Report No. 1357

New York State Bar Association

Tax Section

Report on Guaranteed Payments and Preferred Returns

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Contents

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I. INTRODUCTION

This report[1] of the Tax Section of the New York State Bar Association provides comments in response to certain statements made in the notice of proposed rulemaking issued by the Internal Revenue Service on July 23, 2015. This notice contains proposed regulations concerning disguised payments for services under Section 707(a)(2)(A), proposed conforming modifications to the regulations governing guaranteed payments under Section 707(c) (the proposals collectively, the "**Proposed Regulations**") and statements regarding the interpretation of and planned modifications to Revenue Procedure 93-27 relating to issuance of partnership profits interests to service providers.[2]

We previously submitted a report recommending that the IRS and the Treasury consider certain revisions to the Proposed Regulations.[3]

The Preamble to the Proposed Regulations (the "**Preamble**") requested comments regarding certain issues relating to "targeted capital account agreements." Specifically, the Preamble states:

> Some taxpayers have expressed uncertainty whether a partnership with a targeted capital account agreement must allocate income or a guaranteed payment to a

[1] This report is drafted principally by Kirk Wallace and Jay Cosel, with very substantial contributions by a working group consisting of Jonathan Brenner, Jason Factor, Marcy Geller, Kathleen Gregor, Adele Karig, Rafael Kariyev, Stephen Land, David Schnabel, Eric Sloan, David Sicular and Joel Scharfstein. Helpful comments were received from Andy Braiterman, Phillip Gall, John Hart, Michael Schler and Andrew Solomon. This report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or House of Delegates.

[2] Notice of Proposed Rulemaking, *Disguised Payments for Services*, REG-115452-14, 80 Fed. Reg. 43,652 (July 23, 2015). All "Section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" references are to the Treasury Regulations promulgated under the Code. References to the "IRS" are to the Internal Revenue Service, and references to the "Treasury" are to the United States Department of the Treasury.

[3] *See* N.Y. ST. BA. ASS'N, TAX SEC., *Report on the Proposed Regulations on Disguised Payment for Services* (Rep. No. 1330, Nov. 13, 2015).

> 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.

This report provides comments in response to that request, although, as discussed below, the topic's relevance is not limited to partnerships that use targeted allocations.

As to nomenclature, we note that the phrase "targeted allocations," or, as our report submitted in September 2010 on the subject (the "**2010 Report**")[4] phrased it, "target allocations," generally refers to partnership agreement allocation provisions that require the partnership to allocate income or loss (usually net) annually among the partners in a manner that causes the partners' capital accounts to match (to the extent possible) the amounts that would be received by the partners if the partnership sold all of its assets for their then book value, repaid its liabilities and then distributed the remaining proceeds to the partners. Targeted allocation provisions generally are driven by book income, not taxable income under the Code. This report will refer to the hypothetical distribution entitlements as the partners' "target capital accounts."

Generally, a targeted allocation provision involves a two-step process. First, the partnership determines the target capital accounts of the partners by determining the amount of cash each partner would receive if all of the partnership's assets were sold for an amount of cash equal to the assets' "book values" (within the meaning of the Treasury Regulations promulgated under Section 704(b) (the "**704(b) Regulations**"))[5] in a hypothetical sale, the partnership liabilities were satisfied, and the remaining cash were distributed to the partners in accordance with the distribution priorities in the partnership agreement. In the second step, the partnership allocates income or loss among the partners in a manner that results, to the extent possible, in each partner's capital account being equal to that partner's target capital account.

While some partnership agreements with targeted allocation provisions provide that allocation of *gross* items of partnership income, gain, deduction and loss can be made if necessary to

[4] *See* N.Y. ST. BA. ASS'N, TAX SEC., *Report on Partnership Target Allocations* (Rep. No. 1219, Sept. 23, 2010).

[5] "Book value" refers to the value of partnership assets as carried on the partnership's books for purposes of maintaining capital accounts in accordance with the rules prescribed by Treas. Reg. § 1.704-1(b)(2)(iv).

cause the partners' capital account balances to match their target capital accounts, others provide that only *net* income or loss for the taxable period may be allocated.

As we discuss in greater detail below, at its core, the question that the IRS and the Treasury have asked regarding the relationship between targeted allocations and priority distribution rights such as preferred returns (*i.e.*, whether gross income allocations or guaranteed payments are required in certain situations) is merely a manifestation of the conflict between the realization doctrine (or "wait and see" taxation) and the annual accounting doctrine.[6] Furthermore, this conflict is not limited to partnerships that use targeted allocations. The fundamental question of when an accreting right to eventual payment that is based on time value of invested capital results in current income inclusion, or on what factors such inclusion turns, arises in any partnership that includes such an economic arrangement, regardless of whether it uses traditional "layer-cake" allocations or targeted allocations.[7]

As this report explains in further detail below, in general, we believe that there are difficult questions raised in the context of certain partnership preferred returns by the interplay of the annual accounting doctrine, the realization doctrine and basic concepts of accrual-basis accounting. Ideally, the IRS and the Treasury could provide guidance clarifying the answers to these questions. In considering crafting such guidance, the IRS and the Treasury should, we believe, note that there is no obvious "pro-fisc" or "pro-taxpayer" position. A regime resulting in more guaranteed payments than are believed to exist under current law and practice would tend to result in more ordinary income, but in many instances, that income may well be taken into account by tax-indifferent persons (*e.g.*, pension funds, charitable endowments and sovereign investors). Similarly, guaranteed payments generate ordinary income deductions where none may have otherwise existed, and in many cases those deductions will be allocated to persons not subject to limitations on their use (*e.g.*, the passive loss rules of Section 469 or the miscellaneous itemized deduction rules of Section 67). Conversely, in other situations, the income may be allocated to taxable persons and the majority of the deductions may be allocated to partners in whose hands those deductions are subject to limitations on their use. That lack of symmetry might seem to

[6] *See, e.g.*, Burnet v. Sanford A. Brooks Co., 282 U.S. 359 (1931); *cf.* Burnet v. Logan, 283 U.S. 404 (1931).

[7] Many practitioners seem to believe that these are issues that are caused by the use of targeted (or other distribution-driven) allocation provisions in partnership agreements. This is not correct. Rather, these issues arise from the economic arrangement of the partners. It simply is easier to identify them in targeted allocation provisions.

benefit the fisc, at least as a superficial matter, but it also may be viewed as inequitable and, as such, give rise to a variety of unforeseen and unintended negative consequences.[8]

II. RECOMMENDATIONS

Targeted allocation provisions, and partnership preferred equity of various types, are commonplace in partnership arrangements. This report makes the following recommendations with regard to the interplay between them:[9]

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) ("**PIP**").

   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.[10] (*See* Examples 4–6, below.)

[8] Concerns about asymmetry seem to be among the reasons that recent legislative proposals that would alter the tax treatment of carried interest arrangements in investment partnerships do so, generally, by characterizing net income or loss allocated to the fund manager as ordinary income (or loss) attributable to the performance of services, without affecting the tax treatment of the other partners (thus avoiding, for example, additional deductions in the hands of limited partners that might be subject to substantial limitations on their usefulness). *See, e.g.*, H.R. 4213, 111th Cong., 2d Sess., § 412(a) (2010); American Jobs Act of 2011, § 412(a) (2011).

[9] This report does not address payments that are treated as guaranteed payments by reason of Section 736(a)(2).

[10] It should be noted that "income" for this purpose should exclude any built-in gain allocated to other partners under Treas. Reg. § 1.704-1(b)(2)(iv)(*f*) before or in connection with the issuance of the preferred equity interest.

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.

III. BACKGROUND

A. Section 704(b)

The 2010 Report on "target allocations" did not discuss either the definition of "guaranteed payments" under Section 707(c) or when the interaction of a partnership's distribution provisions and allocation provisions might result in a distribution (or a right to a distribution) being treated as a guaranteed payment. Furthermore, the 2010 Report did not discuss the extent to which the 704(b) Regulations implicitly support or contradict such a characterization.[11]

The 2010 Report did, however, set out in detail the treatment of targeted allocations under the 704(b) Regulations, and focused on whether those allocations have "economic effect" under the "economic effect equivalence" test set forth in Treas. Reg. § 1.704-1(b)(2)(ii)(i) ("**EEE**") or are in accordance with PIP.[12] We will not repeat that analysis here, and rely in large

[11] *See* 2010 Report, n. 4.

[12] Under Treas. Reg. § 1.704-1(b)(3), PIP is generally determined by the manner in which the partners have agreed to share the economic benefit or burden corresponding to the income, gain, loss, deduction or credit (or item thereof) being allocated. This sharing arrangement may or may not correspond to the overall economic arrangement of the partners. In determining PIP, all facts and circumstances related to the economic arrangement of the partners are taken into account, including (i) the partners' contributions to the partnership, (ii) the interest of the partners in economic profits and losses (if different from that in taxable income or loss), (iii) the interest of the partners in cash flow and other non-liquidating distributions, and (iv) the rights of the partners to distributions of capital upon liquidation. *See* Treas. Reg. § 1.704-1(b)(3)(ii).

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part on the 2010 Report's explanations. For purposes of this report, we take it as a given that targeted allocations, if written in the typical manner, including providing for the allocation of gross items, are, at a minimum, in accordance with PIP.

B. Guaranteed Payments

Section 707(c) and Treas. Reg. § 1.707-1(c) provide that payments made by a partnership to a partner for services or use of capital are considered as made to a person who is not a partner, to the extent these payments are determined without regard to the income of the partnership.

Congress enacted Section 707(c) as part of the Internal Revenue Code of 1954 (the "**1954 Code**"),[13] primarily to eliminate the complexity that arose under prior law when compensatory payments to partners exceeded the net income of the partnership. Before the enactment of Section 707(c), courts often applied an "aggregate" theory of partnerships when analyzing the U.S. federal income tax treatment of purported "salary" payments to a partner, reasoning that a partner could not be an employee of the partnership because he could not be an employee of himself. Consequently, payments to a partner who performed services for the partnership were considered as part of the partner's distributive share. As long as partnership earnings were in excess of the partners' "salaries," this treatment did not generally present any difficulties. However, when partnership earnings were less than the partners' salaries, complex tax accounting was often required.[14] When this situation arose, 100 percent of the partnership's earnings would be allocated to the partners receiving a salary, generally in proportion to their salaries. The excess of the stated salary amount over the allocated earnings would be considered a return of partnership capital, and, to the extent it was chargeable against the recipient partner's own capital account, would be nontaxable. Finally, to the extent that other partners' capital accounts were charged in respect of

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Under the test for EEE, allocations made to a partner that do not otherwise have economic effect under Treas. Reg. § 1.704-1(b)(2)(ii) will nevertheless be deemed to have economic effect, provided that as of the end of each partnership taxable year, a liquidation of the partnership at the end of that year or at the end of any future year would produce the same economic results to the partners as would occur if the three requirements of the primary test for economic effect had been satisfied, regardless of the economic performance of the partnership. Treas. Reg. § 1.704-1(b)(2)(ii)(*i*). Very generally, the three requirements of the primary test for economic effect are that the partnership maintain capital accounts in accordance with the rules set forth in the 704(b) Regulations, liquidate in accordance with capital account balances, and provide for a "deficit restoration obligation," which generally means partners with deficit capital accounts balances must be obligated to restore such deficits on liquidation. Treas. Reg. § 1.704-1(b)(2)(ii)(*b*).

13 Pub. L. No. 83-591, 68A Stat. 3.

14 *See, e.g.*, Lloyd v. Comm'r, 15 B.T.A. 82 (1929).

the salary paid to the partner receiving a salary, the partner receiving the salary would recognize ordinary income and the other partners would generally be entitled to a deduction. These determinations became significantly more complex as the number of partners in a partnership in-increased.

To eliminate the need for these complex calculations, the House of Representatives proposed the addition of Section 707(c) to the 1954 Code. The House Committee Report accompanying the initial bill stated:

> The payment of a salary by the partnership to a partner for services…raises the problem as to whether the partnership is to be viewed as an entity or merely as an aggregate of the activities of the members. Under present law, fixed payments to a partner are not recognized as a salary but considered as a distributive share of partnership earnings. This creates obvious difficulties where the partnership earnings are insufficient to meet the salary. The existing approach has been to treat the fixed salary in such years as a withdrawal of capital, taxable to the extent that the withdrawal is made from the capital of other partners. Such treatment is unrealistic and unnecessarily complicated. The bill provides that 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.[15]

The Joint Committee on Taxation's Summary of the 1954 Code stated:

> The 1954 Code provides that payment of a fixed or guaranteed amount for services is to be treated as salary income to the recipient and allowed as a business deduction to the partnership. Where a minimum payment is guaranteed but the maximum depends on the net earnings of the partnership, it will be necessary to examine the intent of the partners in determining whether or not payments made under such an arrangement constitute a salary.[16]

In short, an important purpose of Section 707(c) was to eliminate the complexity that arose under prior law when compensatory payments to partners exceeded partnership income.

Neither the Code nor the Treasury Regulations elaborate on the proper interpretation of the term "income." For instance, it is not clear from the plain text of the statute whether "income" refers to gross income, net income, or both.

[15] H.R. Rep. No. 83-1337, at A-226 (1954). The Senate Report included a substantially identical discussion. S. Rep. No. 83-1662, at 387 (1954).

[16] STAFF OF THE JOINT COMM. ON TAX'N, 83d CONG., SUMMARY OF THE NEW PROVISIONS OF THE INTERNAL REVENUE CODE OF 1954, at 91 (1955).

In *Pratt v. Commissioner*,[17] the Tax Court concluded that the language "determined without regard to income" in Section 707(c) referred to payments or allocations determined without regard to either gross income or net income, based on a literal reading of the statute. There, the taxpayer was a general partner in two limited partnerships formed to build and operate shopping centers. The taxpayer and the other general partners agreed to provide management services to the partnerships, and in return they received a percentage of the gross rental income. It was stipulated that the fees were reasonable in amount and proper compensation for the services provided.

At issue in the case was whether the payments to the partners were governed by either Section 707(a) or 707(c). The general partners, including the taxpayer, were cash method taxpayers, while the partnerships were on the accrual method. The partnerships accrued and deducted the service fees annually but did not pay them to the partners. The taxpayer's position was that the payments were governed by Section 707(a), and consequently, matching of the timing of the income and deduction was not required.[18]

In the alternative, the taxpayer argued that if the Tax Court were to conclude that the payments were governed by Section 707(c) instead of Section 707(a), it would not alter the consequences (that is, matching the timing of the partner's income to the partnership's deduction still would not be required). The taxpayer based this alternative argument on an assertion that Treas. Reg. § 1.707-1(c)—which clearly requires the matching treatment he sought to avoid—was invalid.

The Tax Court upheld the validity of the regulation, in part because it was consistent with statements in the legislative history of the 1954 Act. In addition, the Tax Court held that the management fees were part of the general partners' distributive share of partnership income, and not payments described in Section 707(a) or 707(c). With regard to the applicability of Section 707(c), the Court stated:

> Section 707(c) refers to payments "determined without regard to the income." The parties make some argument as to whether payments based on "gross rentals" as provided in the partnership agreements should be considered as payments based on "income." In our view there is no merit to such a distinction. The amounts of the management fees are based on a fixed percentage of the partnership's gross rentals which in turn constitute partnership income. To us it follows that the payments are

17 64 T.C. 203 (1975), *aff'd in part, rev'd in part*, 550 F.2d 1023 (5th Cir. 1977).

18 The timing mismatch the taxpayer in *Pratt* sought to achieve was subsequently eliminated by a 1984 amendment to Section 267(a), which makes it clear that a partner's accounting method controls the timing of a partnership's deduction in respect of a Section 707(a) payment. *See* note 28 *infra*.

> not determined without regard to the income of the partnership as required by section 707(c) for a payment to a partner for services to be a "guaranteed payment."

On appeal, the Fifth Circuit did not consider the application of Section 707(c) to the fee for managerial services because, in light of Treas. Reg. § 1.707-1(c), the general partners' tax treatment would have been the same whether the fee was treated as a guaranteed payment or as part of the general partners' distributive share.[19]

The IRS did not acquiesce to the Tax Court's interpretation of Section 707(c) in *Pratt*. Four years after the disposition of the case, the IRS announced in Revenue Ruling 81-300 that it would not follow the Tax Court's holding.[20] Revenue Ruling 81-300 involves the same basic facts as *Pratt*, *i.e.*, the general partners in a real estate limited partnership formed to purchase, develop, and operate a shopping center are each entitled to a fee for managerial services equal to 5% of gross rental income, and collectively have a 10% interest in residual partnership income or losses. The management fee is to be paid in all events, and is a reasonable fee in view of the services to be provided. After summarizing the legislative history of the 1954 Act, the IRS stated that, while a fixed amount is the most obvious form of guaranteed payment, compensation determined by reference to gross income may be a guaranteed payment as well. The IRS continued by noting that the arrangement in issue is "not [an] unusual" means for compensating a manager of real property, and does not give the service provider a share in profits of the enterprise, but is designed to accurately measure the value of the services that are provided.

In view of the legislative purpose of Section 707(c) (*i.e.*, eliminating the need for unnecessarily complex calculations when compensatory payments to partners exceed partnership income), the Service concluded that a payment for services determined by reference to gross income will be a guaranteed payment if, on the basis of all the facts and circumstances, the payment is compensation rather than a share of partnership profits. Relevant facts for making the determination include the reasonableness of the payment for the services provided and whether the method used to determine the amount of the payment would have been used to compensate an unrelated party for the services.

The Deficit Reduction Act of 1984 (the "**1984 Act**")[21] amended Section 707(a) by adding Section 707(a)(2)(A), the Code section pursuant to which the Proposed Regulations were promulgated. Generally, Section 707(a)(2)(A) treats a transaction as occurring between the

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

[20] Rev. Rul. 81-300, 1981 2 C.B. 143. As discussed in more detail below, the IRS and the Treasury have obsoleted Revenue Ruling 81-300 in the Preamble.

[21] Pub. L. 98-369, § 73, 98 Stat. 494, 591.

partnership and one who is not a partner under Section 707(a) if: (1) a partner performs services for or transfers property to a partnership for which the partner receives a related indirect or direct allocation and distribution from the partnership and (2) the transaction is properly characterized as between the partnership and a partner acting in a non-partner capacity. The Senate Report accompanying the 1984 Act included the following statement, without elaboration:

> [T]he committee intends that the provision [Section 707(a)(2)(A)] will lead to the conclusions contained in Rev. Rul. 81-300,…and Rev. Rul. 81-301,…except that the transaction described in Rev. Rul. 81-300 would be treated as a transaction described in Section 707(a).[22]

The Preamble notes that the IRS and the Treasury are obsoleting Revenue Ruling 81-300 based on the legislative history of the 1984 Act, and requests comments on whether the ruling should be reissued with modified facts.

C. Treasury Regulation § 1.707-1(c)

The Treasury and the IRS issued regulations under Section 707(c) in 1956.[23] Treas. Reg. § 1.707-1(c) provides some additional gloss on the statutory provision. It notes that "a partner must include [a guaranteed payment] as ordinary income for his taxable year within or with which ends the partnership taxable year in which the partnership deducted such payments as paid or accrued under its method of accounting."[24] The regulations further provide that guaranteed

[22] S. Prt. No. 169 (Vol. 1), 98th Cong., 2d Sess. 227 (1984). Revenue Ruling 81-301, 1981-2 C.B. 144, is a companion ruling to Revenue Ruling 81-300, and provides an illustration of when activities rendered by a partner would be considered to be rendered in the capacity of a nonpartner for purposes of Section 707(a).

[23] T.D. 6175, 1956-1 C.B. 211. Treas. Reg. § 1.707-1(c) was revised by T.D. 7891, 1983-1 C.B. 117, to reflect the Tax Reform Act of 1976's amendment to Section 707(c) expressly requiring that, for the purposes of Section 162(a), a guaranteed payment is also subject to the provisions of Section 263. Prior to the amendment, some taxpayers argued (generally unsuccessfully) that the failure of Section 707(c) to reference Section 263 and statements in the 1954 Act's legislative history that a guaranteed payment is deductible by the partnership meant that the capitalization rules were inapplicable.

As discussed below, the Proposed Regulations would revise Treas. Reg. § 1.707-1(c).

[24] When Treas. Reg. § 1.707-1(c) was promulgated in 1956, there had not yet been enacted either the Code's "original issue discount" regime or Section 305(c), which require, respectively, that holders of certain debt instruments and holders of certain corporate stock include income as it accrues. These provisions were codified in 1969. *See* Tax Reform Act of 1969, P.L. 91-172, §§ 413(a), 421, 83 Stat. 604, 609, 614. Thus, it may well be that the drafters of Section 707(c), and the Treasury Regulations promulgated thereunder, were focused principally on accruing income and deductions with respect to services, rather than capital.

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payments do not constitute an interest in partnership profits for purposes of Sections 706(b)(3), 707(b), and 708(b), although for purposes of other Code provisions, "guaranteed payments are regarded as a partner's distributive share of ordinary income." For example, a partner who receives a guaranteed payment is not viewed as an employee of the partnership for purposes of "withholding of tax at source, deferred compensation plans, etc."

Treas. Reg. § 1.707-1(c) also includes four illustrative examples involving partners who are entitled to a guaranteed payment as well as a share of partnership profits. Pertinent here, Example 2 of the regulation states:

> Partner C in the CD partnership is to receive 30 percent of partnership income as determined before taking into account any guaranteed payments, but not less than $10,000. The income of the partnership is $60,000, and C is entitled to $18,000 (30 percent of $60,000) as his distributive share. No part of this amount is a guaranteed payment. However, if the partnership had income of $20,000 instead of $60,000, $6,000 (30 percent of $20,000) would be partner C's distributive share, and the remaining $4,000 payable to C would be a guaranteed payment.

Thus, Example 2 of Treas. Reg. § 1.707-1(c) adopts a "wait and see" approach to determine whether an arrangement gives rise to a guaranteed payment or allocation and distribution in arrangements that allocate a percentage of income to a partner, subject to a minimum. Guaranteed payment treatment applies only to the extent the minimum affects the amount paid to the partner.[25] It is arguably unclear if the same approach applies where a partner's entitlement is not described as a percentage of partnership income with a minimum guaranteed amount, particularly where the partner is entitled to both a preferred return on its invested capital (a "capital-based entitlement") and a percentage of residual profits. That is, for example, if a partner is entitled to an 8% per year capital-based entitlement plus 50% of the remaining partnership net profits, is it appropriate as a Federal income tax matter for the partnership agreement to provide that the 8%

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Further, requiring the matching of the deduction and the income does not answer the initial, definitional question of "is there a guaranteed payment?"

25 Example 2 of Prop. Treas. Reg. § 1.707-1(c) would change this result by providing that when a partnership agreement provides that a partner is to receive the greater of a percentage of the partnership's income and a fixed sum, the fixed sum is treated as a guaranteed payment even if the partner receives more than the fixed sum (*i.e.*, the percentage of income exceeds the fixed sum). In our 2015 Report on the Proposed Regulations, *supra* note 3, we recommended that the IRS and the Treasury consider whether the scope of revised Example 2 should be limited to payments for services (and exclude payments for the use of capital). Based on public comments by IRS personnel, it seems that this limitation is likely to be adopted in the final Regulations.

capital-based entitlement is not a guaranteed payment but instead is to be covered by gross income to the extent of available gross income?[26] Absent guidance to the contrary, we think that such an approach is appropriate and Example 2 of Treas. Reg. § 1.707-1(c) does extend to such a situation.

Put another way, 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? Many practitioners draft partnership agreements based on the conclusion that the answer to this question is yes, at least where the partner is also participating in residual partnership profits. As we discuss below, the approaches the Regulations have taken to deal with non-compensatory options and the forfeiture of compensatory options support that conclusion.[27]

D. Tax Accounting Principles Applicable to Guaranteed Payments

Notwithstanding the use of the word "payment" in Section 707(c), it seems quite clear that, unless and to the extent required under the economic performance rules, an actual payment is not necessary for a guaranteed payment deduction to be taken into account by an accrual-basis partnership. As described above, Treas. Reg. § 1.707-1(c) provides that a partner must include a guaranteed payment as ordinary income in the partner's taxable year within or with which ends the partnership taxable year in which the partnership deducted the guaranteed payment as paid *or accrued* under the partnership's method of accounting.[28] This rule is consistent with language from the legislative history of the 1954 Code,[29] but importantly, it does not dictate, for an accrual-basis partnership, the year in which a guaranteed payment is deemed to accrue.

[26] Obviously, the character of, and hence potential income tax rate on, the income may be different depending on whether there is a gross income allocation or a guaranteed payment. Furthermore, on the deduction side, in some cases, the deduction will be subject to substantial or complete limitations on use. *See, e.g.*, Sections 67, 68, 263A, 469.

[27] Example 2 of Treas. Reg. § 1.707-1(c) can be read to similarly support the position that where items of income are sufficient, there is a preference to avoid guaranteed payment treatment.

[28] This matching principle was included in the final Treasury Regulations issued in 1956. *See* T.D. 6175, 1956 C.B. 211.

A different timing rule applies with regard to payments governed by Section 707(a). Under Section 267(a)(2) and 267(e), Section 707(a) payments are not deductible by the partnership until includible in income by the partner under the partner's method of accounting.

[29] *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 387 (1954) (stating that "It should be noted that [guaranteed payments], whether for services or for the use of capital, will be includible in the recipient's return for the taxable year in which the payment was made, or accrued, ends.").

For cash-basis partnerships that do not liquidate in accordance with positive capital account balances and do not permit interim partial redemptions or withdrawals of the partners' capital account balances, it is clear that a guaranteed payment is not taken into account[30] by the partnership (and hence not includible by the payee partner) until the guaranteed payment is made or constructively received.[31]

For accrual-basis taxpayers, however, the economic performance rules under Section 461(h), added to the Code in 1984,[32] and Treas. Reg. § 1.461-4, finalized in 1992,[33] make the situation more complex. A taxpayer (including a partnership) on the accrual method of accounting generally is not permitted to treat a liability as accrued until the "all-events test" is satisfied (*i.e.*, all events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy) and economic performance is deemed to have occurred. Different rules apply for determining the time when economic performance occurs with regard to different types of liabilities, and, in the case of a partnership's guaranteed payment to a partner for the use of capital, three distinct rules may apply.

Under Section 461(h)(2)(A)(iii) and Treas. Reg. § 1.461-4(d)(3)(i), economic performance with respect to a taxpayer's obligation to pay for the use of property occurs ratably over the period of use. Under Treas. Reg. § 1.461-4(e), economic performance with respect to interest expense occurs as the interest accrues. Finally, Treas. Reg. § 1.461-4(g)(7) sets forth a "catch-all" rule whereby economic performance occurs as the taxpayer makes payments in satisfaction of the liability. The catch-all rule applies to any liability not otherwise covered by an economic performance rule set forth in the Code or Treasury Regulations, or in any revenue ruling or revenue procedure.[34]

[30] Generally, guaranteed payments for the use of capital should be deductible under Section 162(a) or Section 212, unless a specific rule requires a different treatment. *See* Treas. Reg. § 1.707-1(c). For instance, under Treasury Regulations, guaranteed payments for the use of capital are treated as a substitute for interest for purposes of the avoided cost method of the uniform capitalization rules of Section 263A. *See* Treas. Reg. § 1.263A-9(c)(2)(iii).

[31] *See* Treas. Reg. § 1.461-1(a)(1).

[32] *See* Deficit Reduction Act of 1984, P.L. 98-369, § 91(a), 98 Stat. 494, 598–601.

[33] TD 8408 (April 9, 1992).

[34] Treas. Reg. § 1.461-4(g)(7) states that if a liability may properly be characterized as, for example, a liability arising from the provision of services or property to, or by, a taxpayer, the determination as to when economic performance occurs with respect to that liability is made under Treas. Reg. § 1.461-4(d), and not under the catch-all rule. In the preamble to the proposed Section 461(h) regulations, the IRS and the Treasury stated that it is anticipated that few liabilities will fall under the catch-all rule. *See* IA-258-84, 1990-2 C.B. 805, 807.

The economic performance rule for interest does not appear to govern guaranteed payments for the use of capital, because partnership equity is not "indebtedness" under general federal income tax principles. Accordingly, the preferred return on such equity is not "interest."[35] And, whether intentional or not, Treas. Reg. § 1.461-4(e) does not extend to income that is equivalent to interest, as some other provisions of Code or Treasury Regulations do.[36]

Furthermore, it is unclear whether a preferred return for the use of capital (*e.g.*, money) is captured by the economic performance rule for the taxpayer's obligation to pay for the use of property. There is no specific indication that the IRS and the Treasury intended for the rules in Treas. Reg. § 1.461-4(d) to cover payments for the use of money. All of the examples under that subsection refer to payments for the use of tangible property.[37] Nevertheless, the Code often uses the word "property" to include money,[38] and when the Code means to distinguish money from "property," it uses phrases such as "money or other property" or "property other than money."[39] In other instances, however, property is distinguished from cash.[40]

Accordingly, it is unclear whether payments for the use of cash that are not "interest" are governed by Treas. Reg. § 1.461-4(d) or under the catch-all provision of Treas. Reg. § 1.461-4(g). Given the purposes of Section 461(h), however, and the general understanding that ambiguity in a regulation or statute should be resolved by looking to the purposes of such statute or regulation, acknowledging that it may have been an oversight for Regulation Section 1.461-4(e) not to cover guaranteed payments for capital expressly, it would not be surprising for the IRS to interpret Treas. Reg. § 1.461-4(d) to apply in that case.

35 *See*, *e.g.*, Deputy v. du Pont, 308 U.S. 488 (1940). Nearly 50 years after Section 707(c) was enacted, the Joint Committee on Taxation, in describing the consequences of repealing Section 707(c), stated that certain payments formerly treated as guaranteed payments would be treated as interest on debt because "[t]he 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 the partner, *conceptually resembles* interest on debt." STAFF OF JOINT COMM. ON TAX'N, 107TH CONG., 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, at 294 (Comm. Print 2001) (Emphasis added).

36 *See, e.g.,* Section 954(c)(1)(E); Treas. Reg. § 861-9T(b); Treas. Reg. § 1.954-2(a)(1)(v).

37 It may well be that the regulation drafters intended for time value payments for the use of money to be covered by subsection (e)'s reference to "interest," but simply overlooked guaranteed payments for the use of capital.

38 *See*, *e.g*., Section 304(a); Treas. Reg. § 1.304-2, Examples 1–3; Section 1034.

39 *See, e.g.*, Sections 362, 732, 1001.

40 *See*, *e.g*., Section 351(b).

Indeed, it seems anomalous in the context of "economic performance" for a guaranteed payment for non-cash property to be subject to different rules than a guaranteed payment for cash. We can discern no clear purpose for such a result and it would produce unexpected and, we think, clearly unintended distinctions. We also note that Treas. Reg. § 1.461-4(g) expressly has a limited scope, applying only where no other rule applies.[41] This further suggests that Treas. Reg. § 1.461-4(d) could well be interpreted to cover guaranteed payments for capital—including cash—but perhaps the IRS and the Treasury have a different view.

In any event, given the grant of authority provided by Congress to the Treasury to prescribe regulations under Section 461(h)(2), we encourage the IRS and the Treasury to issue guidance providing either (i) that the rule in Treas. Reg. § 1.461-4(e) governing interest also applies to payments that are similar to interest, including amounts properly treated as a guaranteed payment for the use of capital; (ii) that these payments are governed by the rules of Treas. Reg. § 1.461-4(d) with respect to payments for the use of property; or (iii) that the catch-all rule of Treas. Reg. § 1.461-4(g) applies.[42]

Whatever economic performance rule is applicable to guaranteed payments for the use of capital, we believe that tax accounting principles apply only to questions of *timing* of inclusion and deduction in respect of a payment or liability that has independently been determined to be a guaranteed payment under subchapter K; tax accounting principles should not drive the determination of whether or not a guaranteed payment is appropriate in a particular situation in the first instance.

E. Treatment of Certain "Capital Shifts" in Connection with Exercise of Noncompensatory Options and Forfeitures of Compensatory Partnership Interests

In a variety of subchapter K contexts, the IRS and the Treasury have issued guidance confirming that a capital shift is not itself an immediately taxable event, under Section 707(c) or otherwise.

The exercise of a noncompensatory partnership option can result in a capital shift among the partners. Treasury Regulations finalized in 2013[43] addressing the treatment of noncompensatory partnership options ("**NCOs**") provide that any capital shift by the historic partners in favor of the optionee that occurs in connection with the exercise of a noncompensatory partnership in-

[41] *See* note 34 *supra*.

[42] We note that the all-events must also be satisfied and that, in the case of some payments, particularly those to which Section 707(c) is made applicable by Section 736(a)(2), that will not be the case.

[43] T.D. 9612, 78 Fed. Reg. 7997 (Feb. 5, 2013).

terest is not itself a taxable event. In general, the holder of an NCO is not treated as a partner unless and until the exercise of the NCO. Upon exercise of the NCO, the optionee's initial capital account balance is equal to the consideration paid to the partnership to acquire the NCO and the fair market value of any property (other than the option) contributed to the partnership.[44] The partnership is required to revalue (*i.e.*, "book-up" or "book-down") its property immediately following the exercise of the NCO, and to allocate unrealized gain or loss, as applicable, first, to the optionee, to the extent necessary to reflect the optionee's right to share in partnership capital under the partnership agreement, and, then, to the historic partners, to reflect the manner in which the unrealized income, gain, loss, or deduction in partnership property would be allocated among those partners if there were a taxable disposition of that property for its fair market value on that date.[45] To the extent that unrealized appreciation or depreciation in the partnership's assets has been allocated to the capital account of the holder of the NCO, the holder will, under Section 704(c) principles, recognize any income or loss attributable to that appreciation or depreciation as the underlying assets are sold, depreciated, or amortized.

If, after the allocations of unrealized gain and loss items to an exercising option holder, the exercising option holder's capital account still does not reflect his right to share in partnership capital under the partnership agreement, the partnership must reallocate capital between the existing partners and the exercising option holder (a "capital account reallocation").[46] In the event of such a shift, the partnership is required, in the year of exercise and, if necessary, in subsequent years, to make "corrective allocations" of tax items that differ from the allocation of the corresponding book items until the reallocation is fully taken into account.[47] Thus, a capital shift in connection with the exercise of an NCO is given tax effect, often over multiple years, through allocations of partnership items of income or loss (for income tax purposes only) and not through the means of a guaranteed payment or otherwise in some taxable event.

Capital shifts can also occur where a service provider who is granted an unvested partnership interest in connection with the performance of services ultimately forfeits that interest. This situation is addressed by Proposed Treasury Regulations issued in 2005 (the "**2005 Proposed Regulations**") relating to the tax treatment of certain transfers of partnership interests in connec-

[44] *See* Treas. Reg. § 1.704-1(b)(iv)(*d*)(4).

[45] These requirements must be satisfied for capital accounts to be considered to be determined and maintained in accordance with Treas. Reg. § 1.704-1(b)(2)(iv). Treas. Reg. § 1.704-1(b)(2)(iv)(*s*).

[46] *See* Treas. Reg. § 1.704-1(b)(2)(iv)(*s*)(3).

[47] *See* Treas. Reg. § 1.704-1(b)(4)(x).

tion with the performance of services.[48] Under the 2005 Proposed Regulations, Section 83 applies to a transfer of a partnership interest in connection with the performance of services. If a Section 83(b) election is made with respect to such an interest, the service provider will be treated as a partner for income tax purposes. Accordingly, the holder of the nonvested interest may be allocated partnership items that may later be forfeited. When such a forfeiture occurs, capital must be shifted from the forfeiting partner back to the remaining partners. However, the 2005 Proposed Regulations do not treat such a capital shift as a taxable event. Instead, the rules mandate "forfeiture allocations" which, very generally, are allocations to the service provider of partnership gross income and gain or gross deduction and loss (to the extent those items are available) that offset prior distributions and allocations of partnership items with respect to the forfeited partnership interest.[49] As with the hypothetical shifts that arise in connection with partnership preferred equity discussed below, this type of capital shift would not be necessary if not for the annual accounting principle. As we discuss below, we think the approach of the 2013 Regulations relating to NCOs and the 2005 Proposed Regulations argue in favor of the view that the mere accretion of preferred partnership return should also not be viewed as an immediate recognition event, at least in certain cases.

IV. Treatment of Partners with Preferred Returns

As an initial matter, we note that a preferred return should never give rise to a guaranteed payment 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 generates cumulative net earnings during the period that the interest is outstanding.[50] (*See* Examples 4–6, below.) We believe this is true even if, as a result of the Section 704(b) allocation rules, the partnership allocates income away from the holder of an interest with a preferred return in one taxable year but then "shifts" the right to that income back to the holder in a subsequent taxable year in light of the continued accrual of the preferred return, since the shift would never have arisen if the partnership had not generated the income being shifted back.

Second, we do not believe that a guaranteed payment should arise solely because the target capital account of a partner at the end of a taxable year differs from the partner's Section

[48] *See* Notice of Proposed Rulemaking, *Partnership Equity for Services*, REG-105346-03, 70 Fed. Reg. 29675 (May 24, 2005).

[49] *See* Prop. Treas. Reg. §§ 1.704-1(b)(4)(xii)(*b*)(*1*), (b)(4)(xii)(*c*) (2005).

[50] It should be noted that "income" for this purpose should exclude any built-in gain allocated to other partners under Treas. Reg. § 1.704-1(b)(2)(iv)(*f*) prior to or in connection with the issuance of the preferred equity interest.

704(b) capital account at the end of the taxable year. The capital account rules of the 704(b) Regulations (including the presumption in the "substantiality" rules that the fair market value of partnership assets is equal to their book values[51]) and target capital accounts are useful tools in allocating partnership income and loss. However, except where there is a contemporaneous re-valuation of a partnership's assets, these tools are not designed to cause the capital account of a partner to equal the actual fair market value (or the actual liquidation value) of the partner's interest. Similarly, the target capital account used in a targeted allocation approach equals the amount of cash a partner would receive upon a partnership liquidation if the partnership sold its assets for their book values, not their fair market values. As a result, the difference (if any) between a partner's actual capital account (after all allocations have been made) and the partner's target capital account does not measure or approximate (and in many cases is not even correlated with) the unaccounted for change in value of the partner's interest in the partnership or what the partner (or another partner) would receive if the partnership sold its assets at fair market value and liquidated. Finally, it bears noting that differences in these amounts are not limited to partnership arrangements in which there is a preferred return but can also arise in any partnership in which there is a contingent distribution right of some sort. Accordingly, many of us believe that the existence of a difference between a partner's target capital account and the partner's actual capital account is not an independent basis for the creation of a deemed guaranteed payment.

Whether a guaranteed payment exists and, if so, the timing of its accrual, is a more difficult question in cases where a partner is entitled to a preferred return for the use of capital without regard to the income of the partnership and, as of the end of a given taxable year, the accrued preferred return exceeds the income of the partnership. In a sense, the answer to this question reflects a tension between the realization doctrine and the annual accounting doctrine. Whether a potential guaranteed payment should be deemed to arise in this context depends somewhat on how one views that tension in the case of partnership equity. First, such a preferred return could be seen as akin to a debt instrument with original issue discount, and as such, requiring the partner to recognize income "outside" of the partnership would be appropriate.[52] Such a view, however, seems contrary to the fundamental distinction between debt and equity. In the case of debt, the creditor has, by definition, a strong expectation of payment without regard to the success of the debtor's business or assets.[53] By contrast, depending on the particular facts, (i)

[51] *See* Treas. Reg. § 1.704-1(b)(2)(iii)(*c*)(*2*).

[52] This debt treatment analogy seems particularly inapt where the holder of the preferred will receive more than its capital back only if and to the extent that the partnership generates income after its issuance.

[53] *See, e.g.*, Gilbert v. Comm'r, 248 F.2d 399, 406 (2d Cir. 1957) ("Congress evidently meant the significant factor to be whether the funds were advanced with reasonable expectations of repayment regardless of the

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the partnership interest entitled to the preferred return may represent a substantial portion (or even substantially all) of the equity in the partnership and (ii) the equity capital of the other partners may represent only a small fraction of the potential preferred return (with the remaining portion payable only if and to the extent that the partnership generates income). Moreover, the partner's preferred return is expected to be paid out of partnership income—it *may* be paid out of the other partners' capital, but only if (i) there is insufficient income and (ii) losses or more senior claims do not eliminate that capital first.

One might argue that a potential guaranteed payment should be treated as having accrued to the extent that the partner's target capital account at the end of the year exceeds the partner's Section 704(b) capital account at the end of the year (after allocating the partnership's items of income and loss for the year). Although nothing under PIP would require (or prohibit) doing so, EEE is satisfied by the partnership not merely making allocations that cause the partners' respective capital accounts to be *as close as possible* to the amounts they would receive under the hypothetical liquidation, but by making the capital account balances actually equal those amounts. In a case where a partner's legal entitlement *may* represent an "invasion" of other partners' capital in the event partnership income is ultimately insufficient to cover the entitlement, one way to make the capital accounts "square" at the end of each year, if there are insufficient items of income or deduction, is to deem a guaranteed payment to the partner.[54] However, as noted above, the target capital account of a partner is a tool used in allocating partnership income and loss, and is not designed or intended to reflect the value of a partner's interest in the partnership or the amount the partner would receive if the partnership sold its assets for their fair market value. As a result, it seems inappropriate to look to target capital accounts in determining whether to accrue a potential guaranteed payment.

Admittedly the tax system's reliance on an annual accounting system supports the view that there should be annual determination of whether a potential guaranteed payment will be treated as such rather than as a Section 704(b) allocation of income. However, this view is at odds with the tax system's general reliance on, and adherence to, the realization doctrine.[55] And

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success of the venture or were placed at the risk of the business…."); *see also* Nassau Lens Co. v. Comm'r, 308 F.2d 39, 47 (2d Cir. 1962) (Marshall, J.).

54 Another way would be to simply "shift" capital from the burdened partner(s) to the benefited one(s). However, this merely leads to the question of what should be the income tax result of such a shift.

55 *See, e.g.*, Eisner v. Macomber 252 U.S. 189 (1920); *cf*. Helvering v. Bruun, 369 U.S. 461 (1940) (landlord realized income when it repossessed leased property that tenant has built or improved in excess of the value of the original property).

where Congress has wanted to override the results of the realization doctrine, it has been specific about it.[56] Although there are arguments on both sides, ultimately it seems to us reasonable to interpret Section 707(c) as not reflecting any such intent on Congress' part. Going further to require deemed guaranteed payments and deemed contributions to make the capital accounts actually equal the payments that would be made if the partnership were liquidated on the hypothetical basis using a year-end snapshot may be contrary to the principles behind Example 2 of Treas. Reg. § 1.707-1(c) and the general bias of the realization doctrine.

One can also question the conclusion that a guaranteed payment arises simply because the preference accretes economically, especially as the "shiftee" has no separate property right that it can dispose of, and question whether the traditional "all events" test has been met or even if it is the appropriate lens through which to look at partnership equity entitlements.[57]

To make sense of this tension, we think it is essential to understand that in the situations posed by the Preamble and others where this question arises, the partners' capital account balances are essentially without economic significance: no partner is entitled to redeem or withdraw all or a portion of its capital account balance. The economic sharing arrangement of the partners depends on the operating and liquidating distribution waterfalls, not the positive capital account balances of the partners.[58] Hence, it is not clear that there should be a recognition event as the result of a disparity between a partner's capital account and its target capital account. Nor is it clear that a book entry by the partnership to true up the capital account balance and eliminate such a disparity should impact the tax consequences to the relevant partner.

These facts seem to us to argue conclusively that the so-called shift is not a separate property right and in fact is nothing more than a future expectation. Given that a preferred return arises in the context of an equity investment, one might well think that the applicable rules

[56] *See, e.g.,* Section 305(b) (treating certain stock distributions as distributions of property subject to Section 301); Section 305(c) (treating certain transactions as constructive stock distributions subject to Section 305(b)); Section 475 (imposing mark-to-market rules for securities dealers); Section 1259 (requiring gain recognition in respect of constructive sales of appreciated financial positions); Section 1272 (requiring accrual of original issue discount).

[57] *See* note 24 *supra*.

[58] It is worth noting that for such partnerships, it does not matter whether the partnership agreement provides for traditional "layer-cake" allocations or targeted allocations. The fundamental question is the same: how, if at all, to deal with a potential increase in economic entitlement in a given year that exceeds available items of income and deduction.

should be more like the rules for dividends and not interest on debt;[59] this makes the preferred entitlement more akin to an unfunded promise to pay, which has long been understood not to generate current taxable income for cash-basis taxpayers.[60] Furthermore, Example 2 of Treas. Reg. § 1.707-1(c) and the approach of the 2013 Regulations relating to NCOs and the 2005 Proposed Regulations with respect to forfeitures of compensatory partnership options indicate a policy preference to avoid creating immediate phantom income events and instead look to future allocations of income and expense items to align the partners' economic entitlements with their annual income tax profile.

On the other hand, Treas. Reg. § 1.707-1(c) does require answering the question of whether an entitlement to payment for services or capital, to the extent determined without regard to the income of the partnership, has "accrued." If it has, then the absence of a current right to payment seems not to prevent guaranteed payment treatment, to the extent the amount of the entitlement exceeds available net income (or gross items thereof).

Looking at the above (albeit not entirely dispositive) authorities and the statutory language, we conclude that the following principles should be used to resolve these questions:

(1) To the extent a partner is getting back its own capital or the earnings on its own capital, guaranteed payment treatment is inappropriate.

(2) A circumstance where a particular year's allocation turns out to be economically incorrect in light of events in subsequent years (*e.g.*, an allocation of income in respect of a carried-interest in an early year gets reversed in a later year because cumulatively there was not enough profit to support the entitlement to the allocation) and as a result capital must be shifted to match the preferred return entitlement should not result in a guaranteed payment. This principle is consistent with 2013 Regulations relating to NCOs and the 2005 Proposed Regulations with respect to forfeitures of compensatory partnership options.

(3) In general, except where Congress has expressly provided otherwise, the realization doctrine should be the guiding principle and creating phantom income should be disfavored.

[59] *See* Treas. Reg. § 1.301-1(b); Comm'r v. American Light & Traction, 156 F.2d 398 (7th Cir. 1946)*;* Rev. Rul. 78-117, 1978-1 C.B. 214.

[60] *See, e.g.*, Treas. Reg. § 1.83-3(e) (excluding from the definition of property "an unfunded and unsecured promise to pay money or property in the future").

Accordingly, we can summarize the paths of analysis, and the choices for guidance to make, as follows:

Where the parties' economic arrangement provides a preferred return that is dependent (in whole or part) on and limited to the partnership having sufficient income, it seems clear that there is no guaranteed payment as the preferred return accrues. Instead, the economic accrual of preferred return for a partnership year should be matched, to the extent possible, by allocations of income in the year of economic accrual (either net income or gross income, if net income is insufficient and allocating gross income results in the preferred partner's capital account being equal (or closer) to its target capital account) and treated as distributive share rather than a guaranteed payment.

On the other hand, where the parties' economic arrangement provides for a preferred return that is not dependent on or limited to the partnership having sufficient income, there are alternative views regarding how to treat the accruing preferred return, as follows:

(1) the economic accruals of preferred return are guaranteed payments as of the time of accrual ("**Approach 1**").[61] In that case, inclusion and deduction of the accruals may (or may not) be delayed under the economic performance rules of Section 461; or

(2) the economic accrual of preferred return for a partnership year is to be matched, to the extent possible, by allocations of income in the year of economic accrual (either net income or gross income, if net income is insufficient and allocating gross income results in the preferred partner's capital account being equal (or closer) to its target capital account) and treated as distributive share rather than a guaranteed payment (a result based on the concept of Example 2 of Treas. Reg. § 1.707-1(c) and conceptualizing guaranteed payments as more like dividends than interest on indebtedness) ("**Approach 2**"). Then either:

   (a) any excess of accrued preferred return over gross income in the year of accrual is treated as a guaranteed payment (in line with (1), above) in the year of the accrual (but, perhaps, only to the extent that the target capital account of the partner exceeds the Section 704(b) capital account of the partner) ("**Approach 2A**"); or

[61] As discussed above, the statutory language of and policy considerations animating Section 707(c) do not seem to support Approach 1 generally, other than in circumstances where the preferred return is required to be paid annually (or perhaps within some other fixed period of sufficiently short duration after issuance). *See* Example 2, *infra*.

(b) any excess is covered by income allocations in future years, except that if the return is actually paid before full coverage occurs, the uncovered portion of the payment is treated as a guaranteed payment at the time of payment ("Approach 2B"). In this case, special rules would be needed to determine what constitutes payment of uncovered preferred return (as opposed to previously covered return on preferred capital).

A. Unconditional Preferred Returns

The following three examples illustrate the principles and alternatives discussed above in the context of a partnership with a preferred return that is *not* limited to annual or cumulative partnership income. In each of the examples that follow, the partnership in question is on the accrual method.

Example 1. Unconditional Preferred Return that is not Required to be Paid Annually.

Assume Investor and Owner form Partnership PRS, a calendar year, accrual method partnership. Investor contributes $100 to PRS in exchange for an interest with a preferred return (a "preferred interest"). Owner contributes Property with a fair market value of $100 to PRS in exchange for a common interest. The PRS partnership agreement provides that distributions are to be made to Investor first until Investor receives its money back plus an annual simple, cumulative preferred return of 10%,[62] then to Owner, until Owner receives a sum equal to the fair market value of Property at the time of PRS's formation ($100), and thereafter 50/50 to Investor and Owner. Investor's preference accrues without regard to whether or not PRS has income. Any unpaid accrued preference is payable upon liquidation of PRS or, if earlier, the redemption of the preferred interest.

The PRS partnership agreement further provides for targeted allocations using only net income and loss (and not gross items thereof).

[62] The preferred partnership interests in the examples in this Report provide for a simple return rather than a compounding return. This is in the interest of computational simplicity, and does not affect our analysis or conclusions.

The partners' initial capital accounts and the PRS balance sheet are as follows:

	Capital Accounts		**PRS Balance Sheet**	
	Investor	**Owner**	Assets	
Initial Balance	100	100	Property	100
			Cash	100
			Total	**200**

In Year 1, PRS earns $30 of ordinary income and accrues $10 of deductible expenses. PRS distributes $10 to Investor at the beginning of Year 2 in respect of Investor's preferred return for Year 1. In a hypothetical liquidation at book value at the end of Year 1, Investor would be entitled to the first $110 of proceeds, Owner would be entitled to the next $100, and the remaining $10 balance would be shared equally.

It is clear that Investor will have $10 of income in respect of the preferred return in Year 1. Because Investor's right to receive the coupon (or, more precisely, at least $10 of the coupon) is not dependent on income and is therefore potentially a guaranteed payment, Approach 1 would (i) provide Investor with a $10 guaranteed payment, (ii) reduce the partnership's net income by a $10 corresponding deduction and (iii) allocate the $10 net income equally to Investor and Owner.[63] By contrast, Approach 2 would allocate Investor the first $10 of net income and allocate the remaining $10 of net income equal to Investor and Owner. We do not believe following Approach 1 is appropriate in this situation. Accordingly, PRS income should be allocated as follows:[64]

63 This approach effectively allocates 50% of the guaranteed payment deduction to Investor. Although this is consistent with the examples in Treasury Regulation § 1.707-1(c), it is not entirely consistent with our recommendation that guaranteed payment treatment is not appropriate where recipient is getting back its own capital. A more precise allocation would allocate the $10 guaranteed payment deduction to Owner and then allocate the remaining $20 of net income $5 to Investor and $15 to Owner to cause their capital account balances to match their target capital accounts.

64 There are different methods that could be used to allocate in this situation. Under one approach, Investor would first be allocated a priority allocation of $10 of gross income, and then Investor and Owner would each be allocated $5 of the remaining $10 of net partnership income (comprising, in each case, $10 of gross income and ($5) of gross deduction). Alternatively, Investor would first be allocated $10 of the partnership's $20 of net income, and then Owner and Investor would each be allocated $5 of the remaining $10 of net income. Under the first alternative, Investor is allocated $20 of gross income and ($5) of gross deduction, whereas under the second alternative Investor is allocated $22.50 of gross income and ($7.50) of gross deduction. Different approaches might bear on the issue of "substantiality," which could be rele-

(cont'd)

	Capital Accounts			Distribution Waterfall	
	Investor	**Owner**		**Investor**	**Owner**
Initial Balance	100	100	Capital	100	100
Year 1 Preferred Return	10	-	Total Preferred Return	10	-
Year 1 Remaining Profit	5	5	Remaining Proceeds	5	5
	$115	**105**		**115**	**105**

In Year 2, PRS earns $10 of ordinary income and accrues $10 of deductible expenses. As PRS has no net income in Year 2, PRS does not distribute any amount to Investor in respect of the preferred return. Nevertheless, Investor's 10% preference for Year 2 accrues, because the entitlement arises without regard to whether or not PRS has income. Thus, the amounts distributable to Investor and Owner in a hypothetical liquidation (and hence their target capital accounts) are $110 and $100 respectively. Under either Approach 1 or Approach 2, Investor should have $10 of income in respect of the preferred return in Year 2. Approach 1 would provide Investor with a $10 guaranteed payment and allocate the corresponding $10 deduction equally to Investor and Owner.[65] Under Approach 2, even though PRS has no net income or loss to allocate, regardless of what the partnership agreement provides, gross items of income and expense should be allocated so as to cause the partners' capital account balances to equal their target capital accounts.[66]

Example 2. Preferred Return Required to be Paid Annually.

Assume the same facts as in Example 1, except that under the partnership agreement, PRS is required to pay Investor its 10% preferred return annually. In this case, because Investor has an enforceable right to receive a payment each year that quite clearly is determined without regard to PRS's income, the payment or accrual of the preferred return should give rise to a guaranteed payment. Here, particularly because of the annual nature of the entitlement, it is not appropriate to allow for the possibility of Investor "earning its way out of" potential guaranteed payment treatment as contemplated by Treas. Reg. § 1.707-1(c), Example 2.

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vant under the substantial economic effect safe harbor of Treas. Reg. § 1.704-1(b)(2)(ii) (but not under PIP), but this should not be relevant in analyzing whether the allocations have economic effect.

65 This assumes that PRS can take a deduction under the all-events test. If PRS cannot take a deduction until the coupon is paid, Investor would not have an income inclusion until that time.

66 As described in note 64 *supra*, there are alternative approaches to allocating gross items to accomplish the appropriate net result.

Example 3. Preferred Return in a Dry Partnership.

Some partnerships do not realize any items of income or loss in many taxable years (we refer to such a partnership in such a year as a "dry" partnership). For example, suppose that PRS is formed to acquire and hold the stock of a C corporation ("Subsidiary"), and the managers of the business ("Management") contribute (in aggregate) $200 to PRS in exchange for common interests, while a financial sponsor ("Sponsor") contributes $1,000 in exchange for a preferred interest.

Under the partnership agreement, distributions are required to be made first to Sponsor, until it receives its money back, plus an annual simple preferred return of 10%, then to Management until Management receives its money back, and thereafter Sponsor and Management will split the profits 50/50.

PRS uses the $1,200 to purchase 100% of the stock of Subsidiary and as growth capital for Subsidiary's business. It is not anticipated that Subsidiary will pay any dividends. Thus, PRS will realize a profit, if at all, upon a sale or other disposition of Subsidiary.

Quite clearly, the expectation (of Management, at least) is that Sponsor's preference will be satisfied from partnership profits. Consistent with one hallmark that distinguishes debt from equity is the lender's expectation that borrower can repay the debt without the borrower's business growing,[67] this expectation is more evident in the partnership preferred setting than in a creditor-debtor situation.

At the end of Year 1, if PRS were to liquidate at book value, Sponsor would be entitled to $1,100 and Management would be entitled to $100. At the end of Year 2, if PRS were to liquidate at book value, Sponsor would be entitled to $1,200 and Management would not be entitled to anything.

As discussed above, it is not clear whether these circumstances result, or under future guidance should result, in guaranteed payment treatment at the end of Years 1 and 2. Under Approach 2A, based on the strictures of the annual accounting period concept and the "all-events test," there would be a guaranteed payment when and to the extent that Sponsor becomes entitled to a preferred return that is in excess of Sponsor's distributive share of partnership income in respect of the relevant tax year. The question then becomes when the guaranteed payments are taken into account. As an accrual method partnership, the timing of when PRS takes the guaranteed payment into account depends upon which of the economic performance rules governs.

[67] *See* note 53 *supra*.

In the case at hand, under this view, PRS would take the $100 guaranteed payments into account in each of Years 1 and 2 (under the rule for use-of-property[68] or for interest[69]), unless the "catch-all" rule[70] applies, in which case PRS would not take the guaranteed payments into account unless and until payment is made.[71]

Any deduction should be specially allocated to Management, so that Management's capital account matches its target capital account at the end of each year (*i.e.*, $100 and $0 in Year 1 and Year 2, respectively). Under Treas. Reg. § 1.707-1(c), Sponsor is required to include the guaranteed payments in income in its taxable year within or with which ends the PRS taxable year in which PRS takes the guaranteed payments into account.[72]

Some practitioners argue that whether PRS is anticipated to continue as a dry partnership may also be relevant in determining the applicability of Approach 2A or Approach 2B. They view a partnership that is not expected to continue as a dry partnership as a less compelling case for imposing guaranteed payment treatment, because it is relatively likely that gross items of income will be available in future periods to allocate to the partner holding a preferred interest, and the likelihood of the preferred return eating into the common capital may be remote. On the other hand, some practitioners believe that deferral (non-guaranteed payment treatment) is justified even in the dry case, because the expectation is that the partnership will only recognize sufficient income or gain upon the disposition of its assets to fund the preference and until that disposition it is unclear whether Management's capital will be used to fund Sponsor's preference. Ultimately, we do not think that the parties' expectations in this case are helpful in determining whether a guaranteed payment should be required.

Although Approach 2A is compelling, there are also strong countervailing arguments that lead to the conclusion that on these facts, there should be no guaranteed payment in Year 1 or Year 2, and many of us believe Approach 2B should be followed instead. If, as noted above, one should think of preferred returns more like dividends, and Treas. Reg. § 1.701-1(c) Example 2 is

[68] *See* Section 461(h)(2)(A)(iii) and Treas. Reg. § 1.461-4(d)(3)(i).

[69] *See* Treas. Reg. § 1.461-4(e).

[70] *See* Treas. Reg. § 1.461-4(g)(7).

[71] If PRS were instead a cash method partnership, then it generally would not take the guaranteed payment into account unless and until the preference is paid.

[72] Notably, even if there is a guaranteed payment in respect of Years 1 and 2 of the dry partnership on the facts of this Example 3, there should not be one in respect of Year 3. As of the end of Year 2, Management's $200 of capital has shifted to Sponsor in its entirety; consequently, any additional preferred return that inures to Sponsor cannot be funded from Management's capital; it will be paid, if at all, out of PRS's profits.

meant to permit partners to "earn their way out of" potential guaranteed payment treatment to the extent possible, it is anomalous to generate an item of deduction for the partnership (and income for a partner) when the partnership may ultimately have sufficient income (or deductions) to cover the partner's entitlement. Doing so tilts the scales overly in favor of the annual accounting concept. Proponents of Approach 2B acknowledge Treas. Reg. § 1.707-1(c)'s reference to "paid or accrued" and the traditional application of the all-events test, but note that the Regulation deals only with the timing of the inclusion of the income and tells us nothing about whether the entitlement should be treated as a guaranteed payment.[73]

Approach 2B is mindful that under the existing Treasury Regulations, Example 2 of Treas. Reg. § 1.707-1(c) concludes that when the partnership does not have sufficient income to support the payment to the partner-recipient of the full $10,000 minimum amount, the payment is in part characterized as a guaranteed payment. Nevertheless, Example 2 of Treas. Reg. § 1.707-1(c) does not expressly address whether the partnership has to accrue the deduction for the $10,000 guaranteed payment if the partnership does not make the actual payment.[74] Accordingly, it is unclear whether a partner entitled to such a preferred return must accrue a guaranteed payment before a payment is actually made from other partners' capital, *i.e.*, when the capital actually "shifts."

There is no clear authority for requiring accrual of such guaranteed payments in the subchapter K context under principles similar to the original issue discount rules applicable to certain debt instruments under Section 1272, the analogous rules for stripped preferred stock found in Section 305(e), or the deemed dividend rules of Section 305(c).[75] Absent Congress having mandated such a rule, forcing an accrual in this situation, when it is quite possible that the

[73] See note 24, above.

[74] While Treas. Reg. § 1.707-1(c) requires that a partner must include a guaranteed payment in income in the taxable year that ends with or within the partnership's taxable year in which the partnership deducts the guaranteed payment as paid or accrued under its method of accounting, it does not mandate that the partnership accrue the deduction as it accretes.

[75] The application of Section 305(c) results in a deemed distribution under Section 301, but not necessarily deemed income for the relevant shareholder. To the extent the distribution exceeds the corporation's current and accumulated earnings and profits, Section 301(c)'s usual rule of basis reduction followed by gain applies.

In situations where Section 305(c) is inapplicable, accruals in respect of accreting preferred stock are not required. Notably, Section 305(c) generally would not apply to preferred stock with terms similar to the preferred partnership equity at issue in the Examples in this Report, because such stock would not be "preferred" for purposes of Section 305(c), as it participates meaningfully in corporate growth. *See* Treas. Reg. § 1.305-5(a).

partnership will earn sufficient income to cover the preference, is artificial and inconsistent with the realization doctrine and the approaches taken in the 2013 Regulations with respect to NCOs and the 2005 Proposed Regulations with respect to forfeitures of compensatory partnership options.[76] Accordingly, this argument concludes, a partner should not, in such a situation, be required to recognize any income unless and until there is an income recognition event at the partnership level or an actual payment to the partner.

If no guaranteed payment or taxable capital shift is required to address the shortfall, then the disparity between liquidating distributions and capital accounts would not have income tax consequences in Year 1 or Year 2. If PRS has income in subsequent periods, allocations will be made to reduce or eliminate the disparity between capital accounts and target capital accounts. Any remaining mismatch will have tax consequences upon some later event (for example, a liquidating distribution of cash by PRS or a taxable sale by Investor of its partnership interest).

Further along this line, even if no guaranteed payment is required, some are in favor of permitting a partnership to provide in its partnership agreement the flexibility to choose guaranteed payment treatment in these circumstances, arguing that it provides for greater certainty to the partners because it avoids the vagaries of annual income and loss recognition. In fact, one can think of such an election as being similar to the option that the "remedial allocation" method under Treas. Reg. § 1.704-3(d) affords taxpayers, with the limit imposed by annual recognized gross items replacing the role of the ceiling rule.[77] If such an election were permitted, we think it should have to be made at the partnership's outset and be irrevocable. Anti-abuse rules might also be appropriate.

Finally, we note that if Approach 2B is the correct one, there should be limiting principles that would preclude the potential to earn out of guaranteed payment treatment in some situations. For example, the timing of any mandatory payments to the preferred partner should be viewed as relevant, and if the partner holding a preferred interest has the right to be paid any accrued and unpaid preference after some fixed number of years that is relatively short (*e.g.*, three years after the preferred interest is issued) regardless of partnership income, then the priority dis-

[76] One benefit of the realization doctrine is not to impose tax on hypothetical shifts in wealth. Requiring a guaranteed payment in this situation is to say that Sponsor *will* be paid out of Management's capital when, of course, there is no assurance that such a result will occur, and it may well be at least as likely as not that it will not occur.

[77] The remedial method creates tax allocations as necessary for the noncontributing partners to match their Section 704(b) book allocations with offsetting items to the contributor. Treas. Reg. § 1.704-3(d). It does not require the partnership to have a matching tax item to cure ceiling rule distortions.

tribution begins to resemble the preferred partnership interest in Example 2, *supra,* hence counseling in favor of guaranteed payment treatment.

If Approach 2A is followed and a guaranteed payment is required on the facts of this Example 3, it raises additional issues without clear resolutions, such as how the accrued (but unpaid) guaranteed payment should be treated. One possibility would be to treat the accrued guaranteed payments of $200 as partnership liabilities described in Section 752. Under this approach, Investor would be treated as holding, in addition to its partnership interest in PRS, a $200 receivable owed by PRS.[78] In a liquidation, or a redemption of Sponsor's preferred interest, PRS would be required to make a $200 payment to Sponsor that would be treated as a repayment of the partnership liabilities created at the end of Years 1 and 2. Sponsor's target capital account at the end of Year 2 would remain at $1,000, because in a liquidation, Sponsor would be entitled to a $1,000 partnership distribution in respect of its preferred capital, and a $200 payment in respect of the partnership liabilities.

Another, more widely accepted, approach would be to treat the $200 of guaranteed payments in a manner similar to how consent dividends are treated, *i.e.,* as though they were paid to Sponsor, and then Sponsor transferred such amounts back to the partnership as a capital contribution. The $200 increase to Sponsor's capital account balance would cause it to equal the target capital account balance at the end of Year 2.

Following Approach 2A is also more likely to result in timing and character mismatches for taxpayers. If a guaranteed payment arises in a given year in respect of an accrued and unpaid preference, but the partnership ultimately incurs sufficient losses such that it has insufficient assets to satisfy the accumulated preferred return entitlement, absent new provisions providing for some sort of special, remedial allocations, there would likely be the unfortunate result of having the preferred partner incurring ordinary income in the earlier year(s) and a capital loss later. This inequity and any resultant complexity to attempt to ameliorate it are avoided under Approach 2B.

Finally, we note that if PRS were permitted to revalue its property and adjust the partners' capital accounts as contemplated in Treas. Reg. § 1.704-1(b)(2)(iv)(*f*) (a "book-up"), it might generate sufficient book items of income and gain to "cover" all or a portion of a partner's preferred return. Of course, the current 704(b) Regulations offer fairly limited circumstances in which the partnership can elect to undergo a book-up. Accordingly, we recommend that the IRS and the Treasury consider revising Treas. Reg. § 1.704-1(b)(2)(iv)(*f*) (or issuing other guidance)

[78] The Section 752 liability would be allocated pursuant to the Section 752 regulations.

to permit partnerships to book-up where doing so would prevent (or mitigate) guaranteed payment treatment.[79]

B. Preferred Returns Limited to Partnership Income

As noted above, where the parties' economic arrangement provides a preferred return that is dependent on and limited to the partnership having sufficient income, it seems clear that there is no guaranteed payment as the preferred return accrues. Instead, the economic accrual of preferred return for a partnership year should be matched, to the extent possible, by allocations of income in the year of economic accrual (either net income or gross income, if net income is insufficient and allocating gross income results in the preferred partner's capital account being equal (or closer) to its target capital account) and treated as distributive share rather than a guaranteed payment.

The following three examples illustrate these principles and conclusions.

Example 4. Preferred Return Limited to Cumulative Income.

Assume Investor and Owner form Partnership PRS, a calendar year, accrual method partnership. Investor contributes $100 to PRS in exchange for a preferred interest. Owner contributes Property with a fair market value of $100 to PRS in exchange for a common interest. The PRS partnership agreement provides that distributions are to be made to Investor first until Investor receives its money back plus an annual simple preferred return of 10% *that is limited to PRS's cumulative net earnings over the periods in which the preferred interest is outstanding*, then to Owner, until Owner receives a sum equal to the fair market value of Property at the time of PRS's formation ($100), and thereafter 50/50 to Investor and Owner. Investor's preference is not required to be paid annually.

The PRS partnership agreement further provides for targeted allocations using only net income and loss (and not gross items thereof).

[79] Some practitioners argue that that there should be no guaranteed payment in a case where, if there were a book-up (even if no actual book-up is undertaken), there would not be a capital shift. Revenue Procedure 93-27, 1993-27 C.B. 343, lends some conceptual support for this approach. Under Section 2.01 of Rev. Proc. 93-27, a capital interest is as an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership, even if there is no actual book-up on the partnership's books. Guidance from the IRS and the Treasury on this approach would be welcome.

The partners' initial capital accounts and the PRS balance sheet are as follows:

	Capital Accounts		**PRS Balance Sheet**	
	Investor	**Owner**	**Assets**	
Initial Balance	100	100	Property	100
			Cash	100
			Total	**200**

In Year 1, PRS earns $30 of ordinary income and accrues $10 of deductible expenses. If PRS were to liquidate at the end of Year 1, Investor would be entitled to the first $110 of proceeds, Owner would be entitled to the next $100, and the balance would be shared 50/50. Accordingly, the $20 of net income in Year 1 should be allocated as follows:

	Capital Accounts			**Distribution Waterfall**	
	Investor	**Owner**		**Investor**	**Owner**
Initial Balance	100	100	Capital	100	100
Year 1 Preferred Return	10	-	Total Preferred Return	10	-
Year 1 Remaining Profit	5	5	Remaining Proceeds	5	5
	115	**105**		**115**	**105**

In Year 2, PRS earns $10 of ordinary income and accrues $10 of deductible expenses. Because PRS has cumulative net income of $20 (all in Year 1), Investor still has the right to its 10% preference for each of Years 1 and 2. Thus, the amounts distributable to Investor and Owner, respectively, under the agreed economic arrangement are $120 ($100 plus $20 of preferred return) and $100. However, PRS has no net income or loss to allocate in Year 2. Thus, if the partnership agreement's allocation provision were followed, Investor's and Owner's capital account balances would remain at $115 and $105, respectively, at the end of Year 2.

In this situation, we believe that the allocation provisions in the partnership agreement should be considered of questionable validity under Section 704(b). We think in this situation, and in most ordinary situations, gross items should be allocated between Investor and Owner to match capital accounts with distribution rights to the greatest extent possible for the allocations to be in accordance with PIP. Given that targeted allocations purport to allocate partnership items to the partners in a manner that results in the partners' capital accounts matching (as closely as possible) the amounts that would be distributed to them in the hypothetical liquidation, where gross items exist, if there are insufficient net items, gross items ordinarily should be allocated as necessary to cause capital accounts to match target capital accounts.

In addition, if a contrary position were adopted, and the PRS partnership agreement's express allocation provision were considered as valid under Section 704(b) in this situation, it would allow for significant taxpayer electivity. Essentially, Investor and Owner could choose between two alternatives: either Investor would be allocated gross items of income and Owner would be allocated gross items of deduction, or both would be allocated $0 of net income or loss. Moreover, under Section 761, Investor and Owner would even have the flexibility to decide which of the two approaches is more favorable up until the due date for filing the PRS income tax return for Year 2 (not including extensions).[80]

Accordingly, in respect of Year 2, allocations should be as follows:[81]

	Capital Accounts			**Distribution Waterfall**	
	Investor	**Owner**		**Investor**	**Owner**
As of 1/1 Year 1	115	105	Capital	100	100
Year 2 Preferred Return	5	(5)	Total Preferred Return	20	-
	$120	**100**	Remaining Proceeds	-	-
				120	**100**

Example 5. Absence of Gross Items in Year 2.

Assume the same facts as in Example 4, except that PRS is a dry partnership in Year 2. As with Example 4, at the end of Year 2, Investor is entitled to its 10% preference for each of Years 1 and 2 because PRS has $20 of cumulative profits. However, because PRS has no gross income to allocate, it is impossible for allocations to match capital account balances to target capital accounts at the end of Year 2.

Some argue that, because if PRS were to liquidate at book value at the end of Year 2, $5 of Investor's preference would be funded from undistributed partnership earnings that have been booked to Owner's capital account, Investor should be deemed to recognize a $5 guaranteed payment for Year 2. That is, in essence, concluding that a preference that is funded from another partner's capital, whether contributed capital or booked capital, should be treated as a guaranteed payment. On these facts, however, such an approach is not correct.[82] The PRS partnership

80 *See* Section 761(c); Treas. Reg. § 1.761-1(c).

81 As described in note 64 *supra*, there are alternative approaches to allocating gross items to accomplish the appropriate net result.

82 This is especially true where there is built-in gain in PRS's assets that has not yet been allocated to the partners' capital accounts. It would be anomalous to force Investor to take into account a guaranteed payment because of "incorrect" prior income allocations when a book-up would provide sufficient income to cover the amount of the entitlement.

agreement gives Investor an entitlement to its preference only if there are cumulative earnings over the periods in which the preferred interest is outstanding. Since Section 707(c) applies only to payments determined without regard to the income of the partnership, this entitlement does not give rise to a guaranteed payment. The temptation to look at the results of the hypothetical liquidation at the end of Year 2 that might lead one to think a guaranteed payment might be appropriate is understandable, but when one takes a broader look, one can see this temptation as a misleading artifact of the annual accounting period and the arguably incorrect temptation to import the tax accounting principles contained in the 704(b) Regulations: if PRS were able to allocate based on the combined results of Year 1 and Year 2, Owner would not be allocated any net income—instead, all $20 of cumulative net income would be allocated to Investor, resulting in capital account balances being equal to target capital account balances and quite clearly foreclosing guaranteed payment treatment.[83] As noted above, Example 2 of Treas. Reg. § 1.707-1(c), the approach of the 2013 Regulations relating to NCOs, and the 2005 Proposed Regulations with respect to forfeitures of compensatory options, all indicate a policy preference to avoid creating immediate phantom income events. This policy preference is all the more compelling when addressing contingent allocations that turn out to be incorrect, as in this Example 5.

Example 6. Preferred Return Limited to Annual Income.

Assume the same facts as in Example 4, except that Investor's preference only accrues in a year if and to the extent PRS has sufficient net income in that year. For Year 1, in which PRS earns $30 of ordinary income and accrues $10 of deductible expenses, the results are the same as in Example 4.

	Capital Accounts			**Distribution Waterfall**	
	Investor	**Owner**		**Investor**	**Owner**
Initial Balance	100	100	Capital	100	100
Year 1 Preferred Return	10	-	Total Preferred Return	10	-
Year 1 Remaining Profit	5	5	Remaining Proceeds	5	5
	$115	105		115	105

[83] Note that if the facts in this Example 5 were changed to provide that Investor is entitled to keep any preferred return actually paid (without reducing its entitlement to return of its preferred capital) even if there are not sufficient cumulative net profits over the life of the partnership to cover that return, then payment would have substantive economic consequences. This change in the Example's facts would support treating the payment as a guaranteed payment at the time of payment.

In Year 2, PRS earns $10 of ordinary income and accrues $10 of deductible expenses. Because PRS has not earned any net income in Year 2, Investor is not entitled to its $10 preferred return for Year 2. Therefore, in contrast to Example 4, a gross income allocation to Investor is not required to cause the partners' capital accounts to match target capital accounts. Accordingly, Investor and Owner should each be allocated $0 of net book income for Year 2.

Further, when a preferred return accrues for a taxable year only if and to the extent that the partnership earns net income in such year, the preference should never give rise to a guaranteed payment because, quite clearly, it is not "determined without regard to the income of the partnership" within the meaning of Section 707(c).