RECOMMENDATION

Section 707(a) of the Code provides that, as a general rule—

"If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and on who is not a partner."

Section 707(c) provides--

"To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61 (relating to gross income) and, subject to section 263, for the purposes of section 162(a)(relating to trade or business expenses)"

Payments under section 707(c) referred to as "guaranteed payments", although they are not actually guaranteed by anyone. They are guaranteed only in the sense that they are payable even if the partnership does not have any income.

Several other provisions of the law refer to "guaranteed payments" under '707(c), including '736(b)(1) of the Code (relating to certain payments to a retired or deceased partner) and '1.721-1(b)(2) of the U.S. Treasury Department's Regulations on Income Tax (1986 Code)("Regulations"(relating to transfers of interest in partnerships capital in consideration of services).

Over the years, the IRS and the courts have wrestled with both the definition of a guaranteed payment and the exact consequences of characterizing a payment as a guaranteed payment.

Section 707(a) and (c) were added to the code in 1954 in an attempt to resolve problems that had arisen under prior law when a partner engaged in a transaction with a partnership in a capacity purportedly other than as a partner. Applying the aggregate theory of partnerships, the IRS and the courts usually held that a partner could not be an employee of his partnership.

Therefore, any payments which the parties tried to treat as salaries or other amounts as compensation for services were recharacterized as distributions of income. Similarly, it was held that a debtor-creditor relationship could not exist between a partner and a partnership, and payments of interest were also recharacterized. The accounting became quite complex in those cases where the payments to the partners for services or in the nature of interest exceeded the amount of income. In most cases, however, the final result was identical to the one that would have been reached had the payments been treated as salaries or interest in the first place.

It was also assumed that, under the 1939 Code, partnerships could not make special allocations of income to partners. The IRS reversed its position on this point several years after the 1954 Code was enacted, but, when the draftsman of the 1954 Code wrote "707(a) and (c) into the statute, they were under the impression that the law was to the contrary.
The courts often reached inconsistent results for transactions in which the partner was acting more like an independent contractor than an employee. Sometimes the aggregate theory was applied; in other cases, the entity theory was applied.

The legislative history to the 1954 Code indicated that Congress attempted to solve these problems as follows:

1. Section 707(a) provides that if a person acts in the capacity other than as a partner, the transaction should be treated as though the person were to a partner; and

2. Section 707(c) provides that payments for services should be treated the same as salaries.

3. Section 707(c) also provides that payments for the use of capital shall be considered as made to one is not a member of the partnership.

Payments are covered by 707(c) only if made "without regard to the income of the partnership". The statute refers to them as "guaranteed payments", although they are not in any way guaranteed. Guaranteed payments are treated as though made to a nonpartner only for purposes of '61 (gross income) and '162(e)(trade or business expenses).

One of the fundamental problems with 707(c) is the statutory language, which is drawn from the February, 1954 draft of the ALI's Federal Income Tax Statute, assumes that it is possible to distinguish situations in which a partner is acting in his capacity as a partner from those in which he is not. Over the years, the IRS, the courts and even Congress have attempted to impose an objective set of rules to determine the issue, but all such efforts have been unsuccessful. The commentators have long noted that there is no objective test on which such a distinction can be based. The reasoning in many of the cases and rulings that have attempted to frame and apply objective criteria is invariably unsatisfactory and the results often appear capricious.

For Example, on one leading case, Pratt v. Commissioner, the IRS persuaded the Tax Court to hold that payments for services and for capital were not guaranteed payments because the taxpayers were not acting in their capacity as partners. On appeal, the IRS confessed error on the payment for capital, and the Fifth Circuit affirmed the IRS's position on the payment for services. In Revenue Ruling 81-301, the IRS ruled that the appellate division in the Fifth Circuit was incorrect, and that the partners in the Pratt were, after all, acting in their capacity as partners with respect to both the interest-type and the service-type payments. In the Committee Reports to the 1984 amendments to 707, the Senate Finance Committee repudiated a key part of Revenue Ruling 81-301 and stated that payments for services of the type rendered in Pratt and described in that ruling would no longer be deemed guaranteed payments, even though the language of 707(c) on this point was never changed.

In Schneer v. Commissioner, which involved the question of whether a partner was acting in his capacity as a partner, the Tax Court issued four different opinions, none of which agreed with the IRS position. One leading tax journal published articles by three different commentators, each of whom disagreed either with result in the case or with the opinions of most, if not all of the judges or both, as well as with each of the other commentators.

The problem is that a partner is acting in his capacity when the parties themselves agree that he is so acting, and he is not acting in his capacity as a partner when the parties agree that he is not. If the partnership agreement says that a person is rendering services qua partner, then he is a partner; if the
partnership agreement or other binding agreement provides otherwise, then he is not acting *qua* partner with respect to the activity in question. There is no other objective test.

The legislative history to the 1954 Code indicated that Congress wanted to avoid disputes over when a person is acting in his capacity as a partner and suggests that the application of "707(a) should be elective with the taxpayers. If both the partnership and partners take consistent positions with respect to the issue, the IRS should not take a contrary position. At least two courts have opined that Congress intended the applicability of "707(a) and (c) to be elective with taxpayers. At most, the IRS should be entitled to require that the decision to treat a person with respect to one or more transactions as acting not in his capacity as a partner must be set forth clearly in the partnership agreement or in other documents which are binding on all of the parties.

Another problem with '707(c) has been in identifying what kind of payment is covered. The statute indicates that a payment is covered by Section 707(c) only if it is made without regard to partnership income. The legislative history indicated that this was intended to cover payments like salaries and interest payments which had to be made to employees and creditors, respectively, even if the firm lost money. However, the regulations define guaranteed payments in some situations by reference to partnership income.

In *Pratt*, the IRS argued, and the courts agreed that a payment equal to a percentage of gross income could not qualify as a guaranteed payment under '707(c). In Revenue Ruling 81-300, 1981-2 C.B. 143, the IRS reversed itself, and said that it could. As a policy matter, the ruling makes sense, but it is hard to square with the statute or the case law.

The treatment of payments for the use of capital the same as interest has been another ongoing puzzle. If a true debtor/creditor relationship exists, the payments should be treated as interest under '707(a), and '707(c) is irrelevant. If the payment to the partner providing capital is merely a priority distribution of income (as is often the case), section 704(b), which authorizes special allocations of income, including allocations of gross or net income to partners who provide capital to the partnership, is the appropriate provision. Again, '707(c) is irrelevant. Section 707(c) seems to applicable only when a person supplies capital in his capacity as a partner, and not as a creditor, and is entitled to compensation for the use of that capital regardless of whether the partnership has even $1 of gross income. Whether or not as a policy matter that type of payment should be treated the same as interest is unclear.

Another troublesome provision is the limitation that payments will be treated as guaranteed payments only for the purposes of "61 and 162. It is often necessary to determine whether guaranteed payments are distributive shares of income or interest-type payments for purposes of other selections. For example: do the limitations on interest deductions in '163 apply? Two private letter rulings held that they do not apply in determining the nature of the income received by a REIT from a partnership.

Issues also arise as to whether guaranteed payments are portfolio income or passive income within the meaning of 469, with no clear pattern or logic as to result.

In its recent report on partnership issues, the Staff of the Joint Committee (AStaff Report@) recommended that section 707(c) be repealed but only with respect to interest type payments, and not with respect to payments for services.
Before reaching a final conclusion as to whether '707(c) should be repealed, the Task Force reviewed the impact of repeal under Code sections. For example, if '707(c) is repealed with respect to interest-type payments, the Staff Report does not indicate how payments for the use of capital which do not meet the traditional definitions of interest (because of the lack of a true indebtedness) and which exceed the income of the partnership will be treated.

Another issue that the repeal raises is the treatment of income from foreign sources. Section 707(c) is often used by partnerships which engage in business both in the United States and outside the United States to allocate income to the partners located abroad to permit them to utilize the full foreign tax credit. There is some question whether guaranteed payments in the form typically used for this purpose meets the statutory definition (Awithout regard to the income of the partnership@) or whether an allocation of part of the balance of the partnership=s net income to the foreign based partner has economic effect. In many cases, the amount of the guaranteed payment is determined or readjusted after the amount of the foreign source income is known. In other cases, the guaranteed payment for a particular year may not be changed, but the adjustment is made to the amount of the guaranteed payment for the following year, it being the intention of the parties that the guaranteed payment in fact be equal to the amount that the foreign based partner would have received had he received his normal distributive share of the firm=s earnings from all source. Regardless of whether such practices are proper or valid as a matter of law, it is questionable whether they are consistent with the concepts and purposes of either '707(c) or '707(b).

The view of the Task Force is that the typical allocation of foreign source income primarily to foreign based partners has economic effect and should be recognized as valid under '704(b). This type of allocation was recognized by the IRS prior to 1954, even when no other special allocations were recognized, so they have always had a preferred status, at least prior to 1954. There is no indication that Congress, in adopting the 1954 Code, intended to make it more difficult to make this type of allocation after 1954. A normal allocation of foreign source income to foreign based partners is economically realistic and should be recognized under '704(b). If Treasury is willing to recognize the validity of such allocations, by either a ruling or an amendment to the regulations, artificially pegged and recalculated guaranteed payments to foreign based partners can become a thing of the past. If Treasury is unable or unwilling to recognize the validity of such allocations, any repeal of '707(c) should be accompanied by an explicit statutory amendment to '704(b) to permit them.

Repeal will require changes to be made to a number of other sections of the Code, but it is believed that conforming changes will not be a serious problem. For example, although '736 states that certain payments made to retired or deceased partners should be treated as guaranteed payments under section 707(c), that cross reference is unnecessary. In fact, that section would probably make more sense of the type of payment in question were treated as a pension, annuity, or other form of deferred compensation. Similarly, the reference in Regulations 1.721-1(b)(2) to the treatment of a transfer of capital as a guaranteed payment is unnecessary. The transfer of capital to a partner for services is taxable as ordinary income, without regard to the applicability of section 707(c); nor does the reference to guaranteed payments help with the analysis of whether such transfer should be deductible by the transferors.

Finally, rules would have to be adopted to alleviate transitional problems created by partnership agreements which call for guaranteed payments under current law. In general, it is anticipated that such payments in future years would be treated, depending upon their substance, under either '707(a) or '704(b).

There is one type of transaction which is presently covered by '707(c) which would not be directly covered by any other section if '707(c) were repealed. Payments made to partners for the use of capital would come within '707(a), because there is no indebtedness as that term is usually defined for tax
purpose and, therefore, the payment cannot be treated as interest. Where the payment is payable solely out of income (including gross income), it can be treated as an allocation of gross income, as the pre-1954 cases held. But to the extent that such a payment exceeds the gross income out of which it is payable, there would be no specific provision of subchapter to cover it. In this case, the law would revert to the pre-1954 case authority. Although the computations required by these cases were deemed complex at the time those decisions were rendered, the complexity of those computations pale in comparison to the normal subchapter K computations encountered everyday by practitioners currently. In any event, such transactions occur rarely, and the Task Force does not believe that the issue justifies retention of an otherwise complex section of the Code. On balance, the amount of complexity that would be eliminated be repeal far outweighs the problem of dealing with interest-type payments under pre-1954 Code.

The only issue that should be clarified, however, is the nature of the income to the recipient, and the allowability of the deduction. It is the view of the Task Force that these payments are sufficiently similar in nature to interest that they should be so treated by both the recipients and the transferors. The clarification could be included in the legislative history to the repeal provisions, or in regulations to be issued by the IRS.

In conclusion, it is recommended that '707(c) be repealed in its entirety.

Respectfully Submitted,

Stefan F. Tucker, Chair

February, 1999

EXECUTIVE SUMMARY

1. Summary of the Recommendation

To repeal section 707(c) in the Internal Revenue Service Code of 1986 to eliminate the special rules dealing with Aguaranteed payments.

2. Summary of the issues which the Recommendation Addresses

The Partnership Committee's Task Force on the Simplification of Subchapter K has been formed and is operating for the purpose of promoting the simplification of the Internal Revenue Service Code. Simplification can be accomplished in part by repealing statutory provisions which have proved unadministerable and confusing, and which offer no administrative benefits.

Section 707(c) meets all of these criteria

The treatment of payments to partners for either the use of capital or for services can be adequately addressed by other applicable provisions of the Code.

3. Please explain how the proposed policy position will address the issue.

Repeal will eliminate the long-standing confusion in the law, as reflected by judicial decisions, administrative rulings and legislative history, over the determination as to when a person is or is not acting in his capacity as a partner. There is no present need in the law to continue to provide special
treatment for these types of payments and, therefore, no need to continue the futile attempts to define when a partner is acting *qua* partner.

4. Summary of any minority views of oppositions which have been identified.

The Staff of the Joint Committee has proposed repeal, but only with respect to interest-type guaranteed payments.

**GENERAL INFORMATION FORM**

Submitting entity: Section of Taxation

Submitted by: Stefan F. Tucker, Chair, Section of Taxation

1. Summary of Recommendation

The resolution proposes the repeal of section 707(c) of the internal Revenue Code. The purpose is to simplify subchapter K of the Code, which deals with the taxation of partnerships.

Section 707(c) provides that certain payments to partners should be treated as though made to persons who are not partners. Such payments are denominated by the statute as "guaranteed payments" (although not actually guaranteed by either the partnership or any of the partners).

The meaning and proper application of this section has been unclear and it is the source of much litigation often with inconsistent results. It is also superfluous, because the treatment of payments to partners is adequately covered by other provisions of subchapter K.

2. Approval by Submitting Entity.

This is submitted contingent on Section of Taxation approval at its January 15-16, 1999 Midyear Meeting.

3. Has this or a similar recommendation been submitted to the House or Board previously?

No

4. What existing Association policies are relevant to this recommendation and how would they be affected by its adoption?

None

5. What urgency exists which requires action at this meeting of the House?

None


None
7. Cost to the Association.

None


No member of the originating Committee or the Council of the Section of Taxation is known to have material interest in the Resolution by virtue of specific employment or engagement to obtain the results of the Resolution.

9. Referrals.

All Sections and Divisions

10. Contact Persons

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12. Contact persons regarding amendments to this recommendation.

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