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The Lazarus Effect: A Commentary on In-Kind Guaranteed Payments

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THE LAZARUS EFFECT: A COMMENTARY ON IN-KIND GUARANTEED PAYMENTS

by

*David L. Cameron**
*Philip F. Postlewaite***

When he had said this, he cried with a loud voice, “Lazarus, come out!” The dead man came out, his hands and feet bound with strips of cloth, and his face wrapped in a cloth. Jesus said to them, “Unbind him, and let him go.”

– John 11:43-44

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I. INTRODUCTION

Section 707 of the Internal Revenue Code contains a number of provisions that control the tax implications of transactions involving a partnership and its partners.¹ In particular, section 707(a) provides that a transaction between a partnership and a partner, in which the partner is not acting in his capacity as a partner, is to be treated as a transaction with a third party. Alternatively, section 707(c) provides that a transaction between a partnership and a partner, in which the partner is acting in his capacity as a partner, is also to be treated as a transaction with a third party but only for certain limited purposes and only if the payment to the partner is not determined with regard to the income of the partnership. Payments satisfying the requirements of section 707(c) are referred to as guaranteed payments.

Almost 20 years ago, in response to various congressional enactments and amendments, we authored a eulogy proposing the repeal of section 707(c).² Although we may have been somewhat premature in laying to rest the concept of guaranteed payments as no longer possessing purpose or use in Subchapter K, at a minimum we viewed section 707(c) as “twisting slowly in the wind.”

Like many tax academics who offer their modest contributions to society at large and hope that somewhere in the tax-making machinery their constructive suggestions will be seized upon to effectuate meaningful change, we hoped that our proposed repeal of section 707(c) would actually find its way into the tax law. Regularly, albeit privately, we lamented the continuation of section 707(c), wondering why our call for its repeal had not been fully embraced by those charged with the effectuation of meaningful tax policy. We were particularly hopeful and watchful for such a change when many in both the academic and political communities were actively

1. IRC § 707. All references herein are to the Internal Revenue Code of 1986, as amended.

2. Philip F. Postlewaite & David L. Cameron, “Twisting Slowly in the Wind: Guaranteed Payments After the Tax Reform Act of 1984,” 40 *Tax Law.* 649 (1987).

calling for simplification of the Code.³ The repeal of a Code provision is, by definition, the ultimate act of simplification.

Against this backdrop of anticipation, one can easily imagine our excitement when, in January of 2005, the Joint Committee on Taxation proposed the repeal of section 707(c) in response to a Congressional request for a periodic report from the Committee recommending improvements to the tax law.⁴ Not only might the reform we advocated 20 years earlier finally see the light of day, but the narrative accompanying the proposal and explaining the reasons for the repeal of section 707(c) discussed and cited with approval our earlier article.⁵

We quickly characterized ourselves as visionaries, men ahead of their time, who fortunately had lived sufficiently long to see the fruits of their labor actively embraced by the tax-making machinery. However, while celebrating this public (foot)note of recognition, we uncovered a recently

3. See, e.g., Staff of the Joint Comm. on Tax'n, "Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to § 8022(3)(B) of the Internal Revenue Code of 1986" (JCS-3-01, Apr. 2001); Samuel A. Donaldson, "The Easy Case Against Tax Simplification," 22 *Va. Tax Rev.* 645 (2003); Samuel Diamon, "Simplification of the Internal Revenue Code," 95 *Tax Notes* 575 (2002); Pamela Olson, "Thoughts on the Impact of Tax Complexity on Small Businesses," 88 *Tax Notes* 1531 (2000); Joseph A. Snoe, "Tax Simplification and Fairness: Four Proposals for Fundamental Tax Reform," 60 *Albany L. Rev.* 61 (1996); Pamela J. Pecarich & Siobhan C. Rausch, "Tax Simplification Versus the Legislative Process," 133 *Trusts & Estates* 24 (Mar. 1994); Michael A. Andrews, "Tax Simplification," 47 *SMU L. Rev.* 37 (1993); Edward J. McCaffery, "The Holy Grail of Tax Simplification," 1990 *Wisc. L. Rev.* 1267; Charles E. McLure Jr., "The Budget Process and Tax Simplification/Complication," 45 *Tax L. Rev.* 25 (1989).

4. Staff of the Joint Comm. on Tax'n, "Options to Improve Tax Compliance and Reform Tax Expenditures" 170-73 (JCS-02-05, Jan. 27, 2005). The text of the Report was in excess of 400 pages and offered over 65 proposals through which to improve the tax law. See also Staff of the Joint Comm. on Tax'n, "Review of Selected Entity Classification and Partnership Tax Issues," 45-47 (JCS-6-97, Apr. 8, 1997) (proposing to modify the treatment of guaranteed payments and noting prior recommendations, including ours, for the repeal of § 707(c)).

5. "Several commentators have questioned the continued viability of a concept of guaranteed payments separate from the concept of payments treated as made to a partner in a non-partner capacity." Staff of the Joint Comm. on Tax'n, "Options to Improve Tax Compliance and Reform Tax Expenditures," *supra* note 4, at 172, n.401 (citing, *inter alia*, P. Postlewaite and D. Cameron, "Twisting Slowly in the Wind: Guaranteed Payments After the Tax Reform Act of 1984," 40 *Tax Law.* 649 (1986)). Later, the Report stated: Several commentators have advocated an approach like that of the proposal, stating that the 'better approach would be to eliminate § 707(c) totally and provide that any payment to a partner, not determined with regard to partnership income, constitutes a § 707(a) payment.'" *Id.* (citing P. Postlewaite & J. Pennell, "JCT's Partnership Tax Proposals – 'Houston, We Have a Problem'," 76 *Tax Notes* 527 (1997)).

published article in this journal by Douglas Kahn and Faith Cuenin regarding the treatment of in-kind guaranteed payments.⁶ Because of the article's provocative and thorough analysis, we feared that Kahn and Cuenin's efforts might be viewed as breathing new life into section 707(c), not dissimilar from the return of Lazarus from the dead.

Lazarus was a Biblical figure appearing in the Gospel of John, which, like the Gospels of Matthew, Mark, and Luke, can be found in the New Testament.⁷ Lazarus, who was brought back from the dead by Christ, presages the most important event of the New Testament, the resurrection of Christ following his crucifixion.⁸ Thus, the character of Lazarus now serves

6. Douglas A. Kahn & Faith Cuenin, "Guaranteed Payments Made In Kind by a Partnership," 6 Fla. Tax Rev. 405 (2004).

7. John 11:1-44 (New Revised Standard). It has become quite fashionable in the tax academy to invoke biblical references in scholarly articles. See, e.g., Martin J. McMahon, Jr., "The Matthew Effect and Federal Taxation," XLV B.C. L. Rev. 993 (2004) (referring to the "Matthew Effect" as based on the verse from Matthew 25:29 ("For to all those who have, more will be given, and they will have an abundance; but from those who have nothing, even what they have will be taken away." (New Revised Standard))), which is synonymous with the colloquialism "the rich get richer and the poor get poorer," and decrying the failure of the federal tax system to address the Matthew Effect); Deborah H. Schenk, "The Luke Effect and Federal Taxation: A Commentary on McMahon's *The Matthew Effect and Federal Taxation*," XLV B.C. L. Rev. 1129 (2004) (referring to the "Luke Effect" as based on the verses from Luke 18:22-25 ("How hard it is for those who have wealth to enter the kingdom of God! Indeed, it is easier for a camel to go through the eye of a needle than for someone who is rich to enter the kingdom of God." (New Revised Standard))), which may be paraphrased as "the rich love their money and will not give it up easily," and concluding that significantly greater progressivity of tax rates will not effectively reduce the Matthew Effect). Any trend in the use of Biblical references in the tax literature may reflect the influence of Professor Susan Pace Hamill, whose work directly relies upon the Biblical text of both the New and Old Testaments in assessing the appropriateness of certain tax policies. See Susan Pace Hamill, "An Evaluation of Federal Tax Policy Based on Judeo-Christian Ethics," 25 Va. Tax Rev. 671-764 (2006); Susan Pace Hamill, "An Argument for Tax Reform Based on Judeo-Christian Ethics," 54 Ala. L. Rev. 1 (2002). See also Adam Chodorow, "Tax Reform: What Would God Do?," 108 Tax Notes 1167 (2005) (noting that an income tax may be more consistent with Biblical text than a consumption tax).

8. The character of Lazarus referred to herein is not to be confused with the Lazarus appearing in the story of a rich man and a beggar named Lazarus, in which the rich man finds himself cast into hell following his death while Lazarus is carried by angels to be with Abraham. Luke 16:19-31 (New Revised Standard). Seeing Lazarus on the other side of the chasm, the rich man asks Abraham to "have mercy on me, and send Lazarus to dip the tip of his finger in water and cool my tongue; for I am in agony in these flames." Abraham reminds the rich man that because he received good things during his lifetime while Lazarus received only evil things, Lazarus is comforted after death. The rich man then asks that Lazarus be sent to warn his five brothers so that they will not suffer like him after death. Abraham responds that, if the brothers have not

in both high and popular culture as the emblem for any person or idea that once dead, or thought dead, is miraculously returned to life.⁹

The fact that our recommendation concerning the repeal of section 707(c) has belatedly received the support it deserves by definition ensures that we will oppose any interpretation of section 707(c) that may delay its interment. An acceptance of Kahn and Cuenin's thesis concerning section 707(c) would also undercut our previously articulated position that no meaningful distinction exists between the operation of sections 707(a) and 707(c). Over and above the potential damage to our crusade for the repeal of section 707(c) that may result if Kahn and Cuenin's thesis is left unchallenged, we believe that their conclusions regarding the application of section 707(c) are, by themselves, incompatible with sound tax policy.¹⁰

However, this commentary is compelled by more than our goal of ensuring that section 707(c) and the concept of guaranteed payments soon become a distant and fading recollection of the tax bar. It is also driven by the confusion caused by the discussion, or the limitations of the discussion, of guaranteed payments in our treatise on partnership taxation.¹¹ Kahn and Cuenin detected both a lack of clarity and, at times, a lack of coverage on this topic, an observation that has been most instructive.¹² Consequently, we

heeded the warnings of Moses and the prophets, they would not repent even if warned by someone who is raised from the dead, alluding to Christ and his resurrection. Although the Biblical tale of the rich man and Lazarus is obviously ripe for application to the tax law, we leave any direct analogies to a future commentator.

9. See, e.g., Davis Bunn, *The Lazarus Trap* (2005); Rashid Darden, *Lazarus* (2005); Joanna Brooks, *America Lazarus: Religion and the Rise of African-American and Native American Literatures* (2003); David Sherman & Dan Cragg, *Lazarus Rising* (2003); Carl Marcum, *Cue Lazarus* (2001); John Bayer, *The Lazarus Project* (1999); Robert Mawson, *The Lazarus Child* (1998); Jo Bannister, *The Lazarus Hotel* (1997); *The Lazarus Man* (directed by Johnny E. Jensen, 1996); Robert Pensak, *Raising Lazarus* (1994); *The X-Files: Lazarus* (directed by David Nutter, 1994); Samuel Brassfield, *The Lazarus Generation: How to Raise the Spiritually Dead* (1993); Robert Richardson, *The Lazarus Tree* (1992); Morris West, *Lazarus* (1990); Franklin W. Dixon, *The Lazarus Plot* (1987); Sting, "The Lazarus Heart," in *Nothing Like the Sun* (1987); Frank Herbert & Bill Ransom, *The Lazarus Effect* (1983); John Lutz, *Lazarus Man* (1979); Andre Malraux, *Lazarus* (1977); Sylvia Plath, "Lady Lazarus," in *The Collected Poems* (1962); and Leonid Andreyev, *Lazarus* (1918).

10. Regretfully, our position on this issue places us in the role of the chief priests who, following Lazarus' return from the dead, planned the death not only of Jesus but of Lazarus as well, "since it was on account of him that many of the Jews were deserting and were believing in Jesus." John 12:10-11 (New Revised Standard).

11. Arthur B. Willis, John S. Pennell, & Philip F. Postlewaite, *Partnership Taxation* (6th ed. 2002).

12. See Kahn & Cuenin, *supra* note 6, at 407.

will utilize this commentary as an initial forum in which to eliminate this defect.¹³

In their article, Kahn and Cuenin conclude that the transfer of property by a partnership to a partner as a guaranteed payment does not result in gain or loss recognition by the partnership. This surprising result conflicts with the generally held interpretation of section 707(c) as adopting the entity theory of partnerships with respect to guaranteed payments. Although their conclusion in this regard is consistent with the aggregate theory of partnerships, they also conclude that the recipient partner takes a fair market value basis in the transferred property rather than a carryover basis from the partnership. Curiously, this conclusion is consistent with the entity theory of partnerships rather than the aggregate theory of partnerships. Finally, they conclude that the recipient partner's basis in his partnership interest is reduced by the partner's share of the deduction generated by the guaranteed payment but is not otherwise affected by the transfer of the property. This conclusion is also consistent with the entity theory of partnerships rather than the aggregate theory of partnerships. Thus, their analysis results in an odd combination of both the aggregate and entity theories of partnerships in connection with the tax treatment of a single transaction, in this case a transaction involving an in-kind guaranteed payment.

Our analysis will demonstrate that a consistent application of the entity theory of partnerships best implements the policy objectives of Subchapter K with respect to the treatment of in-kind guaranteed payments. As a result, our ultimate conclusions differ from Kahn and Cuenin's only with respect to the question of gain or loss recognition by the transferring partnership. However, in reaching this conclusion, we undertake a more searching analysis of the statutory language, legislative history, and judicial interpretation of section 707 as well as a more careful application of the governing law to a number of hypothetical situations that Kahn and Cuenin posed in their article.

This commentary proceeds as follows. Part II provides a summary of the history and evolution of section 707 that we detailed in our previous article.¹⁴ In particular, we reiterate the fact that the enactment of section 707(a)(2) in 1984 fundamentally changed the interpretation of section 707 and effectively repealed section 707(c). Part III then considers the question of in-kind guaranteed payments, focusing first on Kahn and Cuenin's central

13. Authors of treatises regularly fear the discovery of inaccurate or incomplete coverage of the topics they address. As one of us is about to begin a rolling revision of the Sixth Edition of Partnership Taxation, Kahn and Cuenin's provocative article has alerted him to a need to clarify his views on the tax treatment of in-kind guaranteed payments. Thus, the thoughts herein will soon find their way into the Seventh Edition of Partnership Taxation to be completed in 2009.

14. See *infra* text accompanying notes 21-40.

thesis¹⁵ and then considering the three questions that in-kind guaranteed payments explicitly raise: (1) the recognition of gain or loss by the transferring partnership,¹⁶ (2) the basis of the transferred property in the hands of the recipient partner,¹⁷ and (3) the effect of the transfer on the recipient partner's basis in his partnership interest.¹⁸ Although we acknowledge that, in the absence of section 707(a)(2), our conclusions are not entirely free from doubt, we believe that the better interpretation of section 707(c) requires that a partnership recognize gain or loss on the transfer of property in satisfaction of a guaranteed payment. After bringing the changes wrought by section 707(a)(2) into the analysis, any lingering doubt in this regard vanishes.¹⁹ Finally, we consider the treatment of in-kind transfers in the liquidation setting that are referred to as guaranteed payments under section 736 and again conclude that the proper interpretation of Subchapter K requires that the partnership recognize gain or loss in connection with any such transfers.²⁰

II. SECTION 707(C) – TWISTING SLOWLY IN THE WIND

In 1954, Congress enacted sections 707(a) and 707(c). While both provisions ensured third-party treatment for payments between a partnership and its partners, Congress intended that some differences, as reflected in the statutory language, would exist between the tax treatment of transfers under the two subsections. As originally enacted, section 707(a) provided as follows:

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 one who is not a partner.²¹

15. See *infra* text accompanying notes 41-68.

16. See *infra* text accompanying notes 69-110.

17. See *infra* text accompanying notes 111-31.

18. See *infra* text accompanying notes 132-37. This portion of the article is followed by a detailed examination of Kahn and Cuenin's incomplete analysis that resulted in their questionable conclusion that a partnership should not recognize gain or loss on the transfer of an in-kind guaranteed payment. See *infra* text accompanying notes 138-55.

19. See *infra* text accompanying notes 156-62.

20. See *infra* text accompanying notes 163-91.

21. IRC § 707(a).

Notwithstanding a similar focus, section 707(c) was somewhat more narrow in its statutory command as its breadth was circumscribed by the following language:

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 for purposes of section 162(a) (relating to trade or business expenses).²²

Based on the language of these provisions, section 707(a) governed payments to a partner for activities not connected to those required by his partner status, while section 707(c) controlled if the activities were connected to his partner status.²³ The mutual exclusivity of the two subsections ensures that a payment can not simultaneously fall into both categories.

Given the differing statutory language and the explanations of each type of payment in the legislative history, differences in the tax treatment of payments under sections 707(a) and 707(c) initially existed. However, over the ensuing 30 years, Congress eroded the most significant differences between the two subsections.

The first such change occurred with respect to the capitalization requirements applicable to payments under sections 707(a) and 707(c).²⁴ Following the enactment of section 707, it was generally accepted that section 707(a) payments were subject to the capitalization rules of section 263. However, the limited reference in section 707(c) to sections 61(a) and 162(a) emboldened some practitioners to suggest that guaranteed payments were not subject to the capitalization requirements of the Code. Once this issue was identified, the Service and the courts did not hesitate to expand the number of sections beyond those to which guaranteed payments are

22. IRC § 707(c). As discussed below, for clarity purposes, Congress subsequently added a requirement to ensure that payments under § 707(c) were subject to the capitalization rules of § 263 as well.

23. Although § 707(c) makes no explicit reference to the capacity in which the partner is acting, the legislative history and the Regulations indicate that § 707(a) is the controlling provision for transactions in which the partner is acting in the capacity of a non-partner, leaving § 707(c) to govern transactions in which the partner is acting in the capacity of a partner and the payments are determined without regard to the income of the partnership. Postlewaite & Cameron, *supra* note 2, at 676-77.

24. For a more expansive discussion of this issue, see Postlewaite & Cameron, *supra* note 2, at 665-66.

explicitly subject under the language of section 707(c).²⁵ Congress subsequently put the capitalization question to rest with an amendment specifically subjecting guaranteed payments to the rules of section 263.²⁶

Regarding timing issues, section 706(a) and the Regulations for guaranteed payments mandated a matching of income inclusion by the recipient of the guaranteed payment with the deductibility of the payment to the partnership.²⁷ If the partnership were on a different accounting method

25. *Cagle v. Comm’r*, 63 T.C. 86 (1974), aff’d, 539 F.2d 409 (5th Cir. 1976); Rev. Rul. 75-214, 1975-1 C.B. 185.

The courts also confronted the question of whether the reference to § 61(a) in § 707(c) incorporated other provisions of the Code pertaining to exclusions from gross income as well. In *Carey v. United States*, 427 F.2d 763 (Ct. Cl. 1970), the court concluded that guaranteed payments in the form of salary received by a partner for services performed abroad were excludable from the partner’s gross income under § 911. The court reasoned that § 707(c)’s reference to § 61(a) included the phrase “[e]xcept as otherwise provided in this subtitle.” The court rejected the argument that the guaranteed payments represented a portion of the partner’s distributive share of partnership income for purposes of § 911. See *Miller v. Comm’r*, 52 T.C. 752 (1969), acq. (interpreting § 707(c) in the same manner as the court in *Carey*). Similarly, in *Armstrong v. Phinney*, 394 F.2d 661 (5th Cir. 1968), the court stated that, if the benefits involved in that case were found to be guaranteed payments, they would be excludable from the gross income of the recipient partner under § 119 as a result of § 707(c)’s reference to § 61(a). But see Rev. Rul. 91-26, 1991-1 C.B. 184 (accident and health insurance premiums paid by a partnership on behalf of its partners are includable in the partners’ gross incomes because the premiums are treated as a distributive share of partnership income under § 707(c)); G.C.M. 34173 (arguing that a partner cannot be treated as an employee of the partnership even if the partner is treated as “one who is not a partner” under § 707(a) or “one who is not a member of the partnership” under § 707(c)). Accord Rev. Rul. 69-184, 1969-1 C.B. 256 (bona fide members of a partnership are not employees of the partnership for purposes of FICA, FUTA, and income tax withholding).

26. Tax Reform Act of 1976, Pub. L. No. 94-455, § 213(b)(3), 90 Stat. 1520, 1547 (1976). Following this amendment, § 707(c) read as follows:

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).

Interestingly, the original House bill regarding this amendment made it applicable to all taxable years to which the 1954 Code applied on the rationale that the provision merely declared and clarified existing law. H.R. 10612, 94th Cong. § 210(e) (1975); H.R. Rep. No. 94-658, at 122 (1975), reprinted in 1976 U.S.C.C.A.N. 2897, 3017.

27. IRC § 706(a); Regs. § 1.707-1(c). For a more expansive discussion of this issue, see Postlewaite & Cameron, *supra* note 2, at 668-73.

than the partner (accrual versus cash or vice versa), the accounting method of the partnership controlled the year of the income inclusion to the partner. Thus, a cash method partner could experience an acceleration of income without receipt of payment if the partnership were an accrual method partnership and the partner was on the cash method of accounting.

However, section 707(a) payments were not subject to such matching. A partnership on the accrual method of accounting could deduct the payment before its payment and inclusion by a service-performing, cash-method partner. Again such differences and their exploitation precipitated a Congressional response which subjected most section 707(a) payments to the matching requirements of section 267, which further minimized the distinctions between sections 707(a) and 707(c).²⁸ Although the timing of payments under section 707(a) was controlled by the accounting method of the recipient partner while the timing of payments under section 707(c) was controlled by the accounting method of the partnership, a matching of income inclusion by the partner and expense deduction by the partnership generally resulted.²⁹ Thus, much of the difference in the tax treatment between the two types of payments was rapidly eroding.³⁰

In 1984, Congress dealt the final blow to what little remained of the vitality and independence of section 707(c) through its enactment of section

28. IRC §§ 267(a)(2) and 267(e). Section 267(e) specifically excludes guaranteed payments from the requirements of § 267(a)(2). IRC § 267(e)(4). Section 267(e) was enacted as part of the Tax Reform Act of 1984, Pub. L. No. 98-369, § 174(a)(2), 98 Stat. 494, 705-06 (1984).

29. Matching in the timing of the income inclusion by the partner and the expense deduction by the partnership is not required under § 267(a)(2) in connection with a transaction under § 707(a) if the partnership is on the cash method and the payee is on the accrual method, the services are rendered in Year 1, and the payment is not made until Year 2. Such a situation is not considered abusive because the income, and not the deduction, is accelerated as a result of the accounting methods of the parties involved.

30. In 2001, the Joint Committee on Taxation recommended conformity of the timing rules applicable to guaranteed payments and to transactions between a partnership and a partner not acting in the capacity of a partner. 2 Joint Comm. on Tax'n, "Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to § 8022(3)(B) of the Internal Revenue Code of 1986," 291-94 (JCS-3-01, Apr. 2001). The Joint Committee recommended that the timing of the income inclusion by the partner be based on the partnership's time of deduction. The Joint Committee also considered the repeal of § 707(c) but refused to recommend such a proposal on the grounds that it would create complexity by eliminating the existing certainty surrounding the treatment of guaranteed payments and because such a proposal was unnecessarily broad in curing the inconsistent timing rules applicable to payments under §§ 707(a) and 707(c).

707(a)(2).³¹ The legislative history behind the enactment suggested that the capacity distinction between sections 707(a) and 707(c) warranted a new focus on entrepreneurial risk, as to both fact and amount of payment, from the perspective of the recipient partner.³²

Historically, capacity was determined by focusing on the nature of the services rendered by the partner in relation to the activities of the partnership.³³ For example, in Revenue Ruling 81-300,³⁴ the general partners of a limited partnership contributed time and effort through the rendition of managerial activities on behalf of the partnership in return for a fee equal to 5% of the gross rentals of the partnership. The Service reasoned that, because the partners rendered the managerial activities in their capacity as partners, section 707(a) was inapplicable to the transaction. In addition, the Service concluded that a fee dependent on the gross rentals of the partnership was “determined without regard to the income of the partnership.”³⁵ Thus, the Service treated the fee as a guaranteed payment under section 707(c).

As part of the Tax Reform Act of 1984, Congress enacted section 707(a)(2) which requires third-party treatment for any partner who renders services or transfers property to a partnership and who thereafter receives a related direct or indirect allocation of partnership income and a distribution of partnership property if such transfers are “properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership.” In making this determination, the legislative history focused on the entrepreneurial risk to which the partner is exposed with respect to the amount of any related distribution and whether the distribution will, in fact, be made.³⁶

As part of its discussion of section 707(a)(2)(A) in the legislative history, Congress referenced Revenue Ruling 81-300 and stated that the transaction described therein should be governed by section 707(a), rather

31. Tax Reform Act of 1984, Pub. L. No. 98-369, § 73(a), 98 Stat. 494, 591 (1984).

32. For a more expansive discussion of this issue, see Postlewaite & Cameron, *supra* note 2, at 676-94.

33. See, e.g., *Pratt v. Comm’r*, 64 T.C. 203 (1975), *aff’d* in part and *rev’d* in part, 550 F.2d 1023 (5th Cir. 1977); Rev. Rul. 81-300, 1981-2 C.B. 143; Rev. Rul. 81-301, 1981-2 C.B. 144.

34. 1981-2 C.B. 143.

35. In this regard, Revenue Ruling 81-300 rejected the position of the Tax Court in *Pratt v. Comm’r*, 64 T.C. 203 (1975), *aff’d* in part and *rev’d* in part, 550 F.2d 1023 (5th Cir. 1977), concluding that payments determined with respect to gross rentals of the partnership were determined with regard to the income of the partnership and, thus, excluded from treatment under § 707(c).

36. S. Rep. No. 98-169, at 227 (1984). See also Staff of the Joint Comm. on Tax’n, General Explanation of H.R. 4170, 227-28 (1984). In issuing Regulations under § 707(a)(2) following its enactment in 1984, the Service did not address the treatment of services but reserved Regulation § 1.707-2 for future coverage of the issue.

than section 707(c).³⁷ The only apparent explanation for this statement is that the new concept of capacity reflected in section 707(a)(2) focusing on economic risk should apply in the context of section 707(c) as well.³⁸

With this dramatic alteration in the determination of capacity, the distinction between a section 707(a) payment and a section 707(c) payment virtually disappeared because most transactions designed to compensate a partner/service-provider or partner/capital-provider lack risk as to both the fact and the amount of payment. Consequently, most, if not all, payments previously falling under section 707(c) now fall under section 707(a). It is a rare setting in which a payment could meet the textual requirements of section 707(c) and yet possess entrepreneurial risk as to the fact and the amount of payment.³⁹ As described above, this change was not all that

37. S. Rep. No. 98-169, at 230 (1984). See also Staff of the Joint Comm. on Tax'n, General Explanation of H.R. 4170, 230-31 (1984).

38. Most casebook authors and other academic commentators have not rushed to acknowledge that the enactment of § 707(a)(2) dramatically affected the capacity analysis applicable to guaranteed payments. Instead, they largely limit any discussion of § 707(a)(2) to the issue of distinguishing payments under § 707(a)(1) from a partner's distributive share of partnership income and a distribution of partnership property and continue to cite the law as it existed prior to 1984, including the *Pratt* decision, when considering the capacity question in the context of guaranteed payments. See, e.g., Stephen A. Lind, Stephen Schwartz, Daniel J. Lathrope & Joshua D. Rosenberg, *Fundamentals of Partnership Taxation: Cases and Materials* 222-42 (7th ed., 2005); Glenn C. Coven, Robert J. Peroni & Richard C. Pugh, *Taxation of Business Enterprises: Cases and Materials* 973-90 (2d ed., 2002); Laura E. Cunningham & Noel B. Cunningham, *The Logic of Subchapter K: A Conceptual Guide to the Taxation of Partnerships* 120-21 (2d ed., 2000); Jerold A. Friedland, *Understanding Partnership and LLC Taxation* § 7.02 (2000). But see Alan Gunn & James R. Repetti, *Partnership Income Taxation* 124-25 (4th ed., 2005) (acknowledging the difficulty of applying the capacity analysis under § 707(a)(2) to the problem of distinguishing a guaranteed payment from a § 707(a) payment); Karen C. Burke, *Federal Income Taxation of Partners and Partnerships* 234-35 and 243 (3d ed., 2005) (acknowledging the capacity analysis introduced by § 707(a)(2) and noting that "[s]ince § 707(c) payments are by definition fixed, all such payments might plausibly be treated as § 707(a) payments"). See also 4 Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates & Gifts* ¶ 89.1.3 (3d ed., 2003) (noting that the distinction drawn in the *Pratt* decision between activities within and without the scope of the partnership to resolve the capacity question was effectively eliminated by the enactment of § 707(a)(2)(A)).

39. Nevertheless, the Regulations under § 707 do recognize a continuing role for guaranteed payments following the enactment of § 707(a)(2). Thereunder, a payment for the use of capital that is characterized by the parties as a guaranteed payment and is reasonable (as defined therein) is presumed to be a guaranteed payment for capital and not part of a sale of property for purposes of § 707(a)(2)(B). Regs. § 1.707-4(a)(1). The Regulations make no mention of the revised capacity analysis introduced by § 707(a)(2) to determine if such payments properly fall within § 707(c) as subject to the entrepreneurial risks of the partnership and, thus, paid to the partner in his capacity as

remarkable because the distinctions between the two subsections had been previously eroded.

Given these developments, we, almost 20 years ago, called into question the continuation of section 707(c).⁴⁰ The erosion of any distinctions between the subsections as a result of legislative changes by Congress between 1954 and 1984 had effectively eliminated any differences in the tax treatment for payments classified as payments under section 707(a) and those classified as guaranteed payments under section 707(c). Furthermore, the revised capacity analysis introduced through the enactment of section 707(a)(2) made section 707(c) inapplicable to the typical types of payments that it previously covered. Section 707(c) had been effectively repealed and all that remained was statutory surplusage prone to produce confusion and complexity. Accordingly, we advocated that the slow death of the concept of guaranteed payments be hastened by the outright repeal of section 707(c).

III. NON-LIQUIDATING GUARANTEED PAYMENTS MADE IN-KIND

A. Central Thesis of Kahn and Cuenin's Article

Kahn and Cuenin begin their article with a brief introduction to the purpose and operation of section 707(c) and the concept of guaranteed payments.⁴¹ Kahn and Cuenin embrace the historical emphasis, no longer controlling in light of the subsequent legislative enactments previously described, on an evaluation of the capacity in which a partner is acting in order to distinguish between payments under sections 707(a) and 707(c). Thus, their discussion fails to incorporate the profound developments introduced by the Tax Reform Act of 1984 that resulted from a Congressional reinterpretation of the capacity test. As a result, they overlook the central role played by section 707(a)(2) to the questions they consider.

a partner. Nevertheless, the Regulations apply a facts and circumstances inquiry to determine if the payment should properly be treated as part of a sale of property. Compare Regs. § 1.707-4(a)(4), example (1) (in which a payment is treated as a guaranteed payment for capital) and example (2) (in which the presumption that a payment is a guaranteed payment for capital is rebutted). Although this portion of the Regulations is seemingly inconsistent with the proper application of the capacity analysis following the enactment of § 707(a)(2), such payments do not raise the complications associated with in-kind guaranteed payments that are at issue herein because they are expressly limited to transfers of money. Regs. § 1.707-4(a)(1)(ii). Thus, their treatment under § 707(c), rather than § 707(a), is virtually meaningless.

40. Postlewaite & Cameron, *supra* note 2, at 694-96.

41. Kahn & Cuenin, *supra* note 6, at 408-10. Kahn and Cuenin also provide the reader with a review of the tax treatment for both the partnership and the recipient partner of liquidating and non-liquidating distributions of partnership property. *Id.* at 411-14.

While acknowledging that guaranteed payments are traditionally made in cash, Kahn and Cuenin conclude, given the absence of a statutory or regulatory prohibition, that such payments can be made in-kind as well.⁴² Kahn and Cuenin briefly acknowledge the infrequency with which such payments are made, a recognition which by itself might dictate an interpretation of the statutory and regulatory framework in such a way as to minimize aberrational results.⁴³ They then move their focus from the typical type of guaranteed payment (a payment fixed in amount) to address an infrequent, atypical type of guaranteed payment (a payment structured as a percentage of partnership income with a minimum dollar amount) and the tax issues which present themselves in such a case.⁴⁴

42. Kahn & Cuenin, *supra* note 6, at 406-07. They also cite leading treatises in the field of partnership taxation as supporting this conclusion. *Id.* (citing 2 Willis, Pennell & Postlewaite, *supra* note 11, at ¶ 15.06 and 1 William S. McKee, William F. Nelson & Robert L. Whitmire, *Federal Taxation of Partnerships and Partners* ¶ 13.03[5] (3d ed., 1997). See also Rev. Rul. 91-26, 1991-1 C.B. 184 (treating accident and health insurance premiums paid by a partnership on behalf of its partners as a guaranteed payment and referring to guaranteed payments under § 707(c) as “[a]mounts paid in cash or in-kind by a partnership”).

Given Kahn and Cuenin’s subsequently articulated desire to implement the statutory language of § 707(c) as closely as possible, it is curious that they do not explore the distinct difference in the statutory language between § 707(c)’s explicit reference to “payments” to a partner and § 707(a)’s more general reference to “transactions” between a partner and a partnership. This difference in language, as well as the acknowledged Congressional failure apparently to consider in-kind guaranteed payments when enacting § 707 in 1954, may well suggest that § 707(c) was never intended to apply to in-kind transfers of partnership property. See *Armstrong v. Phinney*, 394 F.2d 661 (5th Cir. 1968) (questioning whether in-kind meals and lodging received by a partner could constitute “payments” for purposes of § 707(c)). Thus, through close attention to the statutory language and through the adoption of reasonable assumptions regarding Congressional intent, the problems encountered in considering the application of § 707(c) to in-kind transfers could easily be avoided.

43. Kahn & Cuenin, *supra* note 6, at 407 and 417-18.

44. Kahn & Cuenin, *supra* note 6, at 410 and 423-24. This latter type of guaranteed payment is illustrated through an example contained in the Regulations. Regs. § 1.707-1, example (2). Under this example, Partner C provides services to the partnership and is entitled to receive 30% of partnership income, before taking into account any guaranteed payments, but not less than \$10,000. If the partnership’s income is \$60,000, C will receive a distributive share of partnership income of \$18,000 and no guaranteed payment. However, if the partnership’s income is only \$20,000, C will receive a distributive share of partnership income of only \$6,000. Because C is entitled to receive not less than \$10,000, the difference, \$4,000, is a guaranteed payment.

Kahn and Cuenin’s attention to this type of guaranteed payment is curious for three reasons. First, it is not clear how frequently payments are structured in this manner. Thus, their importance in determining the proper interpretation of § 707(c) may be overstated. Second, the Regulations apparently fail to follow the legislative history

Kahn and Cuenin assert that the “unresolved question” is whether in-kind guaranteed payments made by the partnership “will cause the partnership that made the payment to recognize gain or loss if the property is appreciated or depreciated.”⁴⁵ With respect to this question, they conclude that the partnership should recognize neither gain nor loss on the transfer of an in-kind guaranteed payment, treating such a payment instead as a distribution of partnership property.⁴⁶

Thereafter, Kahn and Cuenin focus on two related but “unresolved questions . . . (1) how is a partner’s basis in property that was received as a guaranteed payment to be determined, and (2) . . . what effect does the payment have on the partner’s outside basis in his partnership interest.”⁴⁷ Referencing the lack of coverage and clarity in the treatment of the issue in the leading works on partnership taxation, Kahn and Cuenin conclude, in the first of their deviations from the statutory language of Subchapter K, that the service provider/partner receives a fair market value basis in the transferred property.⁴⁸ Furthermore, and in another deviation from the statutory language of Subchapter K, they conclude that a partner’s basis in his partnership interest is not directly affected by the payment.⁴⁹ They do note that an indirect impact on the recipient’s partnership interest occurs because the

with respect to such payments. Both the House and Senate Reports regarding § 707 state that “[a] partner who is guaranteed a minimum annual amount for his services shall be treated as receiving a salary in that amount.” H.R. Rep. No. 83-1337, at A227 (1954), reprinted in 1954 U.S.C.C.A.N. 4017, 4367; S. Rep. No. 83-1622, at 387 (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 5029. We raised this issue in our earlier article and proposed that the entire minimum amount be considered as a payment to a third party regardless of the partner’s share of partnership income. See Postlewaite & Cameron, *supra* note 2, at 700-02. But see Rev. Rul. 66-95, 1966-1 C.B. 169 (prohibiting a partnership from treating the entire minimum amount of a guaranteed payment structured as a percentage of partnership income, but not less than a specified dollar amount, as deductible under § 707(c)). Third, a payment in this form is not “determined without regard to the income of the partnership” as required by the explicit language of § 707(c). See Martin B. Cowan, “Compensating the General Partner: The *Pratt* Case,” 56 *Taxes* 10 (1978). As described above, the amount of the guaranteed payment depends entirely on the income of the partnership. Some of the potential problems regarding guaranteed payments structured in this manner were noted immediately following the enactment of § 707(c). See J. Paul Jackson, Mark H. Johnson, Stanley S. Surrey, Carolyn K. Tenen & William C. Warren, “The Internal Revenue Code of 1954: Partnerships,” 54 *Colum. L. Rev.* 1183, 1203 (1954). See also Rev. Rul. 69-180, 1969-1 C.B. 183 (detailing the treatment of this type of guaranteed payment when the partnership has both ordinary income and capital gain).

45. Kahn & Cuenin, *supra* note 6, at 406.

46. Kahn & Cuenin, *supra* note 6, at 422-27.

47. Kahn & Cuenin, *supra* note 6, at 407.

48. Kahn & Cuenin, *supra* note 6, at 428-36.

49. Kahn & Cuenin, *supra* note 6, at 419-22.

payment is deductible to the partnership and the partner's share of the deduction filters its way through to the partner in the determination of his distributive share of partnership income.

To reach their conclusions regarding the tax implications of in-kind guaranteed payments, Kahn and Cuenin rely heavily on the precise language of section 707(c), which requires that guaranteed payments be treated as made to a third party "*but only for the purposes of* section 61 . . . and, subject to section 263, for purposes of section 162(a)" ⁵⁰ For any purpose other than those specified in the statute, Kahn and Cuenin assert that the payment is to be treated as a distribution by the partnership subject to the controlling provisions of Subchapter K. ⁵¹ However, on a number of subsequent occasions, Kahn and Cuenin recognize a policy need to deviate from the confines of the statutory language. As a result, they do not advocate a literal application of the language of section 707(c) but suggest that it creates a "presumption" that a payment will be treated as a partnership distribution other than for the purposes of sections 61(a), 162(a), and 263. ⁵² Thus, "there is a burden on those who would seek to expand the entity treatment to demonstrate that there is a compelling reason to do so." They claim to have satisfied this burden when they deviate from the strictures of the legislative language, as for example, when they conclude that the recipient partner takes a fair market value basis in the property received. Nevertheless, they implicitly fail to satisfy this burden when they conclude that a partnership recognizes neither gain nor loss on the transfer of an in-kind guaranteed payment despite the unusual tax treatment when property is transferred in return for the rendition of services. This willingness to selectively apply the statutory language of section 707(c) for different aspects of the same transaction calls into question the persuasiveness of their advocacy.

Their analysis also appears to be in conflict with the Tax Court's approach to the statutory language of section 707(c). In *Miller v. Comm'r*, ⁵³ the court concluded that guaranteed payments in the form of salary received by a partner for services performed abroad were excludable from the partner's gross income under section 911. The court reasoned that section 707(c)'s reference to section 61(a) included the phrase "[e]xcept as otherwise provided in this subtitle" and that section 911 provided otherwise. The court also reasoned that the legislative history to section 707 indicated that "the general approach of the section is to apply the entity theory to the dealings

50. IRC § 707(c) (emphasis added). Kahn & Cuenin, *supra* note 6, at 409-10 and 415-19.

51. Kahn & Cuenin, *supra* note 6, at 415 (stating that "[t]he 'but only for the purposes of' language of the statute strongly suggests that for all other purposes the payment is treated as a distribution to a partner").

52. Kahn & Cuenin, *supra* note 6, at 418.

53. 52 T.C. 752 (1969).

between partners and the partnership,”⁵⁴ relying on the following statement from the legislative history:

No inference is intended, however, that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions.⁵⁵

The court found no reason why, for purposes of section 911, the entity theory should not be applied as consistent with the policy goals of both sections 707(c) and 911. Thus, the court appeared to create a presumption that the entity, not the aggregate, theory should prevail under section 707(c) unless the aggregate theory was more appropriate in a particular context.

The Tax Court also addressed the implications of the “but only for the purposes of” language under section 707(c) and concluded that it was intended to achieve only a very narrow purpose regarding the timing of guaranteed payments.

This conclusion does not ignore the effect of the “but only” words. These words were added to section 707(c) by the Senate which at the same time also amended section 706 to provide that guaranteed payments received by a partner are to be included in his income for his taxable year in which the partnership’s taxable year ends. In connection with section 707(c), the Senate committee report indicates that the reason for the change was to provide that guaranteed payments are to be included in income at the same time as a partner’s distributive share – not at the time when compensation would ordinarily be included in income. This is the only example in the legislative history of the need for the “but only” words.⁵⁶

Thus, the Tax Court did not view the “but only for the purposes of” language as creating any presumption regarding the interpretation of section 707(c).

In summary, Kahn and Cuenin conclude that an in-kind guaranteed payment results in ordinary income for the recipient partner equal to the fair market value of the property received, a basis for the property in the hands of the recipient partner equal to the property’s fair market value, and no direct

54. *Id.* at 761.

55. *Id.* (quoting H.R. Rep. No. 83-2543, at 59 (1954) (Conf. Rep.), reprinted in 1954 U.S.C.C.A.N 5280, 5319-20.

56. *Id.* at 762.

basis adjustment to the recipient partner's partnership interest. While the partnership receives a deduction on the transfer, they assert that it is immune from gain or loss recognition. According to Kahn and Cuenin, these results are dictated by a combination of the statutory language of section 707(c), the provisions of Subchapter K applicable to partnership distributions, and general tax policy principles.

B. The Non-Partnership Setting

Interestingly, the conclusions reached by Kahn and Cuenin conflict with the results derived in an identical transaction in the context of an individual/sole proprietorship. Although considered by Kahn and Cuenin only in passing,⁵⁷ the sole proprietorship paradigm involving an employer satisfying an obligation for services rendered by his employee through the transfer of property rather than cash not only is instructive regarding the proper tax treatment of guaranteed payments, but also serves as a baseline against which any conclusions regarding the tax treatment of guaranteed payments can be compared. Significantly, the identical questions are confronted – income issues to the employee, including the amount of income and its character, the basis of any property received by the employee, the recognition of income or loss by the employer through the transfer of property to satisfy an obligation for services rendered, and the deduction by the employer for the expenditure incurred.

In the sole proprietor paradigm, encountered in the first four weeks of virtually every basic tax course, the tax landscape is fairly well defined with regard to the tax issues confronted by both the employer and the employee. The typical hypothetical involves the following: Assume that a full-time employee, E, has rendered services during the past month in return for his employer's promise to pay him \$10,000 per month. At the end of the month, E's employer, R, offers to pay him in-kind through the transfer of property previously purchased for \$8,000. E and R agree that the value of the property is \$10,000, and E is willing to accept the property in satisfaction of his claim for payment for the services rendered. What are the tax consequences to the parties?

57. Kahn & Cuenin, *supra* note 6, at 414-15. Interestingly, Kahn and Cuenin suggest that a sole proprietor recognizes gain or loss because "the employer is satisfying a debt with appreciated or depreciated property, and so there is an exchange of the property for the debt." *Id.* at 414. Subsequently, they claim that the issue for determination is whether an in-kind guaranteed payment should "be treated as if it were made by an employer (a separate entity) to an employee." *Id.* at 415. By moving the issue to whether an employer-employee relationship exists, they ignore the more important component of their formulation – whether there was an exchange of property for debt.

Notwithstanding the usual confusion that ensues in the classroom, ultimately the professor leads the class to see, understand, and conclude that E has ordinary income in the amount of \$10,000 from compensation for services rendered under section 61 of the Code.⁵⁸ Since his receipt was in-kind, rather than in cash, the tax law accords him a basis in the property in order that, upon a future sale, a proper determination of gain or loss can be made.⁵⁹ The tax law quite properly and logically accords E a basis equal to the amount of income reported on the transfer. Thus, E receives the property with a basis equal to its fair market value of \$10,000.

After addressing the tax consequences to E, the class turns its attention to the other side of the transaction. Most students instantly advocate a deduction for R, assuming of course that the activity in which E rendered his services is one that is either a trade or business or an activity for the production of income, in the amount of \$10,000.⁶⁰ (It is usually left to the professor to caution that, before finalizing such a conclusion, a determination needs to be made as to whether such a payment, in cash or in-kind, requires capitalization under section 263.) The final component in addressing the totality of the tax issues presented, often left to the professor to forcefully advocate, is the determination of whether gain or loss results from R's satisfaction of an obligation by transferring property with a fair market value that differs from R's basis in that property.⁶¹ Students soon realize that R should be treated as if he transferred cash to E in the amount of the obligation and subsequently transferred the property to E in return for the cash deemed paid.⁶² Thus, in this example, R takes a \$10,000 current deduction, combined with the realization and recognition of \$2,000 of gain, the character of which will depend on the type of property transferred in the hands of R.⁶³

Most would neither question nor object to the conclusions reached in this example involving a sole proprietor. Nevertheless, Kahn and Cuenin advance the bold proposition that the movement of a virtually identical transaction into the poorly understood and frequently complex world of partnership taxation can upset our understanding of these fundamental tax principles. While acknowledging that the tax treatment involving an in-kind guaranteed payment generally follows the sole proprietor paradigm, Kahn and Cuenin conclude that for purposes of gain or loss recognition by the

58. IRC § 61(a)(1); Regs. § 1.61-2(d).

59. IRC § 1012; Regs. §§ 1.61-2(d)(2) and 1.1012-1(a).

60. IRC §§ 162(a)(1) and 212; Regs. §§ 1.162-1(a), 1.162-7, and 1.212-1.

61. IRC §§ 61(a)(3) (referring to gains from dealings in property), 1001(a) (specifying the determination of gain realized), and 1001(c) (requiring the recognition of realized gain unless a non-recognition provision is applicable). See also Regs. §§ 1.61-6, 1.1001-1(a), and 1.1002-1.

62. Kahn & Cuenin, *supra* note 6, at 414-15.

63. IRC §§ 1221 and 1231.

transferring partnership, the transfer constitutes a distribution of partnership property otherwise subject to the property distribution scheme of Subchapter K. Accordingly, the partnership recognizes neither gain nor loss on the satisfaction of its obligation through the transfer of an in-kind guaranteed payment. As a general matter, one would expect a heavy burden of proof on those advocating any tax treatment that is so obviously contradictory with the basic principles of taxation.

In responding to our asserted analogy between the sole proprietor and partnership situations, Kahn and Cuenin would likely claim that the involvement of a partner rendering services to a partnership rather than a third-party employee complicates any attempt to apply the sole proprietor paradigm and raises the slippery questions of whether the partnership should be conceptualized as an entity separate from its partners or as simply an aggregate of its individual partners.⁶⁴ Indeed, Kahn and Cuenin decline to take sides on this question, recognizing that Congress refused to exclusively adopt either an entity or aggregate approach to the taxation of partnerships in enacting Subchapter K. Moreover, they assert that individual sections of Subchapter K, including section 707(c), reflect this “dual approach.”⁶⁵ As stated in their article, “[section 707(c)] treats the partnership as an entity to the extent that it requires the partner to recognize ordinary income and grants the partnership a deduction; and it applies aggregate or conduit treatment to the extent that the payment is treated as a partnership distribution.”⁶⁶

Nevertheless, Kahn and Cuenin acknowledge that Congress likely did not consider the tax consequences of in-kind guaranteed payments.⁶⁷ We agree with them that any legislative intent regarding this question “will have to be extrapolated from the meager history that is available and from the assumption that Congress would wish the statute to be construed in a manner that arrived at results that conform to the broad policies that underlie Subchapter K.”⁶⁸ However, we believe that the proper interpretation of section 707(c) is derived from a comprehensive understanding of the history of section 707(c) and an appreciation of the fact that Subchapter K’s non-recognition provisions are an exception from baseline principles, illustrated in the sole proprietor paradigm, requiring the recognition of realized gain or loss resulting from any and all property transactions.

64. See Kahn & Cuenin, *supra* note 6, at 417.

65. Kahn & Cuenin, *supra* note 6, at 417. Kahn and Cuenin cite § 751 as another example of a section of Subchapter K that applies both the entity and aggregate approach.

66. Kahn & Cuenin, *supra* note 6, at 417. Kahn and Cuenin cite the legislative history in support of their assertion that Congress intended to adopt this flexible approach to transactions between a partnership and its partners. *Id.* at n.48 (citing H.R. Rep. No. 83-2543, at 59 (1954) reprinted in 1954 U.S.C.C.A.N. 5280, 5319-20).

67. Kahn & Cuenin, *supra* note 6, at 417-18.

68. Kahn & Cuenin, *supra* note 6, at 418.

C. Non-Recognition of Gain or Loss by the Partnership

As previously described, Kahn and Cuenin part company with the sole proprietor paradigm with respect to the partnership's recognition of gain or loss on the transfer of an in-kind guaranteed payment. As a result, the resolution of this question is central to their analysis. The mere comparison of the partnership setting with the sole proprietor paradigm without more would seemingly mandate an affirmative response to the question. Nothing from the standpoint of general tax policy principles appears to distinguish the two situations and, thus, from a policy perspective, there would appear to be no compelling rationale for treating the virtually identical situations differently.

Nevertheless, Kahn and Cuenin resolve this question in the negative, based on two related rationales – the statutory language of section 707(c) and the policies underlying Subchapter K. According to Kahn and Cuenin, the statutory language of section 707(c) imposing third-party treatment in connection with guaranteed payments is applicable “only for the purposes of sections 61(a) . . . 263 . . . [and] 162(a).”⁶⁹ As a result, Kahn and Cuenin

69. Kahn and Cuenin suggest that the statutory reference to § 61 contained in § 707(c) was only to ensure ordinary income treatment by the recipient partner. Kahn & Cuenin, *supra* note 6, at 422. They do note, however, that an argument could be made that the reference to § 61(a) incorporates § 61(a)(3) applicable to “gains derived from dealings in property” which could require gain recognition by the partnership in connection with an in-kind guaranteed payment. *Id.* (citing 1 McKee, Nelson & Whitmire, *supra* note 42, at ¶ 13.03[5], n.174). They reject this argument because § 61(a) does not refer to losses, and, under such an argument, a partnership making an in-kind guaranteed payment would not be allowed to realize a loss if property with a basis greater than its fair market value were transferred as a guaranteed payment.

The argument that § 707(c)'s reference to § 61(a) incorporates § 61(a)(3) is probably erroneous because it is inconsistent with the statutory evolution of § 707(c) in any event. As originally passed by the House, § 707(c) applied only to partnership payments for the rendition of services by a partner, and the language referred specifically to § 61(a)(1)'s inclusion of compensation for services in gross income. H.R. 8300, 83d Cong. § 707(c) (1954). The more general reference to § 61(a) was made by the Senate, presumably when it expanded § 707(c) to apply to payments for the use of capital. S. Rep. No. 83-1622, at 387 (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 5029. The reference to § 61(a)(1) in the original bill strongly suggests that the reference to § 61(a) was intended to apply only to the treatment of a guaranteed payment by the recipient partner and not to the transferring partnership. An appreciation of the statutory evolution of § 707(c) and its intended reference to § 61(a)(1) and, presumably, § 61(a)(4) with respect to payments for the use of capital also avoids any possible confusion that the intended reference is to § 61(a)(13) – a partner's distributive share of partnership gross income – and any possible implications that such a reference might generate. See G.C.M. 34173. Nevertheless, the courts have not adopted such a limited

acknowledge that third party treatment is mandated with respect to the compensatory aspects of the transaction, i.e., income inclusion on the part of the recipient partner under section 61(a) and the availability of the corresponding deduction on the part of the transferring partnership under sections 162 and 263.⁷⁰

Kahn and Cuenin then assert that the “language of the statute *strongly suggests* that *for all other purposes* the payment is treated as a distribution to a partner.”⁷¹ Thus, they maintain that the default treatment of a guaranteed payment is that of a distribution of partnership property. To support this assertion, they point to the Code and Regulations which use the partnership’s accounting method for determining the timing of the recipient partner’s income inclusion of the guaranteed payment.⁷² They observe that the rule applicable to the timing of the recipient partner’s inclusion of a guaranteed payment is the same as the rule applicable to a partner’s distributive share of partnership income. For Kahn and Cuenin, this similarity of treatment between the timing rules governing guaranteed payments and those governing a partner’s distributive share of partnership

view of the statutory language of § 707(c) and have interpreted it as incorporating all of § 61(a). See *supra* note 25.

Kahn and Cuenin are probably incorrect that the reference to § 61(a) was only to ensure ordinary income treatment by the recipient partner. The problem that existed prior to the enactment of § 707(c) was that a salary payment to a partner in excess of the partnership’s income was treated as derived from the partners’ capital. Thus, a portion of such a payment was a return of capital for the recipient partner, which was excluded from gross income. See *Lloyd v. Comm’r*, 15 B.T.A. 82 (1929); *Estate of Tilton*, 8 B.T.A. 914 (1927); G.C.M. 6582, VIII-2 C.B. 200 (1929). The reference to § 61(a) was probably intended to ensure that the entire payment was included in the recipient partner’s gross income and was not intended to characterize for tax purposes the nature of the income received. See *infra* note 149.

70. While Kahn and Cuenin do not explicitly explore this aspect of the history of § 707(c) as part of their interpretative methodology, it is noteworthy that earlier “strict constructionists” concluded that the limiting language of § 707(c), as originally enacted, precluded the application of the capitalization rules. See *supra* text accompanying notes 24-26. Nevertheless, the courts held to the contrary, and Congress subsequently amended § 707(c) to resolve any lingering uncertainty. Although the frequency of transactions involving guaranteed payments that should be capitalized probably exceeds that of transactions involving in-kind guaranteed payments, the judicial approach in addressing the capitalization issue suggests that the resolution of the question of in-kind guaranteed payments in a manner consistent with third-party treatment should not easily be dismissed.

71. Kahn & Cuenin, *supra* note 6, at 415 (emphasis added.)

72. IRC § 706(a); Regs. §§ 1.706-1(a) and 1.707-1(c). Kahn & Cuenin, *supra* note 6, at 415, n.42. Kahn & Cuenin also note that the timing rules applicable to related persons in certain circumstances under § 267(a)(2) do not apply to guaranteed payments under § 267(e)(4). *Id.*

income is interpreted as evidence of Congressional intent to treat a guaranteed payment as a distribution of partnership property.

However, the similarity of rules regarding the timing of income resulting from guaranteed payments and distributive shares of partnership income are largely irrelevant to any connection between guaranteed payments and distributions of partnership property. A partner includes his distributive share of partnership income in gross income whether or not he receives a distribution of partnership property from the partnership during the year. Similarly, a cash-method partner includes a guaranteed payment in gross income whether or not he receives property, either in cash or in-kind, from an accrual-method partnership during the year in satisfaction of that guaranteed payment.⁷³ Nevertheless, this observation implies little, if anything, about the treatment of a guaranteed payment as a distribution of partnership property.

The similarity of guaranteed payments and distributive shares of partnership income becomes relevant to a conclusion that guaranteed payments should be treated in a manner similar to distributions of partnership property only if a guaranteed payment is conceptualized as a special allocation of partnership income and a simultaneous (or subsequent distribution) of partnership property.⁷⁴ Kahn and Cuenin are supported in this

73. IRC § 706(a); Regs. §§ 1.706-1(a) and 1.707-1(c). Regulation § 1.707-1(c) specifically states that “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 *Gaines v. Comm’r*, T.C. Memo. 1982-731, 45 T.C.M. (CCH) 363 (noting the equivalent treatment of the partner’s distributive share of partnership income and stating that “any unfairness in taxing a partner on guaranteed payments that he neither receives nor benefits from results from the conduit theory of partnerships, and is a consequence of the taxpayer’s choice to do business in the partnership form”). Although § 707(c) refers to a “payment,” the timing of a guaranteed payment by an accrual-method partnership to a cash-method partner is unrelated to the time of actual payment. The potential inconsistency between the use of the word “payment” in § 707(c) and the timing rule under § 706(a) was noted immediately following the enactment of Subchapter K. See J. Paul Jackson, et al., *supra* note 44, at 1203.

74. Such a view would be consistent with the conceptualization of guaranteed payments prior to the 1954 enactment of Subchapter K. See Kahn & Cuenin, *supra* note 6, at 409. For a more extensive discussion of the treatment of guaranteed payments prior to the enactment of Subchapter K, see Postlewaite & Cameron, *supra* note 2, at 651-53. Kahn and Cuenin acknowledge that Congress viewed the pre-1954 treatment of such payments as “unrealistic and unnecessarily complicated.” Kahn & Cuenin, *supra* note 6, at 409 (citing H.R. Rep. No. 83-1337, at 68 (1954), reprinted in 1954 U.S.C.C.A.N. 4017, 4094). Nevertheless, they insist Congress intended to retain this earlier conceptualization rather than treat guaranteed payments as payments to a third party for all purposes. Although they may be correct with regard to Congress’s original intent (see *infra* note 149), the courts have not interpreted § 707(c) in this manner.

endeavor by the regulatory statement that, with certain exceptions, “guaranteed payments are regarded as a partner’s distributive share of ordinary income.”⁷⁵

However, Kahn and Cuenin must confront the fact that the explicit statutory limitations contained in the language of section 707(c) are not exclusive. For example, the Regulations provide that guaranteed payments do not constitute an interest in partnership profits for purposes of sections 706(b)(3), 707(b), and 708(b).⁷⁶ These provisions are each concerned with determining the extent of a partner’s interest in a partnership and exclude guaranteed payments from that determination. However, if guaranteed payments are properly viewed as a special allocation of partnership income and a subsequent distribution of partnership property, the opposite conclusion would appear to ensue. Because guaranteed payments are typically structured as predictable distributions of fixed amounts, it is surprising they are excluded from the determination of a partner’s interest in a partnership.⁷⁷

Significantly, Kahn and Cuenin also cite the fact that guaranteed payments are not treated as allocations of partnership income and distributions of partnership property for purposes of maintaining the partners’ capital accounts under the Regulations to section 704.⁷⁸ Under these

75. Regs. § 1.707-1(c). Interestingly, the statement in the Regulations that “guaranteed payments are regarded as a partner’s distributive share of ordinary income” is seemingly inconsistent with statements included in the legislative history. Both the House and Senate Reports regarding § 707 state that “[t]he amount of such payment shall be included in the partner’s gross income, and shall not be considered a distributive share of partnership income.” H.R. Rep. No. 83-1337, at A227 (1954), reprinted in 1954 U.S.C.C.A.N. 4017, 4367; S. Rep. No. 83-1622, at 387 (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 5029.

76. Regs. § 1.707-1(c). Kahn & Cuenin, *supra* note 6, at 415. In addition, the Regulations dictate that a guaranteed payment cannot qualify for the sick pay exclusion under prior law at § 105(d) and that a partner who receives a guaranteed payment is not regarded as an employee for purposes of employee withholding and deferred compensation.

77. Kahn and Cuenin note that no similar limitations exist under § 707(a), thereby suggesting that the limiting language of § 707(c) was intended to have some significance. However, the question is not whether a difference exists between §§ 707(a) and 707(c), but whether the statutory and non-statutory exclusions can be reconciled with the treatment of guaranteed payments as distributions of partnership property.

78. Regs. § 1.704-1(b)(2)(iv)(o). Kahn & Cuenin, *supra* note 6, at 418. While the Regulations under § 704 dictate the treatment of guaranteed payments for capital account purposes, their guidance is meager at best. Regulation § 1.704-1(b)(2)(iv)(o), which addresses guaranteed payments, provides nothing more than an instruction consistent with a conceptualization of guaranteed payments as transfers in cash. Under this Regulation, the recipient partner’s capital account is adjusted only by his share of the partnership’s “deduction, loss, or other downward capital account adjustment

Regulations, a partner's capital account is only adjusted by the partner's distributive share of any deduction resulting from a guaranteed payment. This provision, at a minimum, suggests that a guaranteed payment is conceptualized for purposes of maintaining capital accounts as a payment to a third party. If, as Kahn and Cuenin propose, a guaranteed payment should be treated as an allocation of partnership income and a distribution of partnership property, additional adjustments would be required.⁷⁹ Thus, the exceptions to the regulatory statement that "guaranteed payments are regarded as a partner's distributive share of ordinary income" appear to effectively swallow the general rule.

As a result of these non-statutory exceptions to the treatment of guaranteed payments as distributions of partnership property, Kahn and Cuenin are forced to shift the focus of their analysis from the statutory language of section 707(c) to a policy-based approach in order to suggest that the classic aggregate/entity dichotomy supports the treatment of a guaranteed payment as a distribution of partnership property.⁸⁰ Kahn and Cuenin's earlier reliance on the statutory language of section 707(c) is transformed into a pragmatic approach in which Congress in enacting Subchapter K refused to "slavishly adhere to consistency" in choosing between an entity or aggregate approach. Thus, the literal text is no longer controlling. Instead, Kahn and Cuenin acknowledge that the principles of sound tax policy should control the question presented. Presumably, a symmetry between sole proprietorships and partnerships should become compelling under such an analysis.

However, as part of their pragmatic approach to resolving the section 707(c) problem, Kahn and Cuenin contend that "the statutory limitation creates a presumption that, for purposes other than those three Code sections, the payment will be treated as a partnership distribution"⁸¹ This presumption imposes "a burden on those who would seek to expand the entity treatment to demonstrate that there is a compelling reason to do so."⁸² For Kahn and Cuenin, a compelling reason is apparently a conflict with either the policies of Subchapter K or the avoidance of any potential tax

resulting from such payment." The focus of the language on a "deduction, loss, or other downward adjustment" most likely reflects the drafters' desire for thoroughness and to ensure a proper adjustment should the payment constitute a capital expenditure. The reference to "loss" is puzzling, although possibly explained in an overall loss, rather than net income, situation for the partnership. Significantly, the Regulation does not reference the term "gain." Thus, it seems logical to conclude that the Regulations gave no consideration to in-kind guaranteed payments.

79. Regs. § 1.704-1(b)(2)(iv)(b).

80. Kahn & Cuenin, *supra* note 6, at 417.

81. Kahn & Cuenin, *supra* note 6, at 418.

82. Kahn & Cuenin, *supra* note 6, at 418.

liability.⁸³ Because they fail to find any such compelling reason, they conclude that the statutory limitations of section 707(c) control. As a result, a guaranteed payment should be treated in the same manner as a distribution of partnership property in which the partnership recognizes neither gain nor loss on an in-kind transfer.⁸⁴

Not only do Kahn and Cuenin not find a compelling reason to treat guaranteed payments as payments to a third party, they suggest that the treatment of guaranteed payments as distributions of partnership property better effectuates the policy objectives of Subchapter K.⁸⁵ This conclusion is based on the policy of Subchapter K to defer the recognition of gain or loss in connection with property transfers between partners and partnerships “to the extent that deferral is feasible and [any transfer] does not create an opportunity for significant tax evasion.”⁸⁶ Kahn and Cuenin clearly demonstrate that deferral of gain or loss by the partnership is feasible, but, as described below,⁸⁷ they fail to adequately consider the opportunities for tax evasion that their proposal entails.

Additionally, Kahn and Cuenin assert that recognition of gain or loss on the transfer of an asset in satisfaction of its obligation to a service provider “would cause a greater amount of complexity than that which Congress sought to remove by adopting the guaranteed payment provision.”⁸⁸ To document the potential complexity resulting from a requirement that the partnership recognize gain or loss, they resort to an atypical type of payment, one in which the payment is, in part, a guaranteed payment and, in part, a distribution of partnership property, thereby requiring an apportionment of the inside basis of the transferred property between the guaranteed payment portion of the transfer and the distribution portion.⁸⁹

83. Kahn & Cuenin, *supra* note 6, at 418. Curiously, Kahn and Cuenin make no effort to determine the compelling reason that the Regulations depart from the statutory language for purposes of §§ 704(b), 706(b)(3), 707(b), and 708(b). See *supra* text accompanying notes 76-77. Such an inquiry might shed some light on the government’s view of any such compelling reason standard.

84. IRC § 731(b). Kahn & Cuenin, *supra* note 6, at 418-19 and 427.

85. Kahn & Cuenin, *supra* note 6, at 422.

86. Kahn & Cuenin, *supra* note 6, at 422.

87. See *infra* text accompanying notes 138-55.

88. Kahn & Cuenin, *supra* note 6, at 423.

89. The type of guaranteed payment at issue is one in which the partner receives a percentage of partnership income, but not less than a specified dollar amount. For example, assume that Partner C provides services to the partnership and is entitled to receive 30% of partnership income, before taking into account any guaranteed payments, but not less than \$10,000. Regs. § 1.707-1(c), example (2). If the partnership’s income is \$60,000, C will receive a distributive share of partnership income of \$18,000 and no guaranteed payment. However, if the partnership’s income is only \$20,000, C will receive a distributive share of partnership income of only

However, any necessary allocation of basis to ensure proper results would hardly be unique to section 707(c). It is present elsewhere in the Code and, in itself, has not been found debilitating to the administration of the tax law.⁹⁰ One should not be surprised that an added layer of difficulty is encountered in such an atypical setting.⁹¹

\$6,000. Because C is entitled to receive not less than \$10,000, the difference, \$4,000, is a guaranteed payment.

Kahn and Cuenin protest that, if gain or loss had to be recognized by the partnership with respect to an in-kind guaranteed payment, the transfer of property in satisfaction of the guaranteed payment in such a situation would require that the inside basis of the transferred property be apportioned between the part of the transaction treated as a partnership distribution and the part of the transaction treated as a guaranteed payment. Kahn & Cuenin, *supra* note 6, at 423. But this assumes that the partnership transfers property worth \$10,000 to the partner, equal to both the partner's distributive share of partnership income and the partner's guaranteed payment. If property worth only \$4,000, the amount of the guaranteed payment, is distributed, no such apportionment would be necessary.

90. See, e.g., IRC § 1011(b) (requiring the allocation of basis in a part sale/part gift to a charitable organization in order to determine the amount of gain from the sale portion of the transfer); IRC § 1060 (requiring the allocation of basis among the assets of a going business when acquired for a lump sum); Regs. § 1.61-6(a) (requiring the equitable apportionment of basis among the several parts of a larger parcel of property when one or more of those parts are sold); Regs. § 1.167(a)-5 (requiring the allocation of basis between depreciable and non-depreciable property acquired for a lump sum "as for example, buildings and land"); Rev. Rul. 53-286, 1953-2 C.B. 20 (requiring the allocation of basis between the personal and business use of property in determining gain or loss on sale); *Sharp v. United States*, 199 F. Supp. 743 (D. Del. 1961), *aff'd*, 303 F.2d 783 (3d Cir. 1962) (same).

91. Kahn and Cuenin go on to complain that further complication ensues in such a situation because the amount of the guaranteed payment depends on the dollar amount of the partner's distributive share of partnership profits. Kahn & Cuenin, *supra* note 6, at 423-24. They apparently believe that the gain or loss resulting from the distribution of partnership property in satisfaction of the guaranteed payment will require the recomputation of the amount of the guaranteed payment. Even if correct, their concern in this regard is overstated. More importantly, any such complications are easily avoided.

Their concern that any gain or loss resulting from the distribution of partnership property in satisfaction of the guaranteed payment will require the recomputation of the amount of the guaranteed payment is overstated because in many, if not most, instances the partnership will not distribute property in satisfaction of a guaranteed payment until the taxable year following that in which the services are actually rendered. This is because the partnership's income, and thus the amount of the guaranteed payment, cannot be determined until after the end of the taxable year. For a cash-method partnership, the transfer of the property in the following taxable year means that both the deduction of the guaranteed payment and the recognition of any gain or loss resulting from the transfer would be deferred to that year. Although an accrual-method partnership would be allowed a deduction for the guaranteed payment

in the taxable year in which the services are actually rendered, the recognition of any gain or loss resulting from the transfer would be deferred to the following taxable year when the transfer is made. Thus, in both cases, any gain or loss resulting from the transfer is not relevant to the determination of the amount of the guaranteed payment in the taxable year in which the services are rendered.

Nevertheless, Kahn and Cuenin's concern could arise for either an accrual-method partnership or a cash-method partnership that transfers property in satisfaction of the guaranteed payment in the year the services are actually rendered despite the fact that the amount of the guaranteed payment is unknown at the time of the transfer. In such a situation, the amount of the gain or loss resulting from the transfer could be relevant to the determination of the amount of the guaranteed payment itself. However, the complexities encountered in this situation are easily avoided.

The basic equation to determine the amount of a guaranteed payment when structured as a percentage of partnership income subject to a minimum amount is:

$$GP = MA - (PI * DS) \qquad \text{Equation 1}$$

where $PI > 0$ and $MA > PI * DS$

and GP = guaranteed payment;
 MA = the guaranteed minimum dollar amount;
 PI = partnership income before taking into account any guaranteed payment; and
 DS = the partner's distributive share of partnership income.

Using the facts of the regulatory example described in note 89, *supra*, in which the partner is entitled to a distributive share of partnership income of 30% but not less than \$10,000 and the partnership has income of only \$20,000, the partner would receive a distributive share of partnership income of \$6,000 and a guaranteed payment of \$4,000. Regs. § 1.707-1, example (2).

Admittedly, the determination of the amount of the guaranteed payment is made significantly more complicated through the inclusion of any gain or loss recognized by the partnership as a result of the transfer of partnership property in satisfaction of the guaranteed payment. Kahn and Cuenin are correct that the inclusion of this recognized gain or loss will affect the amount of the partnership's income which will affect the amount of the guaranteed payment which will, in turn, affect the amount of the recognized gain or loss which will affect the amount of the partnership's income, and so on in a pyramiding fashion. They recognize that this problem "can be solved through the use of an algebraic formula" but caution that concerns regarding the administrability of the tax laws favor the avoidance of such a formula. Kahn & Cuenin, *supra* note 6, at 424. See *Old Colony Trust Co. v. Comm'r*, 279 U.S. 716 (1929) (recognizing that an algebraic formula could be used to determine the appropriate amount of tax when an employer pays the income taxes of an employee which generates additional income to the employee, which, in turn, results in additional income taxes to be paid by the employer, thereby generating additional income to the employee, and so on).

Assuming that the fair market value of the property to be transferred is equal to the amount of the guaranteed payment, the algebraic formula necessary to determine the amount of the guaranteed payment in such a situation is:

$$GP = [MA - (PI * DS)] / [1 + (1 - X) * DS] \quad \text{Equation 2}$$

where $PI > 0$ and $MA > PI * DS$

and

- GP = guaranteed payment;
- MA = the guaranteed minimum dollar amount;
- PI = partnership income before taking into account any guaranteed payment;
- DS = the partner's distributive share of partnership income; and
- X = is the ratio of the basis of the property to be transferred to its fair market value.

Using the facts of the example previously described and assuming that the partnership wishes to satisfy the guaranteed payment through the transfer of an interest in property with a fair market value of \$25,000 and a basis of \$15,000 (in which case X would equal 0.6 (\$15,000 divided by \$25,000)), the guaranteed payment would be only \$3,571 rather than \$4,000, partnership income would be \$21,429, and the partner's distributive share of partnership income would be \$6,429. In this case, the partnership would transfer to the recipient partner a 14.28% interest in the property with a value of \$3,571 and a basis of \$2,143.

Fortunately, all of the computational complications previously described can be easily avoided in the same manner that they are avoided in connection with the deduction of guaranteed payments in the determination of partnership income. In the example from the Regulations, the facts provide that partnership income is determined 'before taking into account any guaranteed payments.' Regs. § 1.707-1, example (2). Thus, the deduction generated by the guaranteed payment is not considered for purposes of determining the amount of partnership income. In the absence of such a provision, the guaranteed payment would be deductible by the partnership in the determination of partnership income which would affect the amount of the guaranteed payment which would, in turn, affect the amount of the partnership's income, and so on. The algebraic formula that would have to be applied to properly account for the deduction of any guaranteed payment in this situation is:

$$GP = [MA - (PI * DS)] / (1 - DS) \quad \text{Equation 3}$$

where $PI > 0$ and $MA > PI * DS$

and

- GP = guaranteed payment;
- MA = the guaranteed minimum dollar amount;
- PI = partnership income before taking into account any guaranteed payment; and
- DS = the partner's distributive share of partnership income.

Kahn and Cuenin suggest that the complexity incurred by requiring the partnership to recognize gain or loss on the transfer of partnership property in satisfaction of a guaranteed payment is exacerbated if the partnership has an election in effect under section 754.⁹² After providing an example of the basis adjustments under section 743(b) resulting from an election under section 754, they assert that the administrative burden of complying with such a requirement could become significant.

[I]f the partnership must recognize gain or loss on the guaranteed payment portion of the distributed property, not only will the inside basis of each asset that was distributed have to be apportioned between the guaranteed payment portion and the partnership distribution portion, but there would have to be a separate calculation and apportionment made for every partner's share. Especially when there are a sizeable number of partners, all of whom have special shares of inside basis, that could become burdensome.⁹³

Using the facts of the regulatory example described in note 89, *supra*, and assuming that partnership income is determined only *after* taking into account any guaranteed payment, the guaranteed payment would be \$5,714, partnership income would be \$14,286, and the partner's distributive share of partnership income would be \$4,486.

If the complications that the deduction of any guaranteed payment would create can be avoided simply by providing that partnership income for purposes of calculating any guaranteed payment is determined "*before taking into account any guaranteed payments*," such words could also easily be interpreted to avoid the complications of a requirement that the determination of any guaranteed payment take into account any gain or loss recognized on the transfer of partnership property in satisfaction of the guaranteed payment. In a footnote, Kahn and Cuenin acknowledge that "[t]he gain or loss from making the guaranteed payment would be excludable, for example, if the partnership provision that the partner is to receive a percentage of partnership income 'computed before taking into guaranteed payments into account' is construed to exclude a gain or loss recognized on the constructive sale of the distributed property as well as the deduction allowed for making that payment." *Id.* at n.61. Significantly, however, they fail to suggest any reason why such a similar interpretation would somehow be improper. Furthermore, if the words "before taking into account any guaranteed payments" apply to avoid the complications resulting from the deduction of a guaranteed payment, they should apply to any gain or loss on the transfer of property in satisfaction of a guaranteed payment when, unlike the deduction generated by a guaranteed payment for an accrual-method partnership, the transfer might not even occur in the partnership's current taxable year. Thus, no need to recompute the partnership's income would actually arise.

92. Kahn & Cuenin, *supra* note 6, at 424-25.

93. Kahn & Cuenin, *supra* note 6, at 425. Kahn and Cuenin recognize that a similar burden arises under § 751, which requires gain or loss recognition in connection with certain distributions of partnership property. They conclude, however, that Congress viewed this added administrative burden as justified in order to prevent the

However, in a footnote, Kahn and Cuenin acknowledge that the partnership will have to apportion the inside basis of the transferred assets between the guaranteed payment and the distribution portions of the transaction in order to determine the proper basis of the property in the hands of the recipient partner regardless of whether the partnership is required to recognize gain or loss.⁹⁴ Thus, the only additional administrative burden in requiring the recognition of gain or loss with respect to the property transferred to satisfy the guaranteed payment arises in determining each partner's share of that gain or loss. The real question is whether this added level of complexity is appropriately attributable to a requirement to recognize gain or loss with respect to the in-kind guaranteed payment or simply one of a number of additional burdens that result from a partnership's decision to make a section 754 election.

Only at this point in their analysis do Kahn and Cuenin finally address the real issue at hand: whether the treatment of a guaranteed payment as a distribution of partnership property entails any opportunity for abuse and whether a requirement that the partnership recognize gain or loss on the transfer of partnership property in satisfaction of a guaranteed payment might avoid such abuse.⁹⁵ In other words, this inquiry attempts to determine if a compelling reason exists to rebut the presumption that a guaranteed payment will be treated as a distribution of partnership property under the statutory language of section 707(c).⁹⁶ Interestingly, Kahn and Cuenin acknowledge that the potential for abuse exists under their proposal if the partnership transfers appreciated property that would otherwise generate ordinary income if sold by the partnership to the recipient partner in satisfaction of a guaranteed payment. Because the partnership level gain in the transferred property is preserved in the outside basis of the partners' partnership interests under the approach advanced by Kahn and Cuenin,⁹⁷ the potential exists that the preserved gain might be converted into capital gain on the sale of a partner's interest.⁹⁸

potential shifting of characterization of income among partners. Properly framed, the question then becomes whether the absence of a requirement for gain or loss recognition by the partnership presents a similar opportunity for abuse. See *infra* text accompanying notes 127-31.

94. Kahn & Cuenin, *supra* note 6, at 425, n.63.

95. Kahn & Cuenin, *supra* note 6, at 426-27.

96. See *supra* text accompanying notes 81-84.

97. Kahn & Cuenin, *supra* note 6, at 426 and 430-31.

98. Kahn & Cuenin, *supra* note 6, at 426, 433, n.77. In addition, the timing of any preserved gain is deferred of course, although this result occurs any time that a transfer of property is treated as a distribution of partnership property. *Id.* at 433. Kahn and Cuenin fail to appreciate that their approach gives rise to yet another form of abuse, a partnership deduction in excess of any amounts previously included in the income of the partners. See *infra* text accompanying notes 128-30.

Although recognizing the potential for abuse, Kahn and Cuenin state that the possibility of such abuse “is not of sufficient significance to warrant both abandoning the principle of non-recognition that plays such a prominent role in Subchapter K and embracing the administrative complexity that recognition will engender.”⁹⁹ In addition, they state:

the choice available for the construction of the currently applicable provision is either to deny nonrecognition entirely to guaranteed payments or to accept the potential for shifting of characterization as a relatively minor cost of the benefit of having nonrecognition so that ordinary transactions of this nature are not deterred. The latter course seems far more desirable given the strong sentiment in Subchapter K to allow nonrecognition so as to prevent the tax law from unnecessarily influencing legitimate business transactions.¹⁰⁰

However, their position in this regard appears flawed for a number of reasons as discussed below. Furthermore, they are not explicit in describing why the policy of non-recognition under Subchapter K weighs more heavily on the decision-making scale than the concern over the potential for tax abuse. Their only possible response in this regard would be based on a failure to rebut the implicit presumption that they earlier asserted exists under section 707(c).

Kahn and Cuenin do acknowledge that Congress enacted section 751 to prevent a similar type of potential abuse.¹⁰¹ They point out that the

The treatment of an in-kind guaranteed payment as a distribution of partnership property also raises the curious result that, under § 735, the transfer of any unrealized receivables or inventory items as described in § 751(c) and 751(d), respectively, will give rise to ordinary income or loss on disposition (albeit only if disposed of within five years in the case of inventory items) by the recipient partner despite the fact that, under Kahn and Cuenin’s approach, he receives a fair market value basis in the property. See 2 Willis, Pennell & Postlewaite, *supra* note 11, at ¶ 13.04. Such a result seems inappropriate if the property is properly characterized as a capital asset in the hands of the partner since the characterization rules of § 735 are intended to prevent the conversion of ordinary income at the partnership level into capital gain at the partner level, principally with respect to pre-distribution gain. In addition, § 735 again demonstrates the extent to which Congress is willing to impose restrictions on transactions that can result in the conversion of ordinary income into capital gain as a result of distributions of partnership property.

99. Kahn & Cuenin, *supra* note 6, at 426.

100. Kahn & Cuenin, *supra* note 6, at 426.

101. Curiously, Kahn and Cuenin do not grapple with the question whether § 751 would actually apply to a transfer of property in satisfaction of a guaranteed payment, relying solely on a Regulation suggesting that payments for services are immune from the application of § 751. Kahn & Cuenin, *supra* note 6, at 411-12 (citing

complexity engendered by section 751 has been the subject of “severe criticism” and that an interpretation of section 707(c) as requiring third-party treatment would also entail an element of complexity.¹⁰² As a result, they caution against an interpretation of section 707(c) that would introduce a “complex and cumbersome structure that [would prove] very difficult to administer.”¹⁰³

However, the existence of section 751 cuts against their argument in this regard since it indicates a high degree of Congressional tolerance for complexity to combat potential abuse. Presumably, we should be more concerned about interpreting the Code in a manner that will best effectuate the policies of Subchapter K and basic tax principles¹⁰⁴ than in avoiding “severe criticism.” Given the doubts described above concerning the extent of any significant additional complexity that a gain or loss recognition requirement would entail, the balance may well fall in favor of preventing the potential for tax abuse.

Kahn and Cuenin cite as illustrative of an asserted Congressional preference for non-realization, even at the expense of potential conversion of ordinary income into capital gain, the basis adjustment rules under sections 108(b)(2)(E) and 1017 in connection with discharge of indebtedness income under section 108(a)(1)(B).¹⁰⁵ They assert that these provisions create the possibility that a taxpayer may convert deferred discharge of indebtedness income that would otherwise be taxable as ordinary income into capital gain

Regs. § 1.751-1(b)(1)(ii)). However, if a guaranteed payment is properly conceptualized as a distribution of partnership property, § 751 would be applicable if the transfer resulted in a disproportionate distribution of the partners’ rights to ordinary income assets. See 2 Willis, Pennell & Postlewaite, *supra* note 11, at ¶ 14.02. Alternatively, if the transfer of property in satisfaction of a guaranteed payment results in the recognition of gain or loss on the transfer by the partnership, § 751 is not implicated and the complexities to which Kahn and Cuenin allude can be avoided.

102. Kahn & Cuenin, *supra* note 6, at 426. Kahn and Cuenin cite only the 1986 statement of one commentator before a subcommittee of the House Ways and Means Committee as evidence of the “severe criticism” surrounding § 751. *Id.* at 426, n.64.

103. Kahn & Cuenin, *supra* note 6, at 426. They also state that a provision requiring the recognition of gain in connection with a guaranteed payment to the extent of any appreciation that would be taxed as ordinary income if sold could only be adopted through legislative amendment. *Id.* at n.64. Although the necessity for legislative action is probably correct if we were advocating such an approach, the third-party treatment that we propose, requiring the recognition of gain or loss by the transferring partnership regardless of its character, would not require legislative amendment. Instead, it would require only the application of basic principles of the existing tax law as reflected in the sole proprietor paradigm.

104. Kahn & Cuenin, *supra* note 6, at 418, 426. See also *supra* text accompanying note 85.

105. Kahn & Cuenin, *supra* note 6, at 427.

to be recognized at a later date.¹⁰⁶ At a minimum, they suggest that these provisions “indicate that Congress is willing to allow ordinary income to be converted into capital gain in order to implement a system of non-recognition.”¹⁰⁷ However, Kahn and Cuenin appear to have overlooked the fact that section 1017(d) specifically requires that any gain resulting from a basis reduction under sections 108 and 1017 be recaptured as ordinary income.¹⁰⁸ Thus, sections 108 and 1017 may better serve to illustrate a Congressional tolerance of non-recognition only when the shifting of the character of any gain can be avoided.

To us, it would appear easier, more logical, and “better attuned” to Congressional concerns regarding tax policy to conclude that under section 707(c) the transfer of partnership property in satisfaction of a guaranteed payment requires gain or loss recognition by the partnership rather than treatment as a distribution of partnership property.¹⁰⁹ Although there may be some additional administrative complexity as a result, this approach equates guaranteed payments with payments to a third party, payments with which most taxpayers are intimately familiar. Even Kahn and Cuenin acknowledge that, under section 707(c), the references to sections 61(a), 162(a), and 263 are not exclusive: “Entity treatment is applied in a few other circumstances,

106. They assert that such a result could occur because the Regulations under § 1017 provide ordering rules under which the basis of property that would produce capital gain (or § 1231 gain) can be reduced to account for the discharge of indebtedness income excluded from gross income under § 108. Regs. § 1.1017-1(a).

107. Kahn & Cuenin, *supra* note 6, at 427.

108. Section 1017(d) requires that any property whose basis is reduced under § 1017 and that is not § 1245 or § 1250 property will be treated as § 1245 property and that a reduction under § 1017 is to be treated as a depreciation deduction. IRC § 1017(d)(1). With respect to § 1250 property, the determination of what would have been the depreciation adjustments under the straight line method are made as if no basis reduction had been made under § 1017. IRC § 1017(d)(2). “The effect of this rule is that if the property was actually depreciated on a straight line basis, there is additional depreciation, subject to recapture, equal to the § 1017 reduction.” Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* ch. 51.3.2, n.19 (3d ed., 2000). Thus, any gain attributable to a basis reduction under § 1017 will be recaptured as ordinary income under any circumstances.

109. Several commentators have reached a similar conclusion, albeit for a variety of reasons. McKee, Nelson & Whitmire, *supra* note 42, at ¶ 13.03[5]; Sheldon I. Banoff, “Guaranteed Payments for the Use of Capital: Schizophrenia in Subchapter K,” 70 *Taxes* 820, 836-37 (1992). One commentator has noted that an in-kind guaranteed payment can be conceptualized as a cash payment in satisfaction of the guaranteed payment followed by a sale of the transferred property in a taxable transaction in exchange for the cash. *Id.* at 836, n.122. In such a situation, the partnership would recognize gain or loss on the transfer. This is, of course, precisely the type of transaction that Congress intended to be treated as a transaction with a third party under § 707(a)(2)(A). See *infra* text accompanying notes 156-62.

but only where it was needed to prevent results that would contravene basic tax principles.”¹¹⁰ As illustrated by the paradigm of the sole proprietor, compensatory in-kind transfers of property result in income to the recipient and (typically) a deductible expense to the payor, as well as the recognition of gain or loss by the payor with respect to the property transferred. Clearly, the tax results in the sole proprietor paradigm are illustrative of “basic tax principles” under the Code. The proposed non-recognition of gain or loss on the transfer of partnership property in satisfaction of a guaranteed payment, as advocated by Kahn and Cuenin, conflicts with these basic principles.

D. Basis of Property Received as a Guaranteed Payment

Having concluded that there is no gain or loss recognition to the partnership on the transfer of partnership property in satisfaction of a guaranteed payment, Kahn and Cuenin address the determination of the basis of the property received in the hands of the recipient partner.¹¹¹ As previously described, they conclude that the recipient partner takes a fair market value basis in the property received.¹¹² Because the result of their approach is consistent with that under the sole proprietor paradigm, we can find no fault with their conclusion. Their analysis, however, is another matter.¹¹³

Because section 707(c) makes no reference to specific provisions of the Code that would require third-party treatment in connection with the basis issue, the presumption employed by Kahn and Cuenin requires that the transferred property be treated as a distribution of partnership property generally resulting in a carryover basis for the property in the partner’s hands.¹¹⁴ To avoid this result and provide the property with a fair market value basis, Kahn and Cuenin attempt to identify a compelling reason for such a conclusion in order to rebut this presumption. They claim to have accomplished this objective through a capital account analysis demonstrating that a carryover basis for the transferred property would improperly account

110. Kahn & Cuenin, *supra* note 6, at 427.

111. Kahn & Cuenin, *supra* note 6, at 428-36.

112. See *supra* text accompanying notes 47-48.

113. Curiously, Kahn and Cuenin begin this section of their article with the observation that “the basis of the property received is important not only for its own sake, but also because that determination could influence the decision whether the partnership should recognize gain.” Kahn & Cuenin, *supra* note 6, at 428. Unfortunately, their failure to revisit the implications of this observation means that they do not fully explore the opportunities for tax avoidance that their proposal entails. See *infra* text accompanying notes 129-30.

114. IRC § 732(a)(1). The basis of the property received in a distribution by the partnership is limited to the partner’s basis in his partnership interest. IRC § 732(a)(2).

for the amount of income that the recipient partner would ultimately recognize on the subsequent disposition of his partnership interest.¹¹⁵

Kahn and Cuenin acknowledge that their approach, which does not require the recognition of gain or loss by the partnership and allows the recipient partner to receive a fair market value basis in the transferred property, preserves the appropriate amount of gain or loss as does a third-party approach in which gain or loss is recognized by the partnership and the transferred property takes a fair market value basis in the hands of the recipient partner.¹¹⁶ They claim the only difference between their proposal and the sole proprietor paradigm is the timing of the recognition of this gain or loss and the potential character of the gain or loss. Under their proposal, the gain or loss attributable to the transferred property will not be recognized when the transfer is made but only at some later time when the partners dispose of their partnership interests.¹¹⁷ In addition, and as previously described, gain that would otherwise be taxable as ordinary income can be converted into capital gain if the property transferred would have generated ordinary income if sold by the partnership.¹¹⁸

Despite these differences, Kahn and Cuenin revert to their previous discussion that promoting the policy goal of Subchapter K to allow for the non-recognition of gain or loss on distributions of partnership property is more important than the “minor cost” associated with the conversion of ordinary income into capital gain.¹¹⁹ However, in dismissing this type of potential for abuse, they overlook another significant problem that their proposal entails. Unlike typical distributions of partnership property, in which the unrecognized gain or loss is preserved in the property itself, the unrecognized gain or loss in the transferred property under their proposal is transferred to the partners’ partnership interests. In addition, because the transferred property receives a fair market value basis in the hands of the recipient partner, that partner can subsequently deal with the property free of any tax implications. These two facts, by themselves, create opportunities for abuse.

This problem can be illustrated through the examples developed by Kahn and Cuenin. They describe a situation in which P, a general partnership, has three equal partners, A, B, and C.¹²⁰ In Year 1, P has neither

115. Kahn & Cuenin, *supra* note 6, at 428-32. As described below, this analysis appears flawed. See *infra* text accompanying notes 138-49.

116. Kahn & Cuenin, *supra* note 6, at 432.

117. Kahn & Cuenin, *supra* note 6, at 433.

118. Kahn & Cuenin, *supra* note 6, at 433.

119. Kahn & Cuenin, *supra* note 6, at 433. See *supra* text accompanying notes 95-108.

120. Kahn & Cuenin, *supra* note 6, at 428-29.

net income nor net loss. In addition, the partnership has no liabilities.¹²¹ The bases and fair market values of the partnership's assets and the partners' partnership interests are as provided in Figure 1. Each partner has \$10,000 of gain inherent in his partnership interest (\$30,000 fair market value minus each partner's \$20,000 outside basis).

Figure 1
Partnership's Assets and Partners' Partnership Interests
Prior to the Guaranteed Payment

	Assets			Partnership Interests	
	AB	FMV		AB	FMV
Cash	\$35,000	\$35,000	A	\$20,000	\$30,000
Land 1	\$10,000	\$25,000	B	\$20,000	\$30,000
Land 2	\$15,000	\$30,000	C	\$20,000	\$30,000
Total	\$60,000	\$90,000	Total	\$60,000	\$90,000

On December 31, Year 1, P transfers Land 2 to A as a guaranteed payment. Under Kahn and Cuenin's proposal, A has ordinary income of \$30,000 and takes a basis in Land 2 equal to its fair market value, \$30,000.

121. In their description of the facts of the example, Kahn and Cuenin state that the book value of each asset equals its fair market value. In addition, they focus on the partners' capital accounts and assert that, because the book value of each asset equals its fair market value, the appreciation of each asset has already been included in the partners' capital accounts. Kahn and Cuenin may have made the assumption that the book value of each asset equals its fair market value to simplify the explication of their analysis. In reality, this would be a most unusual situation because capital accounts are not adjusted except as authorized under the § 704 Regulations. Kahn and Cuenin state only that "[u]nder certain specified circumstances, the book value of the partnership's assets and the partners' capital accounts can be written up or down to reflect a revaluation of the partnership's assets." Kahn & Cuenin, *supra* note 6, at 428, n.68 (citing Regs. § 1.704-1(b)(2)(iv)(f)). While this general statement is correct, the difficulty is that a revaluation of all assets is not permitted under the circumstances that they are addressing, a distribution of partnership property. In such a situation, only the book value of the distributed asset would be written up or down to its current value. Regs. § 1.704-1(b)(2)(iv)(f)(5)(ii). A further difficulty arises because of their unique interpretation that the transfer of the asset is not a distribution for purposes of determining the property's basis. Thus, it is far from clear that any book up would be available for any asset under their interpretation. Confusingly, later in the article, they apply their analytical framework to a situation in which the book and fair market values of the distributed property differ and demonstrate that their approach is unaffected. Kahn & Cuenin, *supra* note 6, at 433-35. Because the use of the partners' capital accounts is unnecessary to the actual analysis, we have modified Kahn and Cuenin's examples and refer only to the bases and fair market values of the partners' partnership interests instead of referring to their capital accounts.

In addition, P is allowed a deduction of \$30,000. The deduction reduces each partner's outside basis by \$10,000.¹²² As a result, the bases and fair market values of the partnership's assets and the partners' partnership interests are as provided in Figure 2. As can be seen, each partner continues to have \$10,000 of gain inherent in his partnership interest (\$20,000 fair market value minus \$10,000 outside basis).¹²³

Figure 2
Partnership's Assets and Partners' Partnership Interests
Under Kahn and Cuenin's Approach

Assets			Partnership Interests		
	<u>AB</u>	<u>FMV</u>		<u>AB</u>	<u>FMV</u>
Cash	\$35,000	\$35,000	A	\$10,000	\$20,000
Land 1	\$10,000	\$25,000	B	\$10,000	\$20,000
Total	\$45,000	\$60,000	C	\$10,000	\$20,000
			Total	\$30,000	\$60,000

If the guaranteed payment is treated as a payment to a third party, the results are different.¹²⁴ As under the Kahn and Cuenin proposal, A has ordinary income of \$30,000 and takes a basis in Land 2 equal to its fair market value, \$30,000. However, P recognizes \$15,000 of gain on the transfer and is allowed a deduction of \$30,000. Each partner is allocated a net deduction of \$5,000 because the recognized gain increases each partner's outside basis by \$5,000 while the deduction reduces each partner's outside basis by \$10,000.¹²⁵ As a result, the bases and fair market values of the partnership's assets and the partners' partnership interests are as provided in Figure 3. As can be seen, each partner has only \$5,000 of gain inherent in his partnership interest (\$20,000 fair market value minus \$15,000 outside basis). This reflects the fact that each partner has already accounted for \$5,000 of gain attributable to the property transferred to partner A.¹²⁶ As compared to

122. See IRC § 705(a)(2); Regs. § 1.705-1(a)(3).

123. Although each partner continues to have \$10,000 of gain inherent in his partnership interest, the distribution of partnership property that would have resulted in ordinary income to the partnership if sold will result in the conversion of what would have been ordinary income into capital gain on the sale of the partnership interest. See supra text accompanying notes 95-108.

124. See Kahn & Cuenin, supra note 6, at 432.

125. See IRC § 705(a); Regs. § 1.705-1(a).

126. The character of this gain would be based on the type of property transferred to A in satisfaction of the guaranteed payment. Thus, this approach would not result in a potential shift of the character of gain realized by the partners on the disposition of their partnership interests as compared with the approach proposed by Kahn and Cuenin. See supra note 123.

the results under Kahn and Cuenin's proposal, the third-party approach prevents both the deferral of income and the potential shift in the character of the gain from ordinary income to capital gain if the property transferred is a non-capital asset.

Figure 3
Partnership's Assets and Partners' Partnership Interests
Under an Entity Approach

Assets			Partnership Interests		
	<u>AB</u>	<u>FMV</u>		<u>AB</u>	<u>FMV</u>
Cash	\$35,000	\$35,000	A	\$15,000	\$20,000
Land 1	\$10,000	\$25,000	B	\$15,000	\$20,000
Total	\$45,000	\$60,000	C	\$15,000	\$20,000
			Total	\$45,000	\$60,000

In addition, and as shown in Figure 2, Kahn and Cuenin's approach leads to a discrepancy between the partners' aggregate outside bases (\$30,000) and the aggregate inside bases of P's assets (\$45,000).¹²⁷ In their article, they acknowledge this fact but ignore its true significance.

Prior to the making of the guaranteed payment, there was \$30,000 appreciation in both P's inside assets and in the partners' partnership interests. The appreciation in the partners' partnership interests was unchanged by the payment, but \$15,000 of P's inside appreciation in Land 2

127. Kahn and Cuenin acknowledge the fact that "[i]deally, a partner's share of the net unrealized appreciation of properties held by the partnership should be the same as the appreciation of the partner's interest in the partnership . . ." but note that this situation will not always exist as a result of §§ 734(a) and 743(a). Kahn & Cuenin, *supra* note 6, at 430. Unfortunately, the adoption of Kahn and Cuenin's approach will create yet another situation in which the tax results will diverge from the ideal.

Kahn and Cuenin will have difficulty in claiming that the imbalance between the partners' aggregate outside bases and the aggregate inside bases of the partnership's assets could be cured through an adjustment to the bases of the partnership's assets under § 734 if the partnership files a timely election under § 754. This is because an adjustment under § 734 is available only if the distributee partner recognizes gain or loss under § 731(a)(1) or § 731(a)(2) as a result of the distribution or the basis of the distributed property in the hands of the recipient partner differs from that of the property in the hands of the partnership as a result of the application of the basis limitations under § 732(a)(2) or § 732(b). IRC § 734(b). Because the recipient partner does not recognize gain or loss on the distribution of an in-kind guaranteed payment under § 731(a)(1) or § 731(a)(2) and takes a fair market value basis in the transferred property unaffected by the basis limitations of § 732(a)(2) or § 732(b), a basis adjustment under § 734(b) is unavailable under Kahn and Cuenin's approach.

was removed from P and exists only as it continues to be reflected in the partners' appreciation in their partnership interests. The total potential amount of gain to be recognized was not changed. There was \$30,000 of potential gain before the payment was made, and the same amount afterwards.¹²⁸

As a result, transactions involving the partnership's assets will not fully account for the gain inherent in the partners' partnership interests. For example, the partnership could sell Land 1, resulting in P's recognition of \$15,000 of gain and causing each of the partners to report a distributive share of partnership income of \$5,000. Despite having liquidated the partnership's assets, each of the partners will still have \$5,000 of gain inherent in their partnership interests. The partners will only recognize this gain if the partnership is itself liquidated or the partners sell their partnership interests.

Although Kahn and Cuenin's approach preserves the proper amount of gain in the partners' partnership interests, this discrepancy creates the opportunity for abuse through the manipulation of basis. For example, under their proposal, A, B, and C have each obtained a \$10,000 deduction, \$5,000 of which is attributable to appreciation in value that, although preserved in the partners' partnership interests, will not be subject to tax until the disposition of those interests. In effect, the partnership can use appreciated property to create deductions equal to the value of the transferred appreciated property without the partners suffering the burden of the corresponding gain recognition until some indefinite time in the future. Deductions are typically not allowed on the transfer of appreciated property unless the taxpayer has previously taken the value supporting the deduction into income.¹²⁹ Thus,

128. Kahn & Cuenin, *supra* note 6, at 432. No similar discrepancy results under the third-party approach because the partners' aggregate outside bases (\$45,000) is equal to the aggregate inside bases of P's assets (\$45,000). Thus, the gain inherent in the partners' partnership interests is fully reflected in the partnership's assets. Transactions involving these assets will cause the partners to recognize neither excess or inadequate gain or loss.

129. See McKee, Nelson & Whitmire, *supra* note 42, at ¶ 13.03[5] (noting that "[i]nherent in the allowance of a market value deduction is the realization of gain or loss by the transferor of the property"). See also Martin J. McMahon, Jr., "Recognition of Gain By a Partnership Issuing an Equity Interest for Services," 109 Tax Notes 1161 (2005) (describing the opportunity for tax arbitrage when a partnership is permitted a deduction equal to the value of any appreciated property transferred in return for the rendition of services without the concomitant recognition of gain).

We recognize that the Service has recently issued a Proposed Regulation providing that no gain or loss is recognized by a partnership on the transfer or substantial vesting of a compensatory partnership interest despite the fact that the transfer is treated as a guaranteed payment and the partnership is entitled to a deduction in connection therewith. Prop. Regs. § 1.721-1(b)(2). Nevertheless, the proper treatment of compensatory partnership interests (assuming that no gain or loss recognition by the

Kahn and Cuenin's proposal creates unacceptable tax shelter opportunities. In addition, A now has an asset, Land 2, that can be disposed of without recognition of gain.

Kahn and Cuenin may maintain, as they do with the potential abuse resulting from the conversion of ordinary income into capital gain, that this concern is simply a "minor cost" that must be tolerated to effectuate the policy of non-recognition on distributions of partnership property under Subchapter K that they otherwise find compelling. However, a typical distribution of partnership property does not entail the creation of deductions that can be used to shelter other income nor does it result in a fair market value basis in the distributed property that allows the recipient partner to dispose of the property without tax implications. These distinctions seem, to us, to be sufficiently compelling to require third-party treatment in connection with all aspects of a guaranteed payment.¹³⁰

partnership on the transfer of such an interest is the proper treatment) may be distinguishable from the proper treatment of the more typical situation involving guaranteed payments paid in return for the rendition of services since no actual transfer of partnership property occurs in the context of compensatory partnership interests.

130. Kahn and Cuenin end this portion of their article with an example in which the outside basis of the partner receiving the guaranteed payment is not equal to the partner's share of the partnership's aggregate inside bases of the partnership's assets because the partner acquired the interest through either purchase or inheritance. Kahn & Cuenin, *supra* note 6, at 435-36. They proceed to demonstrate how, under their proposal, the transfer of appreciated partnership property to the partner in satisfaction of a guaranteed payment will allow the partner to avoid gain recognition on any subsequent sale of the property as well as any subsequent sale of his partnership interest. In the absence of a § 754 election, the partner would have been required to recognize his share of partnership gain had the property been sold by the partnership to a third-party. Of course, the partner could have avoided any such gain if a § 754 election had been in effect. At the same time, the proper amount of gain for the remaining partners is unaffected.

Kahn and Cuenin appear to be making the argument that their proposal has the benefit of avoiding gain recognition for such a partner when the partnership has not made a § 754 election and that third-party treatment of a guaranteed payment would not provide such a benefit. Kahn & Cuenin, *supra* note 6, at 439 (stating that "the deferral system that applies to the guaranteed payment is one that would actually cure a glitch in Subchapter K in some circumstances, and so can be said to further tax policy rather than to hinder it" (footnote omitted)). However, their proposal has no effect in connection with any other assets held by the partnership so that, unless the partnership expects to transfer all of its property to the partner in satisfaction of a guaranteed payment obligation, the problems faced by the partner in the absence of a § 754 election cannot be avoided. Instead of viewing this as a benefit of their proposal, it simply illustrates why a § 754 election is often of value to a partner acquiring a partnership interest by purchase or inheritance. It would seem to be of only minor significance that a particular approach to a question of statutory interpretation should be preferred to another approach when, under certain circumstances, the first approach alleviates in part

At the beginning of the section addressing the basis determination for the property received in the hands of the recipient partner, Kahn and Cuenin observed that “the basis of the property received is important not only for its own sake, but also because that determination could influence the decision whether the partnership should recognize gain.”¹³¹ For the reasons articulated in this section of our article, as well as those in the previous section, we believe that gain or loss recognition by the partnership is a necessary consequence of in-kind guaranteed payments.

E. Effect on Outside Basis of Guaranteed Payments

Finally, Kahn and Cuenin address the effect of an in-kind guaranteed payment on the recipient partner’s basis in his partnership interest.¹³² Because section 707(c) makes no reference to specific provisions of the Code that would require third-party treatment in connection with this basis issue, the presumption employed by Kahn and Cuenin would require that the transferred property be treated as a distribution of partnership property generally, thus resulting in a reduction of the partner’s partnership interest in an amount equal to the basis of the transferred property.¹³³ To avoid this result and conclude that no basis reduction results from the guaranteed payment (other than the partner’s share of the deduction associated with the guaranteed payment as provided under the Regulations to section 705),¹³⁴ Kahn and Cuenin attempt to identify a compelling reason for such a conclusion to rebut this presumption. As with the question involving the basis of the transferred property in the hands of the recipient partner, they claim to have accomplished this objective through a capital account analysis in which treating the transfer as a distribution of partnership property with a reduction in the basis of the recipient partner’s partnership interest equal to

a problem that the second approach does not when an election, freely available to all taxpayers regardless of which approach is adopted, may be made to fully resolve the precise problem at hand.

131. Kahn & Cuenin, *supra* note 6, at 428.

132. Kahn & Cuenin, *supra* note 6, at 419-22. Actually, Kahn and Cuenin address this question before addressing the questions of the recognition of gain or loss by the partnership and the basis of the transferred property in the hands of the recipient partner. Unlike the answers to the latter two questions, the answer to the question of the effect of an in-kind guaranteed payment on the recipient partner’s basis in his partnership interest appears not to raise issues that might have caused Kahn and Cuenin to reassess their conclusions regarding gain or loss by the partnership and the basis of the transferred property. See *supra* text accompanying notes 69-131.

133. IRC § 733; Regs. § 1.731-1.

134. See IRC § 705(a)(2); Regs. § 1.705-1(a)(3). Kahn and Cuenin note that the effect on the partner’s outside basis would be identical to the effect of the distribution on the partner’s capital account. Kahn & Cuenin, *supra* note 6, at 419 (citing Regs. § 1.704-1(b)(2)(iv)(o)).

the basis of the property in the hands of the partnership improperly accounts for the amount of income that the recipient partner should appropriately recognize.¹³⁵

Kahn and Cuenin begin their analysis by examining a guaranteed payment paid in cash to reach their conclusion that no direct basis reduction is appropriate. They then extend the same treatment to in-kind payments without any further discussion.¹³⁶ The important aspect of this analysis is that the same result is far more directly achieved through the application of the basic tax principles reflected in the sole proprietor paradigm. The question then becomes whether Congress would have endorsed this more complicated analysis if, as Kahn and Cuenin acknowledge, it had paid any attention to in-kind guaranteed payments when drafting Subchapter K.¹³⁷ The complexity of the analysis (as well as the potential for abuse as described in the previous sections of this article) leaves us with significant doubts that it would.

F. Kahn and Cuenin's Erroneous Application of the Modified Aggregate Approach

Before considering the implications of the enactment of section 707(a)(2) to the treatment of guaranteed payments under section 707(c), Kahn and Cuenin's overall analysis must be revisited. As described above, they claim that (1) the partnership recognizes neither gain nor loss on the transfer of an in-kind guaranteed payment, (2) the basis of the transferred partnership property in the hands of the recipient partner is equal to its fair market value, and (3) the only adjustment in the recipient partner's basis in his partnership interest resulting from a guaranteed payment is the partner's share of the deduction generated by the guaranteed payment. To reach their first conclusion, they treat a guaranteed payment as a distribution of partnership property based on the limitations contained in the language of section 707(c). They depart from the language of section 707(c) to reach their second and third conclusions and claim to have compelling reasons to do so, largely because they assert that the appropriate results are otherwise impossible to achieve. However, consistent treatment of a guaranteed payment as both an allocation of partnership income and a distribution of partnership property will produce the appropriate results, albeit results different from those obtained by Kahn and Cuenin, who fail to follow through with their analysis based on the statutory language of section 707(c).

If a guaranteed payment is treated as an allocation of partnership income followed by a distribution of partnership property, Kahn and

135. Kahn & Cuenin, *supra* note 6, at 419-22. But see *infra* text accompanying notes 138-55.

136. Kahn & Cuenin, *supra* note 6, at 421-22.

137. See *supra* text accompanying notes 67-68.

Cuenin's first conclusion that the partnership realizes neither gain nor loss on the transfer of an in-kind guaranteed payment is correct. However, their second and third conclusions do not follow from the first. Instead, the basis of the transferred partnership property in the hands of the recipient partner should be a carryover basis from the partnership, consistent with the general rule applicable to distributions of partnership property, and the adjustments to the recipient partner's outside basis similarly should follow the rules applicable to all allocations of partnership income and distributions of partnership property.

Kahn and Cuenin's analysis with respect to their second and third conclusions is based on a consideration of the economics of the transaction. To demonstrate the proper application of Kahn and Cuenin's preferred interpretation of section 707(c), let us return to the example contained in their article and described above.¹³⁸ P, a general partnership, has three equal partners, A, B, and C. In Year 1, P has neither a net income nor a net loss. In addition, the partnership has no liabilities. The bases and fair market values of the partnership's assets and the partners' partnership interests are as provided in Figure 1. (For convenience, Figures 1 and 2 are reproduced below.)

Figure 1
Partnership's Assets and Partners' Partnership Interests
Prior to the Guaranteed Payment

	Assets			Partnership Interests	
	<u>AB</u>	<u>FMV</u>		<u>AB</u>	<u>FMV</u>
Cash	\$35,000	\$35,000	A	\$20,000	\$30,000
Land 1	\$10,000	\$25,000	B	\$20,000	\$30,000
Land 2	<u>\$15,000</u>	<u>\$30,000</u>	C	<u>\$20,000</u>	<u>\$30,000</u>
Total	\$60,000	\$90,000	Total	\$60,000	\$90,000

On December 31, Year 1, P transfers Land 2 to A as a guaranteed payment. Under Kahn and Cuenin's proposal, A has ordinary income of \$30,000 and takes a basis in Land 2 equal to its fair market value, \$30,000. In addition, P is allowed a deduction of \$30,000. The deduction reduces each partner's outside basis by \$10,000. As a result, the bases and fair market values of the partnership's assets and the partners' partnership interests are as provided in Figure 2.

¹³⁸. See *supra* text accompanying notes 120-23.

Figure 2
Partnership's Assets and Partners' Partnership Interests
Under Kahn and Cuenin's Approach

	Assets			Partnership Interests	
	<u>AB</u>	<u>FMV</u>		<u>AB</u>	<u>FMV</u>
Cash	\$35,000	\$35,000	A	\$10,000	\$20,000
Land 1	<u>\$10,000</u>	<u>\$25,000</u>	B	\$10,000	\$20,000
Total	\$45,000	\$60,000	C	<u>\$10,000</u>	<u>\$20,000</u>
			Total	\$30,000	\$60,000

According to their analysis, the amount of appreciation in each partner's partnership interest, \$10,000, is the same before the transfer (\$30,000 fair market value minus \$20,000 outside basis) as after the transfer (\$20,000 fair market value minus \$10,000 outside basis). If the basis of the transferred property in the hands of the recipient partner, A, is equal to its fair market value, A's potential gain on the sale of both Land 2 (\$0) and his partnership interest (\$10,000) will be the appropriate amount, \$10,000. Alternatively, if the basis of Land 2 is \$15,000, its basis in the hands of the partnership, they claim that A's potential gain on the sale of both Land 2 (\$15,000) and his partnership interest (\$10,000) will be \$25,000. "Clearly, a gain of \$25,000 would be excessive."¹³⁹

But had Kahn and Cuenin adjusted the recipient partner's basis in his partnership interest by treating the guaranteed payment as a distributive share of partnership income followed by a distribution of partnership property as they claim the explicit language of section 707(c) requires, a gain of \$25,000 would not have arisen. We will refer to the treatment of a guaranteed payment in this manner as the "modified aggregate approach."¹⁴⁰ To appreciate all of the adjustments that must be made, the bases of the partners' partnership interests must be considered at two points in time: (1) immediately following the determination of the guaranteed payment but prior to its payment and (2) immediately following the transfer of partnership

139. Kahn & Cuenin, *supra* note 6, at 432.

140. The modified aggregate approach described herein is intended to describe the treatment of a guaranteed payment under § 707(c) as originally enacted. It is an alternative to the pure aggregate approach that the courts generally applied in determining the tax treatment of partner salaries prior to the enactment of § 707(c). For further discussion of the pure aggregate approach and the modified aggregate approach, see *infra* note 149. Kahn and Cuenin's approach is not reflective of either the pure aggregate approach or the modified aggregate approach. As described previously, Kahn and Cuenin's approach is a strange hybrid, combining aspects of the modified aggregate approach and the entity approach.

property in satisfaction of the guaranteed payment.¹⁴¹ This two-step analysis is appropriate regardless of the method of accounting adopted by the partnership. However, its application is more clearly illustrated by considering an in-kind guaranteed payment in the context of an accrual-method partnership and a cash-method partner in which the transfer of property in satisfaction of the guaranteed payment does not occur until the year following that in which the services giving rise to the guaranteed payment are rendered.

Assume that in Year 1, A is entitled to a guaranteed payment of \$30,000 for services rendered to an accrual-method partnership, but no transfer of partnership property occurs until Year 2. For Year 1, A has ordinary income of \$30,000, and P is allowed a deduction of \$30,000. The deduction reduces each partner's outside basis by \$10,000.¹⁴² In addition, treating the guaranteed payment as a distributive share of partnership income creates a \$30,000 increase in A's outside basis.¹⁴³ As a result, the bases and fair market values of the partnership's assets and the partners' partnership interests are as provided in Figure 2A. As can be seen, each partner continues to have \$10,000 of gain inherent in his partnership interest (\$50,000 fair market value minus \$40,000 outside basis for A and \$20,000 fair market value minus \$10,000 outside basis for B and C).¹⁴⁴

141. Such an approach is consistent with the Regulations under § 707(c) which recognize that an accrual-method partnership can make a guaranteed payment without making an actual transfer of money or property. Regs. § 1.707-1(c) (second sentence). See *Gaines v. Comm'r*, T.C.Memo. 1982-731, 45 T.C.M. (CCH) 363 (noting that the absence of any actual payment does not affect the status of a transaction as a guaranteed payment under § 707(c)); *Pratt v. Comm'r*, 64 T.C. 203 (1975), *aff'd in part, rev'd in part*, 550 F.2d 1023 (5th Cir. 1977). As a result, a guaranteed payment can be bifurcated into the two steps referred to in the text although the statutory language speaks only in terms of a single payment.

142. See IRC § 705(a)(2); Regs. § 1.705-1(a)(3).

143. See IRC § 705(a)(1); Regs. §§ 1.705-1(a)(2). See *Gaines v. Comm'r*, T.C. Memo. 1982-731, 45 T.C.M. (CCH) 363, n.17 ("As part of a partner's distributive share of profit and loss, the guaranteed payments included in his income increase the partner's basis in his partnership interest. Sec. 705(a)(1) and (2)."). Cf. Rev. Rul. 9126, 1991-1 C.B. 184 (accident and health insurance premiums paid by a partnership on behalf of its partners are includable in the partners' gross incomes because the premiums are treated as a distributive share of partnership income under § 707(c)).

144. The existence of an unpaid guaranteed payment could be conceptualized in two ways. Under the first approach (adopted in the text), the unpaid guaranteed payment could be reflected in the capital account of the service partner as simply a special allocation of partnership income. The partner's capital account would be increased by the amount of the guaranteed payment/special allocation and then reduced by the fair market value of the partnership property distributed in satisfaction of the guaranteed payment. Regs. §§ 1.704-1(b)(2)(iv)(b) and 1.704-1(b)(2)(iv)(e)(I). Of course, the partner's capital account would also be reduced by the partner's share of the

We now turn our attention to the implications of the transfer of partnership property in satisfaction of the guaranteed payment. To do so, we first consider the implications of a \$30,000 cash payment, rather than an

deduction attributed to the guaranteed payment. Regs. §§ 1.704-1(b)(2)(iv)(b). If the fair market value of the property distributed in satisfaction of the guaranteed payment exactly equals the amount of the guaranteed payment, the net effect on the partner's capital account is a reduction equal to the partner's share of the deduction attributed to the guaranteed payment. This is exactly the result dictated by the Regulations in connection with guaranteed payments that are presumably paid in cash. Regs. § 1.704-1(b)(2)(iv)(o). See *supra* note 78.

Under the second approach, the unpaid guaranteed payment could be viewed as creating an obligation on the part of the partnership and a claim by the service partner against the assets of the partnership that must be satisfied before any liquidating distributions may be made to the partners based on the balances of their capital accounts. The partner's claim would thus be analogous to that of a third party in a comparable situation. Presumably, the obligation of an accrual-method partnership would create a liability for purposes of § 752 that would be allocable to the partners and result in an increase in the bases of their partnership interests. Regs. § 1.752-1(a)(4)(i)(B). The \$20,000 basis of each partner's partnership interest (see Figure 1) would be reduced by that partner's share of the deduction attributable to the guaranteed payment and increased by that partner's share of the resulting liability. In such a situation, the bases and fair market values of the partnership's assets and the partners' partnership interests would be as provided below. If, prior to the transfer of cash or property by the partnership in satisfaction of the guaranteed payment, one of the partner's sold his partnership interest, that partner would have \$10,000 of gain equal to the difference between the amount realized of \$30,000 (\$20,000 fair market value plus \$10,000 relief of liability) and the \$20,000 basis of his partnership interest.

**Partnership's Assets/Liabilities and Partners' Partnership Interests
Under the Modified Aggregate Approach**

	Assets/Liabilities			Partnership Interests	
	AB	FMV		AB	FMV
Cash	\$35,000	\$35,000	A	\$20,000	\$20,000
Land 1	\$10,000	\$25,000	B	\$20,000	\$20,000
Land 2	<u>\$15,000</u>	<u>\$30,000</u>	C	<u>\$20,000</u>	<u>\$20,000</u>
Total	\$60,000	\$90,000	Total	\$60,000	\$60,000
Liability		(\$30,000)			
Net		\$60,000			

Although an unpaid guaranteed payment is conceptualized differently under the two approaches described above, the tax treatment of the guaranteed payment is not affected. The Code and Regulations are ambiguous on which conceptualization is preferred. However, to the extent that the Regulations under §§ 704 and 752 would treat the guaranteed payment in a manner similar to a payment involving a third party, they serve as support for our argument that entity treatment of the guaranteed payment is more appropriate than the approach proposed by Kahn and Cuenin.

in-kind transfer of partnership property, in satisfaction of the guaranteed payment. If the guaranteed payment is treated as a distribution of partnership property, A's outside basis will be reduced by \$30,000.¹⁴⁵ As a result, the bases and fair market values of the partnership's assets and the partners' partnership interests are as provided in Figure 2B. As can be seen, each partner continues to have \$10,000 of gain inherent in his partnership interest (\$20,000 fair market value minus \$10,000 outside basis). Thus, the proper amount of income has been preserved for each partner.

Figure 2A
Partnership's Assets and Partners' Partnership Interests
Under the Modified Aggregate Approach

	Assets			Partnership Interests	
	<u>AB</u>	<u>FMV</u>		<u>AB</u>	<u>FMV</u>
Cash	\$35,000	\$35,000	A	\$40,000	\$50,000
Land 1	\$10,000	\$25,000	B	\$10,000	\$20,000
Land 2	<u>\$15,000</u>	<u>\$30,000</u>	C	<u>\$10,000</u>	<u>\$20,000</u>
Total	\$60,000	\$90,000	Total	\$60,000	\$90,000

Figure 2B
Partnership's Assets and Partners' Partnership Interests
Under the Modified Aggregate Approach
(Cash Payment)

	Assets			Partnership Interests	
	<u>AB</u>	<u>FMV</u>		<u>AB</u>	<u>FMV</u>
Cash	\$ 5,000	\$ 5,000	A	\$10,000	\$20,000
Land 1	\$10,000	\$25,000	B	\$10,000	\$20,000
Land 2	<u>\$15,000</u>	<u>\$30,000</u>	C	<u>\$10,000</u>	<u>\$20,000</u>
Total	\$30,000	\$60,000	Total	\$30,000	\$60,000

Importantly, Figure 2B is virtually identical to Figure 2 except in two respects. First, the types of the partnership's assets after the transfer are different because P distributed cash instead of Land 2 to A to satisfy the guaranteed payment. Second, and far more significant, there is no discrepancy between the partners' aggregate outside bases (\$30,000) and the aggregate inside bases of P's assets (\$30,000). As a result, transactions involving the partnership's assets will fully account for the gain inherent in the partners' partnership interests. For example, if P liquidates the

¹⁴⁵ See IRC § 733; Regs. § 1.733-1.

partnership's assets and realizes \$30,000 of gain, this gain will account for all of the gain inherent in the partners' partnership interests.

Now consider the implications if P satisfies the guaranteed payment by transferring Land 2, property with a fair market value of \$30,000, and the transfer is treated as a distribution of partnership property.¹⁴⁶ A's outside basis will be reduced by \$15,000, the basis of Land 2 in P's hands.¹⁴⁷ In addition, A will take a carryover basis of \$15,000 in Land 2.¹⁴⁸ As a result, the bases and fair market values of the partnership's assets and the partners' partnership interests are as provided in Figure 2C.

Figure 2C
Partnership's Assets and Partners' Partnership Interests
Under the Modified Aggregate Approach
(In-Kind Payment)

	Assets			Partnership Interests	
	<u>AB</u>	<u>FMV</u>		<u>AB</u>	<u>FMV</u>
Cash	\$35,000	\$35,000	A	\$25,000	\$20,000
Land 1	<u>\$10,000</u>	<u>\$25,000</u>	B	\$10,000	\$20,000
Total	<u>\$45,000</u>	<u>\$60,000</u>	C	<u>\$10,000</u>	<u>\$20,000</u>
			Total	\$45,000	\$60,000

Like Figure 2B, Figure 2C is virtually identical to Figure 2 except in two respects. First, like the results shown in Figure 2B, there is no discrepancy between the partners' aggregate outside bases (\$45,000) and the aggregate inside bases of P's assets (\$45,000). As a result, transactions involving the partnership's assets will again fully account for the gain inherent in the partners' partnership interests. Second, A's outside basis is \$25,000 rather than \$10,000, which will result in a \$5,000 loss if sold for \$20,000. This basis and the resulting loss is appropriate, however, because A holds Land 2 with a basis of \$15,000 and a fair market value of \$30,000. A's potential gain on the sale of both Land 2 (\$15,000) and his partnership interest (a \$5,000 loss) will be \$10,000. B and C continue to have \$10,000 of gain inherent in their partnership interests (\$20,000 fair market value minus \$10,000 outside basis). Thus, each partner's potential gain of \$10,000 before the payment was determined remains the same following the transfer of the partnership property in satisfaction of the guaranteed payment.

The benefit of treating the guaranteed payment consistently as a distributive share of partnership income and a distribution of partnership

¹⁴⁶ See McKee, Nelson & Whitmire, *supra* note 42, at ¶ 13.03[5]; Sheldon I. Banoff, *supra* note 109, at 836.

¹⁴⁷ See IRC § 733; Regs. § 1.733-1.

¹⁴⁸ See IRC § 732(a)(1); Regs. § 1.732-1(a).

property is that, as compared to Kahn and Cuenin's proposal, there is no necessity to depart from the language of section 707(c). In addition, the treatment of the guaranteed payment follows the general rules applicable to allocations of partnership income and distributions of partnership property. No special rules are necessary to properly determine either the basis of the transferred property in the hands of the recipient partner or the basis of the recipient partner's partnership interest.¹⁴⁹

149. The modified aggregate approach is, in our view, the approach most likely intended by Congress when it originally enacted § 707(c). Prior to the enactment of the 1954 Code, salaries paid to partners were viewed as simply a special allocation of partnership income and a distribution of partnership property in the form of cash. This view prevailed because, under a pure aggregate theory of partnerships, a partner was considered as incapable of being an employee of the partnership. *Pauli v. Comm'r*, 11 B.T.A. 784 (1928) (concluding that an agreement between the partners to pay salaries only served as a basis for dividing partnership profits); *Estate of Tilton*, 8 B.T.A. 914 (1927) ("In effect any allowances drawn by a partner from partnership assets are payments which he makes to himself and no man can be his own employer or employee."). But see *Wegener v. Comm'r*, 119 F.2d 49 (5th Cir. 1941) (employing the entity theory of partnerships to require that a partner rendering services to a partnership include the full amount of compensation in income without reduction for any alleged self-paid portion thereof); *Sverdup v. Comm'r*, 14 T.C. 859 (1950) (compensation for services not considered as a distributive share of partnership income and, thus, excludable from gross income under § 116 of the 1939 Code); *Toy v. Comm'r*, BTA Memo. 1442 (1942) (concluding that a partner was taxable on commissions he paid the partnership on acquisition of partnership property; partner's share of commissions not a reduction in purchase price).

The application of the pure aggregate theory can be illustrated through the following example. Assume that A and B are members of the AB partnership in which A holds a 25% interest and B holds a 75% interest. In addition to a distributive share of partnership income, A is entitled to receive a salary of \$30,000 each year. If the partnership income is \$100,000 before taking into account A's salary, A will receive a \$47,500 distributive share of partnership income, made up of a \$30,000 special allocation of partnership income equal to the specified salary plus \$17,500, A's distributive share of the partnership income (\$70,000 after taking into account the special allocation times 25%). B will receive a \$52,500 distributive share of partnership income (\$70,000 after taking into account the special allocation times 75%). A's distributive share of partnership income is the same as a salary of \$30,000 plus A's distributive share of the partnership income after treating the salary as a deductible expense. The same is true for B as well.

Problems with the pure aggregate theory arise, however, when partnership income is less than the salary payment in a particular year. Under Service Rulings and judicial decisions prior to the enactment of the 1954 Code, a partner's salary in such a situation was considered to be comprised of the recipient partner's distributive share of partnership income plus a return of capital shared between the two partners. *Lloyd v. Comm'r*, 15 B.T.A. 82 (1929), acq.; *Estate of Tilton*, 8 B.T.A. 914 (1927); Rev. Rul. 55-30, 1955-1 C.B. 430; G.C.M. 6582, VIII-2 C.B. 200 (1929); G.C.M. 2467, VIII-2 C.B. 188 (1928). See *Stout v. Comm'r*, 31 T.C. 1199 (1959), aff'd in part and remanded

sub nom., *Rogers v. Comm'r*, 281 F.2d 233 (4th Cir. 1960) (applying pre-'54 law). See also *Benjamin v. Hoey*, 139 F.2d 945 (1944) (partner not taxable on share of commissions paid to a partnership by the partner). The recipient partner's share of his own return of capital was not taxable while the portion contributed by the other partners was treated as income to the recipient partner and a deduction for the other partners.

The complications resulting from application of the aggregate theory in such a situation can be illustrated using the facts of the prior example. If the partnership income was only \$20,000 in a particular year, A's salary of \$30,000 was considered to be comprised of all of the partnership income plus a return of capital shared between the two partners. A's distributive share of partnership income would be \$20,000 (the amount of the partnership's income less than the salary amount). The \$10,000 of salary in excess of A's distributive share was considered as funded in the amount of \$2,500 (\$10,000 times 25%) from A's contributed capital and \$7,500 (\$10,000 times 75%) from B's contributed capital. Thus, A had income of \$27,500 (\$20,000 distributive share of partnership income plus \$7,500 of capital from B). A's \$2,500 return of capital was not taxable. B had a deduction of \$7,500 (B's share of capital transferred to A). Of course, the calculations become more complicated if multiple partners receive a salary in such a situation. See *Lloyd v. Comm'r*, 15 B.T.A. 82 (1929).

The complicated calculations described in the preceding paragraph could be vastly simplified by treating the salary as a deductible expense of the partnership. Thus, if the partnership's income were only \$20,000 before accounting for the partner's salary and partner A was entitled to a salary of \$30,000, the partnership could be treated as having a loss of \$10,000 (\$20,000 partnership income - \$30,000 partner A's salary), allocated \$2,500 (\$10,000 partnership loss times 25%) to A and \$7,500 (\$10,000 partnership loss times 75%) to B. Thus, A would have net income of \$27,500 (\$30,000 from the salary paid - \$2,500 distributive share of partnership loss), and B would have loss of \$7,500 (\$10,000 partnership loss times 75%), the same results produced above.

Recognizing the equivalence in result between these two methods, Congress probably only intended that § 707(c) incorporate the less complicated approach rather than the more complicated approach applicable under prior law. (We have referred to the more complicated approach applicable under prior law as the "pure aggregate approach" and to the less complicated approach as the "modified aggregate approach.") This interpretation would explain the "but only" language of § 707(c) under which the entire amount of the partner's salary is included in the partner's gross income under § 61(a) (with no portion treated as a return of capital) and the partnership is allowed a corresponding deduction under § 162 (which had not been permitted under the pure aggregate approach). This interpretation would also explain the statements in the legislative history to the effect that the pre-1954 treatment of transactions between partners and partnerships was "unrealistic and unnecessarily complicated." H.R. Rep. No. 83-1337, at 68 (1954), reprinted in 1954 U.S.C.C.A.N. 4017, 4094. See Arthur B. Willis, *Handbook of Partnership Taxation* § 11.05 (1st ed., 1957) ("The Senate Committee on Finance suggests that one significant effect is to clarify the tax status of the situation where the guaranteed compensation paid to a partner exceeds partnership net income, computed before deducting compensation to the partners." (footnote omitted)).

Unfortunately, the modified aggregate approach cannot be characterized as solely a simplified version of the pure aggregate approach because it does not reach the same results as the pure aggregate approach when the partnership has capital gain or tax

exempt income rather than, or in addition to, ordinary income. Under the modified aggregate approach, no portion of the partner's salary is treated as capital gain or tax exempt income although it would be under the pure aggregate approach. Commentators at the time noted this inconsistency. *Id.* at § 11.05, n.21; J. Paul Jackson, et al., *supra* note 44, at 1202. Indeed, one group of commentators criticized § 707(c) as "inequitable in that it may deprive a partner of the tax benefits of capital gains or tax exempt interest." *Id.* at 1204. In addition, the two approaches are not the same if, under the modified aggregate approach, the partnership is required to capitalize the salary payment as if the payment had been made to a third-party when a distribution of partnership income under the pure aggregate approach would not be capitalized. Curiously, a desire to keep the results under the modified aggregate approach as consistent as possible with the results under the pure aggregate approach may explain why § 263 was not included in § 707(c), along with §§ 61(a) and 162(a), as originally enacted.

In suggesting that Congress originally intended to implement the modified aggregate approach under § 707(c), we acknowledge the conflict thus created with our argument in this commentary that the entity theory should be applied to in-kind guaranteed payments. Although the treatment of partner salaries by both a partner and the partnership under the modified aggregate approach is consistent with certain aspects of the entity theory, the modified aggregate approach was not viewed as the adoption of the entity theory but as only a restatement of the aggregate theory in simplified form. See Willis, *Handbook of Partnership Taxation*, *supra* at § 11.05 at 131 ("When it's all sifted down, the net effect of considering guaranteed compensation paid to a partner as made to one who is not a partner is quite innocuous and marks little change from prior law."). See also J. Paul Jackson, Mark H. Johnson, Stanley S. Surrey & William C. Warren, "A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners – American Law Institute Draft," 9 *Tax L. Rev.* 109, 138-39, 177 (1954) (advocating the adoption of the entity theory in connection with transactions between partners and partnerships but only when the partner is not acting in his capacity as a partner). Because § 707(c) represented a continuation of the aggregate approach, albeit in modified form, the aggregate theory should have continued to serve as the model for all other purposes including, presumably, in-kind guaranteed payments, at least until the enactment of § 707(a)(2)(A) in 1984.

Nevertheless, almost immediately following the enactment of Subchapter K, § 707(c) was seen as incorporating the entity theory for most, if not all, purposes. See *Cagle v. Comm'r*, 63 T.C. 86 (1974) (requiring the capitalization of guaranteed payments prior to the amendments of § 707(c) in 1976 and referring to the "employment of the entity theory of partnerships in this facet of partnership taxation"), *aff'd*, 539 F.2d 409 (5th Cir. 1976); Rev. Rul. 81-300, 1981-2 C.B. 143 ("[u]nder § 707(c), the partnership is considered an unrelated entity for purposes of §§ 61 and 162 . . ."); J. Paul Jackson, et al., *supra* note 44, at 1201-02 ("The new law applies the entity concept not only to a partner's transactions with his partnership when he is not acting in his capacity as a partner, but also to guaranteed annual payments of salary and interest."). Our ultimate conclusion that the entity theory should be applied in connection with in-kind guaranteed payments does not rely on this judicial and administrative "gloss," however, but on the legislative enactment of § 707(a)(2)(A). See *infra* text accompanying notes 156-62.

Of course, the results under Kahn and Cuenin's proposal, the modified aggregate approach developed above, and the entity approach that we advocate differ with respect to both the timing and potentially the character of any resulting income, gain, deduction, or loss. The results are summarized below.

Kahn and Cuenin's Approach

Year 1 tax implications for A

\$30,000	guaranteed payment – ordinary income
(\$10,000)	deduction

Future tax implications for A

\$10,000	gain inherent in partnership interest
\$ 0	no gain or loss in Land 2

Modified Aggregate Approach

Year 1 tax implications for A

\$30,000	guaranteed payment – ordinary income
(\$10,000)	deduction

Future tax implications for A

(\$ 5,000)	loss inherent in partnership interest
\$15,000	gain inherent in Land 2

Entity Approach

Year 1 tax implications for A

\$30,000	guaranteed payment – ordinary income
(\$10,000)	deduction
\$ 5,000	share of gain on transfer of Land 2

Future tax implications for A

\$ 5,000	gain inherent in partnership interest
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The modified aggregate approach produces some potentially troubling results. First, the recipient partner receives a carryover basis in the transferred property despite the fact that she was taxed on the full fair market value of the property. As a result, she would realize additional income on a subsequent disposition of the property.¹⁵⁰ However, this objection becomes questionable if the partner is viewed as taxed on the full fair market value of the services rendered and not on the full fair market value of the property ultimately transferred. In other words, the partner (as a provider of services) should be viewed as the recipient of cash from the partnership in return for the services rendered, which the partner (as a partner) immediately reconveys

150. This concern has been noted by others. 1 McKee, Nelson & Whitmire, *supra* note 42, at ¶ 13.03[5].

to the partnership as a contribution of capital.¹⁵¹ The subsequent distribution of property in satisfaction of the guaranteed payment is viewed as separate and independent of the previous rendition of services. The partner is treated as acting as a third party with respect to the rendition of services and as a partner with respect to the distribution of property. Such an approach is consistent with the statutory language of section 707(c).¹⁵²

The modified aggregate approach also raises the same problem as Kahn and Cuenin's approach because the partnership is permitted a deduction equal to the full fair market value of the property transferred (or the services rendered if one prefers).¹⁵³ In effect, the partnership can use appreciated property to create deductions equal to the value of the appreciated property involved without the partners suffering the burden of the corresponding gain recognition until some indefinite time in the future. Thus, the modified aggregate approach creates the same opportunities for tax shelter abuses that are created by Kahn and Cuenin's approach.

Despite the potential objections to each approach, the issue now is a choice between, not two, but three differing interpretations of section 707(c). Which is the proper approach? We believe that Kahn and Cuenin's proposal is the least acceptable. It is least consistent with the statutory language and combines both entity and aggregate concepts in a manner that creates opportunities for abuse as previously described.¹⁵⁴ Alternatively, both the modified aggregate approach and the entity approach can be supported by various aspects of the statutory language, the legislative history, and the Regulations surrounding section 707(c), as well as statements contained in

151. We acknowledge that this response raises the difficulty of how a partner performing such services is acting, not as a partner, but as a third-party provider of services if § 707(c) applies only when the partner is acting in the capacity of a partner. That difficulty, however, is a result of the legislative shift in the definition of capacity under § 707(a)(2)(A) without a full appreciation of its implications for guaranteed payments under § 707(c).

152. Such an interpretation is not consistent with the capacity analysis of § 707(a)(2)(A), however, which views the rendition of services, the allocation of partnership income, and the distribution of partnership property in such a situation as all parts of a related transaction to be treated as a transaction between the partnership and a non-partner under § 707(a)(1). This inconsistency illustrates the irreconcilability of §§ 707(a)(2)(A) and 707(c) and the reason why we called for the repeal of § 707(c) in our earlier article. Postlewaite & Cameron, *supra* note 2, at 694-96.

153. See *supra* text accompanying notes 129-30.

154. One is reminded of Jacob Rabkin and Mark Johnson's admonition, "[i]f it were a matter of redrafting the partnership tax law, perhaps as good a case can be made for one theory as the other. One of them, however, must be consistently applied." Jacob Rabkin & Mark H. Johnson, "The Partnership Under the Federal Tax Law," 55 *Harv. L. Rev.* 909, 949 (1942), quoted in Mark P. Gergen, "The Story of Subchapter K" in *Business Tax Stories* 221 (Steven A. Bank & Kirk J. Stark eds., 2005).

judicial decisions both before and after 1954.¹⁵⁵ Fortunately, there is no reason to debate the question regarding the application of the modified aggregate approach or the entity approach because Congress resolved any controversy through the enactment of section 707(a)(2) in 1984.

*G. The Application of Section 707(a)(2)*¹⁵⁶

Although we believe that the foregoing discussion more than adequately demonstrates the superiority of treating in-kind guaranteed payments as transfers to a third-party for all purposes, as opposed to the approach advocated by Kahn and Cuenin that treats in-kind guaranteed payments as a distribution of partnership property for some purposes and as a payment to a third-party for other purposes, this debate is largely, if not completely, academic. Congress addressed and resolved this issue through the enactment of section 707(a)(2) as part of the Tax Reform Act of 1984. As a result of the enactment of section 707(a)(2), Congress effectively repealed section 707(c) and decided that the types of guaranteed payments that Kahn and Cuenin describe in their article should be treated as payments to a third party under section 707(a). The enactment of section 707(a)(2) was the motivation for our earlier article.¹⁵⁷ Our conclusion that Congress effectively repealed section 707(c) is applicable to both cash and in-kind guaranteed payments.

Congress effectively repealed section 707(c) through its redefinition of the concept of capacity under section 707(a). As previously described,¹⁵⁸ section 707(a)(2) requires third-party treatment for any partner who renders services or transfers property to a partnership and who thereafter receives a related direct or indirect allocation and distribution if such transfers are “properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the

155. One commentator acknowledges that the modified aggregate approach produces the proper amount of income over the life of the partnership for the partners (as do the other two methods) but results in timing differences. McKee, Nelson & Whitmire, *supra* note 42, at ¶ 13.03[5]. Nevertheless, they reject this approach as inconsistent with the language of § 707(c) and open to uncertainty and complexity when applied in conjunction with other sections of Subchapter K.

156. We apologize to the readers who have followed our discussion up to this point but who are only interested in the final answer to the legal question regarding the proper treatment of in-kind transfers to partners for the rendition of services, transfers that are typically, albeit improperly, referred to as guaranteed payments (assuming that the term “guaranteed payments” is reserved solely for payments falling within § 707(c)).

157. Postlewaite & Cameron, *supra* note 2.

158. See *supra* text accompanying notes 31-39.

partnership.”¹⁵⁹ In making this determination, the legislative history and subsequent Regulations focus on the entrepreneurial risk to which the partner is exposed in connection with the amount of any related distribution and whether the distribution will, in fact, be made.¹⁶⁰ This new definition of capacity represented a dramatic shift from the earlier definition that examined the connection between the types of services performed by the partner and the activities in which the partnership was engaged.

Under this revised definition of capacity, virtually all transfers from a partnership to a partner for the rendition of services, whether in cash or in-kind, will receive third-party treatment under section 707(a) unless the transfer, with respect to both the fact and the amount of payment, is subject to the entrepreneurial risk of the partnership.¹⁶¹ As we stated in our earlier article, it is difficult to envision a transfer for the rendition of services by a partner that, unless expressly dependent on the current or future income of the partnership, could somehow be subject to the entrepreneurial risk of the partnership.¹⁶² Certainly, the types of transfers discussed by Kahn and Cuenin in their article would not be subject to the entrepreneurial risk of the partnership and, thus, would be treated under section 707(a) as a payment to a third party. Accordingly, there is no need to engage in the complicated analysis advocated by Kahn and Cuenin.

Because Kahn and Cuenin did not consider the dramatic change in the concept of capacity introduced by the enactment of section 707(a)(2),

159. In the context of guaranteed payments, the “related allocation” for purposes of § 707(a)(2) is the allocation of income attributable to the guaranteed payment and the “related distribution” is the cash or property transferred by the partnership in satisfaction of the guaranteed payment. This conceptualization of guaranteed payments as an allocation and distribution of partnership income is consistent with the modified aggregate approach described above.

160. S. Rep. No. 98-169, at 227 (1984); Regs. §§ 1.707-3, 1.707-4, 1.707-5, and 1.707-6. See also Staff of the Joint Comm. on Tax’n, General Explanation of H.R. 4170, 227-28 (1984).

161. The Congressional reversal of the conclusion in Revenue Ruling 81-300, 1981-2 C.B. 143, that fees for managerial services based on the gross rentals of the partnership should be treated as payments under § 707(a), rather than § 707(c), illustrates the dramatic effect of the enactment of § 707(a)(2). S. Rep. No. 98-169, at 230 (1984). See also Staff of the Joint Comm. on Tax’n, General Explanation of H.R. 4170, 230-31 (1984).

162. See Postlewaite & Cameron, *supra* note 2, at 691-93. Of course, if the transfer is expressly dependent on the income of the partnership, the transfer will not fall within § 707(c) because it would not be “determined without regard to the income of the partnership” and, thus, would be excluded from § 707(c). Conversely, if not dependent on the income of the partnership, the transfer would not be subject to the entrepreneurial risks of the partnership and, thus, would be included under § 707(a). As a consequence, little, if anything, continues to fall within § 707(c). As we cautioned in our earlier article, § 707(c) has been effectively repealed.

they erroneously assumed that section 707(c) remains alive and well. This was the precise concern that we addressed almost 20 years ago, and the reason why we have expectantly waited for some official recognition that section 707(c) represented only a trap for the unwary.

IV. LIQUIDATING DISTRIBUTIONS

In the concluding section of their analysis, Kahn and Cuenin consider the implications of in-kind guaranteed payments in the context of liquidating distributions under section 736.¹⁶³ Section 736 is a complicated and confusing aspect of Subchapter K with a questionable policy basis when enacted in 1954 that has been significantly undermined since that time as a result of amendments to both Subchapter K and the Code more generally. Because of the problems inherent in section 736, one of us has called for its repeal in a separate article.¹⁶⁴ Consequently, the difficulties that arise in considering the implications of in-kind guaranteed payments under section 707(c) are only compounded in the context of section 736.

Essentially, Kahn and Cuenin incorporate their conclusions with respect to guaranteed payments under section 707(c) into section 736 without significant additional analysis. They simply assert that a partnership recognizes no gain or loss on the transfer of partnership property to a partner in liquidation of that partner's partnership interest and that the partner takes a fair market value basis in the property received regardless of whether the payment falls within section 736(a) or section 736(b).¹⁶⁵ However, Kahn and Cuenin apparently ignore the fact that the context of transfers under section 736 is significantly different from that of section 707(c). Most importantly, transfers under section 736 are not part of a reciprocal relationship between the partner and the partnership involving the rendition of services or the use of capital. This difference, by itself, influences the analysis of the proper treatment of such transfers. Although section 736 explicitly refers to guaranteed payments under section 707(c), this reference may not incorporate all of the particular details of such payments as discussed above for the purposes of liquidating distributions.

163. Kahn & Cuenin, *supra* note 6, at 436-38.

164. Philip F. Postlewaite & Adam H. Rosenzweig, "Anachronisms in Subchapter K of the Internal Revenue Code: Is It Time to Part with § 736?," 100 *Northwestern L. Rev.* 379 (2005). See also Walter D. Schwidetzky, "Hyperlexis and the Loophole," 49 *Okla. L. Rev.* 403 (1996); John A. Lynch, Jr., "Taxation of the Disposition of Partnership Interests: Time to Repeal IRC § 736," 65 *Neb.L. Rev.* 450 (1986); Philip F. Postlewaite, Thomas E. Dutton & Kurt R. Magette, "A Critique of the ALI's Federal Income Tax Project – Subchapter K: Proposals on the Taxation of Partners," 75 *Geo. L. J.* 423 (1986).

165. Kahn & Cuenin, *supra* note 6, at 436.

An example of the differences that exist between the treatment of guaranteed payments under section 707(c) and those under section 736 is the requirement that guaranteed payments under section 707(c) are subject to the capitalization requirements of section 263.¹⁶⁶ Prior to the amendment of section 707(c) in 1976 explicitly subjecting guaranteed payments to the capitalization requirements of section 263, the Tax Court reached the same conclusion but cautioned that its decision for purposes of section 707(c) might not apply for purposes of section 736.

In deciding that the section 707(c) payment herein must run the gauntlet of section 162(a) in order to be deductible, we expressly reserve determination of a similar question under section 736(a)(2) and think that no inference should be drawn from the decision in the instant case. See sec. 1.736-1(a)(4), Income Tax Regs.¹⁶⁷

Thus, the Tax Court recognized that the different policy justifications for sections 707 and 736 may require different approaches to the treatment of guaranteed payments under each section. The court's perceptiveness in this regard was prescient of Congressional intent when Congress amended section 707(c) to clarify that the capitalization requirements of section 263 applied to guaranteed payments. Congress specifically directed in the legislative history that the amendment to section 707(c) "is not intended to adversely affect the deductibility to the partnership of a payment described in section 736(a)(2) to a retiring partner."¹⁶⁸ Consequently, the history of the relationship between sections 707 and 736 suggests that caution should be exercised when assuming that all aspects of section 707(c) apply in the context of section 736(a)(2) payments treated as guaranteed payments.

We conclude that the treatment of in-kind guaranteed payments under section 736, a provision with a narrow statutory focus and legislative purpose, is not identical to that under section 707(c). Instead, the reference to guaranteed payments under section 736 was intended only to resolve questions regarding the characterization of income by the recipient partner and the deductibility of such transfers by the partnership. Section 736 does

166. See also Postlewaite & Cameron, *supra* note 2, at 707-08 (describing how guaranteed payments structured as a percentage of partnership income subject to a minimum amount may not be determined in the same manner under § 736(a) as under § 707(c)).

167. Cagle, 63 T.C. at 95 (1974) (footnote omitted).

168. S. Rep. No. 94-938, 94, n.7 (1976), reprinted in 1976 U.S.C.C.A.N. 3439, 3530, n.7. See Regs. § 1.707-1(c) (specifically stating that the reference to § 263 contained in § 707(c) "does not affect the deductibility to the partnership of a payment described in § 736(a)(2) to a retiring partner or to a deceased partner's successor in interest").

not address the question of whether the partnership must recognize gain or loss on the transfer of partnership property in satisfaction of a guaranteed payment. The answer to that question depends on an independent analysis of the implications of guaranteed payments in the specific context of liquidating distributions.

A. Application of Section 736 to Liquidating Distributions

Section 736 applies to distributions in liquidation of a partner's interest in a partnership. As Kahn and Cuenin explain, section 736 divides such distributions into two categories: section 736(b) applies to distributions in exchange for the partner's interest in partnership property while section 736(a) applies to all other distributions.¹⁶⁹ Importantly, section 736(b) does not apply to unrealized receivables held by the partnership or to goodwill of the partnership provided that (1) capital is not a material income-producing factor for the partnership and (2) the retiring or deceased partner was a general partner in the partnership.¹⁷⁰ In other words, distributions in exchange for a partner's interest in unrealized receivables and goodwill are not treated under section 736(b) if the distribution is in liquidation of a general partner's interest in a service partnership. The exclusion from section 736(b) for distributions with respect to partnership goodwill is subject to the additional requirement that the partnership agreement must not otherwise provide for payments with respect to goodwill.¹⁷¹

Distributions that are not treated as made in exchange for the partner's interest in partnership property are treated under section 736(a) either as a distributive share of partnership income or as a guaranteed payment.¹⁷² Such distributions constitute a distributive share of partnership income if the amount of the distribution is determined with regard to partnership income.¹⁷³ Alternatively, such distributions are treated as a guaranteed payment described in section 707(c) if the amount of the distribution is determined without regard to partnership income.¹⁷⁴

169. IRC §§ 736(a) and 736(b)(1). See Kahn & Cuenin, *supra* note 6, at 437.

170. IRC § 736(b)(3). As originally enacted in 1954, § 736(b) permitted the treatment of payments for unrealized receivables and unspecified goodwill as payments under § 736(a) regardless of the type of partnership or partner involved. Congress enacted the restrictions currently imposed under § 736(b)(3) in 1993. See 2 Willis, Pennell & Postlewaite, *supra* note 11, at ¶¶ 15.02 and 15.03.

171. IRC § 736(b)(2).

172. IRC § 736(a).

173. IRC § 736(a)(1).

174. IRC § 736(a)(2). In our earlier article proposing the repeal of § 707(c), we suggested that payments in excess of those in exchange for the withdrawing partner's interest in partnership property under § 736(b) and determined without regard to partnership income be treated as a payment under § 707(a)(1) as made to a partner other

This distinction between distributions under sections 736(a) and 736(b) means that different tax results arise depending on the category in which the distribution falls. Distributions under section 736(b) are effectively treated as an acquisition by the remaining partners of the withdrawing partner's interest in the partnership property.¹⁷⁵ To the extent that gain is recognized on the distribution, the withdrawing partner typically receives capital gain treatment, and the remaining partners are not permitted a deduction in connection with the distribution. On the other hand, distributions under section 736(a) typically result in ordinary income to the withdrawing partner and a reduction in the remaining partners' share of partnership income.¹⁷⁶

than in his capacity as a member of the partnership. Postlewaite & Cameron, *supra* note 2, at 705-09. Such an approach is consistent with the revised capacity analysis introduced by § 707(a)(2) that considers the risk as to the fact and the amount of the payment in determining the capacity in which a partner is acting. Payments in liquidation of a partner's interest in a partnership that are determined without regard to partnership income bear no risk with respect to the amount of the payment and presumably bear risk similar to that of a payment to a third-party with respect to the fact of payment. The need to treat liquidating payments under § 736(a)(2) as guaranteed payments in order to specify the characterization and timing of such payments could be easily provided by § 707(a)(1).

175. As stated in the legislative history:

The amounts paid for the capital interest of the withdrawing partner are treated in the same manner as a distribution. The remaining partners, of course, are allowed no deductions for such payments. Essentially, these payments represent a purchase by the remaining partners of the withdrawing partner's capital interest in the partnership.

H.R. Rep. No. 83-1337, at 72 (1954), reprinted in 1954 U.S.C.C.A.N. 4017, 40948. See S. Rep. No. 83-1622, at 97 (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 4730.

176. Part of the rationale for treating such distributions as ordinary income to the withdrawing partner combined with a current deduction to the remaining partners was the view that such distributions were in the nature of deferred compensation upon the partner's retirement for services previously rendered. The legislative history for § 736 specifically anticipated a retirement payout function for § 736. The legislative history states:

Where a retiring partner receives a lump sum or fixed payments determined without regard to the income of the partnership, the portion of such payments attributable to the capital interest of the retiring partner is to be treated as the purchase of a capital interest by the remaining partners. The balance, however, will be treated like a salary paid by the partnership. It will constitute ordinary income to the recipient and a deduction to the partnership. . . .

The most disturbing aspect of section 736 lies in the fact that service partnerships may treat distributions in exchange for a general partner's interest in the goodwill of the partnership as a distribution under section 736(a) rather than section 736(b). Although such distributions will effectively be taxed as ordinary income to the withdrawing partner, they will give rise to an immediate deduction to the partnership. Consequently, partners in service partnerships are effectively able to currently deduct payments for the purchase of goodwill from a withdrawing partner while all other taxpayers confront a unified regime under section 197 that requires the amortization of acquired goodwill over a 15-year period.¹⁷⁷

B. In-Kind Guaranteed Payments Under Section 736(a)

Kahn and Cuenin begin their consideration of in-kind guaranteed payments under section 736(a) by suggesting that, although such payments are unusual in the section 707(c) context because payments are typically made in cash, in-kind guaranteed payments will "occur far more frequently" in the liquidation context under section 736.¹⁷⁸ We question whether this assertion is accurate.

Liquidating distributions arise in two distinct situations: the liquidation of the partnership as a whole, in which the enterprise terminates, and the liquidation of a single partner, in which the partnership continues its partnership operations. When terminated, the partnership will liquidate either by selling the assets and distributing the sales proceeds or by distributing the assets in-kind. If the partnership liquidates by selling its assets, the issue of in-kind payments under section 736(a) will not arise because only cash is distributed. Alternatively, if the partnership liquidates by distributing its

Thus, to the extent that payments to a retiring partner or deceased partner's successor are not in exchange for a capital interest, they are treated as deductions to the remaining partners and as income to the withdrawing partner or his successor irrespective of over how long a period they may be paid. . . .

S. Rep. No. 83-1622, at 98 (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 4731.

177. Of course, this result was even more egregious prior to the enactment of § 197 in 1993 when all other taxpayers were prohibited from amortizing goodwill under § 167. Interestingly, even if the distribution falls under § 736(b) because the goodwill is specified in the partnership agreement, the remaining partners may be permitted to amortize the withdrawing partner's share of the partnership goodwill under § 197. If the partnership makes a § 754 election and the anti-churning rules do not apply, the remaining partners may amortize the goodwill payments over a 15-year period under § 197(f)(9)(E).

178. Kahn & Cuenin, *supra* note 6, at 436. As a result, Kahn and Cuenin note that the issues and disputes involving in-kind guaranteed payments are most likely to arise in the context of liquidating distributions. *Id.* at 37.

assets in-kind, the partnership will likely distribute the assets on a pro rata basis to the members of the partnership in accordance with their economic interests in the partnership. In this situation as well, the issue of in-kind guaranteed payments will not arise because none of the partners will receive payments, in cash or in-kind, for their interests in unrealized receivables or partnership goodwill, which is necessary in order to implicate section 736(a). Instead, they will simply receive their individual share of the partnership's assets. Thus, no portion of the transaction would be subject to section 736(a).

The only setting in which section 736(a) might be implicated in a complete liquidation of a partnership would occur in a non-pro rata distribution of the partnership's assets. Importantly, non-pro rata distributions of the partnership's assets in a complete liquidation would have to run the gauntlet of section 751(b), notwithstanding Kahn and Cuenin's assertion that "section 751(b) is rarely invoked" in the context of liquidating distributions.¹⁷⁹ Nevertheless, in this very limited circumstance, the issue of in-kind distributions under section 736(a) may arise.

Similar considerations attend the liquidation of a partner's partnership interest by an ongoing partnership. Kahn and Cuenin assert that "it is common for the liquidation of a partner to include a premium," in which case the premium may well constitute a guaranteed payment under section 736(a)(2). However, since most such payments would presumably be made in cash, the issue of in-kind guaranteed payments under section 736 would not arise. Cash payments presumably occur in the vast majority of situations involving liquidating distributions to a single withdrawing partner because the partnership presumably needs its assets in order to continue conducting business. In addition, distributions of the withdrawing partner's pro rata share of his assets would not implicate section 736(a)(2) as discussed above. Non-pro rata distributions could be subject to section 736(a)(2) but would first have to work their way through the potential application of section 751(b).

Thus, contrary to Kahn and Cuenin's assertion, it appears that in-kind guaranteed payments may not be as frequently encountered in the liquidation context as they suggest. This observation strongly cautions against any conclusion that in-kind guaranteed payments under section 736 warrant special consideration and a possible deviation from fundamental principles of sound tax policy.¹⁸⁰

179. Kahn & Cuenin, *supra* note 6, at 438. The omnipresence of § 1245 depreciation recapture, an unrealized receivable for purposes of § 751(b), given the availability of expensing and rapid amortization and depreciation under §§ 168, 179, and 197 suggests that Kahn and Cuenin's assertion may be exaggerated.

180. As one of us has cautioned elsewhere, in-kind distributions under § 736 involve numerous problems that can be avoided through the use of cash distributions. "If any generalizations can be made, it is that fewer problems exist if property (other

Turning to the question of the proper treatment of in-kind guaranteed payments under section 736, if and when they do arise, an in-depth analysis like that provided above in the context of in-kind guaranteed payments under section 707(c) is required. The first aspect of this analysis requires a consideration of the language of section 736(a)(2) itself. In referring to guaranteed payments, section 736(a) states that “payments made in liquidation of the interest of a retired or deceased partner shall . . . be considered . . . as a guaranteed payment described in section 707(c) if the amount thereof is determined without regard to the income of the partnership.”¹⁸¹ This language appears to treat distributions that fall within section 736(a)(2) as guaranteed payments without regard to the issues previously discussed concerning the application of section 707(c) when a payment is made to a partner deemed to be acting in the capacity of a partner.¹⁸² Apparently, no consideration is to be given to the issue of risk as to the fact or the amount of the payment that is required for purposes of section 707(c) as a result of the enactment of section 707(a)(2). However, we do not believe that the capacity analysis of section 707(a)(2) should be ignored in the context of section 736(a), particularly when considering the treatment of in-kind guaranteed payments.

Although Kahn and Cuenin do not reiterate the point that Congress probably gave little, if any, thought to in-kind guaranteed payments under section 707(c), we suggest that Congress gave even less thought (if that is possible) to in-kind guaranteed payments in the context of section 736.¹⁸³ Consequently, in attempting to divine “Congressional intent” regarding the proper treatment of in-kind guaranteed payments under section 736, we should not disregard subsequent legislative developments under section 707.¹⁸⁴ Assuming that a “guaranteed payment” under section 736(a)(2) is

than money) is not distributed as a § 736(a) payment. In actual practice, the business realities of the situation may dictate the easier approach because many of the assets will be essential to the partnership’s continuing business operation and are unlikely to be distributed.” 2 Willis, Pennell & Postlewaite, *supra* note 11, at ¶ 15.06[4].

181. IRC § 736(a).

182. See *supra* text accompanying notes 31-39 and 156-62.

183. Kahn & Cuenin, *supra* note 6, at 417. Indeed, one group of early commentators on the implications of Subchapter K noted that “§ 736(a) apparently applies only to cash payments.” J. Paul Jackson, et al., *supra* note 44, at 1225, n.81. The Regulations under § 736 as originally proposed provided that payments under § 736(a) be made in cash. Prop. Regs. § 1.736-1(a)(2), available in Notice of Proposed Rulemaking, 20 Fed. Regs. 5,871 (1955) (providing that “[a] distribution of property does not qualify as a payment under § 736. Payments under § 736 must be in money . . .”). However, the final Regulations removed this requirement.

184. Presumably, Congress believed that distributions under § 736(a) were made to the withdrawing partner in his capacity as a member (albeit a former member) of the partnership. The fact that Congress changed the capacity analysis under § 707 from a focus on the activities of the partner giving rise to the allocation and distribution

limited as to risk, such a payment should presumably be treated as a payment to a third party, requiring the recognition of gain or loss to the transferor partnership.

An in-depth analysis to determine the proper treatment of in-kind guaranteed payments under section 736 next requires a consideration of hypothetical situations and an examination of the bases and fair market values of the partnership's assets and the partners' partnership interests following the approach described above.¹⁸⁵ To do so, let us again return to the example posed by Kahn and Cuenin earlier in their article and described above, but this time with certain modifications to facilitate the analysis of section 736.¹⁸⁶ P, a general partnership, has three equal partners, A, B, and C. In Year 1, P has neither net income nor net loss. In addition, the partnership has no liabilities. The bases and fair market values of the partnership's assets and the partners' partnership interests are as provided in Figure 1.

Figure 1
Partnership's Assets and Partners' Partnership Interests
Prior to the Liquidating Distribution

	Assets			Partnership Interests	
	<u>AB</u>	<u>FMV</u>		<u>AB</u>	<u>FMV</u>
Cash	\$35,000	\$35,000	A	\$20,000	\$30,000
Land 1	\$10,000	\$35,000	B	\$20,000	\$30,000
Land 2	<u>\$15,000</u>	<u>\$20,000</u>	C	<u>\$20,000</u>	<u>\$30,000</u>
Total	\$60,000	\$90,000	Total	\$60,000	\$90,000

In this situation, assume that on December 31, Year 1, P transfers \$35,000 to A in liquidation of A's partnership interest, \$5,000 of which is attributable to unspecified goodwill. Section 736 requires that the \$35,000 distribution be divided between that portion made in exchange for A's interest in partnership property under section 736(b) and that portion paid for unspecified goodwill of the partnership under section 736(a). Consequently, \$30,000 of the \$35,000 distribution would result in capital gain to A of \$10,000 (\$30,000 minus A's basis in his partnership interest of \$20,000).¹⁸⁷ Section 736(a)(2) would apply to the remaining \$5,000 distribution, which

to the entrepreneurial risk surrounding the allocation and distribution should be a factor in determining the proper application of § 736(a).

185. See *supra* text accompany notes 120-29 and 138-49. Unfortunately, Kahn and Cuenin provide no such analysis in this portion of their article.

186. See *supra* text accompanying notes 120-23. The only modifications to facilitate the analysis of § 736 are an increase in the fair market value of Land 1 from \$25,000 to \$35,000 and a reduction in the fair market value of Land 2 from \$30,000 to \$20,000.

187. IRC §§ 736(b)(1) and 731(a)(1).

would be treated as a guaranteed payment under section 707(c) resulting in ordinary income of \$5,000 to A. The distribution would result in \$15,000 of gain for A, \$10,000 of capital gain and \$5,000 of ordinary income.

The guaranteed payment would also generate a \$5,000 deduction for the partnership. The \$5,000 deduction would reduce the remaining partners' bases in their partnership interests by \$2,500. Following the liquidating distribution, the bases and fair market values of the partnership's assets and the partners' partnership interests would be as provided in Figure 2A.

Figure 2A
Partnership's Assets and Partners' Partnership Interests
Following the Liquidating Distribution

	Assets			Partnership Interests	
	AB	FMV		AB	FMV
Land 1	\$10,000	\$35,000	B	\$17,500	\$27,500
Land 2	<u>\$15,000</u>	<u>\$20,000</u>	C	<u>\$17,500</u>	<u>\$27,500</u>
Total	\$25,000	\$55,000	Total	\$35,000	\$55,000

Importantly, the \$10,000 of gain previously inherent in each partner's partnership interest has been preserved, but, as can be seen, the liquidating distribution has generated a mismatch between the aggregate inside bases of the partnership's assets and the aggregate outside bases of the partners' partnership interests. If P files a timely election under section 754, the partnership will be permitted to adjust the basis of Land 1 and Land 2 by \$10,000, the amount of gain recognized by A that was attributable to that portion of the distribution made in exchange for A's interest in partnership property under section 736(b).¹⁸⁸ This adjustment would re-establish an equivalence between the aggregate inside bases of the partnership's assets and the aggregate outside bases of the partners' partnership interests as shown in Figure 2B.

¹⁸⁸ IRC § 734(b)(1)(A). A basis adjustment under § 734 is allocated among the partnership's assets in accordance with the rules under § 755. The Regulations under § 755 provide that a basis adjustment resulting from gain recognized by a withdrawing partner under §§ 736(b)(1) and 731(a)(1) is allocated only to capital gain property. Regs. § 1.755-1(c)(1)(ii). The adjustment is then allocated among the capital gain properties in proportion to their respective amounts of unrealized appreciation but only to the extent of each property's unrealized appreciation. Regs. § 1.755-1(c)(2)(i). Assuming that Land 1 and Land 2 in the example are capital assets, the \$10,000 basis adjustment under § 734 would be allocated \$8,333 to Land 1 (\$10,000 basis adjustment times (\$25,000 appreciation in Land 1/\$30,000 total appreciation in Lands 1 and 2) and \$1,667 to Land 2 (\$10,000 basis adjustment times (\$5,000 appreciation in Land 2/\$30,000 total appreciation in Lands 1 and 2)). See 2 Willis, Pennell & Postlewaite, *supra* note 11, at ¶ 13.05[8].

Figure 2B
Partnership's Assets and Partners' Partnership Interests
Following the Liquidating Distribution and
Section 734 Adjustment

	Assets			Partnership Interests	
	<u>AB</u>	<u>FMV</u>		<u>AB</u>	<u>FMV</u>
Land 1	\$18,333	\$35,000	B	\$17,500	\$27,500
Land 2	<u>\$16,667</u>	<u>\$20,000</u>	C	<u>\$17,500</u>	<u>\$27,500</u>
Total	\$35,000	\$55,000	Total	\$35,000	\$55,000

Instead of a \$35,000 cash distribution to A in liquidation of his partnership interest, assume that P transfers Land 1 to A in liquidation of A's partnership interest. Section 736 again requires that the \$35,000 distribution be divided between that portion made in exchange for A's interest in partnership property under section 736(b) and that portion paid for unspecified goodwill of the partnership under section 736(a). Consequently, Land 1 would have to be bifurcated between the section 736(a) and the section 736(b) portions of the transaction. A would receive 6/7ths of Land 1 (hereinafter referred to as "Land 1A") with a fair market value of \$30,000 in exchange for his interest in partnership property and would take a basis in Land 1A of \$20,000, his basis in his partnership interest.¹⁸⁹ If A subsequently disposes of this portion of Land 1A for \$30,000, A will realize and recognize \$10,000 of gain.

Section 736(a)(2) would apply to the remaining 1/7th portion of Land 1 (hereinafter referred to as "Land 1B"). Land 1B would be treated as a guaranteed payment under section 707(c), resulting in ordinary income of \$5,000 to A. In this case, A would have income of \$5,000 as a result of the guaranteed payment and \$10,000 of gain preserved in Land 1A. Because this gain equals that in the prior example involving a \$35,000 distribution of cash, we would expect that A takes a basis in Land 1B equal to its fair market value of \$5,000 so that no further gain or loss would be realized and recognized on a subsequent disposition of Land 1B for \$5,000. A fair market basis in Land 1B is consistent with both Kahn and Cuenin's proposed treatment of guaranteed payments as well as an entity approach to guaranteed payments.

Like a cash distribution, the guaranteed payment would also generate a \$5,000 deduction for the partnership. The \$5,000 deduction would reduce both of the remaining partners' bases in their partnership interests by \$2,500. The interesting question, however, is the effect on the partnership of the \$5,000 guaranteed payment in addition to the \$5,000 deduction. Under Kahn and Cuenin's proposal, P would not recognize gain on the transfer.

¹⁸⁹ IRC § 732(b).

Following the liquidating distribution, the bases and fair market values of the partnership's assets and the partners' partnership interests are as provided in Figure 3A.

Figure 3A
Partnership's Assets and Partners' Partnership Interests
Following the Liquidating Distribution

	Assets			Partnership Interests	
	<u>AB</u>	<u>FMV</u>		<u>AB</u>	<u>FMV</u>
Cash	\$35,000	\$35,000	B	\$17,500	\$27,500
Land 2	\$15,000	\$20,000	C	\$17,500	\$27,500
Total	\$50,000	\$55,000	Total	\$35,000	\$55,000

As in the prior example, the \$10,000 of gain previously inherent in each partner's partnership interest has been preserved, but, as can be seen, the liquidating distribution has generated a mismatch between the aggregate inside bases of the partnership's assets and the aggregate outside bases of the partners' partnership interests. If P filed a timely election under section 754, the partnership would be permitted to reduce the basis of Land 2 by \$11,429, the difference between the adjusted basis of Land 1A in the hands of the partnership (6/7th of the \$10,000 basis or \$8,571) and the adjusted basis of Land 1A in the hands of A (\$20,000).¹⁹⁰ Unfortunately, this adjustment alone would not be sufficient to re-establish an equivalence between the aggregate inside bases of the partnership's assets and the aggregate outside bases of the partners' partnership interests as shown in Figure 3B.

Figure 3B
Partnership's Assets and Partners' Partnership Interests
Following the Liquidating Distribution and
Section 734 Adjustment

	Assets			Partnership Interests	
	<u>AB</u>	<u>FMV</u>		<u>AB</u>	<u>FMV</u>
Cash	\$35,000	\$35,000	B	\$17,500	\$27,500
Land 2	\$ 3,571	\$20,000	C	\$17,500	\$27,500
Total	\$38,571	\$55,000	Total	\$35,000	\$55,000

Assume, however, that the partnership is required to recognize gain in connection with the transfer of Land 1B in satisfaction of the guaranteed payment. In this case, the amount of gain would be \$3,571 (\$5,000 fair

¹⁹⁰ IRC § 734(b)(2)(B). This basis adjustment would be solely allocable to Land 2. IRC § 755; Regs. §§ 1.755-1(c)(1)(i) and 1.755-1(c)(2)(ii).

market value of Land 1B minus its basis of \$1,429 (i.e., 1/7th of \$10,000)). The gain would be divided equally between B and C (i.e., \$1,785.50) and would result in an increase in the bases of their partnership interests. Consequently, the bases of the remaining partners' partnership interests would be adjusted for the deduction generated by the guaranteed payment and for the gain recognized. Consequently, the bases and fair market values of the partnership's assets and the partners' partnership interests would be as shown in Figure 4A.

Figure 4A
Partnership's Assets and Partners' Partnership Interests
Following the Liquidating Distribution

	Assets			Partnership Interests	
	AB	FMV		AB	FMV
Cash	\$35,000	\$35,000	B	\$19,285.50	\$27,500
Land 2	<u>\$15,000</u>	<u>\$20,000</u>	C	<u>\$19,285.50</u>	<u>\$27,500</u>
Total	\$50,000	\$55,000	Total	\$38,571.00	\$55,000

In this case, the proper amount of gain has been preserved in the partner's partnership interests, \$8,214.50 (\$27,500 fair market value minus \$19,285.50 adjusted basis), which, with the \$1,785.50 of gain recognized by each partner on the transfer of Land 1B, results in a total gain of \$10,000. This is the same amount that existed for each partner prior to the liquidating distribution. Unfortunately, the liquidating distribution again results in a mismatch between the aggregate inside bases of the partnership's assets and the aggregate outside bases of the partners' partnership interests. However, if P filed a timely election under section 754 in this situation, the partnership would be permitted to reduce the basis of Land 2 by \$11,429, the difference between the adjusted basis of Land 1A in the hands of the partnership (6/7th of the \$10,000 basis or \$8,571) and the adjusted basis of Land 1A in the hands of A (\$20,000).¹⁹¹ With such an adjustment, an equivalence between the aggregate inside bases of the partnership's assets and the aggregate outside bases of the partners' partnership interests would be restored as shown in Figure 4B.

¹⁹¹ IRC § 734(b)(2)(B). This basis adjustment would be solely allocable to Land 2. IRC § 755; Regs. §§ 1.755-1(c)(1)(i) and 1.755-1(c)(2)(ii).

Figure 4B
Partnership's Assets and Partners' Partnership Interests
Following the Liquidating Distribution and
Section 734 Adjustment

	Assets			Partnership Interests	
	<u>AB</u>	<u>FMV</u>		<u>AB</u>	<u>FMV</u>
Cash	\$35,000	\$35,000	B	\$19,285.50	\$27,500
Land 2	<u>\$ 3,571</u>	<u>\$20,000</u>	C	<u>\$19,285.50</u>	<u>\$27,500</u>
Total	\$38,571	\$55,000	Total	\$38,571.00	\$55,000

This analysis demonstrates that, if the adjustment under section 734 is to achieve its objective of re-establishing an equivalence between the aggregate inside bases of the partnership's assets and the aggregate outside bases of the partners' partnership interests, it can only do so if the transfer of an in-kind guaranteed payment under section 736(a)(2) results in gain or loss recognition by the transferor partnership. Thus, a strong argument can be made that the policy goals and structure of Subchapter K are best implemented if the partnership is required to recognize gain or loss on the transfer of an in-kind guaranteed payment under section 736(a)(2).

V. CONCLUSION

In enacting Subchapter K, Congress specifically noted that it was not adopting either the aggregate or the entity theory of partnerships but was combining the two theories and using one or the other depending on the circumstances involved.¹⁹² Unfortunately, it is not always obvious which of

192. Referring to Subchapter K, the legislative history to the 1954 Code provided that "[i]n general, the proposed statutory treatment retains the existing scheme of regarding the partnership as merely an income-reporting, and not a taxable, entity." H.R. Rep. No. 83-1337, at 65 (1954), reprinted in 1954 U.S.C.C.A.N. 4017, 4091; S. Rep. No. 83-1622, at 89 (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 4722. In addition, the House conference committee report stated:

Both the House provisions and the Senate amendment provide for the use of the "entity" approach in the treatment of the transactions between a partner and a partnership which are described above. No inference is intended, however, that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions.

H.R. Rep. No. 83-2543, at 59 (1954), reprinted in 1954 U.S.C.C.A.N. 5280, 5319-20. See Rev. Rul. 89-85, 1989-2 C.B. 218 (stating that "Subchapter K of the Code is a blend of the 'aggregate' and 'entity' treatment for partners and partnerships").

these two theories Congress intended to apply in a particular context. The difficulties are acutely presented when considering transactions between a partner and a partnership.

Kahn and Cuenin have engaged in a valiant attempt to probe the difficulties of discerning the proper tax treatment of in-kind guaranteed payments. They conclude that the transfer of property by a partnership to a partner as a guaranteed payment does not result in gain or loss recognition by the partnership. They also conclude that the recipient partner takes a fair market value basis in the transferred property and that the recipient partner's basis in his partnership interest is reduced by the partner's share of the deduction generated by the guaranteed payment but is not otherwise affected by the transfer of the property. Their first conclusion is consistent with the aggregate theory of partnerships, while their second and third conclusions are consistent with the entity theory of partnerships. Their analysis thus results in an odd combination of both the aggregate and entity theories to explain the tax treatment of a single transaction, which they claim is reflective of the Congressional refusal to adopt one theory to the exclusion of the other.¹⁹³

We reject Kahn and Cuenin's first conclusion and disagree with portions of their subsequent analysis. Although they address the question presented through an examination of the statutory language and policy objectives of section 707(c), problems involving the application of Subchapter K, or any section therein, cannot be resolved through a narrow focus on the language and application of one section or subsection but must rest on a consideration of how each section and subsection fits within the overall statutory framework. In addition, that framework has evolved over time through legislative, administrative, and judicial action in response to problems and difficulties that have arisen in its application. Rather than resorting to the original Congressional intent underlying one section of Subchapter K for guidance, a consideration of the Congressional intent underlying other subsequently enacted sections may require a modification of what might otherwise have been the applicable law.

Kahn and Cuenin appear to have neglected to follow their initial reliance on the language of section 707(c) that guaranteed payments should be treated as payments to "one who is not a member of the partnership but only for the purposes of section 61(a) . . . and . . . section 162(a)." Their reading of the statutory language led them to the conclusion that the transfer of property by a partnership to a partner as a guaranteed payment does not result in gain or loss recognition by the partnership, treating the transfer instead as a distribution of partnership property. They then deviated from the statutory language and concluded that the recipient partner takes a fair market value basis in the transferred property and that the recipient partner's basis in his partnership interest is reduced only by the partner's share of the

193. Kahn & Cuenin, *supra* note, 6, at 417.

deduction generated by the guaranteed payment, results contrary to the treatment of the transfer as a distribution of partnership property. They do so because they believe that a different result will not properly account for the income attributable to the recipient partner as a result of the basis adjustment that would otherwise be required.

As we have demonstrated above, however, Kahn and Cuenin failed to consider all of the basis adjustments that a transfer of property in satisfaction of a guaranteed payment would trigger.¹⁹⁴ Under the modified aggregate approach, which we believe is reflective of the original Congressional intent regarding the treatment of guaranteed payments, the consistent treatment of a guaranteed payment as an allocation of partnership income *and* a distribution of partnership property, with all of the associated basis adjustments required under Subchapter K, would indeed preserve the proper amount of income for the recipient partner. The complex analysis and combined application of aggregate and entity theories of partnerships proposed by Kahn and Cuenin appears unnecessary to the resolution of the questions that they raise.

Kahn and Cuenin also overlook the impact that the enactment of section 707(a)(2)(A) made on the question of the capacity in which the partner is acting for purposes of section 707. Twenty years ago, we asserted that section 707(a)(2)(A) had effectively repealed section 707(c) because the economic risk analysis that it employed in determining the capacity in which a partner is acting is fundamentally inconsistent with the former capacity analysis upon which guaranteed payments under section 707(c) could be distinguished from payments under section 707(a)(1). As a result, virtually all payments that had previously been categorized as guaranteed payments are instead properly categorized as payments under section 707(a)(1), for which the entity approach is indisputably applicable. With respect to in-kind “guaranteed payments,” the entity approach requires that the partnership recognize gain or loss on the transfer, the recipient partner take a fair market value basis in the transferred property, and the recipient partner’s basis in his partnership interest be reduced only by the partner’s share of the deduction generated by the payment. The Congressional failure to recognize the effective repeal of section 707(c) and erase its language from Subchapter K creates a source of confusion and complexity, a trap for the unwary.

Fortunately, the staff of the Joint Committee on Taxation has finally recognized that a small step in the name of tax reform and simplification can be taken by explicitly repealing section 707(c).¹⁹⁵ The fact that the staff’s recommendation has taken 20 years since we first proposed the explicit repeal of section 707(c) demonstrates how difficult it is to “kill” a subsection

194. See text accompanying notes 140-49.

195. Staff of the Joint Comm. on Tax’n, “Options to Improve Tax Compliance and Reform Tax Expenditures,” *supra* note 4, at 170-73.

of the Code (much less an entire section), even a subsection whose only effect is the promotion of needless confusion and complexity. The Committee staff should draft the required language (one sentence should be all that is necessary) and urge the committees of Congress to act on its recommendation before someone breathes new life into a provision whose time and usefulness has clearly passed.¹⁹⁶

196. Unfortunately, the actual repeal of § 707(c) will require somewhat more than one sentence of statutory language as some conforming amendments and modifications of those provisions currently referring to guaranteed payments or § 707(c) will also be necessary. See IRC §§ 168(h)(6)(G), 267(e)(4), 514(c)(9)(E)(ii)(II), 706(a), 736(a)(2), 736(b)(1), 1402(a)(13), 2701(c)(1)(B)(iii), and 7519(d)(5).