New York State Bar Association

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October 26, 2005

Mr. Eric Solomon
Acting Deputy Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3112 MT
1500 Pennsylvania Avenue, N.W.
Washington D.C. 20220

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

Re: Partnership Equity Received in Exchange for Services

Dear Acting Deputy Assistant Secretary Solomon and Commissioner Everson:

I am pleased to submit the New York State Bar Association Tax Section's Report No. 1098 (the "Report") on the recent proposed regulations and revenue procedure relating to partnership equity received in exchange for the performance of services (the "Proposed Rules").

We commend the IRS and Treasury for the substantial thought and effort reflected in the Proposed Rules. We also agree with the approach adopted under the safe harbor set out in the Proposed Rules – *i.e.*, that a compensatory partnership interest should have a deemed value equal to the amount, if any, that it entitles the holder to receive on liquidation of the partnership. However, while we understand the authority concerns underlying the proposed use of a safe harbor to implement this valuation approach (the

safe harbor treatment"), we believe that Treasury and the IRS should simply require this approach for all taxpayers (the "mandatory treatment").

We believe the mandatory treatment would conform with the long-understood treatment of compensatory partnership interests and avoid the substantial complexity created by the safe harbor treatment. We also believe there is adequate authority to implement the mandatory treatment. Moreover, we believe the mandatory treatment would mitigate any whipsaw potential. By contrast, we think the safe harbor treatment would create whipsaw potential, because it would be easy for some taxpayers to intentionally avoid the safe harbor or to fall out of it unintentionally. The Report discusses a variety of practical concerns regarding the safe harbor treatment and explains why we believe that it would be difficult, if not impossible as a practical matter, for many partnerships to make and maintain the safe harbor election.

In the event that Treasury and the IRS do not agree that they have authority to implement the mandatory treatment, we think the area should continue to be governed by Revenue Procedures 93-27 and 2001-43. Meanwhile, Treasury and the IRS could seek a legislative change.

The Report also discusses a number of difficulties arising from application of the Proposed Rules to traditional service partnerships. For example, it is not clear how basic concepts under Section 83 and the Proposed Rules (such as the meaning of "transfer" and "substantial risk of forfeiture") would apply to a compensatory partnership interest in a traditional service partnership or how the value of such an interest would be determined under the Proposed Rules. Nor is it clear how the special rules applicable to nonlapse restrictions would apply. Moreover, application of the Proposed Rules to traditional service partnerships might distort the relative income of the partners as compared with the current system whereby each partner just takes into account his or her share of partnership income as it is earned. In light of how rare it is for a traditional service partnership to be sold, we do not believe it is appropriate or good tax policy for new partners to recognize income and existing partners to recognize a deduction based on estimate of how the proceeds from such a hypothetical sale would be distributed. In light of such issues, we recommend that the Proposed Rules be revised to exclude interests in traditional service partnerships from Section 83. As an alternative recommendation, we believe that Treasury should issue additional guidance concerning how Section 83 applies to interests in traditional service partnerships, and, if the more general regulations are finalized in advance of that additional guidance, Treasury should issue interim guidance providing that a traditional service partnership and its partners will not recognize income, gain, or loss in connection with the grant or vesting of an interest in the partnership so long as certain conditions are satisfied.

The Report supports the use of forfeiture allocations in cases where the recipient of a compensatory partnership interest makes a Section 83(b) election but later forfeits the interest, as contemplated by the Proposed Rules. However, we believe that the Proposed Rules relating to forfeiture allocations should be revised in a variety of respects,

including by clarifying whether certain aspects are based on Section 704(b) book concepts or taxable income concepts; permitting the character of the forfeiture allocation to match the allocation giving rise to the forfeiture allocation; relaxing the requirement that forfeiture allocations consist of a pro rata portion of gross income and gain or gross deduction or loss in cases where this requirement would further distort the capital accounts of the partners; providing greater flexibility in cases where a partnership interest is forfeited only in part (including by allowing forfeiture allocations to be made in subsequent years and by allowing forfeiture allocations to the made to the other partners); and allowing a partnership to elect to use "notional items" in the event that there are insufficient items otherwise available.

Finally, the Report discusses other aspects of the Proposed Rules, including the requirement that the recipient of a compensatory partnership interest make an affirmative Section 83(b) election in order to be considered the tax owner of the interest in cases where the interest is subject to vesting; the application of the Proposed Rules to tiered and affiliated partnership arrangements; and the need for additional regulations under Sections 704(b) and 707(c) if a compensatory partnership interest is permitted to be valued at something other than its liquidation value.

We appreciate your consideration of the recommendation we have made in the Report. As always, we would be pleased to discuss these matters with you further.

Respectfully submitted,

David P. Hariton
Chair

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