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May 18, 2006

VIA FEDERAL EXPRESS

The Honorable Mark W. Everson
Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Comments on Application of Internal Revenue Code Section 409A to Service Arrangements between Partnerships and Partners

Dear Commissioner Everson:

On behalf of the New York City Bar, as reported by the Committee on Taxation of Business Entities, I am pleased to submit comments on the application of Section 409A to service arrangements between partnerships and partners. The proposed regulations issued under Section 409A, while comprehensive, do not cover arrangements between partnerships and partners. We submit these comments pursuant to a request by the Treasury Department and the Internal Revenue Service in the preamble to the Proposed Regulations for comments on the application of Section 409A to arrangements between partnerships and partners.

Our discussions and recommendations focus on four aspects of partnership service arrangements and their application to Section 409A. The first recommendation concerns the issuance of what is generally referred to as "carried interests", and recommends that such interests generally would not be treated as a form of deferred compensation. The second recommendation concerns the treatment of options in respect of partnership interests, employing the rules in the Proposed Regulations for corporate stock options as a starting point, and making adjustments to the corporate rules to reflect the differing tax status of a partnership for (i) the number of shares "fixed at date of grant", (ii) service recipient partnership interests, (iii) valuation principles and (iv) mergers. Section III of the comments recommends an exception to the short-term deferral rule in the case of a constructive termination of a

partnership under Section 708(b)(1)(B). In Section IV, we recommend a safe harbor for determining whether there has been a "change in control" of a partnership, consisting of a transfer or issuance of more than 50 percent of the capital and profits interest in the partnership as well as certain changes in management that result in a change of effective control of the partnership.

We are pleased to discuss any questions you may have. Please feel free to contact the undersigned at (212) 513-3577 or via e-mail at mark.stone@hklaw.com or Jill Darrow, Esq. at (212) 940-7113 or via e-mail at jill.darrow@kattenlaw.com.

Very truly yours,

Mark Stone
Chair

Enclosure

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NEW YORK CITY BAR

COMMENTS ON APPLICATION OF INTERNAL REVENUE CODE SECTION 409A TO SERVICE ARRANGEMENTS BETWEEN PARTNERSHIPS AND PARTNERS

As Reported by the Committee on Taxation of Business Entities

These comments to the proposed regulations under Section 409A of the Code, concerning service arrangements between partnerships and partners, are submitted on behalf of the New York City Bar by its Committee on Taxation of Business Entities.[1]

BACKGROUND

The American Jobs Creation Act of 2004 added Section 409A to the Internal Revenue Code of 1986, as amended (the "Code"). Section 409A was enacted to address certain perceived abuses associated with deferred compensation. It attempts to do so by providing specific rules for nonqualified deferred compensation arrangements. These rules apply broadly to the compensatory practices of virtually all businesses, whether conducted by large corporations or by small partnerships.

The broad scope of Section 409A and the onerous consequences of non-compliance with the rules[2] underscore the importance of providing understandable and administrable guidance interpreting the new statutory provisions. Notice 2005-1[3] provided preliminary guidance and transitional rules. Significantly more comprehensive guidance was provided by the issuance of proposed regulations under Section 409A (the "Proposed Regulations").[4] As comprehensive as they are, the Proposed Regulations do not address several aspects of deferred compensation arrangements, most notably, those involving partnerships and partners. The preamble (the "Preamble") to the Proposed Regulations[5] states that Section 409A and the legislative history do not specifically address arrangements between partnerships and partners providing services to such partnerships, and also do not expressly exclude such arrangements from the application of Section 409A. The Treasury Department and the Internal Revenue Service (the "Service") have requested comments concerning the application of Section 409A to these arrangements. The comments in this report are submitted in response to that request.

Section I of this report discusses the application of Section 409A to partnership carried interests. Section II discusses options in respect of partnership interests. Section III recommends an exception to the short-term deferral rule for partnership terminations. Section IV sets forth a recommendation for determining whether there has been a change in partnership control.

COMMENTS

I. Application of Section 409A to Carried Interests

A. Summary

In many instances, a partner providing services to a partnership receives a so–called "carried interest" in the partnership providing for an allocation of a percentage of partnership profits to the partner that is not based on capital contributed by such partner. The interest is typically issued to the general partner of a limited partnership, the managing member of a limited liability company, or the managing partner of a general partnership, but in some circumstances has also been issued to non-managing partners or members. The expectation of the parties is that the partner providing the services will be taxed when such partner becomes entitled to a current allocation of realized profits, and that such partner will be allocated partnership income at that time. Rev. Proc. 93-27,[6] as clarified by Rev. Proc. 2001-43,[7] provides a safe harbor under which a service partner's receipt of a carried interest is not a taxable event for the partner.

The Proposed Regulations provide that taxpayers may continue to rely on Q&A-7 of Notice 2005-1 until further guidance is issued. Q&A-7 of Notice 2005-1 provides that Section 409A does not apply to an issuance of a profits interest for services that is properly treated under applicable guidance as not resulting in an inclusion of income by the service provider.

B. Recommendation

We recommend that: (1) a safe harbor be provided under which a partnership's issuance to a partner providing services of a partnership interest that satisfies certain requirements would not be subject to Section 409A; and (2) for periods prior to the effective date of the regulations, clarification be provided that Q&A-7 of Notice 2005-1 applies the same safe harbor suggested in (1), i.e., Section 409A does not apply to any compensatory grant of a partnership interest as to which the amount of compensation (if any) recognized by the service provider on account of the grant is the liquidation value of the partnership interest applying the principles of Rev. Proc. 93-27, whether or not the transaction otherwise satisfies the requirements of Rev. Proc. 93-27.

C. Explanation

A carried interest represents an entitlement to a distributive share of partnership income and related distributions over and above its share (if any) of partnership capital.[8] It is consistent with the provisions of subchapter K relating to partnership allocations (and not a deferral of compensation) to allocate partnership income in accordance with the partners' distributive shares in the year in which such income is realized.

We are not aware of any abuses involving attempts to defer compensation through the issuance of carried interests for services. The grant of a carried interest differs from a legally binding right to future compensation, because a carried interest has no readily ascertainable value when granted. Like a promotion given to an employee, a carried interest is best viewed as a mere expectancy of earning income from a partnership, rather than as an entitlement to a currently ascertainable sum.

It is important that the final regulations provide clear and comprehensive guidance under Section 409A. The issuance of carried interests for services is too widespread and commonplace not to be addressed by the final regulations, particularly if they are intended to supplement and ultimately replace the interim guidance provided by Notice 2005-1. We recognize that further study may be necessary before the final regulations exempt carried interests from Section 409A. In the meantime, we recommend that the final regulations provide a safe harbor under which the issuance of a partnership interest in connection with the performance of services will not be considered to result in the deferral of compensation for purposes of Section 409A if: (1) the partnership interest entitles the service provider to a distributive share of partnership income and related distributions, and the amount of compensation (if any) realized by the service provider on the receipt of the interest is determined under the liquidation principles of Rev. Proc. 93-27, whether or not the transaction otherwise satisfies the requirements of the revenue procedure; (2) the material allocations and capital account adjustments pursuant to the partnership agreement relating to such partnership interest are respected under Code Section 704(b) and the regulations thereunder;[9] and (3) the interest is issued not later than the 15th day of the third month following the end of the calendar year in which the service provider obtained a legally binding right to receive the partnership interest or, if later, the calendar year in which such right was no longer subject to a substantial risk of forfeiture. Such safe harbor is intended to apply to partnership interests that represent merely a right to participate in future profits and related distributions, which is consistent with the approach taken in Q&A-7 of Notice 2005-1. This approach also recognizes that, if the applicable partnership interest has any positive liquidation value that the service provider did not pay for, that amount will be taxable to the service provider at the time of grant and, therefore, is not deferred compensation.

Pending the adoption as part of the final regulations of a safe harbor for carried interests, we also recommend that Q&A-7 of Notice 2005-1 be clarified to remove any implication that it applies only to an issuance of profits interest for services in a transaction that satisfies the requirements of Rev. Proc 93-27, as clarified by Rev. Proc. 2001-43. We are concerned, for example, that a partner who receives an otherwise qualifying profits interest but who disposes of it within two years of receipt, might be considered to have a non-qualifying deferral of compensation (assuming that the grant of the interest was not a taxable event) because the profits interest would be excluded from the application of Rev. Proc. 93-27. A subsequent disposition may be relevant in determining whether the value of a partnership interest was ascertainable when issued (and therefore should be included in the recipient's income in the year of issuance under Code provisions other than Section 409A), but has no apparent relevance to the issue of whether issuance of the partnership interest involved deferred compensation. Similarly, we believe that the applicability of Section 409A to a partnership interest should not turn on whether the partnership's assets generate a substantially certain and predictable stream of income. Unless the partnership interest in question is properly treated as not a partnership interest under Code Section 707(a)(2)(A), we see no reason why Section 409A should apply to a profits interest if the only reason for applying Section 409A is that the partnership owns high-quality debt securities or a high-quality net lease.[10] Given that even a good faith but erroneous interpretation of the Section 409A rules leads to the imposition of a 20 percent penalty, we believe that Q&A-7 should be applied broadly to compensatory partnership interests which, under the principles of Rev. Proc. 93-27, have no ascertainable value apart from their liquidation value. If the Service has any concern that such a clarification would imply a retreat from the limitations imposed by

Rev. Proc. 93-27 as subsequently modified or superseded by final regulations under Code Section 83, the clarification provided can expressly state that it is limited to Section 409A.

II. Options In Respect of Partnership Interests

A. Summary

Under the Proposed Regulations, a non-statutory option to purchase service recipient stock does not provide for a deferral of compensation if (1) the option exercise price may never be less than the fair market value of the underlying stock (disregarding lapse restrictions as defined in Regulations § 1.83-3(i)) on the date the option is granted, and the number of shares subject to the option is fixed on that date, (2) the transfer or exercise of the option is subject to taxation under Code Section 83 and Regulations §1.83-7, and (3) the option does not include any feature for the deferral of compensation other than the deferral of income recognition until the later of exercise or disposition of the option under Regulations §1.83-7, or the time the stock acquired pursuant to the exercise of the option first becomes substantially vested (as defined in Regulations §1.83-3(b)).[11]

Service recipient stock generally means stock that, as of the date of grant, is common stock of the service recipient corporation (or certain affiliated corporations treated as a single service recipient) that is readily tradable on an established securities market, or if none, the class of common stock of such corporation having the greatest aggregate value of all issued and outstanding common stock of such corporation, or common stock with substantially similar rights to stock of such class (disregarding any difference in voting rights).[12] The Proposed Regulations indicate that under no circumstances does stock of the service recipient include stock that is preferred as to liquidation or dividend rights or that includes or is subject to a mandatory repurchase obligation or a put or call right that is not a lapse restriction as defined in Regulations §1.83-3(i) and is based on a measure other than the fair market value (disregarding lapse restrictions as defined in Regulations §1.83-3(i)) of the equity interest in the corporation represented by the stock.[13]

Proposed Regulations §§1.409A-1(b)(5)(iii)(D)(3) and -1(b)(5)(v)(D) contain rules addressing the substitution of stock options in connection with corporate reorganizations. These rules essentially incorporate the rules set forth in Regulations §1.424-1.

Proposed Regulations §1.409A-1(b)(5)(iv) provides detailed guidance concerning the requirements for valuing options on service recipient stock, for purposes of determining whether such options are issued with a fair market value exercise price as of the date of grant. The value of stock that is not readily tradable on an established securities market may be established by "reasonable application of a reasonable valuation method." Whether a method or its application is reasonable is based on the facts and circumstances, taking account of various enumerated factors. The proposed regulations also provide several safe harbors that rely generally on a form of credible, written valuation study. However, unlike the rules applicable to incentive stock options, the valuation rules in the Proposed Regulations do not protect a service recipient even when the service provider made a good faith attempt to determine the fair market value of the underlying stock.

B. Recommendations

We recommend that:

(i) the "fixed at date of grant" requirement, which in the case of stock relates to the number of shares subject to the option, be modified to take account of the differences between stock and partnership interests;

(ii) service recipient stock be defined in the case of partnership interests to include all partnership interests except those which have no meaningful likelihood of participating in residual profits, losses or distributions to any significant extent;

(iii) relevant valuation principles be modified to allow for good faith reliance on a reasonable valuation method; and

(iv) rules analogous to those for stock be issued in respect of substitutions of partnership interests in partnership mergers, acquisitions and similar transactions.

C. Explanation

1. Fixed at date of grant. Interests in a partnership (or other incorporated entity taxed as a partnership) typically are not denominated in shares, but may be expressed in terms of a fixed number of units or, alternatively, in percentage interests. Thus, whereas the number of shares of stock covered by a stock option must be fixed at grant, in the case of partnership options the rule should require that the number of units be fixed at grant, if partnership interests are expressed in units, or that the percentage be fixed at grant, if partnership interests are expressed in percentages.

EXAMPLE 1: Partnership provides for 90 partnership units. At a time when the fair market value of a unit is $1 per unit, Partnership's grant of an option to acquire 10 units at an exercise price of $1 per unit would not be a deferred compensation arrangement.

EXAMPLE 2: Partnership interests are not divided into units, but each partner has a fixed percentage interest in Partnership profits, losses and capital. At a time when the fair market value of a 5 percent interest in Partnership is $200, Partnership's grant of an option with an exercise price of not less than $200 for a 5 percent interest in Partnership would not be a deferred compensation arrangement.

2. Service recipient partnership interests. The definition of service recipient stock in the Proposed Regulations, requiring that the stock be common stock that is not preferred as to dividends or on liquidation, appears intended to prevent the use of stock containing significant debt or cash-equivalent features. However, it is not well designed to apply to partnership interests. The flow-through treatment of partnership tax items distinguishes partnership interests from stock interests. Furthermore, the fact that a partnership interest may include an entitlement to special allocations of partnership items, or may constitute a pure profits interest, adds a degree of flexibility to partnerships that would render an analogy to a class of common stock

inappropriate in trying to apply the definition of service recipient stock to partnership interests. Accordingly, we recommend that in the context of a partnership option, the concept of service recipient stock be replaced with a concept of service recipient partnership interests, which should generally include any partnership interest in the service recipient partnership, except a "preferred" interest in the partnership. We would define a "preferred" interest for these purposes as a partnership interest that has a preferred return and a liquidation preference but no meaningful likelihood of participating in residual profits and losses or distributions to any significant extent.[14].

3. Valuation methodology. The general standard of a "reasonable application of a reasonable valuation method" is likely to cause uncertainty, and the safe harbor provisions contained in the Proposed Regulations for reliance on certain valuation reports and formulas are likely to be cost prohibitive, especially in the case of smaller partnerships. Moreover, partnership interests are likely to be considerably harder to value than interests in corporate stock, because of the flexibility allowed by the partnership form in structuring the economic rights of different parties. Because of this, it is proposed that the final regulations contain a rule similar to that contained in Regulations §1.422-2(e)(2), to the effect that the valuation requirements of Section 409A will be considered to have been met where the only reason for a failure to meet the fair market value exercise price requirement is a failure of an attempt, made in good faith, to determine the fair market value of the underlying stock.

4. Partnership mergers and acquisitions. We also recommend that the final regulations include an example illustrating that the provisions of the regulations relating to the substitution of stock options in corporate reorganizations are also applicable to partnership mergers and divisions.

III. Exception to the Short-Term Deferral Rule for the Termination of a Partnership

A. Summary

The Proposed Regulations incorporate from Notice 2005-1 an exception to the Section 409A definition of deferred compensation for amounts that are received by the service provider within a short period following vesting (referred to as a "short-term deferral").[15] Under this exception, a deferral of compensation does not occur for purposes of Section 409A if the payment is received no later than 2-½ months after the end of the year in which the amount no longer is subject to a substantial risk of forfeiture. The 2-½ month period is measured from the end of the service provider's taxable year or the end of the service recipient's taxable year, whichever is later. For example, under this rule, multi-year bonus arrangements that require payments promptly after the bonus amount vests would be exempt from the requirements of Section 409A.

A "service provider" or a "service recipient" can be a partnership.[16] Accordingly, both a payment to or from a partnership may qualify for the short-term deferral rule.

A partnership is subject to special rules regarding the closing of its taxable year. Section 708(b)(1)(B) provides that a sale or exchange within a 12-month period of 50 percent or more of

the interests in partnership capital and profits results in a termination of the partnership for federal income tax purposes even though the partnership's existence continues for business and state law purposes.[17] As a result of the termination of a partnership, the taxable year of the partnership closes with respect to all partners on the date of such termination and a new partnership is created for tax purposes Unless the partnership terminates on the last day of its tax year, termination will result in a short tax year.[18] The Proposed Regulations do not address the application of the short-term deferral rule in the context of partnership tax year terminations under Section 708(b)(1)(B).

B. Recommendation

We recommend that the short-term deferral rule be applied without regard to a constructive termination of a partnership under Section 708(b)(1)(B). If a payment to or from a partnership would have qualified as a short-term deferral but for the closing of the partnership's taxable year due to a constructive termination, such payment should not become disqualified solely by reason of such termination. Rather, the 2-½ month period should be measured from the end of the partnership's taxable year, without giving effect to the closing of such taxable year due to a constructive termination under Section 708(b)(1)(B).

C. Explanation

The purpose of the short-term deferral rule is to exclude from the definition of deferred compensation for purposes of Section 409A, certain arrangements that provide a limited opportunity for deferral. The opportunity for deferral would not be expanded by permitting the application of this rule for the year in which a constructive termination occurs without regard to the termination of the partnership.[19]

IV. Change in Control

A. Summary

Proposed Regulation §1.409A-3(a)(5) permits deferred compensation to be paid to the service provider upon a "change in control event" affecting a corporate service recipient. As defined, a change in control event means a change in ownership, a change in effective control or a change in the ownership of a substantial portion of the corporation's assets.[20] The Preamble states that the Treasury Department and the Service plan to issue regulations that will allow an acceleration of payments upon a change in the ownership of a partnership or a substantial portion of a partnership's assets, and that until such guidance is issued, the Section 409A rules regarding permissible distributions upon a change in ownership of a corporation or a substantial portion of its assets may be applied by analogy to partnerships. Comments are requested concerning the application of a change in control provision to partnerships.

B. Recommendation

We recommend defining a change in ownership of a partnership to include a transfer or issuance of partnership interests representing more than 50 percent of the capital and profits interests in the partnership, and a change in effective control of a partnership to include any of certain changes, described below, in or affecting the general partner or managing member or, for a limited liability company managed by a non-member, a change in the manager.

C. Explanation

In applying the concept of a change in control to partnerships, due regard must be given to differences in capital structure between corporations and partnerships. It is frequently the case that a limited liability company or partnership is controlled by a managing member or general partner with a relatively small interest in partnership capital and profits. It is also the case that partners' interests in profits change from time to time, and may be a composite of multiple interests rather than a single percentage interest in the profits of the entity. In many instances a partner's share of capital is more readily determinable than the partner's share of profits.

We agree with the thrust of the Preamble to the effect that a change in ownership or effective control with respect to partnerships should be defined in a manner similar to the existing definitions with respect to corporations except where differences between corporations and partnerships make a different approach appropriate. More specifically, a change in ownership should be defined, with respect to a partnership, to include a transfer or issuance of partnership interests representing more than 50 percent of the capital and profits interests in the partnership. A change of more than 50 percent in both capital and profits is a relatively significant event that is objectively determinable. In this regard, we believe that it would be appropriate to exclude from the category of "transfers" of partnership interests that could result in a change in ownership for these purposes, any transfers that are not taken into account in determining whether a partnership constructive termination occurs under Code Section 708(b)(1)(B).[21]

A change in effective control should include any event that results in a change of the person who or which has exclusive authority to bind the partnership or limited liability company, i.e., the general partner, managing member or other manager, as applicable. Where more than one person has such authority, a change in effective control should not be considered to have occurred unless the change involves a change in ownership of more than 50 percent of the aggregate outstanding interests of those persons with the power to bind the entity, with the percentage being determined by reference to the percentage of the management vote represented by the relevant interest(s). If management authority is held by an entity rather than an individual, a change in effective control should include replacing the managing entity with another person or entity that is not controlled by or commonly controlled with the managing entity being replaced, as well as a change in the effective control of the managing entity.

[1] This report was prepared by an ad hoc committee of the Committee on Taxation of Business Entities of the New York City Bar chaired by Jill Darrow, the other members of which were David Kahen, David Mittelstadt and Amanda Nussbaum. Helpful comments were received from Mark Stone, David Richardson and Peter Blessing.

[2] Non-compliance results in current recognition of income, interest at the underpayment rate plus one percentage point, and an additional tax of 20 percent of the compensation required to be included.

[3] 2005-2 I.R.B. 274 (January 6, 2005).

[4] Proposed Regulations §§1.409A-1-6.

[5] Notice of Proposed Rulemaking, 70 Fed. Reg. 57930 (October 4, 2005).

[6] 1993-2 C.B. 343 (July 6, 1993).

[7] 2001-2 C.B. 191 (August 20, 2001).

[8] We are referring to a partnership interest whose "liquidation value," as defined in Section 4.02 of Notice 2005-43 (May 24, 2005), is either zero or a positive amount which does not exceed the amount of cash or the value of any property contributed by the service provider for the partnership interest.

[9] We contemplate that the safe harbor could apply to a partnership interest even if the partnership agreement does not satisfy the "substantial economic test" of Regulations §1.704-1(b)(2), if the material allocations under the agreement are respected as consistent with the partners' economic arrangement.

[10] For the same reasons, we do not believe that the application or non-application of Section 409A should turn on whether the partnership interest qualifies as a "safe harbor partnership interest" under Section 3.02 of the proposed revenue procedure contained in of Notice 2005-43.

[11] Proposed Regulations §1.409A-1(b)(5)(i)(A).

[12] Proposed Regulations §1.409A-1(b)(5)(iii)(A).

[13] Id.

[14] A preferred partnership interest which, if it were stock, would be "preferred stock" within the meaning of Section 351(g)(3)(A) would not qualify for the partnership options safe harbor.

[15] Proposed Regulations §1.409-1(b)(4); Notice 2005-1, Q&A-4(c). A more limited exception was provided in the Conference Committee Report to Section 409A, which stated that "[i]t is intended that the provision does not apply to annual bonuses or other annual compensation amounts paid within 2-½ months after the close of the taxable year in which the relevant services required for payment have been performed." *See* H.R. CONF. REP. NO. 108-755, 108th Cong., 2d Sess., at 525 (Oct. 7, 2004). For a similar rule, *see* Temporary Regulations §1.404(b)-IT.

[16] Proposed Regulations §1.409-1(g).

[17] Under Regulations §1.708-1(b)(4), the following events are deemed to occur upon a constructive termination of a partnership under Section 708(b)(1)(B): (i) the partnership contributes all of its assets and liabilities to a newly formed partnership in exchange for a partnership interest; and (ii) immediately thereafter, the terminated partnership distributes interests in the new partnership to the incoming partner and remaining partners in proportion to their interests in liquidation of the terminated partnership.

[18] Regulations §1.708-1(b)(3), -1(b)(4). Similar issues may arise as a result of the closing of the taxable year of a service provider or service recipient in the event that a corporation becomes a member of or is eliminated from a

consolidated group, or a corporation ceases to be an S corporation, in either case, during such taxable year. See Regulations §§1.1502-76(b)(1)(ii) and 1.1362-3(a). These issues are beyond the scope of this report.

[19] It is theoretically possible that measuring the 2-1/2 month period from the end of the partnership's taxable year without regard to the termination in these circumstances could result in an additional deferral for a service provider whose admission to the partnership causes the partnership to have to adopt a new year. However, we consider the possibility to be too remote to warrant exception to the general rule we are proposing.

[20] Proposed Regulations §1.409A-3(g)(5). Each of these change in control events is itself defined in Proposed Regulations §§1.409A-3(g)(5)(v)-(vii).

[21] These include transfers by bequest, gifts and transfers incident to a divorce.