Sorting Out Partner Payments

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Abstract

Congress enacted section 707 in 1954 to address the tax treatment of payments by a partnership to its partners and to distinguish such payments from distributive shares of partnership income. In contrast with the aggregate approach of section 704(b) to distributive shares, sections 707(a) and 707(c) reflect an entity approach. The 1984 amendments to section 707(a) focus on entrepreneurial risk as the touchstone for distinguishing section 707(a)(2)(A) nonpartner payments from section 704(b) distributive shares. The enactment of section 707(a)(2)(A) threatened to render section 707(c) superfluous, since nonrisky payments for services were potentially subsumed under section 707(a). In 2015, the Treasury Department issued proposed regulations that confirm the continued viability of section 707(c), while modifying the "wait-and-see" approach for minimum guaranteed payments. By classifying such payments under section 707(c) rather than section 707(a), however, the proposed regulations compound the confusion concerning the respective roles of the two provisions. Moreover, the proposed regulations fail to resolve the confusion concerning the treatment of guaranteed payments for use of a partner's capital. As commentators have recognized since 1984, section 707(c) has outlived its useful purpose. Eliminating the intermediate category of section 707(c) payments would restore the American Law Institute's 1954 version of section 707 and finally render the "capacity" issue moot. The entrepreneurial risk standard of section 707(a)(2)(A) would provide a basis for consistent tax treatment of payments for services and capital. Given the perverse incentives under the 2017 Tax Cuts and Jobs Act to exploit the existing classification scheme, section 707(c) is no longer a harmless anomaly, and it should be repealed.

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I. Introduction

In 1954, Congress enacted section 707 to eliminate the confusion and uncertainty under prior law concerning the tax treatment of transactions between a partnership and one of its members.[1] Under current law, compensatory payments by a partnership to a partner may be classified in three different ways: (1) as a section 704(b) distributive share of partnership income if determined with respect to partnership income; (2) as a section 707(c) guaranteed payment if determined without regard to partnership income and made to a partner qua partner; and (3) as a section 707(a) payment if made to a partner acting in a nonpartner capacity. While section 704(b) distributive share treatment reflects an aggregate approach, sections 707(a) and 707(c) reflect an entity approach. Nevertheless, the aggregate and entity approaches often produce a similar result.[2] If a payment is treated as a distributive share,

[1] *See* Martin B. Cowan, *Compensating the General Partner: The Pratt Case*, 56 TAXES 10, 13 (1978). References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (Code), unless otherwise indicated.

[2] *See* J. Paul Jackson et al., *A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners—American Law Institute Draft*, 9 TAX L. REV. 109, 137–38 (1954). Classification of a payment may, of course, affect the timing and character of the recipient's income, as well as deductibility to the partnership.

it is reported by the recipient and excluded from the other partners' income, thereby affording a deduction equivalent. If the payment is instead treated as a section 707(a) or section 707(c) payment, the recipient again reports income, and the partnership either deducts or capitalizes the payment.

In 1984, Congress curtailed flexibility by enacting section 707(a)(2)(A), which recharacterizes certain compensatory payments as section 707(a) nonpartner payments based on an "entrepreneurial risk" standard.[3] Section 707(a)(2)(A) removes nonrisky payments for services from classification as a section 704(b) distributive share but leaves uncertain the continuing role of section 707(c). Because all section 707(c) guaranteed payments are inherently nonrisky, section 707(c) arguably has become redundant and a source of potential confusion.[4] Reformers suggested that the statute could be simplified by repealing section 707(c) and classifying all compensatory payments under the section 707(a)(2)(A) standard.[5] Nevertheless, section 707(c) remains alive and well, as confirmed by proposed regulations under section 707(a)(2)(A) that were issued in 2015. Furthermore, the 2017 Tax Cuts and Jobs Act[6] creates novel incentives to misclassify partner-partnership transactions involving payments for services and guaranteed payments for use of a partner's capital (known as GPUCs).[7]

This Article considers the role of section 707(c) and argues that the provision has outlived its useful purpose. Part II discusses the developments leading to enactment of section 707 and post-enactment interpretive problems. Part III examines the impact of the 1984 statutory changes, focusing on the concept of entrepreneurial risk under section 707(a)(2)(A) and the conflict with section 707(c). Part IV suggests that the 2015 proposed regulations have added to the confusion concerning the respective roles of section 707(a) and section 707(c) while apparently allowing essentially risk-free preferred returns

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[3] *See* I.R.C. § 707(a)(2)(A) (added by the Tax Reform Act of 1984, Pub. L. No. 98-369, § 73, 98 Stat. 494, 591).

[4] *See generally* Philip F. Postlewaite & David L. Cameron, *Twisting Slowly in the Wind: Guaranteed Payments After the Tax Reform Act of 1984*, 40 TAX LAW. 649 (1987).

[5] *See, e.g.*, AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: TAXATION OF PRIVATE BUSINESS ENTERPRISES—REPORTERS' STUDY 289–90 (Jan. 1999) (Reporters George Yin and David Shakow) [hereinafter ALI, REPORTERS' STUDY].

[6] Pub. L. No. 115-97, § 11011(a), 131 Stat. 2054, 2063 (2017) [hereinafter 2017 Act]. Although popularly known as the Tax Cuts and Jobs Act, the 2017 tax legislation is officially titled "Public Law No. 115-97, An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."

[7] GPUCs are "in many ways analogous to the dividend paid to a shareholder on a corporation's preferred stock." Sheldon I. Banoff, *Guaranteed Payments for the Use of Capital: Schizophrenia in Subchapter K*, 70 TAXES 820, 822 (1992). *See generally* Andrew W. Needham, *GPUCs in a Post-tax Reform World: The Proposed Taxation of (Some) Preferred Returns as Interest*, 98 TAXES 109, 112–114 (Mar. 2020) (discussing use of GPUCs in the context of recently enacted sections 163(j) and 199A).

on partner equity to avoid GPUC classification. Finally, Part V considers provisions of the 2017 Act that enhance the tax benefits of section 704(b) distributive share treatment compared to section 707 treatment. Given the incoherent and often elective classification scheme, the Article concludes that section 707(c) should be repealed.

II. Background: 1954–1984

A. *Aggregate-Versus-Entity Approach*

Prior to 1954, it was clear that a partnership could not pay a salary to a partner.[8] Based on an aggregate approach, courts characterized purported salary payments to partners as simply a distributive share of income.[9] This approach worked relatively well as long as such payments did not exceed the partnership's taxable income. If fixed payments exceeded taxable income, however, the aggregate approach might give rise to complex calculations.[10] In this situation, the excess portion of the payment was charged against the partners' capital and was taxed to the service provider to the extent paid from the other partners' capital.[11] In 1954, Congress enacted section 707 to eliminate this confusion and clarify the status of a partner dealing with the partnership as an "outsider."

The 1954 legislation was largely based on a statutory draft proposed by the American Law Institute (ALI) for the taxation of partners and partnerships.[12] Under the ALI proposal, if a partner received salary payments from the partnership in exchange for services or otherwise engaged in transactions with the partnership "not acting in his capacity as a partner," the transaction would be treated as occurring between the partnership and a third party.[13] Thus, the ALI approach would have required entity treatment for salary payments to partners.[14] As initially introduced in the House, section 707 closely tracked the ALI proposal. [15] As finally enacted, however, section 707 included three significant changes. First, the reference to payments for services was removed

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[8] Estate of Tilton v. Commissioner, 8 B.T.A 914, 917 (1927) (partner could not be an employee of his own partnership).

[9] Lloyd v. Commissioner, 15 B.T.A. 82, 87 (1929) (agreement to pay salary represented "nothing more than a basis for dividing profits").

[10] S. REP. NO. 83-1622, at 92 (1954), *as reprinted in* 1954 U.S.C.C.A.N. 4621, 4725 (describing pre-1954 treatment as "unrealistic and unnecessarily complicated").

[11] *Lloyd*, 15 B.T.A. at 88–89; Rev. Rul. 55-30, 1955-1 C.B. 430.

[12] For an overview of the ALI proposals, *see generally* Jackson et al., *supra* note 2; *see id.* at 170–89 (Appendix A, reproducing the ALI's proposed partnership revisions [hereinafter 1954 ALI Proposal]).

[13] 1954 ALI Proposal, *supra* note 12, Section X755(a).

[14] *Id.* (referring to "payments in exchange for services rendered to the partnership").

[15] Donald J. Weidner, *Pratt and Deductions for Payments to Partners*, 12 REAL PROP. PROB. & TR. J. 811, 822 (1977); Cowan, *supra* note 1, at 10.

from section 707(a). Second, the Senate added a new provision, section 707(c), referring specifically to services rendered in a partner capacity.[16] Third, the Senate amended section 707(c) to include guaranteed payments for the use of capital.[17]

Although the House Report would have treated a partner who received a guaranteed payment "like any other employee who is not a partner," the Senate Report referred instead to payments received by "one who is not a partner."[18] Thus, Congress appears to have deliberately chosen not to categorize a partner who receives section 707(c) guaranteed payments as an employee. Since section 707(c) applies only to partner-capacity payments, guaranteed payments cannot be made to a partner in an employee capacity.[19] The legislative history does not provide any guidance concerning the concept of a "guaranteed payment" or the requirement that an amount be "determined without regard to the income of the partnership."[20] Section 707(c) applies to payments to a partner for services but "does not refer at all to the capacity in which services are performed."[21] Under the ALI proposal, there was no need to address the "capacity" issue, since all payments to partners (regardless of capacity) would be treated as third-party payments unless they constituted a distributive share of income.

B. Pratt *Decision and "Capacity" Issue*

By carving out an intermediate category of partner-capacity payments, the 1954 legislation laid the groundwork for continuing confusion concerning

[16] S. REP. NO. 83-1622 at 92, 387, 1954 U.S.C.C.A.N. at 5026. Section 707(c) had no counterpart under the ALI proposal.

[17] *Id.* The Senate Report also specified that guaranteed payments for services or capital would be "includible in the recipient's return for the taxable year with or within which [ends] the partnership [taxable] year in which the payment was made, or accrued." *Id.* at 387, 1954 U.S.C.C.A.N. at 5029. Thus, such payments are includible at the same time as a partner's distributive share. I.R.C. § 706(a).

[18] H.R. REP. NO. 83-1337, at A226 (1954), *as reprinted in* 1954 U.S.C.C.A.N. 4017, 4367; S. REP. NO. 83-1622, at 387, 1954 U.S.C.C.A.N. at 5029.

[19] The regulations specifically provide that "a partner who receives guaranteed payments is not regarded as an employee of the partnership" for purposes of withholding taxes. Reg. § 1.707-1(c). In the case of a limited partner, guaranteed payments for services are subject to self-employment tax. I.R.C. § 1402(a)(13).

[20] The term "guaranteed payment" appears only in the heading of section 707(c). As one commentator has noted, the term "is a complete misnomer, since a guaranteed payment needs to be neither 'guaranteed' nor 'paid.'" William B. Brannan, *The Subchapter K Reform Act of 1997*, 75 TAX NOTES (TA) 121, 128 (Apr. 7, 1997); *id.* at 127 ("Perhaps more than any other provision in Subchapter K, the concept of a guaranteed payment for services or the use of capital has generated an enormous amount of confusion and controversy in the tax law.")

[21] Richard M. Leder, *Guaranteed Payments, Management and Promoter Fees*, 41 N.Y.U. ANN. INST. ON FED. TAX'N § 14.06[1] at 14-13 to 14-14 (1983). But for section 707(a)'s requirement that services must be rendered in a nonpartner capacity, the two provisions would overlap.

the interplay between sections 707(a) and 707(c).[22] The former applied only to transactions involving a partner acting "other than in his capacity as a partner," while the latter covered partner-capacity payments for services that were fixed or otherwise guaranteed. *Pratt v. Commissioner,*[23] the first case to address the interplay between the two provisions, was decided more than 25 years after the enactment of section 707. In *Pratt*, the taxpayers were general partners of two limited partnerships that were formed to purchase, develop, and operate a shopping center. Pursuant to the partnership agreement, they received compensation for management services in the form of a percentage of gross rentals. It was stipulated that the management fees were reasonable and that the partnerships would have paid similar compensation to an unrelated third party.[24] The *Pratt* arrangement sought to exploit a timing mismatch between the accrual-basis partnerships' deduction and the cash-method general partners' inclusion of the fees.[25]

In the Tax Court, the general partners argued that the payments for managerial services constituted nonpartner payments under section 707(a). The Tax Court held that section 707(a) did not apply because the fees were paid to the general partners "for performing services within the normal scope of their duties as general partners and pursuant to the partnership agreement."[26] The court raised, but did not decide, the issue of whether section 707(a) could ever apply to continuous services, rather than isolated transactions.[27] The court also held that the fees did not qualify as section 707(c) guaranteed payments because they depended on gross income, which it concluded was an item of partnership income.[28] As a result, neither section 707(a) nor section 707(c) applied to the payments, which were instead treated as a distributive share of partnership income.

[22] *See* J. Paul Jackson et al., *The Internal Revenue Code of 1954: Partnerships*, 54 COLUM. L. REV. 1183, 1204 (1954) ("[o]n balance, it would seem that the [1954] treatment of guaranteed payments creates more problems than it cures").

[23] Pratt v. Commissioner, 64 T.C. 203 (1975), *aff'd in part and rev'd in part on other issues*, 550 F.2d 1023 (5th Cir. 1977).

[24] *Pratt*, 64 T.C. at 206. The general partners also made interest-bearing loans to the partnerships. The partnership accrued the interest on the loans as well as the management fees and deducted amounts which had not yet been paid to (or reported by) the general partners. On appeal, the government conceded that the loans were made in a section 707(a) nonpartner capacity. *Pratt*, 550 F.2d at 1027.

[25] Although the timing abuse succeeded in *Pratt* with respect to the section 707(a) payments, section 267 now provides a matching rule for the timing of income and deduction. *See* I.R.C. § 267(a)(2) and (e)(1) (deferring the partnership's deduction for section 707(a) payments until the partner's inclusion).

[26] *Pratt*, 64 T.C. at 212. According to the Tax Court, the general partners "were performing basic duties of the partnership pursuant to the partnership agreement." *Id.* at 211–12.

[27] *Id.* at 210–11.

[28] *Id.* at 210 (noting that the fees were "based on a fixed percentage of the partnership's gross rentals which in turn constitute partnership income").

On appeal, the Fifth Circuit affirmed the Tax Court's decision that the payments were not properly deductible under section 707(a), and then concluded that it was unnecessary to decide "whether the same amounts, if properly deductible, should have been reported as" section 707(c) guaranteed payments.[29] The Fifth Circuit's decision did little to clarify the interplay between sections 707(a) and 707(c). Conceivably, the court's language could be read to imply that a guaranteed payment must meet the requirements of section 707(a) before being tested under section 707(c).[30] This reading seems implausible, however, since the provisions are intended to be mutually exclusive; section 707(a) applies to nonpartner-capacity services, while section 707(c) applies to partner-capacity services if compensation is fixed. More likely, the court assumed that it was unnecessary to address section 707(c) because the timing of inclusion and deduction would be the same whether the payments represented a section 707(c) guaranteed payment or a section 704(b) special allocation of gross income.[31]

In considering the capacity issue under section 707(a), the Fifth Circuit focused on the nature of the services rendered and their relationship to the partnerships' activities. According to the court, "in order for the partnership to deal with one of its partners as an 'outsider' the transaction dealt with must be something outside the scope of the partnership."[32] By contrast, if "the activities constituting the 'transaction' were activities which the partnership itself was engaged in," the payments for services "must be treated merely as a rearrangement" among the partners of their respective distributive shares.[33] In light of the circumstances in *Pratt*, the court readily concluded that the management activities of the general partners were partner-capacity services outside the scope of section 707(a).

Pratt proved a Pyrrhic victory for the government. It was strongly criticized by contemporary commentators, who viewed it as frustrating the purpose of section 707.[34] Under the Tax Court's interpretation, a gross income allocation could never be a section 707(c) payment because it was calculated based on the partnership's income. Although the Tax Court's holding is consistent with a literal reading of the statute, the statutory purpose would arguably be better served by reading section 707(c) to apply to any payment that could

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[29] *Pratt*, 550 F.2d at 1024.

[30] Leder, *supra* note 21, § 14.06[1] at 14-14. *See also* Arthur Kalish & Stuart L. Rosow, *Partnerships, Tax Shelters and the Tax Reform Act of 1976*, 31 TAX LAW. 755, 764 (1978) (noting that the Fifth Circuit "concluded that section 707(c) only applies to payments which are deductible under section 707(a)").

[31] Postlewaite & Cameron, *supra* note 4, at 676 n.144.

[32] *Pratt*, 550 F.2d at 1024.

[33] *Id.* at 1026.

[34] *See, e.g.*, Cowan, *supra* note 1, at 19; Weidner, *supra* note 15, at 844. *See also* Kalish & Rosow, *supra* note 30, at 764 (characterizing the Fifth Circuit's opinion in *Pratt* as "totally inconsistent with the meaning and purpose of the statute and regulations").

exceed the partnership's *taxable* income (and would be paid even if in excess of such income).[35] Under the ALI approach, section 707 would clearly reach *Pratt*-type payments; reasonable payments for services, whether fixed or contingent, would qualify as third-party payments. The only purpose of the "determined without regard to income" requirement in section 707(c) was evidently to isolate payments for services or capital that a partner would receive "no matter how unsuccessful the partnership effort may be."[36] From this perspective, the gross income allocation in *Pratt* was precisely the type of nonrisky arrangement that should be subject to section 707(c). By treating the payments instead as part of the general partners' distributive shares, *Pratt* severely curtailed the scope of section 707.[37] It also allowed partners to convert nonrisky salary into a distributive share of partnership gross income, even if the income had a preferential character (such as tax-exempt income or capital gains).

Notwithstanding the confusion in *Pratt*, it is generally accepted that the threshold inquiry, for purposes of section 707, is whether the partner is acting in his capacity as a member of the partnership. If the partner is acting outside his capacity as a partner, the transaction is governed by section 707(a), and both the partner and the partnership should be taxed as if the transaction occurred between unrelated parties. If the partner is acting in a partner capacity, however, section 707(a) is inapplicable, and section 707(c) controls if the payment is determined without regard to partnership income. Whether a partner is acting in his capacity as a partner or as an outsider is determined based on the facts and circumstances.[38] The partner-capacity guardrail is intended to ensure that there is no overlap between section 707(a) and section 707(c); the two categories of payments are intended to be mutually exclusive.[39] Unfortunately, it is not always clear when payments fall within the different categories.[40]

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[35] WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 14.03[1][a] (4th ed. 2007 & Supp.).

[36] G.C.M. 38067 (Aug. 29, 1979); *see* Cowan, *supra* note 1, at 15 (noting that this language "was clearly intended to restrict the provision to payments in the nature of salaries, which are normally payable whether or not the employer has profits").

[37] Weidner, *supra* note 15, at 834–35 (noting that "*Pratt* represent[s] an unfortunately restrictive interpretation of section 707(a) and (c)"). *Pratt* resurrected precisely the type of pre-1954 computational difficulties that section 707 was intended to dispel. *See* Leder, *supra* note 21, § 14.06[1] at 14-15; G.C.M. 38067 (Aug. 29, 1979).

[38] Although the distinction is tenuous at best, services are more likely to be characterized as rendered in a partner capacity if they involve broad management powers. *See* MCKEE ET AL., *supra* note 35, at ¶ 14.01[2].

[39] Needham, *supra* note 7, at 115.

[40] Weidner, *supra* note 15, at 834 (noting metaphysical nature of partner-capacity determination).

C. *Service's Response to* Pratt

In 1980, the Service addressed the capacity issue in two revenue rulings. Revenue Ruling 81-300 involved payments based on gross rentals for management services similar to those in *Pratt*.[41] While agreeing with the Fifth Circuit's conclusion that the services there were performed in a partner capacity, the Service disagreed that a payment for services determined by reference to an item of gross income was automatically excluded from section 707(c). Revenue Ruling 81-300 held that such a payment could qualify as a guaranteed payment if, based on the facts and circumstances, it represented compensation for services rather than a distributive share of partnership profits.[42] Guaranteed payment treatment depended, in part, on the reasonableness of the amounts and whether a similar method would be used to compensate an unrelated party for services. A fixed payment represented the "most obvious form of guaranteed payment," but compensation could also be determined by reference to an item of gross income.[43] Based on the legislative history and statutory purpose, section 707(c) could apply to payments for services that were not necessarily fixed amounts, as long as they were reasonable and were determined in a manner similar to compensation paid to an unrelated party.

By contrast, Revenue Ruling 81-301 concluded that a partnership's payment to an adviser general partner for services rendered in a nonpartner capacity was governed by section 707(a) and not section 707(c).[44] The Service determined that the payment for services, based on a percentage of gross income, was subject to section 707(a) even though the adviser general partner rendered services in connection with activities in which the partnership was directly engaged. Although no single factor was decisive, it was significant that the adviser general partner also performed similar services for third parties as part of its regular investment management business.

In light of the two rulings, it seemed clear (at least to contemporaries) that (1) the capacity guardrail continued to focus on the nature of the services rendered by the partner to partnership and (2) gross income allocations could fall under either section 707(a) or section 707(c) depending on the nature of those services. Unlike *Pratt*, the Service's position prevented taxpayers from circumventing section 707 entirely by using a nonrisky, gross income allocation to compensate partner-capacity services. Under Revenue Ruling 81-300, only an allocation of net income (not gross income) was automatically ex-

[41] 1981-2 C.B. 143.

[42] *Id.*

[43] *Id. See* G.C.M. 38067 (Aug. 29, 1979) (noting that the "most troublesome aspect" of *Pratt* was the Tax Court's determination that a payment "based upon gross income can never be a section 707(c) payment").

[44] 1981-2 C.B. 144.

cluded from section 707(c). A gross income allocation could qualify as a section 707(c) payment, provided the amount was reasonable and the payment would be made "no matter how unsuccessful" the partnership's business proved.[45]

III. Disguised Payments for Services: Section 707(a)(2)(A)

A. *Entrepreneurial Risk Standard*

In 1984, Congress enacted section 707(a)(2)(A) primarily as an anti-abuse provision. Under section 707(a)(2)(A), an arrangement may be treated as a disguised payment for services if an allocation and related distribution to a service provider, when viewed together, are "properly characterized" as occurring between the partnership and a nonpartner.[46] In determining the remaining partners' distributive shares, the partnership must treat the disguised payment as compensation paid to a third party and, when appropriate, must capitalize or deduct the payment. Although section 707(a)(2)(A) was directed mainly at preventing circumvention of the capitalization requirement or conversion of ordinary income into capital gain,[47] the legislative history focused on entrepreneurial risk as the touchstone for distinguishing section 707(a)(2)(A) nonpartner payments from section 704(b) distributive shares.[48] Under section 707(a)(2)(A), allocations and distributions that involve significant entrepreneurial risk (SER) will generally be recognized as a distributive share of partnership income, whereas nonrisky or limited-risk arrangements that resemble payments to a third party may be recharacterized as a disguised payment for services.[49] The legislative history provides two examples of gross income allocations that lack SER.[50]

The enactment of section 707(a)(2)(A) threatened to render section 707(c) entirely superfluous. After 1984, the partner-capacity determination appar-

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[45] G.C.M. 38067 (Aug. 29, 1979).

[46] I.R.C. § 707(a)(2)(A).

[47] In the Senate, the reach of section 707(a)(2)(A) was broadened so that it was "not limited to transactions in which direct partnership payments would have to be capitalized." H.R. REP. NO. 98-861, at 861 (1984) (Conf. Rep.), *as reprinted in* 1984 U.S.C.C.A.N. 1445, 1549.

[48] *See* STAFF OF THE JT. COMM. ON TAX'N, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 226 (Dec. 31, 1984) (JCS-41-84) ("To the extent that a partner's profit from a transaction is assured without regard to the success or failure of the joint undertaking, there is not the requisite joint profit motive, and the partner is acting as a third party.") [hereinafter JCT, GENERAL EXPLANATION]. The legislative history also lists five other factors. *Id.* at 228–29.

[49] *Id.* at 227.

[50] *Id.* at 229–30 (ex. 1) (allocation of a fixed dollar amount of the partnership's gross income); *id.* at 230–31 (ex. 2) (allocation of gross income based on a formula). *See also id.* at 228 (capped allocations).

ently focused on the nature of the compensation received by the service provider, rather than the nature of the service provider's activities in relationship to the partnership's business.[51] If all nonrisky payments for services qualify as payments received in a nonpartner capacity, then logically section 707(c) payments—the least risky category of partnership payments—must be subsumed within section 707(a) payments.[52] This "dramatic alteration in the determination of capacity" signaled that section 707(c) no longer served a useful purpose.[53] Indeed, commentators maintained that the 1984 legislation "effectively repealed" section 707(c), leaving only "statutory surplusage prone to produce confusion and complexity."[54] Without explanation, the legislative history states that the transaction in Revenue Ruling 81-300, based on the *Pratt* facts, should now fall under section 707(a) rather than section 707(c).[55] The most plausible explanation for this statement was that such a gross income allocation could no longer qualify as a section 707(c) partner-capacity payment because it lacked SER.[56]

B. *ALI Approach: Repeal Section 707(c)*

In 1999, the ALI Reporters' Study on Taxation of Private Business Enterprises noted that section 707(c) had engendered considerable confusion from its inception but that "[m]uch of this confusion is now entirely avoidable" as a result of changes in the 1984 legislation.[57] In 1984, Congress amended the section 267 related-party rules to defer the partnership's deduction for a section 707(a) nonpartner payment until the payment was includible in the recipient's income.[58] Thus, an accrual-method partnership could no longer, as in *Pratt*, deduct accrued but unpaid compensation that had not yet been reported by a cash-method service provider. A separate provision in section

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[51] Postlewaite & Cameron, *supra* note 4, at 683 (claiming that "Congress has shifted the focus of the capacity question from the nature of the services rendered to the risks surrounding the partnership allocation and distribution").

[52] *Id.* at 691 (noting that section 707(c) payments "by definition possess limited risk as to amount").

[53] David L. Cameron & Philip F. Postlewaite, *The Lazarus Effect: A Commentary on In-Kind Guaranteed Payments*, 7 FLA. TAX REV. 339, 350 (2006).

[54] *Id.* at 351.

[55] S. PRT. NO. 98-169, at 230 (1984).

[56] Cameron & Postlewaite, *supra* note 53, at 350 ("The only apparent explanation for this statement is that the new concept of capacity reflected in section 707(a)(2) focusing on economic risk should apply in the context of section 707(c) as well."); Postlewaite & Cameron, *supra* note 4, at 681 (claiming that Congress "redefined the capacity issue" in 1984).

[57] ALI, REPORTERS' STUDY, *supra* note 5, at 288.

[58] *See* I.R.C. § 267(a)(2),(e)(1); *see also* I.R.C. § 267(e)(4) (section 267(a)(2) not applicable to section 707(c) guaranteed payments). Like section 707(a) payments, section 707(c) payments are subject to the capitalization requirement of section 263. *See* I.R.C. § 707(c); Cagle v. Commissioner, 63 T.C. 86 (1974), aff'd, 539 F.2d 409 (5th Cir. 1976).

707(c) forestalls timing mismatches by accelerating the compensation reported by a cash-method service partner to the service partner's taxable year in which an accrual-basis partnership deducts the corresponding expense. After 1984, the only significant difference between section 707(a) and section 707(c) treatment is whether the partnership or the partner's method of accounting is controlling for timing purposes. Otherwise, the two provisions produce essentially identical results.

The ALI Reporters' Study proposed to simplify the law by eliminating the intermediate category of section 707(c) payments.[59] The entrepreneurial risk standard was employed to distinguish the two remaining categories—section 707(a) nonpartner payments and section 704(b) distributive shares—as illustrated by several examples. One example considered compensation of a service partner who received a preferred return based on partnership net income, when net income was uncertain; since the partner's compensation was subject to entrepreneurial risk, the preferred return was classified as a section 704(b) special allocation of income taxable as a distributive share.[60] Other examples illustrated a payment subject to a ceiling contingent on the risks of the partnership business (classified as a distributive share) and distinguished a return *of* capital from a return *on* capital (to which neither section 707(a) nor section 707(c) applied).[61]

The ALI Reporters' Study proposed modifying the classification of payments in *Example (2)* of Regulation section 1.707-1(c) to reflect the entrepreneurial risk standard. In *Example (2)*, the *CD* partnership agrees that *C* will receive the greater of $10,000 or 30 percent of partnership income determined without taking into account any guaranteed payment.[62] In the first situation when the partnership income is $60,000, *C* is treated as receiving a distributive share of $18,000 and no guaranteed payment, since *C*'s distributive share exceeds the minimum amount. In the second situation when the partnership income is $20,000, *C* is treated as receiving a distributive share of $6,000 (30 percent of $20,000); only the $4,000 excess of the guaranteed minimum ($10,000) over *C*'s distributive share ($6,000) is treated as a guaranteed payment. By contrast, the ALI Reporters' Study would treat *C*'s entire minimum payment ($10,000) as a section 707(a) payment in both situations, since the payment is not subject to entrepreneurial risk. *C*'s allocable share of

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[59] ALI, Reporters' Study, *supra* note 5, at 289–90. Repeal of section 707(c) would also require conforming changes to section 736(a). *See id.* at 295 (treating guaranteed payments under section 736(a) as partner or nonpartner payments depending on whether such payments are subject to SER).

[60] *Id.* at 293 (ex. 40).

[61] *Id.* at 294–95 (exs. 42–43).

[62] Reg. § 1.707-1(c), Ex. (2). Proposed regulations modify *Example (2)* to treat the entire minimum amount as a section 707(c) guaranteed payment. *See infra* notes 94–106 and accompanying text.

partnership income would be reduced to reflect the guaranteed payment.[63] Thus, *C*'s section 704(b) distributive share would be either $8,000 (first situation) or zero (second situation).[64]

Under the ALI approach, *C* would be treated in the same manner as a third party who receives fixed compensation of $10,000. The result in *Example (2)* of the regulations is anomalous because the amount of the guaranteed payment is a function of the partnership's income, even though section 707(c) payments must be determined without regard to partnership income.[65] The ALI approach is consistent with the 1954 legislative history, which provides that "a partner who is guaranteed a minimum annual payment for his services shall be treated as receiving a fixed payment in that amount."[66] Although the regulations containing *Example (2)* were promulgated in 1956, only two years after enactment of section 707(c), it is unclear why the drafters deviated from this language.[67] *Example (2)* can be reconciled with a narrow view of section 707(c) as simply providing a solution for the computational problems that arise when fixed payments exceed partnership income.[68]

Example (2) adopts a "wait-and-see" approach that maximizes a partner's distributive share.[69] The amount of the guaranteed payment is limited to the shortfall in the amount that cannot otherwise be accounted for as a distributive share of partnership income under the section 704(b) regulations. The wait-and-see attitude may reflect the pre-1954 bias in favor of treating nearly

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[63] *See* ALI, REPORTERS' STUDY, *supra* note 5, at 293 (ex. 41) (entire fixed amount is a nonpartner payment; only the excess is a distributive share). *Example 41* of the ALI Reporters' Study modifies slightly the numbers in *Example (2)* of Regulation section 1.707-1(c).

[64] In the first situation when the partnership has income of $60,000, only the $8,000 excess ($18,000 allocable share less $10,000 guaranteed portion) comprises a distributive share; in the second situation when the partnership has only $20,000 of income, the guaranteed portion ($10,000) equals *C*'s entire payment, leaving a distributive share of zero.

[65] *See* Cowan, *supra* note 1, at 15.

[66] S. REP. NO. 83-1622, at 387, 1954 U.S.C.C.A.N. at 5029. The House language is identical, except that the recipient would be treated as receiving a "salary" equal to the fixed amount. H.R. REP. NO. 83-1337, at A227, 1954 U.S.C.C.A.N. at 4367.

[67] *See* Douglas A. Kahn, *Proposed Regulatory Change of Treatment of a Guaranteed Payment from a Partnership to a Partner*, 5 MICH. BUS. & ENTREPRENEURIAL L. REV. 125, 132 (2016) (arguing that the 1956 regulations should receive deference because of the "proximity of the promulgation of the regulation to the date of enactment of the statute").

[68] *See* Leder, *supra* note 21, § 14.10[3] at 14-28 (noting that "Section 707(c) was enacted primarily to avoid nightmarish accounting problems. This could best be achieved by . . . bring[ing] within section 707(c) those forms of payment that cannot readily be accounted for either as a bottom-line or item allocation, but not those cases where the payment can be so accounted for.").

[69] *See* NYSBA, REPORT ON GUARANTEED PAYMENTS AND PREFERRED RETURNS 11 (Nov. 14, 2016) (Report No. 1357), *available at* https://nysba.org/NYSBA/Sections/Tax/Tax%20Section%20Reports/Tax%20Reports%202016/1357%20Report.pdf [https://perma.cc/UL37-DH6W] (referring to wait-and-see approach of *Example (2)*).

all partner compensation as a mere rearrangement of distributive shares. Understandably, the 1956 drafters may have wished to avoid artificially creating section 707(c) guaranteed payments when distributive share treatment did not create the computational problem that the 1954 statute was intended to obviate. Classification of the payment—as a section 707(c) guaranteed payment or a section 704(b) distributive share—was held open rather than determined at the time the agreement was made. The 1956 drafters may also have been relatively unconcerned about the potential shift in the character of income if a guaranteed payment could be disguised as a distributive share.

C. *Section 707(c) in Limbo*

Predictions concerning the imminent demise of section 707(c) proved premature. In the immediate wake of section 707(a)(2)(A), the Service conspicuously failed to adopt a risk-based approach to section 707(c).[70] The post-1984 disguised sale regulations under section 707(a)(2)(B) provide a safe harbor for certain payments and other distributions received within two years of a contribution; such payments are not recharacterized as part of a disguised sale.[71] These regulations introduce the concept of a guaranteed payment for use of a partner's capital (GPUC) that qualifies under section 707(c).[72] In *Example (1)*, a contributing partner is treated as receiving a GPUC equal to ten percent (compounded annually) of the fair market value of property contributed to the partnership; the regulations classify the preferred return as a section 707(c) payment without any discussion of the SER standard.[73] The disguised sale regulations also define a "preferred return" as a "preferential distribution of cash flow to a partner" with respect to contributed capital "that will be matched to the extent available, by an allocation of income or gain."[74] Under the safe-harbor definitions, the "only substantive difference between a preferred return and a GPUC" is evidently whether there is a matching income allocation.[75]

[70] In 1992, the Service issued final regulations under the disguised sale provisions of section 707(a)(2)(B), enacted together with section 707(a)(2)(A). *See* Reg. § 1.707-4 (special rules applicable to guaranteed payments, preferred returns, and operating cash flows). The Service also issued proposed regulations in 2005 treating transfer of a capital interest in exchange for services as a guaranteed payment. Prop. Reg. § 1.721-1(b)(4)(i), 70 Fed. Reg. 29,683 (May 24, 2005); *see* Reg. § 1.721-1(b)(2). Since a partnership capital interest can be valued upon receipt, such a guaranteed payment presumably lacks SER.

[71] Reg. § 1.707-4.

[72] Reg. § 1.707-4(a)(1).

[73] Reg. § 1.707-4(a)(4), Ex. (1).

[74] Reg. § 1.707-4(a)(2).

[75] Needham, *supra* note 7, at 122. Based on these safe-harbor definitions, commentators have suggested that no section 707(c) payment arises if a partner who is entitled to a preferred return payable in all events receives a matching allocation of gross income. *See*, *e.g.*, Eric B. Sloan &

Even proponents of section 707(c)'s repeal acknowledged that no outright statutory conflict would arise if section 707(a)(2)(A) were limited to special allocations and distributions.[76] Unless the risk-based approach under section 707(a)(2)(A) were expanded to include payments traditionally governed by section 707(c), however, the courts and the Treasury Department would be forced to "wrestle with two definitions of capacity," which might not bode well given the pre-1984 administrative and judicial confusion.[77] The 1984 legislative history may be read as limiting section 707(a)(2)(A) to abusive transactions, particularly those involving short-term arrangements and temporary partners.[78] Rather than applying to continuing payments, section 707(a)(2)(A) would be restricted to isolated transactions of the egregious type that led to its enactment in the first place.[79] The 1984 legislation was intended to curb payments for services masquerading as distributive shares. GPUCs generally received little attention, even though the risk-based definition might appear particularly problematic when a partner receives a preferred return for the use of capital. Treating GPUCs as nonpartner payments would eliminate the traditional distinction between partner loans governed by section 707(a) and preferred returns on partner equity governed by section 707(c).[80] Notwithstanding the 1984 changes, it is widely assumed that partner-capacity GPUCs are not subject to the entrepreneurial risk standard, even if they are essentially equivalent to interest.[81] Thus, the 1984 legislation potentially opened a gap between the treatment of traditional guaranteed payments for services and GPUCs.

Matthew Sullivan, *Deceptive Simplicity: Continuing and Current Issues with Guaranteed Payments*, 142-31 to 142-32, *in* 6 PRAC. L. INST.: THE P'SHIP TAX PRAC. SERIES: PLANNING FOR DOMESTIC AND FOREIGN P'SHIPS, LLCS, JOINT VENTURES & OTHER STRATEGIC ALLIANCES ch. 142 (Clifford M. Warren & Louis S. Freeman eds., 2019).

[76] Postlewaite & Cameron, *supra* note 4, at 694. Of course, it is not always easy to distinguish between section 707 payments, on the one hand, and allocations and distributions, on the other hand.

[77] *Id.* One guardrail would be needed to wall off section 707(c) guaranteed payments from section 707(a) payments, while another guardrail would be required to distinguish section 707(a) payments from section 704(b) distributive shares.

[78] *But see* JCT, GENERAL EXPLANATION, *supra* note 48, at 227 (noting that the "regulations may apply the provision both to one-time and continuing arrangements").

[79] *See* Needham, *supra* note 7, at 118 (suggesting that section 707(a)(2)(A) "may not have been intended to apply to recurring payments in the form of fixed salaries or preferred returns on capital"); *see also Pratt*, 64 T.C. at 210–11 ("Section 707(a) applies to 'transactions' [and can be read as] covering only those services rendered by a partner to the partnership in a specific transaction as distinguished from continuing services").

[80] *See* Reg. § 1.707-1(a).

[81] *See* Lewis R. Steinberg, *Fun and Games with Guaranteed Payments*, 57 TAX LAW. 533, 541 (2004) (claiming that the risk-based approach "has limited scope when applied" to GPUCs, since such payments "are made with respect to equity capital . . . which, by definition, means that they are being made to a partner in a partner capacity").

While the 1984 legislation can be interpreted without reading section 707(c) out of the Code, the fundamental issue is whether the provision continues to serve any useful purpose. Under section 707(a)(2)(A), the SER standard shifted the focus from the capacity in which a partner is acting to whether a purported partner is sharing the entrepreneurial risk of the partnership's business. Unlike the pre-1984 focus on the nature of the services rendered, the risk-based approach emphasizes the central characteristic of partner status—namely, whether the purported partner truly shares the risks and rewards of the partnership business.[82] The risk-based approach properly focuses on the distinction between section 707(a) nonpartner payments and section 704(b) allocations and distributions. At least with respect to guaranteed payments for services, the 1956 regulations were out of step with the emerging risk-based approach.

IV. Long-Awaited 2015 Proposed Regulations

A. *Clarifying Section 707(a)(2)(A)*

More than 30 years after enactment of section 707(a)(2)(A), the Treasury Department finally issued proposed regulations to clarify the provision.[83] The proposed regulations were prompted by the need to address abusive fee waivers by private equity managers in exchange for an increased interest in the profits of the partnership for which they provided management services.[84] The goal of management fee waivers is (1) to obtain capital gain treatment for the foregone fees and (2) to defer the taxable event until the service provider receives an allocation of partnership profits to match the foregone fees. By attacking such fee waivers as nonpartner payments for services under section 707(a)(2)(A), the Service sought to deny these tax benefits, without necessarily implicating broader problems of taxing partnership profits interests.[85] The proposed regulations represent a long overdue effort to implement section 707(a)(2)(A). Unfortunately, they fall short of resolving the inherent tension between section 707(a) and section 707(c).

Consistent with the 1984 congressional directive, the 2015 proposed regulations provide a mechanism based on entrepreneurial risk for distinguishing

[82] If a purported partner is entirely insulated from risk, the person may not be respected as a partner. *See* TIFD III-E, Inc. v. United States, 666 F.3d 836 (2d Cir. 2012), *rev'g* 660 F. Supp. 2d 367 (D. Conn. 2009).

[83] *See* Notice of Proposed Rulemaking, Disguised Payments for Services, 80 Fed. Reg. 43,652 (July 23, 2015).

[84] For background on fee waivers, *see generally* Gregg D. Polsky, *A Compendium of Private Equity Tax Games*, 146 TAX NOTES (TA) 615 (Feb. 2, 2015).

[85] The proposed regulations focus primarily on preventing conversion of ordinary income into capital gain. *See* Prop. Reg. § 1.707-2(d), Exs. (2)–(6), 80 Fed. Reg. 43,652 (July 23, 2015) (all involving investment partnerships); *cf.* Prop. Reg. § 1.707-2(d), Ex. (1) (circumvention of capitalization requirement).

between section 707(a)(2)(A) disguised payments, on the one hand, and bona fide section 704(b) distributive shares, on the other hand. Under this approach, most fee waivers would clearly be recharacterized as section 707(a)(2)(A) payments because they lack entrepreneurial risk: fund managers are generally unwilling to relinquish a nonrisky right to a fee in exchange for a risky offsetting allocation of capital gain.[86] Under the proposed regulations, entrepreneurial risk is the dominant factor in classifying section 707(a)(2)(A) payments.[87] Thus, allocations and distributions that involve SER will generally be recognized as a distributive share of partnership income, whereas nonrisky or limited-risk arrangements that resemble payments to a third party may be recharacterized as a disguised payment for services.[88]

B. *Continuing Viability of Section 707(c)*

The preamble to the proposed regulations describes the confused relationship between section 707(a) and section 707(c) prior to the 1984 legislation.[89] Congress "revisited the scope of section 707(a) in 1984" and determined that the payment in Revenue Ruling 81-300 should be recharacterized as a section 707(a) payment rather than a section 707(c) payment.[90] In light of the 1984 legislation, the Treasury Department and the Service "have concluded that section 707(a)(2) applies to arrangements in which distributions to the service provider depend on an allocation of income, and section 707(c) applies to amounts whose payments are unrelated to partnership income."[91] The Treasury Department and the Service believe that "section 707(a)(2)(A) should generally not apply to arrangements that the partnership has reasonably characterized as a guaranteed payment."[92] The preamble also notes that the existing regulations under section 707(c) must be amended to reflect Congress's emphasis on entrepreneurial risk. Specifically, the treatment of guaranteed minimum payments in the current section 707(c) regulations is "inconsistent with the concept that an allocation must be subject to substantial entrepreneurial risk to be treated as a distributive share under section 704(b)."[93]

[86] By contrast, if the service provider is willing to agree to a so-called "clawback obligation," a common feature in private equity arrangements, it is possible to avoid section 707(a)(2)(A). *See* Notice of Proposed Rulemaking, Preamble, 80 Fed. Reg. at 43,655.

[87] *Id.* at 43,654 (according more weight to entrepreneurial risk than to other factors). The proposed regulations track the other disguised fee factors in the 1984 legislative history but also add a new factor. *Id.* at 43,655; Prop. Reg. § 1.707-2(c)(2)–(6).

[88] Notice of Proposed Rulemaking, Preamble, 80 Fed. Reg. at 43,654.

[89] *Id.* at 43,652–53.

[90] *Id.* at 43,653.

[91] *Id.*

[92] *Id.* at 43,654.

[93] *Id.* at 43,653.

The proposed regulations confirm the continued viability of section 707(c) following enactment of section 707(a)(2)(A), implicitly rejecting the notion that the absence of SER disqualifies a payment as a partner-capacity payment. *Example (2)* would be modified, however, to treat the entire guaranteed minimum as a section 707(c) payment, regardless of the partnership's income.[94] Only the amount in excess of the guaranteed minimum would be characterized as a section 704(b) distributive share, consistent with the SER standard. The puzzle is why new *Example (2)* does not treat the entire guaranteed minimum as falling under section 707(a) rather than section 707(c). In Revenue Ruling 81-300, the services performed by the general partners were clearly performed in their partner capacity, since they were central to the partnership's business. Nevertheless, the 1984 legislative history treated these *Pratt*-type fees as section 707(a) nonpartner payments, presumably because of the lack of SER.[95] If partner capacity were based on SER rather than the nature of the service partner's activities, the entire guaranteed minimum in *Example (2)* should be classified as a section 707(a) payment, consistent with the approach of the ALI Reporters' Study. Since the prototypical section 707(c) payment is a fixed payment that bears no SER, all section 707(c) payments for services would be treated as section 707(a) payments. As one commentator noted, "it is difficult to see how Treasury could conclude that the absence of substantial economic risk causes the amount of minimum guaranty to be a § 707(c) payment."[96]

Critics of the 2015 proposed regulations have defended the prior wait-and-see approach under *Example (2)* on the ground that the guaranteed minimum represents a contingent payment; as such, no guaranteed payment materializes unless the recipient's profit share turns out to be less than the minimum amount.[97] In that event, only the payment that exceeds the profit share is "derived from" the guarantee.[98] While this view is certainly supportable, it seems equally plausible to treat the arrangement in *Example (2)* as consisting, in substance, of a fixed payment up to the amount of the guaranteed minimum governed by section 707, coupled with a right to a section 704(b) distributive share in excess of this amount.[99] Since the substance of the agreement should control, a guaranteed minimum that lacks SER should not be

[94] Prop. Reg. § 1.707-1(c), Ex. (2).

[95] There is no indication in *Pratt* that the general partners performed similar services for third parties. *Cf.* Rev. Rul. 81-301, 1981-2 C.B. 144 (treating payments as falling under section 707(a)(2)(A) when comparable services are provided to third parties).

[96] Kahn, *supra* note 67, at 133. In Kahn's view, lack of SER should not cause "a guaranteed minimum to be treated as either a § 707(a) or a § 707(c) payment." *Id.*

[97] *Id.* at 134.

[98] *Id.*

[99] *See* Needham, *supra* note 7, at 124 (noting that such a "greater of" arrangement may be expressed as a right to a fixed return plus a share of "profits in *excess of*" the fixed return) (italics in original).

treated as a section 704(b) distributive share.[100] To be sure, the stakes are increased if the service partner would otherwise be entitled to a section 704(b) distributive share of partnership income consisting of capital gain, as in the case of a disguised fee waiver. Under new *Example (2)*, if the entire minimum amount is a guaranteed payment, the service partner will recognize more ordinary income from services, without necessarily increasing the deduction to the other partners.[101]

When the 2015 proposed regulations are finalized, Revenue Ruling 81-300 will become obsolete, along with two further rulings relying on old *Example (2)*.[102] In Revenue Ruling 69-180, the Service applied the methodology of old *Example (2)* to a situation in which the partnership earned both ordinary income and capital gain.[103] The approach in new *Example (2)* obviates the complexity that can arise, under Revenue Ruling 69-180, in determining the composition of the guaranteed partner's distributive share. In Revenue Ruling 66-95, the Service also applied the approach of old *Example (2)* to a guaranteed minimum with respect to contributed capital.[104] The decision to make Revenue Ruling 66-95 obsolete suggests that the rationale of new *Example (2)* also extends to GPUCs even though the 2015 proposed regulations focus almost exclusively on payments for services.[105] Given that the treatment of GPUCs is "quite complex and the law is quite unclear," commentators have urged the Treasury Department to reconsider whether new *Example (2)* should apply to GPUCs.[106]

C. *Gross Income Allocations, Preferred Returns, and Target Arrangements*

As the 2015 proposed regulations confirm, the Treasury Department and the Service now agree with Congress that *Pratt*-type payments contingent on

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[100] Reg. § 1.707-1(a) ("[T]he substance of the transaction will govern rather than its form[.]").

[101] Indeed, one commentator has suggested that revised *Example (2)* reflects "Treasury's hostility to carried interest arrangements." Kahn, *supra* note 67, at 136.

[102] Notice of Proposed Rulemaking, Preamble, 80 Fed. Reg. at 43,657.

[103] 1969-1 C.B. 183. *See* Postlewaite & Cameron, *supra* note 4, at 702 n.293; MCKEE ET AL., *supra* note 35, at ¶ 14.03[2] (noting that new *Example (2)* would render these issues moot).

[104] 1966-1 C.B. 169 (right to 25% of net profits but not less than 4% of contributed capital; GPUC only to extent 4% return on capital exceeds 25% of net profits).

[105] *See* Amy S. Elliott, *Fee Waiver Regs May Change Guaranteed Payment Example*, 149 TAX NOTES (TA) 607, 608 (Nov. 2, 2015).

[106] NYSBA, REPORT ON THE PROPOSED REGULATIONS ON DISGUISED PAYMENTS FOR SERVICES 18 (Nov. 13, 2015) (Report No. 1330), *available at* https://nysba.org/NYSBA/Sections/Tax/Tax%20Section%20Reports/Tax%20Reports%202015/1330%20Report.pdf [https://perma.cc/WP3P-ZQVU].

partnership gross income are classified, if they lack SER, as nonpartner payments under section 707(a), not as section 707(c) payments.[107] Contrary to the Service's pre-1984 position and Revenue Ruling 81-300, section 707(c) no longer applies to payments that are contingent on gross income allocations. Service-related gross income allocations that lack SER will generally be treated as section 707(a) payments. Gross income allocations presumptively lack SER, but the legislative history indicates that this presumption may be overcome "in very limited instances."[108] Distributive share treatment is not appropriate for service-related gross income allocations unless the taxpayer can establish SER by "clear and convincing evidence."[109] Capped allocations of partnership income are also suspect if the cap is "reasonably expected" to apply in most years.[110] The Service's ability to challenge such allocations is limited, however, to recharacterization under section 707(a)(2)(A) and does not extend to section 707(c).[111]

If a fixed payment coupled with a matching allocation of gross income suffices to avoid both section 707(a) and section 707(c), partners may elect to treat GPUCs (but not service-related compensation) as section 704(b) distributive shares, without altering the partners' economic arrangement. Assume, for example, that partner *A* is entitled to receive compensation for services equal to the lesser of $5 or 100% of the partnership's gross income.[112] If the partnership's income can reasonably be expected to exceed $5 during all years, *A*'s compensation will be capped at the lower amount.[113] Technically, *A*'s arrangement can be distinguished from the minimum payment in *Example (2)* of the section 707(c) regulations since *A* is entitled to a percentage of partnership profits (100%) subject to a cap ($5) rather than a guaranteed floor. It is difficult, however, to see why that distinction should make a

[107] Notice of Proposed Rulemaking, Preamble, 80 Fed. Reg. at 43,653 (obsoleting Revenue Ruling 81-300 and concluding that section 707(a)(2) applies to payments for services that depend on "an allocation of an item of income," including gross income).

[108] JCT, General Explanation, *supra* note 48, at 228.

[109] Prop. Reg. § 1.707-2(c)(1)(iii).

[110] Prop. Reg. § 1.707-2(c)(1)(i).

[111] *See* Needham, *supra* note 7, at 121 (noting that a capped allocation related to services is no longer susceptible to challenge as a section 707(c) guaranteed payment even if the "identical payment would have been a guaranteed payment" but for a "remote contingency" in the partnership agreement).

[112] By contrast, if *A* is entitled to a fixed salary subject to a "ceiling" based on the partnership's net income, the payments are treated as a distributive share of income rather than a section 707(c) guaranteed payment. Rev. Rul. 67-158, 1967-1 C.B. 188 (situation 2); ALI, Reporters' Study, *supra* note 5, at 294 (ex. 42).

[113] Because gross income by hypothesis will never be less than $5, the matching allocation can never have any economic effect. Even if the partnership earns less than the capped preferred return, the allocation will be economically meaningful only if it is a condition to payment. *See* Needham, *supra* note 7, at 111.

difference.[114] While *A*'s compensation might appear to be "fixed," most practitioners believe that the matching gross income allocation renders section 707(c) inapplicable.[115] Because *A* is receiving compensation for services, *A*'s specified minimum will almost certainly be treated as a disguised payment under section 707(a)(2)(A) rather than a section 704(b) distributive share. The scope of section 707(a) is restricted, however, to disguised payments for services and certain property transfers.[116]

If a partner instead receives a matching allocation of gross income as a preferred return on the partner's capital, section 707(a) does not apply since the payment pertains to partner equity. Because the payment is accompanied by a matching allocation of gross income, section 707(c) is apparently also inapplicable. By structuring the return to fall outside both section 707(a) and section 707(c), the partners can elect more favorable treatment under section 704(b) without significantly altering the economic consequences. Based on section 707(a)(2)(A) principles, it might appear that the allocation and distribution could be collapsed, thereby converting the preferred return into a deemed section 707(c) payment.[117] There is arguably no statutory authority, however, that permits recharacterizing such an arrangement as a section 707(c) payment "merely because there is virtual certainty of payment and the distributee bears little or no significant entrepreneurial risk."[118] Anticipating the Service's position under the 2015 proposed regulations, one commentator noted that, while section 707(a)(2)(A) converts most gross income allocations for services into section 707(a) payments, "most (if not all) payments for the use of capital . . . should continue to qualify as distributive shares of firm (gross) income."[119] In light of the SER standard, the issue is whether the ability of partnerships to elect into section 704(b) distributive share treatment continues to be justified, particularly given the Treasury Department's elimination of the wait-and-see approach under *Example (2)* of the 1956 regulations.

The Treasury Department invited comments concerning the tax consequences when a partner is entitled to a cumulative preferred return on its

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[114] Steinberg, *supra* note 81, at 564.

[115] Needham, *supra* note 7, at 110 ("In the view of most practitioners, a matching allocation of gross income to the service provider will suffice to avoid [section] 707(c) even if the matching allocation is not a condition to payment.").

[116] *See* I.R.C. § 707(a)(2)(B) (certain transfers of property).

[117] The preamble to the 2015 proposed regulations provides that an income allocation itself should be treated as satisfying the requirement of an accompanying distribution under section 707(a)(2)(A). Notice of Proposed Rulemaking, Preamble, 80 Fed. Reg. at 43,654. This treatment reflects the underlying premise of the section 704(b) regulations that an allocation of income corresponds to an increased right to distributions. *Id.*

[118] McKee et al., *supra* note 35, at ¶ 14.03[2] n.225.

[119] Steinberg, *supra* note 81, at 542.

capital investment and the partnership uses target capital accounts to determine the partners' economic entitlements.[120] Partnership agreements often use target allocations to match a partner's entitlement on liquidation with the outcome that would occur if the partnership liquidated in accordance with positive capital accounts, as required under the section 704(b) safe harbor.[121] Under a target capital account agreement, a partner may be entitled to receive a preferred return based on a percentage of the partner's capital account, coupled with a residual share of partnership income in excess of the preferred return. If a partner is entitled to a priority allocation of the first dollars of the partnership's net income but the partnership has insufficient profits in a particular year, these arrangements may give rise to an inchoate guaranteed payment under section 707(c).

Assume, for example, that *A* and *B* each contribute $100 to the accrual-method *AB* partnership. Under *AB*'s target capital account agreement, *A* is entitled to a 10% preferred return (cumulative if unpaid) on *A*'s capital of $100; any remaining income is shared 50/50. Over the life of the partnership, distributions are made in three tiers: first to *A* in the amount required to return *A*'s capital plus a 10% preferred return on that capital, then to *B* in the amount required to return *B*'s capital, and then equally to *A* and *B* to reflect their residual share of profits. If the partnership earns at least $10 of net income each year, the target allocations produce the same economic result as if *A* were entitled to a section 707(c) guaranteed payment of $10 annually. However, if *A*'s preferred return is contingent on the partnership's net income, the entire amount will likely be treated as a section 704(b) distributive share rather than a GPUC.

If *AB* earns net income of $10 in Year 1, *A*'s target capital account will be $110 and *B*'s will be $100 at year end.[122] If the $10 is treated as a distributive share, *A*'s capital account and outside basis will increase by $10, and *A* can receive a tax-free section 731 distribution of $10, reducing *A*'s capital account and outside basis correspondingly. By contrast, if the $10 is treated as a GPUC taxable to *A* when accrued, it affects the partners' capital accounts only to the extent of their shares of the partnership's corresponding deduction.[123] Even though *A* is not entitled to any fixed payment for *A*'s capital,

[120] Notice of Proposed Rulemaking, Preamble, 80 Fed. Reg. at 43,657.

[121] It is unclear whether target allocations can satisfy the economic-effect-equivalence test or the partners'-interest-in-the-partnership ("PIP") test under the section 704(b) regulations. *See* Reg. § 1.704-1(b)(2)(ii)(b)(2), (b)(3); *see generally* Daniel S. Goldberg, *The Target Method for Partnership Special Allocations and Why It Should Be Safe-Harbored*, 69 TAX LAW. 663 (2016).

[122] The *AB* partnership will have $210 of cash at the end of Year 1 ($200 contributed capital plus $10 net income).

[123] Because section 707(c) payments are treated as made to a person other than a partner, *A*'s receipt of a $10 GPUC is not treated as a section 731 distribution and does not reduce *A*'s outside basis or capital account. *See* Reg. § 1.704-1(b)(2)(iv)(*o*). *See also* MCKEE ET AL., *supra* note 35, at ¶ 14.03[1][b] (in distinguishing between section 707(c) payments and section 731 distributions,

the allocation and distribution provisions accomplish the same result, provided the partnership has at least $10 of income to allocate to *A*. If the $10 is treated as a distributive share, *B* excludes the income allocated to *A*. If the amount is instead treated as a GPUC, *B* should generally be allocated the corresponding income, coupled with an offsetting deduction. Depending on the characterization of the payment to *A*, *B* thus receives a deduction or a deduction equivalent.

If the partnership earns insufficient net income to pay *A*'s preference, *A* may nevertheless be required to include the accreting return of $10 annually if it is classified as a section 707(c) guaranteed payment. The 2015 proposed regulations frame the issue as whether a partnership that uses target capital accounts "must allocate income or a guaranteed payment" to a partner who is entitled to a net income preferred return and receives an increased right to a distribution when the partnership has "no, or insufficient, net income" for a particular year.[124] The Treasury Department evidently believes that the existing capital account rules under section 704(b) adequately address this situation "by requiring partner capital accounts to reflect the partner's distribution rights as if the partnership liquidated at the end of the taxable year."[125] The preamble's reference to "distribution rights" upon a deemed liquidation implies that *A* must report income in the year of any shortfall in profits. To the extent the partnership has sufficient gross income to make up the shortfall, *A*'s income would be treated as a section 704(b) distributive share and otherwise as a GPUC. Notwithstanding the Treasury Department's position, sophisticated practitioners generally consider that *A* has "no income at all" in this situation.[126] Under the wait-and-see approach, no GPUC will arise in the year of the shortfall because *A*'s future share of profits may eliminate the earlier shortfall. Also, no GPUC will arise in the year of payment as long as *A*'s profit share is sufficient to cover the payment.

For example, assume the accrual-method *AB* partnership above makes no distributions in Year 1 and has only $8 of net income in Year 2, consisting of gross income of $12 and deductions of $4. At the end of Year 2, A's target capital account is increased to $118 ($110 capital account at the end of Year 1 increased by $8 allocation of net income in Year 2), and *B*'s target capital account ($100) is unchanged. Because *A* should be entitled to a liquidating distribution of $120 ($100 capital contribution increased by $20 preference

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the "touchstone" is the effect on partners' capital accounts (or rights to future distributions if the partnership does not liquidate in accordance with capital accounts)).

[124] Notice of Proposed Rulemaking, Preamble, 80 Fed. Reg. at 43,657.

[125] *Id.*

[126] Needham, *supra* note 7, at 126; *see* NYSBA, *supra* note 69, at 22 ("Where the parties' economic arrangement provides a preferred return that is dependent (in whole or part) on and limited to the partnership having sufficient income, it seems clear that there is no guaranteed payment as the preferred return accrues.").

in Years 1–2), the target allocation leaves a shortfall of $2.[127] The Treasury Department's approach would apparently require the partnership to allocate income or "items thereof" to *A* to the extent necessary to satisfy *A*'s preference and eliminate the economic mismatch.[128] Allocating gross income of $10 to *A* would cause *B* to report a net loss of $2 (the partnership's remaining gross income of $2 less deductions of $4). *A*'s ending capital account balance would be $120 ($110 capital account at the end of Year 1 increased by $10 allocation of gross income for Year 2) and *B*'s would be $98 ($100 capital account at the end of Year 1 reduced by $2 net loss for Year 2). This approach achieves the right economic result: if the partnership were liquidated at the end of Year 2, the cash of $218 would be distributed $120 to *A* and $98 to *B*.[129]

Under the 1956 regulations, *Example (2)*'s "wait-and-see" approach furnished support for the position that a preferred partner such as *A* should be permitted to "earn its way out of" guaranteed payment treatment.[130] If the partnership expected to have ample profits over its life and the preferred return were payable on a deferred basis, the transaction would be held open. There would be no GPUC, either annually as the preferred return accreted or in the year of actual payment, provided the partnership had sufficient income in the later year. By contrast, under the Treasury Department's approach, both the existence and the timing of any gross income allocation or imputed guaranteed payment would seem to depend on the partnership's method of accounting, including the "economic performance" rules in the case of an accrual-method partnership.[131] Proponents of the wait-and-see approach argue that the "fundamental flaw" in the Treasury Department's position 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."[132]

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[127] The *AB* partnership will have cash of $218 at the end of Year 2 ($200 contributed capital plus cumulative net income of $18).

[128] The forced allocation of *gross income* operates in a manner similar to a qualified income offset under the alternate-economic-effect test of the section 704(b) regulations. *See* Reg. § 1.704-1(b)(2)(ii)(*d*).

[129] If the partnership does not have sufficient gross income to satisfy the preference, the accreting preferred return potentially shifts capital from *B* to *A*. Upon liquidation, *B* may have an offsetting capital loss or reduced gain.

[130] NYSBA, *supra* note 69, at 12; *see id.* at 20 (claiming that imputing a guaranteed payment would conflict with "the principles behind Example 2 of Treas. Reg. § 1.707-1(c) and the general bias of the realization doctrine").

[131] Sloan & Sullivan, *supra* note 75, at 142-33 (noting that "it is possible that the economic performance rules might affect the timing of the partnership's deduction for the payment and, thus, affect the timing of the partner's inclusion, but that [u]nfortunately, it is not clear which economic performance rule should apply . . . ."); *see also* NYSBA, *supra* note 69, at 13–15 (discussing timing rules under section 461(h)).

[132] Richard M. Lipton, *Preferred Returns and "Phantom" Income*, 19 J. PASSTHROUGH ENTITIES 7, 52 (Jan./Feb. 2016).

The counterargument is that the annual net income cap on *A*'s preference constitutes merely a timing contingency that does not affect whether *A*'s preference will ultimately be paid. Under this view, the full amount of the accreting preferred return (not just any shortfall) should be treated as a GPUC; indeed, *A* may be treated as not entitled to a share of partnership profits in the first place.[133] As a result, *A* should be required to include the preferred return of $10 annually as a guaranteed payment, even if the partnership has no net (or gross) profits and makes no distributions.[134] Consistent with new *Example (2)*, only *A*'s profit share (if any) in excess of the GPUC would be treated as a distributive share.[135] If the partners truly intend that *A*'s preference will be satisfied under all circumstances, any shortfall in income will be satisfied from *B*'s capital. Because *B*'s capital will be repaid only after return of *A*'s capital and accreting preference, the partnership's distribution priorities are structured to ensure that *A*'s interest-equivalent return will be paid "no matter how unsuccessful the partnership effort may be."[136] Somewhat surprisingly, the Treasury Department seems to have implicitly assumed that such a preferred return subject to a net income cap necessarily falls outside section 707(c).[137] If the "goal . . . is to capture preferred returns that resemble interest," the Treasury Department may need to reconsider the impact of revised *Example (2)*, particularly in light of incentives to elect out of GPUC status under current law.[138]

V. Section 707 Payments After the 2017 Act

In 2017, Congress enacted section 199A which generally allows noncorporate taxpayers to deduct up to 20% of qualified business income (QBI).[139] Section 199A was intended to preserve parity between corporations taxed at 21% after the 2017 Act and passthrough businesses taxed at higher individual income tax rates. To be eligible for the section 199A deduction, income must be derived from a qualified trade or business, which generally excludes a specified service trade or business.[140] For individuals with taxable income above

[133] Steinberg, *supra* note 81, at 564–65.

[134] *Cf.* Lipton, *supra* note 132, at 7 (objecting to the Treasury Department's approach as creating "phantom" income when the partnership has no net income); *id.* at 8 (maintaining that the result should not change if the partnership has gross income but the preference is subject to a "net income limitation").

[135] While *Example (2)* involves an actual payment, that difference should not matter under the timing rules of section 707(c).

[136] G.C.M. 38067 (Aug. 29, 1979).

[137] Needham, *supra* note 7, at 126 (noting that, in this situation, "the profit contingency . . . affects when, not whether, the preferred return will be paid").

[138] *Id.* at 112.

[139] I.R.C. § 199A(a), (b)(2).

[140] I.R.C. § 199A(c)(1), (d)(1).

specified threshold amounts, additional limitations also may reduce the maximum QBI deduction.[141] When the maximum deduction is fully available, passthrough income of high earners is taxed at 29.6% (80% × 37%).

Consistent with the notion that the passthrough deduction was intended to benefit only capital (and not labor) income, section 199A(c)(4)(A) excludes from QBI any reasonable compensation paid to a passthrough owner for services.[142] Importantly, the regulations restrict the reasonable compensation standard to owner-shareholders of S corporations.[143] Expanding the concept beyond S corporations would violate the long-standing principle, set forth in Revenue Ruling 69-184, that a partner cannot be an employee of a partnership.[144] Section 199A(c)(4)(B) also excludes from the definition of QBI all section 707(c) guaranteed payments for services, while section 199A(c)(4)(C) authorizes the Treasury Department to exclude section 707(a) payments for services. The final regulations exclude section 707(a) and section 707(c) payments alike from QBI; the exclusion extends to GPUCs but only if they are classified as guaranteed payments.[145]

A. *Section 707 Payments for Services*

The preamble to the proposed regulations explains that "[w]ithin the context of section 199A," section 707(a) payments for services "are similar to, and therefore should be treated similarly as, guaranteed payments, reasonable compensation, and wages—none of which are includible in QBI."[146] The proposed regulations also requested comments on whether, in certain circumstances, it would be appropriate to permit certain section 707(a) payments to be included in QBI.[147] Commentators argued that not all section 707(a) payments resemble wages and that section 707(a) payments should be included in QBI if they are received in connection with a partner's own qualified trade or business separate from the partnership.[148] The final regulations generally

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[141] I.R.C. § 199A(b)(2)–(3) (taxable income and wage or wage-and-property limits).

[142] I.R.C. § 199A(c)(4)(A).

[143] According to the preamble to the proposed regulations under section 199A, the statutory reference to reasonable compensation is "best read as limited to the context from which it arises: compensation of S corporation shareholders-employees." Notice of Proposed Rulemaking, Qualified Business Income Deduction, Preamble, 83 Fed. Reg. 40,884, 40,893 (Aug. 16, 2018).

[144] *See* T.D. 9847, Preamble, 84 Fed. Reg. 2,952, 2,964 (Feb. 8, 2019) (noting commenters' concerns that the interaction between section 199A and the reasonable compensation requirement gives rise to "disparities between taxpayers operating businesses in different entity structures" and invites "minimization of compensation" for purposes of self-employment taxes).

[145] *See infra* notes 163–172 and accompanying text.

[146] Notice of Proposed Rulemaking, Preamble, 83 Fed. Reg. at 40,893.

[147] *Id.*

[148] NYSBA, Report on Proposed Section 199A Regulations 37–40 (Oct. 19, 2018) (2018) (Rep. No. 1403), *available at* https://nysba.org/NYSBA/Sections/Tax/Tax%20Section%20Reports/Tax%20Reports%202018/1403%20Report.pdf [https://perma.cc/CZY3-XATN].

do not adopt these comments. Given the difficulty of distinguishing between section 707(a) and section 707(c) payments for services, "creating such a distinction would be difficult for both taxpayers and the IRS to administer."[149] Under the final regulations, some payments classified as section 707(a) payments may not be treated as QBI even though similar payments for services rendered by a third party might have constituted QBI.[150] Thus, services rendered in a nonpartner capacity by a partner may receive less favorable QBI treatment than the same services performed by a third party.

The final regulations categorically exclude from QBI payments for services, whether classified as section 707(a) or section 707(c) payments, in the hands of the recipient.[151] The seeming simplicity of this approach belies the uncertainty concerning the classification of section 707 payments generally. Under the 2017 Act, service partners have an enhanced incentive to classify payments as falling entirely outside section 707, thereby increasing their section 704(b) distributive shares of QBI (and section 199A deductions). Given the porousness of the different categories and the enhanced classification stakes, the purported guardrails under section 199A to prevent labor income from masquerading as capital income are likely to prove hopelessly inadequate.[152] Unlike S corporations, which are subject to a reasonable compensation constraint, partnerships are not required to compensate their partners separately for services rendered to the partnership. Thus, section 707 represents the only opportunity for the Service to prevent partners from disguising payments for services as capital income.

Guaranteed payments for services are disfavored from the perspective of both the recipient partner (since they are not QBI) and the payor partnership (since they reduce entity-level QBI). Guaranteed payments to a partner for services reduce the partnership's QBI but, unlike reasonable compensation

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[149] T.D. 9847, Preamble, 84 Fed. Reg. at 2,963.

[150] NYSBA, *supra* note 148, at 38–39 (Ex. 29); ABA, Comments on the Proposed Regulations Regarding the Deduction for Qualified Business Income Under Section 199A 20–21 (Oct. 12, 2018), *available at* https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/101218comments.pdf (arguing that from a policy perspective, a partner rendering services in a nonpartner capacity "should not be disadvantaged" in comparison to a third party who renders the identical services to the partnership").

[151] Reg. § 1.199A-3(b)(2)(ii)(I), (J). Nevertheless, the section 707(a) or section 707(c) payment reduces partnership QBI if it is properly allocable to the partnership's trade or business and otherwise deductible. *Id.*

[152] *See* David Kamin et al., *The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the 2017 Tax Legislation*, 103 MINN. L. REV. 1,439, 1,460 n.77 (2018) (noting that restrictions are "easy for partners . . . to avoid"); *see also* Michael L. Schler, *Reflections on the Pending Tax Cuts and Jobs Act*, 157 TAX NOTES (TA) 1,731, 1,738 n.38 (Dec. 18, 2017) (noting that section 707(a) may be read aggressively to avoid treatment of compensatory payments as received in a nonpartner capacity).

paid to S corporation owner-employees, such payments are not W-2 wages.[153] Assume, for example, that *A* and *B* are equal partners in the *AB* partnership, which has $1,000 of net income (comprised entirely of qualified items under section 199A) before taking into account a $400 deduction for a section 707(c) payment for *A*'s services. *A* and *B* share all partnership items equally, except for the partnership's payment of $400 to *A*. Under a pure aggregate approach, the partnership would have total QBI of $1,000; *A* would have QBI of $700 ($400 salary plus $300 distributive share) and *B* would have QBI of $300.[154] Assuming the 20% of QBI limit is binding, *A*'s section 199A deduction would be $140 (20% × $700) and *B*'s would be $60 (20% × $300), or a total of $200 (20% × $1,000 QBI). By comparison, under the entity approach of section 199A, no portion of *A*'s salary of $400 is treated as QBI; nevertheless, the partnership's deduction for *A*'s compensation reduces overall QBI from $1,000 to $600 (allocated $300 to *A* and $300 to *B*); each partner would have a section 199A deduction of $60 (20% × $300).[155] The total section 199A deduction is reduced from $200 to $120, a reduction of $80 (20% × $400 section 707(c) payment). For purposes of section 199A, the result would be identical if *A* were instead treated as receiving a section 707(a) payment for services, rather than a section 707(c) payment.[156]

If partners can structure compensatory payments for services to fall outside section 707, aggregate-versus-entity treatment may be largely elective under section 199A. By substituting priority cash flow distributions coupled with priority income allocations, a partnership can generally replicate the economic effect of a guaranteed payment. Nevertheless, such payments should generally escape treatment as section 707(c) guaranteed payments.[157] While section 707(a) could recharacterize the priority income allocation/cash distribution as a disguised payment for services, a sufficiently risky arrangement should also fall entirely outside section 707. Even if such an arrangement fails to accomplish an identical economic result, the tax advantage of the section 199A deduction is likely to outweigh any detriment.

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[153] Hence, such payments do not count for purposes of the wage or wage-and-property limit under section 199A. I.R.C. § 199A(b)(2).

[154] *See* Reg. § 1.199A-3(b)(2)(ii)(I). The payment to *A* can be considered the equivalent of a special allocation of $400 of QBI, which reduces the partnership's remaining QBI to $600 ($1,000 less $400) allocated equally between *A* and *B* ($300 each). Special allocations of QBI are unlikely to run afoul of the substantiality rules under the section 704(b) regulations. *See* Stephen Utz, *Substantiality of QBI Allocations Under Subchapter K*, 162 TAX NOTES (TA) 55, 60 (Jan. 7, 2019).

[155] The section 199A deduction is reduced by $80 (20 percent × *A*'s salary of $400).

[156] *See* Reg. § 1.199A-3(b)(2)(ii)(J).

[157] *See* Banoff, *supra* note 7, at 828 n.51; *but see* SLOAN & SULLIVAN, *supra* note 75, at 142-10 (noting that the disguised sale safe harbors "should not, however, necessarily be interpreted to mean that a cash flow-based payment cannot be a guaranteed payment"); G.C.M. 38670 (Mar. 31, 1981) (Service should not limit its ability to characterize a payment dependent on available cash as a section 707(c) payment).

The 2017 Act enhances the incentive for limited partners and LLC members to structure compensation for services as a section 704(b) distributive share rather than a section 707(c) guaranteed payment, thereby minimizing self-employment taxes and maximizing the section 199A deduction. Under section 1402(a)(13), state-law limited partners are exempt from self-employment taxes on their distributive share, but the exclusion does not apply to section 707(c) guaranteed payments for services.[158] The limited-partner exception under section 1402(a)(13), originally intended to prevent passive investors from qualifying for Social Security benefits,[159] has given rise to a widening gap in self-employment taxes driven by the rise of LLCs.[160] Exploiting uncertainty concerning the definition of a limited partner, members of LLCs and other limited liability entities have aggressively used the exception to avoid self-employment taxes.[161] In the case of general partners, distributive share treatment reduces income taxes under section 199A even if self-employment taxes are unchanged. Distributive share treatment also reduces employment taxes and the section 1411 tax on net investment income to the extent that a general partner can bifurcate a profits interest into a general and a limited interest.[162]

B. *Section 707 Payments for Capital*

Section 199A does not explicitly exclude guaranteed payments for capital from QBI. Nevertheless, such payments may often be economically indistinguishable from interest income which is specifically excluded from QBI.[163] The proposed regulations under section 199A provided that GPUCs "are not considered attributable to a trade or business" (and hence do not constitute QBI) because they are necessarily "determined without regard to the income of the partnership."[164] Although the statute is silent concerning GPUCs, only

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[158] I.R.C. § 1402(a)(13); *see* Reg. § 1.707-1(c) (partner who receives a guaranteed payment is not treated as an employee).

[159] David W. Mayo & Rebecca C. Freeland, *Delimiting Limited Partners*, 66 TAX LAW. 391, 393 (2013). While guaranteed payments for services are generally excluded from net investment income, GPUCs are included in net investment income. Prop. Reg. § 1.1411-4(g)(10), 78 Fed Reg. 72,393 (Dec. 2, 2013).

[160] STAFF OF THE JT. COMM. ON TAX'N, REVIEW OF SELECTED ENTITY CLASSIFICATION AND PARTNERSHIP TAX ISSUES 48 (Apr. 8, 1997) (JCS-6-97) (noting that, when the exclusion was enacted, many states did not permit limited partners to participate actively) [hereinafter JCT, PARTNERSHIP TAX STUDY].

[161] *See, e.g.*, Renkemeyer v. Commissioner, 136 T.C. 137 (2011).

[162] *See* Karen C. Burke, *Exploiting the Medicare Tax Loophole*, 21 FLA. TAX REV. 570, 598–600 (2018). Drafting around GPUC status also avoids the section 1411 tax. Prop. Reg. 1.1411-4(g)(10), 78 Fed Reg. 72,393 (Dec. 2, 2013).

[163] I.R.C. § 199A(c)(3)(B)(iii).

[164] This rationale may be overly broad; if applied to section 707(c) guaranteed payments for services, it would make the specific exclusion under section 199A(c)(4)(B) redundant.

income from a qualified trade or business is eligible for the section 199A deduction.[165] Excluding GPUCs from the definition of qualified trade-or-business income allowed the Treasury Department to sidestep whether GPUCs in fact constitute interest (or an interest equivalent).

Given the lack of clarity in the 2017 Act, GPUCs clearly represented a "hard case" under section 199A.[166] Commentators argued that section 199A(c)(4)(B)'s specific reference to guaranteed payments for services gave rise to a negative inference that GPUCs should be included in QBI.[167] In enacting section 199A, Congress understandably focused primarily on excluding section 707(c) payments for services without addressing interest-like GPUCs also described in section 707(c). While GPUCs are treated as third-party payments for purposes of inclusion and deduction (or capitalization), they are regarded as distributive shares for all other purposes.[168] Given their hybrid debt-equity nature, commentators argued that GPUCs should constitute QBI to the recipient, at least if the recipient is also entitled to a distributive share of partnership net income.[169] The Treasury Department mostly rejected these comments, while allowing QBI treatment for GPUCs that are properly allocable to the recipient's separate qualified trade or business.[170]

Even though GPUCs generally do not constitute QBI in the recipient's hands, they reduce the partnership's QBI if they are properly allocable to the partnership's trade or business and otherwise deductible.[171] Thus, the section 199A deduction at the partner level is automatically reduced by 20% of the amount treated as a GPUC, increasing the tax burden on this income from 29.8% to 37% for high-bracket partners. Preferred returns that resemble interest will reduce QBI only if they are classified as GPUCs, however. If partners can easily elect out of GPUC status by restructuring preferred returns as section 704(b) distributive shares, unfavorable QBI treatment is essentially meaningless. While arguably a feature of the existing rules, such electivity is inconsistent with the notion that classification of section 707(c) payments should be based on substance. Particularly if non-GPUC status confers a distinct tax advantage, it seems unlikely that Congress intended to allow partners to elect the most favorable tax consequences without significantly altering their economic arrangement.[172]

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[165] *See* I.R.C. § 199A(c)(1).

[166] NYSBA, *supra* note 148, at 40.

[167] *Id.* at 42; ABA, *supra* note 150, at 18–19.

[168] *See* JCT, PARTNERSHIP TAX STUDY, *supra* note 160, at 45; *see also* NYSBA, *supra* note 148, at 42 (noting that section 707(c) payments are "betwixt and between").

[169] NYSBA, *supra* note 148, at 42.

[170] Reg. § 1.199A-3(b)(1)(ii).

[171] *Id.*

[172] Needham, *supra* note 7, at 119 (noting that a "drafting choice that alters the tax consequences but not the expected payment terms is tantamount to an election"). The hallmark of such electivity is that "only the government stands to lose." *Id.*

C. *GPUCs as Interest-Equivalents*

The 2017 Act imposes a new limitation on business interest expense (BIE) applicable to passthrough entities. Under section 163(j), a taxpayer may generally deduct business interest only up to the sum of the taxpayer's business interest income (BII) plus 30% of the taxpayer's adjusted taxable income (ATI) for the year.[173] ATI is defined as the amount of a taxpayer's taxable income without taking into account items such as BIE and BII and the section 199A deduction.[174] Any disallowed BIE may be carried forward and deducted in future years (subject to the section 163(j) limitation).[175] For partnerships and S corporations, the interest limitation applies to the entity, with the consequences of that determination passing through to the entity's owners.[176]

In implementing section 163(j), the proposed regulations adopted a broad definition of interest that included items not treated as interest under other Code provisions.[177] Thus, some items that were previously deductible as trade-or-business expenses under section 162 without limitation would be tested under section 163(j). Specifically, the proposed regulations included GPUCs within the definition of interest.[178] This treatment, if confirmed in final regulations, would have effectively eliminated, for purposes of section 163(j), the distinction between section 707(a) payments for partner loans and section 707(c) payments for contributed equity: both types of payments would have been treated as interest. GPUCs would be required to run the gauntlet of section 163(j), notwithstanding the express language of the section 707(c) regulations treating such payments as deductible under section

[173] I.R.C. § 163(j)(1). The CARES Act retroactively increases the section 163(j) limit from 30% to 50% of ATI for taxable years beginning in 2019 and 2020. Coronavirus Aid, Relief, and Economic Security (CARES) Act, Pub. L. No. 116-136, § 2306, 134 Stat. 281, 358–59 (2020) (enacting I.R.C. § 163(j)(10)(A)(i)).

[174] ATI also excludes any net operating loss deduction and, prior to 2021, any deduction for depreciation, amortization, or depletion. I.R.C. § 163(j)(8)(A).

[175] I.R.C. § 163(j)(2).

[176] I.R.C. § 163(j)(4).

[177] The proposed regulations treated as interest certain amounts that are "closely related to interest and that affect the economic yield or cost of funds of a transaction involving interest, but that may not be compensation for the use or forbearance of money on a stand-alone basis." Notice of Proposed Rulemaking, Limitation on Deduction of for Business Interest Expense, Preamble, 83 Fed. Reg. 67,490, 67,493 (Dec. 28, 2018).

[178] Prop. Reg. § 1.163(j)-1(b)(20)(iii)(I), 83 Fed. Reg. 67,490 (Dec. 28, 2018).

162, not section 163.[179] Commentators argued that treating GPUCs as interest was inconsistent with existing authority and the congressional policy underlying section 707(c).[180]

Under the proposed regulations, a preferred return on a partner's capital would be subject to section 163(j) only if it were treated as a section 707(c) guaranteed payment; otherwise, the preferred return would be treated as a section 704(b) distributive share and would not be subject to the interest limitation.[181] If GPUC treatment applied, the net result would be to convert an otherwise deductible section 707(c) payment into a potentially nondeductible interest expense. Assume, for example, that the *AB* partnership has $110 of income and pays $10 to partner *A* as a section 707(a) payment or a section 707(c) payment. Except for the guaranteed payment, *A* and *B* share profits and losses equally. As long as the amount is deductible, *A* has a $10 payment and the partnership has $100 of income divided between *A* and *B*.[182] If the GPUC is treated as nondeductible interest by virtue of section 163(j), the partners must report total income of $110 (rather than $100), allocable $55 each to *A* and *B*.[183] *A* is effectively taxed twice on a portion of the $10 payment, once under section 707(c) as a guaranteed payment and again on *A*'s distributive share of income under section 705.[184] By contrast, if the preferred return escapes GPUC treatment, section 163(j) does not apply and the special allocation to *A* is equivalent to a deduction for *B*.

The preamble to the final regulations notes that GPUCs "have both equity and debt characteristics" because the partner "who provided capital is an

[179] Reg. § 1.707-1(c) ("For a guaranteed payment to be a partnership deduction, it must meet the same tests under section 162(a) as it would if the payment were made to a [third party], and the rules of section 263 (relating to capital expenditures) must be taken into account."). *See* Cagle v. Commissioner, 539 F.2d 409 (5th Cir. 1976) (guaranteed payment deductible under section 162 unless required to be capitalized under section 263).

[180] *See* ABA, Comments on the Impact of the Proposed Regulations under Section 163(j) on Passthrough Entities and their Owners 13, 15 (Mar. 7, 2019), *available at* https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/030719comments.pdf (recommending that GPUCs be removed from the definition of interest).

[181] The preferred return cannot be a section 707(a) payment, since section 707(a) only applies to partner loans. Reg. § 1.707-1(a).

[182] The result is the same as if *A* had received a special allocation of income of $10, coupled with an offsetting distribution of $10.

[183] Under section 163(j)(2), any disallowed interest would be carried over and potentially deductible in a subsequent year.

[184] Final regulations exempt from section 163(j) a portion of a GPUC treated as "self-charged interest," analogous to the section 469 rules. Reg. § 1.163(j)-6(n); Reg. § 1.469-7(a)(1). Such treatment mitigates overtaxation, since the lender's share of the interest deduction and interest income offsets. *See* Needham, *supra* note 7, at 113.

owner of the business, but also receives payments that are similar to interest."[185] Rather than automatically treat GPUCs as interest, the final regulations provide an anti-abuse rule that may characterize a GPUC as interest expense (and interest income) for purposes of section 163(j).[186] *Example (5)* of the regulations illustrates the anti-abuse rule. In the example, partner *A* agrees to make an additional capital contribution, in exchange for a GPUC, to the *ABC* partnership, which already has significant debt and interest expense. The example concludes that the payment is economically equivalent to interest that the partnership would otherwise be obliged to pay to obtain additional third-party borrowing. Because a "principal purpose" for the GPUC was to reduce the interest expense that the partnership would otherwise incur, the guaranteed payment to *A* is treated as interest expense for purposes of section 163(j).[187] The anti-abuse rule is intended to prevent a partnership that would otherwise be unable to deduct business interest by virtue of section 163(j) from restructuring debt as equity capital for which the contributor receives an interest-like return in the form of a GPUC. The anti-abuse approach may also discourage partners from taking advantage of section 163(j) by using GPUCs to create BII that would shelter partner-level BIE dollar-for-dollar.[188]

The character of GPUCs as interest to both the payor and payee has long been unsettled. Indeed, one commentator has suggested that "the classification of GPUCs is at best confused, and at worst, seemingly schizophrenic."[189] Although it is not entirely clear why Congress included GPUCs in section 707(c), the intent was apparently to allow such payments to be deducted under section 162, similarly to payments for services. The reference in the 1954 legislative history to "guaranteed interest payments on capital" [190] may support the Service's historical position that GPUCs should be treated as interest

[185] T.D. 9905, Preamble, 85 Fed. Reg. 56,686, 56,749 (Sept. 14, 2020). The final regulations generally narrow the definition of interest, subject to an anti-abuse rule. *See id.* at 56747; Reg. § 1.163(j)-1(b)(22)(iv)(A)(*1*).

[186] Reg. § 1.163(j)-1(b)(22)(v)(E), Ex. (5).

[187] If *A* is aware of *ABC*'s treatment of the GPUC as BIE, *A* is treated as receiving BII under section 163(j). *Id. See* NYSBA, REPORT ON FINAL AND PROPOSED SECTION 163(J) REGULATIONS 30 (Nov. 2, 2020) (Rep. No. 1444), *available at* https://nysba.org/app/uploads/2020/11/Report-1444.pdf [https://perma.cc/563E-SB8K] (noting that "broadly applying the anti-abuse rule . . . puts pressure on the often elusive distinction between guaranteed payments and preferred returns").

[188] *See* Needham, *supra* note 7, at 113; *see also* Notice 2004-31, 2004-1 C.B. 830 (2004) (preventing use of GPUCs to convert nondeductible interest payments under former section 163(j) to deductible section 707(c) payments).

[189] Banoff, *supra* note 7, at 837; *see id.* (noting that, given the inconsistent positions taken by the Treasury Department and the Service, a payor or payee of a GPUC may seemingly find "support . . . for almost any position").

[190] S. REP. NO. 83-1622, at 94, 1954 U.S.C.C.A.N. at 4727.

by the recipient partner under section 61(a)(4). Although the Service has described GPUCs as interest payments on "fictional indebtedness,"[191] such payments lack the normal indicia of debt. In treating GPUCs as interest income to the recipient, the Service was apparently not troubled by the fact that the section 707(c) regulations explicitly provide a section 162 deduction for such amounts.[192] More recent rulings have treated GPUCs as a distributive share of partnership income in some situations,[193] but in other contexts the Service has treated GPUCs as interest to both the payor and the payee.[194] In the recent regulations concerning allocation and apportionment of foreign tax credits, the Treasury Department indicated that a GPUC need not be "indebtedness" to be treated as an interest equivalent.[195]

Clearly, the notion that GPUCs are a return on partner equity should not preclude interest-like treatment for guaranteed payments that share many characteristics of interest payments that a partnership would normally make to a lender. The Service's approach would appear to determine whether GPUCs are equivalent to interest based on a case-by-case analysis of specific provisions. In theory, it would be desirable to determine when the characteristics of a fixed preferred return are sufficiently debt-like to warrant treating such returns as interest rather than a distributive share, regardless of whether they constitute GPUCs under current law.[196] As experience with sections 199A and 163(j) illustrates, however, the electivity of the existing rules allows taxpayers to draft around unfavorable treatment for GPUCs without significantly altering the partners' economic arrangement. Regardless of whether GPUCs should be classified as a "new category of interest expense," classification should not be elective as under current law.[197]

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[191] G.C.M. 36702 (Apr. 12, 1976) (noting that section 707(c) "in a sense . . . creates a fictional indebtedness").

[192] *Id.*; *see also* G.C.M. 38133 (Oct. 10, 1979). *But see* Notice 2004-31, 2004-1 C.B. at 830 (acknowledging that bona fide GPUCs do not constitute debt for purposes of the former section 163(j) limit).

[193] *See*, *e.g.*, P.L.R. 87-28-033 (Apr. 13, 1987) (guaranteed payment to REIT had same character, for purposes of REIT rules, as in the partnership's hands); P.L.R. 8639035 (June 27, 1986) (same).

[194] *See* Reg. § 1.469-2(e)(2)(ii) (characterizing a GPUC, for purposes of passive loss rules, as an interest payment rather than a distributive share). The rule prevents taxpayers from offsetting passive losses against such interest income under section 469(e)(1)(A). *See also* Reg. § 1.263A-9(c)(2)(ii) (guaranteed payments subject to interest capitalization rules).

[195] T.D. 9922, 85 Fed. Reg. 71,998, 72,004 (Nov. 12, 2020).

[196] *Compare* Needham, *supra* note 7, at 127–28 (considering common law debt-equity factors) w*ith TIFD III-E, Inc.*, 666 F.3d at 837 (purported partners' interests were "overwhelmingly in the nature of a secured lender's interest" since partners were virtually assured of receiving a specified minimum return on their invested capital and lacked significant upside potential).

[197] Needham, *supra* note 7, at 128; *see id.* at 112 ("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 is contingent on or otherwise matched by a low-risk allocation of gross income.").

VI. Conclusion

Section 707(a)(2)(A) imposes a risk-based standard for determining whether a purported allocation and related distribution should be treated as disguised compensation for services. Guaranteed payments for partner-capacity services, governed by section 707(c), are generally devoid of entrepreneurial risk. Following enactment of section 707(a)(2)(A), commentators suggested that section 707(c) should be repealed since the provision no longer served any useful purpose. The 2015 proposed regulations revise *Example (2)* under the 1956 regulations, eliminating the existing wait-and-see approach to classification. Unfortunately, the proposed regulations classify guaranteed minimum payments under section 707(c) rather than section 707(a), thereby perpetuating long-standing confusion over the scope of the two provisions. A preferable approach would treat all nonrisky payments for services as subject to section 707(a), regardless of the capacity in which they are rendered.

If nonrisky payments for services are no longer governed by section 707(c), that provision would apply only to GPUCs, a category that Congress failed to adequately conceptualize in 1954. In the absence of section 707(c), the current category of GPUCs could be treated either as section 707(a) payments or as section 704(b) distributive shares. Since GPUCs are subject to significantly less entrepreneurial risk than a distributive share of partnership income, there is a strong argument for treating such payments as section 707(a) payments even if they lack the normal indicia of debt. If Congress were writing on a clean slate, section 704(b) might seem adequate to prevent the potential abuses that section 707(c) invites.[198] While section 704(b) is clearly sufficiently flexible to deal with the computational complexity that prompted enactment of section 707(c), differential treatment of GPUCs and partner loans would invite further gaming opportunities.[199] In light of section 707(a)(2)(A), allowing taxpayers to elect to treat most guaranteed payments for capital as distributive shares is no longer a viable approach.

Repealing the intermediate category of section 707(c) payments would restore the ALI's 1954 version of section 707 and finally render the "capacity" issue moot. The entrepreneurial risk standard would provide a basis for consistent tax treatment of payments for services and capital, as recommended by the ALI's 1999 proposals.[200] It may seem surprising that section 707(c) has survived virtually unchanged since 1954, despite repeated calls for its repeal. One possible explanation is that differential tax treatment may have

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[198] Steinberg, *supra* note 81, at 540 (claiming that the section 704(b) approach would be "optimal").

[199] *See* Banoff, *supra* note 7, at 876 (rejecting section 704(b) treatment of all GPUCs as "a concept whose time has passed").

[200] *See* ALI, REPORTERS' STUDY, *supra* note 5, at 292–93.

seemed relatively unimportant, at least prior to 2017.[201] The 2017 Act, however, has raised the tax stakes while creating perverse incentives for taxpayers to choose the most favorable tax treatment under the current classification scheme. Section 707(c) is no longer an innocuous anomaly but a source of continuing confusion and uncertainty. It serves no useful purpose, and its repeal is long overdue.

[201] Needham, *supra* note 7, at 110 ("One explanation is that [clarification of the status of section 707(c)] never really mattered until now . . . ."). In the case of GPUCs, structured finance and investment partnerships clearly benefited from the ability to exploit inconsistencies in the classification scheme even prior to the 2017 Act. *See id.* (limiting equivalence to "most operating partnerships").