GPUCs in a Post-tax Reform World: The Proposed Taxation of (Some) Preferred Returns as Interest

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I. Introduction

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

Under recent guidance, the IRS and Treasury extended the new interest limitations under Code Secs. 163(j) and 199A to GPUCs even though a GPUC is a return on an equity investment. Whether the proposed treatment of GPUCs as interest will achieve its intended purpose will depend on the answers to these questions. This paper explores the many difficulties the government is likely to confront in its effort to apply the new interest limitations of Code Secs. 163(j) and 199A to this new category of "interest," with particular emphasis on how affected taxpayers are likely to respond in the absence of fundamental changes to the current law definition of a GPUC.

Under current law, whether a fixed payment is a guaranteed payment for capital or services under Code Sec. 707(c), a distributive share of partnership income under Code Sec. 704(b) or a payment subject to Code Sec. 707(a) is not a simple question, especially in the service context. It depends on the meaning of "fixed." A $100 salary is certainly fixed, but what about a salary equal to the lesser of $100 or 100% of partnership gross income? Is the salary no longer fixed? Should it matter that the partnership has never earned less than $100 of gross income?

As discussed in this paper, this type of payment is not a guaranteed payment under Code Sec. 707(c). The incremental risk associated with the income contingency is irrelevant. Indeed, it is not even necessary to avoid the guaranteed payment rules that the payment be contingent on gross income. In the view of most practitioners, a matching allocation of gross income to the service partner will suffice to avoid Code Sec. 707(c) even if the matching allocation is not a condition to payment.

The impact of these minor drafting distinctions and the electivity it promotes is well understood by practitioners. While Code Sec. 707(c) may be mandatory in form, it is largely optional in practice. Perhaps worse, some contend that Congress eviscerated the guaranteed payment rules when it amended Code Sec. 707 in 1984. As this paper will explore,[2] the story of the de facto repeal of Code Sec. 707(c) is not the idle musing of some crackpot, but rather the considered and well-argued opinion of a co-author of a distinguished treatise on partnership taxation.[3] If this interpretation is correct, the GPUC as a new category of interest does not exist.

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

One explanation is that it never really mattered until now, at least for most operating partnerships. Why? Because the tax consequences to the partners under Code Sec. 707(a), Code Sec. 707(c) or Code Sec. 704(b) were more or less the same: the payee partner reported the payment as ordinary income and the partnership either deducted it as a business expense or allocated an equivalent amount of additional income to payee partner (resulting in the economic equivalent of a deduction to the remaining partners).

Suppose, for example, that Code Sec. 707(c) is indeed elective and that a partnership with $105 of income pays an additional $5 to a 25% partner. If Code Sec. 707(a) or (c) applies, the partnership would deduct the $5 as a business expense, leaving the 25% partner with $5 of ordinary income and $25 of distributive share. If the $5 is instead treated as distributive share, the partnership would allocate $30 of distributive share to the 25% partner instead of $25. In all three scenarios, the 75% partner would report $75 of net income.

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

But this was before the TCJA.[4] Under the proposed Code Sec. 163(j) regulations, a GPUC is treated as interest. If the interest is not deductible, multiple partners will be subject to tax on the same income. Under the Code Sec. 199A regulations, a GPUC is subject to tax to an individual partner at ordinary income rates. It is not eligible for the new 20% deduction for "qualified business income" (QBI). For any other type of preferred return on capital, the TCJA amendments to the Code do not apply even if the expected payment terms are identical.

Assume the $5 in the last example was classified as a GPUC. Unless 30% of the "adjusted taxable income" (ATI) of the partnership exceeded its total interest expense by at least $5, none of the $5 would be deductible under Code Sec. 163(j). The other partners would therefore report $5 of additional income even though the 25% partner already reported the GPUC as interest income. If the preferred return were *not* a GPUC, only the 25% partner would report the $5 as income. What about Code Sec. 199A? Of the $30 of total income to the 25% partner, $5 would not be eligible for the new 20% deduction. If the $5 had *not* been classified as a GPUC, the entire $30 would have been eligible.

If the difference between a GPUC and other types of preferred returns were always meaningful, the difference in tax consequences may well be justified. After all, a preferred return contingent on profits may never be paid. But this is not current law. Indeed, the economic difference between a GPUC and many preferred returns is often trivial, depending more on drafting distinctions than expected payment terms. As a result, a partnership that cannot deduct a preferred return classified as a GPUC under Code Sec. 163(j) for want of sufficient ATI may be able to avoid Code Sec. 707(c) by redrafting the terms of the preferred return to make it contingent on a capped allocation of gross income. For most operating partnerships, the incremental risk associated with this type of deduction-equivalent allocation is likely to be quite small, perhaps even remote.

Indeed, some partnerships may choose to exploit the electivity of current law by drafting *into* the GPUC rules. Suppose a partnership with plenty of ATI to deduct its own interest expense has a partner with insufficient ATI to deduct interest at the partner level. If the partner were to recapitalize its investment into a common and GPUC-preferred interest, it may be able to convert what would otherwise be a distributive share of partnership income under Code Sec. 704(b) into "business interest income" under Code Sec. 163(j)(6), allowing it to deduct a larger share of such interest.

Under recent guidance, the IRS and Treasury extended the new interest limitations under Code Secs. 163(j) and 199A to GPUCs even though a GPUC is a return on an equity investment.

A few words about what this paper is *not* about.

First, it is not about whether applying the interest limitations of Code Secs. 163(j) and 199A to GPUCs is consistent with the purpose of these provisions. I prefer to remain neutral on this question. While one could argue that Code Sec. 707(c) was enacted in 1954 to address a perceived abuse having nothing to do with whether preferred returns on capital resemble interest, this is a topic for another paper.[5] Moreover, while one could further argue that the many opportunities available under current law to avoid Code Sec. 707(c) counsel against expanding the guaranteed payment rules, it could also be argued that these self-help opportunities must be narrowed if Code Sec. 707(c) is to apply more broadly.

Second, it is not about the shortcomings of current law except insofar as they facilitate the avoidance of Code Secs. 163(j) and 199A. Whether it is proper to tax *any* return on an equity investment as interest is at best debatable. Reasonable people disagree. Whether the taxation of such returns as interest should be elective is not. In the absence of the TCJA amendments, however, this paper does not propose any new guidance in this area. While no tax regime that is elective in practice should be ignored, this one has been elective for many years, with little empirical evidence of significant revenue loss.

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

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

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

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

First and foremost, it should reduce electivity. The treatment of a preferred return as a GPUC should be based on whether the return possesses the basic hallmarks of interest, not on whether payment is contingent on or otherwise matched by a low-risk allocation of gross income. Interest on indebtedness is typically fixed rather than contingent, is not discharged in the absence of sufficient profits and is senior to the claims of other stakeholders. A preferred return that shares these traits should generally be treated as a GPUC.

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

Finally, the government should consider the extent to which the factors governing the common law determination of whether an instrument is debt or equity should also inform the definition of a GPUC. In considering the relevance of such factors, however, the government must be mindful of the different context. Like a dividend on preferred stock, a GPUC is a return on an equity investment. The treatment of a GPUC as interest cannot be defended on the basis that a preferred partner is like a creditor. The investment is unlikely to have a fixed maturity date or to convey creditor's remedies in a default. Indeed, the investment is likely to be subordinated to the claims of even the most junior creditors.[6] On the other hand, the absence of certain attributes often cited as indicia of debt under the common law may provide helpful guideposts in the GPUC determination.

II. GPUCS as Interest Under Code Sec. 163(J)

A. Overview of Code Sec. 163(j)

Code Sec. 163(j) disallows the deduction of net "business interest expense" (BIE) in excess of 30% of ATI.[7] BIE is defined as interest expense incurred on indebtedness allocable to a trade or business of the borrower.[8] Any BIE that is disallowed under Code Sec. 163(j) during the taxable year due to insufficient ATI is treated as BIE incurred by the borrower in the following year.[9]

B. Treatment of Partnerships

For debt incurred by a partnership, Code Sec. 163(j) applies at the partnership level.[10] Subject to certain exceptions, therefore, any net BIE of a partnership is in effect "trapped" within the partnership to the extent it exceeds 30% of partnership ATI.[11] Although the non-deductible "excess business interest" (EBI) of the partnership is allocated among the partners, the partners may not deduct the EBI against partner level ATI. The EBI is instead treated as BIE incurred by the partners in the following taxable year, but only to the extent of their share of the "excess taxable income" (ETI) of the same partnership in such year.[12] A partnership has ETI in any taxable year to the extent the BIE of the partnership in such year is less than 30% of partnership ATI.[13] A partner is permitted to increase its partner level ATI by its allocable share of the ETI of the partnership, allowing it to deduct additional BIE at the partner level.[14]

C. GPUCs Treated as BIE

Under the proposed Code Sec. 163(j) regulations, a GPUC is treated as interest.[15] If a partnership pays a preferred return on an equity investment of a partner, therefore, the expense is treated in the same manner as interest expense on a partner loan, but only if the preferred return is classified as a GPUC. A preferred return that is *not* classified as a GPUC is exempt from the deduction limitations of Code Sec. 163(j) even though distributive share treatment under Code Sec. 704(b) conveys the equivalent of a full deduction.

Suppose, for example, that a partner advances $1,000 to a partnership in exchange for an annual preferred return of $100. If the $100 is classified as a GPUC, the partnership will not be permitted to deduct the $100 from partnership income unless it has "unused" ATI of at least $333 (*i.e.*, $100/0.3). If the $100 is instead classified as distributive share, the partnership will not claim a deduction. Instead, it will specially allocate $100 of additional income to the preferred partner. Nevertheless, a special allocation of $100 of partnership income is no different from a *pro rata* allocation of the same income to the common partners together with an offsetting deduction.

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

D. GPUCs as Self-charged Interest

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

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

For this purpose, self-charged interest includes interest on a loan from a partner. By analogy to a similar relief provision under the passive loss rules of Code Sec. 469,[18] the rationale for extending relief to self-charged interest is that the lending partner's share of the interest deduction is matched by an offsetting amount of interest income, resulting in a net deduction of zero. If Code Sec. 163(j) were to disallow the deduction, the lending partner would be taxed twice, first on the BII as interest income and then again on its increased distributive share of partnership income attributable to the foregone deduction. Because the purpose of Code Sec. 163(j) is to disallow the tax benefits of excessive leverage,[19] granting such relief is appropriate. Unlike interest expense on debt between a corporation and a shareholder, interest expense on debt between a partnership and a fully-taxable partner generally does not convey a meaningful tax benefit.[20]

> *The central contention of this paper is that the guaranteed payment rules are essentially elective for most partnerships, in particular as applied to preferred returns on capital.*

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

III. GPUCS as Interest Under Code Sec. 199A

A. Overview of Code Sec. 199A[22]

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

The deduction is limited to "qualified business income" of the taxpayer, or QBI.[27] For this purpose, QBI does not include interest.[28] If a partner lends money to a partnership, therefore, the interest on the loan is subject to tax at regular rates even if it shelters income at the partnership level that would have qualified as deduction-eligible QBI.

B. Treatment of GPUCs

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

IV. Partner Capacity: The Evolution of Code Sec. 707

A. Life Before Subchapter K: Aggregate Reigns Supreme

Before subchapter K, the aggregate treatment of partnerships under the common law was far more pervasive. Under basic aggregate principles, a partnership is not regarded as a separate entity from its partners. It is treated as a conduit thorough which the partners are deemed to own and conduct the business of the partnership directly. As a conduit, the partnership itself is disregarded. Unlike stock in a corporation, therefore, the equity interests in the partnership are not recognized as separate and distinct claims on the partnership assets with their own tax bases and holding periods.

Aggregate treatment so permeated the common law before 1954 that most transfers of property, whether to or from a partnership, were exempt from tax even without any express statutory protection from gain recognition.[33] There was no statutory counterpart to Code Sec. 351 for transfers of property to a partnership, to Code Sec. 368(a)(1)(E) for amendments to partnership agreements, or to Code Secs. 332, 355 or 368 for distributions of property to a partner. These provisions of subchapter C defer gain recognition by corporate transferors and transferees. For partnership transferors and transferees, these same transactions were not transfers at all under the common law. Viewed through an aggregate lens, the partners were instead treated as transferring the property to and among themselves. They required no statutory protection from gain recognition for the same reason a transfer of property to or from a modern day "disregarded entity" requires no relief: non-realization.[34]

The same was true of salaries. Prior to 1954, partner salaries were not taxed as compensation to the partner or deducted as a business expense by the partnership. They were treated as a distributive share of partnership profits.[35] Under the aggregate construct, the partners were treated as providing the services to themselves through the conduit partnership rather than a separate legal entity and sharing the resulting profits. This approach to the taxation of partner salaries produced acceptable results as long as the taxable income of the partnership equaled or exceeded the salaries.[36] The service partner would report the entire salary as distributive share, which in turn conveyed the economic equivalent of a deduction to the remaining partners.

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

Suppose, for example, a one-third partner receives $400 of salary from a partnership with taxable income of only $100. Under prior law, the first $100 of salary would be reported by the partner as distributive share. The tax consequences of the remaining $300 depended on which partners bore the excess expense. If the capital accounts of the partners were debited pro rata by the $300 of expense, the service partner would report an additional $200 in income and the two-thirds partner would claim an offsetting deduction. The last $100 of salary, which depleted the capital of the service partner, was treated as a tax-free withdrawal of capital.

The deemed distribution of capital was not regarded as compensatory for the same reason a transfer of property did not result in gain recognition: a partner cannot provide services to itself.[39]

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

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

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

To address the "excess" salary problem described above, Congress enacted Code Sec. 707 of the Code. Under Code Sec. 707, a partnership is treated as a separate entity from its partners. Code Sec. 707(c) applies to any salary or other fixed payment to a partner for services as long as the payment is received in a partner capacity and is determined without regard to partnership income. As a guaranteed payment, the entire salary is reportable as compensation to the service partner regardless of the character of the income that funded it or even whether the salary exceeded partnership income. In contrast to its treatment under prior law, a guaranteed payment is not reportable as a distributive share of partnership income. While the House version of Code Sec. 707(c) was limited to guaranteed payments for services, the Senate extended it to GPUCs.[42]

Like Code Sec. 707(c), Code Sec. 707(a) also prohibits many of the under-inclusions of income once possible under the aggregate construct, including service income. Unlike Code Sec. 707(c), however, Code Sec. 707(a) applies only if a partner is acting *other than* in his capacity as a partner. If, for example, a partner leases a building to a partnership to provide office space, Code Sec. 707(c) does not apply to the rent because the leasing partner is not acting in a partner capacity. He is acting as a landlord. As such, the leasing partner must report 100% of the rent as income under Code Sec. 707(a). He cannot exclude all or any portion of the rent under the aggregate fiction that one cannot rent property to oneself. Under Code Sec. 707(a), the partner is treated as renting the property to the partnership, not to himself and the other partners.

C. The Capacity Guardrail Between Code Secs. 707(a) and (c)

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

Code Sec. 707(c) applies only to transactions in which a partner is acting in a partner capacity. Code Sec. 707(a), on the other hand, applies only to transactions in which a partner is acting "other than" in a partner capacity.[43] The purpose of the capacity guardrail is to ensure that no payment to a partner is subject to Code Sec. 707(a) and Code Sec. 707(c) at the same time. The provisions are mutually exclusive and were intended to be so.

> *Whether a GPUC should be treated as a new category of interest expense for these purposes is at best debatable. Most practitioners would agree, however, that if a GPUC is to be so treated, it should not be elective.*

Until 1984, the capacity determination depended on the relationship between the activity of the partner (usually a service) and the business of the partnership. It did not depend on the manner in which the partner was compensated. In *Pratt*, for example, the general partners of two partnerships received 5% of the gross rental income of the partnerships as a management fee.[44] While both partnerships reported income on the accrual method of accounting, the general partners reported income on the cash method of accounting. Relying on the timing rules governing Code Sec. 707(a) payments, the partnerships deducted the fees as they accrued while the general partners included the fees in income only when they were paid. The IRS contended that the general partners should have reported the management fees in the year of accrual based on the accounting method of the partnerships, either as distributive share under Code Sec. 704(b) or as guaranteed payments under Code Sec. 707(c).[45]

The Tax Court held that Code Sec. 707(a) did not apply because the general partners were acting in a partner capacity. The capacity determination was based on the nature of the management activities, which the Tax Court found was consistent with the duties of a general partner.[46] The Tax Court further held that Code Sec. 707(c) did not apply because the fees were based on gross income and therefore violated the "not based on income" limitation of the statute. As a distributive share of partnership income, therefore, the fees were includible in income in accordance with the partnership's method of accounting.

On appeal, the Fifth Circuit affirmed the capacity determination under Code Sec. 707(a) but neither affirmed nor reversed the gross income determination under Code Sec. 707(c).[47] Although the IRS was the prevailing party in *Pratt*, it later disputed the status of the fees as distributive share. In Rev. Rul. 81-300,[48] it held that the fees in *Pratt* were guaranteed payments, finding that the income limitation of Code Sec. 707(c) did not prohibit payments based on gross income.

Based on these and other authorities, it was settled law before 1984 that the capacity determination depended on the nature of the activities. If a partner received interest on a loan to a partnership, he was subject to tax under Code Sec. 707(a) because he received the interest in his capacity as a lender. If a partner received rent on property leased to a partnership, she was subject to tax under Code Sec. 707(a) because she received the rent in her capacity as a landlord. On the other hand, if a partner received a fee for providing legal advice to a partnership engaged in the practice of law, she was subject to tax under Code Sec. 707(c) because she received the fee in her capacity as a partner. This was how Code Sec. 707 divided the world. The capacity determination depended upon the nature of the activities.

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

a) The Guaranteed Payment Is Dead. As discussed above, the capacity determination before 1984 depended on the nature of the activities. If the activities of the partner were proximately related to the business of the partnership (*e.g.*, providing investment advice to an LBO fund or grilling hamburgers at a McDonald's franchise), Code Sec. 707(c) applied as long the compensation was fixed. If the activities were *not* related, Code Sec. 707(a) applied to the compensation.[49]

In 1984, Congress amended Code Sec. 707 to add new Code Sec. 707(a)(2)(A) and (B). According to the 1984 legislative history to Code Sec. 707(a)(2)(A) and the 2015 preamble to the implementing regulations, the purpose of the legislation was two-fold: to prevent partnerships from circumventing the capitalization requirements of Code Secs. 263 and 709[50] and to prevent service partners from converting ordinary income to capital gain.[51] As perhaps the prototypical example of the first, suppose a partnership agreed to pay a relatively fixed amount to a third party that, if incurred by the partnership as an expense, would not be deductible. Rather than doing so, the partnership instead admits the third party as a putative partner and disguises the expense as a special allocation of income followed by a distribution.[52] If respected, the special allocation to the new "partner" conveyed the economic equivalent of a deduction to the real partners.

New Code Sec. 707(a)(2)(A) disallows distributive share treatment of the payment if the transaction is "properly characterized" as one between the partnership and a partner acting *other than* in his capacity as a partner.[53] In a sea change from prior law, however, the capacity determination would no longer depend on what the partner did for the partnership. It would instead depend on how the partner was paid:

> Partners extract the profits of the partnership with reference to the business success of the venture while third parties generally receive payments which are not subject to this risk. An allocation and distribution provided for a service provider under the partnership agreement which subjects the partner to *significant entrepreneurial risk* … generally should be recognized as a distributive share and a partnership distribution.[54]

So while Code Sec. 707(a) still applies only when a partner is acting in a non-partner capacity, the question of capacity shifted from an *activity-based* determination to a *risk-based* determination. An allocation of income to a partner followed by a related distribution would therefore be treated as a disguised payment for services under Code Sec. 707(a)(2)(A), but *only* if the payment was not subject to "significant entrepreneurial risk" (SER).[55] The nature of the activities was no longer relevant.

Recall that in *Pratt*, a fee to a partner was treated as a distributive share of partnership income under Code Sec. 704(b). The Tax Court had held that Code Sec. 707(a) did not apply because the partner had acted in a partner capacity and that Code Sec. 707(c) did not apply because the amount of the fee depended on gross income. In Rev. Rul. 81-300, the IRS concurred with *Pratt* on the capacity determination under Code Sec. 707(a) but dissented from *Pratt* on the "not based on income" determination under Code Sec. 707(c).[56] Construing the income limitation to *permit* such payments, the IRS ruled that the fees in *Pratt* were guaranteed payments. In the 1984 legislative history, however, Congress indicated that the fees in *Pratt* and Rev. Rul. 81-300 should have been subject to tax under Code Sec. 707(a),[57] most likely on the basis that they were contingent on gross (rather than net) income and therefore were *not* subject to SER under the new risk-based standard.

So if entrepreneurial risk was to be new focal point of the "capacity" determination, what was left of Code Sec. 707(c) following the 1984 amendments? It has been credibly argued by the author of a leading treatise on partnership taxation that the new definition of capacity *repealed* the guaranteed payment rules for all intents and purposes.[58] The essence of his argument is as follows.

The capacity guardrail, which predated the 1984 amendments by over 30 years, is at the very foundation of any transaction subject to Code Sec. 707. Code Sec. 707(c) only applies when a partner is acting in a partner capacity (provided that the payment is not contingent on income). Code Sec. 707(a), on the other hand, only applies when a partner is acting "other than" in his capacity as a partner. As a result, no single payment can be governed by Code Sec. 707(a) and Code Sec. 707(c) at the same time.

But if "capacity" is now a risk-based determination, how can a partner receive a fixed payment in a partner capacity? Fixed payments are *not* subject to entrepreneurial risk. Yet this is the very thing the statute requires. In its zeal to roll out "entrepreneurial risk" as the new gold standard of capacity, Congress eviscerated Code Sec. 707(c): the only way to satisfy the capacity requirement is to make the payment variable and the only way to satisfy the "not based on income" requirement is to make the payment fixed. The two requirements of the statute had become incompatible with each other. Even a fixed salary, for 30 years the paradigmatic example of a guaranteed payment, no longer satisfied the basic statutory requirement that the partner receive it in a partner capacity.[59]

That's the basic argument. While "capacity" had once served as an effective guardian of Code Sec. 707(c), the radical shift from an activity-based to a risk-based definition of capacity had made it irrelevant. If this is correct, it does not bode well for tax reform. Indeed, the proposed extension of the interest limitations of Code Sec. 163(j) and Code Sec. 199A to GPUCs is dead on arrival.

b) Long Live the Guaranteed Payment. The case described above for the "de facto" repeal of Code Sec. 707(c) rests on the contention that the new risk-based definition of capacity applies across the board to all payments governed by Code Sec. 707. It is not limited to Code Secs. 707(a)(2)(A) and (B).[60] While the argument that Code Sec. 707(c) became statutory surplusage in the wake of the 1984 amendments may have been plausible at the time, 1984 was a long time ago. The General Utilities doctrine was alive and well,[61] Code Sec. 704(c) had just been made mandatory and the "substantial economic effect" regulations under Code Sec. 704(b) were only eight years old. But as of the date of this paper, Code Sec. 707(c) remains in effect. While Congress has had many opportunities to repeal the guaranteed payment rules, it never did so. Surely the new definition of capacity in 1984 did not reach this far.[62]

Treasury and the IRS certainly believe Code Sec. 707(c) is still viable. The original Code Sec. 707(c) regulations, which were promulgated 28 years *before* the 1984 amendments,[63] were not amended in 1984 to reflect the new definition and remain in effect in substantially identical form. Indeed, in one of the very first examples in these regulations, the right to a minimum payment from a partnership whenever it exceeded the partner's share of the profits is treated as a guaranteed payment even though it is not subject to any entrepreneurial risk.[64] If Treasury and the IRS had believed that lack of SER disqualified a fixed payment from the guaranteed payment rules, it would have withdrawn the example years ago. But it never did. While it did *replace* the example a full 31 years after the 1984 amendments,[65] the new example proposed to treat the minimum payment as a guaranteed payment in every year. Rather than narrowing the circumstances under which such a payment was a guaranteed payment, therefore, the government actually expanded them.

It is in fact possible to interpret the new risk-based definition of capacity in a way that does not read Code Sec. 707(c) out of the Code.[66]

First, the new definition may apply only to those portions of Code Sec. 707 that were amended in 1984. The original Code Sec. 707(a) regulations, which apply to many transactions not subject to Code Secs. 707(a)(2)(A) or (B),[67] state that a partner is not acting in a partner capacity when he pledges property to the creditors of a partnership to support a borrowing.[68] This is an activity-based definition of capacity. When Treasury issued the disguised sale regulations under Code Sec. 707(a)(2)(B) in 1992 and the proposed disguised services regulations under Code Sec. 707(a)(2)(A) in 2015, it did not amend the regulations that preceded them.[69] This suggests that the new definition of capacity may be limited to transactions governed by Code Sec. 707(a)(2)(A) or (B).[70]

Second, Code Sec. 707(a)(2)(A) may have been intended to apply only to abusive transactions, especially those of relatively short duration or involving a counterparty other than an historic partner.[71] It may not have been intended to apply to recurring payments in the form of fixed salaries or preferred returns on capital.[72] Indeed, the status of Code Sec. 707(a)(2)(A) as a targeted anti-abuse rule is implied by the very word "transaction" in the statute, as are the specific types of transactions that inspired its enactment.[73]

Finally, it is possible that Code Secs. 707(a) and (c) *both* apply to payments not subject to SER, the former if the payment is variable and the latter if the payment is fixed.[74] Consistent with this view, Code Sec. 707(a)(2)(A) *requires* "a related direct or indirect allocation" of income while Code Sec. 707(c) prohibits it. While the government was granted the authority to challenge a variable payment masquerading as distributive share as a disguised payment for services in 1984, it has always had the authority to challenge a fixed payment as distributive share. Fixed payments were never subject to SER and were therefore treated as guaranteed payments before and after the 1984 amendments.[75]

The argument that lack of SER is not disqualifying but rather an inherent attribute of any guarantee payment is supported by the 2015 proposed regulations under Code Sec. 707(a)(2)(A). The preamble to these regulations states that "Congress's emphasis on entrepreneurial risk requires changes to existing regulations *under section 707(c)*."[76] As discussed above, the change to which the preamble refers was limited to the example involving the minimum payment discussed above. Recognizing that the payment in the original example lacked SER, Treasury modified the example to treat the payment as a guaranteed payment in its entirety.[77] If the government had believed that lack of SER deprived a partner of capacity for purposes of Code Sec. 707(c), it would have revoked the example rather than modified it.

For these and other reasons, the case for the de facto repeal of Code Sec. 707(c) has been described as "very weak."[78]

V. 20th Century GPUCs: How Did We Get Here?

A. All Paths Lead to Rome

Elective regimes do not last very long unless that were intended to be elective. If the guaranteed payment rules are indeed elective, they have been so for decades. How is this possible? Perhaps the answer to this paradox is that it is not a paradox but rather a misguided interpretation of current law. The failure of the government to intercede certainly suggests something is amiss with the electivity theory. In most of the published articles, electivity is at most hinted at but otherwise never mentioned. The far more consistent complaint from practitioners in this area is the lack of guidance.

In 1992, one practitioner described current law at the time as ranging between "confused" and "schizophrenic," concluding that "support seemingly exists for almost any position a recipient or payer of GPUCs wishes to take."[79] In 2004, another practitioner complained that the law was "conflicting," "inconclusive" or "simply non-existent."[80] In 2011, yet another dismissed the relevant authorities as "notoriously conflicting."[81] Finally, in 2015, the government announced that many of the very authorities cited in the published articles as largely responsible for the current state of affairs would be revoked, obsoleted or modified in favor of new proposed regulations that appear to going nowhere. In almost any other area of law, these kinds of ambiguities would have been resolved years ago.[82]

While conflicting guidance promotes a form of electivity, the electivity at issue here is different. The guaranteed payment rules are elective in the sense that they permit two otherwise similar economic investments to be taxed differently based on drafting nuances that do not alter the expected payment terms. Legal uncertainly has nothing to do with it. The reason this particular type of electivity has persisted for so long is that, at least prior to the TCJA amendments, the status of a preferred return as a guaranteed payment or a distributive share of partnership income did not matter a great deal, at least for most operating partnerships. In either case, the preferred partner reported the preferred return as ordinary income and the partnership either deducted the preferred return as a business expense or allocated less income to the other partners.

The tax treatment of a payment subject to Code Sec. 707(a) is now virtually identical to the tax treatment of a payment subject to Code Sec. 707(c). This was not always so.

One difference that has since been eliminated concerned expenses subject to capitalization under Code Sec. 263. Unlike payments subject to Code Sec. 707(a), it was once unclear whether a guaranteed payment was exempt from the deduction limitations of Code Sec. 263. Following years of litigation, Congress amended Code Sec. 707(c) in 1976 to prohibit the deduction of any guaranteed payment that, if paid to a non-partner, would have been subject to capitalization.[83]

Even after the 1976 amendments, other partnerships attempted to circumvent the capitalization requirements by admitting the payee as a transitory partner and disguising the capital expenditure as an allocation of income followed by a distribution. If respected, the income diverted to the transitory partner conveyed the equivalent of a full deduction to the historic partners. As discussed earlier in this paper,[84] this maneuver was no longer viable after Congress enacted Code Sec. 707(a)(2)(A) in 1984.[85]

Finally, the relevant timing rules governing the deduction and related income inclusion under Code Secs. 707(a) and (c) differed as well. If Code Sec. 707(c) applied, the timing of these items depended on the accounting method of the partnership.[86] If Code Sec. 707(a) applied, the timing depended on the accounting method of the partner. In the *Pratt* case, the general partners had claimed a current deduction for the accrued cost of their own salaries, deferring the income inclusion until payment.[87] After Congress amended Code Sec. 267 in 1984 to treat partners and partnerships as related parties,[88] partnerships on the accrual method of accounting could no longer deduct the salaries until their cash basis partners included them in income.[89]

Following these amendments, the few remaining differences between Code Sec. 707(a) and Code Sec. 707(c) payments were no longer meaningful. The recipient partner reported the payment as ordinary income and the partnership either deducted or capitalized the expense. With the proposed extension of Code Secs. 163(j) and 199A to GPUCs, however, this is no longer true. A preferred return may constitute non-deductible interest under Code Sec. 163(j) if the partnership has insufficient ATI and may be subject to tax at a higher rate as non-QBI at the partner level under Code Sec. 199A. These new limitations apply, however, only to preferred returns that are classified as GPUCs under Code Sec. 707(c). A preferred return that is classified as a GPUC is exempt from these limitations.

B. What Do You Mean by Elective?

Suffice it to say that if Code Sec. 707(c) is a dead letter, a GPUC cannot be exported to Code Secs. 163(j) or 199A as a new category of interest, at least without legislation. But what if Code Sec. 707(c) is alive and well, but elective for all intents and purposes? Are the prospects of raising additional revenue any better? Could an elective regime actually *lose* revenue under Code Secs. 163(j) or 199A?

First of all, what do I mean by "elective"?

I do not mean an actual tax election. Nor do I mean a change to the terms of the investment that alters the pre-tax economic position of the partners. An unconditional preferred return, for example, is very different from a preferred return contingent solely on future profits, even if the actual payments turn out to be identical. A decision of this nature is no more "elective" than the decision to issue stock rather than cash in an acquisition. These types of choices alter the economic agreement between the parties. On the other hand, a drafting choice that alters the tax consequences but not the expected payment terms is tantamount to an election. For these types of choices, only the government stands to lose.

For most operating partnerships, the difference between a fixed preferred return and a preferred return capped by a fixed allocation of gross income is not economically meaningful. As long as the partnership earns the minimum amount of gross income, the fixed and capped payments to the preferred partner will be identical. Even for those partnerships that may not earn sufficient gross income, the difference is not economically meaningful *unless* the allocation is a condition to payment. Under current law, it is not necessary to impose such a condition to avoid a guaranteed payment. Many preferred returns in the market require a matching allocation of gross income, but only to the extent the income is available. In the event of a shortfall, the unpaid preferred return continues to accrue at the stated rate for future payment, deferring rather than discharging the payment obligation.

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

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

1. The Meaning of "Income" Under Code Sec. 707(c)

To be subject to Code Sec. 707(c), a payment to a partner must be determined "without regard to the income of the partnership." Neither the statute nor the regulations define the word "income" for this purpose.[90] Was the income limitation intended to exclude payments contingent on net income only or was it intended to exclude payments contingent on gross income as well? Although it is likely that Congress originally intended to exclude only those payments contingent on net income,[91] there is almost no support for this position under current law.

As discussed earlier in this paper,[92] Code Sec. 707(c) was enacted to address the underreporting of salary income in the partnership context. Before 1954, partner salaries were not taxed as compensation income. Like the grant of a profits interest under current law,[93] the service nature of the arrangement prior to the enactment of subchapter K was generally ignored. Because investment partnerships were far less pervasive at the time, the treatment of salary as distributive share did not affect the ordinary character of the income and generally produced acceptable results, provided the income of the partnership exceeded the salary. If it did not, the "excess" portion of the salary was treated as a withdrawal of capital by the partners, allowing the service partner to exclude a portion of the salary from income.[94]

If the "not based on income" limitation under Code Sec. 707(c) were to prohibit payments contingent on gross income, a fixed salary subject to such a contingency would not be a guaranteed payment even if it exceeded the income of the partnership. Because this is the very abuse Code Sec. 707(c) was intended to address, it seems unlikely that Congress intended the income prohibition of the statute to exclude these payments.[95] In *Pratt*, however, the Tax Court disagreed.

The Tax Court held that fees based on gross rental income of a partnership were not guaranteed payments, finding "no merit" to the contention that the "not based on income" limitation under Code Sec. 707(c) was intended to exclude payments based on gross income.[96] As discussed above, however, the IRS disagreed with the Tax Court, ruling in Rev. Rul. 81-300 that Code Sec. 707(c) did not exclude such fees from the definition of a guaranteed payment.[97] The precedential value of both of these authorities was later called into serious question, first by Congress in 1984 and then again by Treasury and the IRS in 2015.[98]

According to the 1984 legislative history, the fees in *Pratt* were neither a distributive share of partnership income under Code Sec. 704(b) nor guaranteed payments under Code Sec. 707(c); as payments received in a non-partner capacity, they were instead subject to tax under Code Sec. 707(a). While Congress failed to articulate its reasoning, the most likely explanation for rejecting both *Pratt* and Rev. Rul. 81-300 is that such fees can no longer be received in a partner capacity under the new risk-based definition of capacity.

The preamble to the 2015 proposed regulations is consistent with the legislative history.[99] In the preamble, Treasury and the IRS officially obsoleted Rev. Rul. 81-300, stating that a payment for services linked to "an allocation of an *item* of income" (*i.e.*, gross income or net income) would henceforth be governed by Code Sec. 707(a)(2)(A).[100] Moreover, the proposed regulations themselves treat payments for services contingent on gross income as subject to Code Sec. 707(a)(2)(A) (rather than Code Sec. 707(c)) for want of SER unless the taxpayer is able to establish SER "by clear and convincing evidence."[101]

Based upon the foregoing, it now appears that Congress, Treasury and the IRS all agree that the income limitation under Code Sec. 707(c) excludes payments contingent on gross income. Under current law, a payment to a partner contingent on gross income cannot be a guaranteed payment.

2. Capped Allocations of Gross Income: In General

Based on the foregoing, it is well-settled that a variable payment that fluctuates with gross income cannot be a guaranteed payment under current law.[102] But suppose the variation is capped, for example a right to 100% of the gross income of the partnership, but no greater than a fixed dollar amount equal to a percentage of a partner's capital. One might think that a gross income allocation subject to a cap would be more vulnerable to challenge as a "disguised" guaranteed payment under Code Sec. 707(c) than an allocation not subject to a cap, in particular when the projected income of the partnership is expected to exceed the cap by a substantial margin. In such a case, the future payments will be fixed rather than variable.

The basic legal argument that this type of capped arrangement should be recast as a guaranteed payment is straightforward: the allocation of gross income to the recipient partner is not expected to vary from the cap from period to period and serves no non-tax business purpose. With or without the allocation, the recipient partner is expected to receive the same distribution. In stark contrast, for every dollar of gross income *not* subject to a cap, the recipient partner will receive more and the other partners will receive less. Given these differences, one might think that a capped allocation subject to a truly *de minimis* risk of non-payment would be ignored as a remote contingency, allowing a court to recast the distributions as disguised guaranteed payments.[103] After all, the Code Sec. 707 regulations expressly provide that "the substance of the transaction will govern rather than its form."[104]

There appears to be virtually no support for this argument. Indeed, the 1984 legislative history anticipated this very type of allocation in the service context. Under the proposed regulations, a payment linked to a capped allocation of income that is "reasonably certain" and involves "limited risk" is prone to recharacterization, but *not* as a guaranteed payment under Code Sec. 707(c).[105] In the service context, the authority of the IRS to challenge the status of such an allocation is expressly limited to Code Sec. 707(a)(2)(A). That the identical payment would have been a guaranteed payment if the remote contingency had been removed entirely from the partnership agreement appears to be irrelevant.

3. Capped Allocations of Gross Income: GPUCs Only

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

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

What should one conclude from this? Is the IRS just out of luck? Or could the IRS plausibly assert that a preferred return of this kind should be treated as a guaranteed payment because the gross income contingency is too remote to be given effect and the IRS is statutorily precluded from challenging the preferred return as distributive share under Code Sec. 707(a)(2)(A)? Imagine, for example, that Amazon, a company with GAAP gross sales income in 2018 that was $85 billion *greater* than its GAAP net income of $10 billion, were taxable as a partnership and that Amazon was obligated to pay an annual preferred return equal to its total interest expense that year of $1 billion, but only to the extent it earned at least $1 billion of gross income.[110] Should such a preferred return be respected as a distributive share or should it be recast as a disguised guaranteed payment? By almost any measure, the likelihood that Amazon will fail to earn the gross income necessary to compel the $1 billion payment is remote in the extreme.

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

Perhaps only those who do not practice much in subchapter K would make such an argument. McKee, a person who does *not* fit this description, contends that a preferred return contingent on gross income may *never* be recast as a GPUC under Code Sec. 707(c) *even if* the risk of non-payment due to the income contingency is vanishingly small.[117] Indeed, it is not even necessary that the gross income contingency be a contingency at all. All that is required to avoid a guaranteed payment is an actual gross income allocation, either as the preferred return accrues or in the year of payment (depending on your point of view). If this is correct, the relatively "remoteness" of the contingency is not even relevant.[118]

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

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

First, the definition is intended to differentiate between preferred returns and GPUCs, which are separately defined under the same regulations. Second, the only substantive difference between a preferred return and a GPUC under the definition is a matching allocation income (including gross income).[120] Unlike in the service context, the absence of SER does not appear to be relevant. Finally, the matching allocation need not be a condition to payment. The partnership is only required to allocate gross income "to the extent [such income is] available." Unlike the "wait and see" approach to guaranteed payments in the service context, the definition of preferred return does not by its terms prohibit distributive share treatment even in the year of payment should the partnership not have sufficient net or gross income.[121] Unless a GPUC is imputed in this scenario, the preferred partner will likely recognize Code Sec. 731 gain upon receipt of the payment or in a future liquidation.[122]

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

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

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

VI. 21st Century GPUCs: Where Should We Go from Here?

This paper argues that the proposed extension of Code Secs. 163(j) and 199A to GPUCs is unlikely to achieve its intended purpose unless the definition of a GPUC under current law is amended. In the absence of any amendment, many well-advised partners and partnerships will engage in self-help to avoid the new interest limitations. A fixed preferred return contingent on a capped allocation gross income, for example, is likely to be exempt from Code Secs. 163(j) and 199A as a distributive share of partnership income even if the expected payments to the preferred partner are identical to their GPUC-equivalent.

This section discusses certain possible modifications to the current law definition of a GPUC to reduce these self-help opportunities, as well as other modifications to narrow the existing differences between the accounting rules governing GPUCs and the accounting rules governing interest. It begins with an attribute intrinsic to interest (other than the time value of money nature of the return) as a possible line of demarcation, treating only those preferred returns that share this attribute as interest equivalents for this purpose. It then discusses two significant timing differences under current law and the likely impact of these differences under Code Secs. 163(j) and 199A even if the definition of a GPUC is properly amended to reduce electivity. One is the right to "hold open" the GPUC determination, allowing partnerships to report a preferred return as a GUPC in some years and as a non-GPUC in others even though the same return on a debt instrument is always treated as interest. Another is the proper timing of the deduction and related income inclusion for accrued but unpaid amounts at the end of any year: in the case of GPUCs, the timing is governed by the partnership's method of accounting; in the case of interest, it is governed by the accrual method of accounting. Finally, this section discusses the extent to which any of the common law indicia of debt should inform future guidance in this area.

A. The True Badge of a GPUC

One change in current law that should eliminate most of the self-help opportunities discussed in this paper without affecting preferred returns subject to real entrepreneurial risk is the definition of "income" under Code Sec. 707(c). Consistent with its original purpose, Code Sec. 707(c), whether by future guidance or perhaps a legislative amendment, should only exclude payments contingent on net income or otherwise subject to SER. In should not exclude a preferred return contingent on a capped allocation of gross income. If this types of return is not treated as a GPUC, it will be exempt from the limitations of Code Secs. 163(j) or 199A. Of all the debt-like attributes on an equity investment, the continuing obligation to pay whether or not the issuer is profitable is perhaps the most important. If this is the true badge of interest—the obligation to pay is not forgiven in the absence of sufficient profits—it should make no difference whether a preferred return is unconditional or contingent on a capped allocation of gross income. Unlike a preferred return subject to SER, the obligation is not forgiven in the event of a loss.

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

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

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

B. Preferred Returns in the Nature of Distributive Share

If lack of entrepreneurial risk is the true badge of a GPUC, then many (perhaps even most) categories of preferred returns on capital should be exempt from the limitations of Code Secs. 163(j) or 199A. Preferred returns contingent on net income are not payable in the event of a loss and therefore lack one of the core attributes intrinsic to interest on debt.

1. Hurdle Returns

In many investment partnerships, the first tier of the distribution waterfall following the return of capital distributions is a "hurdle" distribution. Hurdle returns should not be confused with preferred returns. Unlike a preferred return, a hurdle return merely subordinates the general partner's right to distributions to a minimum level of gain. It does not reduce the general partner's overall share of the investment gains unless the gains fall below a certain threshold. As long as the gains equal or exceed the threshold, the total distributions to the general partner over the life of the partnership will not be reduced by the hurdle distributions. To ensure this result, the general partner will typically be entitled to receive 100% of any distributions following the hurdle distribution until it fully "catches up" to the limited partners.

Suppose, for example, that a partnership distributes the sales proceeds of its investments first to the limited partners to return their capital contributions, then to the limited partners until they receive an 8% hurdle return on those contributions, then to the general partner until it receives a "catch up" distribution equal to 25% of the prior hurdle distributions, and finally 80% to the limited partners and 20% to the general partner. As long as the partnership earns an aggregate return of at least 10%, the general partner will receive 20% of the total investment gains. This is the same amount the general partner would have received if the hurdle rate had been zero.

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

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

2. Returns of Capital

In most cases, the capital of the partner entitled to a preferred return is senior to the capital of the other partners. The senior position of the preferred partner is typically reflected in the priority of future distributions under the partnership agreement. For example, if one group of partners provides the capital and another group of partners provides the services, the capital partners will often be entitled to all future distributions until their capital has been returned before the service partners may participate. In some partnerships, however, the capital partners may not be entitled to a preferred return on their capital. Their rights to any further distributions are *parri passu* with those of the service partners.

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

3. Returns Contingent on Net Income

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

In the service context, an allocation of this kind would generally be treated as subject to SER under the proposed Code Sec. 707(a)(2)(A) regulations. Entrepreneurial risk under these regulations is measured on a relative rather than absolute basis, comparing the risk of the special allocation to "the *overall* entrepreneurial risk of the partnership."[129] If the absolute entrepreneurial risk of a pro rata allocation to a partner is already small, therefore, the incremental reduction in risk attributable to the special allocation should be small as well.[130]

4. Not Based on Time Value of Money

In limited cases, future guidance should narrow rather than expand the current law definition of a GPUC, at least for purposes of Code Secs. 163(j) and 199A. Not every GPUC conveys a time value of money return. Suppose, for example, that a partner contributes a building to provide office space or a marketing intangible to facilitate the sale of goods or services within a particular region and, in consideration thereof, earns a preferred return equal to the current rental or royalty value of the property. The partner is not being compensated for the use of money and is not earning a time value of money return. A preferred return of this kind is not in the nature of interest and should not be treated as interest even if the return is subject to tax under Code Sec. 707(c) as a guaranteed payment.

C. Preferred Returns in the Nature of Interest

Applying this same attribute as the badge of a GPUC—the absence of entrepreneurial risk—other categories of preferred returns should be treated as interest equivalents subject to the limitations of Code Secs. 163(j) and 199A.

1. Uncapped Returns Subject to Fixed Floor

Suppose a partnership admits a new partner and agrees to pay her the greater of a fixed preferred return on her capital or 25% of the profits. A preferred return of this kind should be treated as a GPUC every year regardless of whether it exceeds 25% of the profits. While it may appear that the return is forgiven in any year it falls below the profit threshold, the partner is in fact entitled to a *larger* distribution in these years. Indeed, another way of expressing the same agreement is a fixed preferred return *plus* 25% of the profits *in excess of* the preferred return.

The obligation to pay is not contingent on profits and is not subject to SER.

This approach is consistent with the approach of the proposed regulations to guaranteed payments in the service context. As discussed earlier in this paper,[131] the proposed regulations would modify a longstanding example under the Code Sec. 707(c) regulations involving a similar "greater of" arrangement with a partner. In the original example, the minimum payment was characterized as a guaranteed payment only during those years in which it exceeded the partner's share of the residual profits.[132] Under the modified example, the payment is recharacterized as a guaranteed payment each and every year.[133] The reason for the change is that the minimum payment was not subject to SER.[134]

2. Capped Returns Contingent on Gross Income

While the amount distributable to a partner entitled to an uncapped share of the profits subject to a minimum preferred return will always exceed the preferred return whenever the partner's share of the profits is greater, the amount distributable to a partner entitled to a fixed preferred return contingent on a capped allocation of gross income will never exceed the cap and could in fact be zero. Although the economic nature of these returns are fundamentally different, the level of entrepreneurial risk associated with the preferred return component may be very similar. Unlike the minimum preferred return, however, a preferred return contingent on a capped allocation of gross income is probably not a GPUC under current law even if the risk of non-payment due to the income contingency is remote.[135]

While it may seem that this type of return is a GPUC in substance, there is surprisingly little support for this view. Indeed, it is not even necessary that the income contingency (remote as it may be) operate as a permanent prohibition on future distributions.[136] Because this type of return is based on the time value of money and is not contingent on net profits, it should be treated as an interest equivalent under Code Secs. 163(j) and 199A. Much like the minimum preferred return described in the preceding section, the obligation to pay a preferred return contingent on a capped allocation of gross income is not discharged in the event of a loss and is not subject to SER.

3. "When" Contingencies vs. "Whether" Contingencies

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

As discussed below, a preferred return contingent on net profits is not a guaranteed payment under current law even if the profit contingency only affects *when* the preferred return is paid. Like the right to a share of the profits subject to a minimum preferred return, a preferred return subject to a profit contingency that merely defers rather than discharges the obligation will impair the capital of the other partners in the event of a loss.[137] Because it conveys a time value of money return without regard to profits and is not subject to SER, a preferred return of this kind should be treated as an interest equivalent under Code Secs. 163(j) and 199A.

Under current law, however, the status of a preferred return subject to a "when" contingency is held open on the date of issue. If the partner's share of the profits in future years is sufficient, the preferred return will be respected as a distributive share of partnership income under Code Sec. 704(b) even though the failure to generate such profits does not reduce the liability to pay.[138] The only tax issue that appears to be unsettled is the proper timing of the GPUC inclusion *if* the profits fail to keep pace with the preferred return: should the accrued but unpaid preferred return be reported as a GPUC in each successive year to the extent of the shortfall or only in the year payment is due?

As discussed earlier in this paper,[139] the IRS and Treasury apparently believe that an "inchoate" GPUC should be reported as such in each year the accrued preferred return exceeds the available profits. Many practitioners disagree, however, contending that an unpaid preferred return should be reported as a GPUC only when the payment obligation is no longer contingent.[140] Moreover, even in the absence of sufficient profits in such year, many further contend that an accrued preferred return should be reported as a GPUC only to the extent the partnership is unable to effect a matching allocation of gross income in the year of payment.[141]

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

> Some taxpayers have expressed uncertainty whether a partnership with a targeted capital account agreement must allocate income or a guaranteed payment to a partner who has an increased right to partnership assets determined as if the partnership liquidated at the end of the year even in the event that the partnership recognizes no, or insufficient, net income. The Treasury Department and the IRS generally believe that existing rules under §§1.704-1(b)(2)(ii) and 1.707-1(c) address this circumstance by requiring partner capital accounts to reflect the partner's distribution rights as if the partnership liquidated at the end of the taxable year, but request comments on specific issues and examples with respect to which further guidance would be helpful.[142]

Based on the reference to "distribution rights" in a deemed liquidation, the IRS and Treasury appear to believe that the preferred partner should report income in the year of any shortfall in profits to properly account for its accreting claim to the partnership assets even though the partnership did not realize a profit in such year and the preferred partner did not receive any distributions. The income in such a case is either distributive share under Code Sec. 704(b) to the extent the partnership is able to make up the shortfall with gross income or a GPUC under Code Sec. 707(c).[143] In the view of many practitioners, the partner has no income at all during these periods.[144]

Far more noteworthy, however, is the implicit assumption of the government that such a preferred return is not a GPUC in its entirely. As one practitioner put it, to even describe such a return as contingent on profits is begging the question.[145] The profit contingency here affects when, not whether, the preferred return will be paid. If the goal of future guidance is to capture preferred returns that resemble interest, the full amount of the preferred return should be treated as GPUC.[146]

D. Timing Issues

Even if the definition of a GPUC is amended to reduce electivity, the timing differences governing the reporting of a GPUC as an item of interest income and expense under Code Secs. 163(j) and 199A are likely to produce incongruous results. The timing rules governing GPUCs are very different from the timing rules governing interest on debt, even for partnerships on the accrual method. If future guidance were to redefine a GPUC for purposes of Code Secs. 163(j) and 199A but ignore these differences, it will be difficult to integrate both types of "interest" into a single regime in a coherent and sensible manner.

The first timing difference concerns *when* the GPUC determination is made. Under current law, the status of a payment as a GPUC or as distributive share often fluctuates from year to year. The second timing difference concerns when, in the case of a GPUC that is not paid on an annual basis, the accrued but unpaid preferred return should be reported as interest expense to the partnership and interest income to the partner. Under current law, the timing depends on the accounting method of the partnership and, in the case of a partnership on the accrual method, when "economic performance" is deemed to occur.

1. Once a GPUC, Always a GPUC

Suppose a partner is entitled to a preferred return equal to the greater of a minimum preferred return or a percentage of future profits. Under current law, the status of such a return as a GPUC is held open on the date of issue, resulting in distributive share treatment in some years and GPUC treatment in others. It is quite possible, therefore, that the status of such a return as a GPUC will vary from year to year. While such a rule may have been administrable prior to 2018, it will be far less so in a world that would characterize a GPUC (and only a GPUC) as interest. If Code Secs. 163(j) and 199A are to operate in a coherent way, the status of a preferred return as a GPUC must be known on the date of issue. It cannot vary from year to year.[147]

Consider, for example, the consequences to a partnership with both types of payment obligations if the IRS and Treasury were to retain the "wait and see" approach for GPUCs. It would be very difficult to integrate this new category of interest into Code Secs. 163(j) and 199A for such partnerships. Nor would it make any sense to do so. Prior to 2018, preferred returns on capital were either deductible or conveyed the economic equivalent of a deduction depending on whether they were GPUCs or distributive share. As interest, however, the deduction would only be subject to disallowance under Code Sec. 163(j) during the GPUC years. As a policy matter, the limitations of Code Sec. 163(j) should not toggle back and forth, disallowing the deduction in some years and allowing its economic equivalent in others.[148]

As discussed above, the government recently announced that "wait and see" accounting for many guaranteed payments would no longer be available, proposing in 2015 to withdraw a longstanding example under the current regulations involving a guaranteed payment for services and to obsolete a published ruling involving a similar preferred return on capital.[149] As a result, this type of preferred return will likely be treated as a GPUC in the near future. Following comments from members of the tax bar, however, it is possible that "wait and see" accounting will continue to apply to GPUCs even if final regulations abandon this approach in the service context.[150]

2. Mandatory Reporting on Accrual Method

A second timing issue is when an accrued but unpaid GPUC that is not mandatorily payable at least annually should be reported as an item of income and expense. For a comparable debt instrument, the timing of such amounts is governed by the accrual method of accounting.[151] For an accrued but unpaid GPUC, the timing is governed by the method of accounting of the partnership.[152] If a partnership on the cash method of accounting incurs both types of interest expense, therefore, the deductibility of each category will often be tested under Code Sec. 163(j) in different taxable years. Indeed, even for partnerships on the accrual method, the deduction may be deferred until payment under the "economic performance" regulations of Code Sec. 461(h).[153]

The argument that the rules should be conformed is that reporting GPUC expense in the year of payment and interest expense in the year of accrual does not clearly reflect income.[154] Unless the accounting methods and/or rules are conformed, the deductibility of the actual interest will depend upon the ATI of the partnership in the year of accrual and the deductibility of the "GPUC-interest" will depend on the ATI of the partnership in the year of payment. This could lead to a number of anomalies.

Suppose, for example, that a cash method partnership with $100 of annual ATI incurs $20 of interest on a bond and $10 of GPUC-interest on an equity contribution, in each case over a five year period. Suppose further that the $10 of GPUC-interest is payable only at the end of the fifth year. If the accrual method were to apply to both categories of interest, the partnership will be allowed to deduct the full $20 of interest on the bond and $10 of GPUC-interest on the preferred return (*i.e.*, 30% of $100 = $30). If the accrual method is limited to the bond interest, however, the $50 deduction of the GPUC-interest (ignoring compounding) would be deferred until the fifth year. Because the ATI of the partnership in the fifth year is only $100, only $10 of the $50 of GPUC interest would be deductible by the partnership even though the partnership had $10 of "unused" ATI in each of the preceding four years.[155]

To avoid these anomalies, the accounting rules and/or methods should be conformed. Without such a change, the "bunching" of deductions for accrued but unpaid GPUCs in the last year will reach uneconomic and inappropriate results under 163(j). As a practical matter, however, it is highly unlikely in the author's view that any future guidance in this area would extend this far. A change of this magnitude would not only require new legislation, but legislation that would mandate a method of accounting intended solely for debt instruments.[156] There is no evidence the author is aware of that the current Congress would consider such legislation. Indeed, as the expansion of the Code Sec. 163(j) and Code Sec. 199A limitations to GPUCs was by regulation and not by statute, the current Congress may not even agree with the basic premise that a GPUC should be treated as interest.

E. What About Other Debt vs. Equity Factors?

1. Factors That Should Be Ignored

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

Whether an instrument is debt or equity is a determination governed largely by case law. Although no single factor is controlling,[157] the most frequently-cited factors are (a) an unconditional promise to pay on a fixed maturity date; (b) the existence of creditors' remedies; (c) the degree of subordination to other creditors; (d) the capitalization of the debtor; (e) the degree of overlap among the creditors and the owners of the debtor; (f) the form of the instrument; and (g) the intent of the parties.[158]

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

2. Factors That Should Be Considered

While most of the common law indicia of debt should be ignored for these reasons, an advance to a partnership denominated as a loan has been treated as equity because the "interest" on the loan was payable only from partnership profits.[159] This is more or less the standard proposed in this paper for separating preferred returns in the nature of interest from those more in the nature of distributive share: whether in the event of a loss the obligation to pay is discharged. By this standard, a preferred return that is unconditional in form but is in substance contingent on profits by virtue of its terms is more entrepreneurial in nature.

a) Subordination to Common Capital. In most cases, the capital of any partner entitled to a preferred return is like preferred stock in a corporation: it is senior to the common capital but subordinated to creditors. But suppose partner A and partner B contribute equal amounts of capital to a partnership and that all future distributions go first to partner A until partner A has received its capital back plus a 6% preferred return, then to the partner B until partner B has received its capital back plus a 6% preferred return, then equally between partners A and B. Should the preferred return to partner B be treated as a GPUC if is it unconditionally payable without regard to partnership profits?

Because the capital of partner B is subordinated to the capital of partner A, the 6% preferred return to partner B will only be paid if the partnership earns a profit (or has sufficient unrealized appreciation in its assets). In the absence of such profits, the partnership will run out of assets before partner B has received a single dollar of preferred return. This will be true even if the terms of the partnership agreement provide that the 6% return to partner B is unconditionally payable. While the preferred return to partner B conveys a time value of money return, it is wholly contingent on future profits. Because it is subject to SER, it should probably *not* be classified as a GPUC.[160]

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

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

VII. Conclusion

Under recent guidance, the IRS and Treasury extended the new interest limitations under Code Secs. 163(j) and 199A to GPUCs even though a GPUC is a return on an equity investment. This paper has explored many of the difficulties the government is likely to confront in its effort to apply these limitations to this new category of "interest," with particular emphasis on how affected taxpayers are likely to respond in the absence of fundamental changes to the current law definition of a GPUC.

The central contention of this paper is that the guaranteed payment rules are essentially elective for most partnerships, in particular as applied to preferred returns on capital. By adding a capped allocation of gross income to an otherwise fixed payment obligation, a preferred return on capital can be converted from a GPUC to a distributive share of partnership income without doing any violence to the basic economic agreement among the partners. The incremental risk associated with the income contingency is irrelevant. The impact of such minor drafting distinctions is well understood by practitioners. While Code Sec. 707(c) may be mandatory in form, it is largely optional in practice.

Whether a GPUC should be treated as a new category of interest expense for these purposes is at best debatable. Most practitioners would agree, however, that if a GPUC is to be so treated, it should not be elective. The government should endeavor to determine what attributes of a fixed preferred return on capital in a partnership make it more like interest than distributive share and apply the limitations to such returns whether or not they constitute GPUCs under current law. As discussed in this paper, this will require substantial new guidance, some of which will likely require legislation.

* This article is based on a panel discussion presented at the University of Chicago Law School's 72nd Annual Federal Tax Conference. The author thanks his friend and partner Mike Schler for a number of thoughtful comments on an earlier draft. The views expressed in this paper are those of the author and do not reflect the views of Cravath, Swaine & Moore LLP.

1 The various references to "preferred returns" in this paper are intended to be descriptive, applying only to returns on equity capital from a partnership that are economically similar to interest. They are *not* intended to differentiate between time-value-of-money returns respected as distributive share under Code Sec. 704(b) and time-value-of-money returns treated as GPUCs under Code Sec. 707(c). *Compare* Reg. §1.707-4(a)(2) (defining only the former as a "preferred return").

2 See *infra* text accompanying notes 49–59.

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

4 Tax Cuts and Jobs Act of 2017, P.L. 115-97.

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

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

7 ATI is defined as taxable income before taking into account interest income or expense, net operating losses, depreciation, amortization and various other items. Code Sec. 163(j)(8). Beginning in 2020, ATI is not adjusted for depreciation and amortization. Code Sec. 163(j)(8)(A)(iv).

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

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

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

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

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

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

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

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

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

17 Preamble to REG-106089-18, 83 FR 67,490 (Dec. 28, 2018) (emphasis added).

18 Code Sec. 469 generally limits the use of deductions from "passive activities" to shelter nonpassive income, including investment income. If a partner makes a loan to a partnership engaged in passive activities, therefore, the interest expense on the loan may be disallowed as a passive activity deduction because the interest income to the partner level is treated as investment income. In recognition of the fact that the offsetting items of income and expense on the loan "lack economic significance", the Code Sec. 469 regulations allow the deduction by recharacterizing the interest income to the lending partner as passive activity income. *See* T.D. 9013, 2002-2 CB 542; *see also* Reg. §1.467-7 (self-charged interest rules).

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

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

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

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

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

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

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

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

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

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

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

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

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

32 *See* Karen C. Burke, *section 199A and Choice of Partnership Entity*, 72 TAX LAW. 551, 586–587 (2019) ("Burke") (stating that a preferred return *not* subject to Code Sec. 707(c) "will likely be treated as QBI to the recipient partner while affording a deduction equivalent for the payor partners."). Many have criticized the proposed treatment of GPUCs on these grounds. *See* Preamble to Preamble to T.D. 9847, 2019-9 IRB 670 (Feb. 8, 2019) (stating that one commenter argued that difficulty in distinguishing between payments governed by Code Sec. 707(c) and Code Sec. 707(a) would make proposed treatment of GPUCs as interest under Code Sec. 199A "difficult for both taxpayers and the IRS to administer" and that another commenter cited the "significant uncertainty in determining whether an arrangement is a guaranteed payment for the use of capital, a gross income allocation, or something else"); *see also* Burke at 586 (noting that "the guardrails for guaranteed payments [can be] easily avoided … [b]y substituting priority cash flow distributions coupled with priority income allocations …").

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

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

[35] *See, e.g.*, *Estate of Tilton, et. al.* 8 BTA 914, Dec. 2963 (1927); *A.M. Lloyd*, 15 BTA 82, Dec. 4800 (1929).

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

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

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

[39] *Estate of Tilton*, 8 BTA 914, Dec. 2963 (1927) (service partner not subject to tax because "no man can be his own employer or employee."); *see also* Rev. Rul. 55-30, 1955-1 CB 431.

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

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

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

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

[44] *E.T. Pratt*, 64 TC 203, Dec. 33,189 (1975), *aff'd in part, rev'd in part*, CA-5, 77-1 USTC ¶9347, 550 F2d 1023.

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

[46] *E.T. Pratt*, 64 T.C. 203, Dec. 33,189 (1975) ("Petitioners in this case were to receive the management fees for performing services within the normal scope of their duties as general partners and pursuant to the partnership agreement. There is no indication that any one of the petitioners was engaged in a transaction with the partnership other than in his capacity as a partner."); *see also William P. Zahler*, 41 TCM 1074, Dec. 37,745(M), TC Memo. 1981-112 (commission income to partner of brokerage business not subject to Code Sec. 707(a) because activity was within scope of partnership business activities).

[47] *E.T. Pratt*, CA-5, 77-1 USTC ¶9347, 550 F2d 1023 ("the duties to be performed [by the general partners] were activities for which the partnership was created …, *i.e.*, the management of the shopping centers.").

[48] Rev. Rul. 81-300, 1981-2 CB 143.

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

[50] H.R. Rep. No. 432, 98th Cong., 2d Sess. 1216–1221 (1984); S. Prt. No. 169 (Vol. 1), 98th Cong., 2d Sess. 223–232 (1984). Although the original House version of the bill would have limited Code Sec. 707(a)(2)(A) to transactions in which the expense was subject to capitalization, the Senate rejected this limitation. H.R. Conf. Rep. No. 98-861, at [] (1984) ("the rule is not limited to transactions in which direct partnership payments would have to be capitalized").

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

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

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

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

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

[56] Rev. Rul. 81-300, 1981-2 CB 143.

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

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

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

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

[61] Tax Reform Act of 1976, P.L. 94-455, §213(d), 95 Stat. 1548.

[62] Douglas A. Kahn, *Is the Report of Lazarus's Death Premature – A Reply to Cameron and Postlewaite*, 7 FLA. TAX. REV. 411, 420–421 (2006) ("Kahn") ("There is no basis for concluding that section 707(c) is a nullity; to the contrary, the application of the 1984 amendment by Treasury demonstrates that section 707(c) continues to have vitality.").

[63] The regulations were proposed in 1955 and made final in 1956. 20 FR 5854 (August 12, 1955) (proposed); T.D. 6175, 1956-1 CB 211 (final). The only changes to the these regulations since then were to incorporate the Tax Reform Act of 1976 amendments prohibiting the deduction of guaranteed payments subject to capitalization under Code Sec. 263. T.D. 7891, 1983-1 CB 117.

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

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

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

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

[68] Reg. §1.707-1(a).

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

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

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

[72] Even before the 1984 amendments, the Tax Court in *Pratt* had suggested in 1975 that Congress may have intended to limit Code Sec. 707(a) to "one off" transactions of this kind. 64 T.C. 210–211 (1975) ("section 707(a) refers to 'transactions' between a partner and a partnership and is susceptible of being interpreted as covering only those services rendered by a partner to the partnership in a special transaction.").

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

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

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

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

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

[78] Kahn, *supra* note 62, at 450 ("The case for treating section 707(c) as having been impliedly repealed by the 1984 adoption of section 707(a)(2) is very weak."). The case for de facto repeal has also been criticized as inconsistent with the common law rule of statutory construction that "implied repeals of statutes are disfavored". *Id. See also Posadas, Collector of Internal Revenue v. National City Bank*, 296 US 497, 503 (1936) ("The cardinal rule is that repeals by implication are not favored.").

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

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

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

[82] *See also* Schnabel, *supra* note 73, at 4 ("The scope and application of section 707(c) remains somewhat of a mystery today in many cases to even the most experienced partnership practitioners").

[83] Even before the 1976 amendments to Code Sec. 707(c), the IRS contended that these types of guaranteed payments were subject to capitalization. *See J.E. Cagle*, 63 TC 86, Dec. 32,828 (1974), *aff'd*, CA-5, 76-2 USTC ¶9672, 539 F2d 409, Rev. Rul. 75-214, 1975-1 CB 185.

[84] See *supra* text accompanying notes 50–55.

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

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

[87] *E.T. Pratt*, 64 TC 203, Dec. 33,189 (1975), *aff'd in part, rev'd in part*, CA-5, 77-1 USTC ¶9347, 550 F2d 1023.

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

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

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

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

[92] See *supra* text accompanying notes 35–39.

[93] Rev. Proc. 93-27, 1993-27 CB 343.

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

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

[96] *E.T. Pratt*, 64 TC 203, Dec. 33,189 (1975), *aff'd in part, rev'd in part*, CA-5, 77-1 USTC ¶9347, 550 F2d 1023; *see also* GCM 34173 (7/25/1969) (amounts contingent on gross income were not guaranteed payments).

[97] Rev. Rul. 81-300, 1981-2 CB 143.

[98] See *supra* text accompanying notes 56–57.

[99] Schnabel, *supra* note 73, at 25 ("While not entirely clear, it appears that the IRS now agrees with the position of the Tax Court in *Pratt* that a gross income based allocation is not governed by section 707(c) but rather is governed by section 704(b) or (if section 707(a)(2)(A) applies) section 707(a)").

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

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

[102] The author understands that some practitioners may disagree. If the preferred partner has no further entitlement to a residual share of the future profits, he may not qualify as a partner, in which case the preferred return would not qualify as distributive share. *See, e.g., W.O. Culbertson*, SCt, 49-1 USTC ¶9323, 337 US 733, 69 SCt 1210. The concern that a partner who is only entitled to a debt-like return is not participating

in the risks of the venture is more commonly cited in the guaranteed payment context. *See* Banoff, *supra* note 79, at 854–855 (while acknowledging the absence of definitive guidance, asking whether a purported partner who is only entitled to a GPUC is a partner for tax purposes); *see also* Eric B. Sloan and Matthew Sullivan, *Deceptive Simplicity: Continuing and Current Issues with Guaranteed Payments*, 916 PLI/TAX 124-1 at 34 (2010) ("Sloan") ("Whether a 'pure' guaranteed payment interest is properly treated as a partnership interest has traditionally been dependent on case law regarding who is a partner."). In most partnerships, however, the preferred partner participates in the residual profits of the business.

[103] The argument that the allocation of gross income should be disregarded in this context is oddly similar to the far more familiar argument that a special allocation of income does not have substantial economic effect: it is not expected to affect the amount distributable to the recipient partner. Here, however, the consequence of disregarding the allocation is not to render the allocation invalid under the Code Sec. 704(b) regulations but to convert what is in form an item of partnership income (*i.e.*, a gross income allocation) to an item of partnership expense (*i.e.*, a guaranteed payment).

[104] Reg. §1.707-1(a) (as amended in 1983).

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

[106] *See* Steinberg, *supra* note 80, at 542 ("The bottom line appears to be that while section 707(a)(2)(A) arguably transforms many gross income-based payments for services into section 707(a) payments, some such payments, *as well as most (if not all) payments for the use of capital*, should continue to qualify as distributive shares of firm (gross) income.") (emphasis added).

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

[108] *See* Schnabel, *supra* note 73, at 21 (Nov. 2, 2015) ("it is not clear whether (or how) [section 707(a)(2)(A)] applies to certain other transfers of property, such as a transfer of cash to a partnership in exchange for preferred equity").

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

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

[111] Reg. §1.1275-2(h)(2), 1.1275-4.

[112] Reg. §1.1273-1(c)(1)(ii).

[113] Reg. §15a.453-1(d)(2)(ii)(A).

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

[115] Reg. §1.860G-1(b)(3)(vi).

[116] Reg. §1.752-2(b)(4).

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

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

[119] Reg. §1.707-4(a)(2).

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

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

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

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

[124] Many practitioners believe that the partner has no current GPUC or other income in the year of a shortfall in net profits even when the unpaid return continues to accrue as a future claim on the partnership assets. The same practitioners also contend that a GPUC is avoided in the year of actual payment as well if the gross income in such year is sufficient. *See, e.g.,* NYSBA Tax Section, "Report on Guaranteed Payments and Preferred Returns", Report No. 1357, p. 18–19, Nov. 14, 2016 ("does a partner who is entitled to a distribution that would otherwise be treated as a guaranteed payment always have the opportunity to 'earn its way out of' guaranteed payment treatment [by a matching allocation of gross income]? Many practitioners draft partnership agreements based on the conclusion that the answer to this question is yes …"); *see also* Sloan, *supra* note 102, at 29–30 (stating in the case of an unconditional preferred return that while there is no published guidance, there is "arguably" no guaranteed payment as long as the partnership allocates gross income to the preferred partner).

[125] *See* Steinberg, *supra* note 80, at 540–541 ("Under the McKee approach, a purported gross income allocation would presumably be potentially subject to recharacterization as a section 707(a) payment [rather than a guaranteed payment] where the payment and amount of the gross income allocation could be predicted *ab initio* with a high degree of confidence. This would likely be the case, for example, where the underlying gross income of the partnership was not subject to material variation, or the gross income allocation was subject to a cap that was substantially below the excepted gross income of the partnership.")

[126] *See* Schnabel, *supra* note 73, at 26 ("a [section 704(b)] arrangement cannot be recharacterized under section 707(a)(2)(A) as a section 707(c) payment").

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

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

[129] Proposed Reg. §1.707-2(c)(1); *see also* McKee, *supra* note 37, at ¶ 14.02[4][a] ("in assessing entrepreneurial risk, the risk assumed by the service partner should generally be weighed against the risk inherent in the partnership business, although this is not explicitly stated in the legislative history. If the partnership engages in a 'safe' business, its service partners necessarily receive a commensurately safe entrepreneurial return. Partners who bear the risks of the partnership business should not be penalized with §707(a) treatment solely because the partnership engages in a low-risk business.").

[130] In very limited circumstances, the proposed regulations would even treat a net income allocation as presumptively lacking SER under Code Sec. 707(a)(2)(A). *See* Proposed Reg. §1.707-2(c)

(1)(iv) (referring to "an allocation … that is predominantly fixed in amount, is reasonably determinable under all the facts and circumstances, or is designed to assure that sufficient net profits are highly likely to be available" and citing as examples allocations from isolated transactions or accounting periods when the allocation "does not depend on the long-term future success of the enterprise").

[131] See *supra* text accompanying notes 63–65.

[132] Reg. §1.707-1(c), Ex. 2.

[133] *See* Proposed Reg. §1.707-1(c), Ex. 2. The example also appears to be contrary to the original legislative history. *See* H.R. Rep. No. 1337, 83d Cong., 2d Sess. A226 (1954) ("… a partner who is guaranteed a minimum annual amount for his services should be treated as receiving a salary in that amount"); S. Rep. No. 1622, 83d Cong., 2d Sess. 387 (1954) (containing similar language). Although the example involved a payment for services, the IRS has applied the same approach to preferred returns on capital. *See* Rev. Rul. 66-95, 1966-1 CB 169 (right to 25% of net profits but no less than 4% of contributed capital treated as GPUC only to extent 4% return on capital exceeded 25% of the profits). In the preamble to the proposed regulations, the government announced that this ruling would be obsoleted. *See* Preamble to REG-115452-14, 80 FR 141 (July 23, 2015) ("The Treasury Department and the IRS intend to obsolete Rev. Rul. 66-95 … when the regulations are published in final form.").

[134] *See* Preamble to REG-115452-14, 80 FR 141 (July 23, 2015) (describing original example as "inconsistent with the concept that an allocation must be subject to significant entrepreneurial risk to be treated as a distributive share under section 704(b).").

[135] See *supra* text accompanying notes 106–126.

[136] See *supra* text accompanying notes 120–124.

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

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

[139] See *supra* text accompanying notes 123–124.

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

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

[142] Preamble to Proposed Regulations, FR Vol. 80, No. 141, p. 43652 (July 23, 2019).

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

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

[145] Steinberg, *supra* note 80, at 564.

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

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

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

[149] Preamble to REG-115452-14, 80 FR 141 (July 23, 2015).

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

[151] Code Sec. §§163(e), 1272.

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

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

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

because the OID provisions of the Code apply or because the principles of the OID provisions of the Code apply. Reg. §1.446-2(c).

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

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

[157] *See John Kelly,* SCt, 46-1 USTC ¶9133, 326 US 521, 66 SCt 299.

[158] *See, e.g., Fin Hay Realty Co.*, CA-3, 68-2 USTC ¶9438, 398 F2d 694 (3rd Cir. 1968); Notice 94-47, 1994-1 CB 357.

[159] *E.C. Hartman*, 17 TCM 1020, Dec. 23,271(M), TC Memo. 1958-206.

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