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IS THE REPORT OF LAZARUS'S DEATH PREMATURE? A REPLY TO CAMERON AND POSTLEWAITE

by

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I. INTRODUCTION

Over a year ago, Ms. Faith Cuenin and I wrote an article in this Review (which I hereafter refer to as the “2004 Article”) about the tax treatment of guaranteed payments under section 707(c) that are made in kind.¹ We concluded that a partnership does not recognize gain or loss on the making of a guaranteed payment with appreciated or depreciated property. We also concluded that the partner’s basis in the property received will equal its fair market value at the time of payment, and that the payment does not affect the partner’s outside basis in his partnership interest except to the extent of the partner’s share of any deduction that the partnership obtained by making the payment. Professors Cameron and Postlewaite strongly disagree with one of the conclusions we reached in our Article (i.e., our conclusion that the partnership does not recognize gain or loss) and with all of our reasoning. They are publishing in this issue of the Florida Tax Review (in what I will refer to as their “Lazarus Effect” Article) their analysis for rejecting our treatment of the topic.² While I find their arguments well reasoned and documented, for reasons that I will explain in this response, I continue to hold to the conclusions that Ms. Cuenin and I reached in the 2004 Article. I will not reiterate in this response all of the analysis that is set forth in the 2004 Article, and I hope that an interested reader will turn to that piece. I will, however, respond to many of the points that are made in Cameron and Postlewaite’s Lazarus Effect Article.

The Lazarus Effect Article can be divided into two principal parts. One is the contention that section 707(c) was impliedly or effectively repealed by the adoption of section 707(a)(2) as part of the Tax Reform Act of 1984.³ The second is a contention that, even if section 707(c) is still viable, the conclusion concerning the partnership’s nonrecognition of income that Ms. Cuenin and I reached in the 2004 Article, and our reasons for reaching that conclusion, are wrong. I will address both contentions.

While there is no discussion in the 2004 Article concerning the issue of the continuing vitality of section 707(c), the 2004 Article is predicated on the assumption that section 707(c) is still operative. There would be no point in examining the question of the proper treatment of making guaranteed payments in kind if there were no such thing as a guaranteed payment. The assumption that section 707(c) is viable and that it applies to the circumstances described

1. Douglas A. Kahn and Faith Cuenin, *Guaranteed Payments Made In Kind By A Partnership*, 6 Fla. Tax Rev. 405 (2004) [hereinafter 2004 Article].

2. David L. Cameron and Philip F. Postlewaite, *The Lazarus Effect: A Commentary on In-Kind Guaranteed Payments*, 7 Fla. Tax Rev. 339 (2006) [hereinafter Lazarus Effect].

3. *Id.* at 351 and 391.

in the 2004 Article is shared by a number of other commentators⁴ and, as we shall note below, by Treasury as well.⁵

Cameron and Postlewaite expressed concern that the 2004 Article would breathe life into a previously moribund statutory provision by ascribing significant consequences to the application of the statute – i.e., the “Lazarus Effect.”⁶ They authored an Article some 18 years earlier contending that the legislative history to the adoption of section 707(a)(2) as part of the Tax Reform Act of 1984 establishes that the standard for determining the capacity in which a partner performs services for a partnership was altered by that Act in such a manner as to make section 707(c) “self-contradictory and, thus, obsolete.”⁷ In that Article, the authors also contended that other statutory changes adopted in 1984 minimized the difference in consequence between applying section 707(a) and section 707(c) to a transaction. Given the asserted obsolescence of section 707(c) and the asserted insignificance of its operation from that of section 707(a), Cameron and Postlewaite urged Congress to expressly repeal section 707(c) to avoid any confusion its retention in the Code might engender.⁸ While, in their current Lazarus Effect Article, the authors acknowledge that they may have been “somewhat premature” in authoring a eulogy for section 707(c) 18 years ago,⁹ they flatly state that “[a]s a result of the enactment of section 707(a)(2), Congress effectively repealed section 707(c)” and that, in our 2004 Article, Cuenin and I “erroneously assumed that section 707(c) remains alive

4. E.g., William S. McKee, William F. Nelson & Robert L. Whitmire, *Federal Taxation of Partnerships and Partners* ¶ 13.03 (3d ed. 1997) [hereinafter McKee]; Stephen A. Lind, Stephen Schwarz, Daniel J. Lathrope & Joshua D. Rosenberg, *Fundamentals of Partnership Taxation* 233-42 (7th ed. 2005) [hereinafter Lind] Laura E. Cunningham and Noel B. Cunningham, *The Logic of Subchapter K* 127-29 (3d ed. 2006) [hereinafter Cunningham].

5. Cameron and Postlewaite expressly acknowledge that a number of post-1984 commentators and regulations treat § 707(c) as a viable provision. *Lazarus Effect*, supra note 2, at n. 38.

6. *Lazarus Effect*, supra note 2, at 341-42, where the authors state:

[W]e uncovered a recently published article in this journal by Douglas Kahn and Faith Cuenin regarding the treatment of in-kind guaranteed payments. 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 § 707(c), not dissimilar from the return of Lazarus from the dead.

7. Philip F. Postlewaite and David L. Cameron, *Twisting Slowly In The Wind: Guaranteed Payments After The Tax Reform Act of 1984*, 40 *Tax Law* 649, 696 (1987) [hereinafter *Twisting Slowly*].

8. *Id.* at 711.

9. *Lazarus Effect*, supra note 2, at 340.

and well.”¹⁰ Since the conclusions reached in the 2004 Article give added significance to the characterization of a transfer of property to a partner as a guaranteed payment, Cameron and Postlewaite feared that if those conclusions were accepted, it might adversely effect the prospects for the adoption of their proposal for an explicit legislative repeal of section 707(c). Independently of that concern, they disagree with the analysis and one of the conclusions of the 2004 Article.

II. WAS THERE AN IMPLIED OR EFFECTIVE REPEAL OF SECTION 707(C) IN 1984?

A. Post-1984 Regulations Apply IRC Section 707(c)

As Cameron and Postlewaite note, many tax commentators continue to discuss section 707(c) and treat it as a viable provision.¹¹ Moreover, in regulations promulgated after the 1984 amendments, Treasury has demonstrated its belief that section 707(c) is an operative provision. For example, Regulations section 1.721-1(b)(2), which was last amended in 1996, characterizes a partnership's transfer of a partnership interest in exchange for services as a “guaranteed payment for services under section 707(c).” Treasury repeated that statement in a proposed amendment of that regulation that was promulgated in 2005.¹² In a Preamble to the 2005 proposed amendments of regulations dealing with a transfer of a partnership interest for services, Treasury expressly examined the question of whether a transfer of a partnership interest for services should be treated as a guaranteed payment under section 707(c), and concluded that section 707(c) does apply to such transfers.¹³ While Cameron and Postlewaite note the 2005 proposed version of the section 721 regulation in footnote 129 of the Lazarus Effect Article, they fail to explain why the proposed regulation refers to section 707(c) guaranteed payments and why Treasury concluded that the transfer constitutes a guaranteed payment if they are correct in asserting that the 1984 amendment rendered section 707(c) obsolete. Moreover, several other final regulations that were promulgated or amended

10. Lazarus Effect, *supra* note 2, at 391-92. In addition to other statements to that effect, the Lazarus Effect Article also states that “[i]n 1984, Congress dealt the final blow to what little remained of the vitality and independence of § 707(c) through its enactment of § 707(a)(2)” and “[e]ffectively, § 707(c) had been repealed and all that remained was statutory surplusage prone to produce confusion and complexity.” *Id.* at 348, 351.

11. See *supra* note 4.

12. Prop. Regs. § 1.721-1(b)(4)(i).

13. Preamble, Proposed Regulations – Partnership Equity for Services, 70 Fed. Reg. 29675 (May 24, 2005), item 2 [hereinafter Preamble].

years after the 1984 amendments discuss guaranteed payments and refer to section 707(c).¹⁴

B. Disfavor of Implied Repeal of Statutes.

1. No conflict in language or purpose of two statutes – There is nothing in the language of section 707(a)(2) itself that conflicts with or makes obsolete the previously established construction of section 707(c). Reading section 707(a)(2) alone, there would be no reason to assert that it has effectively or impliedly repealed section 707(c). There is no possibility that the drafters of section 707(a)(2) were unaware of section 707(c), and so it is virtually certain that Congress did not intend that the 1984 addition to the Code of section 707(a)(2) replace section 707(c), since it did not delete the latter section from the Code and left it intact. If Congress had wished to repeal section 707(c), it surely would have included the repeal in the 1984 Act. Thus, if Cameron and Postlewaite are correct in their assertion that Congress effectively repealed section 707(c) in 1984, it did so unintentionally.

As a matter of statutory construction, implied legislative repeals of statutes are disfavored. The Supreme Court stated that view as follows:

The cardinal rule is that repeals by implication are not favored. Where there are two acts upon the same subject, effect should be given to both if possible. There are two well-settled categories of repeals by implication – (1) where provisions in the two acts are in irreconcilable conflict, the later act to the extent of the conflict constitutes an implied repeal of the earlier one; and (2) if the later act covers the whole subject of the earlier one and is clearly intended as a substitute, it will operate similarly as a repeal of the earlier act. But, in either case, the intention of the legislature to repeal must be clear and manifest¹⁵

In a more recent case, the Supreme Court stated, “the only permissible justification for a repeal by implication is when the earlier and later statutes are irreconcilable.”¹⁶

14. E.g., Regs. § 1.707-4(a)(1)(i) (1992). Additionally, the proposed amendments to Regs. § 1.707-1(c), promulgated in 2005, left intact the references in that regulation to guaranteed payments. Prop. Regs. § 1.707-1(c)

15. *Posadas v. National City Bank*, 296 U.S. 497, 503 (1936).

16. *J.E.M. AG Supply v. Pioneer Hi-Bred Intern.*, 534 U.S. 124, 122 S.Ct. 593, 604 (2001). See also, *Morton v. Mancari*, 417 U.S. 535, 550 (1974).

2. *Purported repeal by legislative history is unwarranted* – The asserted repeal or obsolescence of section 707(c) is especially questionable because it does not rest on the adoption of a statute whose language or purpose is in any way inconsistent with section 707(c). The purported repeal is based on a more tenuous ground. It rests on language in the legislative history to the adoption of a 1984 amendment that proposed standards for the application of such amendment (i.e., section 707(a)(2)) that conflict with the established standard for determining partner capacity for purposes of section 707(c).¹⁷ It would be quite a stretch to find that a statute had been made obsolete or effectively repealed, not by the subsequent adoption of a conflicting statute, but by a conflict with the legislative history of a subsequent statute, the provisions of which are fully consistent with the statute that is claimed to have been repealed. In any event, let us consider the legislative history to the adoption of section 707(a)(2) and the question of whether it has affected the operation of section 707(c).

3. *Proposal of standards for determining partner capacity contained in the legislative history* – Section 707(a)(2) is aimed at preventing a partnership from successfully disguising a payment to a partner for the purchase of property or for services as an allocation of partnership income. Section 707(a)(2) applies to certain transactions between a partnership and a partner who is “acting other than in his capacity as a member of the partnership.” Section 707(c) applies to payments to a partner for services or for the use of property in the latter’s capacity as a partner to the extent that the payments are determined without regard to the income of the partnership. In construing section 707(c), the standard that the Service and the courts have applied to determine whether the services that a partner provided were performed in his capacity as a partner turned on the nature of the services in relation to the activity of the partnership.¹⁸ The claim that section 707(c) was effectively repealed rests on the contention that since the legislative history to the 1984 amendment that added section 707(a)(2) proposed that, in applying that provision, Treasury adopt a standard that utilizes six factors to determine partner capacity, and since that proposed standard differs from the standard for determining partner capacity for purposes of section 707(c) that the Service and the courts have previously applied, the proposed new standard should also be applied to section 707(c) in substitution of the previously employed standard.¹⁹ Cameron and Postlewaite contend that an application of the new proposed standard to section 707(c)

17. Lazarus Effect, *supra* note 2, at 348-50; Twisting Slowly, *supra* note 7, at 677-81.

18. See Twisting Slowly, *supra* note 7, at 677-81.

19. As noted below, Treasury has not yet adopted those six proposed factors and has impliedly rejected their application to § 707(c).

would prevent that provision from applying to virtually any payment by a partnership.

(a) Absence of the risk factor

The proposed new standard is comprised of six factors listed in the Senate Finance Committee's Report to the 1984 Act and in the Blue Book to that Act.²⁰ The Senate Report and the Blue Book state that "[t]he first, and generally the most important factor is whether the payment is subject to an appreciable risk as to amount"[emphasis added].²¹ The word "generally" gives some indication that entrepreneurial risk is not always the most important of the six proposed factors. Cameron and Postlewaite, however, treat the absence of risk as conclusively establishing non-partner capacity. Since most payments that were previously characterized as guaranteed payments are of fixed value, the contention of Cameron and Postlewaite is that, after the 1984 amendment, virtually no payment to a partner can qualify as a guaranteed payment under the risk standard. I will examine below the question of whether the proposed new standard has been adopted, but first let us consider whether entrepreneurial risk is a necessary and sufficient factor under the new proposed standard.

(b) Role of absence of the risk factor

Entrepreneurial risk is merely one of six factors. Even acknowledging that generally it is the most important of the six factors, it does not necessarily follow that that factor alone is sufficient to determine partnership capacity. The Senate Finance Committee's Report provides an example (Example (1)) of the application of its multi-factor standard.²² In that example, an architect for a building constructed by a partnership purchased a partnership interest and also received an allocation of \$20,000 of the partnership's gross income for each of the first two years of partnership operations after the building was leased. The architect's normal fee for his services was \$40,000. In determining that the partnership's allocation of a specified amount of two years' gross income was a fee under section 707(a) rather than a partnership allocation, the Senate Report concluded that four of the six listed factors were satisfied. The absence of risk factor was one of those four. The listing and discussion of the other three factors suggest that the absence of risk alone was not sufficient to resolve the issue, and the support of other factors was needed to determine the capacity in which the money was received. The example goes on to state that if meaningful risk as to

20. S. Rep. No. 169, 98th Cong., 2d Sess., at 227-28 (1984). Joint Committee Staff's "General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984," H.R. 4870, 98th Cong. at 227-229 (1984) [hereinafter Blue Book].

21. S. Rep. No. 169, supra note 20, at 227; Blue Book, supra note 20, at 227.

22. S. Rep. No. 169, supra note 20, at 228-29.

whether the partnership would have sufficient gross income to pay the architect was present, “the special allocation might (even though a gross income allocation), depending on all the facts and circumstances, properly be treated as a distributive share and partnership distribution.”²³ The Senate Finance Committee’s discussion of that example suggests that, under the proposed new standard, the presence of significant risk is *nearly* sufficient to establish partner capacity, but the absence of significant risk is not sufficient by itself to establish non-partner capacity, even though it is an important factor.

4. *Rejection by Treasury of standards contained in the legislative history – an invitation declined.* The contention of Cameron and Postlewaite that section 707(c) does not apply to a payment of a specified amount of property where there is no significant risk as to whether the partnership can make the payment is belied by regulations adopted years after the 1984 amendment. Regulations section 1.707-4(a)(4), Example (1), which was adopted in 1992, treats a cash payment of a specified amount (plus compounded interest) as a guaranteed payment under section 707(c). Regulations section 1.721-1(b)(2) and Proposed Regulations section 1.721-1(b)(4)(i) (promulgated

23. *Id.* at 229. Cameron and Postlewaite point out that the Senate Finance Committee’s Report also stated that the payments that were characterized as § 707(c) guaranteed payments in Rev. Rul. 81-300 would, under the Committee’s view, be treated as § 707(a) payments. S. Rep. No. 169, *supra* note 20, at 230. Rev. Rul. 81-300 dealt with a provision compensating general partners for their ongoing managerial services by granting them 5% of gross rentals from a shopping center that the partnership owned. The ruling indicates that the provision for a percentage of gross rentals did not provide a fixed amount of money since the Service deemed it necessary to rule that guaranteed payments are not limited to fixed amounts. The Service focused on the fact that the payments were reasonable for the services performed and that the method of payment was one that would have been used to compensate an unrelated party for those services. It would seem that a partner who has a right to a percentage of gross income does bear an entrepreneurial risk unless the amount can be determined with some certainty. It is difficult to see why the arrangement in Rev. Rul. 81-300 did not fall outside of the Senate Finance Committee’s standards for § 707(a) transactions. In discussing the risk standard, the Senate Finance Committee stated, “continuing arrangements in which purported allocations and distributions (under a formula or otherwise) are fixed in amount or reasonably determinable under all the facts and circumstances and which arise in connection with services also shield the purported partner from entrepreneurial risk.” The facts stated in Rev. Rul. 81-300 do not indicate that the payments of the percentage of gross rents fit the requirements of the above statement. The Committee’s reference to that ruling is therefore hard to reconcile with the risk standard as the Committee explained it. The Committee did state that short-lived gross income allocations are suspect, but the facts of the ruling indicate that the gross income provision therein was not a temporary or short-lived one.

in 2005) treat the transfer of a partnership interest²⁴ in exchange for services to the partnership as a guaranteed payment under section 707(c). The value of a partnership capital interest can be ascertained and is no different in that respect from the payment of any other property in kind. The value of a partnership interest is subject to subsequent market changes and risk, but that is true of any property in kind that is paid to a partner. The risk to which the legislative history to the 1984 Act refers is the risk as to the amount of property the partner will receive. Proposed Regulations section 1.721-1(b)(2) also provides that a partnership does not recognize gain or loss upon transferring a partnership interest in payment for services, and I will discuss that provision later in this Article.

Cameron and Postlewaite acknowledge that, to date, the regulations have not adopted the risk standard in applying section 707(c).²⁵ Indeed, as discussed below, Treasury adopted an entirely different standard in Regulations section 1.707-4(a), which was promulgated some eight years after the 1984 Congressional adoption of section 707(a)(2). There is no suggestion that Regulations section 1.707-4(a) is invalid. It is far from certain that the risk

24. A partnership interest can be either a “partnership capital interest” or a “partnership profits interest.” A “partnership capital interest” is a partnership interest that includes an interest in the assets of the partnership, as contrasted to a “partnership profits interest” which represents an interest only in the partnership’s income. See Rev. Proc. 93-27, 1993-2 C.B. 343. The transfer of a partnership capital interest as payment for services will be treated as ordinary income to the transferee in an amount equal to the value of the partnership interest. Prop. Regs. § 1.721-1(b)(4)(i) that is cited above treats that payment as a guaranteed payment. There has been some controversy as to whether the transfer of a partnership profits interest for services causes income to be recognized by the transferee. After some mixed results in litigation, the Service appeared to have resolved that issue by conceding in a Revenue Procedure that the receipt of a partnership profits interest for services generally does not cause the transferee to recognize income, but there are a few exceptions to that general rule. Rev. Proc. 93-27, 1993-2 C.B. 343, and Rev. Proc. 2001-43, 2001-2 C.B. 191 (both of which rulings will be obsolete by IRS Notice 2005-43, 2005-24 I.R.B. 1221 when a proposed regulation under IRC § 83 is finalized). The 2005 proposed regulation, which states that the transfer of a partnership interest as payment for services constitutes a guaranteed payment, refers to a “partnership interest” without specifying whether it has to be a capital interest. Prop. Regs. § 1.721-1(b)(4)(i). One pair of commentators has concluded that the proposed regulation applies to both capital and profits partnership interests and will therefore obsolete those revenue procedures if finalized. Cunningham, *supra* note 4, at 134. Perhaps, the proposed regulation will be restricted to the compensatory transfer of partnership interests that are otherwise taxable to the transferee. In any event, even if the Cunninghams are correct, they also note that, under the method commonly used to value a partnership interest (the so-called “liquidation method”), a partnership profits interest will have a zero value and so will not cause the transferee to recognize any income. *Id.* at 135. For a description of the liquidation method, see § 2.01 of Rev. Proc. 93-27, 1993-2 C.B. 343 and IRS Notice 2005-43, *supra*.

25. Lazarus Effect, *supra* note 2, at n. 39.

standard will ever be adopted, much less that it will be made determinative. There is no basis for concluding that section 707(c) is a nullity; to the contrary, the application of the 1984 amendment by Treasury demonstrates that section 707(c) continues to have vitality.

The legislative history to the 1984 amendment is not the equivalent of the adoption of a statute. The suggestion that Treasury adopt the six factors described in the Senate Finance Committee's report is no more than an invitation to Treasury to adopt those standards. Regulations that were subsequently adopted by Treasury show that the invitation was declined and that Treasury adhered to a quite different standard.

Regulations section 1.707-4(a), which deals with disguised sales of property by a partner to a partnership (i.e., with section 707(a)(2)), expressly states that a "guaranteed payment" to a partner for capital is not treated as part of a sale of property. The regulation further states, "[t]he term *guaranteed payment for capital* means any payment to a partner by a partnership that is determined without regard to partnership income and is for the use of that partner's capital" [emphasis in original], and the regulation refers specifically to section 707(c).²⁶ Significantly, the regulation makes no mention of entrepreneurial risk, or of any of the other five factors that are listed in the legislative history, in determining whether a payment constitutes a guaranteed payment. Any doubt as to whether Treasury rejected the invitation contained in the legislative history to adopt a risk standard is laid to rest by the two examples in that regulation that illustrate how guaranteed payments are to be determined.

Let us examine Example (1) of Regulations section 1.707-4(a)(4). In that example, *A*, a partner, transfers property with a fair market value of \$100,000 to partnership *AB*. At that time, "the partnership agreement is amended to provide that *A* is to receive a guaranteed payment for the use of [his] capital of 10% (compounded annually) of the fair market value of the transferred property in each of the three years following the transfer." Partnership net income and loss and cash flow will be allocated and distributed equally between *A* and *B*. If the payment qualified as a guaranteed payment under section 707(c), the deduction the partnership obtained thereby would be allocated equally between the two partners (that is, in the same manner as other partnership items are allocated). The amount payable to *A* for the use of his capital for the three-year period was found to be reasonable. The regulation concludes that the payments to *A* over the three year period are guaranteed payments for the use of capital. It is noteworthy that there is no mention in Example 1 of any facts suggesting that there was a significant risk as to whether the partnership would be able to make the payments when they are due. To the contrary, the facts suggest that there was no significant risk of nonpayment and that the certainty of payment did not prevent them from being characterized as guaranteed payments. This regulation demonstrates that Treasury has not

26. Regs. § 1.707-4(a)(1)(i).

accepted the invitation to adopt risk and the other five factors for purposes of applying section 707(c).²⁷

In their Lazarus Effect Article, Cameron and Postlewaite concede that, in Regulations section 1.707-4, Treasury did not utilize the standards for determining capacity that were suggested in the legislative history to the 1984 Act.²⁸ Surprisingly, they treat that evidence of this decision not to accept the invitation to adopt the new criteria for determining partner capacity as “virtually meaningless” because the payments made in the regulatory examples were made in cash.²⁹ Because the regulation did not have to deal with the added complexity of a payment made in kind, they conclude that the regulation is of no consequence in determining whether the adoption of section 707(a)(2) has changed the standards for determining partnership capacity. Surely, that cannot be so. The test of partnership capacity is the same for payments made in kind as it is for payments made in cash. Cameron and Postlewaite’s contention that section 707(c) was rendered a nullity by the 1984 amendment is not limited to payments made in kind. Indeed, when they wrote their *Twisting Slowly* Article 18 years ago, which is when they first articulated their contention that section 707(c) was impliedly repealed, they did not even consider payments made in kind. The fact that Treasury declined to adopt the criteria enunciated in the 1984 legislative history and set forth an example in which a provision for a payment with no significant risk factor was characterized by Treasury as a guaranteed payment is of great significance; it demonstrates that not only has Treasury declined the invitation to change its criteria for determining partner capacity, it has effectively repudiated the absence of risk factor by characterizing as a guaranteed payment a payment in which there was no risk factor. Moreover, the question of how partner capacity should be determined for purposes of applying section 707(c) to a payment is not made more or less complex when the payments are in kind or in cash. The question of how to treat a guaranteed payment that was made in kind raises complex considerations, but the

27. While Example (2) of that Regs. § 1.704-4(a)(4) found that payments of a specified amount from a newly formed two-person partnership were not guaranteed payments, in reaching that conclusion, the regulation did not rely on (or refer to) the absence of risk factor or to any of the other five factors listed in the legislative history to the 1984 Act. Under the terms of the partnership agreement, the payments in question were borne entirely by the partner who was not the distributee (i.e., the non-distributee partner). Treasury determined that the substance of the transaction was identical to a pre-partnership sale by the distributee partner of a portion of his property to the non-distributee partner, followed by a contribution of the properties by both parties to the newly formed partnership. The specified payments to the distributee partner were deemed to have been made by the non-distributee partner utilizing the partnership as a conduit to make the payments. See Regs. § 1.707-4(a)(4), Ex. (2)(iv).

28. Lazarus Effect, *supra* note 2, at n. 39.

29. *Id.*

complexity of the determination of partner capacity is not affected by the type of the payment.

III. SHOULD IRC SECTION 707(C) BE REPEALED?

If a partner provides ongoing services to a partnership in his capacity as a partner, the benefit that the partner provides to the partnership needs to be reflected in some manner, such as granting the partner an additional share of profits or capital, by paying the partner a specified amount, or some combination of these options. If the parties choose to have the partnership pay the partner a specified amount, that amount could be characterized either the same as a payment to an unrelated third party for services rendered, or as a division of partnership profits or capital to reflect the contribution made by the partner. By adopting section 707(c), Congress chose a middle ground between those two options – treating the payment as if it were made to a third party for some purposes, but not for others. Cameron and Postlewaite urge the repeal of section 707(c) so that such payments would be treated under section 707(a) as having been made to a third party. While, for reasons noted in the paragraph below, I prefer the retention of the current separate treatment, reasonable people can differ on that issue.

Congress has given special treatment in Subchapter K to a partner's receipt of property from a partnership. That treatment is part of a complex scheme that Congress adopted as to how partners and a partnership are to be treated for federal income tax purposes. If a partner receives a payment from the partnership for services performed in a non-partner capacity, there is merit to treating that payment the same as a payment made for services provided by a non-partner. There is no reason to give any special treatment to such a payment just because the recipient also happens to be a partner when the payment had nothing to do with his partner capacity. However, when a partner performs services for the partnership in his partner capacity, the manner in which the partnership chooses to reflect that contribution should not alter the fact that the partnership is dealing with him as a partner. There are good reasons to treat such payments differently from ones made to a non-partner (or to those made to a partner in a non-partner capacity).

One consideration against repealing section 707(c) is that the application of section 707(a) to guaranteed payments could make other tax provisions outside of Subchapter K applicable to those payments.³⁰ Moreover,

30. For example, the payments could be subjected to withholding and employment taxes, and favorable tax provisions for fringe benefits might be deemed to apply. See e.g., *Armstrong v. Phinney*, 394 F.2d 661 (5th Cir. 1968) (applying the § 119 exclusion for employees to meals and lodging provided to a partner where § 707(a) was held to apply). Employment taxes, withholding provisions, and employee benefit

in the 2005 Preamble to a number of proposed amendments to regulations dealing with the transfer of partnership equity for services, Treasury stated:

In drafting these regulations, the Treasury Department and the IRS considered alternative approaches for resolving the timing inconsistency between section 83 and section 707(c). One alternative approach considered was to provide that the transfer of property in connection with services is not treated as a guaranteed payment within the meaning of section 707(c). This approach was not adopted in the proposed regulations due to, among other things, concern that such a characterization of these transfers could have unintended consequences on the application of provisions of the Code outside of Subchapter K that refer to guaranteed payments.³¹

In addition, if Ms. Cuenin and I are correct in our view that the principle of deferring gain for partnership to partner transactions, together with additional considerations, are of sufficient importance to warrant granting nonrecognition of gain for guaranteed payments made in kind, then that view is another strong point in favor of retaining section 707(c) in the Code. As noted later in this Article, reasonable people can come to different conclusions on the question of whether a partnership recognizes gain in that circumstance; I do not know whether the position that Ms. Cuenin and I took ultimately will prevail. While I believe that section 707(c) should not be repealed, I am content to urge no more in this Article than that it has not yet occurred.

IV. REPLY TO THE CRITICISMS OF THE 2004 ARTICLE

Cameron and Postlewaite make several points in support of their contention that the 2004 Article was wrong in its analysis and in the conclusion that the partnership does not recognize gain on making a guaranteed payment with appreciated property. I will address their points concerning nonliquidating guaranteed payments made in kind. Because of time limitations, I will not comment on the points they made concerning the discussion in the 2004 Article of liquidating distributions. I do not intend my failure to discuss liquidating distributions to be deemed a concession of error on that issue. I think that the discussion below of nonliquidating payments is sufficient to show the difference between my analysis of this subject and that of Cameron and Postlewaite, and the time frame for writing this reply led me to focus on what I believe to be their principal topic.

provisions do not apply to guaranteed payments under § 707(c). McKee, *supra* note 4, at ¶ 13.03[6][b], [c].

31. Preamble, *supra* note 13, at item 2.

A. The Adoption of IRC Section 707(a)(2) Has No Bearing on Issues Discussed In The 2004 Article.

On page 345 of the Lazarus Effect Article, Cameron and Postlewaite state:

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.

The changes “wrought by section 707(a)(2)” to which Cameron and Postlewaite refer is the change in the standard for determining partner capacity that they contend was effected by the adoption of section 707(a)(2). In the preceding Part II of this response, I set forth my reasons for concluding that neither section 707(a)(2), nor its legislative history, changed the standard for determining partner capacity. Regulations adopted after the 1984 addition of section 707(a)(2) have treated section 707(c) as viable and have not applied the proposed new standards for determining partnership capacity that the legislative history to the 1984 Act invited Treasury to adopt.³² Unless and until Treasury adopts the new standards proposed in the 1984 legislative history and applies those standards to the application of section 707(c), the 1984 adoption of section 707(a)(2) is of no consequence to the issue at hand (namely, whether a partnership recognizes gain on making a guaranteed payment with appreciated property). The deletion of the section 707(a)(2) point from Cameron and Postlewaite’s argument that the partnership recognizes gain weakens their case, as they themselves acknowledge in the two sentences quoted above. However, independently of their section 707(a)(2) contention, Cameron and Postlewaite have made significant points in criticism of the analysis employed in the 2004 Article, and I will address those points. Before doing so, there are several general propositions on which the 2004 Article relies that need to be put in focus.

B. No Expressed Legislative Intent Regarding Guaranteed Payments In Kind

As acknowledged in both the 2004 Article and the Lazarus Effect Article,³³ it is virtually certain that Congress did not contemplate the possibility that guaranteed payments might be made in kind when it adopted section

32. See *supra* notes 25-29, and the accompanying text.

33. Lazarus Effect, *supra* note 2, at 358.

707(c). So, there is no explicit legislative intent to guide us in deciding whether a partnership can recognize gain or loss in that circumstance. Instead, it is necessary to look to the basic structure of Subchapter K and the tax principles that are represented both there and in other parts of the Code. The resolution of the question of gain recognition depends upon a determination of what treatment best accommodates those tax principles and best conforms to the statutory language of section 707(c). I do not believe that there is any disagreement between Cameron and Postlewaite and myself on that framing of the issue; our disagreement centers on the weight to be accorded to competing tax values that are implicated in that decision.

C. Congressional Goal of Nonrecognition For Transactions Between Partnership and Partners.

A premise on which the 2004 Article rests is that, in Subchapter K, Congress showed that it was willing to go to great lengths to prevent the recognition of gain on transactions between a partnership and a partner when it was reasonable to do so, and instead to defer the recognition of gain. It was Ms. Cuenin's and my contention that the principle of deferring gain on such transactions plus the desirability of avoiding complexity must be weighed against contrary considerations in determining whether a partnership should recognize gain on making a guaranteed payment. I will examine later the opposing considerations and the weight to be accorded them. For now, I merely wish to establish that the principle of deferral is a highly valued goal of Subchapter K. Treasury itself made reference to the importance of that goal (at least as to one aspect of Subchapter K) in its Preamble to the 2005 promulgation of amendments to regulations dealing with the transfer of a partnership interest for services. In that Preamble, Treasury stated:

[T]he Treasury Department and the IRS believe that partnerships should not be required to recognize gain on the transfer of a compensatory partnership interest. Such a rule is more consistent with the policies underlying section 721 – to defer recognition of gain or loss when persons join together to conduct a business³⁴

I do not believe that Cameron and Postlewaite disagree with the statement that deferral of recognition is an important goal of Subchapter K. Their thesis focuses on competing tax principles which they believe outweigh the goal of nonrecognition. I will discuss that later.

34. Preamble, *supra* note 13, at item 6. The determination of Treasury that a partnership does not recognize gain on transferring a compensatory partnership interest is discussed in Part IV.F.1 of this Article.

D. Eclectic Application of Entity and Aggregate Treatments of A Partnership.

A partnership could be viewed as an entity that is separate from its partners in the same manner that a corporation is regarded as an entity that is separate from its shareholders. That is sometimes referred to as the “entity approach.” Alternatively, a partnership could be regarded as a convenient fiction representing an aggregate of interests of each of its partners. That is sometimes referred to as the “aggregate” or “conduit” approach. The question of whether to treat a partnership as an entity or as an aggregate of interests could be resolved by treating it entirely as one or the other. When Congress adopted Subchapter K in 1954, it chose to treat a partnership as an entity for some purposes and as an aggregate of interests for other purposes.³⁵ Congress declined to adopt a single approach to the treatment of partnerships, and instead adopted an eclectic approach. One prominent treatise described this blending of entity and aggregate concepts in the following language:

The drafters of Subchapter K combined the entity and aggregate concepts in developing a comprehensive scheme for the taxation of partnerships. The aggregate concept predominates in connection with the taxation of partnership income to partners and *the general nonrecognition provisions for contributions to and distributions from partnerships*. Even in these matters, however, the drafters incorporated certain entity notions. . . . The entity approach, on the other hand, predominates in the treatment of transfers of partnership interests as transfers of interests in a separate entity rather than in the assets of the partnership. Aggregate notions come into play in this area as well, however . . . [Emphasis added].³⁶

This eclectic application of entity and aggregate approaches is a pragmatic solution to the treatment of partnerships, in that aggregate treatment operates better in some circumstances and entity treatment better in others. Congress chose to treat each situation individually rather than to commit exclusively to one approach or the other. The eclectic treatment is not limited to having the entity approach apply to some sections of the Code and the aggregate to others. A single section of Subchapter K can have both entity and aggregate approaches apply to different applications of that provision.³⁷ This eclectic approach to a single section of the Code is evident in section 707(c) itself. Section 707(c) directs an entity approach for guaranteed payments for purposes of the three Code provisions listed in that section. For purposes of

35. See McKee, *supra* note 4, at ¶ 1.02; Lind, *supra* note 4, at 3-4.

36. McKee, *supra* note 4, at ¶ 1.02[3].

37. See e.g., IRC § 751.

other tax provisions, one might expect guaranteed payments to be given aggregate treatment – i.e., treated the same as partnership distributions to a partner. In fact, however, the regulations to that section list three additional Code provisions to which entity treatment is accorded,³⁸ and another regulation applies entity treatment in determining the effect of a guaranteed payment on the distributee partner’s capital account.³⁹

In the 2004 Article, Ms. Cuenin and I acknowledged that the language making the entity approach applicable to section 707(c) only for purposes of three Code sections has not controlled the construction of that provision.⁴⁰ Instead, as noted above, Treasury has expanded the circumstances in which a guaranteed payment will be treated as one made to an unrelated third party (i.e., an entity treatment). We concluded that the same pragmatic eclectic approach should be applied to section 707(c) that Congress applied to Subchapter K. It is for that reason that, in reaching our conclusions, we were able to accept that a guaranteed payment in kind should be treated as a partnership distribution for some purposes and as a payment to a third party for other purposes. That treatment is consistent with the eclectic statutory scheme and with the very language of section 707(c). The determination of how a guaranteed payment should be treated therefore often will turn on a weighing of tax policy considerations, which was the approach taken in the 2004 Article.

E. Slight Presumption Favoring Aggregate Treatment.

Given the statement in section 707(c) that a guaranteed payment is to be treated as having been made to a third party only for purposes of three Code provisions, and given the statement in the Treasury regulation, after listing three other exceptions to aggregate treatment, that “[f]or the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner’s distributive share of ordinary income,”⁴¹ Ms. Cuenin and I concluded that the aggregate approach should be applied to the application of section 707(c) for purposes other than those expressly designated for entity treatment, unless there are strong reasons to apply the entity approach.⁴² In other words, our point is that if there are competing tax policies, some pointing towards entity treatment and some towards aggregate treatment, the choice should be made for aggregate treatment unless the policies favoring entity treatment clearly outweigh those favoring aggregate treatment. If the competing policies are in equilibrium, or nearly so, then the tie goes to the aggregate approach. I do not think that it is essential to the adoption of the 2004 Article’s conclusions

38. Regs. § 1.707-1(c).

39. Regs. § 1.704-1(b)(2)(iv)(b).

40. 2004 Article, *supra* note 1, at 416-18.

41. Regs. § 1.707-1(c).

42. 2004 Article, *supra* note 1, at 418-19.

that one accept the contention that there is a slight presumption in favor of aggregate treatment since I believe that the policies for nonrecognition of gain outweigh the competing considerations. I will examine those factors later. As discussed later, the amount of weight to be accorded to competing tax policies will vary among individuals depending upon their priorities; it is not surprising that even specialists in the tax field arrive at different conclusions.

F. Examination of Policies Cameron and Postlewaite Rely Upon for Contention That Partnership Recognizes Gain or Loss.

Let me now turn to Cameron and Postlewaite's criticisms of the conclusion in the 2004 Article that a partnership does not recognize gain or loss on making a distribution of property in kind. The thrust of those criticisms is that when tax policies favoring recognition of income are matched with those that favor nonrecognition, the balance lies with recognition. The policies favoring nonrecognition that are stated in the 2004 Article are: (1) the general policy of Subchapter K to defer recognition of income for transactions between a partnership and a partner when it is reasonable to do so, and (2) the complexity engendered by requiring recognition of income in certain circumstances. Cameron and Postlewaite question the extent of the complexity to which the 2004 Article refers and question the significance of that issue.⁴³ I will address those questions later. First, let us look at the policies favoring recognition upon which the Lazarus Effect Article relies.

1. Deduction for disposition of unrealized appreciation – One principle on which the Lazarus Effect Article relies is that a taxpayer should not be allowed a deduction for a transfer of unrealized appreciation unless the taxpayer is required to recognize the gain that the appreciation represents.⁴⁴ That proposition is generally correct, but there are exceptions when competing policies warrant it. A contribution of appreciated property to a qualified charity can be deducted, subject to limitations, even though the contributor is not required to recognize gain for the appreciation that created the deduction.⁴⁵

More significantly, as Cameron and Postlewaite note,⁴⁶ Proposed Regulations section 1.721-1(b)(2) provides that a partnership that transfers a partnership interest in exchange for services does not recognize income therefrom, even when the partnership can deduct the value of the partnership interest as a business expense.

43. Lazarus Effect, *supra* note 2 at 364-68.

44. 7 Fla. Tax Rev., pg. 377, where the authors state, "Deductions are typically not allowed on the transfer of appreciated property unless the taxpayer has previously taken the value supporting the deduction into income."

45. IRC § 170(b)(1)(C), (D).

46. Lazarus Effect, *supra* note 2, at n. 129.

In *McDougal v. Commissioner*,⁴⁷ Mr. McDougal and Mr. McClanahan formed a partnership in which Mr. McDougal contributed a race horse and Mr. McClanahan contributed services. The court treated the transaction as a sale of an interest in the horse from Mr. McDougal to Mr. McClanahan before the partnership was formed, followed by a contribution of the horse to the newly created partnership by both Mr. McDougal and Mr. McClanahan. As a result, Mr. McDougal had income for the appreciation of the fraction of the horse that was deemed to have been sold to Mr. McClanahan.

A number of commentators concluded that the same approach as that used in *McDougal* should be applied to an existing partnership's transfer of a partnership interest to a person in exchange for services.⁴⁸ Under that approach, the partnership would be treated as having sold a fraction of each of its assets and recognized gain or loss on each constructive sale. Proposed Regulations section 1.721-1(b)(2) rejects that approach and provides that a partnership does not recognize gain or loss in that situation even though the partnership can deduct the value of the payment. The Preamble that Treasury wrote for that regulation states:

Generally, when appreciated property is used to pay an obligation, gain on the property is recognized. . . . However, the Treasury Department and the IRS believe that partnerships should not be required to recognize gain on the transfer of a compensatory partnership interest. Such a rule is more consistent with the policies underlying section 721— to defer recognition of gain or loss when persons join together to conduct a business — than would be a rule requiring the partnership to recognize gain on the transfer of these types of interests.⁴⁹

The Preamble makes clear that Treasury and the IRS deem the nonrecognition policy of Subchapter K to be more important than the policy of forcing recognition of unrealized appreciation that creates a deduction. One might question whether the policy for deferral of gain for partnership distributions is of the same magnitude as the policy for nonrecognition on

47. 62 T.C. 720 (1974).

48. McKee, *supra* note, 4 at ¶ 5.08[2][b].

49. Preamble, *supra*, note 13 at item 6. Interestingly, the Preamble states that while the proposed regulation's provision for nonrecognition applies to the compensatory transfer of an interest in an existing partnership, it does not apply to the receipt of a partnership interest in a newly formed partnership. In the latter case, the exchange of property for services is deemed to occur between the parties before the partnership comes into existence, and so the nonrecognition principles of Subchapter K do not apply to that situation. *Id.* So, the *McDougal* case is still good law for newly formed partnerships.

partnership formation, but there seems little reason to treat the former as being of less consequence. In this regard, note the statement, quoted above, of the McKee, Nelson and Whitmire treatise that the aggregate concept predominates the general nonrecognition provisions for contributions to and distributions from partnerships.⁵⁰

In a recent article by Professor Martin J. McMahon Jr.,⁵¹ he contends that Treasury and the IRS erred in providing in Proposed Regulations section 1.721-2(b) that a partnership does not recognize gain on making a compensatory transfer of a partnership interest even though the partnership is allowed to deduct (or capitalize) the value of the partnership interest. McMahon argues that the combination of allowing nonrecognition for a portion of the appreciation of the partnership's assets and also allowing a deduction for the full value of the partnership interest provides the other partners with a double tax benefit that results in what is sometimes referred to as "tax arbitrage." He predicts that aggressive tax planners will exploit that benefit. McMahon proposes that either the partnership should be required to recognize gain for a portion of the appreciation of its assets or the amount of deduction allowable to the partnership should be limited to a pro rata portion of the partnership's inside basis in its assets. It would seem that the latter proposal could be adopted only by Congressional action.

Even if McMahon's contention were correct, and I do not think that it is, it would serve to emphasize how strongly the Treasury adheres to the policy of deferring recognition of gain or loss on transactions between a partnership and its partners to the extent that it is reasonable to do so. Even facing the possibility that its nonrecognition policy could lead to abuses, Treasury and the IRS chose not to require recognition of gain or loss. They balanced the competing considerations and deemed the policy for nonrecognition the weightier. Similarly, in balancing the opposing considerations for determining the treatment of a guaranteed payment that is made in kind, it is likely that Treasury would assign greater weight to the nonrecognition policy.

Professor McMahon's analysis is similar to some of those advanced by Cameron and Postlewaite in the Lazarus Effect Article. It should come as no surprise then that I disagree with Professor McMahon's conclusions and with much of his analysis. To discuss all of the points made by McMahon in his article would expand this piece far beyond the scope that I intended. So, I will discuss only two of the points that Professor McMahon has made.

Before taking up those two points, I wish to note that I am not alone in concluding that Proposed Regulations section 1.721-1(b)(2) appropriately provided that the partnership does not recognize gain. In a recently published

50. *Supra* note 36 and the accompanying text.

51. Martin J. McMahon Jr. "Recognition Of Gain By A Partnership Issuing An Equity Interest For Services: The Proposed Regulations Get It Wrong," 109 *Tax Notes* 1161, 1161 (Nov. 28, 2005), [hereinafter cited as "McMahon Article"].

text on partnership taxation, Professors Noel Cunningham and Laura Cunningham expressly approved of the nonrecognition treatment that was adopted in the Proposed Regulations. They stated:

Although some may argue that . . . [nonrecognition] is difficult to justify technically, we believe that the rule is justified from an administrative point of view and is consonant with the underlying policies of section 721.⁵²

Their view, like mine, is contrary to the position that Professor McMahon adopted. Let us now turn to the two points of Professor McMahon that I wish to discuss.

In his recent article, Professor McMahon states:

In light of the legislative history and statutory structure, section 721 simply cannot be read to provide nonrecognition to a partnership that admits a service-provider partner with a capital account that is transferred in exchange for services. Under the current statutes, the transaction must be a recognition event.⁵³

But, the inapplicability of section 721 is besides the point. In the Preamble to the proposed regulation, Treasury did not claim that section 721 applies to the transaction. What Treasury said was that it was adopting a position that conforms to “the policies underlying section 721.”⁵⁴ Treasury sought to conform to those policies its construction of the application of the guaranteed payment provision to a compensatory transfer of a partnership interest. I suggest that the underlying nonrecognition policy of section 721 to which Treasury referred is merely one aspect of a broader policy to defer gain or loss on transactions between a partnership and its partners.

Another point that McMahon makes relates to what is sometimes called “tax arbitrage.” He notes that by granting a full deduction to the partnership and not requiring it to recognize gain, the amount of the other partners’ investment that had previously been taxed is reduced by the amount of the deduction. That reduction causes a rise in the other partners’ subsequent after-tax rate of return on their remaining previously taxed investment. As McMahon uses the term, “previously taxed investment” apparently refers to the basis of the partnership’s assets, provided that cash is included in the figure. More accurately, the term should refer to the outside basis that the other partners have in their partnership interests. McMahon maintains that the resulting increase in the non-distributee

52. Cunningham, *supra* note 4, at 136.

53. McMahon Article *supra* note 51, at 1167.

54. Preamble, *supra* note 13, at item 6; See also accompanying text to *supra* note 49.

partners' after-tax rate of return amounts to tax arbitrage and should be prevented. Let us examine whether the result reached in the proposed regulations is inappropriate. Consider the following examples that are drawn from illustrations that McMahon provided in his article.

Example (1) – P partnership has two equal partners, A and B. P's assets consist of cash in the amount of \$120, and a Widget (a capital asset) with a value of \$120 and a basis of zero. The aggregate value of P's assets therefore is \$240, and P's aggregate basis in its assets is \$120. P earns a before-tax return of 10% on its assets, and so P has income of \$24 per year. C performs services for P in exchange for which P transfers to C a 25% capital interest in the partnership. The value of the partnership interest that C received is \$60. P is allowed a \$60 deduction for transferring the partnership interest to C, all of which is allocated to A and B. Under the proposed regulations, P does not recognize any gain. As a result of the transaction, A and B will have a 75% interest in P's assets instead of the 100% interest they previously had. P retains all of its assets and continues to earn \$24 per year, of which \$18 is allocated to A and B. Instead of calculating the after-tax rate of return of A and B for their share of P's subsequent income, I will concede that the rate of their after-tax return on their previously taxed investment (i.e., on their outside basis in their partnership interests) will be increased as a result of these transactions even though the partnership continues to produce the same amount of annual income. But, does that constitute an abuse that needs to be prevented? Contrast Example (1) with the following two examples.

Example (2) – The same facts as those stated in Example (1) except that instead of giving C a partnership interest, P pays C \$60 cash for his services. P takes a \$60 deduction for making that payment, all of which is allocated to A and B. Immediately after that payment, D, an unrelated party, pays \$60 cash to P to purchase a 25% partnership interest. P does not recognize income because of the payment to C, nor does it recognize income because of D's payment to P. When all the smoke is cleared, P has \$120 of cash and has a Widget with a value of \$120 and a basis of zero. P's annual income will be \$24, of which A and B's share is \$18. The end result is that P (and A and B) are in the identical economic and tax position that they occupied at the close of Example (1) except that D has been substituted for C as the new 25% partner. Since the economic and tax positions of A, B and P are identical in both Examples, and since the tax treatment described for the parties in Example (2) is incontrovertible, there is no reason to regard the treatment accorded to the parties in Example (1) as abusive or even inappropriate.

Before D made his contribution to P in Example (2), the partnership had \$60 in cash and the \$120 Widget, all of which were allocable to A and B. After D joined the partnership, it had \$120 in cash, and the Widget; and A and B's allocable share of those properties was \$90 of cash and \$90 of the Widget. As a result of D's addition to the partnership, the value of A and B's share of the partnership's cash increased by \$30, and the value of their share of the Widget

decreased by \$30. In effect, the addition of D resulted in A and B's selling 1/4 of their interest in the Widget for \$30 of cash. But Subchapter K prevents P (and therefore A and B) from recognizing gain in this circumstance. This policy of providing nonrecognition, even though there was an effective sale of a portion of the Widget for a gain, is the policy on which Treasury and the IRS relied when they extended nonrecognition to the facts of Example (1). The consequence of allowing P a deduction for its cash payment to C and not requiring P to recognize income on the admission of D to the partnership provides A and B with the same after-tax rate of return on their previously deducted investment (i.e., on their outside basis in their partnership interests) that they achieved in Example (1).

Example (3) – The same facts as those stated in Example (2) except that after receiving his payment of \$60 cash for his services, C pays \$60 to P to purchase a 25% partnership interest. If the formal facts are respected, P will have a \$60 deduction, and P will not recognize gain on receiving C's \$60 contribution. Yet, the economic circumstances of Example (3) are identical to those of Example (1). There is no reason that the tax treatment of the parties should differ.

Of course, the step transaction doctrine could be applied to the facts of Example (3) to ignore the payment of cash to C and the repayment from C to P. If so, the transaction in Example (3) would be recharacterized to describe it as a payment of a 25% partnership interest in P to C for his services. But, why should the step transaction be applied here? The formal facts of Example (3) track the substance of the transaction. If an employer transfers property in kind to an employee as compensation for services, the transaction is treated for tax purposes as if the employer had paid the employee cash equal to the value of the distributed property, followed by the employee's purchase of that property from the employer with the cash that the employee constructively received. True, the taxation of the transaction as if those events had occurred does not necessarily mean that they should be regarded as actually having occurred. But, the reconstruction of the transaction to a cash-out and cash-in structure is helpful to see the true nature of the transaction. Similarly, in the case of a compensatory payment of a partnership interest, the cash-out, cash-in scenario is useful to grasp the nature of the transaction. When Example (3) is compared to the facts of Example (2), it becomes difficult to see a reason to punish the partnership in Example (3) just because C is the investor instead of D. The economic positions of A and B in Example (3) are identical to their positions in Example (2), and it is A and B who would bear any tax imposed on P for the recognition of gain if the proposed regulation were rejected.

(a) Partnership-partner and employer-employee transactions are not equivalent.

Cameron and Postlewaite equate a guaranteed payment in kind to a partner with an employer's payment of compensation to an employee in kind and urge that the two should be treated the same, i.e., the employer would recognize gain on making payment with appreciated property, and so Cameron and Postlewaite contend that the partnership should also have to recognize gain.⁵⁵ But, there is a significant difference between a payment to an employee and a payment from a partnership to a partner in the latter's capacity as a partner. The income and deductions of a partnership are not taxed to the firm as an entity. Instead, they pass through to the partners. In that important aspect, as well as with many others, Subchapter K treats the partnership as an aggregate of interests rather than as an entity. This aggregate treatment of the partnership as a conduit of tax items to the partners is a foundational element of Subchapter K. If a partnership were required to recognize gain on making guaranteed payments in kind, that gain would be allocated among the partners.⁵⁶

The aggregate of interests approach means that each partner can be viewed as owning an interest in a fraction of each asset that the partnership holds. While, for some purposes, Subchapter K treats a partnership as an entity, it recognizes in numerous provisions that realistically the partners have a kind of equitable interest in the partnership's assets. For example, section 751 is predicated on that assumption, and so is the election provided by section 754.⁵⁷

A portion of the guaranteed payment to a partner therefore can be seen as a transfer of property which, while held in the name of the partnership, in one meaningful sense is beneficially owned by the distributee partner. One might question whether such a transfer, essentially from the distributee to himself, should trigger any income recognition, but it especially should not trigger recognition of the appreciation in the portion of the property that essentially already belonged to the distributee.

Concededly, the same point as that made above could be applied to payments that are made in kind to a partner for his services in a non-partner capacity to which section 707(a) applies. Yet, gain or loss is recognized in such transactions. Why should section 707(c) payments to a partner be treated differently? The Congressional scheme for section 707(a) is to ignore, for almost all purposes,⁵⁸ the partnership role of the partner since he is not acting in that capacity. In other words, the partner in a section 707(a) transaction has two hats, a partner hat and a non-partner hat, and Congress chose in section

55. Lazarus Effect, *supra* note 2, at 356-58.

56. *Id.* at 375.

57. See also IRC § 732(d).

58. The partnership interest of the partner is taken into account for purposes of characterizing any gain recognized on the transaction and for determining whether a recognized loss can be deducted. IRC § 707(b).

707(a) to ignore the partner hat.⁵⁹ By ignoring his partnership role, Congress also ignores the fact that the distributee has an interest in a percentage of the distributed property. Section 707(a) represents an unqualified adoption of the entity approach; and since the partner is not acting in his partner capacity, that approach is justified. In contrast, Congress chose an eclectic approach to section 707(c) transactions and applies an entity approach only in certain circumstances. Since the partner is acting in his partner capacity, there is good reason to treat that transaction, for many purposes, as one between a partner and a partnership rather than as one between two strangers.

As noted below, there is little substantive difference between allocating a share of partnership profits to a service partner in recognition of the ongoing services he provides or, instead, providing for a fixed amount to be payable to that partner. In both cases, the distribution satisfies a kind of obligation, i.e., the distributee is owed either a share of the partnership's profits or a specified amount. If the distribution is made in kind with appreciated property, regardless of whether the distribution is a guaranteed payment or a distribution of partnership profits, the partnership is satisfying an obligation with appreciated property. Yet, under section 731(b), a distribution of property in kind to a service partner that represents a distribution of his share of partnership profits does not cause the partnership to recognize gain. Just because a service partner is provided a specified amount, instead of a share of income, and just because section 707(c) then applies, there seems little reason to deny the partnership the nonrecognition of gain or loss that applies to a similar in kind distribution of profits.

(b) Comparison of guaranteed payments to ordinary section 731 distributions.

To the extent that the property that a distributee partner received was beneficially owned by the non-distributee partners, one could see a justification for requiring a recognition of gain. But the transfer of property as a guaranteed payment is much the same in this respect as an ordinary section 731 distribution⁶⁰ of partnership property. When a partnership makes an ordinary section 731 distribution of property in kind to one partner, the distributee acquires the portion of that property that represented the beneficial interests of the non-distributee partners. Yet, except for the special circumstances addressed by section 751(b), the partnership (and therefore the non-distributee partners)

59. Id. Section 707(a)'s treatment of a partnership as a separate entity puts the transaction in the same light as a similar transaction between a corporation and its shareholder in which gain on an appreciated asset will be recognized.

60. Gain or loss is not recognized on ordinary distributions to partners under IRC § 731. To distinguish ordinary distributions from guaranteed payments, I refer to the former as "ordinary § 731 distributions."

does not recognize gain even though the property has unrealized appreciation.⁶¹ The preclusion of gain recognition for operating distributions is one element of the Congressional scheme to defer gain recognition for transactions between partnerships and partners.

To what extent does a guaranteed payment differ in its nature from an ordinary section 731 distribution of property to a partner? The fact that a guaranteed payment is given because of the receipt of the partner's services is not a substantive difference since ordinary section 731 distributions of partnership profits can be made to service partners because of the receipt of their services. The difference between a guaranteed payment and an ordinary section 731 distribution of profits is that the right to a guaranteed payment does not depend upon there being partnership income (regardless of whether there is a genuine risk that it will be paid). Putting aside for the moment the other considerations that Cameron and Postlewaite have raised, which are discussed below, it seems likely that if Congress were presented with this issue, it would give the same nonrecognition treatment to guaranteed payments in kind that it chose for ordinary section 731 distributions.

(c) Similar consequences of partnership's deduction and allocation of partnership income

What about the fact that the distributee partner of a guaranteed payment recognizes ordinary income for receiving the property and the partnership often obtains a deduction? Prior to 1954, such transfers were treated as distributions of partnership income to the extent that the partnership had income.⁶² The consequence of that treatment, at least to the extent that the partnership had income, was to shift the recognition of the non-distributee partners' portion of that income from them to the distributee partner. In effect, an amount of the partnership's income that otherwise would have been allocated to the non-distributee partners was instead allocated to the distributee partner. Because of the complexity that arose when the partnership did not have income, Congress chose, in section 707(c), to treat the distributee partner as receiving ordinary income and allowing the partnership an offsetting deduction (unless it was a capital expenditure).⁶³ If the partnership did not have sufficient income to make

61. IRC § 731(b).

62. See the 2004 Article, *supra* note 1, at 408-410 (discussing the history of IRC § 707(c)).

63. Section 707(c)'s treatment of some guaranteed payments as capital expenditures reflects the entity approach utilized by that section for some purposes. Section 707(c) expressly provides entity treatment to guaranteed payments for the application of three Code sections, of which, the capital expenditure provision is one. In the case of a capital expenditure, there is no immediate offsetting deduction to the distributee's recognition of income. Instead, the deduction is deferred. If the capital expenditure can be amortized, the deduction will be taken ratably over a period of years.

the guaranteed payment and made it anyway, the payment is more like compensation to the service partner than a return of his capital, and section 707(c) adopted an entity approach to accommodate that situation.

The entity approach that section 707(c) applies for purposes of causing the distributee to recognize ordinary income and usually allowing the partnership to deduct the amount is blended with conduit treatment because the partnership's deduction passes through to the partners.⁶⁴ The economic effect of the section 707(c) provision, when the partnership has sufficient ordinary income and the payment is deductible, is to shift the portion of the partnership's ordinary income that would have been taxed to the non-distributee partners from them to the distributee partner. The effect is the same as can be accomplished by allocating to the distributee partner some of the partnership's ordinary income that otherwise would have been allocated to the non-distributee partners. The identity of consequences of those circumstances suggest that if property in kind is used by the partnership to make either a distribution of profits (that is, a distribution made in accordance with the partnership agreement's allocation of an amount of ordinary income to that partner) or a guaranteed payment, the rules for recognition or nonrecognition of gain or loss for the distributed property should be the same for either transaction. To illustrate how the section 707(c) scheme operates in the situation when there is ample ordinary income and the guaranteed payment is deductible, consider the following example.

Example – *A*, *B* and *C* are equal partners of the *P* partnership. In Year One, before taking any guaranteed payment into account, *P* had taxable income of \$90,000, all of which is ordinary income. If no guaranteed payments were payable, each of the three partners would report \$30,000 of ordinary income from *P*. But, *P* is required to pay *A* \$30,000 as a guaranteed payment under section 707(c), and *P* made that payment. The payment is deductible. After taking a deduction for that payment, *P* had taxable income of \$60,000. Each of the partners reports \$20,000 of ordinary income from *P*. In addition, *A* has \$30,000 of income as a guaranteed payment, and so *A* has a total of \$50,000 income from *P* – \$20,000 as his distributable share of the partnership's taxable income and \$30,000 as a guaranteed payment. Of the \$30,000 guaranteed payment income that *A* recognized, \$10,000 would have been taxed to him in any event if no partnership distribution had been made. The remaining \$20,000 of guaranteed payment income represents the \$20,000 of ordinary income that *B* and *C* would have recognized if the guaranteed payment had not been made. The net effect then is to shift the \$20,000 of ordinary income that otherwise would have been taxed to the non-distributee partners (*B* and *C*) to the distributee partner (*A*).

If it cannot be amortized, the basis created by the expenditure is taken into account when the asset is disposed of. IRC § 1001(a).

64. IRC § 702.

The economic consequence that attended the example above is the same as would attend a section 704 special allocation and distribution of \$30,000 of ordinary income to *A* instead of a guaranteed payment of that amount. In that case, the partnership would have \$90,000 of ordinary income with no deduction. The special allocation and distribution to *A* would have caused \$30,000 of the partnership's ordinary income to be allocated to *A* under sections 702 and 704. The remaining \$60,000 of partnership income would be allocated equally among the three partners. The net effect is that the three partners will have the same economic consequence whether the payment to *A* represents a guaranteed payment or an allocation of partnership profits.⁶⁵

However, if a guaranteed payment is not deductible because it is a capital expenditure, or if the partnership's ordinary income is less than the amount of the payment, the consequences of making the payment as a distribution of profits will be significantly different from the consequences of making a guaranteed payment. That difference in consequence does not mean that recognition of gain treatment for the two types of transactions should also be different, but it does not provide a ground for treating the two the same. The similarity of consequence in the situation described in the Example above provides an additional ground for granting the same nonrecognition treatment to both types of transactions; the dissimilarity of consequences in the latter situations does not detract from that consideration, albeit it does not add weight to it.

2. Potential for abuse

A major point of the Lazarus Effect Article is that the conclusions reached in the 2004 Article open up an opportunity for taxpayers to manipulate the making of a guaranteed payment in such manner as to abuse the tax system by deferring income from the disposition of an appreciated asset and by shifting the characterization of income from ordinary to capital gain.⁶⁶ The potential for abuse arises, not because of the nonrecognition of income alone, but because of the combination of that nonrecognition with the 2004 Article's conclusion that the distributee's basis in the distributed asset will equal its fair market value.

When Ms. Cuenin and I began writing the 2004 Article, I anticipated that we would conclude that the distributee would take a carryover basis in the distributed asset (i.e., take over the partnership's basis) because of our view that no gain or loss would be recognized by the partnership and because we had adopted the aggregate approach in resolving the nonrecognition issue. Upon further reflection, we realized that the built-in gain of an appreciated asset will continue to be reflected in the partners' outside basis in their partnership

65. Even if the partnership in the example above also had capital gain income, the result of an allocation of partnership profits will be the same if the partnership agreement makes a § 704 allocation of \$30,000 of its ordinary income to *A*.

66. Lazarus Effect, *supra* note 2, at 368-69.

interests, and so there would be double taxation of that gain if the distributee partner took a carryover basis in the property and if no adjustment was made to the partners' outside basis in their partnership interests. It was for that reason that we determined that the amount of built-in gain does not escape taxation if the distributee receives a fair market value basis and that the fair market value treatment prevents double taxation of the built-in gain. Obviously, other methods of dealing with the double taxation issue are possible, but the one we chose does not require a legislative solution and seems to solve the problem adequately.

Ms. Cuenin and I recognized that the approach we adopted raised opportunities for abuse, and we expressly noted that in the 2004 Article. We stated in that Article that while the same amount of income will be recognized, the timing of recognition will be different and that the transaction could be manipulated to change the characterization of the income.⁶⁷ We noted that the change of timing of recognition and the potential for changing characterization weighed against our conclusions, but we regarded them as minor costs that are outweighed by the considerations that favor nonrecognition.⁶⁸

In their Lazarus Effect Article, Cameron and Postlewaite have done a thorough and commendable job of illustrating how our proposed treatment alters the timing of recognition and how it can be manipulated to alter characterization. While these points were noted in the 2004 Article, the Lazarus Effect Article demonstrates with clarity just how this can take place.

Ultimately, the determination of whether gain should be recognized rests on a weighing of the potential for abuse on one side and the objective of nonrecognition for partnership to partner transactions on the other. There is an additional consideration on each side of that issue,⁶⁹ but those two are the principal considerations. In the 2004 Article, we concluded that the potential for abuse consideration is of less significance than the nonrecognition principle, and Cameron and Postlewaite have properly taken us to task for not fleshing out our reasons for that conclusion.⁷⁰

67. 2004 Article, *supra* note 1, at 425-26, 433.

68. *Id.*

69. On the recognition side, there is the principle of not allowing a deduction for a disposition of unrealized appreciation. That principle, and its significance to the issue at hand, is discussed in Part IV (F)(1) of this article. On the nonrecognition side, there is the point that requiring recognition of income will unduly complicate the administration of § 707(c) in certain circumstances. That point is discussed below in Part IV (G) of this article.

70. In regard to that issue, Cameron and Postlewaite identified an error in the 2004 Article. Lazarus Effect, *supra* note 2, at 371. In that Article, I stated that Congress had accepted the transfer of potential ordinary income to capital gain in the operation of §§ 108 and 1017. 2004 Article, *supra* note 1, at 427. They correctly point out that § 1017(d) prevents that change from occurring. I inserted that statement in the article and so I am the one responsible for the error. Ms. Cuenin's only error was to defer to my insertion in the article.

As to the possibility that taxpayers will manipulate the making of guaranteed payments so as to shift what would have been ordinary income on the disposition of a distributed asset to the capital gain that is recognized on the disposition of a partnership interest, that seems unlikely to occur with any frequency. The shifting of potential gain from an ordinary income asset to a capital asset can be accomplished under the system advocated in the 2004 Article by the partnership's using an ordinary income asset to make the guaranteed payment. The principal ordinary income assets of a business are inventory and accounts receivable. Inventory can be sold more readily by the business entity than by the owners, and so inventory typically will be sold and the proceeds distributed to partners rather than distributing the inventory directly to them. Similarly, accounts receivable typically will be collected by the business entity and the proceeds distributed to the partners. One type of ordinary income property that could conveniently be used to make a guaranteed payment is property in which there is a potential recapture of depreciation (e.g., property for which some or all of the gain on disposition would be ordinary income under section 1245). However, there is a significant possibility that one of the recapture provisions (such as section 1245) would override the nonrecognition principle and require the partnership to recognize gain. While section 731 nonrecognition takes priority over recapture of depreciation provisions,⁷¹ the nonrecognition proposed in the 2004 Article is not based on an application of section 731 itself, but rather on the principles which are reflected in section 731. In a regulation, Treasury has applied section 1245 recapture rules to a constructive receipt of cash from a partnership because of nonrecourse liabilities encumbering property contributed to the partnership to the extent that the partner recognized gain therefrom under section 731(a)(1).⁷² That regulation shows that Treasury will protect the recapture of income by applying the recapture provision broadly to cover transactions that are not literally within its scope.⁷³

71. E.g., IRC § 1245(b)(3).

72. Regs. § 1.1245-4(c)(4), Ex. (3). The gain was recognized to the extent that the liability of which the partner was relieved exceeded his outside basis in his partnership interest. See IRC § 731(a)(1).

73. *Id.* The regulation has been criticized because the gain recognized by the partner literally was on his partnership interest rather than on the contributed property, and the recapture rules do not apply to gain on a partnership interest. However, the regulation arrives at a proper result by recognizing that the gain that is created by the transaction is attributable to the previous depreciation deductions taken on the contributed property and to the contribution of that property to the partnership.

The regulation was promulgated before changes were made to the regulations under § 752 dealing with the allocation of partnership liabilities among the partners. Under the current rules, the constructive distribution to the contributing partner resulting from his relief of a nonrecourse liability would not be large enough to trigger gain

Of course, it is possible that if the views of the 2004 Article are adopted, it might induce partnerships to make guaranteed payments with ordinary income assets, and the abuse would then become significant. If that occurs, then Congress could address the problem and cure it. The potential for shifting ordinary income to capital gain was the object of the adoption of section 751 to prevent that from occurring in the circumstances to which that provision applies. While section 751 has been criticized and thought to be unnecessary, it shows that Congress chose to address the problem by singling out the ordinary income issue rather than to change Subchapter K's basic treatment of sales of partnership interests and partnership distributions. Similarly, if it turns out that there are significant instances in which partnerships actually do abuse the 2004 Article's approach, rather than to abandon the nonrecognition principle entirely, Congress could adopt a more limited and targeted prevention of that abuse.

Apart from the ordinary income issue, there also is a timing question of whether it is an abuse to permit the parties to shift the potential gain on the distributed property to the partners' partnership interests. The distributee could then sell the distributed property for no gain, and the potential gain from the distributed property will be deferred until it is recognized on the disposition of the partnership interests of all the partners. The timing certainly will be different, and that is acknowledged in the 2004 Article. The gain may be recognized before the distributee disposes of the distributed asset if the partnership liquidates before then or if the partners sell their interests before then. Concededly, the liquidation of the partnership or the disposition of the partnership interests could occur later. But, just how does that transfer of appreciation from one asset to another differ from the transfer of appreciation that commonly occurs in other nonrecognition provisions?

There are a number of circumstances in which the Code allows the gain from one asset to be deferred by transferring the potential gain to a different asset.⁷⁴ Many nonrecognition provisions operate in that manner. What makes the nonrecognition in this instance different is that the distributee continues to possess the distributed property and can dispose of it without gain. However, the non-distributee partners, whose potential gain in the asset also was not recognized, do not possess the distributed property, and so their position is no different in principle from beneficiaries of other nonrecognition provisions whose appreciation in one asset is transferred to another asset.

The deferral to which Cameron and Postlewaite object, therefore, seems to apply only to the deferral of the distributee's share of the appreciation and not to the deferral of the share of the appreciation attributable to the non-distributee partners. The deferral of the distributee's income applies only to his percentage share of the pre-distribution appreciation of the distributed property. To obtain that deferral of only a fraction of the built-in gain of the property, the distributee

recognition. Regs. § 1.752-3(a)(2). But, the regulation is still significant in demonstrating that the recapture rules will be applied broadly.

74. E.g., IRC §§ 358, 722, 1031(d).

has to endure recognizing ordinary income in the amount of the full value of the distributed property, or more accurately, in the amount of the full value that exceeds his share of the partnership's deduction. It would seem that the cost of this transaction to the distributee will deter the making of guaranteed payments primarily for the purpose of obtaining a deferral, but if a guaranteed payment is otherwise to be made, it might encourage the partnership to make it in kind in certain circumstances.

There is some evidence that Congress rates the nonrecognition principle for transactions between a partnership and a partner higher than the potential for deferral. When a partnership makes ordinary section 731 distributions to its partners, it can distribute property with a large amount of appreciation to one partner (the second partner) and property with little or no appreciation to another partner (the first partner). In so doing, the partnership can shift one partner's (the first partner) share of the appreciation of a partnership asset to another partner (the second partner) so that the first partner will not recognize his share of that appreciation until he disposes of his partnership interest. The cost of that deferral may be borne by the second partner when he disposes of the appreciated asset, but the second partner may be in a lower tax bracket or have carryover losses to offset against the gain. This consequence is permissible so long as the transaction does not cause a shift of a partner's share of the built-in gain of the partnership's ordinary income assets to capital gain assets. The manner in which a partner's share of the appreciation of a partnership asset can be transferred to another partner is illustrated by the following example.

Ex. *A* and *B* are equal partners of the *P* partnership. *P*'s assets consist of \$130,000 in cash, Land 1 having a basis of \$20,000 and a fair market value of \$50,000, and Land 2 having a basis of \$50,000 and a value of \$50,000. *A*'s outside basis in his partnership interest is \$100,000, and *B*'s outside basis in his partnership interest also is \$100,000. Since the value of each of their partnership interests is \$115,000, each had a potential gain of \$15,000 if he disposes of his partnership interest. This reflects each partner's one-half share of the \$30,000 appreciation of Land 1.

As operating distributions, *P* distributes Land 1 to *A* and Land 2 to *B*. *A*'s basis in Land 1 will be \$20,000, and *A*'s outside basis in his partnership interest will be reduced to \$80,000.⁷⁵ Since the value of *A*'s partnership interest will be reduced to \$65,000 because of the partnership's distributions, *A* has a built-in loss of (\$15,000) in his partnership interest and a built-in gain of \$30,000 on Land 1. *B* has a \$50,000 basis in Land 2, and *B*'s outside basis in his partnership interest is \$50,000.⁷⁶ So, *B* has no built-in gain on Land 2, and he has a \$15,000 built-in gain on his partnership interest. The parties have successfully shifted *B*'s one-half share of the partnership's \$30,000 built-in gain to *A*, and *B* has thereby deferred his recognition of that gain until he disposes of his partnership interest. This transaction is significantly different from the

75. IRC §§ 705(a)(2), 732(a)(1), 733.

76. *Id.*

deferral to which Cameron and Postlewaite object because *B*'s deferral is obtained by transferring *B*'s \$15,000 share of the built-in gain on Land 1 to *A* who can offset it only by disposing of his partnership interest and recognizing the (\$15,000) loss thereby. But, insofar as *B* is concerned, the potential for abuse is similar to the one about which Cameron and Postlewaite complain, and yet it has not moved Congress to change its nonrecognition rules on partnership distributions to prevent it from occurring.

Because of the significant differences with the guaranteed payment situation, the above example does not prove that Congress would choose nonrecognition over deferral in the case of guaranteed payments in kind. But, it is evidence that, in general, the deferral of the potential gain from a partner's share of a partnership's appreciated asset until the partner disposes of his partnership interest is of lesser concern to Congress than the nonrecognition principle.

The ultimate question is whether the principle of nonrecognition should be sacrificed because of a possibility that it will lead to abuses or whether Congress should wait to see if those abuses arise and, if so, deal with them then in an appropriate fashion. The weight to be accorded to the possibility that abusive tactics might be employed depends, in part, on how likely and how extensively one believes that practice will occur. In balancing the competing considerations against each other, different people will evaluate them differently and will attribute different amounts of weight to them. I cannot say that Cameron and Postlewaite are wrong in balancing these competing considerations differently than I do. On the other hand, I prefer the balance that Ms. Cuenin and I have reached. Time will tell which of these choices is more attractive to the profession. If the competing policies are deemed to be of approximately the same weight, then I suggest that the slight presumption for aggregate treatment that is proposed in Part IV (E) of this article tip the decision in favor of nonrecognition. For purposes of my own evaluation, I do not need that presumption because I find the policies for nonrecognition to weigh more heavily on the scales.

G. Administrative Burden Generated By Requiring Gain Recognition.

As noted above, the most important considerations weighing for and against requiring the partnership to recognize gain are the potential for abuse on one side and the policy favoring nonrecognition for partnership-partner transactions on the other side. Those two competing considerations are discussed earlier in this article. There are two other considerations, albeit of lesser significance, that weigh in on opposite sides of the recognition issue. On the side of recognition, Cameron and Postlewaite rely on the basic tax principle that a deduction should not be allowed for a disposition of unrealized appreciation. That principle, and the weight to be accorded it, is discussed in Part IV (F)(1) of this article. On the side of nonrecognition, Cuenin and I

contend in the 2004 Article that requiring recognition would, in certain circumstances, complicate the administration of the applicable tax provisions, and the avoidance of that complexity is a factor favoring nonrecognition.⁷⁷ Our contention is that the complexity that can be caused by gain recognition is a factor to be considered, but we do not claim that it is dispositive.

The complexity described in the 2004 Article arises when the guaranteed payment occurs in the form of a guaranty by the partnership that a partner's share of partnership profits will not be less than a stated minimum figure. In such a case, a portion of the distribution to that partner can be a guaranteed payment and a portion can be an ordinary section 731 distribution. The Regulations deal with a partner who is entitled to a percentage of partnership income "as determined before taking into account guaranteed payments," but not less than a minimum amount. The Regulations provide that an amount of the distribution to that partner that equals the partner's share of the partnership income is treated as an ordinary section 731 distribution. Only the excess that the partner received over the amount of the ordinary section 731 distribution is treated as a guaranteed payment.⁷⁸ So, a distribution to a partner in that circumstance is divided into two parts,⁷⁹ one part is an ordinary section 731 distribution, and one part is a guaranteed payment. The determination of the portion of the distribution that is a guaranteed payment depends upon the size of the partnership's income. This problem arises only when the minimum guaranty is greater than the distributee partner's share of partnership income.

If the distribution to the partner in the circumstance described above is made with appreciated property, and if gain recognition is required for guaranteed payments made in kind, the partnership will recognize gain on the portion of the property that constitutes a guaranteed payment, but will not recognize gain on the portion of the property that is treated as an ordinary section 731 distribution.⁸⁰ To calculate the gain on the guaranteed payment, the partnership's basis in the distributed property must be apportioned between the two parts of the distribution. Unless the partnership agreement excludes from the calculation of the partner's share of partnership income gain or loss that is recognized by making a guaranteed payment in kind, the gain recognized by the partnership on the guaranteed payment portion of the distribution will increase the partnership's income, thereby increasing the dollar amount of the distributee partner's share of partnership income and accordingly increasing the percentage of the distributed property that constitutes an ordinary section 731 distribution. Similarly, that distribution reduces the portion of the distributed property that constitutes a guaranteed payment. Once the guaranteed payment is reduced, the

77. 2004 Article, *supra* note 1, at 423-24.

78. Regs. § 1.707-1(c), Ex. (2).

79. Of course, if the partner's share of partnership income is not less than the minimum guaranty, then all of the distribution is an ordinary § 731 distribution and none of it is a guaranteed payment.

80. IRC § 731(a)(1).

amount of gain recognized therefrom must be recalculated using a smaller amount of guaranteed payment and a smaller amount of basis. That will result in a smaller amount of gain than was originally calculated. Consequently, the amount of the partnership's gain must be recalculated using the smaller amount of gain from the guaranteed payment. The resulting reduction in the partnership's gain will reduce the portion of the distributed property that constitutes an ordinary section 731 distribution and will increase the amount of the guaranteed payment. This recalculation will continue until the two mutually dependent figures (i.e., the amount of the guaranteed payment and the amount of the partnership's income) are finally settled. The recalculations are made even more complicated by the fact that the portion of the basis of the distributed property that is allocated to the guaranteed payment portion of the distribution will have to be recalculated each time that the amount of the guaranteed payment is changed.

Cameron and Postlewaite describe the circumstance of a partner's receiving a right to a percentage of partnership profits subject to a minimum figure as unusual. In their words, they said:

To document the potential complexity resulting from a requirement that the partnership recognize gain or loss, they [Kahn and Cuenin] 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, . . . One should not be surprised that an added layer of difficulty is encountered in such an atypical setting.⁸¹

Cameron and Postlewaite do not explain why they think that this situation is unusual. Treasury considered the occurrence of sufficient magnitude to warrant the promulgation of a Regulation that describes how the tax law treats it.⁸² While I have no empirical data, the situation seems likely to occur frequently. For example, if a small law firm offers to make an associate a partner, the firm may provide a minimum guaranty to assure the associate that his income will not be reduced if he accepts the partnership's offer. Shortly after joining the faculty at Michigan, I received an offer from a law firm of a partnership position with a percentage interest in the partnership's income and a minimum guaranty. The offer did not strike me as unusual. After reading the Lazarus Effect Article, I asked a senior partner of a large national law firm whether he had ever encountered an arrangement of this type. He informed me

81. Lazarus Effect, *supra* note 2, at 364-365.

82. Regs. § 1.707-1(c), Ex. (2).

that his firm had made that arrangement with newly appointed partners during several years when law earnings were depressed.

Perhaps it is not the arrangement that Cameron and Postlewaite find unusual. Perhaps, they mean that it would be unusual for a partner's share of partnership income to be less than his minimum guaranty. Again, Treasury thought that this situation occurs frequently enough to justify promulgating a Regulation describing how such payments are taxed.⁸³ Also, it seems reasonable that this occurrence will not be a rarity. The purpose of providing the partner with a guaranty likely is because there is reason for doubt that partnership profits will be adequate to produce the minimum amount. One might expect there to be a fair number of occurrences in which that fear is realized.

Cameron and Postlewaite contend that the complexity of which the 2004 Article complains is "overstated, and, in any event, can easily be avoided."⁸⁴ As to the overstatement, they wrote in a footnote,

Their [Kahn and Cuenin] 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.⁸⁵

It is not necessary for the partnership to know the amount of its taxable income to make guaranteed payments to its partner in the year in which the payments are earned. The partner is guaranteed a minimum figure. The partnership can make distributions to the partner up to the amount of that minimum in complete confidence that the entire amount is owed to the partner. The partnership and the partner will not know how much of a distribution that was made to the partner is a guaranteed payment and how much is a section 731 distribution until the amount of the partnership's income is determined in the following year, but that does not interfere with making the distribution before that determination is made.

Partners cannot wait until the end of the year to receive their distributions. They need to pay their living expenses and other items currently. The problem can be solved by paying a partner a "draw" or advance on the share of income it is anticipated he will earn. The "draw" is treated as an

83. *Id.*

84. *Lazarus Effect*, *supra* note 2, at n. 91.

85. *Id.*

interest-free loan which is then converted to a distribution at the end of the partnership's taxable year.⁸⁶ Regardless of whether that deferral to the end of the year will apply to the portion of a withdrawal that constitutes a guaranteed payment, the gain from making that payment with appreciated property will be recognized in the taxable year of the partnership in which the payment is made.

In the 2004 Article, Ms. Cuenin and I acknowledged that guaranteed payments, other than liquidating distributions, are typically made in cash. Guaranteed payments in kind are unusual. The 2004 Article seeks to resolve some difficult issues that will arise when a guaranteed payment is made in kind, but it was never our expectation that such payments would become a common occurrence.

In the 2004 Article, Cuenin and I expressly note that the problem of recalculation will not arise if the partnership's income is to be computed without taking into account gains or losses recognized from making guaranteed payments.⁸⁷ So, the partnership can avoid the recalculation problem by including an express provision in the partnership agreement to exclude from the calculation of the guaranteed partner's share of partnership income any gain or loss recognized from making a guaranteed payment in kind. If adopted, the provision should indicate whether such gains or losses are to be excluded only if they are recognized on a guaranteed payment to the distributee of that payment, so that gains or losses on guaranteed payments made to other partners are to be included. While the inclusion of a provision of this nature will resolve the recalculation problem, it is not likely to be included in a partnership agreement unless the parties are aware of the problem and are informed as to how it can be resolved. Unfortunately, not all parties are well informed.

One of the facts of the example in the regulation that deals with the tax treatment of minimum guarantees is that the partner's share of partnership income is to be determined "before taking into account any guaranteed payments." Obviously, that provision prevents the taking into account of any deduction that the partnership may receive for making the guaranteed payment. Can that same language be construed to prevent taking into account the gain or loss that the partnership recognized from making a guaranteed payment in kind? In footnote 61 of the 2004 Article, Cuenin and I noted the possibility that that language could be so construed and thereby eliminate the recalculation problem. Cameron and Postlewaite give reasons why that language should be so construed and question why Cuenin and I did not give reasons why that construction would be improper.⁸⁸ Cuenin and I did not argue against that construction because we do not believe that it is improper. On the other hand, we do not know whether that construction will be adopted. A contrary construction also is not improper. The question of how that language will be

86. See Regs. § 1.731-1(a)(1)(ii).

87. 2004 Article, *supra* note 1, at 423-424.

88. Lazarus Effect, *supra* note 2, at n. 91.

construed is unresolved. Until it is resolved, requiring gain recognition by the partnership would raise the possibility of causing the recalculation problem.

If the recalculation problem does occur, as noted in the 2004 Article,⁸⁹ the two mutually dependent figures can be determined by using an algebraic formula. The fact that they can be determined does not mean that the necessity to resort to a mathematical solution does not impose complexity and burden the administration of the provision. Cameron and Postlewaite have included in their Article several algebraic formulas that solve this problem and a related one.⁹⁰ I am impressed by their mathematical acumen. While there are other examples of mutual dependency in the tax law, and they have not prevented the administration of those provisions, one might still prefer a statutory construction that does not present that problem.

Apart from the recalculation issue, there is another consequence of gain recognition that adds to the complexity it can create. The gain recognized by the partnership is determined by comparing its basis in the guaranteed payment portion of the distributed property with the amount of the guaranteed payment. That gain is then allocated among the partners under the conduit approach applied to partnership tax items. The partnership's basis in its assets is sometimes referred to as 'inside basis.' If the partnership has made an election under section 754, the partnership may effectively have a different inside basis for each partner. The section 754 election invokes section 743, which requires that the inside basis attributable to a partner must be adjusted in certain circumstances. In effect, the inside basis that is attributable to each partner's share of a partnership asset must be determined separately. So, in that situation, the partnership will have to calculate the gain for each of its partners by using the specific inside basis that applies to that partner's share of the property. If there are a number of partners, that could be a burdensome requirement. In addition, if recalculation of the partnership's gain is required, then the amount of basis for each partner that is allocated to the part sale of the distributed asset will also have to be recalculated to conform to the changes in the portion of the property that is deemed to have been sold, and that would magnify the complexity of calculation. That separate set of calculations would not be necessary if the partnership does not recognize gain on making the distribution. Although the distributee takes the same basis that the partnership had in the portion of the distributed property that constitutes the ordinary section 731 distribution, his basis will be equal to the partnership's inside basis in that portion of the property without adjustment for the special inside basis that other partners might have under the section 754 election. Any adjustment for a special inside basis of the distributee partner will have to be taken into account, but the

89. 2004 Article, *supra* note 1, at 424.

90. Lazarus Effect, *supra* note 2, at n. 91.

adjustments for the other partners can be ignored. The calculations will be much less onerous if the partnership does not recognize a gain on the transaction.

Cameron and Postlewaite shrug off this additional computational burden as being “simply one of a number of additional burdens that result from a partnership’s decision to make a section 754 election.”⁹¹ It is true that the section 754 election creates comparable burdens in other situations, and that the computational problem in the instant situation would not arise were it not for the operation of the section 754 election. But, section 754 is part of the landscape. If gain is required to be recognized, it will cause a computational burden that would not occur if nonrecognition is adopted. The fact that the burden is a product of another Code provision is irrelevant to the determination of whether it might be preferable to avoid that burden by adopting nonrecognition. Moreover, if recalculation of gain is required, the determination of each partner’s share of inside basis to be allocated to the portion of the distributed asset that is deemed to have been sold will be much more complex than occurs with the ordinary operation of section 754.

V. CONCLUSIONS

The case for treating section 707(c) as having been impliedly repealed by the 1984 adoption of section 707(a)(2) is very weak. It rests on the assertion that the criteria that the Senate Finance Committee’s Report to the 1984 Act adopted for determining partner capacity would vitiate the application of section 707(c) to any payment if the absence of risk factor of those criteria were applied to section 707(c). There is reason to doubt that the absence of risk factor alone is determinative of non-partner capacity under the Senate Finance Committee’s standard. More importantly, the criteria that the Senate Finance Committee suggested have not been adopted by Treasury and have impliedly been rejected in one of the examples provided in a regulation adopted some years after 1984. Given the well established doctrine that implied repeals of statutes are disfavored and occur only when two statutes are totally inconsistent, there is little to be said for the suggestion that section 707(c) no longer exists.

The question of whether a partnership recognizes gain or loss on making a guaranteed payment in kind is a closer issue. There is much to be said on both sides of that question. For the reasons discussed in the body of this article, I favor nonrecognition. However, I cannot say that Cameron and Postlewaite are wrong in arguing for recognition and that my view is correct. There are competing policies that favor each side of that issue, and the difference between us rests on how we weigh those competing policies. In their Lazarus Effect Article, Cameron and Postlewaite generously concede that, absent their contention that section 707(c) was impliedly repealed by the 1984 adoption of section 707(a)(2), their “conclusions are not entirely free from

91. *Id.* at 368.

doubt.”⁹² I will concede with equal candor that my conclusion that gain should not be recognized also is not free from doubt. Nevertheless, they are convinced that theirs is the better conclusion, and I am convinced that mine is better. Reasonable people can take either side. Individual evaluations and priorities determine how one balances close questions. Judge Posner, writing about the correctness of the Supreme Court’s constitutional decisions, expressed a similar thought. Judge Posner wrote,

a federal appellate judge has convinced me that it is rarely possible to say with a straight face of a Supreme Court constitutional decision that it was decided correctly or incorrectly. . . . One may be able to give reasons for liking or disliking the decision . . . and people who agree with the reasons will be inclined to say that the decision is correct or incorrect. . . . The problem . . . is that there are certain to be equally articulate “reasonable” people who disagree and can offer plausible reasons for their disagreement. . . .⁹³

When Ms. Cuenin and I decided to write the 2004 Article, we were hoping to generate interest in exploring a question that seemed to have been given little thought by the commentators. If that were true, it certainly is no longer. Professors Cameron and Postlewaite have done an exemplary job of exploring the issues. While I disagree with their conclusions, I am pleased that the issues have been given such careful and thoughtful attention.

92. *Id.* at 345.

93. Richard A. Posner, *Forward: A Political Court*, 119 *Harvard L. Rev.* 32, 40-41 (2005).