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GPUCs in A Post-Tax Reform World:

The Proposed Taxation of (Some) Preferred Returns as Interest

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GPUCs in a Post-Tax Reform World*

I. INTRODUCTION

What attributes of a preferred return distinguish a guaranteed payment for the use of capital under section 707(c), otherwise known as a "GPUC", from a distributive share of partnership income?[1] Is the definition of a GPUC under current law sufficiently robust to be exported wholesale to new sections 163(j) and 199A or it is not quite ready for prime time? If it is not ready, how will taxpayers respond?

The IRS and Treasury have determined that the new interest limitations under sections 163(j) and 199A should be extended to GPUCs even though the underlying capital is an equity investment in a partnership. Whether the proposed treatment of GPUCs as interest for this purpose will achieve its intended purpose will depend on the answers to these questions. This paper explores some of the likely difficulties of integrating the interest limitations of sections 163(j) and 199A with this new category of "interest", with particular emphasis on the many available opportunities for taxpayer "self-help" to avoid these limitations under current law.

Under current law, whether a fixed payment is a guaranteed payment for capital or services under section 707(c), a distributive share of partnership income under section 704(b) or a payment subject to section 707(a) is not a simple question, especially in the service context. It depends on the meaning of "fixed". A $100 salary is certainly fixed,

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* The author thanks his friend and partner Mike Schler for a number of thoughtful comments on an earlier draft. The views expressed in this paper are those of the author and do not reflect the views of Cravath, Swaine & Moore LLP.

[1] The references to "preferred returns" in this paper are generally intended to describe a return on equity capital from a partner that is similar to interest, without regard to whether future payment of the return is contingent on income. In contrast to the definition under the disguised sale regulations, the label is *not* intended to differentiate between preferred returns treated as distributive share and GPUCs. *See* Reg. §1.707-4(a)(2) (defining only the former as a "preferred return").

but suppose the salary is $100 or 100% of the gross income of the employer, whichever is lower? Is the salary no longer fixed because it may be zero? Should it matter that the likelihood that the employer will earn less than $100 of gross income every year is close to zero?

As discussed in this paper, this particular type of "fixed" payment is probably subject to tax under section 707(a). It is *not* a guaranteed payment. Under current law, the degree of entrepreneurial risk appears to be irrelevant. Indeed, it is not even necessary that the income contingency be a condition to payment. In the view of most practitioners, a matching allocation of gross income may suffice to avoid a guaranteed payment even if the obligation would still be payable without the allocation.

The impact of these minor drafting distinctions and the electivity it promotes is well understood by practitioners. While section 707(c) may be mandatory in form, it is largely optional in practice. Perhaps worse, some even claim that Congress gutted the guaranteed payment rules when it chose to amend section 707 in 1984, leaving only an empty shell in its wake. As this paper will explore,[2] the story of the de facto repeal of section 707(c) is not the idle musing of some crackpot, but rather the considered and well-argued opinion of a co-author of a distinguished treatise on partnership taxation.[3] If this is correct, the entire subject matter of this paper is of no practical relevance whatsoever.

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[2] See *infra* text accompanying notes 48-58.

[3] Philip F. Postlewaite & David I. Cameron, *Twisting Slowly In the Wind: Guaranteed Payments After the Tax Reform Act of 1986*, 40 TAX LAW. 649, 696 (1986) ("Twisting") ("Because of the effects of the Tax Reform Act of 1984, section 707(c) should be repealed ... the risk analysis framework ... renders section 707(c) self-contradictory and, thus, obsolete.").

In most other areas of the law, a state of affairs such as this is strictly temporary. Electivity is eliminated in due course and statutory surplusage is eventually repealed. Here, however, the status of section 707(c) as either elective or duly departed has been current law for decades. How is this possible?

One explanation is that it did not matter, at least for a typical operating partnership. Why? Because the tax consequences to the partners under section 707(a), section 707(c) or section 704(b) were more or less the same: the payee reported the "fixed" payment as ordinary income and the partnership either deducted the "fixed" payment as a business expense or allocated more income to the payee partner and less to the other partners (resulting in the economic equivalent of a deduction).

Suppose, for example, that section 707(c) is elective and that a partnership with $105 of income pays an additional $5 to a 25% partner. If section 707(a) or (c) applies, the partnership would deduct the $5 as a business expense, leaving the 25% partner with $5 of ordinary income and $25 of distributive share. If the $5 is instead treated as a distributive share of partnership income, the partnership would allocate $30 of taxable income to the 25% partner rather than $25. Meanwhile, the 75% partner reports $75 of taxable income in all three cases.

This is not the sort of electivity in dire need of remediation.

But this was before the TCJA.[4] Under the proposed section 163(j) regulations, a GPUC is treated as interest expense. If the interest is not deductible, multiple partners will be subject to tax on the same income. Under the section 199A regulations, a GPUC

[4] P.L. 115-97.

is always subject to tax to an individual partner at full rates because it cannot qualify for the new 20% deduction available for "qualified business income" (QBI). For other types of preferred returns on capital, the TCJA amendments to the Code do not apply even if the likely payment terms are the same.

Assume the $5 in the last example was a GPUC. Unless the difference between 30% of the "adjusted taxable income" of the partnership and its other interest expense is at least $5, all or a portion of the GPUC would be non-deductible under section 163(j). The other partners would therefore be required to report up to $5 of additional income even though the 25% partner already reported the $5 as interest. For any other type of preferred return, only the 25% partner would have reported the income. What about section 199A? Of the $30 of total income to the 25% partner, $5 would not be eligible for the new 20% deduction. If the $5 had *not* been a GPUC, the entire $30 may have qualified.

If the economic difference between a GPUC and all other preferred returns were always meaningful, these starkly different tax consequences would be justified. After all, a preferred return contingent on profits may never be paid. But this is not current law. Indeed, the differences between two preferred returns may be quite trivial, depending more on drafting distinctions than expected payment terms. As a result, a partnership that would otherwise not be permitted to deduct a GPUC under section 163(j) for want of sufficient ATI may be able to avoid section 163(j) by redrafting the preferred return to make it contingent on a "low-risk" allocation of gross income. For most operating partnerships, the incremental risk to the recipient partner is likely to be small, perhaps even remote.

Indeed, some partnerships may decide to draft *into* the GPUC rules. Suppose a partnership with plenty of ATI to deduct its own interest expense has a partner with insufficient ATI to deduct interest on debt at the partner level. If the partner were to recapitalize its investment into a common and preferred interest, it may be able to convert a portion of its distributive share from the partnership into "business interest income", allowing it to deduct a larger percentage of the partner level interest.

Before going any further, a few words about what this paper is *not* about.

First, it is not about whether the decision of the government to extend the limitations of sections 163(j) and 199A to GPUCs is consistent with the purpose of these limitations. I prefer to remain neutral on this question. While one could argue that section 707(c) was enacted in 1954 to address an entirely unrelated problem under the common law involving the taxation of fixed payments to partners in excess of partnership taxable income, this is a topic for another paper.[5] Moreover, while the opportunities to avoid section 707(c) though taxpayer self-help could also be cited as a reason not to extend the GPUC provisions, the same opportunities could also be cited as a call for new guidance. If well-advised partnerships are able to draft around the new GPUC limitations under current law without altering the fundamental economic agreement among the partners, it is unlikely that the proposal will achieve its intended purpose or raise any significant revenue.

Second, it is not about the shortcomings of current law except insofar as they may facilitate the avoidance of sections 163(j) and 199A. Whether it is proper to tax *any*

[5] For a discussion of the common law prior to the enactment of subchapter K, *see infra* text accompanying notes 33-39.

return on equity as interest is at best debatable. Reasonable people disagree on this question. Whether that treatment should be should be up to the taxpayer is not debatable. In the absence of the TCJA amendments, however, this paper does not propose any new guidance. While no tax regime that is effectively elective should be ignored, this one has been elective for many years, with little empirical evidence of significant revenue loss.

Assuming the new GPUC limitations are here to stay and mindful of the inherent difficulty of identifying which attributes of a preferred return resemble interest even in the absence of a debtor-creditor relationship, what sorts of preferred returns should be subject to section 707(c)? How should a GPUC be defined?

Broadly speaking, it should be defined in a manner that captures preferred returns more in the nature of interest than distributive share. To this end, income contingencies should be disregarded except insofar as the contingencies constitute actual conditions to payment and the allocations are subject to entrepreneurial risk. If the allocations are unlikely to reduce the economic entitlements of the partners, the preferred return should be treated as a GPUC.

The definition should also be administrable. It should not depend to any significant extent on the special facts and circumstances of every partnership, treating a preferred return in one partnership as a GPUC and as distributive share in another based on the nature of the partnership assets or the relative profitability of the business. It should depend on the economic terms of the underlying partnership interest.

As discussed more fully in this paper, any future GPUC guidance should also endeavor to address the following three areas:

First and foremost, any future guidance should reduce electivity. The treatment of a preferred return as a GPUC should be based on whether it possesses the basic hallmarks of interest, not on whether payment of the preferred return is contingent on gross income. Most interest on debt is fixed rather than contingent, is not discharged in the event of a loss and has priority over the claims of other stakeholders. A preferred return that shares these economic attributes should generally be treated as a GPUC.

Second, it should abandon the "wait and see" approach to the GPUC determination. Under current law, the status of a fixed preferred return as a GPUC is often held open on the date of grant, then vacillates between GPUC and non-GPUC treatment from year to year depending on the profitability of the partnership. While consistent with longstanding precedent, this approach will be difficult to administer in the context of a single integrated regime if one category of expense is allowed to "toggle" between interest and non-interest while the other is treated as interest during the entire term of the investment.

Finally, the government should consider the extent to which the factors governing the common law determination of whether an instrument is debt or equity should inform the definition of a GPUC. In considering such factors, however, the government must be mindful of the different nature of the inquiry. Like a dividend on preferred stock, a GPUC is a return on an equity investment. The treatment of a GPUC as interest cannot be defended on the basis that the partner is a creditor. The underlying investment is unlikely to have a fixed maturity date or any creditor's remedies in a default and will be

completely subordinated to the claims of trade creditors.[6] On the other hand, the absence of certain attributes often cited as indicia of debt under the common law may provide helpful guideposts in the GPUC determination.

II. GPUCS AS INTEREST UNDER SECTION 163(J)

A. Overview of Section 163(j)

Section 163(j) disallows the deduction of net "business interest expense" (BIE) to the extent it exceeds 30% of "adjusted taxable income" (ATI).[7] BIE is defined as interest expense incurred on indebtedness allocable to a trade or business.[8] BIE that is disallowed under section 163(j) due to insufficient ATI is treated as BIE in the following year.[9]

B. Treatment of Partnerships

For debt incurred by a partnership, Section 163(j) applies at the partnership level.[10] Subject to certain exceptions, therefore, any net BIE of a partnership is in effect "trapped" within the partnership to the extent it exceeds 30% of partnership ATI.[11] The excess interest, or EBI, is allocated to the partners as interest expense but is not deductible by the partners regardless of whether they have additional ATI at the partner

[6] Noting the absence of any debt-like attributes, the NYSBA Tax Section expressed its opposition to the proposed extension of sections 163(j) and 199A to GPUCs in 2019. NYSBA Tax Section, "Report on Proposed Section 163(j) Regulations", Report No. 1412, p. 29-30, Feb. 26, 2019 (noting that "guaranteed payments represent payments for partnership equity … and not debt" and that "[p]artners having rights to guaranteed payments for equity capital have no creditor rights …").

[7] ATI is defined as taxable income before interest income or expense, net operating losses, depreciation, amortization and various other items. Code Sec. 163(j)(8). Beginning in 2020, ATI is further reduced by depreciation and amortization. Code Sec. 163(j)(8)(A)(iv).

[8] Code Sec. 163(j)(5).

[9] Code Sec. 163(j)(2).

[10] Code Sec. 163(j)(4).

[11] Code Sec. 163(j)(4)(A)(i) (applying section 163(j) at the partnership level).

level. It is instead treated as BIE incurred by the partner in the following taxable year, but only to the extent of their share of the "excess taxable income" (ETI) of the partnership in such year.[12] A partnership has ETI if the BIE of the partnership is less than 30% of ATI.[13] A partner is permitted to increase its partner-level ATI by its allocable share of the ETI of the partnership, allowing it to deduct additional BIE at the partner level.[14]

C. GPUCs Treated as BIE

Under proposed regulations, a GPUC is treated as interest for purposes of section 163(j).[15] If a partnership pays a preferred return on an equity investment of a partner, therefore, the expense is treated like interest on a loan from a partner, but only if the preferred return is classified as a GPUC. A preferred return that is *not* classified as a GPUC is exempt from section 163(j) even though the special allocation of income to the preferred partner under section 704(b) conveys the equivalent of an interest deduction.

Suppose, for example, that a partner advances $1,000 to a partnership in exchange for a 10% preferred return. If the annual payment of $100 is classified as a GPUC, the partnership would not be permitted to deduct the $100 unless it had additional ATI of at least $333 (i.e., $100/.3). If the $100 is not a GPUC, the partnership would not claim a deduction, but would specially allocate $100 of additional income to the preferred. The

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[12] Code Sec. 163(j)(4)(B)(ii)(I). Any EBI that remains after sheltering such ETI is treated as BIE of the partner in succeeding taxable years. Code Sec. 163(j)(4)(B)(ii)(II).

[13] Code Sec. 163(j)(4)(C).

[14] Code Sec. 163(j)(4)(A)(ii)(II) (ATI of partner increased by such partner's distributive share of partnership ETI).

[15] Proposed Reg. §1.163(j)-1(b)(20)(iii)(H).

diversion of the $100 of income from the other partners to the preferred partner is comparable to a current deduction.

On the other hand, suppose the partnership had plenty of ATI to deduct the $100 as a GPUC but the partner did not have enough ATI to deduct its own BIE at the partner level. If the $100 of preferred return is *not* a GPUC, the additional income to the partner would be treated as ETI, allowing the partner to deduct an additional $30 of partner level BIE. If the $100 is a GPUC, however, the additional income would be treated as "business interest income" (BII).[16] Unlike ETI, BII shelters partner level interest on a dollar-for-dollar basis, allowing the partner to deduct $100 of BIE.

D. <u>GPUCs as Self-Charged Interest</u>

Under future regulations, a portion of any preferred return treated as GPUC expense may be exempt from section 163(j) as "self-charged interest". The preamble to the proposed regulations includes the following statement:

> The Treasury Department and the IRS intend to adopt rules for the proper treatment of [BIE and BII] with respect to lending transactions between a passthrough entity and an owner of the entity ... to re-characterize [BIE and BII] … arising from a *self-charged lending transaction* that may be allocable to the owner, *to prevent such [BIE and BII] from entering or affecting the section 163(j) limitation calculations ...*[17]

For this purpose, self-charged interest would include interest on a loan from a partner. By analogy to a similar exception under the passive loss rules of section 469,[18] the

[16] Code Sec. 163(j)(6) (definition of BII).

[17] Preamble to REG-106089-18, 83 Fed. Reg. 67,490 (Dec. 28, 2018) (emphasis added)

[18] Section 469 generally limits the use of deductions from "passive activities" against non-passive income, including investment income. If a partner makes a loan to a partnership engaged in passive activities, the interest expense on the loan may be disallowed as a passive activity deduction even though it is "self-charged" because the interest income to the partner level is treated as investment income. Because the offsetting items "lack economic significance", the section 469 regulations allow the deduction by

rationale for extending relief to such interest is that the lending partner's share of the interest deduction is matched by an offsetting amount of interest income, resulting in a net deduction of zero. If section 163(j) were to disallow the deduction, the lending partner would be taxed twice, first on the BII as interest income and then again on its increased distributive share of partnership income even though it derived no tax benefit from the debt. Because the purpose of section 163(j) is to disallow the tax benefits from excessive leverage,[19] this seems to be a sensible result. Unlike related party debt between a corporation and an individual shareholder, related party debt between a partnership and a domestic partner generally does not convey a meaningful tax benefit.[20]

If future guidance grants such relief, it will likely extend comparable relief for "self-charged" GPUCs.[21]

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recharacterizing the interest income at the partner level as passive activity income. *See* TD 9013; *see also* Reg. §1.467-7 (self-charged interest rules).

[19] H.R. Rep. 115-409, 115th Cong., 1st Sess., at p. 159 (2017) (""The Committee believes that the general deductibility of interest payments on debt may result in companies undertaking more leverage than they would in the absence of the tax system.").

[20] Presumably, the excluded interest expense will be limited to the portion allocated to the lending partner. As noted by others, however, the case for extending even this limited relief may be less sympathetic in certain cases, for example if the lending partner's share of the interest deduction significantly exceeds its share of the partnership ATI. *See, e.g.,* NYSBA Tax Section, "Report on Proposed Section 163(j) Regulations", Report No. 1412, p. 51-52, Feb. 26, 2019.

[21]The section 469 regulations grant similar relief to GPUCs under the self-charged interest rules. *See* Reg. §1.469-7(a)(1).

III. GPUCS AS INTEREST UNDER SECTION 199A

A. Overview of Section 199A[22]

For taxable years beginning after 2017, section 199A generally allows non-corporate taxpayers to deduct up to 20% of their income from a domestic business.[23] Congress added section 199A to the Code to reduce the gap between the new 21% rate on corporate income and the higher rate of tax on income from other entities, including partnerships. The deduction applies to income from any "qualified trade or business".[24] For taxpayers with income in excess of a threshold amount,[25] the full benefit of the deduction is reduced unless the business pays sufficient W-2 wages to employees and/or has sufficient unadjusted basis in its assets.[26]

The deduction is only available to shelter "qualified business income", or QBI.[27] For this purpose, QBI does not include interest income.[28] If a partner lends money to a

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[22] The summary of section 199A in this paper is intended as a general overview of the statute and regulations. Any discussion of the specific requirements of section 199A, including the right to aggregate related trades or businesses and the "crack and pack" limitations under the final regulations, has been intentionally omitted.

[23] Section 199A does not apply to taxable years beginning after December 31, 2025. Code Sec. 199A(i).

[24] A "qualified trade or business" is any trade or business other than a "specified service trade or business" (SSTB) or the trade or business of performing services as an employee. Code Sec. 199A(d). The exclusion of SSTB only applies to taxpayers with income in excess of a threshold amount. Code Sec. 199A(d)(3).

[25] Code Sec. 199A(b)(3)(A).

[26] For such taxpayers, the deduction is capped at the greater of (a) 50% of the W-2 wages and (b) the sum of 25% of the W-2 wages plus 2.5% of the unadjusted basis of qualified property. Code Sec. 199A(b)(2)(B). Qualified REIT dividends and qualified PTP income are exempt the wage and basis limitations. Reg. §1.199A-1(c)(1).

[27] Code Sec. 199A(c)(3)(B)(iii) (excluding interest other than interest properly allocable to a trade or business).

[28] Code Sec. 199A(c)(1) (definition of QBI).

partnership, therefore, the interest on the loan is taxed at regular rates even if 100% of the underlying income is QBI.

B. Treatment of GPUCs

Although the statute only excludes interest income from QBI, the final regulations under section 199A extend the QBI exclusion to GPUCs.[29] According to the preamble, GPUCs are excluded from QBI because they are similar to interest.[30] As in the case of section 163(j), a preferred return that is *not* classified as a GPUC is not treated as interest,[31] even if the expected payment terms are the same.[32]

IV. PARTNER CAPACITY: THE EVOLUTION OF SECTION 707

A. Life Before Subchapter K: Aggregate Reigns Supreme

Before the enactment of subchapter K in 1954, the aggregate treatment of partnerships was far more pervasive. Under basic aggregate principles, a partnership is

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[29] Regs §1.199A-3(b)(1)(ii). *See also* Preamble to T.D. 9847, 2019-9 I.R.B. 670 ("Although section 199A is silent with respect to [GPUCs], section 199A does limit the deduction under section 199A to income from qualified trades or businesses. The Treasury Department and the IRS believe that [GPUCs] are not attributable to the trade or business of the partnership because they are determined without regard to the partnership's income.").

[30] Preamble to T.D. 9847, 2019-9 I.R.B. 670 ("for purposes of section 199A, guaranteed payments for the use of capital should be treated in a manner similar to interest income").

[31] Under the regulations, service compensation is excluded from QBI regardless of whether section 707(a) or (c) applies. *See* Reg. §1.199A-3(b)(2)(ii)(I) (compensation under section 707(c) excluded from QBI) and (J) (compensation under section 707(a) excluded from QBI). Income attributable to a preferred return, on the other hand, is only excluded from QBI if it is classified as a GPUC.

[32] *See* Karen C. Burke, *Section 199A and Choice of Partnership Entity*, 72 TAX LAW. 551, 586-7 (2019) ("Burke") (stating that a preferred return *not* subject to Section 707(c) "will likely be treated as QBI to the recipient partner while affording a deduction equivalent for the payor partners."). Many have criticized the proposed treatment of GPUCs on these grounds. *See* Preamble to Preamble to T.D. 9847, 2019-9 I.R.B. 670 (Feb. 8, 2019) (stating that one commenter argued that difficulty in distinguishing between payments governed by section 707(c) and section 707(a) would make proposed treatment of GPUCs as interest under section 199A "difficult for both taxpayers and the IRS to administer" and that another commenter cited the "significant uncertainty in determining whether an arrangement is a guaranteed payment for the use of capital, a gross income allocation, or something else"); *see also* Burke at 586 (noting that "the guardrails for guaranteed payments [can be] easily avoided ... [b]y substituting priority cash flow distributions coupled with priority income allocations ...").

not treated as a separate entity from its partners. It is treated more like a "conduit" thorough which the partners directly own and operate the partnership business. As a conduit, the partnership itself is disregarded as a separate entity. The interests in the partnership are not recognized as separate and distinct assets from those of the partnership with their own tax bases and holding periods.

Before 1954, aggregate treatment so permeated the common law that most transfers of property, whether to or from a partnership, required no statutory relief from gain recognition.[33] There was no counterpart to section 351 for transfers of property to a partnership, to section 368(a)(1)(E) for amendments to partnership agreements, or to sections 332, 355 or 368 for distributions of property to a partner. These provisions of subchapter C defer gain recognition by corporate transferors and transferees of property. If a partnership is just a conduit, these same transfers were not transfers at all. Viewed through an aggregate lens, the transferor or transferee partners were merely transferring property to themselves. The transfers required no relief from gain recognition for the same reason a transfer of property to or from a modern day "disregarded entity" requires no relief: they were not realization events.[34]

The same was true of partner salaries. Prior to 1954, a salary was not taxed as compensation to the partner or deducted as a business expense by the partnership. It was

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[33] With one exception prior to the enactment of the partnership audit rules, the internal revenue laws of the United States have never imposed entity level income tax on a partnership. *See* War Revenue Act of 1917, §201, 40 Stat. 300, 313, 65th Cong., Sess. I, Ch. 63 (1917).

[34] Even under current law, non-realization under the aggregate theory is still relevant in many transactions. For example, the reason that an amendment to a partnership agreement is not a taxable event even though there is no partnership counterpart to section 368(a)(1)(E) is non-realization.

treated as a distributive share of partnership profits even if the salary was fixed.[35] Under the aggregate construct, the partners were treated as providing the services to themselves through a conduit entity rather than a separate legal entity and sharing the resulting profits. This approach to the taxation of partner salaries produced acceptable results as long as the taxable income of the partnership equaled or exceeded the salary.[36] The service partner would report the entire salary as distributive share, which in turn conveyed the economic equivalent of a deduction to the remaining partners.

If the salary exceeded the income of the partnership, however, it could no longer be taxed as distributive share in its entirely. The treatment of the excess required a "new" aggregate construct. The construct developed by the courts for doing so involved an examination of how the cost of the excess salary was borne by the other partners.. To the extent the excess salary depleted the capital of the other partners, the service partner reported it as additional income and the other partners reported an offsetting deduction claimed.[37] To the extent the excess salary depleted the capital of the service partner, the service partner excluded the salary from income entirely.[38]

Suppose, for example, a one-third partner receives $400 of salary from a partnership with taxable income of only $100. Under prior law, the first $100 of salary

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[35] *See, e.g.*, *Estate of Tilton, et. al.* 8 B.T.A. 914 (1927); *Lloyd*, 15 B.T.A. 82 (1929).

[36] H.R. Rep. 83-1337, At A-226 (1954) ("Under present law, fixed payments to a partner are not recognized as a salary but considered as a distributive shares of partnership earnings. This creates obvious difficulties where the partnership earnings are insufficient to meet the salary.").

[37] *See* McKee, Nelson & Whitmire, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS, ¶ 14.03[1][a] (4th ed. 2007) ("McKee") ("This approach worked tolerably well as long as "salary" payments did not exceed partnership taxable income; however, if partners' salaries exceeded partnership income, complexity ... reigned.").

[38] A textbook example of this approach is *Augustine M. Lloyd*, a case decided by the Board of Tax Appeals in 1929. 15 B.T.A. 651 (1927).

would be reported by the partner as distributive share. The tax consequences of the remaining $300 depended on which partners bore the economic burden of the expense. If the capital accounts of the partners were debited by $300 on a pro rata basis, the service partner would report an additional $200 in income and the two-thirds partner would claim a deduction of $200. The last $100 of salary, which depleted the capital of the service partner, was treated as a tax-free withdrawal of capital. The cash distribution was not regarded as compensatory in nature under the same aggregate rationale governing property transfers: a partner cannot provide services to itself.[39]

B. Section 707(a) and Section 707(c): Entity Trumps Aggregate

It was these types of discontinuities that led to the enactment of subchapter K in 1954. Codifying parts of the common law and overriding other parts with a new "entity-based" approach to partnerships, Congress introduced the new regime with a rather unflattering assessment of its predecessor:[40]

> The existing tax treatment of partners and partnership is among the most confused in the entire income tax field. The present statutory provisions are wholly inadequate. The published regulations, rulings, and court decisions are incomplete and frequently contradictory. As a result partners today cannot form, operate, or dissolve a partnership with any assurance as to tax consequences.[41]

To address the "excess" salary problem described above, Congress enacted section 707 of the Code. Under section 707, a partnership is treated as a separate entity from its partners. Section 707(c) applies to any salary or other fixed payment to a partner

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[39] *Estate of Tilton*, 8 B.T.A. 914 (1927) (service partner not subject to tax because "no man can be his own employer or employee."); *see also* Rev. Rul. 55-30, 1955-1 CB 431.

[40] Donald J. Weidner, *Pratt and Deductions for Payments to Partners*, 12 R. PROP. PROB. & TRUST J. 811, 819 (1977) (describing the quoted language as a virtual "declaration of war").

[41] H. Rep. No. 1337, 83rd Cong., 2d Sess. 65(1954); S. Rep. No. 1622, 83rd Cong., 2d Sess. 89 (1954).

for services as long as the payment is received in a partner capacity and is determined without regard to partnership income. As separate compensation, the entire salary is reportable as ordinary compensation income to the partner regardless of its character at the partnership level or even whether the payment exceeds partnership income. In contrast to its treatment under prior law, a guaranteed payment is not reportable as distributive share. While the House version of section 707(c) was limited to guaranteed payments for services, the Senate extended it to GPUCs.[42]

Like section 707(c), section 707(a) also prohibits many of the under-inclusions of income once possible under the aggregate construct, including service income. Unlike section 707(c), however, section 707(a) applies only if a partner is acting *other than* in his capacity as a partner. If, for example, a partner leases a building to a partnership to provide office space, section 707(c) does not apply because the partner is not acting in a partner capacity. Because he is acting as a landlord, the partner must include 100% of the rent in income under section 707(a). He cannot exclude any portion of the rent under the aggregate construct of prior law on the basis that he rented the property to himself. Under the new entity approach, the partner is treated as renting the property to a separate partnership.

C. The Capacity Guardrail between Sections 707(a) and (c)

1. Pre-TRA of 1984: What Did the Partner Do?

Section 707(a) applies only to transactions in which the partner is acting "other than in his capacity as" a partner. Section 707(c), on the other hand, applies only to

[42] S. Rep. No. 1622, 83d Cong., 2d Sess. 94 (1954) (referring to GPUCs as "guaranteed interest payments on capital").

transactions in which the partner is acting *in* a partner capacity.[43] The capacity guardrail was intended to ensure that no payment to a partner could be subject to section 707(a) and section 707(c) at the same time. They are mutually exclusive and were intended to be so.

Until 1984, the "capacity" determination depended on the relationship between the activity of the partner (usually services) and the underlying business of the partnership. It did not depend on how the partner was paid. In *Pratt*, for example, the general partners of two partnerships were entitled to 5% of the gross rental income of the partnerships as a management fee.[44] Because the partnerships reported income on the accrual method and the general partners on the cash method, the partnerships deducted the management fees as they accrued while the general partners included them in income as they were paid. The IRS contended that the general partners should have reported the fees as income in the year of accrual, either as distributive share under section 704(b) or as guaranteed payments under section 707(c).

The Tax Court held that section 707(a) did not apply to the management fees because they were received in a partner capacity. They were treated as received in a partner capacity because the management activities of the general partners were regarded

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[43] While the word "capacity" does not appear in section 707(c), both the legislative history and the regulations makes clear that it only applies to payments received in a partner capacity. *See* Preamble to REG-115452-14, 80 Fed. Reg. 141 (July 23, 2015) ("Congress simultaneously added section 707(c) to address payments to partners of the partnership acting in their partner capacity"). GCM 38,069 (August 29, 1979) ("We believe that Congress added subsection (c) to apply the entity approach in certain situations not covered by subsection (a), namely, when a partner receives a guaranteed payment in his capacity as a partner."); *see also* Twisting, *supra* note 3, at 693 ("Section 707(c) ... traditionally has been deemed to apply only when the partner is acting in the capacity of a partner.").

[44] 64 T.C. 203 (1975), *aff'd in part, rev'd in part*, 550 F.2d. 1023 (5th Cir. 1977).

as consistent with their duties to the partnership.[45] The Tax Court further held that section 707(c) did not apply either, finding that the "not based on income" limitation prohibited payments based on gross income. It therefore treated the management fees as distributive share under section 704(b). On appeal, the Fifth Circuit affirmed the capacity holding of the Tax Court under section 707(a) but neither affirmed nor reversed its holding under section 707(c).[46] Because the fees were treated as distributive share, the IRS was the prevailing party in *Pratt*. However, the IRS did not agree that the fees in *Pratt* qualified as distributive share. In Revenue Ruling 81-300,[47] therefore, the IRS ruled that the fees in *Pratt* should have been treated as guaranteed payments under section 707(c), interpreting "not based on income" limitation to *allow* fees based on gross income.

Based on *Pratt,* Revenue Ruling 81-300 and other authorities, it was well-settled before 1984 that the question of capacity was an activity-based determination. If a partner received interest on a loan to a partnership, he was subject to tax under section 707(a) because he received the interest in his capacity as a lender and not as a partner. If a partner received rent on property leased to a partnership, she was subject to tax under section 707(a) because she received the rent in his capacity as a landlord and not as a partner. On the other hand, if a partner received a fee for providing legal advice to a

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[45] 64 T.C. 203 (1975) ("Petitioners in this case were to receive the management fees for performing services within the normal scope of their duties as general partners and pursuant to the partnership agreement. There is no indication that any one of the petitioners was engaged in a transaction with the partnership other than in his capacity as a partner."); *see also William P. Zahler*, 41 TCM 1074 (1981) (commission income to partner of brokerage business not subject to section 707(a) because activity was within scope of partnership business activities).

[46] 550 F.2d. 1023 (5th Cir. 1977) ("the duties to be performed [by the general partners] were activities for which the partnership was created …, i.e., the management of the shopping centers.").

[47] 1981-2 CB 143.

partnership engaged in the practice of law, she would be subject to tax under section 707(c) because she received the fee in his capacity as a partner and not as a lawyer. This was how section 707 divided the world. The capacity determination depended upon the nature of the activity, not the nature of the compensation.

2. Post-TRA of 1984: What Did the Partner Receive?

a) The Guaranteed Payment Is Dead

As discussed above, the capacity determination before 1984 depended on the activities of the partner. If the activities of the partner were proximately related to the business of the partnership (e.g., providing investment advice to an LBO fund or grilling hamburgers at a McDonald's franchise), section 707(c) applied as long the compensation was fixed because the compensation was treated as received in a partner capacity. If the activities were *not* related, section 707(a) applied to the compensation.[48]

In 1984, Congress amended section 707. According to the 1984 legislative history to section 707(a)(2)(A) as well as the later preamble to the implementing regulations in 2015, the purpose of the legislation was two-fold. First, to prevent partnerships from circumventing the capitalization requirements of sections 263 and 709.[49] As perhaps the prototypical example, suppose a partnership agrees to pay a relatively fixed amount to a third party that, if incurred by the partnership as an expense, would not be deductible. Rather than doing so, therefore, the partnership admits the third

[48] McKee, *supra* note 37, at ¶ 14.02[4][a] ("Prior to the enactment of §707(a)(2)(A) in 1984, the principal distinction between §707(a) and §707(c) was whether the services rendered were in connection with activities in which the partnership itself was engaged.").

[49] H.R. Rep. No. 432, 98th Cong., 2d Sess. 1216-21 (1984); S. Prt. No. 169 (Vol. 1), 98th Cong., 2d Sess. 223-32 (1984). Although the original House version of the bill would have limited section 707(a)(2)(A) to transactions in which the expense was subject to capitalization, the Senate rejected this limitation. H.R. Conf. Rep. No. 98-861, at [ ] (1984) ("the rule is not limited to transactions in which direct partnership payments would have to be capitalized").

party as a putative partner and disguises the expense as a special allocation of income followed by a distribution.[50] If respected, the special allocation to third party conveyed the economic equivalent of a deduction. Second, to prevent service partners from converting ordinary income to capital gain.[51]

Under new section 707(a)(2)(A), distributive share treatment is disallowed if the transaction is "properly characterized" as one between the partnership and a partner acting *other than* in his capacity as a partner.[52] In a sea change from prior law, however, whether a transaction was so characterized would no longer depend on what the partner did. It would depend on how the partner was paid:

> 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. An allocation and distribution provided for a service provider under the partnership agreement which subjects the partner to *significant entrepreneurial risk* ... generally should be recognized as a distributive share and a partnership distribution.[53]

So while a partner must still act in a non-partner capacity for section 707(a) to apply, the question of capacity shifted from an *activity-based* determination to a *risk-based*

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[50] McKee, *supra* note 37, at ¶ 14.02[4][a] ("While distributive share treatment is appropriate in the context of a true partnership relationship, it is inappropriate where a service provider merely disguises himself as a partner. For example, an architect might become a partner, in form, in a real estate development partnership, so that the partnership could compensate him for his design services through an allocation of partnership gross income in a specified amount. The hoped-for effect is avoidance of the normal cost capitalization rules (which would require that the architect's fee be capitalized) through a gross income allocation to the architect-partner, which is the equivalent, for the other partners, of a deduction of the architectural design fee.").

[51] Character conversion was the primary target of the 2015 proposed regulations under section 707(a)(2)(A). Five of the six examples in the proposed regulations involved allocations of income by investment partnerships in lieu of a customary fee or commission. *See* Proposed Reg. §1.707-2(d), Ex. 2-6.

[52] Congress also enacted section 707(a)(2)(B) in 1984. Unlike section 707(a)(2)(A), section 707(a)(2)(B) applies to disguised sales of property. The first disguised sale regulations were enacted in [1992]. *See* Reg. §1.707-3, -4, -5 and -6.

[53] S. Prt. No. 169 (Vol. 1), 98th Cong., 2d Sess. at 227 (1984) (emphasis added).

determination. An allocation of income to a partner followed by a related distribution would therefore be treated as a disguised payment for services under section 707(a)(2)(A), but *only* if the payment was not subject to "significant entrepreneurial risk" (SER).[54] It would no longer depend on the nature of the activities.

Recall that in *Pratt*, a fee based on gross rent was respected as distributive share. The Tax Court held that the general partner was acting in a partner capacity based on the nature of the its activities on behalf of the partnership. Nor did section 707(c) apply because the fees were contingent on gross income. In Revenue Ruling 81-300, the IRS concurred with *Pratt* on the capacity determination under section 707(a) but not on the "not based on income" determination under section 707(c).[55] Interpreting the latter to prohibit payments based on net income but not gross income, the IRS ruled that the fees in *Pratt* should have been treated as guaranteed payments. In the 1984 legislative history, however, Congress indicated that the fees in *Pratt* and Revenue Ruling 81-300 should have been subject to tax under section 707(a),[56] most likely on the basis that they were tied to gross income and therefore *not* subject to SER under the new risk-based standard.

So if entrepreneurial risk is to be new focal point of the "capacity" determination, what is left of section 707(c)? It has been credibly argued by the author of a leading treatise on partnership taxation that the new definition of capacity *repealed* the

[54] Although the legislative history indicates that future regulations would take other factors into account in the capacity determination, the most important factor is the presence of SER. S. Prt. No. 169 (Vol. 1), 98th Cong., 2d Sess. at 227 (1984)

[55] 1981-2 CB 143.

[56] S. Prt. No. 169 (Vol. 1), 98th Cong., 2d Sess. 223-32 (1984) (stating that facts in ruling should be governed by section 707(a) rather than section 707(c), strongly implying that the word "income" in 707(c) includes gross income).

guaranteed payment rules for all intents and purposes.[57] The essence of the argument is as follows:

The capacity guardrail, which predated the 1984 amendments by over 30 years, is at the very foundation of any transaction subject to section 707. Section 707(c) only applies when a partner is acting in a partner capacity (provide that the payment is fixed). Section 707(a), on the other hand, only applies when a partner is *not* acting in a partner capacity. No single payment can be governed by section 707(a) and section 707(c) at the same time and the reason is the conflicting capacity requirement.

But if the 'capacity' is now a risk-based determination, how can a partner receive a fixed payment in such a capacity? Fixed payments are utterly devoid of SER. Yet this is the very thing the statute requires. In its zeal to roll out "entrepreneurial risk" as the new gold standard, Congress eviscerated section 707(c): the only way to satisfy the capacity requirement is to make the payment variable and the only way to satisfy the "not based on income" requirement is make the payment fixed. The two conditions are no longer compatible. Even a fixed salary, for 30 years the paradigmatic example of a guaranteed payment, no longer satisfies the statutory definition.[58]

That's the basic argument. While "capacity" had once served as an effective guardrail between section 707(a) and (c), the radical shift from an activity-based to a risk-based definition of capacity destroyed the guardrail. If this is correct, it does not bode

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[57] Twisting, *supra* note 3; David L. Cameron & Philip F. Postlewaite, *The Lazarus Effect: A Commentary on In-Kind Guaranteed Payments*, 7 FLA. TAX. REV. 339, 351 (2006) ("The Lazarus Effect") (stating that section 707(c) "had been effectively repealed", leaving only "statutory surplusage").

[58] *See* H.R. Rep. No. 1337, 83d Cong., 2d Sess. at 67-68 (1954) ("the payment of a fixed or guaranteed amount for services shall be treated as salary income to the recipient and allowed as a business deduction to the partnership").

well for tax reform. Indeed, the proposed extension of the interest limitations of section 163(j) and section 199A to GPUCs is dead on arrival.

b) Long Live the Guaranteed Payment

The case for "de facto repeal" of section 707(c) rests on the contention that the new risk-based definition of capacity applies across the board to all payments governed by section 707. It is not limited to payments governed by sections 707(a)(2)(A) and (B).[59] While the argument that section 707(c) became statutory surplusage in 1984 may have been plausible at the time, 1984 was a long time ago. The General Utilities doctrine was still alive and well,[60] section 704(c) had just been made mandatory, the "substantial economic effect" regulations under section 704(b) were only eight years old and I was still in law school. As of the date of this paper, section 707(c) is still in the Code. While Congress has had countless opportunities since 1984 to repeal section 707(c) outright, it never did so. Surely the new definition of capacity in 1984 did not seize all jurisdiction from section 707(c).[61]

Treasury and the IRS certainly believe section 707(c) is still viable. The original section 707(c) regulations, which were promulgated 28 years *before* the 1984 amendments,[62] were not amended in 1984 and remain in in effect in substantially

[59] *See* Twisting, *supra* note 3, at 693 (stating that section 707(c) is "self-contradictory" if payments are classified under new definition of capacity as received in non-partner capacity because section 707(c) only applies to payments received in a partner capacity).

[60] P.L. No. 94-455, §213(d), 95 Stat. 1548.

[61] Douglas A. Kahn, *Is the Report of Lazarus's Death Premature – A Reply to Cameron and Postlewaite*, 7 FLA. TAX. REV. 411, 420-21 (2006) ("Kahn") ("There is no basis for concluding that section 707(c) is a nullity; to the contrary, the application of the 1984 amendment by Treasury demonstrates that section 707(c) continues to have vitality.").

[62] The regulations were proposed in 1955 and made final in 1956. 20 Fed. Reg. 5854 (August 12, 1955) (proposed); T.D. 6175, 1956-1 CB 211 (final). The only changes to the these regulations since then

identical form. In one of the very first examples in these regulations, the right to a minimum payment whenever it exceeded the partner's share of the profits is treated as a guaranteed payment even though it is not subject to SER.[63] If Treasury and the IRS believed that lack of SER was now disqualifying in the wake of 1984 amendments, it would have withdrawn the example many years ago. But it never did. While it did *replace* the example 31 years later in 2015, the replacement example treated the minimum payment as a guaranteed payment in its entirely. Rather than narrowing the circumstances under which a payment not subject to SER was a guaranteed payment, therefore, the government actually expanded them. Clearly, Treasury and the IRS do not believe the absence of SER deprives a partner of capacity for purposes of section 707(c).[64]

It is in fact possible to interpret the new risk-based definition of capacity in a way that does not read section 707(c) out of the Code.[65]

First, the new definition may apply only to those portions of section 707 that were amended in 1984. The original section 707(a) regulations, which apply to many

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were to incorporate the Tax Reform Act of 1976 amendments prohibiting the deduction of guaranteed payments subject to capitalization under section 263. T.D. 7891, 1983-1 CB 117.

[63] Reg. §1.707-1(c), Ex. 2. In the example, a partner was entitled to 30% of partnership profits or $10,000, whichever was greater. The example treats the $10,000 as a guaranteed payment only during those years in which it exceeded 30% of the profits.

[64] *See* Proposed Reg. §1.707-1(c), Ex. 2; *see also* Preamble to REG-115452-14, 80 Fed. Reg. 141 (July 23, 2015) (stating that because original example was "inconsistent with the concept that an allocation must be subject to significant entrepreneurial risk", it would be replaced with new example treating entire amount as a guaranteed payment each and every year regardless of whether it exceed the partner's share of the profits).

[65] Years after the 1984 amendments, the government issued new guaranteed payment regulations, none of which adopted a risk-based approach to the capacity determination. *See* Regs §1.707-4(a)(4), Ex 1 (treating cash payment of specified amount as guaranteed payment); Regs §1.721-1(b)(2) and Proposed Reg. §1.721-1(b)(4)(i) (treating transfer of capital interest for services as guaranteed payment).

transactions not subject to sections 707(a)(2)(A) or (B),[66] state that a partner is not acting in a partner capacity when he pledges property to the creditors of a partnership to support a borrowing.[67] This is an activity-based definition of capacity. When Treasury issued the disguised sale regulations under section 707(a)(2)(B) in 1992 and the proposed disguised services regulations under section 707(a)(2)(A) in 2015, it did not amend these regulations.[68] This suggests that the new definition of capacity may be limited to transactions governed by section 707(a)(2)(A) or (B).[69]

Second, section 707(a)(2)(A) may have been intended to apply only to abusive transactions, especially those of relatively short duration or involving a counterparty other than an historic partner.[70] It was not intended to apply to recurring payments in the form of fixed salaries or preferred returns on capital.[71] Indeed, the status of section

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[66] A loan or lease of property from a partner to a partnership, for example, is subject to section 707(a) even though it is not described in sections 707(a)(2)(A) or (B). *See* Reg. §1.707-1(a)

[67] Reg. §1.707-1(a).

[68] T.D. 8439, 1992-2 CB 126.

[69] Even the advocates of de facto repeal acknowledge this possibility. *See* Twisting, *supra* note 3, at 694 ("It may be argued that because section 707(a)(2)(A) applies only to special allocations and distributions, its new definition of capacity should be confined solely to allocations and distributions and not expanded to, for example, fixed payments that traditionally have been recognized under section 707(c) as guaranteed payments. Such an approach would avoid the apparent self-contradictory interpretation of section 707(c), but it would require courts and the Service to wrestle with two definitions of capacity").

[70] Twisting, *supra* note 3, at 660. The preamble to proposed regulations under section 707(a)(2)(A) is also consistent with this interpretation. Preamble to REG-115452-14, 80 Fed. Reg. 141 (July 23, 2015) (distinguishing between allocations and distributions "for an extended period to reflect [a partner's] contribution of property or services" from allocations and distributions that are "in substance direct payments for services").

[71] Even before the 1984 amendments, the Tax Court in *Pratt* had suggested in 1975 that Congress may have intended to limit section 707(a) to "one off" transactions of this kind. 64 T.C. at 210-11 (1975) ("Section 707(a) refers to "transactions" between a partner and a partnership and is susceptible of being interpreted as covering only those services rendered by a partner to the partnership in a special transaction.").

707(a)(2)(A) as a targeted anti-abuse rule is implied by the very word "transaction" in the statute, as are the specific types of transactions that inspired its enactment.[72]

Finally, sections 707(a) and (c) may apply to different categories of low-risk payments, one consisting of payments that are variable and the other consisting of payments that are fixed.[73] Consistent with this view, while section 707(a)(2)(A) *requires* "a related direct or indirect allocation" of income, section 707(c) prohibits any such allocation. Accordingly, while the government certainly has the authority to challenge a variable payment masquerading as a distributive share of partnership income as a disguised payment for services under section 707(a)(2)(A), it never needed any special grant of authority to recharacterize a completely fixed payment. These payments were never subject to SER and were treated as guaranteed payments before and after the 1984 amendments.[74]

The argument that lack of SER is not disqualifying but rather is an inherent attribute of any guarantee payment is supported by the 2015 proposed regulations under section 707(a)(2)(A). The preamble to these regulations states that "Congress's emphasis

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[72] *See* Schnabel, *Proposed Regulations under Section 707(a)(2)(A) and the Opacity of Capacity*, TAX FORUM NO. 668 (Nov. 2, 2105) ("Schnabel") (stating as possible explanation of why certain distributive share arrangements may be recast as section 707(a) payments rather than section 707(c) payments that "Congress intended to limit Section 707(a)(2)(A) to arrangements in which the partner capacity is artificial …") ; *see also* Richard M. Leder, *Guaranteed Payments, Management and Promoter Fees*, New York University, 41ST INSTITUTE ON FEDERAL TAXN, Vol. 1, ¶14.06[2] (1983) ("By broadly construing Section 707(c), and leaving Section 707(a) essentially for isolated or occasional transactions, the Congressional purpose of limiting artificial timing benefits in transactions between partners and partnerships would be furthered.").

[73] Schnabel, *supra* note 72 (citing this explanation as one way to reconcile the difference between payments subject to section 707(a)(2)(A) and section 707(c)).

[74] While this interpretation is inconsistent with a prior IRS ruling treating a variable management fee as a guaranteed payment, the ruling was criticized by Congress in the 1984 legislative history and has since been obsoleted. *See* Rev. Rul. 81-300, 1981-2 CB 143; *see also* S. Prt. No. 169 (Vol. 1), 98th Cong., 2d Sess. at 230 (1984); Preamble to REG-115452-14, 80 Fed. Reg. 141 (July 23, 2015).

on entrepreneurial risk requires changes to existing regulations *under section 707(c)*."[75] As discussed above, the change to which the preamble refers was limited to the example involving the minimum payment discussed above. Recognizing that the payment in the original example lacked SER, Treasury modified the example to treat the payment as a guaranteed payment in its entirety.[76] If the government had believed that lack of SER deprived a partner of capacity for purposes of section 707(c), it would have revoked the example rather than modified it.

For these and other reasons, the case for the de facto repeal of section 707(c) has been described as "very weak".[77]

V. 20TH CENTURY GPUCS: HOW DID WE GET HERE?

A. All Paths Lead to Rome

Elective regimes do not last very long unless that were intended to be elective. If the guaranteed payment rules are indeed elective, they have been so for decades. How is this possible? Perhaps the answer to this paradox is that it is not a paradox at all. Just a misguided view of current law. The failure of the government to intercede suggests something may be amiss with this theory. In most of the published articles, electivity is

[75] Preamble to REG-115452-14, 80 Fed. Reg. 141 (July 23, 2015) (emphasis added). The preamble further states that "section 707(a)(2) applies to arrangements in which distributions to the service provider depend on an allocation of an item of income, and section 707(c) applies to amounts whose payments are unrelated to partnership income". *Id.*

[76] *See* Proposed Reg. §1.707-1(c), Ex. 2; *see also* Preamble to REG-115452-14, 80 Fed. Reg. 141 (July 23, 2015) (stating that because the original example was "inconsistent with the concept that an allocation must be subject to significant entrepreneurial risk", it would be replaced with a new example treating the entire amount as a guaranteed payment each and every year regardless of whether it exceeded the partner's share of the profits).

[77] Kahn, *supra* note 61, at 450 ("The case for treating section 707(c) as having been impliedly repealed by the 1984 adoption of section 707(a)(2) is very weak."). The case for repeal has also been criticized as inconsistent with the common law rule of statutory construction that "implied repeals of statutes are disfavored". *Id. See also Posadas, Collector of Internal Revenue v. National City Bank*, 296 U.S. 497, 503 (1936) ("The cardinal rule is that repeals by implication are not favored.").

at most hinted at but otherwise never mentioned. The far more consistent complaint from practitioners is the lack of clear guidance.

In 1992, one practitioner described current law at the time as ranging between "confused" and "schizophrenic", concluding that "support seemingly exists for almost any position a recipient or payer of GPUCs wishes to take."[78] In 2004, another practitioner complained that the law was "conflicting", "inconclusive" or "simply non-existent".[79] In 2011, yet another dismissed the relevant authorities as "notoriously conflicting".[80] Finally, in 2015, the government announced that many of the very authorities cited in the published articles as largely responsible for the current state of affairs would be revoked, obsoleted or modified in favor of new proposed regulations that appear to going nowhere. In almost any other area of law, these kinds of ambiguities would have been resolved years ago.[81]

While conflicting guidance promotes a form of electivity, it is not the kind of electivity at issue here. The guaranteed payment rules are elective in the sense that they tax two otherwise similar economic investments differently based on drafting changes that do not materially alter the expected payment terms. Legal uncertainly has nothing to do with it. The reason this particular brand of electivity has persisted for so long is that,

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[78] *See* Sheldon I. Banoff, *Guaranteed Payments for the Use of Capital: Schizophrenia In Subchapter K*, 70 TAXES 820, 837 (1992) ("Banoff").

[79] Lewis Steinberg, *Fun and Games with Guaranteed Payments*, 57 TAX LAW. 533 (2004) ("Steinberg").

[80] Kreisberg, *Guaranteed Payments for Capital: Interest or Distributive Share?*, 132 TAX NOTES 55 (July 4, 2011) ("The law is notoriously conflicting, and it seems the best taxpayers can do is to make a judgement call based on their particular circumstances …").

[81] *See also* Schnabel, *supra* note 72, at 4 ("The scope and application of Section 707(c) remains somewhat of a mystery today in many cases to even the most experienced partnership practitioners").

at least prior to the TCJA amendments, the status of a preferred return as a guaranteed payment or a distributive share of partnership income did not matter a great deal, at least for most operating partnerships. In either case, the preferred partner reported the preferred return as ordinary income and the partnership either deducted the preferred return as a business expense or allocated less taxable income to the other partners.

The tax treatment of a payment under section 707(a) once differed in many important respects from the tax treatment of a payment under section 707(c).

One such difference concerned the deductibility of expenses subject to capitalization under sections 263. Unlike payments subject to section 707(a), it was once unclear whether a guaranteed payment was exempt from these limitations. Following years of litigation, Congress amended section 707(c) in 1976 to prohibit the deduction of any guaranteed payment that, if paid to a non-partner, would have been subject to section 263.[82]

Even following the 1976 amendments, other partnerships attempted to circumvent the capitalization requirements by admitting the payee as a transitory partner and disguising the capital expenditure as an allocation of income followed by a distribution. If respected, the income diverted to transitory partner conveyed the equivalent of a full deduction to the historic partners. As discussed earlier in this paper,[83] this alternative

[82] Even before the 1976 amendments to section 707(c), the IRS contended that these types of guaranteed payments were subject to capitalization. *See Cagle*, 63 T.C. 86 (1974), *aff'd,* 539 F. 2d 409 (5th Cir. 1976), Rev. Rul. 75-214, 1975-1 CB 185.

[83] See *supra* text accompanying notes 48-56.

was no longer possible for fixed payments following the enactment of section 707(a)(2)(A) in 1984.[84]

Finally, the relevant timing rules governing the deduction and related income inclusion differed as well. If section 707(c) applied, the timing of these items depended on the accounting method of the partnership.[85] If section 707(a) applied, it depended on the accounting method of the partner. In the *Pratt* case, for example, the general partners attempted to claim a current deduction for the accrued cost of their own services without reporting the salary as income until it was paid.[86] When Congress amended section 267 in 1984 to treat partners and partnerships as related parties,[87] the partnership could no longer deduct the salary until the partner included the salary in income.[88]

Following these amendments, the few remaining differences between section 707(a) and section 707(c) payments were no longer meaningful. The recipient partner reported the payment as ordinary income and the partnership either deducted or capitalized the expense. With the proposed extension of sections 163(j) and 199A to GPUCs, however, this is no longer true. A preferred return may constitute non-deductible interest under section 163(j) if the partnership has insufficient ATI and may be taxed at a higher rate to the recipient partner as non-QBI under section 199A. These new

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[84] *See* Proposed Reg. §1.707-2(c) ("An arrangement that lacks significant entrepreneurial risk constitutes a payment for services.").

[85] Reg. §1.707-1(c) ("a partner must include such payments as ordinary income for his taxable year within or with which ends the partnership taxable year in which the partnership deducted such payments … under its method of accounting").

[86] 64 T.C. 203 (1975), *aff'd in part, rev'd in part*, 550 F.2d. 1023 (5th Cir. 1977)

[87] Code Sec. 267(e) (treating a partner and a partnership as related parties for purposes of section 267(a)(2)).

[88] See Code Sec. 267(a)(2).

limitations apply, however, only to a preferred return that is classified is a GPUC under section 707(c). A preferred return that is not a GPUC is exempt from these limitations.

B. What Do You Mean By Elective?

Suffice it to say that if section 707(c) is a dead letter, it cannot be exported as a GPUC to sections 163(j) or 199A as a new category of interest, at least not without legislation. But what if it is "merely" elective? Are the prospects any better, or could they be worse?

First of all, what do we mean by 'elective'?

By elective, I do not mean an actual tax election. Nor do I mean a drafting change that alters the economic nature of the preferred return in a meaningful way. An unconditional preferred return is very different from a preferred return contingent solely on future profits, even if the actual payments turn out to be identical. A drafting change of this nature no more "elective" than a decision to issue stock rather than cash in an acquisition. Choices of this nature alter the economic agreement between the parties. On the other hand, a drafting change that alters the tax consequences without altering the nature of the economic agreement in a material way is an election. For these types of choices, only the government stands to lose.

For most operating partnerships, the difference between a fixed preferred return and a preferred return capped by a matching allocation of gross income is not economically meaningful. As long as the partnership earns sufficient gross income, the payments will be identical. For partnerships in which the likelihood of sufficient gross income is less certain, the difference between the two is still not economically meaningful *unless* the allocation is a condition to payment. Under current law, this does

not appear to be necessary. Some preferred returns in the market purport to avoid the guaranteed payment rules by requiring a matching allocation of gross income to the extent such income is available, even though the return continues to accrue for future payment if it is not. The shortfall in gross income defers rather than discharges the liability.

C. Electing Out of Section 707(c): A Roadmap

Assuming section 707(c) is still alive (if not well), current law is relatively clear in two important respects: first, a preferred return on capital that accrues like interest without regard to partnership income is a GPUC; second, an otherwise identical preferred return is *not* a GPUC if the payment is contingent on gross income.

1. The Meaning of "Income" under Section 707(c)

To be subject to section 707(c), a payment to a partner must be determined "without regard to the income of the partnership". Neither the statute nor the regulations define the word "income" for this purpose.[89] Did Congress mean to exclude only those payments contingent on net income, in which case a payment contingent on gross income may still be a guaranteed payment, or did it mean to exclude these payments as well? Although it probably intended to exclude only payments contingent on net income,[90] there is almost no support for this position under current law.

[89] NYSBA Tax Section, "Report on Guaranteed Payments and Preferred Returns", Report No. 1357, p. 7, Nov. 14, 2016 ("it is not clear from the plain text of [section 707(c)] whether "income" refers to gross income, net income, or both.").

[90] *See* GCM 38067 (August 29, 1979) (because section 707(c) is intended to apply to all amounts payable "no matter how unsuccessful the partnership effort may be", the word 'income' under the statute should be interpreted to mean net income); *see also* McKee, *supra* note 37, at ¶ 14.03[1][a] ("reading the statutory phrase 'determined without regard to the income of the partnership,' as 'determined without regard to the *taxable* income of the partnership,' produces results more consistent with the congressional purpose") (emphasis added).

As discussed earlier in this paper,[91] section 707(c) was enacted to address the underreporting of salary income by partners under the common law. Before 1954, partner salaries were not treated as compensation. They were treated as distributive share. Like the compensatory grant of a profits interest,[92] the service nature of the relationship was ignored. Because few private equity funds existed at the time, the treatment of salary as distributive share did not alter the actual character of the income and generally produced an acceptable result, but only if the salary of the service partner did not exceed the pre-salary profits of the partnership. If it did, the portion of the salary in excess of such profits was treated as a withdrawal of capital by the partners, which often allowed the service partner to exclude a portion of the salary from income.[93]

If the "not based on income" limitation under section 707(c) were to exclude payments contingent on gross income, a fixed salary subject to such a contingency would not be a guaranteed payment even if it exceeded the profits of the partnership. Because this is the very abuse section 707(c) was intended to address, it seems unlikely that Congress intended the income prohibition of the statute to exclude these payments.[94] In *Pratt*, however, the Tax Court disagreed.

The Tax Court in *Pratt* held that the management fees based on gross rental income were not guaranteed payments, finding "no merit" to the contention that the "not

[91] See *supra* text accompanying notes 33-39.

[92] Rev. Proc. 93-27, 1993-27 C.B. 343.

[93] Twisting, *supra* note 3, at 674, note 127.

[94] McKee, *supra* note 37, at ¶ 14.03[1][a] ("The Tax Court's holding [in *Pratt*], while defensible as a literal reading of the statute, runs counter to the congressional purpose in enacting 707(c) – to obviate the need for complex calculations when salary-type payment exceed partnership *taxable* income.") (emphasis added).

based on income" limitation allowed payments contingent on gross income.[95] While the IRS disagreed with the Tax Court, ruling in Revenue Ruling 81-300 that the management fees were in fact guaranteed payments even though they were contingent on gross income,[96] the precedential value of both of these authorities was called into serious question, first by Congress in 1984 and then again by Treasury and the IRS in 2015.[97]

In the 1984 legislative history, Congress disagreed with the Tax Court that the fees were distributive share and with the IRS that the fees were guaranteed payments, stating that the facts in *Pratt* should have been governed by section 707(a). While it failed to articulate its reasoning, the most likely explanation for rejecting both *Pratt* and the ruling is that the fees in *Pratt* could not have been received in a partner capacity under the new risk-based standard. It therefore rejected any notion that a fee based on gross income could be a guaranteed payment.[98]

The IRS and Treasury adopted the same approach in the preamble to the 2015 proposed regulations.[99] In the preamble, which quotes extensively from the 1984 legislative history, they announced that Revenue Ruling 81-300 was obsoleted and that a payment for services linked to "an allocation of an *item* of income" (i.e., gross income or

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[95] 64 T.C. 203 (1975), *aff'd in part, rev'd in part*, 550 F.2d. 1023 (5th Cir. 1977); *see also* GCM 34173 (7/25/1969) (amounts contingent on gross income were not guaranteed payments).

[96] 1981-2 CB 143.

[97] See *supra* text accompanying notes 45-58.

[98] Twisting, *supra* note 3, at 675 ("While Congress provided no further explanation. the legislative history presumably indicates that most payments determined with respect to the gross income of the partnership will constitute section 707(a) payments.").

[99] Schnabel, *supra* note 72, at 25 ("While not entirely clear, it appears that the IRS now agrees with the position of the Tax Court in *Pratt* that a gross income based allocation is not governed by Section 707(c) but rather is governed by Section 704(b) or (if Section 707(a)(2)(A) applies) Section 707(a)").

net income) would henceforth be governed by section 707(a)(2)(A).[100] Moreover, the proposed regulations treat payments for services contingent on gross income as subject to section 707(a)(2)(A) (rather than section 707(c)) for want of SER unless the taxpayer is able to establish SER "by clear and convincing evidence".[101]

Did Congress mean to exclude only those payments contingent on net income, in which case a payment contingent on gross income may still be a guaranteed payment, or did it mean to exclude these payments as well?

Based upon the foregoing, section 707(c), as interpreted by Congress, the Treasury and the IRS, does not apply to payments received in a partner capacity that are contingent on gross income.

2. Capped Allocations of Gross Income: In General

Based on the foregoing, it appears to be relatively well-settled that a variable payment contingent on gross income cannot be a guaranteed payment under current law.[102] But suppose the variation is capped, for example a right to 100% of the gross

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[100] Preamble to REG-115452-14, 80 Fed. Reg. 141 (July 23, 2015) (emphasis added) ("the Treasury Department and the IRS are obsoleting Rev. Rul. 81-300 and request comments on whether it should be reissued with modified facts.").

[101] Proposed Reg. §1.707-2(c)(1)(iii); *see also* S. Prt. No. 169 (Vol. 1), 98th Cong., 2d Sess. at 227 (1984) ("gross income may, *in very limited instances*, represent an entrepreneurial return, classifiable as distributive share under [section] 704") (emphasis added).

[102] The author understands that some practitioners may disagree. If the preferred partner has no further entitlement to a residual share of the future profits, he may not qualify as a partner, in which case the preferred return would not qualify as distributive share. *See, e.g., Culbertson*, 337 U.S. 733 (1949). The concern that a partner who is only entitled to a debt-like return is not participating in the risks of the venture is more commonly cited in the guaranteed payment context. *See* Banoff, *supra* note 78, at 854-855 (while acknowledging the absence of definitive guidance, asking whether a purported partner who is only entitled to a GPUC is a partner for tax purposes); *see also* Eric B. Sloan and Matthew Sullivan, *Deceptive Simplicity: Continuing and Current Issues with Guaranteed Payments*, 916 PLI/TAX 124-1 at 34 (2010) ("Sloan") ("Whether a "pure" guaranteed payment interest is properly treated as a partnership interest has traditionally been dependent on case law regarding who is a partner."). In most partnerships, however, the preferred partner participates in the residual profits of the business.

income of the partnership, but no greater than a fixed percentage of a partner's capital. One might think that a gross income allocation subject to a cap would be more vulnerable to challenge as a "disguised" guaranteed payment under section 707(c) than an allocation not subject to a cap, in particular when the projected income of the partnership is expected to exceed the cap by a substantial margin. In such a case, *none* of the actual payments to the partner will actually vary from the cap.

The basic legal argument that such arrangements should be treated as "disguised" guaranteed payments is straightforward: a capped allocation of gross income under these conditions is unlikely to alter the expected payment terms and therefore does not serve a non-tax business purpose. The partner will receive the same distributions as a partner entitled to an equivalent GPUC. In stark contrast, every dollar of gross income subject to an *uncapped* allocation will increase the economic entitlements of the preferred partner to the detriment of the common partners. Given this difference, one might think that a capped allocation subject to a truly *de minimis* risk of non-payment would be ignored on remoteness grounds, allowing a court to treat the return as in substance a non-contingent guaranteed payment.[103]

Although the section 707 regulations do provide that "the substance of the transaction will govern rather than its form,"[104] there appears to be virtually no support for this line of argument.

[103] The argument that the allocation of gross income should be disregarded in this context is oddly similar to the argument that a special allocation of income is invalid under the section 704(b) regulations: it is not expected to affect the amount distributable to the preferred partner. Here, however, the effect of disregarding the allocation would be to convert what is in form an item of income to the partnership into an item of expense (i.e., a guaranteed payment).

[104] Treas. Reg. §1.707-1(a) (as amended in 1983). The regulations recognize that a partner can loan money to his partnership and have that loan respected. *Id.*

Indeed, the 1984 legislative history anticipated this type of allocation in the service context. Under the proposed regulations, a payment linked to a capped allocation of income that is "reasonably certain" and involves "limited risk" is prone to recharacterization, not as a guaranteed payment but as a section 707(a)(2)(A) payment.[105] In the service context, therefore, the authority of the IRS to challenge the status of a capped allocation of income as distributive share is limited to section 707(a)(2)(A). That the identical payment would have been a guaranteed payment if the capped allocation had been removed from the partnership agreement entirely appears to be irrelevant.

3. Capped Allocations of Gross Income: GPUCs Only

As in the service context, the risk that a preferred return will not be paid for want of sufficient gross income may also be remote. Here, however, the IRS cannot argue that a preferred return contingent on a low-risk allocation of gross income should be recharacterized as a payment subject to section 707(a)(1).[106] The regulations under section 707(a)(2)(A) apply only to disguised service compensation, and even those regulations remain in proposed form. While section 707(a)(2)(A) authorizes Treasury to issue regulations governing property transfers, no such regulations have been issued.[107] Even if the statutory language of section 707(a)(2)(A) is broad enough to include a preferred return on capital, the statute is not self-implementing.

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[105] *See also* Proposed Reg. §1.707-2(c)(1) (capped allocations cited as evidence that arrangement lacks SER "if the cap is reasonably expected to apply in most years").

[106] *See* Steinberg, *supra* note 79, at 542 ("The bottom line appears to be that while section 707(a)(2)(A) arguably transforms many gross income-based payments for services into section 707(a) payments, some such payments, *as well as most (if not all) payments for the use of capital*, should continue to qualify as distributive shares of firm (gross) income.") (emphasis added).

[107] *See* Code Sec. 707(a)(2) (authorizing recharacterization of property transfers "under regulations prescribed by the Secretary …"); *see also* McKee, *supra* note 37, at ¶ 14.02[4][a] (""While §707(a)(2)(A) is theoretically applicable to property transactions, its primary focus is on service transactions. Property transactions will generally be scrutinized under §707(a)(2)(B).").

Nor is there any clear evidence that section 707(a)(2)(A) was ever intended to apply to a preferred returns on capital.[108] Indeed, the only regulations that even refer to a preferred return on capital are the disguised sale regulations. The regulations under section 707(a)(2)(B) do *not* treat a preferred return like a typical section 707(a)(1) payment (i.e., ordinary income to the partner, deductible expense to the partnership). They respect the preferred return as distributive share under a special safe harbor or recharacterize it as presumptive disguised sales proceeds.[109]

What should one conclude from this? Is the IRS just out of luck? Or could the IRS assert that a preferred return of this kind should be treated as a guaranteed payment because the gross income contingency is too remote to be given effect and the IRS does not have the option of challenging the preferred return as distributive share under section 707(a)(2)(A)? Imagine, for example, that Amazon, a company with GAAP gross sales income in 2018 that was $85 billion *greater* than its GAAP net income of $10 billion, were taxable as a partnership and that Amazon was obligated to pay an annual preferred return equal to its net interest expense of $1 billion, but only to the extent it earned at least $1 billion of gross income.[110] Should such a preferred return be respected as a distributive share of Amazon income or should it be recast as a disguised guaranteed

[108] *See* Schnabel, *supra* note 72, at 21 (Nov. 2, 2015) ("it is not clear whether (or how) [Section 707(a)(2)(A)] applies to certain other transfers of property, such as a transfer of cash to a partnership in exchange for preferred equity").

[109] Under the disguised sale regulations of section 707(a)(2)(B), a preferred return is generally respected as distributive share if it is "reasonable", even if paid within two years of a transfer of property. Reg. §1.707-4(a)(2) and (3).

[110] Amazon.com Inc. Form 10-K for the Fiscal Year Ended December 31, 2018, Item 8 (income statement).

payment? By almost any measure, the likelihood that Amazon will fail to earn the gross income necessary to compel payment is remote in the extreme.

Remote payment contingencies are ignored all the time, both within and without subchapter K. They are disregarded, for example, for purposes of determining whether a debt instrument is a CPDI,[111] whether interest on a debt instrument is "qualified stated interest",[112] whether an installment obligation is "fixed" under section 453,[113] whether preferred stock is non-qualified preferred stock under section 351(g),[114] whether an interest in a REMIC is a "regular interest" under section 860G(a)(1)[115] and whether a partner bears risk of loss under section 752.[116] Why not here?

Perhaps only those who do not practice much in subchapter K would worry about such things. McKee, a person who does *not* fit this description, contends that a preferred return contingent on gross income may *never* be recast as a GPUC under section 707(c) *even if* the risk of non-payment due to the income contingency is vanishingly small.[117] Indeed, it is not even necessary that the gross income contingency be a contingency at all. All that is required is an actual gross income allocation, either as the preferred return

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[111] Reg. §1.1275-2(h)(2), 1.1275-4.

[112] Reg. §1.1273-1(c)(1)(ii).

[113] Reg. §15a.453-1(d)(2)(ii)(A).

[114] Code Sec. 351(g)(2)(B).

[115] Reg. §1.860G-1(b)(3)(vi).

[116] Reg. §1.752-2(b)(4).

[117] McKee, *supra* note 37, at ¶ 14.03[2] ("There is no statutory basis for applying 707(a)(2)(A) principles to convert a putative distribution/allocation arrangement into a 707(c) guaranteed payment *merely because there is virtual certainty of payment* and the distribute partner bears little or *no* significant entrepreneurial risk.") (emphasis added).

accrues or when the return is paid (depending on your point of view). If this is correct, the relatively "remoteness" of the contingency is not even relevant.[118]

Consider, for example, the definition of "preferred return" under the disguised sale regulations. The disguised sale regulations under section 707(a)(2)(B) grant safe harbor relief to preferred returns and GPUCs payable within two years of a prior transfer of property as long as the obligation to pay is in writing and is not unreasonable. The definition of preferred return, which has no statutory counterpart, is noteworthy in several respects:

> "a preferential distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of income or gain."[119]

First, the definition is intended to differentiate between preferred returns and GPUCs, which are separately defined under the same regulations. Second, the only substantive difference between a preferred return and a GPUC under the definition is a matching allocation income (including gross income).[120] Unlike in the service context, the absence of SER does not appear to be relevant. Finally, the matching allocation need not be a condition to payment. The partnership is only required to allocate gross income "to the extent [such income is] available". Unlike the "wait and see" approach to guaranteed payments in the service context, the definition of preferred return does not by its terms prohibit distributive share treatment even in the year of payment should the partnership

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[118] In the absence of sufficient gross income even in year of payment, a portion of the preferred return would likely constitute a GPUC.

[119] Reg. §1.707-4(a)(2).

[120] Reg. §1.707-4(a)(2) (referring to allocation of "income or gain"); *see also* Sloan, *supra* note 102 (stating in case of preferred return payable in all events but accompanied by matching allocation of gross income that "arguably there should be no guaranteed payment" and that such position is "supported by the definition of "preferred return" in the disguised sale regulations.").

not have sufficient net or gross income.[121] Unless a GPUC is imputed in this scenario, the preferred partner will likely recognize section 731 gain upon receipt of the payment or in a future liquidation.[122]

The absence of the need for a true payment contingency to avoid automatic GPUC classification was confirmed by the government in the 2015 preamble to the proposed regulations under section 707(a)(2)(A). In the preamble, the IRS invited comments on the proper tax treatment of a preferred return payable on a current basis to the extent of net income but on a deferred basis in the event of a shortfall in net income.[123] Rather than even considering whether such a preferred return was a GPUC in its entirely, the IRS limited its request for comments to a far narrower timing issue: whether, in the year of a shortfall in net income, a partnership must allocate *gross* income to the preferred partner to avoid a deemed guaranteed payment.[124]

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[121] *See also* TAM 8752004 (treating current preferred return conditioned on net income allocation as subject to sufficient entrepreneurial risk to be respected as distributive share even though any unpaid amounts due to failure of net income condition was still payable in future years regardless of net income, reasoning that temporary net income condition applied "for a significant period of time").

[122] *But see* McKee, *supra* note 37, at ¶14.02[3][b][iii][A] (noting that IRS believes matching allocations are "essential" to avoid a net reduction in the capital account of the preferred partner without explaining the consequences to the partners in the absence of a matching allocation).

[123] Preamble to REG-115452-14, 80 Fed. Reg. 141 (July 23, 2015) ("Some taxpayers have expressed uncertainty whether a partnership with a targeted capital account agreement must allocate income or a guaranteed payment to a partner who has an increased right to partnership assets determined as if the partnership liquidated at the end of the year *even in the event that the partnership recognizes no, or insufficient, net income*. The Treasury Department and the IRS generally believe that existing rules under §§1.704-1(b)(2)(ii) and 1.707-1(c) address this circumstance by requiring partner capital accounts to reflect the partner's distribution rights as if the partnership liquidated at the end of the taxable year ...") (emphasis added).

[124] Many practitioners believe that the partner has no current GPUC or other income in the year of a shortfall in net profits even when the unpaid return continues to accrue as a future claim on the partnership assets. The same practitioners also contend that a GPUC is avoided in the year of actual payment as well if the gross income in such year is sufficient. *See, e.g.,* NYSBA Tax Section, "Report on Guaranteed Payments and Preferred Returns", Report No. 1357, p. 18-19, Nov. 14, 2016 ("does a partner who is entitled to a distribution that would otherwise be treated as a guaranteed payment always have the opportunity to "earn its way out of" guaranteed payment treatment [by a matching allocation of gross

Based on the foregoing, there appears to be no set of circumstances in which the likelihood of insufficient gross income is so remote that it is disregarded entirely.[125] In the service context, remoteness is only relevant to whether the payment is respected as distributive share or recharacterized as a section 707(a)(2)(A) payment for want of SER.[126] With a preferred return, it is not relevant at all.

This would hardly matter, of course, if the tax treatment of a preferred return under sections 707(a) and 707(c) were the same. But it is not. The proposed regulations under section 163(j) and the final regulations under section 199A treat GPUCs (and *only* GPUCs) as interest equivalents. If a preferred return contingent solely on a capped allocation of gross income is never a GPUC regardless of how remote the contingency, the proposed treatment of GPUCs as interest is likely to be elective for most operating partnerships.

VI. 21ST CENTURY GPUCS: WHERE SHOULD WE GO FROM HERE?

This paper argues that the proposed extension of sections 163(j) and 199A to GPUCs is unlikely to achieve its intended purpose unless the definition of a GPUC under current law is amended. In the absence of an amendment, many well-advised partners and partnerships will engage in self-help to avoid the new interest limitations. A fixed

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income]? Many practitioners draft partnership agreements based on the conclusion that the answer to this question is yes …"); *see also* Sloan, *supra* note 102, at 29-30 (stating in the case of an unconditional preferred return that while there is no published guidance, there is "arguably" no guaranteed payment as long as the partnership allocates gross income to the preferred partner).

[125] *See* Steinberg, *supra* note 79, at 540-41 ("Under the McKee approach, a purported gross income allocation would presumably be potentially subject to recharacterization as a Section 707(a) payment [rather than a guaranteed payment] where the payment and amount of the gross income allocation could be predicted *ab initio* with a high degree of confidence. This would likely be the case, for example, where the underlying gross income of the partnership was not subject to material variation, or the gross income allocation was subject to a cap that was substantially below the excepted gross income of the partnership.")

[126] *See* Schnabel, *supra* note 72, at 26 ("a [Section 704(b)] arrangement cannot be recharacterized under Section 707(a)(2)(A) as a Section 707(c) payment").

preferred return contingent on gross income, for example, is likely to be exempt from sections 163(j) and 199A as a non-guaranteed payment even if there is no significant risk that the failure to satisfy the gross income contingency will reduce the fixed payments.

This section discusses certain possible modifications to the current law definition of a GPUC to reduce these self-help opportunities, as well as other modifications to narrow the existing differences between the accounting rules governing GPUCs and the accounting rules governing interest. It begins with an attribute intrinsic to interest (other than a time value of money return) as a possible line of demarcation, treating only those preferred returns that share this attribute as interest equivalents for this purpose. It then turns to a discussion of two significant timing differences under current law. One is the right to "hold open" the GPUC determination, allowing partnerships to report a preferred return as a GUPC in some years and as a non-GPUC in others even though a comparable return on a debt instrument is always interest. Another is the proper timing of the deduction and related income inclusion for accrued but unpaid amounts at the end of any year: in the case of GPUCs, the timing is governed by the partnership's method of accounting; in the case of interest, it is governed by the accrual method of accounting. Finally, this section discusses the extent to which any of the common law indicia of debt should inform future guidance in this area.

A. The True Badge of a GPUC

One change in current law that should eliminate most of the self-help opportunities discussed in this paper without affecting preferred returns subject to real entrepreneurial risk is the definition of 'income' under section 707(c). Consistent with its original purpose, section 707(c), whether by future guidance or perhaps a legislative

amendment, should only exclude payments contingent on net income or otherwise subject to SER. In should not exclude a payment merely because it is contingent on gross income. If these payments are excluded as well, a fixed preferred return contingent on a low risk allocation will not be subject to under sections 163(j) and 199A. Of all the debt-like attributes on an equity investment, the continuing obligation to pay whether or not the issuer is profitable is perhaps the most important. If this is the true badge of interest -- the obligation to pay is not forgiven for want of sufficient profits -- it should make no difference whether a preferred return is unconditional or contingent on gross income. Unlike a preferred return that is truly subject to SER, the obligation to pay remains outstanding in the event of a loss.

To illustrate with a simple example, suppose a partnership with gross income consistently in excess of $10 million admits a new partner, agreeing to pay the new partner a preferred return of $1 million on its capital without regard to income plus a share of the future profits. Suppose further that the expenses of the partnership consistently exceed its gross income. If the preferred return were contingent on net profits, the new partner would never receive the $1 million. Because the preferred return is a GPUC, however, the full $1 million would remain due and payable.

Now suppose the $1 million is contingent on gross rather than net income. Even if the partnership incurs an aggregate loss while the preferred return is outstanding, any such loss will not impair the rights of the new partner vis-à-vis the other partners. The annual gross income of the partnership will still exceed the annual preferred return by a factor of at least 10. As long as the gross income of the partnership exceeds the preferred return, the intervening losses will not discharge the obligation.

As illustrated in this example, for any partnership with sufficient gross income, there is no meaningful difference between a preferred return contingent on an allocation of gross income and a pure GPUC. Both returns impair capital in the event of a loss and do so in precisely the same way. In contrast, a preferred return contingent on *net* profits is not payable in the event of a loss and therefore cannot impair the capital of the other partners. The reason is entrepreneurial risk.

B. Preferred Returns in the Nature of Distributive Share

Applying this attribute as the true badge of a GPUC -- that the liability to pay is not discharged if the partnership fails earn a profit -- many (perhaps most) categories of preferred returns in the market should continue to qualify as section 704(b) income.

1. Hurdle Returns

In many investment partnerships, the first tier of the distribution waterfall immediately following the return of capital distribution is a "hurdle" distribution. Hurdle returns are different from preferred returns. Unlike a preferred return, a hurdle merely subordinates the general partner's right to distributions to a minimum level of gain. It does not increase the limited partners' overall share of the investment gains unless the gains fall below a certain threshold. As long as the gains equal or exceed the threshold, the aggregate distributions to the general partner over the life of the partnership are not reduced. To ensure this result, the general partner is usually entitled to 100% of any future distributions following the hurdle until it "catches up" to the limited partners.

Suppose, for example, that a partnership distributes the sales proceeds of its investments first to the limited partners to return their capital contributions, then to the limited partners until they receive an 8% "hurdle" on such contributions, then to the

general partner until it receives a "catch up" distribution equal to 25% of the prior hurdle distributions, and finally 80% to the limited partners and 20% to the general partner. As long as the partnership earns an aggregate return of at least 10%, the general partner will receive 20% of the total investment gains.

Unlike a preferred return, therefore, a hurdle return in a successful investment partnership does not reduce the economic entitlements of the other partners. It merely reduces distributions that the limited partners would have received if the hurdle rate had been zero. Nor is a hurdle payable in the event the partnership incurs an aggregate net loss. The only scenario in which the general partner will receive less than its agreed share of the total investment gains is when the total distributions of the partnership are insufficient to "catch-up" the general partner. In the preceding example, the general partner would not be entitled to any distributions unless the partnership earned an aggregate return on its investments in excess of the 8% hurdle rate.

Because it bears none of the hallmarks of interest, a hurdle return should not be treated as a GPUC.

2. Returns *of* Capital

In most cases, the capital of the partner entitled to a preferred return is senior to the capital of the other partners. The seniority of the capital is typically reflected in the priority of future distributions under the partnership agreement. For example, if one group of partners funds the capital requirements of the partnership and another group of partners provides the services, the "capital" partners may be entitled to all future distributions until their capital has been returned. In some of these partnerships, however, the capital partners may not be entitled to a preferred return on their capital.

This type of priority is not a GPUC under current law and should not be treated as a GPUC in the future. The priority in such a case does not convey a time value of money return to the partner (or indeed any return at all). Rather, it is intended to liquidate the original investment of the capital partners, providing a return *of* capital rather than *on* capital.[127]

3. Contingent on Net Income

As under current law, a preferred return contingent solely on net income should remain exempt from the interest limitations of sections 163(j) and 199A under future guidance. Nor should the exemption depend on the relative volatility of the business or the relative priority of the distributions. It should not matter, for example, whether the partnership holds a portfolio of Treasury securities or allocates the "first dollars" of net income to the preferred partner.[128] While the right to a preferred return in such a case may not be subject to SER, the return is still contingent on net income.

In the service context, an allocation of this kind would generally be treated as subject to SER under the proposed section 707(a)(2)(A) regulations. Entrepreneurial risk under these regulations is measured on a relative rather than absolute basis, comparing the risk of the allocation to "the *overall* entrepreneurial risk of the partnership."[129] If the

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[127] Under the disguised sale regulations, a return of capital distribution is not a GPUC. *See* Reg. §1.707-4(a)(1)(i) ("one or more payments are not made for the use of a partner's capital if the payments are designed to liquidate all or part of the partner's interest in property contributed to the partnership rather than to provide the partner with a return on an investment in the partnership.").

[128] The hurdle return discussed above is really just a special case of a net income contingency in which the "first dollars" of net income are allocated to one class of partners.

[129] Proposed Reg. §1.707-2(c)(1); *see also* McKee, *supra* note 37, at ¶ 14.02[4][a] ("in assessing entrepreneurial risk, the risk assumed by the service partner should generally be weighed against the risk inherent in the partnership business, although this is not explicitly stated in the legislative history. If the partnership engages in a "safe" business, its service partners necessarily receive a commensurately safe

absolute entrepreneurial risk of a pro rata allocation to a partner is already small, the incremental reduction in risk attributable to a priority allocation should be small as well.[130]

4. Not Based on Time Value of Money

In limited cases, future guidance should narrow rather than expand the current law definition of a GPUC, at least for purposes of sections 163(j) and 199A. Not every GPUC conveys a time value of money return. In some cases, it may track a different benchmark, for example the value of the contributed property to the partnership. If a partner contributes a building to provide office space or IP to facilitate the sale of goods or services within a particular region and, in consideration thereof, earns a preferred return equal to the current rental or royalty value of the contributed property, the partner is not receiving a time value of money return. A preferred return of this kind is not in the nature of interest and should not be treated as such even if the return is subject to tax as a GPUC.

C. Preferred Returns in the Nature of Interest

Applying this same attribute as the true badge of a GPUC -- that the liability to pay is not discharged if the partnership fails earn a profit -- other categories of preferred returns should be treated as interest equivalents subject to the limitations of sections 163(j) and 199A.

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entrepreneurial return. Partners who bear the risks of the partnership business should not be penalized with §707(a) treatment solely because the partnership engages in a low-risk business.").

[130] In very limited circumstances, the proposed regulations would even treat a net income allocation as presumptively lacking SER under section 707(a)(2)(A). *See* Proposed Reg. §1.707-2(c)(1)(iv) (referring to "an allocation ... that is predominantly fixed in amount, is reasonably determinable under all the facts and circumstances, or is designed to assure that sufficient net profits are highly likely to be available" and citing as examples allocations from isolated transactions or accounting periods when the allocation "does not depend on the long-term future success of the enterprise").

1. Uncapped Returns Subject to Fixed Floor

Suppose a partnership admits a new partner and agrees to pay her the greater of a fixed preferred return on her capital or 25% of the future profits. The preferred return in such a case should be treated as a GPUC without regard to whether it exceeds 25% of the profits in any particular year. While in form the preferred return appears to be forgiven in any year in which the partner's share of the profits is greater, it is not forgiven in substance. The partner is instead receiving an even larger distribution. The right to the greater of a fixed return *or* a share of the future profits is no different from a right to a fixed return *and* a share of future profits in excess of such preferred return. The obligation is payable regardless of future profits and is not subject to SER.

The approach is consistent with the approach of the proposed regulations under section 707(a)(2)(A) in the service context. As discussed earlier in this paper,[131] the proposed regulations would modify a longstanding regulatory example under section 707(c) involving a similar "greater of" arrangement. In the original example, the minimum payment was treated as a guaranteed payment only during those years in which it exceeded the partner's share of the residual profits even though the payment was not contingent on such profits.[132] Under the proposed regulations, the modified example would treat the payment as a guaranteed payment every year.[133]

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[131] See *supra* text accompanying notes 62-77.

[132] Reg. §1.707-1(c), Ex. 2.

[133] *See* Proposed Reg. §1.707-1(c), Ex. 2, Preamble to REG-115452-14, 80 Fed. Reg. 141 (July 23, 2015) (proposing to modify example as "inconsistent with the concept that an allocation must be subject to significant entrepreneurial risk to be treated as a distributive share under section 704(b)."). The example also appears to be contrary to the original legislative history. *See* H.R. Rep. No. 1337, 83d Cong., 2d Sess. A226 (1954) ("… a partner who is guaranteed a minimum annual amount for his services should be treated as receiving a salary in that amount"); S. Rep. No. 1622, 83d Cong., 2d Sess. 387 (1954) (containing similar language). Although the example involved a payment for services, the IRS has applied the same

2. Capped Returns Contingent on Gross Income

While the amount distributable in the case of an uncapped return will always exceed the minimum payment whenever the partner's share of the profits is greater, the amount distributable in the case of a preferred return contingent on a capped allocation of gross income will never exceed the cap and could in fact be zero. Although the economic nature of these returns are different, the level of economic risk may be the same. Nevertheless, a preferred return contingent on a capped allocation of gross income is probably not a GPUC under current law, even if the risk of non-payment due to the income contingency is remote.[134]

While it may seem that this type of return is a GPUC in substance, there is surprisingly little support for this view. Indeed, it is not even necessary that the income contingency (remote as it may be) operate as a permanent prohibition on future distributions.[135] Because this type of return is based on the time value of money and is not contingent on net profits, it should be treated as an interest equivalent under sections 163(j) and 199A. Much like the minimum preferred return described in the preceding section, the obligation to pay a preferred return contingent on a capped allocation of gross income is not discharged in the event of a loss and is not subject to SER.

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approach to preferred returns on capital. *See* Rev. Rul. 66-95, 1966-1 CB 169 (right to 25% of net profits but no less than 4% of contributed capital treated as GPUC only to extent 4% return on capital exceeded 25% of the profits). In the preamble to the proposed regulations, the government announced that the ruling would be obsoleted. *See* Preamble to REG-115452-14, 80 Fed. Reg. 141 (July 23, 2015) ("The Treasury Department and the IRS intend to obsolete Rev. Rul. 66-95 … when the regulations are published in final form.").

[134] See *supra* text accompanying notes 106-125.

[135] See *supra* text accompanying notes 120-124.

3. 'When' Contingencies vs. 'Whether' Contingencies

Suppose the terms of a partnership interest provide for current payment of a fixed preferred return to the extent of available profits but defers (rather than forgives) payment in the event of a shortfall in available profits until the following year. Suppose further that if the aggregate profits of the partnership continue to lag the preferred return after a certain number of years, any remaining shortfall in payments becomes immediately due and payment.

As discussed below, a preferred return contingent on net profits is not a guaranteed payment even if the profit contingency only affects *when* the preferred return is paid. Like a right to a share in future profits subject to a minimum preferred return, a preferred return subject to a profit contingency that defers rather than forgives the payment obligation will impair the capital of the other partners in the event of a loss.[136] Because it conveys a time value of money return without regard to net profits and is not subject to SER, a preferred return of this kind should be treated as an interest equivalent under sections 163(j) and 199A.

Under current law, however, the status of a preferred return subject to a 'when' contingency is held open on the date of issue. If the partner's share of the profits in future years is sufficient, the preferred return will be respected as a distributive share of partnership income even though the failure to generate such profits does not discharge the

[136] *See* Sloan, *supra* note 102 (while not contending that either is a guaranteed payment, noting economic similarity between minimum floor payment in Example 2 of Reg. 1.707-1(c) and capped preferred return).

liability.[137] The only tax issue that appears to be unsettled is the proper timing of the GPUC inclusion if the profits fail to keep pace with the preferred return: should the accrued but unpaid preferred return be reported as a GPUC in each successive year to the extent of the annual shortfall or only in the year of payment?

As discussed earlier in this paper, the IRS and Treasury apparently believe that an "inchoate" GPUC should be reported as such in each year the accrued preferred return exceeds the available profits. Many practitioners disagree, however, contending that an unpaid preferred return should be reported as a GPUC only when the payment obligation is no longer contingent.[138] Moreover, even in the absence of sufficient profits in such year, such practitioners further contend that an accrued preferred return should still only be reported as a GPUC to the extent the partnership is unable to effect a matching allocation of gross income.[139]

The IRS and Treasury invited comments on a preferred return of this kind in the preamble to the 2015 proposed regulations under section 707(a)(2)(A). The request for comments was limited to whether a GPUC should be imputed to the preferred partner in the year of any shortfall in net income:

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[137] Much of this analysis is based on the "wait and see" example in the section 707(c) regulations, the very example Treasury and the IRS have proposed to revoke because the minimum payment in the example is not subject to SER *See* Preamble to REG-115452-14, 80 Fed. Reg. 141 (July 23, 2015).

[138] Some argue that a preferred return is not taxable as a GPUC prior to the year of payment. *See* NYSBA Tax Section, "Report on Guaranteed Payments and Preferred Returns", Report No. 1357, p. 18-19, Nov. 14, 2016 (stating that while "a more difficult question", current accrual of an unpaid GPUC would be "contrary to the fundamental distinction between debt and equity" if the parties expected the preferred return would be paid out of partnership income). Nor would a GPUC be attributed even in the year of payment as long as the partnership has sufficient gross or net income in such year.

[139] For this reason, partnership agreements that provide for a preferred return often include a "savings clause" in the profit and loss provisions of the agreement to address this scenario, providing first for a gross income allocation to the preferred partner and, to the extent necessary, a guaranteed payment.

> Some taxpayers have expressed uncertainty whether a partnership with a targeted capital account agreement must allocate income or a guaranteed payment to a partner who has an increased right to partnership assets determined as if the partnership liquidated at the end of the year even in the event that the partnership recognizes no, or insufficient, net income. The Treasury Department and the IRS generally believe that existing rules under §§1.704-1(b)(2)(ii) and 1.707-1(c) address this circumstance by requiring partner capital accounts to reflect the partner's distribution rights as if the partnership liquidated at the end of the taxable year, but request comments on specific issues and examples with respect to which further guidance would be helpful.[140]

Based on the reference to "distribution rights" in a deemed liquidation, the IRS and Treasury appear to believe that the preferred partner should report income in the year of any shortfall in profits to properly account for its accreting claim to the partnership assets even though the partnership did not realize a profit in such year and the partner did not receive any distributions. The income in such a case is either section 704(b) income to the extent the partnership is able to make up the shortfall with an allocation of gross income or a GPUC.[141] In the view of many practitioners, the partner has no income at all during such periods.[142]

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[140] Preamble to Proposed Regulations, Fed. Reg. Vol. 80, No. 141, p. 43652 (July 23, 2019).

[141] *See* Sloan, *supra* note 102 ("The Treasury and the IRS appear to take the view that a partnership would be required to allocate gross income to a preferred partner or be treated as having paid a guaranteed payment to the partner.").

[142] *See* Richard M. Lipton, *Preferred Returns and "Phantom" Income*, J. OF PASSTHROUGH ENTITIES (Jan/Feb 2016) ("The IRS obviously believes that that an annual allocation of gross items of income (or a deemed guaranteed payment) is required in this situation, notwithstanding that the partnership agreement does not provide for such an allocation. Is this right? Does Code Sec. 704(b) allow, let alone mandate, this result? … The fundamental flaw in the question raised by the IRS is the assumption that the partners know that the preferred return will be paid, and a partnership will always have sufficient assets to pay the preferred return.") (emphasis added); *see also* NYSBA Tax Section, "Report on Guaranteed Payments and Preferred Returns", Report No. 1357, p. 22, Nov. 14, 2016 ("Where the parties' economic arrangement provides a preferred return that is dependent (in whole or in part) on and limited to the partnership having sufficient income, *it seems clear that there is no guaranteed payment as the preferred return accrues*.") (emphasis added).

Far more noteworthy, however, is the implicit assumption of the government that such a preferred return is not a GPUC in its entirely. As one practitioner put it, to even describe such a return as contingent on profits is begging the question.[143] The profit contingency here affects when, not whether, the preferred return will be paid. If the goal of future guidance is to capture preferred returns that resemble interest, the full amount of the preferred return should be treated as GPUC.[144]

D. Timing Issues

The timing rules governing GPUCs are very different from the timing rules governing interest on debt. If future guidance were to redefine a GPUC for purposes of sections 163(j) and 199A but ignore the timing differences, it will be difficult to integrate both types of "interest" into a single regime in a coherent and sensible manner.

The first timing issue is when the GPUC determination is made. Under current law, the status of many payments as guaranteed payments may fluctuate from year to year. The second is when, in the case of a GPUC that is not unconditionally payable at least annually, an accrued but unpaid GPUC at the end of any year should be treated as interest expense to the partnership and interest income to the partner. Under current law, it depends on the accounting method of the partnership and, in the case of accrual method partnerships, when "economic performance" is deemed to occur.

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[143] Steinberg, *supra* note 79, at 564.

[144] While it is true that the deferral of the payment for want of sufficient profits increases the risk that the return will never be paid, this is credit risk, not entrepreneurial risk.

1. Once a GPUC, Always a GPUC

Suppose a partner is entitled to a preferred return equal to the greater of a minimum preferred return or a percentage of future profits. Under current law, the status of such a return as a GPUC is held open on the date of issue, resulting in distributive share treatment in some years and GPUC treatment in others. It is quite possible, therefore, that the status of such a return as a GPUC will vary from year to year. While such a rule may have been administrable prior to 2018, it will be far less so in a world that would characterize a GPUC (and only a GPUC) as interest. If sections 163(j) and 199A are to operate in a coherent way, the status of a preferred return as a GPUC should be known on the date of issue. It cannot vary from year to year.[145]

Consider, for example, the consequences to a partnership with both types of payment obligations if the IRS and Treasury were to retain the "wait and see" approach of current law. It would be very difficult to integrate this new category of interest into sections 163(j) and 199A for such partnerships. Nor would it make any sense to do so. Prior to 2018, preferred returns on capital were either deductible or conveyed the economic equivalent of a deduction depending on whether they were GPUCs or distributive share. As interest, however, the deduction would only be subject to

[145] As one example of the type of havoc the "wait and see" approach to GPUCs could wreak under section 163(j), suppose a partnership pays interest to a bank and a preferred return to a partner. The status of the preferred return as distributive share or interest expense in any year under the "wait and see" approach may affect the amount of ETI of the partnership allocable to the partners under section 163(j). Under section 163(j), a partner is permitted to increase its ATI at the partner level by its distributive share of the ETI from a partnership and therefore the amount of interest it may deduct. Whether a preferred return is treated as a GPUC or distributive share would in turn depend on the gross income of the partnership. For years in which the partnership has sufficient gross income, therefore, the BIE of the partnership would be limited to the bank interest, potentially increasing the total ETI. As a result, the partners may not be able to determine their ATI and therefore the amount of their deductible interest until well after the end of the taxable year. Due to more favorable treatment of BII, the status of a preferred return as a GPUC or distributive share in any year presents similar compliance issues at the partner level.

disallowance during the GPUC years. As a policy matter, the limitations of section 163(j) should not toggle back and forth, disallowing the deduction in some years and allowing its economic equivalent in others.[146]

As discussed above, the government recently announced that "wait and see" accounting for many guaranteed payments would no longer be available, proposing in 2015 to withdraw a longstanding example under the current regulations involving a guaranteed payment for services and to obsolete a published ruling involving a similar preferred return on capital.[147] As a result, this type of preferred return will likely be treated as a GPUC in the near future. Following comments from the tax bar, however, it is possible that "wait and see" accounting will continue to apply to preferred returns on capital even if final regulations abandon this approach in the service context.[148]

2. Mandatory Reporting on Accrual Method

A second timing issue is when an accrued but unpaid GPUC that is not mandatorily payable at least annually should be reported as an item of income and expense. For a comparable debt instrument, the timing of such amounts is governed by the accrual method of accounting.[149] For an accrued but unpaid GPUC, the timing is

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[146] *See* McKee, *supra* note 37, at ¶ 14.03[1][a] ("If payments based on partnership gross income are excluded from §707(c) and treated as §704 distributive shares, … the tax effects to the partners may be identical to those under §707(c) – that is, the income of the payee partner is increased and the income of the other partners is reduced by the specially allocated amount.")

[147] Preamble to REG-115452-14, 80 Fed. Reg. 141 (July 23, 2015).

[148] *See* NYSBA Tax Section, "Report on The Proposed Regulations on Disguised Payments for Services", Report No. 1330, p. 5, 15-19, Nov. 13, 2015 (recommending that government limit proposed repeal of "wait and see" approach to guaranteed payments to services); NYSBA Tax Section, "Report on Guaranteed Payments and Preferred Returns", Report No. 1357, p. 7, Nov. 14, 2016 (noting based on "public comments" by IRS personnel that government is likely to adopt proposed limitation).

[149] Code Sec. §§163(e), 1272.

governed by the method of accounting of the partnership.[150] If a partnership on the cash method of accounting incurs both types of interest expense, therefore, the deductibility of each category will often be tested under section 163(j) in different taxable years. Indeed, even for partnerships on the accrual method of accounting, the deduction may be deferred until payment under the "economic performance" regulations of section 461(h).[151]

The argument that the rules should be conformed is that reporting GPUC expense in the year of payment and interest expense in the year of accrual does not clearly reflect income.[152] Unless the accounting methods and/or rules are conformed, the deductibility of the "real" interest will depend upon the ATI of the partnership in the year of accrual and the deductibility of the "GPUC-interest" will depend on the ATI of the partnership in the year of payment. This could lead to a number of anomalies.

Suppose, for example, that a cash method partnership with $100 of annual ATI incurs $20 of interest on a bond and $10 of GPUC-interest on an equity contribution, in

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[150] Reg. §1.707-1(c) (requiring partner to include guaranteed payment in income when paid or accrued by partnership based on accounting method of partnership).

[151] The section 461(h) regulations do not define when economic performance is deemed to occur in the case of a GPUC. In the absence of a specific rule, the deduction may be deferred until payment ever for partnerships on the accrual method. *See* Reg. §1.461-4(g)(7) (for any liability not subject to specific economic performance rule under section 461(h) regulations or published revenue ruling or revenue procedure, economic performance is not deemed to occur before payment); *see also* NYSBA Tax Section, "Report on Guaranteed Payments and Preferred Returns", Report No. 1357, p. 13-15, Nov. 14, 2016 (recommending that economic performance rule governing interest be extended to GPUCs); Reg. §1.461-4(e) (in the case of deferred interest, economic performance occurs as the interest accrues).

[152] Section 446 requires taxpayers to calculate taxable income in the manner that clearly reflects income. Code Sec. 446(b). The regulations under section 446 provide general rules governing the accrual of interest on a debt instrument *other than* a debt instrument governed by the OID rules of sections 1272(a), 1275 and 163(e), the market discount rules of sections 1276 through 1278 and certain other provisions of the Code. Reg. §1.446-2(a)(2). Under the section 446 regulations, accrued interest is reported as the payments are made or as they accrue, depending upon the taxpayer's method of accounting. Reg. §1.446-2(a). For most interest other than "qualified stated interest" (which accrues ratably over the accrual period), the interest is reported as the interest accrues rather than as the interest is paid, either because the OID provisions of the Code apply or because the principles of the OID provisions of the Code apply. Reg. §1.446-2(c).

each case over a five year period. Suppose further that the $10 of GPUC-interest is payable only at the end of the fifth year. If the accrual method were to apply to both categories of interest, the partnership will be allowed to deduct the full $20 of interest on the bond and $10 of GPUC-interest on the preferred return (i.e., 30% of $100 = $30). If the accrual method is limited to the bond interest, however, the $50 deduction of the GPUC-interest (ignoring compounding) would be deferred until the fifth year. Because the ATI of the partnership in the fifth year is only $100, only $10 of the $50 of GPUC interest would be deductible by the partnership even though the partnership had $10 of "unused" ATI in each of the preceding four years.[153]

To avoid these types of anomalies, the accounting rules and/or methods should be conformed. Without such a change, the "bunching" of deductions for accrued but unpaid GPUCs in the last year will reach uneconomic and inappropriate results under 163(j). As a practical matter, however, it is highly unlikely in the author's view that any future guidance in this area would extend this far. A change of this magnitude would not only require new legislation, but legislation that would mandate a method of accounting intended solely for debt instruments.[154] There is no evidence the author is aware of that the current Congress would consider such legislation. Indeed, as the expansion of the section 163(j) and section 199A limitations to GPUCs was by regulation and not by

[153] The partners may be able to derive an offsetting tax benefit for the lost $40 of deductions in the first four years in the form of additional ETI from the partnership. This would depend upon whether the partners had any EBI on partner-level debt during those years. *See* Code Sec. 163(j)(4)(A)(ii)(II) (ATI of partner is increased by partner's distributive share of partnership ETI). If not, the $40 of unused EBI in the fifth year would only be deductible against future ETI from the partnership. Proposed Reg. §1.163(j)-6(g)(2)(i).

[154] The only exception is section 305(c), which applies to redeemable preferred stock issued at a redemption premium.

statute, the current Congress may not even agree with the basic premise that a GPUC should be treated as interest.

E. What About Other Debt vs Equity Factors?

1. Factors That Should be Ignored

What about other indicia of debt? Do any of the factors commonly cited in the determination of whether an instrument is debt or equity under the common law have any bearing on the determination of when a preferred return in a partnership should be treated as interest rather respected as a distributive share?

Whether an instrument is debt or equity is a determination governed largely by case law. Although no single factor is controlling,[155] the most frequently-cited factors are (a) an unconditional promise to pay on a fixed maturity date; (b) the existence of creditors' remedies; (c) the degree of subordination to other creditors; (d) the capitalization of the debtor; (e) the degree of overlap among the creditors and the owners of the debtor; (f) the form of the instrument; and (g) the intent of the parties.[156]

The difficulty with applying most of these indicia of debt, even by analogy, is that a GPUC is a return on an equity investment. By definition, therefore, the claim of the partner is subordinated to creditors, provides no creditors' remedies in a default and has no fixed maturity date. The investment is not debt in form and is not intended to create a debtor-creditor relationship. Nor are the IRS and Treasury proposing to treat a GPUC as actual interest on debt. The most likely basis for the proposed treatment of GPUCs as interest equivalents is that in the absence of such a rule, partnerships that cannot deduct

[155] *See John Kelly,* 326 U.S. 521 (1946).

[156] *See, e.g., Fin Hay Realty Co.*, 398 F.2d 694 (3rd Cir. 1968); Notice 94-47, 1994-1 CB 357.

interest on partner loans will be encouraged to restructure these investments as equity capital.

2. Factors That Should be Considered

While most of the common law indicia of debt should be ignored for these reasons, an advance to a partnership denominated as a loan has been treated as equity because the "interest" on the loan was payable only from partnership profits.[157] This is more or less the standard proposed in this paper for separating preferred returns in the nature of interest from those more in the nature of distributive share: whether in the event of a loss the obligation to pay is discharged. By this standard, a preferred return that is unconditional in form but is in substance contingent on profits by virtue of its terms is more entrepreneurial in nature.

a) Subordination to Common Capital

In most cases, the capital of any partner entitled to a preferred return is like preferred stock in a corporation: it is senior to the common capital. But suppose partner A and partner B contribute equal amounts of capital to a partnership and that all future distributions go first to partner A until partner A has received its capital back plus a 6% preferred return, then to the partner B until partner B has received its capital back plus a 6% preferred return, then equally between partners A and B.

Because the capital of partner B is subordinated to the capital of partner A, the 6% preferred return to partner B will only be paid if the partnership earns a profit (or has sufficient unrealized appreciation in its assets). In the absence of such profits, the partnership will run out of assets before partner B has received a single dollar of

[157] *Hartman*, 17 T.C.M. (CCH) 1020 (1958).

preferred return. This will be true even if the terms of the partnership agreement provide that the 6% return to partner B is unconditionally payable. While the preferred return to partner B conveys a time value of money return, it is wholly contingent on future profits. Because it is subject to SER, it should probably *not* be classified as a GPUC.[158]

b) "High Yield" Preferred

A return on capital that is not "limited and preferred" may present similar issues, even when the capital of the preferred partner is not subordinated. Suppose, for example, that partner C and partner D each contribute $1,000 of business assets to a newly-formed partnership and that partner C is entitled to all future distributions until partner C has received $1,000 plus a 20% preferred return. Suppose further that the partnership does not have sufficient free cash flow to make any distributions to either partner for the first seven years.

At the end of the seventh year, the accrued preferred return to partner C would be nearly $2,600. Unless the partnership has earned at least $1,600 of profits, the preferred return to partner C will not be paid even though partner C's capital is senior to partner D's capital. Although the same could be said of a preferred return at a much lower rate if payment is deferred for a long enough period, part of the preferred return in this example is clearly subject to SER.

[158] Indeed, even a preferred return on capital that is *pari passu* with other capital may not be paid in the absence of future profits. In the preceding example, had the distributions first gone *pro rata* to the two partners until their capital was returned, the preferred return of both partners would be contingent on profits.