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Guaranteed Payments and Interest: Why Treasury Is Overreaching

by Alexandre Marcellesi

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In this report, Marcellesi argues that Treasury and the IRS lack the authority to issue regulations under section 163(j) that treat guaranteed payments for the use of capital as interest for purposes of the business interest deduction limitation.

The views expressed in this report, and any remaining errors, are solely the author's.

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Introduction

Partners contributing capital to a partnership often require a preferred return on their investment.[1] Those returns are analogous to dividends paid to holders of a corporation's preferred stock.[2] Just as there are many ways to structure a preferred dividend (conditional versus unconditional, cumulative versus noncumulative, etc.), there are many ways to structure a preferred return. In any case, the structure adopted dictates the tax consequences. Preferred stock with debtlike features, for instance, may be classified as debt under section 385 or common law principles, with the result that payments from the issuer to the holder would be interest that is deductible by the former but ordinary income to the latter.

The code seemingly provides clear rules regarding the tax treatment of preferred returns. A preferred return that depends on partnership income is included in the partner's distributive share of that income under section 704(b) and is treated as a distribution under section 731.[3] The recipient of such a return will therefore have capital gains to the extent the partnership's income is derived from the sale of capital assets or the receipt of qualified dividend income.

If a preferred return is determined without regard to partnership income, however, it is a guaranteed payment for the use of capital (GPUC) under section 707(c). Despite an apparently clear statutory rule, the line between preferred returns that are GPUCs and those that are not is notoriously blurry.[4] There are few clear-cut cases. A preferred return that is computed as a percentage of capital invested and is required to

[1] *See, e.g.*, Sheldon I. Banoff, "Guaranteed Payments for the Use of Capital: Schizophrenia in Subchapter K," 70 *Taxes* 820, 822 (1992); Eric B. Sloan and Matthew Sullivan, "Deceptive Simplicity: Continuing and Current Issues With Guaranteed Payments," 916 PLI/Tax 124-1 (2010); Lewis R. Steinberg, "Fun and Games With Guaranteed Payments," 57 *Tax Law.* 533, 562 (2004); and Andrew Kreisberg, "Guaranteed Payments for Capital: Interest or Distributive Share?" *Tax Notes*, July 4, 2011, p. 55.

[2] *See, e.g.*, Steinberg, *supra* note 1 ("In order to mimic the payoffs of corporate preferred stock, such partnership equity is typically entitled to a preferential return each year."). *See also* Banoff, *supra* note 1.

[3] Kreisberg, *supra* note 1.

[4] *See, e.g.*, William S. McKee, William F. Nelson, and Robert L. Whitmire, *Federal Taxation of Partnerships & Partners*, para. 14.03[1][b] ("If a partner's right to receive amounts from his partnership is fixed and certain, or 'guaranteed' in some sense, it may be difficult to determine whether the amounts are section 707(c) guaranteed payments or section 731 distributions."); and Sloan and Sullivan, *supra* note 1.

be paid annually, for instance, is most likely a GPUC to the extent it is actually paid.[5] Practitioners, however, emphasize "the significant uncertainty that currently exists in identifying payments that constitute" GPUCs.[6]

Whether a preferred return is a GPUC matters because guaranteed payments are treated as payments made by the partnership to a non-partner, "but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses)."[7] As a result, GPUCs are generally understood to be ordinary income to the payee under section 61 and deductible by the payer under section 162, subject to the capitalization requirement of section 263.[8] The regulations under section 707(c) also provide that "for the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income."[9] However, regulations recently proposed by Treasury and the IRS under section 163(j) (REG-106089-18) call this understanding into question.[10]

Section 163 generally allows taxpayers to deduct interest paid or accrued on indebtedness.[11] The deduction is limited for business interest.[12] That limit was amended by the Tax Cuts and Jobs Act. New section 163(j) generally limits the amount of business interest expense deductible by a taxpayer to the sum of its business interest income and 30 percent of its adjusted taxable income.[13]

Prop. reg. section 1.163(j)-1(b)(20)(iii)(I) provides that for purposes of section 163(j), "any guaranteed payments for the use of capital under section 707(c) are treated as interest." This regulation conflicts with the traditional understanding of GPUCs. First, it suggests that partnerships may no longer be able to deduct GPUCs in full under section 162.[14] Second, it treats GPUCs as non-partner payments for the purposes of a code section other than section 61(a) or 162(a).[15] Third, it suggests that partnership interests that entitle their holders to GPUCs are partnership debt on which interest may accrue. It is no surprise, then, that many members of the tax bar were caught off guard by the decision to propose such a regulation, and they believe Treasury and the IRS are reaching beyond the limits of their power.[16]

This report lays out the argument underlying that widely shared impression. In a nutshell, the proposed regulation, assuming it is finalized without modification, does not pass muster under *Chevron*[17] and is arbitrary and capricious under section 706(2)(A) of the Administrative Procedure Act (APA).[18] There is, moreover, no easy way to modify this regulation to ensure its validity under either *Chevron* or the APA. It should therefore be withdrawn.[19]

[5] New York State Bar Association Tax Section, "Report on Guaranteed Payments and Preferred Returns," at 27 (Nov. 14, 2016).

[6] NYSBA Tax Section, "Report on Proposed Section 199A Regulations," at 40-41 (Oct. 19, 2018).

[7] Section 707(c).

[8] *See, e.g.*, Rev. Rul. 91-26, 1991-2 C.B. 184. As noted by the Supreme Court, revenue rulings "reflect the agency's longstanding interpretation of its own regulations." *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200, 220 (2001). *See also* Laura Cunningham and Noël Cunningham, *The Logic of Subchapter K* 172 (2017).

[9] Reg. section 1.707-1(c). There is no consensus, however, about what it means for GPUCs to be "regarded" as a partner's distributive share of ordinary income.

[10] Although the IRS is a Treasury bureau and the initial drafting of regulations has been delegated to the IRS by the Treasury assistant secretary for tax policy, I refer throughout to Treasury as the agency issuing regulations and to the IRS as the government entity responsible for administering every other aspect of the code. *See* Michael Saltzman and Leslie Book, *IRS Practice and Procedure*, para. 3.02[3].

[11] Section 163(a).

[12] Section 163(j).

[13] Section 163(j)(1)(A) and (B). This limit is increased by the taxpayer's floor plan financing interest expense, *i.e.*, interest on debt incurred by the taxpayer (typically, a car dealership) to finance the acquisition of motor vehicles held for sale or lease and to secure that debt. Section 163(j)(1)(C) and (9).

[14] Interestingly, because the proposed regulation treats GPUCs as interest for purposes of section 163(j) — not for purposes of section 163 in general — it is unclear whether in Treasury's view GPUCs remain deductible under section 162. It would be odd (and arguably incoherent) for Treasury to conclude that GPUCs are deductible under section 162 but that the deduction is limited by section 163(j).

[15] Prop. reg. section 1.163(j)-1(b)(20)(iii)(I) in effect treats GPUCs as payments from a partnership to one of its creditors, not one of its partners, for purposes of section 163(j).

[16] *See, e.g.*, American Bar Association Section of Taxation, "Comments on Proposed Regulations Under Section 163(j) Regarding Passthrough Entities and Their Owners," at 13 (Mar. 7, 2019).

[17] *Chevron U.S.A. Inc. v. Natural Resources Defense Council Inc.*, 467 U.S. 837 (1984).

[18] 5 U.S.C. section 706(2)(A).

[19] Throughout the rest of this report, I assume that prop. reg. section 1.163(j)-1(b)(20)(iii)(I) will be issued in final form without modification. I thus generally refer to it as a regulation rather than a proposed regulation.

It may well be that from the point of view of sound tax policy, some partnership interests entitling their holders to GPUCs should be treated as partnership debt on which interest may accrue. This report, however, focuses on the narrow legal question that most immediately faces Treasury and the IRS: the validity of the proposed regulation.

The *Chevron* Challenge

In *Mayo Foundation*,[20] the Supreme Court held that the principles underlying *Chevron* "apply with full force in the tax context." However, not all agency regulations are subject to judicial review under *Chevron*. Under *Mead*,[21] an agency action is entitled to *Chevron* deference "when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of this authority."[22]

Applying *Mead* to a tax regulation in *Mayo Foundation*, the Supreme Court found the fact that the regulation had been issued through the notice and comment process and under Congress's general grant of regulatory authority in section 7805(a) to be "a very good indicator of delegation meriting *Chevron* treatment" and a "significant sign that a rule merits *Chevron* deference."[23]

Treasury and the IRS are using the notice and comment process to issue the section 163(j) regulations and are doing so under their section 7805(a) authority.[24] Indeed, they have no choice but to invoke section 7805(a) given that section 163(j) — unlike section 163(l), for instance — contains no specific grant of regulatory authority. Interestingly enough, section 163(j) used to contain several explicit grants of regulatory authority. For example, before the TCJA, section 163(j)(9)(A) granted Treasury and the IRS the authority to "prescribe such regulations as may be appropriate to carry out the purposes of this subsection, including . . . such regulations as may be appropriate to prevent the avoidance of the purposes of this subsection."[25]

The fact that Treasury and the IRS are using the notice and comment process and are acting under their section 7805(a) authority implies that the section 163(j) regulations are subject to review under *Chevron*. Although the Supreme Court sidestepped this issue in *Mayo Foundation*, the use of the notice and comment process and the invocation of section 7805(a) also make the section 163(j) regulations legislative regulations subject to the APA.[26]

Judicial review under *Chevron* is a two-step process.[27] The first step requires a court to determine "whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress."[28]

As the Supreme Court has recently stated, the fact that parties to a dispute hold reasonable but conflicting interpretations of a statute is insufficient to establish that Congress's intent was unclear.[29] "Rather, the court must make a conscientious effort to determine, based on indicia like text, structure, history, and purpose, whether the [statute] really has more than one reasonable meaning."[30] And "if a court,

[20] *Mayo Foundation for Medical Education and Research v. United States*, 562 U.S. 44, 55 (2011).

[21] *United States v. Mead Corp.*, 533 U.S. 218, 226-227 (2001).

[22] This is the so-called step zero of a *Chevron* analysis. Thomas Merrill and Kristin Hickman, "*Chevron*'s Domain," 89 *Geo. L.J.* 833, 873 (2001).

[23] *Mayo Foundation*, 562 U.S. at 57 (quoting *Mead*, 533 U.S. at 229-231). Section 7805(a) generally authorizes Treasury and the IRS to "prescribe all needful rules and regulations for the enforcement" of the code.

[24] Preamble to REG-106089-18, 83 F.R. 67490, 67533 (Dec. 28, 2018) (invoking section 7805 as the authority under which the proposed section 163(j) regulations are issued).

[25] Section 163(j)(9) as of December 31, 2016. Current section 163(j)(9) defines floor plan financing interest. *See supra* note 13.

[26] *Altera Corp. v. Commissioner*, 145 T.C. 91, 116-117 (2015). In finding a regulation issued under section 7805(a) legislative, the Tax Court rejected the view long held by the government (and many members of the tax bar) that such regulations, unlike regulations issued under a specific grant of regulatory authority, are always interpretive and therefore not subject to review under the APA. That view is incorrect. *See, e.g.*, Hickman, "Coloring Outside the Lines: Examining Treasury's (Lack of) Compliance With Administrative Procedure Act Rulemaking Requirement," 82 *Notre Dame L. Rev.* 1727, 1759-1795 (2007).

[27] I here apply what Hickman calls the "decision tree" model of *Chevron*. Hickman, "The Three Phases of *Mead*," 83 *Fordham L. Rev.* 527, 537 (2014). As Hickman also points out, "legitimate questions abound regarding *Chevron*'s proper scope and operation." Hickman, "*Chevron*'s Inevitability," 85 *Geo. Wash. L. Rev.* 1392, 1461 (2017). Some readers may therefore disagree with the way in which *Chevron* is applied in this report.

[28] *Chevron*, 467 U.S. at 842-843.

[29] *Kisor v. Wilkie*, 139 S. Ct. 2400, 2423 (2019).

[30] *Id.* at 2423-2424.

employing traditional tools of statutory construction, ascertains that Congress had an intention on the precise question at issue, that intention is the law and must be given effect."[31]

The argument developed in this report assumes that Congress has not directly spoken to the precise question whether GPUCs are interest within the meaning of section 163(j).[32] Courts sometimes adopt this approach of assuming that a regulation satisfies *Chevron* step 1 when they intend to strike it down as failing at *Chevron* step 2.[33] Given this assumption, the *Chevron* analysis can proceed to its second step.

A court's task at *Chevron* step 2 would be to determine whether the regulation treating GPUCs as interest for purposes of 163(j) is a permissible construction of the statute.[34] A court will defer to Treasury and the IRS's interpretation unless it is "arbitrary, capricious, or manifestly contrary to the statute."[35] There is no requirement, however, that their interpretation be the only plausible one.[36]

The regulation fails at *Chevron* step 2 because it is not a permissible interpretation of the term "interest" in section 163(j). The Supreme Court is clear that under *Chevron*, "reasonable statutory interpretation must account for both the specific context in which . . . language is used and the broader context of the statute as a whole."[37] The broader context in which to assess Treasury and the IRS's interpretation of section 163(j) is the code.[38]

Crucially, in the Supreme Court's view, if Treasury and the IRS's interpretation produces a meaning "inconsistent with the design and structure of the statute as a whole, [it] does not merit deference."[39] Evaluating the regulation therefore requires examining the code to determine whether the regulation "produces a substantive effect that is compatible with the rest of the law."[40]

Unfortunately for Treasury and the IRS, it does not. The regulation conflicts with the view that section 707(c) should be read literally and that GPUCs should therefore be treated as non-partner payments *only* for purposes of sections 61(a) and 162(a). The regulation also conflicts with the view that partnership interests that entitle their holders to GPUCs are not partnership debt. Those views are held by most tax practitioners, the Joint Committee on Taxation, and the courts. More importantly, those views have been embraced by Treasury and the IRS themselves, in regulations and in various guidance documents.

Section 707(c) was enacted in 1954.[41] As noted, it provides that guaranteed payments are treated as payments made to non-partners, "but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses)." The language of section 707(c) is unequivocal. It implies that for all other purposes, guaranteed payments are treated as made to partners acting in their capacity as such.

According to legislative history, Congress's primary intent in enacting section 707(c) was "to eliminate the complexity that arose under prior law when compensatory payments to partners

[31] *Chevron*, 467 U.S. at 843 n.9.

[32] Although I will not defend this assumption at length, Congress has not defined interest anywhere in the code, and definitions of the concept have historically come from the courts. *See, e.g.*, *Old Colony Railroad Co. v. Commissioner*, 284 U.S. 552, 560 (1932); and *Deputy v. du Pont*, 308 U.S. 488, 498 (1940).

[33] *See, e.g.*, *Good Fortune Shipping v. Commissioner*, 897 F.3d 256, 261 (D.C. Cir. 2018).

[34] *Chevron*, 467 U.S. at 843 ("If the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.").

[35] *Id.* at 844. *See also Sebelius v. Auburn Regional Medical Center*, 568 U.S. 145, 157 (2013); and *Ragsdale v. Wolverine World Wide Inc.*, 535 U.S. 81, 86 (2002).

[36] *See Natural Resources Defense Council Inc. v. Environmental Protection Agency*, 822 F.2d 104, 117 (D.C. Cir. 1987) ("We are persuaded that EPA's reading of the statute, while not the only plausible one, is reasonable.").

[37] *Utility Air Regulatory Group v. EPA*, 573 U.S. 302, 321 (2014) (internal quotation marks omitted). *See also Koons Buick Pontiac GMC Inc. v. Nigh*, 543 U.S. 50, 60 (2004); and *Clark v. U.S. Department of Agriculture*, 537 F.3d 934, 940 (8th Cir. 2008).

[38] The relevant context can be neither the TCJA nor the bill that originally added section 163(j) to the code, P.L. 101-239. If the proper context was the bill introducing this provision rather than the statute itself, any Treasury and IRS interpretation of a code provision introduced through a bill containing no other tax provision would automatically satisfy what one might call *Chevron*'s "consistency" requirement. The Supreme Court's jurisprudence cannot be read to yield this result.

[39] *Utility Air*, 573 U.S. at 321.

[40] *Id.*

[41] For a brief overview of the history of section 707(c), see Banoff, *supra* note 1, at 824-825; and Kreisberg, *supra* note 1, at 55-56.

exceeded the net income of the partnership."[42] Congress, in particular, sought to ensure that partners receiving guaranteed payments for services would have to include them in income, even when those payments exceed partnership taxable income and might otherwise be treated as a nontaxable return of capital.[43] Although the report of the Senate Finance Committee on the bill introducing section 707(c) refers to GPUCs as "guaranteed interest payments,"[44] it also explicitly states that section 707(c) treatment "is *only* provided for purposes of the reporting of income by the partner and the deducting of the payments by the partnership" (emphasis added).[45]

Consistent with the text of the statute and its legislative history, the section 707 regulations issued by Treasury and the IRS in 1956 specify that section 707(c) treatment applies only to GPUCs for purposes of sections 61(a) and 162(a). They state:

> Guaranteed payments are considered as made to one who is not a member of the partnership only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses). . . . For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income.[46]

Treasury and the IRS's own historical understanding of the scope of section 707(c) could hardly be clearer.

Their reading of section 707(c) was endorsed in 1997 by the JCT staff, which wrote:

> A guaranteed payment made by a partnership to a partner for services, or for the use of capital, is treated in the same manner as if made to a non-partner for purposes of inclusion of the payment in income by the recipient [that is, for purposes of section 61(a)], and deduction and capitalization by the partnership [that is, for purposes of section 162(a)]. For all other purposes, guaranteed payments are treated in the same manner as a distributive share of partnership income.[47]

Although the JCT staff has expressed the view that GPUCs "conceptually resemble . . . interest on debt," it has also acknowledged that section 707(c) does not treat them as such. A 2001 study by the JCT staff stated: "It has been suggested that a broader approach, that of repeal of the rules for guaranteed payments to partners, would eliminate the duplication that causes problems under present law. . . . Guaranteed payments for capital *would be* treated as interest on debt" if section 707(c) were to be repealed (emphasis added).[48]

Consistent with the statutory text and its widely accepted understanding, the IRS has characterized GPUCs as interest for purposes of section 61(a) in two instances. In GCM 36702 (Apr. 12, 1976), the IRS concluded that GPUCs were interest to the payee for purposes of section 61(a)(4). The IRS confirmed that position a few years later in GCM 38133 (Oct. 10, 1979). In both cases, however, the IRS also determined that even though the payments were interest to the payee, they were deductible by the partnership only under section 162, not under section 163. In other words, in the only two instances in which the IRS has treated GPUCs as interest, it was careful to do so within the strict limits set by section 707(c).[49]

By contrast, in LTR 8639035 and LTR 8728033, the IRS ruled that GPUCs from a partnership to a real estate investment trust partner were part of the REIT's distributive share of partnership gross income and thus qualified as rental income for purposes of the section 856(c)(3) gross income

[42] NYSBA Tax Section, 2016 report, *supra* note 5, at 6.

[43] H.R. Rep. No. 83-1337, at A-226 (1954). The Senate report includes a substantially identical discussion. S. Rep. No. 83-1662, at 387 (1954). Congress also sought to ensure that the partnership, rather than the partners, would be allowed to deduct the guaranteed payments for services.

[44] S. Rep. No. 83-1622, at 94.

[45] *Id.* at 394. Note that the House version of section 707(c) targeted only guaranteed payments for services.

[46] Reg. section 1.707-1(c); T.D. 6175.

[47] JCT, "Review of Selected Entity Classification and Partnership Tax Issues," JCS-6-97, at 45 (1997).

[48] JCT, "Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986," JCS-3-01, at 294 (2001). *See also* Kreisberg, *supra* note 1, at 57.

[49] Moreover, many tax practitioners think that the IRS reached the wrong result in these general counsel memoranda in treating the GPUCs involved as interest.

test. Importantly, the IRS based its conclusion on the claim that reg. section "1.707-1(c) provides that, for purposes of the internal revenue laws other than section 707, thus including section 856(c)(3)[,] a guaranteed payment is regarded as a partner's distributive share of ordinary income."[50] The IRS has therefore followed its own regulations and the JCT staff's approach in adopting a literal interpretation of the "but only" language in section 707(c).

Treasury and the IRS have adopted a similarly cautious approach when issuing regulations regarding GPUCs. The regulations under section 263A, for instance, treat some GPUCs as interest and require partnerships making those GPUCs to capitalize them rather than deduct them currently.[51] Importantly, however, section 707(c) expressly provides that GPUCs are to be treated as non-partner payments for purposes of section 162(a), subject to the rules of section 263 regarding expenses that must be capitalized. The caveat regarding section 263 is naturally read to extend to section 263A. The latter is, in effect, an addendum to the former, as indicated by its placement in the code and the fact that it, too, contains rules regarding expenses that must be capitalized. There is therefore no conflict between the regulations issued under section 263A treating GPUCs as interest and section 707(c).

By contrast, when issuing regulations under code provisions other than section 61(a), 162(a), or 263/263A, Treasury and the IRS have refrained from treating GPUCs as non-partner payments, and as interest in particular. They have, for example, proposed regulations according to which, "in accordance with U.S. tax principles," an obligation to make GPUCs is not a liability on which interest may accrue in determining the interest deduction of a foreign corporation that is a partner in a partnership that (1) is engaged in a U.S. trade or business under section 882 and (2) has an obligation to make a GPUC to one of its partners.[52]

[50] LTR 8639035. The IRS appears to have misquoted its own regulation. It must have meant "other than sections 61(a) and 162(a)" rather than "other than section 707."

[51] Reg. section 1.263A-9(c)(2)(iii).

[52] Prop. reg. section 1.882-5(c)(5), Example 4.

One might object that Treasury and the IRS proposed and finalized, without objection, a regulation under section 469 that unambiguously treats GPUCs as interest for the purpose of section 469 — that is, for a purpose not contemplated by section 707(c).[53] Although that observation is correct, Treasury and the IRS were well aware that the section 469 regulation conflicted with their own understanding of section 707(c), as stated in reg. section 1.707-1(c).[54] The preamble to the temporary section 469 regulations, which were issued in final form without modification, states that the IRS "expects that a conforming amendment will be made to [reg.] section 1.707-1."[55]

Although the section 469 regulations were issued in 1988, no amendment has been made to the regulations under section 707. A possible explanation is that Treasury and the IRS are concerned that they lack the authority to issue such a regulation, given the clear limits imposed by the text of section 707(c). If so, the existence of the section 469 regulation hardly undermines the argument developed in this report.

The literal interpretation of the "but only" language in section 707(c) adopted by Treasury, the IRS, and the JCT staff is consistent with case law regarding section 707(c). The principle illustrated by that case law is that section 707(c) treats guaranteed payments — whether for services or for the use of capital — as non-partner payments, but only for purposes of section 61(a), section 162(a), and any other section either of them incorporates by reference.[56] Sections of the code that provide an exclusion from gross income, in particular, have been found to be incorporated by reference in section 61(a).

[53] Reg. section 1.469-2T(e)(2)(ii) and -2(e)(2)(ii). This regulation is unfriendly to taxpayers. Under section 469(e)(1)(A)(i)(I), gross interest income is not taken into account in determining a taxpayer's income from passive activities. A taxpayer receiving GPUCs that are treated as interest under the section 469 regulations therefore reduces the amount they are allowed to deduct under section 469(a)(1).

[54] Section 469 was added to the code by the Tax Reform Act of 1986, sections 501 and 502. There is nothing in the text or the legislative history of the bill to indicate that Congress intended to treat GPUCs as interest for purposes of section 469.

[55] Preamble to T.D. 8175, 53 F.R. 5686, 5692 (Feb. 25, 1988); Steinberg, *supra* note 1, at 564 n.61.

[56] This principle presumably also applies to section 263.

In *Carey*,[57] for instance, the Court of Federal Claims held that section 911 — allowing U.S. citizens residing abroad to exclude any foreign-source earned income from gross income — was incorporated by reference in section 61(a) "by means of the phrase, 'Except as otherwise provided in this subtitle.'"[58] In other words, because section 61(a) contains a caveat referring to exceptions from the general gross income inclusion rule, and because section 911 is one of those exceptions, the latter section was held to be incorporated by reference in the former. The same principle is suggested in *Jenkins*[59] regarding section 104, which excludes some forms of compensation for injuries or sickness from gross income.

This understanding of the "but only" language, which finds its origins in *Miller*,[60] was further confirmed in *Kampel*.[61] In *Kampel*, the Tax Court held that section 1348 was not incorporated by reference in section 61(a) and that as a result, guaranteed payments were a distributive share of partnership income for purposes of section 1348. The Tax Court reasoned that unlike section 911, section 1348 does not provide an exclusion from gross income but merely "alters the tax rate provided by section 1."[62] On that basis, the court found that "the section 61 phrase 'except as otherwise provided in this subtitle' cannot be read as applying to section 1348."[63]

Given the standard adopted by the courts, section 163(j) cannot be incorporated by reference in either section 61(a) or 162(a). Section 163 allows individuals and corporations an itemized deduction for interest paid or accrued on indebtedness. Section 163(j) limits that deduction for business interest expense. Section 163(j) therefore has no conceptual or computational connection to the determination of gross income under section 61(a).

There is no case law addressing the incorporation of any code provision by reference in section 162(a). Section 163(j), however, cannot be so incorporated. First, unlike section 61(a), section 162(a) does not contain an "except as otherwise provided" caveat that could be used to incorporate other code sections denying or limiting the deduction allowed by section 162. Although the presence of this caveat should not be determinative,[64] courts have found it significant.

Second, and most important, the deduction limited by section 163(j) is allowed by section 163(a), not by section 162(a). The preamble to the proposed regulations notes that section 163(j)(1) limits the amount of business interest expense allowed as a deduction under chapter 1 of the code.[65] The scope of the limit imposed by section 163(j) is thus "on its face, broader than merely deductions under section 163."[66] The only provision of chapter 1 allowing a deduction for interest expense, however, is section 163(a).[67] The actual scope of section 163(j) is therefore much narrower than it is on its face. One might also interpret Treasury and the IRS as suggesting that section 163(j) may limit deductions allowed by code sections other than section 163. That is an unorthodox view, and I am unaware of any authority supporting it. As a result, it is also highly unlikely that a court would find section 163(j) incorporated by reference in section 162(a).

There is yet another reason to think that Treasury and the IRS's interpretation of the term "interest" in section 163(j) is impermissible under *Chevron* step 2. Section 163(a) allows a deduction for interest paid or accrued *on indebtedness*. For GPUCs to reasonably be understood to be interest within the meaning of section 163(j), partnership

[57] *Carey v. United States*, 427 F.2d 763, 767 (Fed. Cl. 1970).

[58] *See also Vogt v. United States*, 537 F.2d 405 (Fed. Cl. 1976) (reaching the same holding); and Banoff, *supra* note 1, at 837-840.

[59] *Jenkins v. Commissioner*, 102 T.C. 550, 555 (1994).

[60] *Miller v. Commissioner*, 52 T.C. 752 (1969).

[61] *Kampel v. Commissioner*, 72 T.C. 827 (1979), *aff'd*, 634 F.2d 708 (2d Cir. 1980).

[62] *Id.*, 72 T.C. at 836.

[63] *Id.*

[64] For example, courts may well have found section 104 incorporated by reference in section 61(a) even absent this caveat, given that section 104 provides an exclusion from gross income, the very concept defined by section 61(a).

[65] Preamble to REG-106089-18, 83 F.R. at 67494. Section 163(j)(1) provides that "the amount allowed as a deduction under this chapter for any taxable year for business interest shall not exceed . . . ."

[66] Preamble to REG-106089-18, 83 F.R. at 67494.

[67] It may be that in the absence of section 163(a), interest expense would be deductible under section 162(a) in some cases. There is little doubt, however, that the presence of section 163(a) has the effect that interest expense is not deductible under section 162(a).

interests held by partners entitled to GPUCs must constitute debt rather than equity.

The preamble to the proposed section 163(j) regulations states that Treasury and the IRS intended to include in their definition of interest any amount paid or accrued on an instrument treated as debt for purposes of section 1275 and reg. section 1.1275-1(d).[68] Under the latter, a debt instrument is "any instrument or contractual arrangement that constitutes indebtedness under general principles of the Federal income tax law (including, for example, a certificate of deposit or a loan)."[69] Treasury and the IRS therefore claim that their definition of interest as encompassing GPUCs rests on general principles of federal income tax law.

The IRS, however, has acknowledged that the obligation for a partnership to make GPUCs to a partner does not create indebtedness. In GCM 36702, for example, the IRS recognized that "true indebtedness . . . by definition is not present when Code section 707(c) applies." The proposed section 885 regulation mentioned earlier also reflects Treasury and the IRS's understanding that "in accordance with U.S. tax principles," an obligation to make a guaranteed payment is not a partnership liability.[70] The general principles of federal income tax law invoked by Treasury and the IRS thus do not alone justify treating GPUCs as interest. Although this objection applies to any proposed treatment of GPUCs as interest, it applies with particular force to proposals to treat GPUCs as interest for purposes not sanctioned by section 707(c), because those proposals lack a sound foundation in the first place.

Interpreting "interest" in section 163(j) as encompassing GPUCs contradicts both the text of section 707(c) and the way Treasury, the IRS, the JCT staff, and the courts have long understood it. It also contradicts the view embraced by Treasury and the IRS that partnership interests entitling their holders to GPUCs are not debt. This evidence strongly supports the argument that the interpretation in the proposed section 163(j) regulation is manifestly contrary to the statute and impermissible under *Chevron* step 2. This is especially true given the Supreme Court's willingness to strike down agency interpretations that are, according to the agency itself, inconsistent with the broader statutory scheme.[71]

This argument is not affected by the existence of Notice 2004-31, 2004-1 C.B. 830. That notice purports to limit the ability of corporate partners to avoid former section 163(j) by inappropriately converting interest payments into GPUCs that may be fully deductible under section 162. It does so by classifying specific transactions as "listed transactions," which triggers an obligation for taxpayers to disclose them to the IRS.[72] Although the IRS may have legal authority to challenge some arrangements intended by the parties to be GPUCs as instead constituting payments of interest on indebtedness, this does not imply that Treasury and the IRS have legal authority to treat *all* GPUCs as interest, regardless of the factual circumstances or the statutory text.

Moreover, the section 163(j) regulation would make Notice 2004-31 redundant. If GPUCs are interest for purposes of section 163(j), a partnership can deduct them only within the limits set by that section, and it therefore cannot escape those limits by converting interest payments into GPUCs. If anything, Notice 2004-31 shows that the IRS's historical view is that GPUCs are not subject to the limits of section 163(j) and that section 163(j) does not limit the deduction allowed by section 162. The notice is thus further evidence that in the IRS's own view, "interest" in section 163(j) is not properly interpreted as encompassing GPUCs.

Policy Reversals, *Chevron*, and the APA

Treasury and the IRS's historical view is that GPUCs should be treated as non-partner payments only for purposes of sections 61(a) and 162(a). Their decision to propose a regulation treating GPUCs as interest for purposes of section

[68] Preamble to REG-106089-18, 83 F.R. at 67493.

[69] Reg. section 1.1275-1(d).

[70] Prop. reg. section 1.882-5(c)(5), Example 4.

[71] *Utility Air*, 573 U.S. at 321-322 (noting that the EPA had repeatedly acknowledged that applying the permitting requirements of the Clean Air Act's "prevention of significant deterioration" provisions and title V of the act to greenhouse gases would be inconsistent with — "in fact, would overthrow" — the act's structure and design).

[72] *See* reg. sections 1.6011-4(b)(2), 301.6111-2(b)(2), and 301.6112-1(b)(2).

163(j) thus represents a departure from their prior policy and practice.

Although agency interpretations that change over time may be entitled to *Chevron* deference, the Supreme Court has held that an agency must "display awareness that it *is* changing position" and "show that there are good reasons for the new policy" (emphasis in original).[73] In particular, Treasury and the IRS cannot "depart from a prior policy *sub silentio*."[74] They are therefore required to acknowledge and explain their decision to radically change their understanding of GPUCs. They have thus far failed to do so.

The preamble to the proposed section 163(j) regulations does not explicitly discuss GPUCs. In discussing their definition of interest, Treasury and the IRS simply claim to have adopted a definition "that addresses all transactions that are commonly understood to produce interest income and expense, including transactions that may otherwise have been entered into to avoid the application of section 163(j)."[75] The evidence discussed earlier, however, shows that GPUCs have not commonly been understood to produce interest income and expense.

Treasury and the IRS therefore displayed no awareness that they were changing position regarding GPUCs and did not, *a fortiori*, explain that change. Their failure to acknowledge that the proposed section 163(j) regulation conflicts with reg. section 1.707-1(c) is particularly striking. That failure further undermines any claim that Treasury and the IRS's interpretation of the term "interest" as encompassing GPUCs is permissible under *Chevron* step 2. As the D.C. Circuit has held, "a statutory interpretation . . . that results from an unexplained departure from prior policy and practice is not a reasonable one."[76]

Instead of challenging the section 163(j) regulation under *Chevron*, a taxpayer could do so under section 706(2)(A) of the APA.[77] There is no doubt that after *Mayo Foundation*, Treasury and IRS actions are subject to judicial review under the APA.[78] Indeed, the Federal Circuit was the first court to invalidate a tax regulation under the APA's arbitrary and capricious standard, in its 2012 *Dominion Resources* decision.[79]

The APA provides that agency action is unlawful if it is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."[80] As one commentator has pointed out, the APA's arbitrary and capricious standard is "a powerful tool for taxpayers to use in challenging IRS regulations."[81]

In *State Farm*,[82] the Supreme Court interpreted the arbitrary and capricious standard as requiring (1) that agencies offer contemporaneous explanations of their policy decisions, and (2) that those explanations demonstrate reasoned decision-making.[83] This standard is fairly deferential. In the Supreme Court's words, "the scope of review under the 'arbitrary and capricious' standard is narrow and a court is not to substitute its judgment for that of the agency."[84] When agencies change course, however, they are "obligated to supply a reasoned analysis for the change beyond that which may be required when an agency does not act in the first instance."[85]

Whereas Treasury and the IRS once believed that GPUCS "are considered as made to one who is not a member of the partnership only for the purposes of section 61(a) . . . and section 162(a)," they now believe that GPUCs should be treated as interest for purposes of section 163(j). Because Treasury and the IRS changed their policy regarding GPUCs without acknowledging — let

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[73] *Federal Communications Commission v. Fox Television Stations Inc.*, 556 U.S. 502, 515 (2009). *See also Altera*, 145 T.C. at 113.

[74] *Fox Television*, 556 U.S. at 515.

[75] Preamble to REG-106089-18, 83 F.R. at 67494.

[76] *Northpoint Technology Ltd. v. FCC*, 412 F.3d 145, 156 (D.C. Cir. 2005).

[77] 5 U.S.C. section 706(2)(A).

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

[79] *Dominion Resources Inc. v. United States*, 681 F.3d 1313 (Fed. Cir. 2012) (holding that a regulation promulgated under section 263A was invalid under both *Chevron* and the APA's arbitrary and capricious standard).

[80] 5 U.S.C. section 706(2)(A).

[81] Patrick J. Smith, "The APA's Arbitrary and Capricious Standard and IRS Regulations," *Tax Notes*, July 16, 2012, p. 271, at pp. 272-273.

[82] *Motor Vehicle Manufacturers Association of the United States v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29, 43 (1983).

[83] *See* Hickman, "*Chevron*'s Inevitability," *supra* note 27, at 1412.

[84] *State Farm*, 463 U.S. at 43.

[85] *Id.* at 42. *See also Encino Motorcars LLC v. Navarro*, 136 S. Ct. 2117, 2125 (2016); and *United Student Aid Funds Inc. v. King*, 200 F. Supp. 3d 163, 169-170 (D.D.C. 2016).

alone explaining — this change, they did not "supply a reasoned analysis for the change," as required by *State Farm*.[86] This makes the section 163(j) regulation treating GPUCs as interest arbitrary and capricious and therefore invalid under section 706(2)(A) of the APA.

The Supreme Court has suggested that the APA's arbitrary and capricious standard and *Chevron* step 2 are equivalent in that under both standards, the key question is whether the agency's interpretation is "arbitrary or capricious in substance."[87] As the Tax Court also put it in *Altera*, "whether *State Farm* or *Chevron* supplies the standard of review is immaterial because *Chevron* step 2 incorporates the reasoned decisionmaking standard of *State Farm*."[88] The argument that the section 163(j) regulation fails at *Chevron* step 2 thus further supports the conclusion that it is arbitrary and capricious under *State Farm* and the APA. Conversely, the Supreme Court has also held that if a regulation fails under the APA's arbitrary and capricious standard, it does not deserve deference under *Chevron*.[89]

To be sure, the section 163(j) regulation treating GPUCs as interest has not yet been issued in final form. This means that Treasury and the IRS still have the opportunity to acknowledge and explain their policy change. It is unclear, however, how they could provide an explanation reconciling the proposed section 163(j) regulation with reg. section 1.707-1(c). One cannot coherently conclude that GPUCs are interest for purposes of section 163(j) and that they are "considered as made to one who is not a member of the partnership only for the purposes of section 61(a) . . . and section 162(a)."[90] The only way to reconcile those two positions would be to claim that section 163(j) is somehow incorporated by reference in section 162(a). As discussed earlier, however, there is no legal authority for that claim.

Conclusion

The recently proposed section 163(j) regulation treating GPUCs as interest — assuming it is finalized without modification — is invalid. It fails at *Chevron* step 2 because it is not a permissible interpretation of the statute. It contradicts both the text of section 707(c) and the way Treasury, the IRS, the JCT staff, and the courts have long understood it. It also conflicts with the view embraced by Treasury and the IRS that partnership interests entitling their holders to GPUCs are not debt.

The fact that this regulation also constitutes an (as yet) unacknowledged and unexplained policy change on Treasury and the IRS's part further supports the claim that it fails at *Chevron* step 2 and that it is arbitrary and capricious under *State Farm* and section 706(2)(A) of the APA.

Because Treasury and the IRS will unlikely be able to reconcile the proposed section 163(j) regulation with reg. section 1.707-1(c) and, more generally, with the traditional understanding of GPUCs and of the scope of section 707(c), they should withdraw the proposed section 163(j) regulation. ■

[86] *State Farm*, 463 U.S. at 42.

[87] *Judulang v. Holder*, 565 U.S. 42, 52 n.7 (2011).

[88] *Altera*, 145 T.C. at 120.

[89] *Encino Motorcars*, 136 S. Ct. at 2125.

[90] Reg. section 1.707-1(c).