

## Guaranteed Payments for Capital: Interest or Distributive Share?

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The article addresses how guaranteed payments for the use of capital should be treated, focusing on the two most prevalent approaches, as interest or as a distributive share of partnership income.

### Introduction

It is common for partners who contribute capital to a partnership to receive some form of a preferred return on their investment. Preferred returns can be structured in many ways, and the ultimate tax characterization of those returns will naturally depend on the structure used. To the extent the payments are dependent on profits, such as a fixed percentage of partnership net income, they are generally treated as allocations under section 704(b) when recognized and as distributions under section 731 when paid. To the extent the payments are determined without regard to income of the partnership and are payable in all events, they are generally treated as guaranteed payments under section 707(c) (provided they are paid to one acting in his capacity as a partner, rather than a third party, in which case they would fall under section 707(a)). Given the multitude of complicated economic arrangements that exist, it is often difficult to discern

whether a preferred return for the use of capital is dependent on partnership income, and the law on that issue is perilously sparse and beyond the scope of this article.<sup>1</sup> This article addresses how payments of a return on capital that are treated as guaranteed payments should be treated.<sup>2</sup>

The IRS, courts, and practitioners generally take one of two approaches for the treatment of guaranteed payments: treating such payments as a separate item in the nature of interest or rather as a distributive share of partnership income. The characterization of those payments as interestlike or as a distributive share can lead to vastly different tax consequences for the recipient, including whether a foreign partner has income that is effectively connected income with the conduct of a U.S. trade or business or is eligible for the portfolio interest exception, whether a tax-exempt entity has unrelated business taxable income, and many other issues. The law is notoriously conflicting,<sup>3</sup> and it seems the best taxpayers can do is to make a judgment call based on their particular circumstances, taking into account the history and language of the statute and the way it has been applied in different contexts by the courts, Treasury, and the IRS.

### The Legislative History of Section 707(c)

The legislative history of section 707(c) is muddled. Both the House and Senate reports provide that guaranteed payments should not be considered a distributive share, but it is unclear

<sup>1</sup>For a discussion of this issue, see Eric B. Sloan and Matthew Sullivan, "Deceptive Simplicity: Continuing and Current Issues with Guaranteed Payments," 916 *PLI/Tax* 124-1 (2010); see also William S. McKee et al., *Federal Taxation of Partnerships and Partners*, para. 14.03[1][b] (1989).

<sup>2</sup>For the purposes of this article, generic references to guaranteed payments refer to guaranteed payments in the nature of a return of capital, unless the context indicates otherwise.

<sup>3</sup>Sheldon I. Banoff, in "Guaranteed Payments for the Use of Capital: Schizophrenia In Subchapter K," 70 *Taxes* 12 (1992), states, "There is little guidance as to how they should be characterized. Thus, it is not surprising to find that the classification of GPUCs [guaranteed payments for the use of capital] is at best confused, and at worst, seemingly schizophrenic. As indicated below, several inconsistent approaches have been taken by the Treasury (in regulations), the IRS (in rulings and litigation) and the courts. Indeed, support seemingly exists for almost any position a recipient or payor of GPUCs wishes to take."

whether they intended that rule to apply for all purposes of the code or merely income inclusion and deduction.<sup>4</sup> The statute they drafted, in turn, does not clearly reflect their intent and has created significant uncertainty.

Before enactment of section 707(c) in the Internal Revenue Code of 1954, courts had held that a partner could not be an employee of his own partnership.<sup>5</sup> As a result, compensation paid to a partner for services was treated as part of his distributive share of partnership profits,<sup>6</sup> which meant that the tax treatment of those payments differed based on the amount of underlying partnership income.<sup>7</sup> To the extent there was sufficient underlying partnership income to cover amounts paid as compensation, the recipient included the entire amount in income.<sup>8</sup> To the extent that partnership profits were insufficient to cover compensation payments, the amounts were treated as a return of capital.<sup>9</sup> If the recipient did not have sufficient basis to absorb the payment, the excess was treated as funded by the other partners, was taxable to the recipient, and entitled the other partners to deductions.<sup>10</sup> That this approach could lead to disparate treatments depending on the partnership income for the year came to be known as the “Lloyd problem” after the case first establishing the rule.<sup>11</sup>

Congress found that differing treatment to be “unrealistic and unnecessarily complicated.”<sup>12</sup> Accordingly, the House passed its version of section 707(c) for the 1954 Code:

For the purposes of section 61(a)(1) (relating to the inclusion in gross income of compensation for services, etc.) and section 162(a)(1) (relating to the deduction of expenses for a reasonable allowance for salaries, etc.), payments to a partner for services shall, to the extent determined without regard to the income of the partnership, be considered as a salary paid or incurred with respect to one who is not a member of the partnership.<sup>13</sup>

The House report indicated the intent of the provision was “that payment of a fixed or guaran-

teed amount for services . . . be treated as salary income to the recipient and allowed as a business deduction to the partnership.”<sup>14</sup> It went on to say that “the amount of such salary shall be included in the partner’s gross income, and shall not be considered a distributive share of partnership income or gain. A partner who is guaranteed a minimum annual amount for his services shall be treated as receiving a salary in that amount.”<sup>15</sup>

Thus, it is clear that the House intended for the recipient of the payment to recognize ordinary income and the partnership a deduction in either scenario. However, it is not clear whether the House was contemplating treating such payments as salary for all other purposes of the code, such as employment tax, deferred compensation plans, or fringe benefits, for example. In fact, Treasury and the IRS have explicitly provided in regulations and rulings that that is not the rule.<sup>16</sup>

The Senate version of section 707(c), which was ultimately adopted into law, purported to extend the treatment to guaranteed *interest* payments on capital.<sup>17</sup> In doing so, the Senate rewrote the provision (which is substantially similar to that currently in effect):

To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses).<sup>18</sup>

The Senate report recited the House view that under the provision, salary payments would be included in the gross income of the recipient and

<sup>4</sup>S. Rep. No. 1622 (1954). H.R. Rep. 1337, 68, reprinted at 83d Cong., 2d Sess. 4017.

<sup>5</sup>See, e.g., *Estate of Tilton v. Commissioner*, 8 B.T.A. 914 (1927).

<sup>6</sup>*Id.*

<sup>7</sup>Rev. Rul. 55-30, 1955-1 C.B. 430; *Lloyd v. Commissioner*, 15 B.T.A. 82 (1929).

<sup>8</sup>*Id.*

<sup>9</sup>*Id.*

<sup>10</sup>*Id.*

<sup>11</sup>*Id.*

<sup>12</sup>S. Rep. No. 1622, *supra* note 4.

<sup>13</sup>H.R. 8300, as introduced in the House.

<sup>14</sup>H.R. Rep. 1337, *supra* note 4.

<sup>15</sup>*Id.* at A227.

<sup>16</sup>Reg. section 1.707-1(c) (A “partner who receives guaranteed payments is not regarded as an employee of the partnership for the purposes of withholding of tax at source, deferred compensation plans, etc.”); Rev. Rul. 56-675, 1956-2 C.B. 459 (guaranteed salary payment treated as distributive share for self-employment tax purposes); Rev. Rul. 91-26, 1991-1 C.B. 184 (guaranteed payments of accident and health insurance premiums in exchange for services treated as distributive share of partnership income and therefore not excludable from gross income under section 106); GCM 34173 (1969) (guaranteed payments for living expenses in exchange for services treated as distributive share and therefore did not qualify for income exclusion under section 119).

<sup>17</sup>S. Rep. No. 1622, *supra* note 4, at 4621 (emphasis added).

<sup>18</sup>This was amended in 1976 to include “subject to section 263, for purposes of” immediately before “section 162(a).” P.L. 94-455, section 213(b)(3).

would not constitute a distributive share of partnership income.<sup>19</sup> It went on to state that it intended to provide “the same treatment as that provided in the case of guaranteed salaries to payments for the use of capital, to the extent the payments are determined without regard to partnership income.”<sup>20</sup>

The Senate report’s reference to “interest” has been cited as support for treating guaranteed payments for capital as interest.<sup>21</sup> As with the House, however, there is no indication that the Senate considered whether such payments should constitute interest for all purposes of the code, such as the rules relating to ECI, the portfolio interest exception, and UBTI.

Even less clear is why the Senate rewrote the provision as it did. In the House version, which the Senate was purporting to extend to payments for the use of capital, the rule applied to sections 61 and 162 but not only those sections. The Senate rewrite added the limitation that the rule apply only to those sections, but the reports are silent on the reason for that change. The final section 707(c) requirement that guaranteed payments for services or the use of capital “be considered as made to one who is not a partner” suggests an entity approach (that is, salary or interest) rather than an aggregate one (distributive share). Yet, the limitation “*but only* for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses)” clearly suggests that there are circumstances in which an aggregate approach is warranted. Thus, as discussed below, despite the intent stated in the congressional reports that section 707(c) payments not constitute a distributive share of income, the Senate’s reformulation has generated enormous uncertainty.

If the purpose of section 707(c) was merely to address the *Lloyd* problem and not to change the character of guaranteed payments for all purposes of the code, then the treatment under prior law as a distributive share should hold true unless otherwise provided. The Joint Committee on Taxation has agreed with that interpretation, saying in a 1997 report that:

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, and deduction and capitalization by the partnership (sec. 707(c)). For all other purposes,

guaranteed payments are treated in the same manner as a distributive share of partnership income.<sup>22</sup>

However, the JCT has also said that in substance, guaranteed payments more closely resemble interest on debt. According to the JCT, “the nature of a payment that does not depend upon the income of the partnership, that is made by a partnership on an amount contributed to the partnership by a partner, conceptually resembles interest on debt” and that if section 707(c) were to be repealed, those payments would be treated as such.<sup>23</sup> Given those conflicting statements, it is difficult to glean much guidance from the legislative history of section 707(c) or Congress’s subsequent interpretations thereof.

### Section 707(a) vs. 707(c)

Looking more closely at the statute, if the general rule was to treat section 707(c) payments as salary or interest for all purposes, then the treatment of guaranteed payments would basically mimic that of section 707(a). Subject to some exceptions, section 707(a) applies the entity theory to transactions between a partnership and a partner acting in a role other than as a partner. For instance, when a partner loans capital to the partnership, interest payments for the use of that capital would be treated under section 707(a) as made to a non-partner. However, when a partner contributes capital to the partnership, payments for the use of such capital would be treated as guaranteed payments under section 707(c) (provided that the payments are not dependent on the income of the partnership). If those payments are treated under section 707(c) as interest for all purposes, then the treatment under this provision would be virtually identical to the treatment under section 707(a), with the exception of possible timing differences under section 706(a), as discussed below. This is an argument in favor of distributive share treatment, so as to maintain the debt-equity distinction between the two sections.

However, treating both the transactions as debt would not necessarily render section 707(c) superfluous. There are other instances in which transactions that take different forms (here, a loan versus a capital contribution) are treated the same for tax purposes. For example, when a redemption of shares in a corporation more closely resembles a distribution with respect to such shares, section

<sup>19</sup>*Id.* at 387.

<sup>20</sup>*Id.*

<sup>21</sup>*See, e.g.*, GCM 36702 (1976).

<sup>22</sup>Joint Committee on Taxation, “Review of Selected Entity Classification and Partnership Tax Issues” (Apr. 8, 1997), at 45.

<sup>23</sup>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” (Apr. 8, 1997), at 294.



302(d) provides that the transaction will be treated the same for tax purposes as under section 301.

There is, however, other support in the statute for upholding the debt-equity distinction between section 707(a) and (c). The deduction for payments under section 707(a) is governed by section 163,<sup>24</sup> the section applicable to interest, while the deduction under section 707(c) is governed by section 162, applicable to trade or business expenses. If guaranteed payments were intended to be treated as interest similar to section 707(a) payments, then the deduction for those payments would arguably be governed by section 163, not section 162.

### Treasury Regulations

Treasury has delved into the thicket created by Congress, but its guidance has been remarkably unhelpful. The regulations seem to lean toward distributive share treatment but are so conflicting that taxpayers are left with more questions than answers.

A starting point is reg. section 1.707-1(c), which provides that:

guaranteed payments do not constitute an interest in partnership profits for purposes of sections 706(b)(3), 707(b), and 708(b). For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income.

This indicates that distributive share treatment should be the default rule, at least in Treasury's eyes. Still, commentators have noted that this principle appears to be inconsistently applied and that Treasury has even considered removing the language because of the confusion it has wrought.<sup>25</sup> Of course, the regulation has been in effect for more than 50 years, and no change has occurred.

If reg. section 1.707-1(c) is the most oft-cited provision for distributive share treatment, then reg. section 1.704-1(b)(2)(iv)(o) is not far behind for the treatment of guaranteed payments as interest. It provides that guaranteed payments only result in adjustments to the capital account of the recipient partner to the extent of the deduction or loss of the partnership resulting from the payment (that is, as a result of reducing partnership income or increasing its loss). That may be evidence that guaranteed payments are not properly viewed as a distributive share of income, as that income generally would increase the recipient's capital account when recognized under section 704 and decrease its capital account when paid under section 731, neither of

which appears to be permitted by the regulation. On the other hand, reg. section 1.704-1(b)(2)(iv)(o) may just be intended to prevent double counting of those payments under the aforementioned provisions and section 707(c). Moreover, it should come as no surprise that guaranteed payments do not increase capital accounts, as they are not *actually* a distributive share of income, which would be governed by section 704, not section 707. Rather, to be a guaranteed payment, those amounts must be determined without regard to partnership income. Those accounting issues, which are at the heart of the *Lloyd* problem and what section 707(c) was intended to address, do not necessarily bear on the *characterization* of the payments. That said, reg. section 1.704-1(b)(2)(iv)(o) is a reminder of the disconnect between guaranteed payments and partnership income and the difficulties that ensue in applying the distributive share approach. For example, if guaranteed payments are to be characterized based on the underlying partnership income, then how should they be treated when the partnership has not yet earned any income? The IRS has ruled on that issue in the real estate investment trust context, as discussed below, but the answers are less than satisfying. Moreover, if all the partnership's underlying income happens to be capital gain, then the distributive share analysis breaks down, as reg. section 1.707-1(c) provides for ordinary income treatment in all events. If guaranteed payments are instead treated as interest, then those conceptual and practical problems seem to disappear. Reg. section 1.704-1(b)(2)(iv)(o), while not conclusive on how guaranteed payments should be treated, highlights the practical and conceptual advantages of treating them as interest.

One also might look to the fixed, determinable, annual, or periodical income and ECI withholding regulations to determine if guaranteed payments are considered to be either FDAP, reflecting interest treatment, or ECI, reflecting distributive share treatment. Reg. section 1.1441-5(b)(2)(i)(A), dealing with withholding on FDAP, provides that "a U.S. partnership shall withhold when any distributions that include amounts subject to withholding (including guaranteed payments made by a U.S. partnership) are made." The phrase "amounts subject to withholding" is already defined to include interest.<sup>26</sup> The question arises, therefore, whether the parenthetical "including guaranteed payments made by a U.S. partnership" is intended to modify the phrase "amounts subject to withholding" or the entire phrase "distributions that include amounts subject to withholding." If the former, it would indicate

<sup>24</sup>See, e.g., LTR 8304059.

<sup>25</sup>Banoff, *supra* note 3, at n.26.

<sup>26</sup>Reg. section 1.1441-2(a).

that guaranteed payments are properly viewed as interest (at least for these purposes). If the latter, an inquiry into the underlying partnership income would still be required to determine if the payments constitute “amounts subject to withholding,” thereby suggesting that distributive share treatment is the proper characterization. The location of the parenthetical after “withholding” rather than “distributions” suggests that the former is the better reading, but it is not conclusive. Given the uncertainty in how that reference to guaranteed payments should be interpreted, it does not offer much guidance on how they should be treated.

The ECI withholding regulations under section 1446 do not mention guaranteed payments, possibly suggesting that they constitute FDAP and therefore interest. However, that may be because ECI is determined under those regulations by reference to a foreign partner’s allocable share under section 704.<sup>27</sup> The section 704 regulations, in turn, provide that guaranteed payments are not treated as an allocable share, as discussed above, and the failure to mention guaranteed payments under section 1446 may just be a consequence of that. Therefore, no firm conclusions can be drawn from the failure to mention guaranteed payments in the section 1446 regulations.

The regulations regarding application of the fractions rule for purposes of determining whether a tax-exempt organization has UBTI seem to indicate that guaranteed payments may be properly characterized as a distributive share of income. Reg. section 1.514(c)-2(c)(1)(ii) generally provides that a guaranteed payment to an exempt organization that is not commercially “reasonable” (as defined in reg. section 1.514(c)-2(d)(4)) is treated as an allocable share of partnership income for purposes of the fractions rule. However, reg. section 1.514(c)-2(d)(3) provides that a reasonable guaranteed payment is *not* treated as an allocable share of partnership income under the fractions rule. That should not necessarily be interpreted as support for interest treatment, however, as reg. section 1.514(c)-2(d)(2) provides that even an actual distributive share of income with respect to a reasonable preferred return does not constitute a distributive share for purposes of the fractions rule. Moreover, reg. section 1.514(c)-2(d)(3) provides that “the treatment of a guaranteed payment as reasonable for purposes of section 514(c)(9)(E) does not affect its possible characterization as unrelated business taxable income under other provisions of the Internal Revenue Code,” which suggests that the payments

might be more properly viewed as a distributive share, as interest is generally exempt from UBTI under section 512(b).

There is, however, at least one instance other than those specified in reg. section 1.707-1(c) in which Treasury explicitly requires guaranteed payments to be treated as interest. In particular, reg. section 1.469-2(e)(2)(ii) treats guaranteed payments as interest for purposes of applying the passive loss rules, generally preventing that income from being offset by passive losses because of the exclusion in section 469(e)(1)(A) of interest from the definition of passive activity income. It is not clear whether that is intended to extend a general rule that guaranteed payments should be treated as interest or create yet another carveout from a default rule of distributive share treatment. If it is the latter, it is unclear how such a carveout is consistent with the apparent statutory mandate that the only exceptions from distributive share treatment are for the purposes of sections 61(a) and 162(a).

### Case Law

One would hope that with this confused backdrop, courts would have been able to bring some clarity to the rules. Unfortunately, case law has been equally conflicting.

At issue in *Miller v. Commissioner*<sup>28</sup> was whether guaranteed payments for services were excludable from gross income under section 911. Section 911 excludes from gross income foreign-source income if it constitutes “earned income,” which is defined in that section as “wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered.” The taxpayer, a partner in a law firm, argued that certain guaranteed payments he received in exchange for services provided to the firm constituted salary and therefore earned income for purposes of section 911. The IRS argued that for purposes of section 911 the payments constituted a distributive share of partnership income, not salary, and therefore could not be excluded from gross income.

The Tax Court held for the taxpayer, focusing on the meaning of the “but only” clause of the statute. The court noted that the Senate added the clause at the same time that section 706 was amended to provide that a guaranteed payment is to be included in income for the partner’s tax year in which the partnership tax year ends, as if it were a distributive share. The court also noted that the only explanation in the legislative history for the “but only” clause seemed to be in the Senate report, which provides, “In the case of guaranteed salary

<sup>27</sup>Reg. section 1.1446-1(a).

<sup>28</sup>52 T.C. 752 (1969).

payments your committee followed the House bill but made it clear that such income is to be reported for tax purposes at the end of the partnership year in which it is paid.” Taken together, the court viewed those facts as establishing that the only purpose of the clause is to serve as a backstop to section 706(c), which applies the aggregate theory for purposes of determining the year in which a partner must report guaranteed payments.<sup>29</sup> For all other purposes, the Tax Court determined that the entity approach should apply to characterize section 707(c) payments. Accordingly, the court held that those payments qualified as salary, and therefore earned income eligible for the section 911 exclusion from gross income.

That interpretation of the “but only” clause appears flawed. Section 707(c) makes no reference to section 706(a) and is completely silent on timing. The Tax Court suggested in *Miller* that Congress intended to limit aggregate treatment for purposes of section 707(c) to address possible timing mismatches by in turn providing that entity treatment would apply, but only for the purposes of sections 61(a) and 162(a) (that is, for all purposes other than timing). That approach is rather strained. It is also unclear why the court did not grapple with regulation 1.707-1(c), enacted before the case, which provides that aggregate treatment applies in all instances other than those covered by sections 706(b)(3), 707(b), and 708(b).

The Tax Court took the opposite approach 10 years later in *Kampel v. Commissioner*,<sup>30</sup> in which it held that guaranteed payments are properly viewed as a distributive share for purposes of former section 1348, which imposed a maximum tax rate on earned income, as defined in section 911. In so holding, the Tax Court noted that the legislative history of section 707(c) indicates that entity treatment was intended solely to address the *Lloyd* problem regarding income inclusion and deduction and that the aggregate theory generally should apply for purposes of characterizing guaranteed payments.<sup>31</sup> The Tax Court distinguished *Kampel* from *Miller* based in part on the legislative purposes behind sections 911 and 1348, noting that section

911 was enacted to ease the tax burdens of Americans working abroad, an incentive not present in drafting section 1348.<sup>32</sup>

The court also discussed an alternative interpretation of the “but only” clause, set forth in *Miller* and *Carey v. United States*,<sup>33</sup> that suggested that the entity theory should be the default rule for characterizing guaranteed payments, noting that the facts at issue would be an exception to that general rule.<sup>34</sup> Under that interpretation, section 707(c) facially applies the entity theory for purposes of sections 61(a) and 162(a). Section 61(a), in turn, defines gross income as all income from whatever source derived, “except as otherwise provided in this subtitle.” Based on that clause, the *Miller* and *Carey* courts said that the entity approach applied for purposes of income inclusion under section 61(a) as well as for purposes of all exceptions to gross income found throughout the code, including the exception in section 911.<sup>35</sup> Because section 1348 is not an exception to gross income but rather just a change in the applicable tax rate, guaranteed payments should be treated as distributive shares of income for those purposes, not as compensation, the court said.<sup>36</sup>

Commentators have been critical of that interpretation of the “but only” clause, saying it “is clearly inconsistent with the accepted treatment of guaranteed payments [as a distributive share of income] under a number of other provisions excluding items from gross income, including sections 79, 101, 105, and 106.”<sup>37</sup> And in GCM 34173 (1969), the IRS roundly criticized a similar holding embracing that interpretation.<sup>38</sup>

*Mallory v. United States*<sup>39</sup> is further support for the distributive share approach taken in *Kampel*. In *Mallory*, the court held that a guaranteed payment for services does not decrease the amount of net income from property held by a partnership for purposes of calculating the depletion allowance under section 613. While the court acknowledged

<sup>29</sup>If viewed as compensation for reporting purposes, an accrual basis partnership would deduct the compensation expense in the year it accrues, whereas a cash basis partner would include the amount in income when it is paid, potentially not until much later. Section 706(a), in treating those amounts as a distributive share of partnership income, was intended to eliminate that timing mismatch.

<sup>30</sup>72 T.C. 827 (1979), *aff'd*, 634 F.2d 708 (2d Cir. 1980).

<sup>31</sup>*Kampel*, 72 T.C. at 833-834.

<sup>32</sup>*Id.* at 836.

<sup>33</sup>427 F.2d 763 (Ct. Cl. 1970).

<sup>34</sup>*Kampel*, 72 T.C. at 836.

<sup>35</sup>*Id.* See also *Armstrong v. Phinney*, 394 F.2d 661 (5th Cir. 1968) (although court determined section 707(c) did not apply to the furnishing of some meals and lodging by a partnership to a partner, it provided in a footnote that if it did apply, those payments would be eligible for exclusion from gross income under section 119 as fringe benefits provided to an employee, applying the same reasoning set forth in *Carey*).

<sup>36</sup>*Id.*

<sup>37</sup>McKee et al., *Federal Taxation of Partnerships and Partners*, para. 14.03[6][c], n.262 (2010). See also reg. section 1.707-1(c); Rev. Rul. 91-26, 1991 C.B. 184.

<sup>38</sup>*Supra* note 16. See *Armstrong*, 394 F.2d 661.

<sup>39</sup>238 F. Supp. 87 (1965).



that under section 707(c), the entity approach applies to reduce partnership net income under section 162 by the amount of the salary payment, it held that such payment does not reduce net income for purposes of section 613, applying the aggregate theory.<sup>40</sup> In particular, the court held that for purposes of section 613, the income in question was that of the partners, not the partnership, and that the salary payment does not reduce that income but is merely one way of providing the recipient with its distributive share.<sup>41</sup>

### IRS Rulings

There appears to be only one IRS ruling that guaranteed payments should be treated as interest rather than as a distributive share. In GCM 36702,<sup>42</sup> the IRS commented on a proposed revenue ruling regarding whether an advance to a partnership was properly viewed as equity rather than debt. The IRS noted that the investment had both debt and equity elements but that to allocate a single capital contribution into severable interests created excessive computational problems. The IRS said the solution could be found in section 707(c), which it said permitted the entire interest to be characterized as equity while at the same time recognizing that the holder of that interest is receiving some payments as a creditor. It went on to say that “only Code Section 707(c) permits a partner to earn interest on a capital contribution.” The IRS found no issue with interest characterization despite the fact that section 707(c) allows a deduction to the partnership under section 162 rather than section 163, saying that “Although section 707(c) contains no reference to section 163, we believe that guaranteed payments for the use of capital constitute interest income under Code Section 61(a)(4)” and “The fact that the deduction of guaranteed interest payments is limited by Code Section 162 does not affect the characterization of those payments as interest income under Section 61(a)(4).”

Despite such a clear assertion of interest treatment, there are a few IRS rulings going in the opposite direction. For example, in LTR 8728033 the issue was whether a guaranteed payment made to a REIT was qualifying rental income under section 856(c). The IRS determined that under reg. section 1.707-1(c), providing that a guaranteed payment generally constitutes a distributive share, and reg. section 1.856-3(g), providing that items of gross income of a partnership will retain their character when allocated to a REIT, guaranteed payments to a

REIT are characterized based on the underlying income of the partnership. The IRS applied distributive share treatment even though the partnership was not expected to have sufficient income to cover the guaranteed payments for the first 18 to 24 months. That meant that the characterization of the payments would be somewhat speculative, as the exact mix of underlying partnership income would not be immediately known, although it was expected to consist mainly of qualifying rental income. Note that if the IRS’s conjecture turned out to be wrong, taxpayers in similar situations would be treated differently.

Moreover, the IRS ruled that the guaranteed payment should be bifurcated to the extent a portion was attributable to other types of partnership income. That bifurcation method seems to raise the same type of accounting complexities that the drafters of section 707(c) were trying to avoid, and to the extent the REIT’s underlying income happened to be capital gain, the distributive share analysis would break down, as section 707(c) provides for ordinary income treatment in all events. Those are some of the thornier issues that arise when applying distributive share treatment; that is, what to do when there is not sufficient underlying partnership income or when that income is of a mixed character. Despite those administrative and accounting concerns, the IRS still ruled that distributive share treatment was appropriate.<sup>43</sup>

It should be mentioned that the REIT rulings are geared toward a specific situation, determining whether the REITs would satisfy the income tests of section 856(c). It is possible that the IRS was motivated to help taxpayers in those rulings, given the myriad onerous requirements that are otherwise imposed on REITs and the severe consequences of blowing REIT status. Accordingly, one should be cautious in generalizing from the rulings.

### Final Thoughts

There certainly are benefits to characterizing guaranteed payments for the use of capital as interest. For one, it is the more economically honest approach. Fixed payments made for the use of capital, not dependent on income and therefore not tied to the success of the venture, resemble a debt-like arrangement, not equity. In addition to better reflecting economic reality, the interest approach is more easily administrable. Difficulties

<sup>40</sup>*Id.* at 89-90.

<sup>41</sup>*Id.*

<sup>42</sup>*Supra* note 21, reaffirmed three years later in GCM 38133 (1979).

<sup>43</sup>*See also* LTR 8639035 (guaranteed payment treated as qualifying income under the REIT income tests based on character of underlying partnership income); GCM 34173, *supra* note 16, (IRS provides laundry list of arguments against entity treatment in finding guaranteed payments are not eligible for exclusion from gross income under section 119).

arise with characterizing guaranteed payments according to the underlying partnership income when, for instance, the partnership has not yet generated any income, or when the income is, or is expected to be, of a mixed character. The IRS took up those issues in the REIT context, as discussed above, ruling that distributive share treatment was still appropriate. However, the solutions set forth therein, characterizing guaranteed payments based on conjecture and, when necessary, bifurcating the payment, are not totally satisfying.

Despite the arguments in favor of interest treatment, the statute and legislative history suggest a narrow purpose, to solve the *Lloyd* problem. The

regulations under section 707(c) are even more explicit on that point, providing that distributive share treatment applies in all but a few specified instances. Support for the aggregate theory can also be found in case law and IRS rulings. Unfortunately, support can be found for entity treatment as well. Taken as a whole, the authorities seem to suggest that the result may depend on the particular facts in a given arrangement, which leaves taxpayers in the uncomfortable position of trying to divine the IRS's view of their arrangements. Guidance that clarifies the rule would be welcomed by both taxpayers and practitioners.

#### SUBMISSIONS TO TAX NOTES

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