



[CLICK HERE](#) to return to the home page

## **Prop. Treas. Reg. Section 1.707-2**

### Disguised payments for services

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

(b) Elements necessary to characterize arrangements as disguised payments for services.

(1) In general. An arrangement will be treated as a disguised payment for services if-

(i) A person (service provider), either in a partner capacity or in anticipation of becoming a partner, performs services (directly or through its delegate) to or for the benefit of a partnership;

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

(iii) The performance of such services and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a person acting other than in that person's capacity as a partner.

(2) Application and timing.

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

(ii) Timing of inclusion. The inclusion of income by the service provider and deduction (if applicable) by the partnership of amounts paid pursuant to an

arrangement that is characterized as a payment for services under paragraph (b)(1) of this section is taken into account in the taxable year as required under applicable law by applying all relevant sections of the Internal Revenue Code, including for example, sections 409A and 457A (as applicable), to the allocation and distribution when they occur (or are deemed to occur under all other provisions of the Internal Revenue Code).

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

(c) Factors considered. Whether an arrangement constitutes a payment for services (in whole or in part) depends on all of the facts and circumstances. Paragraphs (c)(1) through (6) of this section provide a non-exclusive list of factors that may indicate that an arrangement constitutes (in whole or in part) a payment for services. The presence or absence of a factor is based on all of the facts and circumstances at the time the parties enter into the arrangement (or if the parties modify the arrangement, at the time of the modification). The most important factor is significant entrepreneurial risk as set forth in paragraph (c)(1) of this section. An arrangement that lacks significant entrepreneurial risk constitutes a payment for services. An arrangement that has significant entrepreneurial risk will generally not constitute a payment for services unless other factors establish otherwise. For purposes of making determinations under this paragraph (c), the weight to be given to any particular factor, other than entrepreneurial risk, depends on the particular case and the absence of a factor is not necessarily indicative of whether or not an arrangement is treated as a payment for services.

(1) The arrangement lacks significant entrepreneurial risk. Whether an arrangement lacks significant entrepreneurial risk is based on the service provider's entrepreneurial risk relative to the overall entrepreneurial risk of the partnership. Paragraphs (c)(1)(i) through (v) of this section provide facts and circumstances that create a presumption that an arrangement lacks significant entrepreneurial risk and will be treated as a disguised payment for services unless other facts and circumstances establish the presence of significant entrepreneurial risk by clear and convincing evidence:

(i) Capped allocations of partnership income if the cap is reasonably expected to apply in most years;

(ii) An allocation for one or more years under which the service provider's share of income is reasonably certain;

(iii) An allocation of gross income;

(iv) An allocation (under a formula or otherwise) that is predominantly fixed in amount, is reasonably determinable under all the facts and circumstances, or is designed to assure that sufficient net profits are highly likely to be available to make the allocation to the service provider (e.g. if the partnership agreement provides for an allocation of net profits from specific transactions or accounting

periods and this allocation does not depend on the long-term future success of the enterprise); or

(v) An arrangement in which a service provider waives its right to receive payment for the future performance of services in a manner that is non-binding or fails to timely notify the partnership and its partners of the waiver and its terms.

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

(3) The service provider receives an allocation and distribution in a time frame comparable to the time frame that a non-partner service provider would typically receive payment.

(4) The service provider became a partner primarily to obtain tax benefits that would not have been available if the services were rendered to the partnership in a third party capacity.

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

(6) The arrangement provides for different allocations or distributions with respect to different services received, the services are provided either by one person or by persons that are related under sections 707(b) or 267(b), and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly.

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

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

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

Example (3).

(i) M performs services for which a fee would normally be charged to new partnership ABC, an investment partnership that will acquire a portfolio of investment assets that are not readily tradable on an established securities market. M will also contribute \$500,000 in exchange for a one percent interest in ABC's capital and profits. In addition to M's one percent interest, M is entitled to receive a priority allocation and distribution of net gain from the sale of any one or more assets during any 12-month accounting period in which the partnership has overall net gain in an amount intended to approximate the fee that would normally be charged for the services M performs. A, a company that controls M, is the general partner of ABC and directs all operations of the partnership consistent with the partnership agreement, including causing ABC to purchase or sell an asset during any accounting period. A also controls the timing of distributions to M including distributions arising from M's priority allocation. Given the nature of the assets in which ABC will invest and A's ability to control the timing of asset dispositions, the amount of partnership net income or gains that will be allocable to M under the ABC partnership agreement is highly likely to be available and reasonably determinable based on all facts and circumstances available upon formation of the partnership. A will be allocated 10 percent of any net profits or net losses of ABC earned over the life of the partnership. A undertakes an enforceable obligation to repay any amounts allocated and distributed pursuant to this interest (reduced by reasonable allowances for tax payments made on A's allocable shares of partnership income and gain) that exceed 10 percent of the overall net amount of partnership profits computed over the life of the partnership (a "clawback obligation"). It is reasonable to anticipate that A could and would comply fully with any repayment responsibilities that arise pursuant to this obligation. The ABC partnership agreement satisfies the requirements for economic effect contained in §1.704-1(b)(2)(ii), including requiring that liquidating distributions are made in accordance with the partners' positive capital account balances.

(ii) Under paragraph (c) of this section, whether A's arrangement is treated as a payment for services in directing ABC's operations depends on the facts and circumstances. The most

important factor in this facts and circumstances determination is the presence or absence of significant entrepreneurial risk. The arrangement with respect to A creates significant entrepreneurial risk under paragraph (c)(1) of this section because the allocation to A is of net profits earned over the life of the partnership, the allocation is subject to a clawback obligation and it is reasonable to anticipate that A could and would comply with this obligation, and the allocation is neither reasonably determinable nor highly likely to be available. Additionally, other relevant factors do not establish that the arrangement should be treated as a payment for services. Thus, the arrangement with respect to A does not constitute a payment for services for purposes of paragraph (b)(1) of this section.

(iii) Under paragraph (c) of this section, whether M's arrangement is treated as a payment for services depends on the facts and circumstances. The most important factor in this facts and circumstances determination is the presence or absence of entrepreneurial risk. The priority allocation to M is an allocation of net profit from any 12-month accounting period in which the partnership has net gain, and thus it does not depend on the overall success of the enterprise. Moreover, the sale of the assets by ABC, and hence the timing of recognition of gains and losses, is controlled by A, a company related to M. Taken in combination, the facts indicate that the allocation is reasonably determinable under all the facts and circumstances and that sufficient net profits are highly likely to be available to make the priority allocation to the service provider. As a result, the allocation presumptively lacks significant entrepreneurial risk. No additional facts and circumstances establish otherwise by clear and convincing evidence. Accordingly, the arrangement provides for a disguised payment for services as of the date M and ABC enter into the arrangement and, pursuant to paragraph (b)(2)(ii) of this section, should be included in income by M in the time and manner required under applicable law as determined by applying all relevant sections of the Internal Revenue Code to the arrangement.

(iv) Assume the facts are the same as paragraph (i) of this example, except that the partnership can also fund M's priority allocation and distribution of net gain from the revaluation of any partnership assets pursuant to §1.704-1(b)(2)(iv)(f). As the general partner of ABC, A controls the timing of events that permit revaluation of partnership assets and assigns values to those assets for purposes of the revaluation. Under paragraph (c) of this section, whether M's arrangement is treated as a payment for services depends on the facts and circumstances. The most important factor in this facts and circumstances determination is the presence or absence of significant entrepreneurial risk. Under this arrangement, the valuation of the assets is controlled by A, a company related to M, and the assets of the company are difficult to value. This fact, taken in combination with the partnership's determination of M's profits by reference to a specified accounting period, causes the allocation to be reasonably determinable under all the facts and circumstances or to ensure that net profits are highly likely to be available to make the priority allocation to the service provider. No additional facts and circumstances establish otherwise by clear and convincing evidence. Accordingly, the arrangement provides for a disguised payment for services as of the date M and ABC enter into the arrangement and, pursuant to paragraph (b)(2)(ii) of this section, should be included in income by M in time and manner required under applicable law as determined by applying all relevant sections of the Internal Revenue Code to the arrangement.

Example (4).

(i) The facts are the same as in Example 3, except that ABC's investment assets are securities that are readily tradable on an established securities market, and ABC is in the trade or business of trading in securities and has validly elected to mark-to-market under section 475(f)(1). In

addition, M is entitled to receive a special allocation and distribution of partnership net gain attributable to a specified future 12-month taxable year. Although it is expected that one or more of the partnership's assets will be sold for a gain, it cannot reasonably be predicted whether the partnership will have net profits with respect to its entire portfolio in that 12-month taxable year.

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

Example (5).

(i) A is a general partner in newly-formed partnership ABC, an investment fund. A is responsible for providing management services to ABC, but has delegated that management function to M, a company controlled by A. Funds that are comparable to ABC commonly require the general partner to contribute capital in an amount equal to one percent of the capital contributed by the limited partners, provide the general partner with an interest in 20 percent of future partnership net income and gains as measured over the life of the fund, and pay the fund manager annually an amount equal to two percent of capital committed by the partners.

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

(iii) Under paragraph (c) of this section, whether the arrangement relating to the Additional Interest is treated as a payment for services depends on the facts and circumstances. The most important factor in this facts and circumstances determination is the presence or absence of significant entrepreneurial risk. The arrangement with respect to A creates significant

entrepreneurial risk under paragraph (c)(1) of this section because the allocation to A is of net profits, the allocation is subject to a clawback obligation over the life of the fund and it is reasonable to anticipate that A could and would comply with this obligation, and the allocation is neither reasonably determinable nor highly likely to be available. Additionally, the facts and circumstances do not establish the presence of other factors that would suggest that the arrangement is properly characterized as a payment for services. Accordingly, the arrangement does not constitute a payment for services under paragraph (b)(1) of this section.

Example (6).

(i) A is a general partner in limited partnership ABC, an investment fund. A is responsible for providing management services to ABC, but has delegated that management function to M, a company controlled by A. The ABC partnership agreement provides that A must contribute capital in an amount equal to one percent of the capital contributed by the limited partners, that A is entitled to an interest in 20 percent of future partnership net income and gains as measured over the life of the fund, and that M is entitled to receive an annual fee in an amount equal to two percent of capital committed by the partners. The amount of partnership net income or gains that will be allocable to A under the ABC partnership agreement is neither highly likely to be available nor reasonably determinable based on all facts and circumstances available upon formation of the partnership. A also undertakes a clawback obligation, and it is reasonable to anticipate that A could and would comply fully with any repayment responsibilities that arise pursuant to this obligation.

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

(iii) Under paragraph (c) of this section, whether the arrangements relating to A's 20 percent interest in future partnership net income and gains and M's Additional Interest are treated as payment for services depends on the facts and circumstances. The most important factor in this facts and circumstances determination is the presence or absence of significant entrepreneurial risk. The allocations to A and M do not presumptively lack significant entrepreneurial risk under paragraph (c)(1) of this section because the allocations are based on net profits, the allocations are subject to a clawback obligation over the life of the fund and it is reasonable to anticipate that A and M could and would comply with this obligation, and the allocations are neither reasonably

determinable nor highly likely to be available. Additionally, the facts and circumstances do not establish the presence of other factors that would suggest that the arrangement is properly characterized as a payment for services. Accordingly, the arrangements do not constitute payment for services under paragraph (b)(1) of this section.