discretion of the award recipients, (ii) the terms of the substitution, assumption or modification are determined solely by the partnership or jointly by the partnership and other parties to the transaction or by operation of law and (iii) similar terms apply to all award recipients.

I. Changes in control

1. Summary

One of the permitted distribution events listed in Section 409A(a)(2)(A) is “(v) . . . a change in the ownership or effective control of the corporation, or in the ownership of a substantial portion of the assets of the corporation.” We understand that Treasury and IRS personnel are inclined to infer from the reference to “corporation” in clause (v) that only corporations may experience a change in control for this purpose. Consistent with this view, the guidance in Notice 2005-1 on the meaning of clause (v) is limited to corporations.

2. Recommendation

We recommend that Section 409A(a)(2)(A)(v) be interpreted to allow distributions upon a change in ownership or effective control of a partnership.

3. Explanation

Our reasons for making this recommendation are set forth below.

First, it is not clear what “the corporation” refers to in Section 409A(a)(2)(A)(v), because there is no antecedent reference to a corporation, and the scope of Section 409A is not otherwise limited to corporations. Possibly Congress used the term because it directed the Treasury and the IRS to use a definition of change in control that is similar to the one used in Section 280G. That definition focuses on corporations because Section 280G applies only to corporations. Because Section 409A applies to compensation payable by other persons as well, it is not clear from this reference alone that Congress intended to exclude partnerships from the scope of the rule. Although Section 409A(a)(2) references a change in ownership or control of a corporation, the legislative history does not provide a reason why only corporate entities should be permitted to make distributions on a change of control.\footnote{H.R. Conf. Rep. No. 108-755, at 716-717 (2004).} In fact, the legislative history contemplates that Regulations will provide other limited exemptions to the rule against acceleration of distributions.\footnote{H.R. Conf. Rep. No. 108-755, at 717 (2004) (“it is intended that the Secretary will provide . . . limited exceptions to the prohibition on accelerated distributions”).} A change in control, whether of a corporate or noncorporate entity, should equally be considered beyond the control of a service provider. Use of this regulatory authority to provide for comparable provisions related to changes in control of noncorporate entities would not give service providers greater control over distributions relative to service providers to corporations. Rather, it would mean that nonqualified deferred compensation plans, and the related income consequence for a service provider, would not be affected by the form in which the service recipient chooses to operate its business.
What constitutes a “change in control” will need to be determined in manner consistent with a noncorporate context. With respect to a sale of substantially all the assets of an enterprise, there is no reason to distinguish between a service recipient that operates as a corporation versus a service recipient that is a noncorporate entity. In the context of sale of a controlling interest of an enterprise, it should be possible to develop a test that looks to whether there has been a sufficient change in ownership interests, or in control of, the noncorporate entity. Pending further review of these issues, we recommend that noncorporate entities should be allowed to provide for distributions on changes in control applying the same principles applicable to corporations.

Second, consistent with the regulations under Section 280G, we anticipate that the Treasury and the IRS will treat publicly traded partnerships as corporations for this purpose. Simply because a partnership is publicly traded and therefore treated as a corporation for some federal income tax purposes does not mean that it does not still have the basic attributes and operations of a partnership. If it is possible under Section 280G to allow a change in control with respect to a partnership (albeit a publicly traded one), there is no reason why a private partnership cannot likewise have a change in control event under similar principles.

Third, although we believe that the definition of “separation from service” in Section 409A should not be interpreted to incorporate the “same desk” concept, if it is so interpreted, corporations will be able to use the change in control rules to allow distributions at that time, which may otherwise be prohibited because of the strictures of the same desk concept. If partnerships are not allowed to cause distributions upon the change in control under Section 409A, they will be severely handicapped simply because of their form of business. This position is also discussed in the Comments Regarding Distribution Restrictions of Section 409A, dated April 15, 2005 that were prepared by other members of the Employee Benefits Committee of the American Bar Association Section of Taxation.

If the Service and Treasury are inclined to consider recommendations regarding how to determine a change in control in the context of a partnership, representatives of the Tax Section, particularly those listed on the first page would be leased to provide assistance.

33 See Treas. Reg. § 1.280G-1, Q&A-45.