What is a Guaranteed Payment?

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Agenda

1. Overview of Guaranteed Payments

2. Tax Cuts and Jobs Act (TCJA) Impact on Guaranteed Payments

3. Taxpayer Response and Renewed Importance of Identifying Guaranteed Payments
Overview of Guaranteed Payments

Section 707(c) of the Internal Revenue Code (IRC) and treas. reg. § 1.707-1(c) govern the Federal income tax treatment of guaranteed payments.

- Section 707(c) guaranteed payments are defined as “[payments made] to the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses).”

- Treas. reg. § 1.707-1(c) adds additional guidance whereby the regulation provides, in part, “[h]owever, a partner must include such payments 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. See section 706(a) and paragraph (a) of section 1.706-1. Guaranteed payments are considered as made to one who is not a member of the partnership only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses). For a guaranteed payment to be a partnership deduction, it must meet the same tests under section 162(a) as it would if the payment had been made to a person who is not a member of the partnership, and the rules of section 263 (relating to capital expenditures) must be taken into account....[g]uaranteed payments do not constitute an interest in partnership profits for purposes of sections 706(b)(3), 707(b), and 708(b). For purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner’s distributive share of ordinary income.”
Overview of Guaranteed Payments

Legislative History

• The Congressional reports leading up to the 1954 enactment of section 707(c) are clear that an entity approach to
  partnerships for services rendered by a partner was appropriate to ensure service payments were treated in a manner
  similar to salaries rather than an underlying share of partnership income.

• In applying a pure entity approach, the House of Representatives passed its version of section 707(c) in which salaries
  paid to partners would be treated “like any other employee who is not a partner, and the partnership [would be] allowed a
  deduction for salary expense.”

• The Senate version, passed in the same year which was ultimately enacted, extended section 707(c) treatment "to
  guaranteed interest payments on capital."
Overview of Guaranteed Payments

Character of Guaranteed Payments for Services

• Entity Treatment
  – Prop. reg. § 1.1411-4(g)(10) (not investment income)
  – *Miller* 52 TC 752 (1969) (treated as compensation for section 911)
  – *Carey* 427 F.2d 1014 (Ct Cl 1970) (excluded from gross income and exempt under section 911(a))
  – Treas. reg. § 1.469-2(e)(2)(ii) (payment for services for passive activity rules)
  – Treas. reg. § 1.514-2(d)(3) (fractions rule)
  – § 1402(a)(13) . . . (net earnings from self-employment)

• Distributive Share Treatment
  – Treas. reg. § 1.1402(a)-1(b) (not net earning from self-employment for payments received from a partnership not engaged in a trade or business)
  – Old Section 105(d) (personal injury or sickness)
Overview of Guaranteed Payments

Character of Guaranteed Payments for Capital

• Entity Treatment
  – Prop. reg. § 1.1411-4(g)(10) (net investment income)
  – GCM 36702 (interest income)
  – GCM 38133 (interest income to recipient)
  – Treas. reg. § 1.469-2(e)(2)(ii) (interest for passive activity rules)
  – Treas. reg. § 1.514-2(d)(3) (fractions rule)

• Distributive Share Treatment
  – PLR 8639035 (section 856(c)(3))
  – PLR 8728033 (treas. reg. § 1.856-3(g))
  – Treas. reg. § 1.1402(a)-1(b) – (net earnings from self-employments unless received from a partnership not engaged in a trade or business)
Section 163(j) Limitation on Business Interest

**General rule:** New section 163(j)(1) limits the deductibility of business interest expense to the sum of (A) the business interest income of such taxpayer for such taxable year, (b) 30% of the adjusted taxable income of such taxpayer for such taxable year, and (c) the floor plan financing interest of such taxpayer for such taxable year.

**Treatment of guaranteed payments for use of capital:** New section 163(j)(5) defines “business interest” as any interest paid or accrued on indebtedness properly allocable to a trade or business. However, prop. reg. § 163(j)-1(b)(20)(iii)(I) provides that any guaranteed payments for use of capital under section 707(c) are treated as interest for purposes of section 163(j).
Section 199A Qualified Business Income (QBI)

**General rule:** New section 199A allows non-corporate taxpayers a deduction for any taxable year an amount equal to the lesser of (1) the combined QBI of the taxpayer, or (2) an amount equal to 20% of the excess (if any) of (A) the taxable income of the taxpayer for the taxable year, over (B) the net capital gain of the taxpayer for such taxable year.

**Treatment of guaranteed payments for services:** Guaranteed payments for services paid to a partner are not considered QBI of the recipient partner (section 199A(c)(4)(B)). Despite reducing the partnership’s QBI, guaranteed payments for services are not considered wages for the purposes of the wage limitation calculation.

**Treatment of guaranteed payments for use of capital:** Section 199A statute is silent on guaranteed payments for the use of capital. However, treas. reg. § 1.199A-3(b)(1)(ii) provides that guaranteed payments for the use of capital are not taken into account in computing QBI except to the extent properly allocable to a trade or business of the recipient. The partnership’s deduction is taken into account for calculating QBI if such deduction is properly allocable to the trade or business of the partnership and is otherwise deductible for Federal tax purposes.
Taxpayer Response

- Comment Letters
- Re-evaluation of guaranteed payment for use of capital instruments
- Re-evaluation of guaranteed payment for services arrangements
- Parameters of what constitutes a guaranteed payment?
  - Treas. reg. § 1.707-1(c), examples (see appendix for the four examples)
  - What about gross income allocations? Capped allocations? Catch-up allocations?
Taxpayer Response

Considerations for taxpayers planning to restructure

• Separate business purposes required to restructure an equity instrument?

• Characterization of the restructured instrument? Equity modification? Equity recapitalization?

• What about ability to restructure in the future based on change in potential changes in tax law?
APPENDIX
Identifying Guaranteed Payments
Example 1

Treas. Reg. Sec. 1.707-1(c) provides four examples to help identify guaranteed payments and distinguish guaranteed payments from distributions of a partner’s respective distributive share of partnership items.

• Facts: Under the ABC partnership agreement, partner A is entitled to a fixed annual payment of $10,000 for services, without regard to the income of the partnership. His distributive share is 10 percent. After deducting the guaranteed payment, the partnership has $50,000 of ordinary income.

• Result: A must include $15,000 as ordinary income for his taxable year within or with which the partnership taxable year ends ($10,000 guaranteed payment plus $5,000 distributive share).
Identifying Guaranteed Payments
Example 2 (scenario 1)

Treas. Reg. Sec. 1.707-1(c) provides four examples to help identify guaranteed payments and distinguish guaranteed payments from distributions of a partner’s respective distributive share of partnership items.

**Facts:** 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.**

- **Result:** C is entitled to $18,000 (30 percent of $60,000) as his distributive share. No part of this amount is a guaranteed payment.

C: Guaranteed Payment: None
Distributive Share: $18,000

C

D

CD
Identifying Guaranteed Payments

Example 2 (scenario 2)

Treas. Reg. Sec. 1.707-1(c) provides four examples to help identify guaranteed payments and distinguish guaranteed payments from distributions of a partner’s respective distributive share of partnership items.

- **Facts**: 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 $20,000**.

- **Result**: C is entitled to $6,000 (30 percent of $20,000) as his distributive share and the remaining $4,000 payable to C would be a guaranteed payment.
Identifying Guaranteed Payments

Example 3

Treas. Reg. Sec. 1.707-1(c) provides four examples to help identify guaranteed payments and distinguish guaranteed payments from distributions of a partner’s respective distributive share of partnership items.

- **Facts:** Partner X in the XY partnership is to receive a payment of $10,000 for services, plus 30 percent of the taxable income or loss of the partnership. After deducting the payment of $10,000 to partner X, the XY partnership has a **loss of $9,000**.

- **Result:** X must report as ordinary income the guaranteed payment of $10,000 made to him by the partnership. In addition, $2,700 (30 percent of the loss) is X’s distributive share of partnership loss and, subject to section 704(d), is to be taken into account by him in his return.

X: Guaranteed Payment: $10,000
Ordinary Loss: $2,700
Identifying Guaranteed Payments

Example 4

Treas. Reg. Sec. 1.707-1(c) provides four examples to help identify guaranteed payments and distinguish guaranteed payments from distributions of a partner’s respective distributive share of partnership items.

X: Guaranteed Payment: $10,000
Ordinary Loss: $3,000
Capital Gain: $9,000

Y:

• Facts: Partner X in the XY partnership is to receive a payment of $10,000 for services, plus 30 percent of the taxable income or loss of the partnership. The XY partnership has a loss of $30,000 of capital gains and no other items of income or deduction except the $10,000 paid X as a guaranteed payment.

• Results: X has received a $10,000 guaranteed payment which is ordinary income to him. In addition, since the items of partnership income or loss must be segregated under section 702(a), the partnership has a $10,000 ordinary loss and $30,000 in capital gains. X's 30 percent distributive shares of these amounts are $3,000 ordinary loss and $9,000 capital gain.
Thank you