1-1-2014

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FLORIDA TAX REVIEW

Volume 16 | *2014* | *Number 1*

MIXING MANAGEMENT FEE WAIVERS WITH *MAYO*

by

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I. INTRODUCTION

The 2012 presidential election cycle brought national attention to a strategy used by private equity firms, like the one founded by Mitt Romney, to convert ordinary income into long-term capital gains.[1] Under the strategy, a private equity firm waives its right to a fixed fee from a managed fund. Instead of the fixed fee, which would be taxed at high rates, the firm receives an additional profits interest (or "waiver interest") in the fund. If this strategy has its intended effect, income allocated to the waiver interest qualifies as low-taxed long-term capital gain.

This apparent conversion of ordinary income to long-term capital gain has drawn withering criticism from several respected commentators. Private equity firms, many of which already enjoy spectacular income, have

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1. *See, e.g.*, Floyd Norris, *A Tax Tactic That's Open to Question*, N.Y. TIMES, Sept. 14, 2012, at B1; Eric Kroh, *Investigation Brings Management Fee Waivers Under Scrutiny*, 136 TAX NOTES 1250 (Sept. 10, 2012); Nicholas Confessore, Julie Creswell & David Kocieniewski, *Financial Firms Face Subpoenas On Tax Strategy*, N.Y. TIMES, Sept. 2, 2012, at A1.

allegedly engaged in aggressive or illegal behavior by taking a waiver interest rather than a fixed fee payment.[2] According to the commentators, the Internal Revenue Service (IRS) could successfully challenge the fee waiver strategy because (1) section 707(a)(2)(A)[3] allows the IRS to recharacterize the transaction as one between strangers (and thus generating ordinary income), (2) a distribution regarding income allocated to the waiver interest may qualify as a "guaranteed payment" under section 707(c) and would again give rise to ordinary income, and (3) the receipt of the waiver interest qualifies as a recognition event under the common law authorities related to profits interests.

Notwithstanding these arguments, the appropriate tax treatment of the fee waiver strategy raises close questions, especially insofar as section 707 is concerned.[4] Section 707(a)(2)(A), by its plain terms, applies under

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2. *See* Gregg D. Polsky, *Private Equity Management Fee Conversions*, 122 TAX NOTES 743, 743 (Feb. 9, 2009) [hereinafter Polsky, *Fee Conversions*]; Victor Fleischer, *Romney's Management Fee Conversions*, VICTOR FLEISCHER, Aug. 23, 2012, http://victorfleischer.com/archives/306. Other prominent commentators have also criticized the fee waiver strategy. *See infra* note 63.

3. Unless otherwise noted or the context otherwise requires, section references are to the Internal Revenue Code of 1986, as in effect during the relevant taxable years.

4. Section 707, as relevant to this Article, provides:

> Sec. 707. Transactions between partner and partnership
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> (a) PARTNER NOT ACTING IN CAPACITY AS PARTNER.—
>
> (1) In general.—If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner.
>
> (2) Treatment of payments to partners for property or services.—Under regulations prescribed by the Secretary—
>
> (A) Treatment of certain services and transfers of property.—If—
>
> (i) a partner performs services for a partnership or transfers property to a partnership,
>
> (ii) there is a related direct or indirect allocation and distribution to such partner, and
>
> (iii) the performance of such services (or such transfer) 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 capacity as a member of the partnership,
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> such allocation and distribution shall be treated as a transaction described in paragraph (1).

regulations prescribed by the Treasury, but none have been issued.[5] Thus, to invoke section 707(a)(2)(A), the IRS or a court would have to invoke so-called phantom regulations.[6] Although some courts have adopted this approach, other courts apply the plain meaning of statutes and do not apply phantom regulations.[7] Additionally, most circuits have not definitively addressed phantom tax regulations one way or another, so the IRS could face significant litigation risks in those jurisdictions.

More importantly, the Supreme Court's recent decision in *Mayo Foundation v. United States* casts serious doubt on phantom tax regulations.[8] In *Mayo*, the Supreme Court expressly refused to apply one set of administrative law principles to tax cases and another set for nontax cases.[9] And, in nontax cases, courts (including the Supreme Court) flatly reject the use of phantom regulations.[10] *Mayo* thus suggests that phantom tax regulations have evaporated. That is, in line with general administrative law authorities, tax statutes that call for regulations necessarily lack effect until regulations are issued. Consequently, section 707(a)(2)(A) presents a weak line of attack against the management fee waiver strategy.

Section 707(c) also presents a weak line of attack against the waiver strategy. Under section 707(c), a guaranteed payment is one made without regard to the partnership's income. However, income will be allocated to a waiver interest only if the fund earns income. Thus, distributions on a waiver interest seem to fall outside of section 707(c). Nonetheless, some argue that Revenue Ruling 81–300, which adopts a policy-driven interpretation of section 707(c), allows for expansion of the statute so as to reach distributions on a waiver interest.[11] However, although Revenue Ruling 81–300 might

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> (c) GUARANTEED PAYMENTS.—To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, 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).

5. *See infra* note 44.

6. *See generally* Phillip Gall, *Phantom Tax Regulations: The Curse of Spurned Delegations*, 56 TAX LAW. 413 (2003); Amandeep S. Grewal, *Substance Over Form? Phantom Regulations and the Internal Revenue Code*, 7 HOUS. BUS. & TAX L.J. 42 (2006) [hereinafter Grewal, *Substance Over Form*].

7. *See infra* Part III.A–B.

8. Mayo Found. for Med. Educ. & Research v. United States, 131 S. Ct. 704, 712 (2011).

9. *See infra* Part III.C.

10. *See infra* Part III.B.

11. Rev. Rul. 81-300, 1981-2 C.B. 143. *See infra* Part IV.

have enjoyed some deference if tax-specific doctrines applied, *Mayo* indicates that *Chevron* and other general doctrines apply to tax guidance. And under those doctrines, because Revenue Ruling 81–300 contradicts the directly relevant case law and section 707(c)'s plain language, that ruling would enjoy no judicial deference. Thus, Revenue Ruling 81–300 should not deny the tax benefits associated with the fee waiver strategy.

The commentators' third argument, relating to the taxability of the waiver interest on its receipt,[12] raises unresolved questions. Under this argument, although Revenue Procedure 93–27 offers a safe harbor regarding the receipt of a profits interest,[13] the receipt of a waiver interest arguably does not comply with that revenue procedure's requirements.[14] And if the receipt of a waiver interest falls outside of the safe harbor, its tax consequences would be determined under the common law, which reflects uncertainties that might favor the IRS during litigation.[15]

Much ink has been spilt regarding the case law on profits interests, and the existing literature provides a useful framework for analyzing whether the fee waiver strategy passes the common law tests.[16] Section 707, conversely, continues to pose some underappreciated issues, especially in light of recent administrative law developments. In particular, the interaction between section 707 and the fee waiver strategy presents a nice vehicle through which to explore how *Mayo* touches on issues related to phantom regulations and regulatory deference standards. This Article will focus on those issues and will only briefly address the receipt of a waiver interest under the common law authorities.

Part II provides a basic overview of the fee waiver strategy and illustrates its principal tax benefits. It also discusses the litigation risks associated with any IRS common law argument against the strategy. Those risks should make a section 707 argument against the strategy far more attractive to the IRS. However, under existing case law, section 707(a)(1)

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12. *See infra* Part II.

13. Rev. Proc. 93-27, 19932 C.B. 343, *clarified by* Rev. Proc. 2001-43, 2001-2 C.B. 191.

14. *See infra* Part II.

15. *See* WILLIAM S. MCKEE, WILLIAM F. NELSON & ROBERT L. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS § 5.01 (3d ed. 1997) [hereinafter MCKEE ET AL., TAXATION OF PARTNERSHIPS] (Profits interests "have never been dealt with legislatively, have been dealt with only opaquely by Regulations, and have been thoroughly confused by a welter of inconsistent and poorly analyzed court decisions."). *See also generally* Sheldon I. Banoff, *Status of Service Partners Remains Unclear Despite Eighth Circuit's Reversal in* Campbell, 75 J. TAX'N 268 (1991) [hereinafter Banoff, *Service Partners*]; ABA Tax Sec., *The Tax Consequences of the Receipt of a Partnership Profits Interest for Services*, 46 TAX LAW. 453 (1993).

16. *See supra* note 15.

does not reach the fee waiver strategy. And, as Part III explains, section 707(a)(2)(A) (the statutory provision most frequently cited in connection with attacks on the fee waiver strategy) should not apply in the absence of implementing regulations. Although some tax-specific authorities have blessed phantom regulations in some circumstances, section 707(a)(2)(A) probably would not be treated as self-executing under those authorities. Additionally, *Mayo* vitiates whatever force those authorities might have once enjoyed. Regarding section 707(c), Part IV shows that, contrary to Revenue Ruling 81-300, a distribution related to a gross income allocation does not qualify as a guaranteed payment, especially in light of the deference standards established by *Mayo*.

Although the arguments against the fee waiver strategy should fail under existing law, the IRS is currently studying fee waivers and might promulgate guidance regarding them.[17] With that potential guidance in mind, Part V makes some general recommendations to the IRS regarding its rulemaking procedures, so as to conform agency practices to the Supreme Court's rejection of tax exceptionalism in *Mayo*.

II. FEE WAIVERS UNDER COMMON LAW AUTHORITIES

Generally speaking, a private equity fund will be formed as an entity treated as a partnership for federal income tax purposes.[18] Investors, like large pension funds or universities, will contribute cash to the fund in

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17. *See* DEP'T OF THE TREASURY, 2013-2014 PRIORITY GUIDANCE PLAN 21 (2013) [hereinafter 2013-2014 PRIORITY GUIDANCE PLAN] (including guidance on management fee waivers among items listed as regulatory priorities); *see also* Amy S. Elliott, *IRS Amplifies Its Views on Management Fee Waivers*, 139 TAX NOTES 999 (May 27, 2013) (noting that the IRS is studying the treatment of management fee waivers). In 2007, the IRS obliquely suggested that it was studying fee waivers, but nothing came of it. *See* Kim Dixon & Patrick Temple-West, *IRS Warned, but Did Not Act on Tax Strategy for Private Equity*, REUTERS, Sept. 3. 2012, http://www.reuters.com/article/2012/09/03/us-usa-taxes-privateequity-irs-idUSBRE 8820LQ20120903; Christopher Faille, *IRS, Ways & Means Grappling with HF Taxes*, HEDGEWORLD, Nov. 2, 2007, http://ibchedgeworld.com/news/read_news_ printable.cgi?section=legl&story=legl2135.html (discussing IRS statement that it is examining various issues related to private equity funds, including the "the characterization of income as ordinary or capital"); Andrew W. Needham & Anita Beth Adams, *Private Equity Funds*, 735-2nd TAX MGMT. PORT. (BNA) § VI.H (2012) [hereinafter Needham & Adams, *Private Equity Funds*] (characterization issues in IRS statement referred to administrative interest in fee waivers).

18. Because the principal focus here is on issues related to administrative law and statutory interpretation, this Part offers a simplified description of the fee waiver strategy. For an excellent and extensive discussion of the strategy's mechanics, see Polsky, *Fee Conversions*, *supra* note 2, at 749–52.

exchange for partnership interests. When the fund makes money, income from the fund will be allocated to the investors' partnership interests. Additionally, if the fund liquidates, these large investors will receive an appropriate share of fund assets. Thus, the large investors enjoy an interest in both the fund's capital and in its future profits.

The large investors, however, do not manage the fund. Instead, a private equity firm, like Bain Capital, will perform that task. To show that it has some skin in the game, the private equity firm will generally put some of its own money into the fund. Although the private equity firm will enjoy some income regarding this capital interest, the bulk of its compensation will usually come from a separate 20 percent profits interest (a carried interest) in the fund. If the fund performs well, this carried interest can generate millions of dollars or more for the firm. Under the Code, income allocated to this carried interest retains its partnership-level characterization (that is, the income will usually be taxed as long-term capital gain, not ordinary income).[19]

To cover various operating expenses, a private equity firm will also usually receive an annual fee equal to two percent of the assets under

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19. *See* I.R.C. § 702(b). Under the conventional view, private equity funds hold portfolio companies for investment purposes, and the sale of those companies gives rise to capital gain income, which flows through to the partners. *See* STAFF OF JOINT COMM. ON TAXATION, 110TH CONG., PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS AND RELATED ISSUES, pt. 1, at 3 (Comm. Print 2007) (discussing the IRS's position that "income from a carried interest may be reported as long-term capital gain"). However, one commentator has provocatively argued that private equity funds actually hold portfolio companies for sale to customers and are engaged in a trade or business, *see* I.R.C. § 1221(a)(1), such that gain on the sale of a portfolio company should give rise to ordinary income or loss. *See* Steven M. Rosenthal, *Taxing Private Equity Funds as Corporate 'Developers,'* 138 TAX NOTES 361 (Jan. 21, 2013). Also, in a recent case, the First Circuit accepted the argument of a union's multiemployer pension plan and concluded that a private equity fund was engaged in a trade or business for purposes of a provision in the Employee Retirement Income Security Act. *See* Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129 (1st Cir. 2013). If the IRS adopted the union's litigating position and successfully extended it to the income tax context, and also established that funds hold portfolio companies for sale to customers, funds would recognize ordinary income on the sale of those companies. Consequently, income allocated to a carried interest or waiver interest would face high tax rates under the flowthrough regime. *See* Amy S. Elliott & Lee A. Sheppard, *Private Equity Fund Is in a Trade or Business, First Circuit Holds*, 140 Tax Notes 413 (July 29, 2013). Fund investors could also face adverse tax consequences. On the implications of private equity reform on fund investors more generally, see Heather M. Field, *The Return-Reducing Ripple Effects of the 'Carried Interest' Tax Proposals*, 13 FLA. TAX REV. 1 (2012).

management.[20] This management fee is, by definition, paid without regard to the income of the fund. Thus, the fee qualifies as a guaranteed payment under section 707(c) and, for purposes of section 61, does not constitute a share of partnership profits. Consequently, the fee income does not qualify for long-term capital gain treatment and will instead face ordinary income rates.[21]

The management fee waiver strategy, if successful, allows a private equity firm to enjoy the economic benefits of the fee and avoid ordinary income treatment. Under the strategy, the private equity firm will waive its right to the management fee for a future year (say, Year Three) in exchange for a waiver interest.[22] The waiver interest will enjoy a priority allocation of profits from Year Three dispositions, in an amount equal to the amount of the fee waived. If the strategy works, income allocated to the waiver interest will be characterized as a distributive share of the fund's long-term capital gain.[23]

The management fee waiver strategy seems to come with a price, though. If the fund loses money in Year Three, no income will be allocated to the waiver interest. The firm would thus have lost out on the management fee that it otherwise would have received.

But things aren't always what they seem. The parties may arrange their transaction such that income will be allocated to the waiver interest, even if the fund loses money for Year Three. That is, to determine whether income will be allocated to the waiver interest, the fund's performance may be measured on (for example) a quarterly basis. Under this method, if the fund has just one strong quarter, income will be allocated to the waiver interest, even if the fund loses money overall in Year Three.[24] Additionally, even if the fund loses money in every quarter in Year Three, quarterly profits

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20. When investments go bad, little income might be allocated to the carried interest, and the fee income, paid quarterly, may be the private equity firm's principal source of profits. *See* Lee A. Sheppard, *Why Are Fee Waivers Like Deep-Fried Twinkies?*, 139 TAX NOTES 107, 107 (Apr. 8, 2013) [hereinafter Sheppard, *Deep-Fried Twinkies*] (describing "zombie" funds, which have little hope of producing gains but which are allegedly kept running to generate management fees).

21. *See* Reg. § 1.707-1(c) (guaranteed payments must be included in gross income as ordinary income).

22. This waiver would be effective for future taxable years, not the current one. If a firm were already entitled to the two percent fee and attempted to waive it, constructive receipt problems would arise. One commentator argues that constructive receipt problems would arise if the firm elects to waive its fee only a short time prior to its accrual, although this argument seems inconsistent with the case law. *See* Sheppard, *Deep-Fried Twinkies*, *supra* note 20, at 109–11.

23. *See* I.R.C. § 702(b).

24. For an illustration, *see* Polsky, *Fee Conversions*, *supra* note 2, at 750.

in later years may be used to satisfy the waiver interest's priority allocation.[25] These significant contractual protections, not associated with garden-variety profits interests, can substantially diminish the risk associated with waiver interests.[26]

The fee waiver strategy thus seems to magically convert ordinary income into long-term capital gain. And it may do so without any appreciable change in economic risk to the partners and without imposing costs on the fund investors.[27] Given the amounts converted under the strategy—Bain Capital alone converted $1 billion of ordinary income into long-term capital gain[28]—it's no surprise that the fee waiver strategy continues to draw close scrutiny, even though the 2012 election year hysteria has mercifully subsided.[29]

Although the IRS has yet to challenge the fee waiver strategy,[30] commentators have suggested several potential lines of attack, with section

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25. *See* Miles Weiss, *Icahn Changes Fund Fee in Move That May Cut Taxes*, BLOOMBERG, Mar. 25, 2008, http://www.bloomberg.com/apps/news?pid =newsarchive&sid=aN6U3l6IgARI [hereinafter Weiss, *Icahn Changes Fund Fee*] (describing carry-over practice of Icahn fund).

26. Of course, whether a private equity firm faces economic risks associated with the fee waiver strategy will depend on the particular facts and circumstances. *See* Sheppard, *Deep-Fried Twinkies*, *supra* note 20, at 109–11 (reporting one lawyer's statement that the risk associated with the strategy is not "theoretical" and that the lawyer was "aware of a case where the fund lost money and the general partner is out lots and lots of money by having used this mechanism"); Lee A. Sheppard, *Carried Away: Management Fee Conversion*, 116 TAX NOTES 532 (Aug. 13, 2007) ("[E]ven a special allocation of gross profits could present more risk than a fund manager could bear."); Needham & Adams, *Private Equity Funds*, *supra* note 17, § VI.H (suggesting strategies to reduce risks associated with fee waiver strategy); Weiss, *Icahn Changes Fund Fee*, *supra* note 25 (According to one practitioner, "The fact remains that a lot of people would not want to give up their automatic management fee in order to get the tax advantage.").

27. *See* Polsky, *Fee Conversions*, *supra* note 2, at 746–47 (describing how tax-exempt investors will likely be indifferent to the fee waiver strategy, and some individual investors may actually benefit from it, because it may allow them to avoid the deductibility limitations under section 212).

28. Nicholas Confessore, Floyd Norris & Julie Creswell, *Documents Show Details on Romney Family Trusts*, N.Y. TIMES, Aug. 24, 2012, at A14.

29. For a good discussion of the counterproductive effects of heated rhetoric in tax debates, see Richard J. Kovach, *Personal and Political Bias in the Debate over Federal Income Taxation Rates and Progressivity*, 21 AKRON TAX J. 1 (2006).

30. It's impossible for an outsider to know the IRS's examination practices, but practitioner commentary suggests that the IRS has not yet challenged the strategy. *See, e.g.*, *Private Equity Firms' Use of 'Management Fee Waivers,'* VINSON & ELKINS, Sept. 13, 2012, http://velaw.com/resources/PrivateEquityFirms

707 receiving especially frequent mention. That statute's general rule, section 707(a)(1), states that if a partner deals with a partnership outside his partner capacity, the transaction will be treated as occurring between strangers. If this rule applied to the fee waiver strategy, the income allocated to the private equity firm's waiver interest would not qualify for passthrough treatment under section 702(a). Instead, the income would be characterized as if it were paid to an outsider.[31] Consequently, instead of enjoying a distributive share of the fund's long-term capital gain income, the private equity firm would be treated as receiving a payment for services, which would be taxed as ordinary income.

The leading authorities under section 707(a)(1) do not support treating a private equity firm as an outsider, however. In *Pratt v. Commissioner*,[32] the Fifth Circuit held that management fees paid by a partnership to its general partners qualified as distributive shares of their partnership income where the services provided by the partners related closely to the partnership's business. Under the partnership agreement in *Pratt*, the general partners received a fixed percentage of the partnership's gross rental income in consideration for management services related to the business of the partnership (the operation of shopping centers). Although the partners argued that the fee for management services should qualify for section 707(a)(1) treatment, the Fifth Circuit rejected that argument. The services related to "activities for which the partnership was created in the first place," and the management fee consequently "must be treated merely as a rearrangement between the partners of their distributive shares in the partnership income."[33] Although the amounts specified in the partnership agreement may have reflected an arm's-length price, which usually suggests that the parties acted like strangers, section 707(a)(1) simply did not apply to payments for "the performance of services for which the partnership exists."[34]

UseManagementFeeWaivers.aspx [hereinafter V&E, *Management Fee Waivers*] ("We are not aware of any pending IRS challenges to management fee waiver structures."). However, the recent popular attention paid to the strategy has apparently motivated the IRS to take another look. *See* Amy S. Elliott, *IRS Studying Fee Waivers*, 139 TAX NOTES 599 (May 6, 2013) [hereinafter Elliott, *Studying Fee Waivers*]. Additionally, guidance regarding fee waivers appears in the 2013-14 Priority Guidance Plan. *See* 2013–2014 PRIORITY GUIDANCE PLAN, *supra* note 17.

31. *See* Reg. § 1.707-1(a).

32. 550 F.2d 1023, 1026 (5th Cir. 1977).

33. *Id.*

34. *Id.* at 1027. The only example in the regulations that illustrates the partner-outsider distinction is consistent with the holding in *Pratt*. *See* Reg. § 1.707-1(a) (stating that when a partner retains ownership of property but allows the partnership to use the property for partnership purposes, like securing partnership debts, the partner is acting as an outsider). However, in Revenue Ruling 81-301, the

Applying these principles to the fee waiver strategy, a private equity firm would not be treated as an outsider under section 707(a)(1). As in *Pratt*, the private equity firm provides the management "services for which the partnership exists."[35] Thus, income allocated to a private equity firm's waiver interest should not be recharacterized as a fee paid to an outsider under section 707(a)(1), and that statute does not deny the tax benefits associated with fee waiver strategy.

However, the subsequent enactment of section 707(a)(2)(A) may have abrogated the *Pratt* approach to partner or outsider determinations. That statute authorizes regulations that require outsider treatment if a partner performs services for a partnership and there is a related allocation of income and accompanying distribution to him.[36] This rule applies only if the performance of services, the allocation of income, and the distribution are together best viewed as occurring between a partnership and an outsider.[37]

Many prominent commentators believe that section 707(a)(2)(A) displaces the *Pratt* analysis for partnership transactions involving the performance of services.[38] The statute's legislative history indicates that the Senate Finance Committee wanted the Treasury to promulgate regulations

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IRS offered an approach different from that taken in *Pratt*. In that ruling, where a corporate general partner provided advisory services to a partnership, outsider treatment followed because the general partner performed similar services for others, was subject to supervision by the other partners, could be relieved of its duties and its right to compensation with 60 days' notice, paid its own expenses, and was not liable to other partners for investment-related losses. Regarding section 707(a)(1), it's not clear whether the IRS follows the factors in Revenue Ruling 81-301 or the *Pratt* approach. The IRS has never cited Revenue Ruling 81-301, and only one agency document approvingly cites *Pratt*. *See* F.S.A. 1999-45-013 (Nov. 12, 1999) ("Services rendered by a partner that relate to the purposes for which a partnership is formed or that promote the business of the partnership will likely be characterized as rendered by the partner in his capacity as a partner."). The lack of materials on section 707(a)(1) may reflect the IRS's focus on section 707(a)(2)(A)'s legislative history in making partner-outsider determinations. *See* T.A.M. 92-19-002 (May 8, 1992) (applying legislative history under section 707(a)(2)(A) to the partner-outsider question).

35. *Pratt*, 550 F.2d at 1027.

36. *See* I.R.C. § 707(a)(2)(A)(i), (ii).

37. *See* I.R.C. § 707(a)(2)(A)(iii).

38. *See, e.g.*, BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS § 89.1 n.8 (2012) [hereinafter BITTKER & LOKKEN, FEDERAL TAXATION OF INCOME]. Other notable commentators do not specifically discuss *Pratt*, but instead just apply section 707(a)(2)(A) to partner capacity questions, notwithstanding the absence of implementing regulations. *See, e.g.*, Howard E. Abrams, *Taxation of Carried Interests: The Reform that Did Not Happen*, 40 LOY. U. CHI. L.J. 197, 222 (2009) [hereinafter Abrams, *Carried Interests*].

establishing a complex multifactor test for partner capacity questions, with entrepreneurial risk being the most important factor.[39] This multifactor test differs substantially from the *Pratt* analysis, which focuses on the nature of the services performed, not entrepreneurial risk.

Under the Senate Finance Committee's entrepreneurial risk test, a private equity firm could very well be treated as an outsider regarding income allocated to its waiver interest. Through the fee waiver strategy, the private equity firm enjoys a priority allocation of the fund's income up to the amount of the waived management fee. Additionally, if a fund adopts the quarterly allocation method and other protections regarding the waiver interest, the private equity firm may face little risk of loss regarding its management fee. And, any income allocated to the waiver interest generally will be distributed (or may be deemed distributed) soon after its allocation.[40] This arrangement arguably establishes that a waiver interest does not reflect participation in the entrepreneurial risk of the fund, and income allocated to the waiver interest should be treated as a payment to an outsider.[41]

There's one major problem with using the entrepreneurial risk test, though—it appears nowhere in the statute. Although the Senate Finance Committee embraced that test,[42] Congress itself directed the Secretary to

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39. *See* S. REP. NO. 169, at 227 (1984) ("The first, and generally the most important, factor is whether the payment is subject to an appreciable risk as to amount. Partners extract the profits of the partnership with reference to the business success of the venture while third parties generally receive payments which are not subject to this risk."). Other factors include whether the partner status of the recipient is transitory, whether the distribution and allocation was close in time to the partner's performance of services, whether the recipient is primarily motivated to become a partner for the tax benefits, and whether the value of the recipient's profits interest is small compared to the allocation in question. *See id.* at 227–28.

40. A fund may provide for a special cash distribution to the private equity firm or may adopt another measure to ensure that the firm immediately enjoys the economic benefits associated with the income allocated in lieu of the fixed fee. *See* Polsky, *Fee Conversions*, *supra* note 2, at 751–52 (describing cash flow issues related to fee waiver strategy); *see also* Sheppard, *Deep-Fried Twinkies*, *supra* note 20, at 111 (Fee waivers "are usually calibrated so that the manager gets a distribution at the moment the management fee would have been payable."). A distribution is critical to section 707(a)(2)(A)'s application because the statute grants regulatory authority only when there has been a distribution, whether direct or indirect. *See* I.R.C. § 707(a)(2)(A)(ii).

41. *See* Polsky, *Fee Conversions*, *supra* note 2, at 762–65 (applying factors in section 707(a)(2)(A)'s legislative history and concluding that those factors support treating amounts allocated to a waiver interest as a payment to an outsider).

42. The Senate Finance Committee, of course, cannot speak for Congress. *See* Exxon Mobil Corp. v. Allapattah Serv., Inc., 545 U.S. 546, 568 (2005) ("As we have repeatedly held, the authoritative statement is the statutory text, not the legislative history or any other extrinsic material."); City of Chicago v. Envtl. Def.

promulgate regulations implementing section 707(a)(2)(A).[43] And while the Secretary surely enjoys the authority to promulgate regulations adopting the entrepreneurial risk test, in the roughly 30 years since the statute's enactment no regulations have been issued.[44] Consequently, to apply section 707(a)(2)(A) to the fee waiver strategy, the IRS would have to create so-called phantom regulations. The next Part explains why that approach should fail.

Fund, 511 U.S. 328, 337 (1994) ("It is the statute, and not the Committee Report, which is the authoritative expression of the law.").

43. Given the difficulties surrounding partner-outsider determinations, it is no surprise that Congress granted Treasury the regulatory authority to address that question, rather than provide rules itself. *See* MCKEE ET AL., TAXATION OF PARTNERSHIPS, *supra* note 15, § 14.02 ("Distinguishing 'true' from 'disguised' partners is difficult. Congress identified the need to make this distinction when it enacted section 707(a)(2)(A) in 1984. Unfortunately, section 707(a)(2)(A) does not come to grips with the difficult task of actually making the distinction; it merely passes the buck to the Treasury."); Bradley T. Borden, *Profits-Only Partnership Interests*, 74 BROOK. L. REV. 1283, 1323 (2009) ("[T]he Senate Committee on Finance instructed Treasury to promulgate regulations to define the distinction between partner and nonpartner capacities. Since that time, no legal guidance has emerged regarding the distinction. The lack of guidance does not indicate the issue is unimportant. Instead, it implies the issue is difficult and new analytical methods are required to create the needed guidance.").

44. Section 707(a)(2)(A) provides regulatory authority to treat some partner-partnership transactions as occurring between outsiders. The statute reaches both services transactions and property transactions. Somewhat confusingly, section 707(a)(2)(B) provides additional regulatory authority for property transactions. *See* Karen C. Burke, *Disguised Sales Between Partners and Partnerships: Section 707 and the Forthcoming Regulations*, 63 IND. L.J. 489, 500–05 (1988) (describing overlaps and differences between the two sections). In 1992, the Treasury issued regulations regarding property transactions under both section 707(a)(2)(A) and section 707(a)(2)(B). *See* T.D. 8439, 1992-2 C.B. 126. Those regulations apply to property transactions after April 24, 1991. For property transactions on or before that date, Regulation section 1.707-9(a)(2) indicates that section 707(a)(2) should be applied with regard to its legislative history. *See also In re* G-I Holdings Inc., No. 02-3082 (SRC), 2009 WL 4911953 (D. N.J. Dec. 14, 2009) (unpublished opinion) (applying Regulation section 1.707-9(a)(2)). Although the Treasury could have provided a similar legislative history rule for services transactions under section 707(a)(2)(A), the 1992 regulations simply reserve on providing guidance. *See* Reg. § 1.707-2. This creates a negative inference that the Treasury, at least in 1992, believed that regulations must be issued for section 707(a)(2)(A) to apply to services transactions or that the Treasury possibly had concerns with the Senate Finance Committee's recommended approach. Unfortunately, the Treasury still has not issued regulations, and no court has applied section 707(a)(2)(A) to services transactions.

But before addressing the statutory arguments related to the fee waiver strategy, a brief discussion of the common law arguments will provide some further context for the discussion. Although the common law arguments enjoy some merit, they also raise serious litigation risks for the IRS. These potential risks help explain why the section 707 arguments would be preferable to the common law arguments, if they didn't suffer the infirmities discussed later. And an understanding of those risks, coupled with an understanding of the problems with the section 707 arguments, helps illustrate why commentators have significantly overstated the prospects of a successful IRS challenge to the fee waiver strategy.

Under the common law argument, the fee waiver strategy could fail because the grant of the waiver interest qualifies as a recognition event, and a private equity firm should consequently pay taxes (at ordinary rates) on the fair market value of its waiver interest at the time of receipt.[45] This argument essentially contemplates that Revenue Procedure 93-27's safe harbor, granting tax-free treatment to the receipt of a profits interest, does not apply, given the typical private equity fund structure. A private equity firm, typically organized as a limited liability company, may provide services to a fund under a contract and hold its profits interests (including its waiver interests) through an affiliated holding company. This bifurcated structure, motivated by state law concerns, raises issues regarding whether the holding company received the waiver interest in a partnership capacity, as required to satisfy Revenue Procedure 93-27's safe harbor.[46] Additionally, although a fund actually issues a waiver interest directly to the holding company, for federal income tax purposes, the transaction arguably should be treated as a deemed issuance to the private equity firm followed by a deemed transfer to the affiliated holding company.[47] Under this recharacterization, the deemed transfer may violate Revenue Procedure 93-27's two-year prohibition on dispositions of profits interests and could again fall out of the regulatory safe harbor.[48]

45. *See* Polsky, *Fee Conversions*, *supra* note 2, at 753–62.

46. *See id.* at 754–55; *see also* Afshin Beyzaee, *Current Tax Structuring Techniques for Private Equity Funds*, 20 J. TAX'N & REG. FIN. INSTITUTIONS 16 (2007). Some practitioners believe that Revenue Procedure 93-27's safe harbor is satisfied even if a private equity firm uses the bifurcated structure. *See* Needham & Adams, *Private Equity Funds*, *supra* note 17, § VI.A.6.

47. *See* Polsky, *Fee Conversions*, *supra* note 2, at 753.

48. The receipt of a profits interest will also fall outside of the regulatory safe harbor if "the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease." Rev. Proc. 93-27, 1993–2 C.B. 343. Under this provision, the receipt of a waiver interest could fall outside of the safe harbor if, for example, the investment fund earned steady interest income from loans to a portfolio company or if a portfolio company paid regular dividends to the fund.

If the receipt of the waiver interest falls outside of Revenue Procedure 93-27's safe harbor, the tax consequences associated with the private equity firm's receipt of that interest would be tested under the common law. In *Diamond v. Commissioner*, the Seventh Circuit held that the receipt of a profits interest will be taxable to the recipient when that interest has a determinable fair market value.[49] If the *Diamond* test applied to a private equity firm's receipt of a waiver interest, that receipt could very well qualify as a recognition event. In some circumstances, a waiver interest may be susceptible to a reasonably accurate valuation,[50] in which case a private equity firm would immediately recognize ordinary income in an amount equal to the waiver interest's fair market value. This would defeat the tax benefits sought under the fee waiver strategy.

The *Diamond* test, however, probably reflects a mere "hiccup"[51] in the case law that otherwise grants nonrecognition treatment to the receipt of

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However, portfolio companies generally do not make interest or dividend payments to investment funds, so the receipt of a waiver interest should not fall outside of the regulatory safe harbor under of the stream of income exception. Nonetheless, one can plausibly argue that priority allocations to waiver interests enjoy the same lack of risk associated with regular interest or dividend payments, and so the stream of income exception should catch the receipt of a waiver interest.

49. Diamond v. Commissioner, 492 F.2d 286, 291 (7th Cir. 1974) (deferring to the Tax Court's expertise and holding "that the receipt of a profit-share with determinable market value is income").

50. To consider one possible example, if a waiver interest received a priority allocation of a fund's income using a quarterly allocation method or a similar method, and the underlying fund enjoyed a steady stream of portfolio exits and adopted a carryover "catch-up" mechanism, it would seem reasonable to value the waiver interest at an amount close to the fee waived, especially if elections were made on a rolling basis, such that the health of the portfolio would be known and valuation would call for less speculation. If a waiver interest were structured with fewer protections, more difficult valuation questions would arise. Additionally, if a court focused on liquidation value, rather than true fair market value, a waiver interest, not being entitled to any partnership capital on the date of the grant, would have no value, and treating it as taxable on receipt would not trigger adverse tax consequences. *See, e.g.*, St. John v. United States, No. 82-1134, 1983 WL 1715, at *5 (C.D. Ill. Nov. 16, 1983) (distinguishing *Diamond* and concluding that the taxpayer "had merely a profit interest and that the liquidation method is the proper one for determining the value of that interest"); Jan Bradshaw & Kim Itakura, Campbell *Renews Controversy Over Taxation of a Partnership Interest for Services*, 7 J. PARTNERSHIP TAX'N 211 (1990) (noting that until *Campbell*, "[e]ach court decision subsequent to *Diamond* ha[d] taken the position that the immediate liquidation value should be used to determine the service partner's income from the transfer of a profits interest in a partnership").

51. Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 16 (2008).

a profits interest.[52] The IRS, in fact, never embraced its victory in *Diamond*.[53] And in *Campbell v. Commissioner*, the Eighth Circuit expressed its belief that the receipt of a profits interest in the partner capacity does not qualify as a realization event.[54] Thus, even if the fair market value of a waiver interest could be determined, taxability should not follow.

This is not to say that the IRS would lose if it pursued a common law argument against the fee waiver strategy. A court could very well adopt the *Diamond* approach and find that a waiver interest has a determinable fair market value. Or, a court could broadly hold that the receipt of a profits interest always constitutes a recognition event, as the Tax Court has done.[55] Even a court that subscribed to the dicta in *Campbell* could hold that a private equity firm's bifurcated structure establishes that the firm receives the waiver interest outside of its partnership capacity.[56] And if the IRS decided to invoke general common law doctrines to challenge the fee waiver

52. *See also* Charles H. Egerton & Richard E. Levine, *The Tax Consequences of the Receipt of a Partnership Profits Interest for Services*, 46 TAX LAW. 453, 455–59, 472–75 (1993) (surveying various judicial and administrative materials reflecting the understanding that the receipt of a profits interest does not qualify as a recognition event).

53. *See* G.C.M. 36,346 (July 23, 1975) ("[T]he Service will not follow *Diamond* to the extent that it holds that the receipt of an interest in future partnership profits as compensation for services results in taxable income.").

54. Campbell v. Commissioner, 943 F.2d 815 (8th Cir. 1991). After a survey of the case law and practitioner commentary, the Eighth Circuit generally suggested that the receipt of a profits interest, received in a partner capacity, does not qualify as a realization event. However, it ultimately distinguished *Diamond* on valuation grounds and thus did not squarely hold that nonrecognition treatment attaches to the receipt of a profits interest in a partner capacity. Although the court should perhaps be applauded for its modesty, its failure to affirmatively resolve issues related to profits interests has drawn some criticism. *See, e.g.*, Terrence F. Cuff, Campbell v. Commissioner*: Is There Now "Little or No Chance" of Taxation of a "Profits" Interest in a Partnership?*, 69 TAXES 643, 651 n.39 (1991) (*Campbell* has "many characteristics of a badly written law school examination: issue spotting without any attempt to come to grips with and to resolve any of the major issues."); Banoff, *Service Partners*, *supra* note 15, at 273 ("[T]he court could only bring itself to 'doubt' that the Tax Court correctly held Campbell's interests to be taxable on receipt.").

55. *See* Diamond v. Commissioner, 56 T.C. 530 (1971), *aff'd on other grounds*, 492 F.2d 286 (7th Cir. 1974); Campbell v. Commissioner, 59 T.C.M. (CCH) 236, T.C.M. (P-H) ¶ 90, at 162 (1990), *rev'd*, 943 F.2d 815 (8th Cir. 1991).

56. Additionally, if a waiver interest entitled a holder to a priority allocation of built-in gains, and not merely future gains, the IRS's common law arguments would be stronger. In these circumstances, the waiver interest would look more like a capital interest, rather than a profits interest, and all agree that the receipt of a capital interest reflects a recognition event. *See* Reg. § 1.721-1(b)(1).

strategy, it could point to the favorable case law created by its impressive string of recent judicial victories.[57]

Nonetheless, given the state of the law on profits interests, the IRS also faces significant litigation risks if it presses an argument based on Revenue Procedure 93-27. Taking the receipt of the waiver interest outside of Revenue Procedure 93-27 requires some technical arguments that apparently are not based on any compelling policy justifications, and a court could give those arguments less weight when applying a regulatory safe harbor.[58] Also, even if the waiver interest falls outside of the safe harbor, a

57. After *Coltec Industries, Inc. v. United States*, virtually any tax-motivated transaction faces invalidation under the economic substance doctrine, depending on how the court decides to frame the inquiry. *See* Coltec Indus., Inc. v. United States, 454 F.3d 1340 (Fed. Cir. 2006). That is, tax planning necessarily involves tax-motivated elements, and if a court focuses on those elements to the exclusion of the business-related elements, the court will ineluctably conclude that the transaction is solely tax-motivated and must be disregarded under the economic substance doctrine. *See generally* David P. Hariton, *The Frame Game: How Defining the "Transaction" Decides the Case*, 63 TAX LAW. 1 (2009). However, the tax-conscious choice to take a profits interest rather than a fixed fee would seem like the sort of transaction that historically has survived economic substance analysis. Also, although some fee waivers might not subject a private equity firm to substantial additional economic risk, the Supreme Court has flatly rejected the government's invitation to disregard a transaction under the economic substance doctrine for want of risk. *See* United States v. Consumer Life Ins. Co., 430 U.S. 725, 740–41 (1977) (rejecting the government's argument to disregard a transaction for absence of risk, because the statute did not make the risk inquiry relevant). Thus, while commentators frequently criticize the fee waiver strategy for not subjecting a private equity firm to extra risk, that factor standing alone cannot negate the benefits associated with the strategy. However, economic risk could be relevant if phantom regulations applied under section 707(a)(2)(A) or if a court looked to section 707(c)'s perceived purpose rather than its actual text. But those lines of reasoning suffer from severe problems. *See infra* Parts III.B, C, IV.

58. Section 4.01(2) of Revenue Procedure 93-27 takes a profits interest out of the regulatory safe harbor when it is disposed of within two years of its receipt. This provision probably contemplates that a taxable disposition shortly after receipt, at arm's length, provides a strong sign that the interest can be easily valued, and any administrative concerns supporting nonrecognition treatment are no longer present. Under the bifurcation analysis, however, the deemed transfer itself qualifies as a tax-free transaction, such that the transfer would be consistent with the purpose of section 4.01(2), although not its letter. While it's generally the case that text, not purpose, controls interpretation, see *In re Cavanaugh*, 306 F.3d 726, 731–32 (9th Cir. 2002) ("courts may not depart from the statutory text because they believe some other arrangement would better serve the legislative goals"), this interpretive principle might not apply to Revenue Procedures. If this principle does apply to Revenue Procedures, and if the IRS showed that the bifurcation analysis reflects the

court could flatly hold, consistent with much scholarly commentary, that the receipt of a profits interest, received in a partner capacity, does not qualify as a realization event.[59] Such a holding could substantially limit or possibly eliminate the IRS's authority to tax the receipt of profits interests in the future.[60] Even if the IRS chooses a strong case to litigate and succeeds, any judicial opinion could essentially create a roadmap to avoiding recognition treatment (that is, private equity firms could prospectively structure their waiver interests to work around the aspects of the taxpayer's arrangement that the court condemned).[61] On top of that, the statute of limitations has surely run on most transactions involving the grant of a waiver interest during the various economic booms over the past 15 years. It's thus easy to understand why a clean statutory argument that focuses on yearly income allocations and distributions would be preferable to a common law argument that focuses on transactions years ago.[62] However, as the next two Parts show, the allegedly strongest statutory arguments—based on sections 707(a)(2)(A) and (c)—suffer from severe problems.

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proper characterization of the management fee waiver strategy, the deemed transfer would take the transaction outside of the regulatory safe harbor.

59. *See, e.g.*, Leo L. Schmolka, *Taxing Partnership Interests Exchanged for Services: Let* Diamond/Campbell *Quietly Die*, 47 TAX L. REV. 287 (1991) (arguing that the partner capacity analysis should control whether the receipt of a profit interest qualifies as a recognition event).

60. Also, to the extent that the IRS argued that the bifurcated structure took the transaction out of Revenue Procedure 93-27, that might cut against applying section 707(a)(2)(A). That statute provides regulatory authority to recharacterize transactions when a partner performs services and receives a distribution, *see* I.R.C. § 707(a)(2)(i)–(ii), but under a bifurcation analysis, a nonpartner (the management company) performs the services and the partner (the affiliated holding company) merely receives a distribution. *See* Polsky, *Fee Conversions*, *supra* note 2, at 763, n.158.

61. For example, if a court relied on the bifurcated structure to deny benefits under the fee waiver strategy, one would expect private equity firms to combine the management company and the holding company into one entity, assuming that the federal tax benefits associated with an integrated structure outweigh the state law benefits associated with a bifurcated structure.

62. Of course, if the IRS focuses on newly or recently formed funds or on funds where the private equity firm elects to take a waiver interest on a yearly basis, statute of limitations concerns would not be present. However, if the IRS attacks only recent transactions, it would probably be safer to address these transactions through the promulgation of modestly retroactive regulations than through an uncertain judicial challenge.

III. FEE WAIVERS UNDER SECTION 707(a)(2)(A)

This Part examines whether section 707(a)(2)(A), the statutory provision most frequently mentioned in connection with criticisms of the fee waiver strategy,[63] may operate without any implementing regulations. It concludes that it cannot. Although, as will be discussed in Subpart A, some courts (most notably the Tax Court and the Seventh Circuit) have blessed phantom tax regulations in some circumstances, it is doubtful, or at best unclear, whether section 707(a)(2)(A) would be treated as self-executing under the criteria established by those courts. Additionally, as discussed in Subpart B, other courts, including the Supreme Court, follow the plain meaning of statutes like section 707(a)(2)(A) and decline to apply phantom tax regulations.

More importantly, *Mayo* rejects tax-specific exceptions to regular administrative law principles. And under general administrative law principles, agencies must actually promulgate regulations to enforce them.[64] Various courts, including the Supreme Court, have rejected phantom regulations in the nontax context.[65] Thus, unless there is something special about the tax law in this regard, courts must interpret tax statutes that call for regulations in the same way that they interpret nontax statutes. Subpart C argues that there is nothing special about the Code that would justify a unique approach to phantom regulations. In fact, any unique features of the tax system counsel against phantom regulations, not in favor of them.

A. Fee Waivers Under the "Phantom" Approach

This Subpart examines whether section 707(a)(2)(A) would be treated as self-executing under the approaches adopted by the Tax Court and

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63. *See, e.g.*, Polsky, *Fee Conversions*, *supra* note 2, at 762–65; Elliott, *Studying Fee Waivers*, *supra* note 30 (reporting that an IRS official believes that "some fee waivers may implicate section 707(a)(2)(A)"); Victor Fleischer, *What's at Issue in the Private Equity Tax Inquiry*, DEALBOOK, Sept. 4, 2012, http://dealbook.nytimes.com/2012/09/04/whats-at-issue-in-the-private-equity-tax-inquiry/?_php=true&_type=blogs&_r=0 ("[A] court would probably treat the waived fee amount as ordinary income under section 707(a)(2)(A)."); Lee A. Sheppard, *The Unbearable Lightness of the Carried Interest Bill*, 116 TAX NOTES 15 (July 2, 2007) ("[T]he tax administrator should be encouraged to interpret section 707(a)(2)(A) to disregard fee waivers."); Karen C. Burke, *Back to the Future: Revisiting the ALI's Carried Interest Proposals*, 125 TAX NOTES 242, 246 (Oct. 12, 2009) [hereinafter Burke, *Back to the Future*] ("[S]ection 707(a)(2)(A) clearly should suffice to catch a typical management fee [waiver].").

64. *See* 5 U.S.C. § 553 (2006) (describing notice and comment procedures that must be followed before regulations can take effect).

65. *See infra* Part III.B.

the Seventh Circuit. Although some other courts have applied phantom regulations, those courts generally adopt approaches similar to those employed by the Tax Court and Seventh Circuit. Consequently, only the approaches of those two courts will be analyzed.

1. Tax Court Factors

On several occasions over the past three decades, the Tax Court has applied phantom regulations. Different judges on the court have justified this practice differently, so no consistent pattern emerges from the Tax Court's case law. However, the various opinions reveal several factors that the court takes into account. Under the case law, the Tax Court will be more likely to treat a statute that refers to regulations as self-executing if (1) the regulations contemplated by the statute provide a clear benefit to the taxpayer, (2) the statute relates merely to how a rule applies, rather than to whether it applies, (3) the statute mandates regulations, or (4) the legislative history provides a clear indication of how a congressional committee wanted the Secretary to exercise his rulemaking authority. None of these factors unambiguously support treating section 707(a)(2)(A) as self-executing.

Regarding the first factor, the Tax Court has emphasized that when a statute calls for regulations that would provide a benefit to a taxpayer, it would be "peculiarly Draconian" to deny the taxpayer the benefit for want of regulations.[66] Thus, for example, the Tax Court held that a taxpayer could apply a tax-benefit rule when computing its alternative minimum tax, even though section 58(h) merely commanded the Secretary to promulgate regulations allowing for that rule.[67] In the Tax Court's view, Congress could not possibly have "intended to give the Treasury the power to defeat the legislatively contemplated operative effect of such provisions merely by failing to discharge the statutorily imposed duty."[68]

This taxpayer-equity approach should not lead the Tax Court to invoke phantom regulations against the fee waiver strategy. The equity approach rests on the principle that the Treasury cannot withhold tax benefits by failing to promulgate regulations, but in this context, phantom regulations would hurt the taxpayer, not help it. That is, if the IRS applied phantom regulations against a private equity firm, income that might otherwise qualify for long-term capital gain treatment would be treated as ordinary income. The equities here would thus push against the application of phantom regulations, especially because the Secretary has already had nearly thirty years to issue real regulations.

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66. Hillman v. Commissioner, 114 T.C. 103, 113 (2000), *rev'd*, 263 F.3d 338 (4th Cir. 2001).

67. *See* Occidental Petroleum Corp. v. Commissioner, 82 T.C. 819 (1984).

68. *Id.* at 829.

It is unclear whether the second factor, which relates to a head-scratching "whether versus how" test, supports phantom regulations under section 707(a)(2)(A). Although the Tax Court has applied this confusing test inconsistently and may have abandoned it,[69] the test apparently distinguishes between statutes that determine whether a rule applies and statutes that merely explain how a rule applies. For example, if subsection A of a statute says that a tax will apply to the sale of all fruits (except apples), and subsection B directs the Secretary to issue regulations establishing a tax on apple sales, subsection B would be a "whether" statute. That is, regulations issued under subsection B would determine *whether* a tax applies to apple sales. In these circumstances, the Tax Court would not treat the statute as self-executing.

If, however, subsection A of the statute said that the tax would apply to the sale of all fruits, and subsection B directed the Secretary to issue regulations relating to the sale of apples, subsection B would be a "how" statute. The regulatory authority under subsection B would simply grant the Secretary further authority to provide details on *how* the statute operates. Subsection A would establish the taxation of apple sales, and the IRS could collect taxes regarding those sales, even with no regulations issued under subsection B.[70]

It's not clear whether section 707(a)(2)(A) reflects a "how" statute or a "whether" statute. Looking at section 707(a)(2)(A) in isolation, it may come across as a "how" statute and thus one that the Tax Court might treat as self-executing. That is, section 707(a)(1) generally states that outsider treatment follows whenever a partner acts in a nonpartner capacity, and,

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69. *See infra* note 76.

70. As described here, the "whether versus how" test does not actually contemplate the use of phantom regulations. Rather, the test reflects the commonsense principle that if one subsection of a statute clearly implements a rule, that rule should be immediately effective, even if another subsection of the statute grants the Secretary further authority to issue regulations detailing that rule. The Tax Court interpreted a statute consistent with this understanding in H Enters. Int'l v. Commissioner, 105 T.C. 71 (1995), *aff'd*, 183 F.3d 907 (8th Cir. 1999). Subsequently, however, the Tax Court and some other courts have applied the "whether versus how" test in a confusing way and have used that test to invoke phantom regulations. *See, e.g.*, Temsco Helicopters, Inc. v. United States, 409 F. App'x 64, 67 (9th Cir. 2010) (holding that a statute that granted regulatory authority to determine whether to impose a tax collection obligation on an air carrier qualified as a "how" statute); Francisco v. Commissioner, 119 T.C. 317, 322–23 (2002), *aff'd on other grounds*, 370 F.3d 1228 (D.C. Cir. 2004); Estate of Neumann v. Commissioner, 106 T.C. 216 (1996) (treating section 2663(2) as a "how" statute, although the regulation essentially grants authority to determine whether to apply the generation-skipping transfer tax to nonresident aliens). For further discussion of *Francisco*, *see infra* note 76.

under one possible interpretation, section 707(a)(2)(A) merely grants the Treasury the authority to issue regulations implementing section 707(a)(1)'s general rule for services transactions. Viewed this way, section 707(a)(2)(A) would simply relate to *how* section 707(a)(1) applies.

But the legislative history, for whatever it's worth,[71] indicates that regulations under section 707(a)(2)(A) would change existing law, not merely implement section 707(a)(1)'s general rule.[72] That is, the Senate Finance Committee wanted the Secretary to displace the *Pratt* approach with an entrepreneurial risk test.[73] Viewed against this history, section 707(a)(2)(A) goes to *whether* the entrepreneurial risk test applies and thus would not be treated as self-executing under the "whether versus how" test.

Ultimately, it's not clear if the Tax Court would classify section 707(a)(2)(A) as a "whether" statute or a "how" statute. But under either classification, section 707(a)(2)(A) should not negate the benefits of the fee waiver strategy. If the statute were treated as a "whether" statute, that would mean that the Tax Court would decline to apply the phantom regulations needed to negate the fee waiver strategy. And if the statute were treated as a "how" statute, that would simply mean that section 707(a)(2)(A) implemented the section 707(a)(1) general rule, under which a private equity firm would not be treated as an outsider.[74] Viewed this way, the "whether versus how" test would not lead the Tax Court to apply section 707(a)(2)(A) adversely against a private equity firm. But the "whether versus how" test itself suffers from inconsistencies,[75] so it's difficult to firmly predict how

71. This Subpart mentions legislative history because the Tax Court frequently looks to that material, and the focus is on how the Tax Court would interpret section 707(a)(2)(A). But as a general matter, legislative history reflects a dubious source of legislative intent, notwithstanding its frequent use by many courts. *See generally* ANTONIN SCALIA, A MATTER OF INTERPRETATION: FEDERAL COURTS AND THE LAW 29–37 (Amy Gutmann ed., 1997).

72. *See* S. REP. NO. 169, at 226–30 (1984) (explaining changes made by section 707(a)(2)(A)); *see also* BITTKER & LOKKEN, FEDERAL TAXATION OF INCOME, *supra* note 38, § 89.1 n.8 (concluding that section 707(a)(2)(A) "effectively overruled" *Pratt*). In one case, the Tax Court explicitly indicated that a related statute, I.R.C. § 707(a)(2)(B), was intended to change existing law under section 707(a)(1). *See* Jacobson v. Commissioner, 96 T.C. 577, 589 (1991) (rejecting the IRS's argument that section 707(a)(2)(B) reflects "a mere 'recodification' of preexisting law").

73. *See* S. REP. NO. 169, at 224–25 (1984).

74. Section 707(a)(2) applies only on a factual finding that a partner acts as an outsider. *See* I.R.C. § 707(a)(2)(A)(iii). But under *Pratt*, a partner's performance of the partnership's core services reflects partner activities, not outsider activities.

75. *See infra* note 76.

section 707(a)(2) would be applied under that test, or whether the Tax Court would even apply that test.[76]

The third factor, relating to whether section 707(a)(2)(A) mandates regulatory action, poses a difficult question. Although its cases reflect confusion, the Tax Court generally will apply phantom regulations when a statute mandates Treasury rulemaking, but will not do so if the statute makes the promulgation of regulations discretionary.[77] A statute providing that the Secretary "shall" issue regulations would clearly reflect a mandatory instruction, whereas a statute using the word "may" would give the Secretary discretion.

Unfortunately, section 707(a)(2)(A)'s text does not provide any obvious indication of whether the Secretary must issue regulations or whether he may do so. The statute merely contemplates that its rule will apply "[u]nder regulations prescribed by the Secretary."[78] And, as the Supreme Court recently explained, the word "under" generally means "in accordance with."[79] This gives the impression that Congress *assumed* that regulations would be issued, not that Congress *demanded* their issuance. Under this reading, section 707(a)(2)(A) would reflect a discretionary delegation of regulatory authority.[80]

Section 707(a)(2)(A)'s effective date, however, may indicate that the statute reflects a mandatory delegation. In an uncodified provision of the Deficit Reduction Act of 1984,[81] Congress provided that section 707(a)(2)(A) would apply retroactively to transfers after February 29, 1984, a few months before the statute's enactment date. Without this provision, the Secretary could, under section 7805(b), choose to apply any regulations as of

76. In the Tax Court's only reviewed opinion on phantom regulations, *Francisco*, 119 T.C. at 322–23, the statute at issue (section 931(d)(2), as it then existed) expressly stated that regulations would determine "whether income is described" in section 931(a), such that the income would qualify for an exclusion related to U.S. possessions. Under any sensible application of a "whether versus how" test, the statute would qualify as a "whether" statute, given its plain language. But the Tax Court made no mention of the "whether versus how" test and analyzed the statute under different factors. *See infra* note 90.

77. *Cf.* DiStasio v. United States, 22 Cl. Ct. 36, 52 (1990) (reading Tax Court cases as allowing for phantom regulations for mandatory delegations only).

78. I.R.C. § 707(a)(2).

79. *See* Kirtsaeng v. John Wiley & Sons, Inc., 133 S. Ct. 1351, 1358–59 (2013).

80. *See, e.g.*, Dunlap v. United States, 173 U.S. 65, 73–76 (1899) (the statute that provided for alcohol tax rebates "under regulations to be prescribed by the secretary of the treasury" reflected discretionary delegation, because Congress left "the entire matter to the treasury department").

81. Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 591.

the date of the statute's actual enactment or even later, if he so decided.[82] But the uncodified provision eliminates this discretion.[83] This provision shows that Congress considered regulations under section 707(a)(2)(A) a high priority, and this suggests that the statute reflects a mandatory delegation of rulemaking authority.[84] After all, Congress probably would not have prescribed a retroactive effective date if it intended to leave the promulgation of the regulations to the Secretary's discretion. However, this interpretation rests on an uncodified provision, and it is not clear whether the Tax Court would treat section 707(a)(2)(A) as a mandatory delegation or whether the mandatory factor, standing alone, will justify phantom regulations.

It's also unclear what weight the Tax Court would give to the fourth factor, regarding legislative history. When a statute's legislative history provides clear recommendations regarding the contents of the Treasury's regulations, the Tax Court may apply phantom regulations consistent with that history. For example, in *International Multifoods v. Commissioner*, the Tax Court addressed whether section 865(j)(1), which directs the Secretary

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82. Under section 7805(b) as it existed at the time of section 707(a)(2)(A)'s enactment, the Secretary enjoyed the authority to "prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect." *See* I.R.C. § 7805(b) (1984). Under current section 7805(b), which applies to statutes enacted on or after July 30, 1996, *see* Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1452 (1996), regulations may be issued with retroactive effect in only limited circumstances.

83. But for section 707(a)(2)(A)'s special effective date, a taxpayer could potentially challenge the Secretary's decision to retroactively apply section 707(a)(2)(A) regulations regarding services transactions. *See* Snap-Drape, Inc. v. Commissioner, 98 F.3d 194, 202 (5th Cir. 1996) ("Although we have noted that regulations generally will have retroactive effect, the failure to limit a regulation to prospective application only is nevertheless reviewable for an abuse of discretion."). The statutory effective date closes off this potential challenge.

84. One might argue that the effective date renders section 707(a)(2)'s delegating language meaningless. Under this potential line of reasoning, section 707(a)(2) is self-executing on enactment because Congress provided an effective date, and the language stating that section 707(a)(2)(A)'s rules apply "[u]nder regulations prescribed by the Secretary" could be dismissed as mere surplusage. This line of reasoning, however, would commit a cardinal sin of statutory interpretation—failing to give each word in a statute effect. *See* Cooper Indus., Inc. v. Aviall Servs., Inc., 543 U.S. 157, 167 (2004) (discussing "the settled rule that we must, if possible, construe a statute to give every word some operative effect"). Additionally, if a court concluded that the mere specification of an effective date nullified delegating language, the consequences would be far-reaching and possibly absurd. Many statutes both in and out of the tax law provide a specific effective date, and Congress might be surprised to learn that its delegations to various agencies could be ignored simply because the legislature specified when the regulations it contemplated would go into effect.

to issue source rules relating to losses from personal property sales, could operate in the absence of regulations.[85] In holding that it could, the Tax Court took guidance from the statute's legislative history and the Joint Committee on Taxation's (JCT) post-enactment explanation, which described the regulations that the Treasury should promulgate.

Although the Senate Finance Committee provided detailed recommendations for regulations under section 707(a)(2)(A), its guidance does not specifically address character-conversion transactions. The Senate Finance Committee expressed primary concern with transactions under which the partnership uses Subchapter K to avoid the section 263 capitalization requirements, and the fee waiver strategy does not implicate that concern.[86] Thus, many of the report's statements seem inapposite.

At the same time, the report recommends that the Secretary establish a general multifactor test, focusing on entrepreneurial risk, which apparently reaches beyond section 263 matters.[87] Consequently, the Tax Court could draw from this legislative history and the JCT's post-enactment explanation of section 707(a)(2) and could examine the fee waiver strategy under the principles described in those materials. However, this inquiry would be far more complex than the relatively straightforward analysis required in *International Multifoods*, and the Tax Court might prefer to stick to its test in *Pratt* rather than conjure phantom regulations.[88]

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85. Int'l Multifoods Corp. v. Commissioner, 108 T.C. 25 (1997).

86. *See* Campbell v. Commissioner, 943 F.2d 815, 822 (8th Cir. 1991) ("This exception was enacted to prevent partnerships from using direct allocations of income to individuals, disguised as service partners, to avoid the requirement that certain expenses be capitalized."). In its post-enactment explanation of section 707(a)(2)(A), the JCT also referred to congressional concerns with character shifting. *See* STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 224 (Comm. Print 1984) ("[I]f a service-providing partner was allocated a portion of the partnership's capital gains in lieu of a fee, then the effect of the allocation/distribution will be to convert ordinary income (compensation for services) into capital gains."). However, even if committee materials reflect an appropriate tool to guide the interpretation of a statute (a principle with which this author disagrees), post-enactment materials receive no weight since they did not exist when Congress passed the statute and thus could not inform legislators' understanding. *See* United States v. Woods, 134 S.Ct. 557, 568 (2013) (flatly and unanimously rejecting use of post-enactment JCT explanations as guide to legislative intent).

87. *See also* H.R. REP. NO. 98-361, at 861 (1984) (Conf. Rep.) (noting that, unlike the House's version of section 707(a)(2)(A), the Senate's version was not limited to partnership payments that would have to be capitalized).

88. The report also contemplates "that the Secretary may describe other factors that are relevant in evaluating whether a purported allocation and distribution should be respected." *See* S. REP. NO. 169, at 226–28 (1984). Thus, if the Tax Court

Nonetheless, one gets the general impression that the Tax Court stands ready to apply phantom regulations when there is some legislative history with which to work. Thus, while the first three Tax Court factors may not support phantom regulations, the legislative history factor could very well overcome those. Additionally, some Tax Court opinions seem to widely embrace phantom regulations without qualification.[89] But the Tax Court has yet to articulate a single coherent or consistent approach to phantom regulations, and its only reviewed opinion on the subject raises more questions than it answers.[90] Consequently, uncertainty about the Tax Court's approach necessarily lingers.

2. The Seventh Circuit's Clarity Standard

Only one circuit court has expressly approved of phantom tax regulations,[91] although it did so with significant reservations. In *Pittway v.*

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decided to hop into the Secretary's shoes and apply phantom regulations, it might not only have to apply the factors stated in the report, but also promulgate new ones.

89. *See, e.g.*, Int'l Multifoods Corp. v. Commissioner, 108 T.C. 579, 587 (1997) ("It is well established that the absence of regulations is not an acceptable basis for refusing to apply the substantive provisions of a section of the Internal Revenue Code.").

90. In *Francisco*, *supra* note 76, the Tax Court treated section 931(d)(2), as it then existed, as self-executing. Section 931(d)(2) directed the Secretary to issue regulations determining whether income qualified for the exclusion provided by section 931(a). Both the IRS and the taxpayer agreed that the statute could operate without regulations, but Judge Foley, writing in dissent, believed that it could not. To justify its position in light of Judge Foley's criticisms, the Tax Court focused heavily on the taxpayer equity and legislative history factors. *See* Francisco v. Commissioner, 119 T.C. 317, 322–325 (2002), *aff'd on other grounds*, 370 F.3d 1228 (D.C. Cir. 2004). The opinion does not indicate whether the legislative history, the beneficial nature of the statute, and the Commissioner's concession are all required for the Tax Court to treat a statute as self-executing, or whether any single one of those factors suffices. The D.C. Circuit, in affirming the Tax Court, provided no further clarification, and instead expressly reserved on the phantom regulations issue. *See Francisco*, 370 F.3d at 1230, n.1.

91. The Ninth, Tenth, and D.C. Circuits have each applied phantom regulations without expressing any official position on them. Regarding the Ninth Circuit, one of its unpublished, nonprecedential opinions affirms a Tax Court opinion rejecting phantom regulations, *see Alexander v. Commissioner*, 95 T.C. 467 (1990), *aff'd without published opinion sub nom. Stell v. Commissioner*, 999 F.2d 544 (9th Cir. 1993), and another one of its unpublished, nonprecedential opinions approves of phantom regulations, *see Temsco Helicopters, Inc. v. United States*, 409 F. App'x 64 (9th Cir. 2010). The Tenth Circuit applied phantom regulations when both parties accepted that the statute was self-executing, but some language in the opinion suggests that phantom regulations cannot apply adversely against a taxpayer.

United States, the Seventh Circuit addressed whether the taxpayer, a user of butane, was liable for an excise tax imposed by section 4661(a). That section, by its terms, applies a tax on the manufacturers of various chemicals, not the users. Section 4662(b)(1), however, provides that "[u]nder regulations prescribed by the Secretary," a user of butane, like Pittway, could be treated as the manufacturer of that chemical and hence be liable for the section 4661(a) excise tax.[92]

The taxpayer consequently argued that it could not be held liable for the excise tax unless regulations were issued. The Seventh Circuit, however, rejected that argument. It acknowledged that the statute referred to "regulations that do not exist" but ultimately concluded that the rule Congress had in mind was clear—users of butane should be subject to tax.[93] Given this clarity, the taxpayer was liable for the excise tax imposed by section 4661(b)(1). However, the court concluded that "[i]n a statute less clear on its face, failure to promulgate regulations as Congress orders could result in a provision not enforceable due to the Secretary's failure."[94]

Section 707(a)(2)(A) does not meet the Seventh Circuit's clarity standard.[95] Unlike section 4662(b)(1), which authorizes a relatively

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See Estate of Hoover v. Commissioner, 69 F.3d 1044, 1047 (10th Cir. 1995) ("[T]he Commissioner concedes the required regulations have not yet been promulgated. That being the case, there exists no basis to justify a redefinition of 'fair market value' [as the Commissioner contends]."). The D.C. Circuit, like the Tenth Circuit, applied phantom regulations when no party challenged the propriety of them and expressly reserved its opinion on whether such an approach was appropriate. *See Francisco*, 370 F.3d at 1230, n.1. The Eleventh Circuit has affirmed two Tax Court opinions that applied phantom regulations. However, the Eleventh Circuit's affirmances are issued in unpublished, nonprecedential form and contain minimal text. Additionally, in both cases, the parties did not dispute whether phantom regulations should apply. Thus, it's impossible to tell where the Eleventh Circuit stands from these opinions. *See* Breakell v. Commissioner, 996 F.2d 1231 (11th Cir. 1993) (unpublished table decision), *aff'g in relevant part* 97 T.C. 282 (1991); Traylor v. Commissioner, 959 F.2d 970 (11th Cir. 1992) (unpublished table decision), *aff'g* 59 T.C.M. (CCH) 93, T.C.M. (P-H) ¶ 90, at 132 (1990).

92. Section 4662(b)(1) grants the Secretary the authority to limit the taxation of butane to circumstances where it is used for non-fuel-related purposes, in which case the user would be subject to the excise tax. *See* I.R.C. § 4662(b)(1) ("Under regulations prescribed by the Secretary, methane or butane shall be treated as a taxable chemical only if it is used otherwise than as a fuel or in the manufacture or production of any motor fuel, diesel fuel, aviation fuel, or jet fuel (and, for purposes of section 4661(a), the person so using it shall be treated as the manufacturer thereof).").

93. Pittway Corp. v. United States, 102 F.3d 932, 936 (7th Cir. 1996).

94. *Id.*

95. The Seventh Circuit previously applied phantom regulations in First Chicago Corp. v. Commissioner, 842 F.2d 180 (7th Cir. 1988). However, in that

straightforward regulation that treats a user of a chemical as the manufacturer of that chemical, section 707(a)(2)(A) authorizes regulations dealing with a complex factual scenario involving the performance of services, partnership allocations, and partnership distributions. Additionally, the statute requires a finding that the partner acted as an outsider, which (if the Senate Finance Committee's recommendations were followed) would require the application of a complex multifactor test focusing on entrepreneurial risk. And on top of all this, the fee waiver strategy itself is wildly complicated—the description in Part II only scratches the surface of the strategy's mechanics. Consequently, if the IRS argued that phantom regulations should apply under section 707(a)(2)(A), the Seventh Circuit would reject that argument.

B. Fee Waivers Under the "Plain Meaning" Approach

Whereas the phantom approach can require a balancing of various factors, the plain meaning approach looks to statutory language to determine whether a statute operates without regulations. That is, if a statute refers to regulations that will implement a rule, the court will apply the rule only if regulations actually exist. Under this approach, section 707(a)(2)(A) would not be treated as self-executing. Its provisions apply "[u]nder regulations prescribed by the Secretary," and none have been issued.[96]

An old and widely overlooked Supreme Court case nicely illustrates the plain meaning approach. In *Dunlap v. United States*, [97] the statute at issue provided that "under regulations to be prescribed by the secretary of the treasury,"[98] persons who used alcohol for artistic purposes could claim a rebate for alcohol taxes paid.[99] However, the Secretary did not issue any regulations under the statute, citing enforcement concerns. Notwithstanding the absence of regulations, the taxpayer filed a rebate claim, which the tax collector rejected.

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case, both parties agreed to apply phantom regulations, so the court did not pass on their validity. *See id.* at 182. Consequently, *Pittway*'s clarity standard probably best reflects the Seventh Circuit's approach to phantom regulations.

96. More precisely, the Treasury has reserved on providing regulations regarding services transactions under section 707(a)(2)(A). *See* Reg. § 1.707-2. Given that the Treasury has expressly reserved on providing guidance under section 707(a)(2)(A), it would be especially awkward for a court to jump in and provide guidance that the agency itself believes needs more time to develop.

97. 173 U.S. 65, 70 (1899). Although a Supreme Court case addressing phantom regulations should be relevant to the lower courts (to put it mildly), none of the various cases dealing with phantom regulations even mentions it. Taxpayers and the government frequently address the phantom regulations issue only in passing, so *Dunlap* probably has not been brought to a court's attention.

98. Act of Aug. 27, 1894, § 61, 28 Stat. 509, 567.

99. *Dunlap*, 173 U.S. at 70.

The controversy ultimately reached the Supreme Court, and the Court agreed with the tax collector. In the Court's view, "congress required that the thing itself [the use of alcohol for artistic purposes] should be done under official regulations," and those regulations, which were "needed in order to carry the section into effect,"[100] did not exist. Additionally, Congress granted the Secretary, not the judiciary, the discretion to provide tax rebates, and the Court had no authority to "perform executive duties."[101] There was "no ground which would justify a departure from the plain words employed," and without regulations, the taxpayer could not secure a rebate.[102]

The Supreme Court's nontax cases similarly apply a plain meaning approach and reject phantom regulations. In *Norton v. Southern Utah Wilderness Alliance*, [103] for example, the Court examined a statute that called for the Federal Communications Commission "to establish regulations to implement"[104] special requirements related to telecommunications carriers. The Court concluded that, although under the Administrative Procedure Act (APA) a private party could file a suit compelling the FCC to issue regulations, a court could not issue a "judicial decree setting forth the content of those regulations."[105]

Consistent with that holding, the Court in *California Bankers Association v. Shultz*, rejected as premature a constitutional challenge to a statute that called for the Treasury to establish reporting requirements for some domestic financial transactions.[106] A three-judge district court had invoked phantom regulations in evaluating and accepting the constitutional challenge, but the Supreme Court took a different approach.[107] According to the Court, the question was "not what sort of reporting requirements might have been imposed by the Secretary under the broad authority given him," as the district court had thought, "but rather what sort of reporting requirements

100. *Id.* at 76.

101. *Id.* at 72 (quoting United States v. McLean, 95 U.S. 750, 753 (1877)).

102. *Id.* at 73.

103. Norton v. S. Utah Wilderness Alliance, 542 U.S. 55, 65 (2004).

104. 47 U.S.C. § 251 (2012).

105. *Norton*, 542 U.S. at 65.

106. Cal. Bankers Ass'n v. Shultz, 416 U.S. 21 (1974). *California Bankers* involved numerous parties who presented various challenges to the Bank Secrecy Act. This discussion is limited to the challenges presented by certain depositors who argued that Title II of the Bank Secrecy Act, which authorizes regulations establishing reporting requirements for domestic financial transactions, unconstitutionally applied to them, even though no regulations had been issued concerning their transactions. *See id.* at 37–41, 56–59, 63–70. The other challenges did not touch on issues related to phantom regulations.

107. *Id.* at 69–70 (concluding that the depositor-challengers lacked standing and the Court could not consider their challenge).

he did in fact impose under that authority."[108] Consequently, without regulations, the statute was not "self-executing,"[109] and the Court reversed the decision below.

Several circuit courts have also applied a plain meaning approach and reject phantom regulations.[110] For example, in a recent controversy over the so-called decoupling amendment to section 3121(a), which grants the Secretary the regulatory authority to adopt a definition of "wages" under the payroll tax regime that differs from the definition under the income tax regime,[111] the Sixth Circuit and Federal Circuit each rejected phantom regulations. In arguing that the amendment is self-executing, the government pointed to committee reports showing that legislators wanted to immediately decouple the payroll tax definition of wages from the income tax definition. However, the decoupling amendment merely refers to regulations allowing for that difference, and the courts rejected the government's arguments: "[T]he actual language Congress used . . . did not achieve its intended effect as expressed in the legislative history."[112] To decouple the payroll tax definition from the income tax definition, the Treasury must issue

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108. *Id.* at 64.

109. *Id.*

110. For other tax cases rejecting phantom tax regulations, see, for example, *Hillman v. Commissioner*, 263 F.3d 338, 343 (4th Cir. 2001) (reversing the Tax Court after it applied phantom regulations to lift some restrictions on the deductibility of passive losses, finding that a mere delegation of regulatory authority provided no help to the taxpayers); *Kleine v. United States*, 539 F.2d 427, 432–33 (5th Cir. 1976) (rejecting phantom regulations regarding section 6325(c)); *Cooper v. United States*, No. 3:97CV502-V, 2000 U.S. Dist. LEXIS 8988 (W.D. N.C. May 17, 2000) ("The fact that legislative history indicates that Treasury regulations could be promulgated . . . is of no significance. [The statute is] simply not subject to expansion absent determination by the Secretary . . . and the resulting issuance of a treasury regulation."); *In re Rueter*, 158 B.R. 163, 166 (1993) (rejecting an invitation to apply a phantom regulation because the statute "expressly empowered only the Secretary of the Treasury" to issue regulations).

111. The decoupling amendment grants regulatory authority to overturn *Rowan Cos. v. United States*, 452 U.S. 247 (1981), which essentially held that an item excluded from "wages" under the income tax withholding regime generally enjoys a similar exclusion under the payroll tax withholding regime. *See* I.R.C. § 3121(a) ("Nothing in the regulations prescribed for purposes of chapter 24 (relating to income tax withholding) which provides an exclusion from 'wages' as used in such chapter shall be construed to require a similar exclusion from 'wages' in the regulations prescribed for purposes of this chapter.").

112. *In re* Quality Stores, Inc., 693 F.3d 605, 613 (6th Cir. 2012), *rev'd on other grounds*, 2014 WL 1168968 (U.S. 2014). The government wisely abandoned its phantom regulation arguments in the Supreme Court, so the Court did not address whether Section 3121(a) could operate without regulations.

regulations,[113] and legislative history materials cannot overcome this "plain reading of the statute."[114]

Also, like the Supreme Court, the circuit courts have routinely rejected phantom regulations in the nontax context.[115] For example, in *Phillips v. Amoco Oil*,[116] the Eleventh Circuit considered whether an ERISA statute regarding retirement plans operated without regulations. Under the statute, when one business acquires another business and creates a new retirement plan, the acquiring business must give employees credit for service to the old business only "to the extent provided in regulations"[117] issued by the Secretary of the Treasury. In *Phillips*, various employees of the Northern Propane Gas Company relied on this statute (under which no regulations had been issued) and argued that the company's retirement plan improperly failed to give them credit for their years of service with their prior employer. However, the court rejected the employees' arguments. The employees had essentially asked that the reference to regulations "be read out of the statute,"[118] and the court had no basis for doing so. The statute's language reflected "Congressional intent to leave this question of policy to the Secretary of the Treasury,"[119] and the court would not apply phantom regulations.

Under a plain meaning approach, section 707(a)(2)(A) cannot apply without regulations. Like the statute at issue in *Dunlap*, section 707(a)(2)(A) applies "[u]nder regulations prescribed by the Secretary," and, according to the Supreme Court, that language makes regulations a condition to the statute's operation. Nontax Supreme Court cases similarly express disapproval of phantom regulations, as do tax and nontax cases decided by various circuit courts. Consequently, if the IRS asserted section 707(a)(2)(A) against the fee waiver strategy, it would face a significant rebuke in any jurisdiction that adopted the plain meaning approach.

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113. *See CSX Corp.*, 518 F.3d at 1344 ("The problem is that, although the committee reports clearly state the intention to decouple the term 'wages' for purposes of income tax withholding and FICA, the statutory language does not have that effect.").

114. *Quality Stores*, 693 F.3d at 614, *rev'd on other grounds*, 2014 WL 1168968 (U.S. 2014).

115. *See, e.g.*, Gholston v. Hous. Auth. of Montgomery, 818 F.2d 776, 785–86 (11th Cir. 1987) (declining to apply phantom regulations regarding a federal housing statute).

116. 799 F.2d 1464 (1986). *Accord* Monarch Cement Co. v. Lone Star Indus., Inc., 982 F.2d 1448, 1456 n.9 (10th Cir. 1992).

117. 29 U.S.C. § 1060(b)(2) (2012).

118. *Phillips*, 799 F.2d at 1471.

119. *Id.*

C. *Applying* Mayo *to Phantom Regulations*

The case law reflects "considerable debate as to how far a court may go in supplying 'phantom legislative regulations' not adopted by the Secretary."[120] The Tax Court has adopted various factors, some inscrutable, to justify those regulations. Other courts, including the Seventh Circuit, have followed the Tax Court's lead and have added further nuances. Yet other courts, including the Supreme Court, adopt a plain meaning approach and reject phantom regulations.

This writer has previously argued that the plain meaning approach best comports with the APA, the Code, and the relevant Supreme Court cases.[121] Those arguments need not be repeated here. Instead, this Subpart will focus on how the Supreme Court's rejection of tax exceptionalism in *Mayo* affects phantom regulations and will argue that that case vitiates whatever force the Tax Court and the Seventh Circuit's approaches may have once had. Consequently, after *Mayo*, section 707(a)(2)(A) reflects an exceptionally weak line of attack on the fee waiver strategy.

In *Mayo*, the Supreme Court settled a long-running controversy regarding the level of deference applicable to Treasury regulations.[122] Some lower courts had followed the Court's decision in *National Muffler Dealers Ass'n v. United States*,[123] which adopted a multifactor test to determine whether the Treasury's regulatory construction of an ambiguous statute enjoyed deference. Other courts followed the subsequently developed *Chevron* standard, under which the "sole question . . . is 'whether the agency's answer is based on a permissible construction of the statute.'"[124]

The Court, concluding that the *Chevron* doctrine applied to Treasury regulations, rejected any claims of tax exceptionalism. There was no reason to "carve out an approach to administrative review good for tax law only."[125] Just the opposite was true—the Court had "expressly '[r]ecogniz[ed] the importance of maintaining a uniform approach.'"[126] And because

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120. Principal Life Ins. Co. v. United States, 95 Fed. Cl. 786, 801, n.34 (2010).

121. *See* Grewal, *Substance Over Form*, *supra* note 6, at 60–79.

122. *See* Bankers Life & Cas. Co. v. United States, 142 F.3d 973, 982–83 (7th Cir. 1998) (describing different judicial approaches to regulatory deference standards).

123. Nat'l Muffler Dealers Ass'n v. United States, 440 U.S. 472, 477 (1979).

124. Mayo Found. for Med. Educ. & Research v. United States, 131 S. Ct. 704, 712 (2011) (quoting Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 843 (1984)).

125. *Id.* at 713.

126. *Id.* (alteration in original) (quoting Dickinson v. Zurko, 527 U.S. 150, 154 (1999)).

administering the tax laws involved "interpretive choices for statutory implementation at least as complex as the ones made by other agencies," no tax-specific deference standard was warranted.[127]

Mayo largely kills tax exceptionalism—no longer can the Treasury validly claim an exemption from generally applicable administrative law principles.[128] And with the death of tax exceptionalism, phantom tax regulations evaporate. That is, in nontax cases, numerous courts, including the Supreme Court, apply the plain meaning approach and flatly hold that courts cannot implement statutes that call for regulations.[129] Instead, persons adversely affected by an agency's failure to promulgate regulations must compel agency action under the APA.[130]

Admittedly, the Supreme Court in *Mayo* focused on administrative law doctrines related to deference standards and did not directly address phantom regulations.[131] However, the Court's hostility to tax-specific exceptions from general administrative law doctrines seems quite clear. In fact, lower courts have already recognized that *Mayo*'s rejection of tax-exceptionalism extends well beyond matters related to deference standards.[132]

That being said, the Court in *Mayo* acknowledged that a departure from general administrative principles would be warranted if some appropriate justification were offered. (In *Mayo*, the taxpayer offered none.) Consequently, if there is some special justification for phantom tax

127. *Id.* at 707.

128. *See also* Cohen v. United States, 650 F.3d 717, 723 (D.C. Cir. 2011) (en banc) ("The IRS is not special . . . [and] no exception exists shielding it—unlike the rest of the Federal Government—from suit under the APA.").

129. *See supra* Part III.B.

130. *See, e.g.*, Arizona v. Inter Tribal Council of Ariz., Inc., 133 S. Ct. 2247, 2259–60 (2013) (describing potential actions under APA section 706(1) to compel the Election Assistance Commission to act).

131. Of course, the phantom regulations problem can be framed as a deference question: To what extent must courts defer to regulations that do not exist? Framed this way, the phantom regulations problem would fit neatly into the general analytical frameworks regarding deference issues. However, courts have generally not addressed phantom regulations through the deference frameworks, probably because it's a bit awkward to ask whether to defer to nonexistent law. Instead, courts have viewed the issue as one of statutory construction.

132. *See Cohen*, 650 F.3d at 736 (citing *Mayo* in rejecting invitation to create special ripeness rule for the IRS under the APA); Antioco v. Commissioner, 105 T.C.M. (CCH) 1234, 1240, 2013 T.C.M. (RIA) 2013-035, at 339 (citing *Mayo* to support application of general *Chenery* doctrine regarding review of collection due process cases); *cf.* Koprowski v. Commissioner, 138 T.C. 54, 67 (2012) (citing *Mayo* to support uniform approach to federal common law of judgments); Dominion Res., Inc. v. United States, 681 F.3d 1313, 1319 (Fed. Cir. 2012) (applying the general *State Farm* doctrine to support invalidation of a Treasury regulation).

regulations, the IRS could apply section 707(a)(2)(A) notwithstanding the absence of regulations. However, a search for a justification proves fruitless.

Starting with the text of the Code,[133] none of its provisions can plausibly sanction phantom regulations or overcome the APA's express-statement rule.[134] In fact, the text of the Code shows that Congress knowingly conditions the operation of some statutes on the promulgation of regulations. Section 7807(a), for example, explicitly acknowledges that a code provision may "depend[] for its application upon the promulgation of regulations."[135] Other provisions similarly assume that a statute that calls for regulations lacks effect until regulations are issued.[136]

One might argue, however, that the potential for abuse raises special concerns in the tax context, and that this policy concern justifies phantom regulations. If regulatory provisions in the tax code were not self-executing, this argument might go, taxpayers could freely take advantage of loopholes

133. Those interested in congressional committee materials probably would find that those materials do not support treating section 707(a)(2)(A) as self-executing. The Senate Report and the JCT's post-enactment explanation repeatedly acknowledge that *regulations* will provide a multifactor test to implement section 707(a)(2)(A). *See* S. REP. NO. 169 (Vol. I) 98th Cong., 2d Sess., at 226–28 (1984) (referring to anticipated Treasury regulations and making recommendations regarding their contents); STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 226–31 (Comm. Print 1984). The conference report generally expresses its agreement with the Senate Report. *See* H.R. REP. NO. 98-861 (1984) (Conf. Rep.). Thus, the understanding of congressional staffers reflects what Congress itself said in the statute—the Secretary would establish the rules necessary to implement section 707(a)(2)(A). Of course, there's no requirement that, to give a statute its plain meaning, legislative history materials must be located that parrot the statute. *See, e.g.*, Harrison v. PPG Indus., Inc., 446 U.S. 578, 592 (1980) ("[I]t would be a strange canon of statutory construction that would require Congress to state in committee reports or elsewhere in its deliberations that which is obvious on the face of a statute."); Morales v. Trans World Airlines, Inc., 504 U.S. 374, 385, n.2 (1992) ("[L]egislative history need not confirm the details of changes in the law effected by statutory language before we will interpret that language according to its natural meaning.").

134. Under 5 U.S.C. § 559 (2012), a later statute trumps the APA only "to the extent that it does so expressly." Thus, to authorize phantom regulations (and overcome the APA's notice and comment rulemaking requirements), a tax statute would have to make an express statement of some sort. *See generally* Amandeep S. Grewal, *Legislative Entrenchment Rules in the Tax Law*, 62 ADMIN. L. REV. 1011 (2010).

135. I.R.C. § 7807(a).

136. *See, e.g.*, I.R.C. § 179D(f) (providing statutory interim rules until the Secretary issues regulations needed to implement partial deductions for energy efficient commercial buildings).

while the Secretary struggled to catch up. Notice and comment rulemaking takes time, and if the Secretary had to follow those procedures to implement statutes, taxpayers could raid the Treasury while the Secretary formulated the relevant regulations.

Under section 7805(b)(3), however, the Secretary enjoys the authority to issue regulations retroactively to address abuse. Thus, wholly aside from the various civil and criminal penalties that apply to improper tax avoidance or tax evasion, taxpayers must recognize that the Secretary enjoys the authority to retroactively issue regulations to deny claimed benefits regarding an abusive tax shelter. And even in close cases (when abuse arguably is not present), section 7805(b)(1)(C) allows the Secretary to retroactively issue any regulation when he has previously explained its contents in a notice. These special provisions trump the APA's anti-retroactivity rule and grant the Secretary of the Treasury far more authority to issue retroactive regulations than that typically enjoyed by an agency head.[137] The "abuse" argument thus actually cuts *against* phantom tax regulations, not for them. An agency without powers to retroactively address abuse would have a much stronger policy argument for phantom regulations than does the Treasury.

Additionally, the death of phantom regulations will not, on the whole, jeopardize tax collections. Although under a plain meaning approach the IRS could not (absent regulations) enforce taxpayer-adverse statutes like section 707(a)(2)(A), taxpayers would not be able to claim benefits under taxpayer-friendly statutes that depend on regulations. The money so saved could more than offset any amounts lost through the temporary inability to enforce anti-abuse statutes.

Also, if the plain meaning approach really did leave the door open for abuse, Congress could just make the anti-abuse rule immediately effective, rather than condition its operation on regulations. For example, if Congress wanted to immediately adopt the entrepreneurial risk test, nothing would prevent it from enacting the Senate Finance Committee's recommendations. But the general administrative law approach recognizes that when Congress delegates the promulgation of anti-abuse rules to an agency, that deliberate choice should be respected.

One might nonetheless argue that the tax system's annual filing and reporting requirements present burdens not seen in other regulatory regimes, and that these burdens justify phantom tax regulations. Under this argument, delays by the Treasury create more significant burdens than those caused by the Environmental Protection Agency, for example. Consequently, taxpayers need phantom tax regulations to complete their tax returns.

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137. *See* Georgetown Univ. Hosp. v. Bowen, 821 F.2d 750, 757 (D.C. Cir.1987), *aff'd on other grounds*, 488 U.S. 204 (1988) ("[T]he APA requires that legislative rules be given future effect only.").

This argument, however, suffers from multiple problems. First, it exaggerates the burdens of Treasury delay and ignores the costs associated with delays by other agencies.[138] Regulatory inaction by any agency can impose burdens on the public, and several agencies require periodic filings.[139] Additionally, it's easy to find areas where the absence of nontax regulations implicates far greater concerns than those associated with the absence of tax regulations. In the past year, for example, the national media has extensively covered the problems posed by the Securities & Exchange Commission's failure to issue regulations related to so-called crowdfunding,[140] which would facilitate small businesses' access to capital.[141] This failure to issue regulations poses burdens substantially greater than any uncertainty caused by the failure to issue regulations under section 707(a)(2)(A) or a similarly narrow provision.

Additionally, the absence of tax regulations will rarely (if ever) prevent a taxpayer from filing a tax return because the vast majority of code sections provide rules that do not depend on regulations. And even when Congress adds a grant of regulatory authority to a statute, the remaining part of the statute can usually operate until regulations are issued. Section 707, for example, existed without section 707(a)(2)(A)'s grant of regulatory authority for nearly three decades. It's thus hard to believe that, without phantom regulations, a taxpayer or a court cannot determine whether an

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138. Interested parties frequently petition the Environmental Protection Agency to act, recognizing the potential costs associated with agency delays. *See, e.g.*, Mass. v. EPA, 549 U.S. 497 (2007).

139. The Securities and Exchange Commission, for example, imposes disclosure obligations on many companies. *See generally* Alan J. Berkeley, *Some FAQs and Answers About Corporate Disclosure*, SU041 ALI-ABA 305 (2013).

140. *See* J.D. Harrison, *Crowdfunding Delays, SEC Silence Spark Hostility on Capitol Hill*, WASH. POST, Apr. 8, 2013, http://www.washingtonpost.com/business/on-small-business/crowdfunding-delays-sec-silence-spark-hostility-on capitol-hill/2013/04/08/655715d2-a090-11e2-9c03-6952ff305f35_story.html; Angus Loten, *Stalled Crowdfunding Rules Leave Business Plans on Ice*, WALL ST. J., Dec. 13, 2012, at B1; *see also* 15 U.S.C. § 77d(a)(6) (2012) (providing crowdfunding exemption); 15 U.S.C. § 77d-1 (2012) (describing various matters that require regulatory implementation).

141. *See* Dina El Boghdady, *'Crowdfunding' Trend Poised to Make Mark on U.S. Investing Landscape*, WASH. POST, Apr. 29, 2013, http://www.washingtonpost.com/business/economy/crowdfunding-breaks-into-us-investing-landscape/2013/2013/04/29/2b58fbe8-a829-11e2-a8e2-5b98cb59187f_story.html. The CROWDFUND Act was enacted as part of the Jumpstart Our Business Startups Act, Pub. L. No. 112-106, tit. III, 126 Stat. 306, 315 (2012). *See generally* Andrew A. Schwartz, *Crowdfunding Securities*, 88 NOTRE DAME L. REV. 1457 (2013).

allocation of partnership income must be treated as a payment to an outsider.[142]

One might nonetheless argue that the tax law is simply more important than other areas of law and that this justifies a special approach to phantom tax regulations. While there's no doubt that "taxes are the lifeblood of government"[143] (a trite but accurate phrase), issues related to phantom tax regulations do not implicate whether the government will collect the monies needed to survive. Phantom tax regulations generally relate to narrow, technical questions, like conflicts between the *Pratt* test and the entrepreneurial risk test. The resolution of those issues one way or another does not seriously threaten the fisc. Consequently, even if one believes that the Treasury is too important to be bound by the APA or general administrative law doctrines (a dubious proposition),[144] a tax-exceptional approach to phantom regulations would not be warranted.

In fact, safeguards like the APA's notice and comment process may be especially important in the tax context because "the power to tax involves the power to destroy,"[145] to use another trite but accurate phrase. That is, tax regulations, like tax statutes, determine how society allocates the burdens of supporting governmental functions.[146] For tax statutes, the Framers recognized the significance of these allocations and consequently required that tax bills originate in the House of Representatives.[147] This origination clause, the Framers believed, would further democratic participation and encourage political accountability, and help prevent the enactment of unjust taxes.[148] For tax regulations, observance of notice and comment procedures—rather than the issuance of phantom regulations—can serve similar purposes.

Some pending cases regarding the section 4261(a) transportation tax nicely illustrate how phantom regulations can subvert the democratic

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142. *See also, e.g.*, Egolf v. Commissioner, 87 T.C. 34, 44–46 (1986) (applying pre-section 707(a)(2)(A) law, including *Pratt*, to the partner-outsider question).

143. Bull v. United States, 295 U.S. 247, 259 (1935).

144. *See Cohen*, 650 F.3d at 723 (rejecting claims that the IRS is "special" under the APA).

145. McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 431 (1819).

146. *See generally* LEONARD E. BURMAN & JOEL SLEMROD, TAXES IN AMERICA: WHAT EVERYONE NEEDS TO KNOW 169–70 (2013).

147. U.S. CONST. art. I, § 7, cl. 1 ("All Bills for raising Revenue shall originate in the House of Representatives; but the Senate may propose or concur with Amendments as on other Bills.").

148. *See* Rebecca M. Kysar, *On the Constitutionality of Tax Treaties*, 38 YALE J. INT'L L. 1, 7–9 (2013) (discussing history and purposes of the origination clause).

principles embodied by the APA.[149] Under section 4261(a), passengers must pay a 7.5 percent excise tax on amounts paid for most air transportation. Under section 4291, the recipient of the payment (*i.e.*, the ticket seller), rather than the passenger, collects the tax and turns it over the government. However, Congress believed that in some circumstances, the carrier, rather than the ticket seller, should collect the transportation tax.[150] Consequently, under section 4263(c), Congress provided that, under regulations prescribed by the Secretary, the carrier must collect the tax when the ticket seller fails to do so.

The Secretary has issued no regulations under section 4263(c), but the IRS has successfully invoked that section to assess taxes and negligence penalties against various carriers.[151] The carriers have countered that without regulations, they are not liable to collect the transportation taxes—the ticket sellers are. The legislative history, they have argued, shows that Congress intended to make carriers only secondarily liable for the transportation tax and that, without regulations, the IRS cannot shift the tax collection burden from the ticket seller to the carrier.[152]

Although the litigation over section 4263(c) continues, the courts that have spoken on the issue have uniformly rejected the carriers' arguments.[153] For example, the Ninth Circuit, in an unpublished opinion, recited various Tax Court factors and held that section 4263(c) operates

149. *See* KENNETH CULP DAVIS, DISCRETIONARY JUSTICE: A PRELIMINARY INQUIRY 66 (1969) ("Rule-making procedure which allows all interested parties to participate is democratic procedure.").

150. Although air carriers frequently sell tickets directly to the public, third-party companies may also sell tickets to customers, as the cases regarding section 4263(c) show.

151. *See* Temsco Helicopters, Inc. v. United States, 409 F. App'x 64, 67–68 (9th Cir. 2010); Papillon Airways, Inc. v. United States, 105 Fed. Cl. 154 (2012) (applying phantom regulations under section 4263(c) and upholding application of negligence penalty); Sundance Helicopters, Inc. v. United States, 104 Fed. Cl. 1, 11 (2012) (applying phantom regulations; penalty issue pending); Schuman Aviation Co. Ltd. v. United States, 816 F. Supp. 2d 941 (D. Haw. 2011) (applying phantom regulations, but without discussion); *see also* T.A.M. 2003–14–028 (Apr. 4, 2003). The taxpayers in these cases have addressed the phantom regulations issue only briefly and have not presented arguments based on *Dunlap*, *Mayo*, and related authorities. *Sundance* and *Papillon* remain at the trial court level, and the Federal Circuit may eventually consider the phantom regulations issue presented in those cases. The Federal Circuit might be less hospitable to the government's position than the Court of Claims, given the Federal Circuit's recent rejection of phantom tax regulations in *CSX Corp. v. United States*, 518 F.3d 1328, 1343–44 (Fed. Cir. 2008).

152. *See, e.g.*, *Papillon Airways*, 105 Fed. Cl. at 163 (describing taxpayer's argument and legislative history).

153. *See id.*

without regulations.[154] The Court of Federal Claims has reached the same result, using an approach similar to *Pittway*'s and emphasizing the clarity of the statute's substantive language.[155]

The courts' application of phantom regulations in this context poses troubling issues. Section 4263(c) reflects the legislature's judgment that carriers should be liable for the transportation tax only under regulations (that is, once notice and comment procedures are followed). And if those procedures were followed, the carriers and other interested parties would be able to present policy arguments to the Treasury regarding the proper person liable for the transportation tax.[156] However, the courts' application of phantom regulations under section 4263(c) strips the carriers of their congressionally granted right to participate in the regulatory process. And the upholding of negligence penalties in this context seems especially harsh—a taxpayer should not face penalties for failing to comply with regulations that the Secretary has not bothered to issue.[157]

Returning to the main point, even if, under *Mayo*, any allegedly special features of the tax system should be taken into account, those features would not support phantom regulations. Although taxes are undoubtedly important, phantom regulations (on net) will not empty the federal coffers. And the imposition of a tax reflects one of the most powerful exercises of legislative power. Consequently, when Congress decides that the imposition of a tax or the loss of a tax benefit should occur under regulations, the Treasury should observe the notice and comment safeguards.

D. Summary

Section 707(a)(2)(A) has received considerable attention in the debate over the fee waiver strategy. Commentators readily argue that the statute can be used to attack the fee strategy, and at least one senior IRS official agrees.[158] As this Part has shown, however, the assertion of that statute runs into a major problem—the statute calls for regulations that do

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154. *See Temsco Helicopters*, 409 F. App'x at 67–68.

155. *Sundance Helicopters*, 104 Fed. Cl. at 10–11 (referring to both "whether versus how" test and *Pittway* test).

156. Sections 4261(a) and (d) actually make passengers, not ticket sellers or carriers, liable for the transportation tax. However, if a seller or carrier has an obligation to collect taxes but fails to do so, the seller or carrier faces a 100 percent penalty equal to the amount of tax that should have been withheld. *See* I.R.C. § 6672. Thus, as a practical matter, the obligation to collect the transportation tax translates to a liability for that tax.

157. *See Papillon Airways*, 105 Fed. Cl. at 164 ("Papillon has no reasonable cause defense and cannot escape liability for the negligence penalties.").

158. *See supra* note 63.

not exist. And several courts, including the Supreme Court, reject phantom regulations. Even under the criteria used by courts that embrace phantom regulations, it is doubtful, or at best unclear, whether section 707(a)(2)(A) would be treated as self-executing. Most important, the phantom approach cannot be reconciled with the Supreme Court's rejection of tax exceptionalism in *Mayo*. Commentators have thus overstated section 707(a)(2)(A)'s force.

Of course, section 707(a)(2)(A) does not present the only potential line of attack against the fee waiver strategy. Commentators have also suggested that section 707(c), as expanded by Revenue Ruling 81-300, can deny the tax benefits associated with the strategy. However, as the next Part shows, Revenue Ruling 81-300 should not enjoy any deference after *Mayo*.

IV. FEE WAIVERS AS GUARANTEED PAYMENTS

Section 707(c) generally provides that if a partner receives a payment for services, and that payment is "determined without regard to the income of the partnership," that payment will be treated as a payment to an outsider. If income allocated to a private equity firm's waiver interest were in fact treated as a "guaranteed payment" under this statute, that income would not qualify for long-term capital gain treatment.[159] Consequently, if section 707(c) applies to the fee waiver strategy, the claimed tax benefits would be denied.[160]

However, like the section 707(a)(2)(A) argument, the section 707(c) argument suffers from problems. Section 707(c), on its face, provides ordinary income treatment only to payments "determined without regard to the income of the partnership." But a fund makes allocations to a waiver interest only if it earns income. Consequently, section 707(c) cannot apply to the fee waiver strategy.

One commentator suggests, with various caveats, that Revenue Ruling 81-300's interpretation of section 707(c) might support a challenge to the waiver strategy in some circumstances.[161] In Revenue Ruling 81-300, the

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159. Section 707(c) would not directly recharacterize an income allocation. Rather, the related distribution would be treated as a section 707(c) payment, and the income allocation would be removed from the distributive share regime. For ease of exposition, this Part will generally refer to the tax treatment of gross income allocations, rather than to the tax treatment of distributions determined by reference to gross income allocations.

160. *See* V&E, *Management Fee Waivers*, *supra* note 30 (noting potential application of section 707(c)); *cf.* Abrams, *Carried Interests*, *supra* note 38, at 201–02 (embracing application of Revenue Ruling 81-300 to gross income allocations regarding carried interests).

161. *See* Polsky, *Fee Conversions*, *supra* note 2, at 766. Professor Polsky notes that this argument ultimately rests on the particular design of a fund's waiver

IRS adopted a policy-based conclusion and held that an allocation of gross income qualifies as a guaranteed payment under section 707(c). That holding arguably could apply to the fee waiver strategy, because like an allocation of gross income, an income allocation to a waiver interest might be made even if the partnership loses money on the year.[162]

But even assuming, for the sake of argument, that income allocated to a waiver interest should be treated as a gross income allocation, Revenue Ruling 81-300's extension of Section 707(c) to gross income allocations should not enjoy any deference. In that ruling, the IRS concluded that the "legislative history and purpose underlying Section 707" supported the treatment of gross income allocations as guaranteed payments. However, that ruling and other IRS materials acknowledge that this interpretation faces an uphill battle, given section 707(c)'s literal language[163] and the Tax Court's holding in *Pratt* that allocations of gross income items do *not* constitute guaranteed payments. Revenue Ruling 81-300 thus does not provide the best interpretation of section 707(c).

Of course, the various administrative law deference standards assume that a court may accept an agency's construction of a statute, even when the court believes that it is not the best one. However, even under the pre-*Chevron* standard (the *National Muffler* test), Revenue Ruling 81-300 could not overcome section 707(c)'s plain language and the relevant case law. Under the *National Muffler* test, judicial deference to a Treasury regulation may be warranted when the Commissioner adopts a consistent position, when the regulation reflects a contemporaneous construction of an

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interest. *See id.* Additionally, Professor Polsky notes that the JCT's post-enactment explanation states that section 707(a)(2)(A), and not section 707(c), provides the exclusive rule for characterizing allocations and related distributions that are not subject to entrepreneurial risk. However, the views of a legislative committee cannot limit section 707(c) in this way. "Congress's constitutional voice is the text of the statutes it enacts." Szehinskyj v. Att'y Gen., 432 F.3d 253, 260 (3d Cir. 2005). Section 707(c)'s plain language must be wrestled with to determine whether it reaches the fee waiver strategy, regardless of anything found in unenacted committee materials. And in any event, although the Court once relied on post-enactment explanations, it now rejects the use of JCT materials. *See* United States v. Woods, 134 S.Ct. 557, 568 (2013).

162. *See* Polsky, *Fee Conversions*, *supra* note 2, at 766 (depending on the structure of a waiver interest, "the priority allocation is likely to be earned regardless of the cumulative profitability of the partnership"). As noted earlier, if a waiver interest were structured without protection mechanisms, private equity firms could face substantial risk. *See supra* note 26.

163. *See* G.C.M. 38,067 (Aug. 27, 1979) ("Although it is literally correct to say that an item of gross income is income of the partnership, this should not necessarily control interpretation of the phrase 'determined without regard to income' in section 707(c).").

enacted statute, when Congress has scrutinized the regulation during subsequent reenactments, or, among other possible factors, the regulation has been relied upon.[164] Testing Revenue Ruling 81-300 under the *National Muffler* standards (which literally provide deference rules only for Treasury regulations and not informal guidance),[165] the ruling would enjoy little deference. Revenue Ruling 81-300 reflects administrative inconsistency,[166] was issued decades after the enactment of section 707(c), has not been blessed by Congress, and has been rarely relied on by the IRS.[167]

After *Mayo*, Revenue Ruling 81-300 would run into further problems. Under the *Chevron* framework reaffirmed in *Mayo*, a court first determines whether "Congress has directly spoken to the precise question at issue."[168] If not, and the court must look to an agency interpretation, the "sole question . . . is 'whether the agency's answer is based on a permissible construction of the statute.'"[169]

Revenue Ruling 81-300 dies at the first step of the *Chevron* analysis. Section 707(c) plainly limits guaranteed payments to those "determined without regard to the income of the partnership." And as the Tax Court in *Pratt* held, if an amount is determined by reference to an item of gross income, that item of course "constitute[s] partnership income," with there

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164. *See* Nat'l Muffler Dealers Ass'n v. United States, 440 U.S. 472, 477 (1979).

165. The appropriate deference standard for revenue rulings remains an open question. *See* Leandra Lederman, *The Fight over "Fighting Regs" and Judicial Deference in Tax Litigation*, 92 B.U. L. REV. 643, 665–68 (2012) [hereinafter Lederman, *Fighting Regs*]. This Part assumes that revenue rulings receive the highest level of deference, so that the section 707(c) argument can be addressed in its strongest terms. However, the government currently believes that revenue rulings receive a lower level of deference. *See* Marie Sapirie, *ABA Section of Taxation Meeting: DOJ Won't Push* Chevron *Deference for Revenue Rulings*, 131 TAX NOTES 674 (May 16, 2011).

166. In front of the Fifth Circuit in *Pratt*, the Commissioner defended the Tax Court's holding that gross income allocations fall outside of section 707(c). *See* Donald J. Weidner, Pratt *and Deductions for Payments to Partners*, 12 REAL PROP. PROB. & TR. J. 811, 832 (1977) (discussing Commissioner's brief).

167. Few IRS materials cite Revenue Ruling 81-300, perhaps because the IRS has shifted its attention to section 707(a)(2)(A) when analyzing income allocations to service partners. *See, e.g.*, T.A.M. 92-19-002 (May 8, 1992). However, given the paucity of IRS materials on guaranteed payments, it is impossible to tell the extent to which IRS agents invoke Revenue Ruling 81-300 when applying section 707(c).

168. Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842 (1984).

169. Mayo Found. for Med. Educ. & Research v. United States, 131 S. Ct. 704, 712 (2011) (quoting *Chevron*, 467 U.S. at 843).

being "no merit" to the opposite view.[170] Thus, even assuming that allocations to waiver interests substantively reflect allocations of gross income, any related distributions would not trigger section 707(c)'s guaranteed payment rule.

One might nonetheless argue that the plain meaning of section 707(c) should not control, because treating gross income allocations under the distributive share regime might create significant tax accounting problems, which the legislators who drafted the statute apparently wanted to eliminate.[171] Suppose, for example, that partner *A* in the *AB* partnership will receive a priority allocation of the first $100 of the partnership's gross income. Suppose further that the *AB* partnership in Year One recognizes $100 of gross income from the sale of property and also recognizes a $100 loss from the sale of a similar piece of property. In these circumstances, the taxable income of the partnership would be $0, thereby giving rise to alleged accounting complexities—how does one allocate $100 of income to *A* when the partnership has no taxable income?

Section 704(b) and related regulations, however, provide relatively straightforward rules that address these circumstances.[172] Under section 704(b), allocations of income or loss items under a partnership agreement will generally be respected if those allocations have substantial economic effect. In this context, if the partnership agreement so provided, the *AB* partnership could allocate $100 of income to *A*, even though the partnership had no overall income. Section 704(b) and the related Treasury regulations allow for allocations of *items* of income or deduction, not merely allocations of overall or "bottom-line" income.[173] Under a straightforward application of

170. Pratt v. Commissioner, 64 T.C. 203, 210 (1975), *aff'd in part on other grounds*, 550 F.2d 1023 (5th Cir. 1977).

171. *See* Kampel v. Commissioner, 634 F.2d 708, 712–13 (2d Cir. 1980) (discussing legislative history); *see also* Phillip F. Postlewaite & David L. Cameron, *Twisting Slowly in the Wind: Guaranteed Payments After the Tax Reform Act of 1984*, 40 TAX LAW. 649, 653 (1986) [hereinafter Postlewaite & Cameron, *Twisting Slowly*].

172. Although the section 704(b) substantial economic effect rule and related regulations did not exist when Congress enacted section 707(c), they remain relevant to the construction of the guaranteed payment rule. Though the meaning of a statute upon enactment provides the natural starting point for analysis, "it is well established that a court can, and should, interpret the text of one statute in the light of text of surrounding statutes, even those subsequently enacted." Vt. Agency of Natural Res. v. U.S. *ex rel.* Stevens, 529 U.S. 765, 786 n.17 (2000). And the "classic judicial task of reconciling many laws enacted over time, and getting them to 'make sense' in combination, necessarily assumes that the implications of a statute may be altered by the implications of a later statute." United States v. Fausto, 484 U.S. 439, 453 (1988).

173. *See* I.R.C. § 704(b); Reg. § 1.704-1(b)(1)(vii).

the regulations, one partner can enjoy a tax loss while another recognizes gross income, even though the partnership has no taxable income. These regulations thus show that allocations of gross income items in excess of partnership taxable income are not so complex that, when they relate to the performance of services by a partner, they must be removed from the distributive share rules[174]

In some circumstances, in fact, a partnership *must* allocate an item of gross income to a partner, and this requirement further supports characterizing gross income allocations under the distributive share regime. To satisfy the so-called alternative test for economic effect under the section 704(b) regulations, the partnership agreement must contain, among other things, a qualified income offset provision (or QIO provision).[175] Generally speaking, under a QIO provision, if unexpected events create a deficit in a partner's capital account, the partnership must restore this deficit as soon as possible by allocating items of partnership income, including gross income, to the partner until the deficit is restored.[176] Consequently, when a QIO provision applies, a partnership must make gross income allocations, the tax consequences of which will be determined under the distributive share regime.[177] This again shows that gross income allocations are not hopelessly

174. Of course, in more complex circumstances, treating a gross income allocation as a distributive share of partnership income can lead to complexity, especially when payments are made for use of a partner's capital. But *not* treating such a gross income allocation as a distributive share of partnership income can also lead to complexity. *See generally* Lewis R. Steinberg, *Fun and Games with Guaranteed Payments*, 57 TAX LAW. 533 (2004). If section 707(c) was intended to make Subchapter K simpler, it has failed in that task. *See* Postlewaite & Cameron, *Twisting Slowly*, *supra* note 171. This perhaps should not have come as a surprise, given that commentators recognized problems with the statute immediately after its enactment. *See* J. Paul Jackson, Mark H. Johnson, Stanley S. Surrey, Carolyn K. Tenen & William C. Warren, *The Internal Revenue Code of 1954: Partnerships*, 54 COLUM. L. REV. 1183, 1204 (1954) ("On balance it would seem that the new law's treatment of guaranteed payments creates more problems than it cures.").

175. *See* Reg. § 1.704-1(b)(2)(ii)(*d*)(*3*). For a discussion of the test, see Emily Cauble, *Was Blackstone's Initial Public Offering Too Good to Be True?: A Case Study in Closing Loopholes in the Partnership Tax Allocation Rules*, 14 FLA. TAX REV. 153, 174–77 (2013).

176. *See* Reg. § 1.704-1(b)(2)(ii)(*d*); *see also, e.g.*, I.R.S. Non Docketed Serv. Adv. Rev. 6,182 (Nov. 19, 1997) ("[T]he partnership agreement must provide for a 'qualified income offset' which automatically allocates income, including gross income and gain, to a partner who has an unexpected negative capital account either as a result of partnership operations or as a result of making the adjustment for reasonably expected reductions.").

177. Income allocated under a QIO provision constitutes a pro rata share of the relevant partnership items, consistent with determining its tax consequences under the distributive share regime. *See* I.R.C. § 1.704-1(b)(2)(ii)(*d*).

complex and that their tax consequences should be determined under section 704(b), not under the section 707(c) guaranteed payment rule.

Section 707(c) does not support an attack on the fee waiver strategy. An allocation of income to a waiver interest may or may not be substantively equivalent to an allocation of gross income, but even if it is, the statute's plain language would not treat it as a guaranteed payment. And even if a court abandoned the plain language of the statute and considered its apparent underlying purpose (an inquiry arguably permissible only at Step Two of the *Chevron* analysis),[178] gross income allocations are not so complex that they must be taken outside of the distributive share rules. Revenue Ruling 81-300's contrary conclusion warrants no deference, especially after *Mayo*.

V. FEE WAIVERS AND LESSONS FOR AGENCY GUIDANCE

Although under current law the attacks against the fee waiver strategy suffer from severe weaknesses, nothing requires that Congress or the IRS bless the strategy going forward. The preferential tax treatment enjoyed by private equity firms reflects a legitimate policy issue and transactions providing that treatment should receive close scrutiny.

In this author's view, Congress should tackle the policy issues in one fell swoop. That is, Congress should entirely phase out the capital gains preference for ultra-high-income earners.[179] To remain revenue neutral (a concern to many legislators),[180] any dollars saved through the phaseout could go towards different tax preference items.

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178. Courts differ on whether legislative history may be considered at Step One of the *Chevron* analysis. *See, e.g.*, Shays v. FEC, 337 F. Supp. 2d 28, 62 n.32 (D. D.C. 2004) ("Plaintiffs make a number of legislative history and legislative purpose arguments under *Chevron* step one. . . . [T]hese sorts of arguments are more appropriately addressed under *Chevron* step two."), *aff'd*, 414 F.3d 76 (D.C. Cir. 2005); Bankers Life & Cas. Co. v. United States, 142 F.3d 973, 983 (7th Cir. 1998) ("[W]e now seem to lean toward reserving consideration of legislative history and other appropriate factors until the second *Chevron* step."); *cf.* Intermountain Ins. Serv. of Vail, LLC v. Commissioner, 134 T.C. 211, 222–24 (2010) (describing different approaches in the case law and ultimately concluding that legislative history should be considered at Step One), *rev'd on other grounds*, 650 F.3d 691 (D.C. Cir. 2011), *vacated*, 132 S. Ct. 2120 (2012).

179. For a thoughtful discussion of the capital gains preference and the taxation of private equity firms, see Samuel D. Brunson, *Taxing Investment Fund Managers Using a Simplified Mark-to Market Approach*, 45 WAKE FOREST L. REV. 79, 94–101 (2010).

180. *See* Jeremy W. Peters, *For Tax Pledge and Its Author, A Test of Time*, N.Y. TIMES, Nov. 19, 2012, at A1 (discussing the status of the so-called Norquist pledge, under which around 200 House members and 40 Senators have pledged to never vote for a tax increase).

Unfortunately, the legislative appetite for a broad solution seems small. Congress generally addresses problems related to the capital gains preference with anti-abuse rules that may distort tax provisions that are, in fact, working as intended.[181] Section 702(a)'s entity-characterization rule and the section 704(b) distributive share regime hardly reflect loopholes,[182] and it is unfortunate that Congress often chooses to address outlier transactions through broad rules, rather than narrow ones.[183]

181. A recent congressional committee publication suggests some legislative interest in fee waivers. *See Senate Finance Committee Staff Tax Reform Options for Discussion*, 2013 TAX NOTES TODAY 111-69 (June 6, 2013) (including fee waivers as a possible area for legislative reform).

182. In simple circumstances, where all partners in a partnership enjoy similar tax attributes, a private equity firm's conversion of ordinary fee income to capital gain income would result in no aggregate tax savings because the fund investors would lose an ordinary loss deduction and get a capital loss deduction instead (or, more precisely, a reduction in the amount of capital gain income allocated to them). *See* Chris William Sanchirico, *The Tax Advantage to Paying Private Equity Fund Managers with Profit Shares: What Is It? Why Is It Bad?*, 75 U. CHI. L. REV. 1071, 1076–79 (2008); Jerome M. Hesch, *The Treatment of Carried Interests Is Income Tax Neutral*, 2013 TAX NOTES TODAY 1169 (Jun. 17, 2013). However, given the special tax attributes of fund investors, the fee waiver strategy actually provides the private equity firm with a tax benefit without making investors worse off. Investors may be tax-exempt and hence immune from the detriment associated with losing an ordinary income deduction. And taxable investors will frequently face deductibility limitations for section 212 expenses, such that they would not be able to enjoy the lost ordinary income deduction in any event. Thus, while the fee waiver strategy may provide an aggregate tax advantage, it does so only because Congress has specifically exempted some types of entities from tax or because it has chosen to deny otherwise available deductions. In other words, Congress has deliberately created distortions (through tax exemptions or deductibility limitations) and these distortions contribute as much to any potential policy problem with the fee waiver strategy as do the partnership tax provisions. In fact, to the extent that the limitations on section 212 deductions contribute to the motivation for the fee waiver strategy, it might be more productive to examine whether those limitations should be lifted than to attack the fee waiver strategy as a loophole.

183. This phenomenon is especially prevalent in the corporate tax context. *See, e.g.*, Douglas A. Kahn & Jeffrey H. Kahn, *Prevention of Double Deductions of a Single Loss: Solutions in Search of a Problem*, 26 VA. TAX REV. 1 (2006) (arguing that Congress overreacted in amending Subchapter C to prohibit duplications of net built-in losses); Karim H. Hanafy, *Section 355 Spin-Off + Section 368 Reorganization ≠ Section 355(e). It's Simple Math: The Anti-*Morris Trust *Bill Simply Does Not Add Up*, 1 HOUS. BUS. & TAX L.J. 119, 122 (2001) (arguing that, in response to abuses by several large corporations, "Less restrictive measures could have been structured rather than the overreaching, all-inclusive provisions contained in section 355(e)").

It would be far better to address progressivity concerns related to the capital gains preference directly by amending section 1, rather than by adding complicated anti-abuse rules to Subchapter K that may cause more trouble than they're worth. The sheer complexity of section 751(b), for example, has made it "one of the most widely ignored provisions of Subchapter K."[184] And proposed section 710, which would negate the tax benefits associated with carried interests, would add yet another complex rule to the partnership tax regime,[185] which was originally intended to accommodate smaller business operations.[186] One can only hope that the fee waiver strategy will not cause further legislative damage to Subchapter K but will instead force Congress to consider whether a capital gains preference reflects good tax policy.

On the administrative front, although the Treasury of course lacks the power to deny the capital gains preference to anyone, it enjoys many other tools to implement tax policy, including the promulgation of guidance. And the Treasury surely enjoys the authority to issue regulations under section 707(a)(2)(A) that could severely limit or entirely defeat the fee waiver strategy. That is, although the Senate Finance Committee may have been principally concerned with avoidance of capitalization requirements, nothing in the statute's plain text limits the Treasury's regulatory authority to section 263 matters. Although some may believe otherwise,[187] guidance under section 707(a)(2)(A) can properly reach many types of partner-partnership transactions regarding the performance of services.[188]

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184. Karen C. Burke, *Origins and Evolution of Section 751(b)*, 60 TAX LAW. 247, 247 (2007).

185. For discussions of the conceptual and practical difficulties related to proposed section 710, see Abrams, *Carried Interests*, *supra* note 38, at 223–27, and Karen C. Burke, *The Sound and Fury of Carried Interest Reform*, 1 COLUM. J. TAX L. 1 (2010). For a discussion of the relationship between proposed section 710 and the fee waiver strategy, see, for example, Bradley M. Van Buren, *The Collateral Effect of Carried Interest Tax Proposal on Fee Waivers*, LAW360, Nov. 18, 2011, http://www.hklaw.com/files/Publication/197c37a7-3648-4a99-ad16-9ff87d71364b/Presentation/PublicationAttachment/f75efd1b-5cde-4caa-ab00-a2440fe7528b/Law360CarriedInterestTaxFeeWaivers.pdf.

186. *See* Jeffrey L. Kwall, *Taxing Private Enterprise in the New Millennium*, 51 TAX LAW. 229, 232 (1998) ("The flexible partnership tax regime was designed to accommodate relatively simple economic undertakings.").

187. *See* Burke, *Back to the Future*, *supra* note 63, at 243–44 (noting that "[t]he 1984 legislation is often portrayed as concerned only with avoidance of the capitalization requirement, not with capital gain conversion," but arguing that the statute can reach character-conversion transactions).

188. Even if one believes that legislative history materials can somehow restrict the scope of the Treasury's regulatory authority, that history should not limit section 707(a)(2)(A) guidance to capitalization avoidance transactions. The House originally limited the regulatory authority under section 707(a)(2)(A) to transactions

Unfortunately, in recent years, the Treasury has sometimes overreached when exercising its rulemaking power to combat tax-motivated transactions or otherwise address contentious issues. For example, courts have expressed skepticism regarding the Treasury's use of the so-called fighting regulations,[189] have invalidated regulations that improperly ignored binding Supreme Court precedents,[190] and have faulted the Treasury for its failure to observe the APA's notice and comment requirements.[191] With regard to the fee waiver strategy, the Treasury could face another judicial rebuke if it insists on applying phantom regulations against private equity firms rather than observing section 707(a)(2)(A)'s plain language.

This Part offers several recommendations (indicated in italics) designed to prevent such a judicial rebuke. Although the prospect of guidance regarding the fee waiver strategy motivates these recommendations, they are not limited to matters related to that strategy. Consequently, these recommendations will be phrased in general terms and carry implications outside the fee waiver context.

First and foremost, *the IRS should adopt a coordinated position that rejects phantom regulations*. The existing administrative and judicial materials reflect inconsistent approaches, with some IRS attorneys believing

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that circumvented section 263, *see* H.R. 4170, 98th Cong. § 73 (1984), but that restriction was eventually lifted. *See* H.R. REP. NO. 98-861, at 861 (1984) (Conf. Rep.) (discussing removal of the restriction). The enacted text consequently reflects no limitation to capitalization avoidance transactions, and the drafting history indicates (by negative implication) that the legislators may have intended a broad scope for section 707(a)(2). Of course, it's far sounder to rely on actual laws than unenacted materials, but whether one looks to the statutory text or the drafting history, the Treasury enjoys broad authority under section 707(a)(2)(A) to address partner-partnership transactions regarding the performance of services. *See also* Bank One Chicago, N.A. v. Midwest Bank & Trust Co., 516 U.S. 264, 279, 283 (1996) (Scalia, J., concurring) ("The law *is* what the law says, and we should content ourselves with reading it rather than psychoanalyzing those who enacted it.").

189. Regarding fighting regulations (*i.e.*, those issued by the Treasury in connection with a pending controversy and issued with retroactive effect), see generally Lederman, *Fighting Regs*, *supra* note 165. For one judicial rebuke to the Treasury, see *Stobie Creek Inv., LLC v. United States*, 82 Fed. Cl. 636 (2008) (holding section 1.752-6 fighting regulation invalid), *aff'd on other grounds*, 608 F.3d 1366 (2010). For the upholding of the same regulation, see *Cemco Investors, LLC v. United States*, 515 F.3d 749, 752 (7th Cir. 2008).

190. *See* Home Concrete & Supply, LLC v. United States, 634 F.3d 249, 257 (4th Cir. 2011) (declining to apply Regulation section 301.6501(e)–1(a)(iii) because, among other problems, it was clearly inconsistent with *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958)), *aff'd*, 132 S. Ct. 1836 (2012).

191. *See In re* Long-Distance Tel. Serv. Fed. Excise Tax Refund Litig., 853 F. Supp. 2d 138 (D. D.C. 2012) (invalidating Notice 2006-50 for want of notice and comment).

that phantom regulations are appropriate and others rejecting them.[192] A single consistent approach would surely further administrative efficiency.

A flat rejection of phantom regulations would prevent the IRS from invoking statutes like section 707(a)(2)(A) against taxpayers and might thus seem unattractive. However, this coordinated position would also discourage taxpayers from selectively applying phantom regulations, since the inconsistency under existing practice encourages gamesmanship. Taxpayers seeking to enjoy the benefits of phantom regulations can point to authorities blessing those regulations, while taxpayers looking to dodge phantom regulations can point to authorities rejecting them.

For example, some taxpayers have apparently taken the position that section 336(e), which allows a corporate taxpayer to treat a stock sale as an asset sale "[u]nder regulations prescribed by the Secretary," can provide tax benefits even without Treasury regulations.[193] In examining this position, the IRS emphasized the "huge"[194] number of issues raised by the delegation of rulemaking authority and reached the commonsense conclusion that taxpayers must wait for regulations before treating stock sales as asset sales. If the IRS extended this conclusion and broadly rejected phantom regulations,[195] agency resources could be conserved, given the difficulties that surely arise when taxpayers decide for themselves how the Secretary should exercise the authority delegated to him.

More important, a flat rejection of phantom regulations would heed *Mayo*'s signal that the tax law no longer enjoys special exceptions from general administrative law doctrines.[196] If the IRS insists on applying

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192. *See* T.A.M. 2003-14-028 (April 4, 2003) (embracing phantom regulations regarding section 4263(c)); *cf.* C.C.A. 2010-09-013 (March 5, 2010) (rejecting phantom regulations under section 336(e)).

193. *See* C.C.A. 2010-09-013 (March 5, 2010). In 2013, the Treasury finally issued regulations under section 336(e), almost 30 years after the statute's enactment as part of the Tax Reform Act of 1986, Pub. L. No. 99-514, § 631(a), 100 Stat. 2085, 2269. *See* T.D. 9619, 2013–1 C.B. 1212.

194. *See* C.C.A. 2010-09-013 (March 5, 2010) ("Congress recognized that the number of issues involved was huge. Congress authorized regulations if the Secretary determined that such regulations would help carry out the purposes of subchapter C, but in no way did Congress mandate them.").

195. The phrase "under regulations prescribed by the Secretary," whether found in a taxpayer-favorable provision like section 336(e) or in an anti-abuse rule like section 707(a)(2)(a), conditions the operation of the statute on action by the executive branch. Common sense dictates that these statutes receive similar interpretations, insofar as their delegating language goes.

196. *See* Jeremiah Coder, *News Analysis: Details in APA Tax Litigation Can Turn Win into Loss*, 139 TAX NOTES 14 (Apr. 1, 2013) ("It's no longer a secret that precepts of administrative law have practical effects on tax law. The Supreme

phantom regulations, taxpayers can invoke *Mayo* and ask that a court follow the many nontax cases that routinely reject phantom regulations. Although taxpayers have generally hesitated to invoke general administrative law doctrines in tax disputes, their hesitance may be disappearing.[197] *Mayo* and other high-profile tax cases have sparked practitioner interest in those doctrines.[198]

Additionally, Congress continues to integrate nontax regulatory regimes with the tax code,[199] and nontax attorneys may look askance at the IRS's practice regarding phantom regulations. The so-called Obamacare legislation,[200] for example, added several new tax code provisions unrelated to the core tax provisions.[201] These provisions contain delegations of regulatory authority,[202] and if the IRS tries to apply these provisions without

Court has emphatically endorsed the notion in recent opinions that the tax system is not special.").

197. *See* Kristin E. Hickman, *Unpacking the Force of Law*, 66 VAND. L. REV. 465, 466 (2013) (*Mayo* and related cases "have given tax lawyers a fresh awareness of administrative law doctrine as relevant to their field."); Patrick J. Smith, *The APA's Arbitrary and Capricious Standard and IRS Regulations*, 136 TAX NOTES 271, 279 (July 16, 2012) (concluding that "*Mayo* has brought to the applicability in the tax world of general administrative law principles" and that the Federal Circuit's recent invalidation of a Treasury regulation "shows that this change is beginning to take place").

198. *See* David J. Shakow, *Who's Afraid of the APA?*, 134 TAX NOTES 825, 825 (Feb. 13, 2012) ("*Mayo* has stirred concern among members of the tax bar. By daring to say that the IRS is just like any other federal agency, the Supreme Court has left the tax bar scrambling to accumulate the expertise it needs to navigate the rules of administrative law."); Jeremiah Coder & Shamik Trivedi, *Supreme Court Has Put Regulatory Challenges in Play, Wilkins Says*, 2013 TAX NOTES TODAY 42-15 (Mar. 4, 2013).

199. *See generally* Susannah Camic Tahk, *Everything Is Tax: Evaluating the Structural Transformation of U.S. Policymaking*, 50 HARV. J. ON LEGIS. 67, 67 (2013) ("Congress and presidential administrations have, more and more frequently, employed the tax code to accomplish goals that have nothing to do with raising revenue.").

200. *See* Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010), *amended by* Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029.

201. *See, e.g.*, I.R.C. § 36B (granting credit to assist with purchase of health insurance); I.R.C. § 4980H (employer penalty); I.R.C. § 40A(a) (providing credit for biodiesel and renewable diesel); I.R.C. § 40A(e)(5) (granting regulatory authority to limit credit in some circumstances).

202. *See, e.g.*, I.R.C. § 4980H(c)(4)(B) (granting regulatory authority to treat workers who are not paid on an hourly basis as if they are full time employees under section 4980H(c)(4)(A), such that an employer's failure to provide insurance to them could trigger the section 4980H penalty). Of course, given the high level of attention currently being paid to the Obamacare legislation, one would expect the

heeding notice and comment requirements, it may face substantial difficulties. Nontax attorneys routinely bring APA-related challenges to agency actions, and these attorneys may aggressively challenge phantom regulations, even if tax attorneys hesitate to do so.

In anticipation of those challenges, and aside from adopting a coordinated position against phantom regulations, *the IRS should prioritize the Priority Guidance Plan*. Currently, the Priority Guidance Plan offers a subject-matter breakdown of various potential areas for further administrative guidance.[203] Although the plan cites specific code sections and subsections, it currently does not distinguish between statutes that call for regulations and those that do not. Because *Mayo* casts doubt on phantom regulations, the IRS should immediately identify any significant statutes that call for regulations and consider how to implement them.

When the IRS does implement statutes that call for regulations, it should actually issue regulations, not other agency guidance. Courts have long stressed the importance of the APA's default rule, under which legislative rules must be promulgated through notice and comment procedures.[204] In the high-stakes telephone excise tax refund litigation, for example, a court invalidated Notice 2006-50[205] for want of notice and comment,[206] and the IRS will have to first issue proposed regulations if it makes another attempt to comprehensively address telephone excise tax refunds.

For any guidance on section 707(a)(2)(A), the IRS should first issue proposed regulations and allow for public comment. The IRS has attempted to implement other aspects of section 707(a)(2) through means short of regulations,[207] and *Mayo* calls the validity of that guidance into question.

Treasury and IRS to heed the APA in issuing regulations, and the Treasury is following the notice and comment process for Obamacare regulations. *See, e.g.*, Prop. Reg. § 4980H, 78 Fed. Reg. 218 (2013) (describing proposed regulations regarding I.R.C. § 4980H(c)(4)(B)). Somewhat strangely, the proposed regulations under section 4980H deny that the APA's rulemaking provisions apply to them. *See id.* at 239 ("It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to this regulation.").

203. *See* 2013–2014 PRIORITY GUIDANCE PLAN, *supra* note 17, at 21.

204. *See, e.g.*, Texaco, Inc. v. Fed. Power Comm'n, 412 F.2d 740, 744 (3d Cir. 1969) ("Section 553 was enacted to give the public an opportunity to participate in the rule-making process.").

205. Notice 2006-50, 2006-25 C.B. 1141.

206. *In re* Long-Distance Tel. Serv. Fed. Excise Tax Refund Litig., 853 F. Supp. 2d 138 (D. D.C. 2012).

207. *See* Notice 2001-64, 20012 C.B. 316 (calling for comments on section 707(a)(2)(B)'s application to transfers of partnership interests and stating that legislative history should provide guidance until regulations are issued). Although the Treasury can (and often does) incorporate guidance from legislative history into

Although notices and other forms of guidance provide a useful tool for addressing abusive situations, especially in light of section 7805(b)(1)(C)'s retroactivity rule, when a statute explicitly calls for regulations, as section 707(a)(2)(A) does, the IRS should commit to following notice and comment requirements.

To facilitate its compliance with those requirements, *the IRS should abandon its policy of treating proposed regulations as binding on agency attorneys*. In Chief Counsel Notice 2003-14, the IRS established a policy under which agency attorneys cannot assert positions inconsistent with proposed regulations.[208] Although the notice also cautions that taxpayers generally cannot rely on proposed regulations,[209] as a practical matter, taxpayers may face little danger in doing so. After all, if IRS attorneys cannot argue against proposed regulations, what risk does a taxpayer face in following them? At least one IRS official has observed that taxpayers may follow proposed regulations when they are helpful and ignore them when they are not.[210]

The IRS should reverse the policy established by Chief Counsel Notice 2003-14. The guidance process becomes far more risky when

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final regulations, it is inappropriate to use a notice to cross-reference legislative history when the relevant statute requires implementation via regulations. Under the regulation process, the public has an opportunity to comment on the Treasury's proposed incorporation of legislative history, to suggest improvements or refinements, and so on. No such benefit is available through the promulgation of a notice, however, and the incorporation of legislative history *in toto* may carry some risks. Perhaps for that reason, the IRS has not issued any official guidance telling taxpayers to examine services transactions under section 707(a)(2)(A) by reference to the legislative history materials. *See also* ABA Comments, *The Tax Consequences of the Receipt of a Partnership Profits Interest for Services*, 46 TAX LAW 453, 461–62 (1992) (stating that the Senate Finance Committee's entrepreneurial risk test, "while helpful, may be too limited in scope to adequately deal with the potential problem[s]" related to disguised services transactions); Burke, *Back to the Future*, *supra* note 63, at 246 (arguing that focus on the legislative history's "entrepreneurial risk" test has improperly turned section 707(a)(2)(A) into a safe harbor provision, rather than an anti-abuse provision).

208. *See* C.C.N. CC-2003-014, (May 8, 2003) ("Chief Counsel attorneys ordinarily should not take any position in litigation or advice that would yield a result that would be harsher to the taxpayer than what the taxpayer would be allowed under the proposed regulations.").

209. *See id.* ("Taxpayers generally should not rely on proposed regulations for planning purposes, except where there are no applicable final or temporary regulations in force and there is an express statement in the proposed regulations that taxpayers may rely on them currently.").

210. *See* Lisa M. Nadal, *CFC Regs Deliver Equitable Result, IRS Official Says*, 2006 TAX NOTES TODAY 215-4 (Nov. 7, 2006) (describing an IRS official's statement regarding proposed regulations under section 987).

proposed regulations essentially become elective to the taxpayer. The IRS's policy thus seriously compromises the intended effects of the APA's procedures, under which proposed regulations should provide a vehicle for an agency to solicit comments and explore potential pitfalls *before* committing itself to a final position.[211] The Treasury should allow itself the same privileges enjoyed by other federal agencies and use proposed regulations to test out possible ideas and interpretations, without allowing the public to seize on any ambiguities and loopholes.

Of course, most taxpayers do not use proposed regulations to abuse the tax system. Rather, taxpayers may look to proposed regulations for help in learning how to apply complex provisions to difficult factual scenarios. Oftentimes, a taxpayer may have to determine a return position without the benefit of any authoritative case law or agency guidance, and it is understandable that a taxpayer might look to a proposed regulation or other unofficial materials.

To address concerns regarding taxpayer fairness (which likely motivated the original policy on proposed regulations), *the Treasury should provide that proposed regulations may be relied on solely for purposes of penalty protection.* This recommendation admittedly suffers from some doctrinal inconsistency—if a proposed regulation reflects good law for purposes of avoiding penalties, why shouldn't it reflect good law for purposes of substantive positions? Nonetheless, the suggested compromise would reduce the risks that the Treasury faces when issuing proposed regulations, while ensuring that a taxpayer will not face penalties for adopting a position that the agency believed was reasonable enough to put into a regulatory proposal. To prevent egregious abuses, however, proposed regulations should not qualify as substantial authority for purposes of defending against penalties related to tax shelter transactions, as they currently do.[212]

VI. CONCLUSION

Like almost any discussion involving the tax planning of large businesses or wealthy persons, the discussion of management fee waivers has

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211. *See* Elizabeth Blackwell Health Ctr. for Women v. Knoll, 61 F.3d 170, 189 (3d Cir. 1995) ("Notice and comment also serves the salutary purpose of forcing the agency to educate itself on the facts, issues and policy options available before issuing binding regulations.").

212. *See* Reg. § 1.6664-4(f)(2)(i) (specifying that, in order to establish a reasonable cause and good faith defense to the corporate tax shelter substantial understatement penalty, substantial authority for the corporation's position is required); Reg. § 1.6662-4(d)(3)(iii) (including proposed regulations among items relevant to determining whether substantial authority exists for a return position).

suffered from some overheated rhetoric. That rhetoric may leave one with the impression that the fee waiver strategy holds a weak position under existing law. It may also leave one with the impression that the IRS's lack of enforcement in this area reflects an administrative giveaway, in line with the alleged Wall Street Rule.[213]

However, as this Article shows, the arguments against the fee waiver strategy actually suffer from serious litigation risks or doctrinal weaknesses, especially in light of recent administrative law developments. It is thus no surprise that the IRS apparently has yet to challenge the strategy, either administratively or in court.

Nonetheless, the preference for long-term capital gains—which lies at the heart of the fee waiver strategy—rests on uncertain intellectual foundations.[214] The public outcry over the private equity industry's enjoyment of that preference should give Congress a reason to examine whether low rates on long-term capital gain reflect optimal tax policy. Even if Congress believes that policy concerns generally support the capital gains preference, Congress could, and perhaps should, conclude that progressivity concerns warrant the elimination of that preference for high-income taxpayers.

Although the Treasury cannot set national tax policy regarding the capital gains preference, it can, to the extent that the tax code permits, address whether transactions designed to take advantage of that preference should be respected. If the Treasury decides to challenge the fee waiver strategy, it should take into account the changes wrought by *Mayo*. Specifically, enforcement through phantom regulations is no longer proper (if it ever was). Additionally, the Treasury should improve its rulemaking procedures to facilitate its compliance with the APA's notice and comment procedures.

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213. *See* Heather C. Maloy, *Tax Administration: Where the Rubber Meets the Road*, 136 TAX NOTES 329, 331 n.13 (July 16, 2012) (describing variations of the Rule, under which the IRS allegedly will not attack the tax treatment of transactions if it has long acquiesced or if too many dollars are at stake).

214. *See, e.g.*, Walter J. Blum, *A Handy Summary of the Capital Gains Arguments*, 35 TAXES 247 (1957). For further discussion, see Noel B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319 (1993).