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November 14, 2016

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Re: *Report No. 1357 on Guaranteed Payments and Preferred Returns*

Dear Messrs. Mazur, Koskinen and Wilkins:

I am pleased to submit the attached report of the Tax Section commenting on issues relating to partnerships that provide for preferred returns to one or more partners. These comments are submitted in response to a request by the Treasury Department and the Internal Revenue Service (the "IRS") in the notice of proposed rulemaking issued on July 23, 2015, which contains proposed regulations concerning disguised payments for services under Section 707(a)(2)(A) and proposed conforming changes to the regulations governing guaranteed payments under Section 707(c) (the "Proposed Regulations") and statements regarding the interpretation of and planned changes to Revenue Procedure 93-27 relating to issuance of partnership profits interests to service providers.

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The Preamble to the Proposed Regulations requested comments regarding certain issues relating to partnerships that use “targeted capital account agreements.” As described in the report, targeted capital account agreements generally provide that income and loss is to be allocated among the partners in a manner that causes the partners’ capital accounts to equal (to the extent possible) the partners’ “target capital accounts,” *i.e.*, the amounts that would be received by the partners if the partnership sold all of its assets for their book values, repaid its liabilities, and then distributed the remaining proceeds to the partners.

The Report focuses on issues regarding preferred equity in partnerships that use targeted capital account agreements (although, as stated in the Report, these issues are not generally limited to such agreements and also arise in traditional “layer-cake” partnership agreements), including how items of partnership income, gain, deduction and loss should be allocated in respect of an accreting preference, and the extent to which the economic accrual of a preferred return gives rise to a guaranteed payment under Section 707(c).

As noted in the Report, in some cases it is not clear whether guaranteed payment treatment is required under current law. While guidance on the proper treatment in these cases would be helpful, the Report does not include a specific recommendation in that regard. However, the Report does note that there is no clear “pro-fisc” or “pro-taxpayer” approach to the question. It also examines some of the additional issues that follow from deeming there to be a guaranteed payment when there is not an *actual* payment by the partnership to the applicable partner.

The principal recommendations included in the Report are as follows:

1. Partnership allocations of net income and, in the absence of sufficient net income, items of gross income or loss or deduction, to or away from a partner that is entitled to a preferred return to cause the partner’s capital account to match its target capital account as closely as possible are in accordance with the “partners’ interest in the partnership” within the meaning of Section 704(b) and Treas. Reg. § 1.704-1(b)(3).

We believe this is clear under current law and no further guidance is necessary. However, if guidance on other aspects of the interplay between guaranteed payment and preferred returns is issued, we recommend that this point be confirmed in that guidance.

2. Guaranteed payment treatment is not appropriate if, as of the time a partnership interest is issued, the holder of the interest will receive more than its invested capital back only if and to the extent the partnership has cumulative net earnings during the period that the interest is outstanding.

We believe this is also clear under current law and no further guidance is necessary. However, if guidance on other aspects of the interplay between guaranteed payment and preferred returns is issued, we recommend that this point be included in that guidance.

3. Guidance should be issued that addresses which of the economic performance rules set forth in Section 461(h) and Treas. Reg. § 1.461-4 applies to guaranteed payments for the use of capital (including cash capital).
4. The IRS and the Treasury should consider issuing guidance permitting partnerships to adjust the capital accounts of the partners to reflect a revaluation of partnership property (as described in Treas. Reg. § 1.704-1(b)(2)(iv)(f)) where doing so would reduce or eliminate the amount of a guaranteed payment that a partner holding a preferred interest would otherwise be treated as receiving or accruing.

We appreciate your consideration of our recommendations. If you have any questions or comments regarding this report, please feel free to contact us and we will be glad to discuss or assist in any way.

Respectfully submitted,



Stephen B. Land
Chair

cc: Emily S. McMahon
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November 14, 2016

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