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Guaranteed Payments Made In Kind By A Partnership

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I. INTRODUCTION

If a partnership makes a payment to a partner for services rendered in the latter's capacity as a partner or for the use of capital, to the extent that the payment is determined without regard to partnership income, it is characterized by the Internal Revenue Code as a "guaranteed payment" and is treated differently from other partnership distributions.¹ In addition, if a partnership makes a payment in liquidation of a retiring or deceased partner's interest in the partnership, part of that payment may be characterized as a guaranteed payment by section 736(a)(2). We will discuss in Part VI of this article the circumstances when a liquidating payment is treated as a "guaranteed payment." While section 707(c) and 736(a) refer to a "payment," there is no reason that it must be made in cash, and the leading treatises on partnership taxation agree that guaranteed payments can be made in kind.²

As used in this article, a "liquidating" distribution or payment refers to a partnership distribution or payment made pursuant to the liquidation of a partner's interest in the partnership. All other partnership distributions or payments are sometimes referred to as "operating" distributions or payments.

An unresolved question is whether a guaranteed payment of property in kind will cause the partnership that made the payment to recognize gain or loss if the property is appreciated or depreciated. Even if the answer to that question were affirmative, and the authors have concluded otherwise, no deduction would be allowed for a loss recognized on a payment to a person owning, directly or indirectly, more than a 50 % interest in the profits or capital

1. IRC § 707(c). Unless stated otherwise, references herein to "IRC" or to the "Code" are to the Internal Revenue Code of 1986 as currently amended.

2. 1 William S. McKee, William F. Nelson & Robert L. Whitmire, *Federal Taxation of Partnerships and Partners* ¶ 13.03[5] (3d ed. 1997), [hereinafter cited as McKee]; Arthur B. Willis, John S. Pennell & Philip F. Postlewaite, *Partnership Taxation* ¶ 15.06 (6th ed. 2002) [hereinafter Willis]. The discussion in the Willis treatise pertains to liquidating distributions of property in kind under IRC § 736, some of which constitute guaranteed payments, and the treatise expressly concludes that such payments can be made in kind. 2 Willis ¶ 15.06[1], [4]. However, the Willis treatise also states that guaranteed payments are "generally thought to be money payments," and that "[n]othing in the Regulations, the case law, interpretive Rulings, or the legislative history considers such payments other than in terms of money." 2 id. ¶ 15.06[1]. The Willis treatise concludes, however, that the statutory language is sufficiently broad to apply to liquidating payments made in property in kind. See also, Stephen A. Lind, Stephen Schwartz, Daniel J. Lathrope & Joshua D. Rosenberg, *Fundamentals of Partnership Taxation* 328-329 n. 10, 20 & 21 (6th ed. 2002) [hereinafter Lind].

of the partnership.³ In this article, the authors will focus on the question of the partnership's recognition of gain or loss, and will not examine questions of deductibility for a recognized loss. Two allied unresolved questions, which are discussed in this article, are: (1) how is a partner's basis in property that was received as a guaranteed payment to be determined, and (2) regardless of whether the guaranteed payment is made in cash or in kind, what effect does the payment have on the partner's outside basis in his partnership interest.

The McKee treatise concludes that the proper treatment of guaranteed payments made in kind is that the partnership will recognize gain or loss for the amount of appreciation or depreciation of the property, and that the partner will have a basis in the property equal to its fair market value.⁴ While the Willis treatise does not discuss the question of gain or loss recognition, the treatise does consider the basis question in the context of a guaranteed payment made as part of the liquidation of a partner's interest. The Willis treatise concludes that although granting the partner a basis equal to the property's fair market value is the logical and desirable treatment, the statutory authority for that treatment is weak.⁵ The Willis treatise does not resolve that issue. The Lind casebook states that the partnership will recognize gain or loss, but does not discuss the basis issue.⁶ In this article, the authors contend that no gain or loss is recognized, and nevertheless, the partner takes a basis in the distributed property equal to its fair market value. The authors also contend that a guaranteed payment does not affect the partner's outside basis in his partnership interest except to the extent that any deduction allowed to the partnership for making the payment is allocated to the partner as his share of a partnership loss.

There is no case, regulation or ruling expressly addressing those issues. One possible explanation for this dearth of authority is that guaranteed payments are rarely made in kind except for liquidating payments, and many of those are made in cash. Nevertheless, especially since liquidating distributions are sometimes made with property in kind, the issue is worthy of exploration. The issue may yet be raised by the Service. The question of the effect of a guaranteed payment, whether made in cash or in kind, on the partner's outside basis in his partnership interest will arise frequently.

Before examining the question of gain or loss recognition, it is useful to set forth the history and role of section 707(a) and (c). Other Code provisions

3. IRC § 707(b). In determining a partner's percentage interest, constructive ownership rules are applied. IRC § 707(b)(3).

4. 1 McKee, *supra* note 2, ¶ 13.03[5]. The McKee treatise also concludes that the partner's outside basis in his partnership interest is affected by the guaranteed payment only to the extent of the partner's share of any deduction allowed to the partnership and the partner's share of the gain or loss that the partnership recognized from the transaction. 1 McKee, *supra* note 2, ¶ 13.03[5], at ex. 13-8.

5. 2 Willis, *supra* note 2, ¶ 15.06[4].

6. Lind, *supra* note 2, 329 n. 21.

come into play, especially when considering the basis that a partner will acquire in the distributed property and the effect that the payment will have on the partner's outside basis, but section 707 is at the epicenter of this subject.

II. HISTORY AND ROLE OF IRC SECTION 707

Section 707 was first adopted in 1954 as part of Subchapter K of Chapter 1 of Subtitle A of the Internal Revenue Code of 1954. Subchapter K was adopted by Congress to bring order to the field of partnership taxation where confusion and inconsistent treatment previously had reigned. The Report of the Ways and Means Committee on H.R. 8300, which bill became the Internal Revenue Code of 1954 when adopted, described the status of the pre-1954 tax law as follows:

The existing tax treatment of partners and partnerships is among the most confused in the entire income tax field. The present statutory provisions are wholly inadequate. The published regulations, rulings, and court decisions are incomplete and frequently contradictory. As a result partners today cannot form, operate, or dissolve a partnership with any assurance as to tax consequences.⁷

One of the areas addressed in the 1954 Code was the treatment of transactions between a partnership and a partner. In section 707(a), Congress dealt with those transactions in which the partner was acting in some capacity other than his role as a partner. In section 707(c), Congress dealt with payments from a partnership to a partner for services rendered in his partnership capacity (or for the use of capital), but only to the extent that the payment was determined without regard to the income of the partnership.

A partnership can hire a partner to perform services and pay the partner a salary, determined without regard to partnership income. If the services were connected to the partner's role as a partner, section 707(c) applies to the payment; but if the services were not pursuant to the partner's role as a partner, section 707(a) controls. That division still exists and is reflected in the current forms of section 707(a) and (c).

Prior to the adoption of the 1954 Code, a partnership was generally not treated as a separate entity whose transactions with a partner are treated similarly to its transactions with a stranger. Section 707(a) changed that; consequently a transaction between a partnership and a partner, other than in the latter's capacity as a member of the partnership, is now treated the same as a

7. H.R. Rept. No. 83-1337, pt. 22, at 65 (1954), reprinted in 1954 U.S.C.C.A.N. 4025, 4091.

transaction between the partnership and a stranger, except that there are rules denying a deduction or requiring ordinary income treatment in certain cases involving a sale or exchange.⁸

A partnership may pay a “salary” to a partner for services performed in the latter’s capacity as a partner. The “salary” may be nothing more than an advance on the partner’s share of partnership income. Or, it can be a payment of a specified amount, after which the profits of the partnership are divided among all of the partners, including the payee, in proportion to their partnership interests. Another version of a “salary” is to provide a partner with a percentage interest in partnership profits, but guarantee that the partner’s share will not be less than a specified dollar amount. Payments made under the first of these alternatives will not constitute a guaranteed payment; payments made under the second alternative will be a guaranteed payment; and the extent to which a payment received under the third alternative constitutes a “guaranteed payment” is discussed in Part III of this article.

Prior to the adoption of the 1954 Code, salary payments to a partner for services rendered were merely a basis for dividing the partnership’s profits.⁹ If the salary payments did not exceed partnership profits, the salaries were treated as distributions of those profits and taxed accordingly. To the extent that partnership profits were less than the amount of salary payments, the excess salary was treated as having been made from the partners’ capital accounts. Salary deemed to have been paid from the service partner’s own capital account was not taxable to him, but salary deemed to have been paid to the service partner from the capital account of another partner was taxable to the service partner and deductible by the partner whose capital account was reduced.¹⁰ The determination of tax was even more complex when, as a consequence of paying salaries, the partnership had a net loss for the year.¹¹ Congress determined that the pre-1954 treatment was “unrealistic and unnecessarily complicated.”¹²

Congress cured this problem by adopting section 707(c), which treats a guaranteed payment as one made to a person who is not a member of the partnership, “*but only for the purposes of section 61 (relating to gross income)*

8. IRC § 707(a). No loss deduction is allowed for a sale or exchange between a partnership and a partner who owns, after applying certain attribution rules, more than a 50% capital or profits interest in the partnership. IRC § 707(b)(1). Also, gain recognized on a sale or exchange between a partnership and a more than 50% partner of an asset that is not a capital asset in the hands of the transferee will be treated as ordinary income. IRC § 707(b)(2); see IRC § 1239.

9. *Lloyd v. Commissioner*, 15 B.T.A. 82, 87 (1929).

10. *Cagle v. Commissioner*, 63 T.C. 86, 93 (1974), *aff’d*, 539 F.2d 409 (5th Cir. 1976).

11. See *Lloyd*, 15 B.T.A. 82 (1929).

12. H.R. Rept No. 83-1337, *supra* note 7, at 68, reprinted in 1954 U.S.C.C.A.N. at 4094.

and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses)."¹³ The "but only for the purposes of" language in the statute was added to the 1954 Bill by the Senate Finance Committee and accepted by the House. The clause referring to "section 263" was added in 1976 to clarify that guaranteed payments will have to be capitalized instead of deducted in appropriate circumstances.¹⁴

III. PARTNER'S PERCENTAGE INTEREST SUBJECT TO A MINIMUM DOLLAR AMOUNT

If a partnership provides that a service partner is to receive a specified percentage of partnership profits, computed before taking any guaranteed payments into account, but also provides that in no event will the amount distributed to the partner in a taxable year be less than a specified dollar amount, what amount of the distribution to that partner will be a guaranteed payment? That issue is resolved in Regulations section 1.707-1(c), ex. 2. The amount that equals the partner's percentage interest in the partnership's profits is treated as a partnership distribution, but the additional amount of the payment above the partner's percentage interest is treated as a guaranteed payment.¹⁵ The following illustration is taken from the regulation.

Partner C, who provides services to the CD partnership in his capacity as a partner, is to receive annually 30% of partnership income as determined before taking into account any guaranteed payments, but no less than \$10,000. If the partnership's income for a year is \$60,000, then C's distributive share would be \$18,000 (\$60,000 X 30%), and there would be no guaranteed payment. In the next year, the partnership's income was only \$20,000. C's distributive share of that income is \$6,000 (\$20,000 X 30%). But C is guaranteed no less than \$10,000. The \$4,000 difference is a guaranteed payment to C. To recap, \$6,000 paid to C is a partnership distribution, and the remaining \$4,000 is a guaranteed payment.¹⁶

13. IRC § 707(c) (emphasis added).

14. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976). This amendment codified the result reached by the courts in *Cagle v. Commissioner*, 63 T.C. 86 (1974), *aff'd*, 539 F.2d 409 (5th Cir. 1976).

15. See Rev. Rul. 69-180, 1969-1 C.B. 183.

16. See Regs. § 1.707-1, ex. 2.

IV. NONRECOGNITION OF GAIN FOR PARTNERSHIP DISTRIBUTIONS AND BASIS OF DISTRIBUTED PROPERTY

The general rule is that neither a partnership nor a partner recognizes gain or loss when property is distributed to a partner either as an operating or as a liquidating distribution.¹⁷ There are several exceptions. One exception is that a partner recognizes gain to the extent that the partner receives cash from the partnership in excess of the partner's outside basis (i.e., "outside basis" is the basis that a partner has in his partnership interest).¹⁸ A second exception, in which both the partner and the partnership can recognize a gain or a loss, arises when section 751(b) comes into play. Section 751(b) applies when the consequence of a distribution is that the value of the partner's aggregate share of certain ordinary income assets (sometimes referred to as "section 751 assets" or as "hot assets")¹⁹ of the partnership, determined immediately before the distribution, is increased or decreased and the value of the partner's aggregate share of other partnership assets is correspondingly decreased or increased.²⁰ When applicable, section 751(b) causes there to be a constructive exchange of assets between the partnership and the partner in which both parties can recognize gain or loss.

While there are several other circumstances in which a partner (not necessarily the partner who received the distribution) can recognize a gain because of a distribution in kind,²¹ it is only in a constructive exchange triggered by section 751(b) that a distribution can cause the partnership to recognize gain or loss.

The section 751(b) constructive exchange arises only under special circumstance and invokes a complex set of tax rules. In the balance of this article, we will deal with distributions that do not trigger section 751(b), and so we will ignore that provision for the most part. Section 751(b) does not apply

17. IRC §§ 731(a), (b), 736(b)(1).

18. IRC § 731(a)(1).

19. Section 751 assets consist of two categories of properties: "unrealized receivables," and "inventory;" and for purposes of IRC § 751(b), the aggregate inventory of the partnership must be substantially appreciated for any of its inventory to be included. The terms "unrealized receivables" and "inventory" are specially defined in IRC § 751(c) and (d), and those special definitions are much broader and inclusive than the ordinary meaning of those terms would imply. Some properties may qualify both as unrealized receivables and as inventory; in such cases, even inventory that otherwise would have been excluded because of failing the "substantially appreciated" requirement of § 751(b) will be a section 751 asset.

20. IRC §§ 731(d), 751(b).

21. See IRC §§ 704(c), 737.

to guaranteed payments,²² and so it bears only minor relevance to the subject of this article.

In the case of an operating distribution (i.e., one not in liquidation of a partner's interest and not a guaranteed payment) of property in kind, the partner's basis in the distributed property is the same as the basis that the partnership had in that property immediately before distributing it.²³ However, there is a ceiling on the basis that a partner can acquire. A partner's aggregate basis in the properties distributed to him cannot exceed the amount of the outside basis that the partner had in his partnership interest reduced by any money "distributed in the same transaction."²⁴ The partner's outside basis is reduced by the amount of cash distributed to him and by the amount of basis he obtained in the distributed properties.²⁵ In other words, the partner's basis in his partnership interest (his "outside basis") is reduced by cash he received, and then any remaining basis is shifted from the outside basis to each item of distributed property, but only to the extent of the partnership's basis in that property immediately before making the distribution. If more than one property was distributed to a partner, and if the partner's outside basis is insufficient to provide the partner with a basis in all of the properties he received equal to the basis that the partnership had therein, the Code provides an ordering method for allocating the permissible basis among those distributed properties.²⁶

A distribution to a partner, regardless of whether an operating or a liquidating distribution, will reduce that partner's capital account by the amount of cash plus the fair market value of property distributed in kind.²⁷ But first, an adjustment will have to be made to the property's book value and to the partners' capital accounts. If the distributed property has a fair market value that is different than its book value in the partnership, then immediately before the distribution takes place, the book value of the property is changed to equal its fair market value, and the increase or decrease in book value is allocated to the partners' capital accounts in proportion to their respective percentage interests in the partnership.²⁸ Thus, the book value of distributed property will always equal its fair market value at the time that the distribution takes place, and the partners' capital accounts will reflect the amount of unrealized appreciation or depreciation that the partnership had in that property.

22. See Regs. § 1.751-1(b)(1)(ii).

23. IRC § 732(a)(1).

24. IRC § 732(a)(2).

25. IRC §§ 705(a)(2), 733.

26. IRC § 732(c).

27. See Regs. § 1.704-1(b)(2)(iv)(b). The fair market value of the distributed property is reduced by any liabilities to which it is subject and which the partner either assumed or accepted. See Regs. § 1.704-1(b)(2)(iv)(c).

28. See Regs. § 1.704-1(b)(2)(iv)(e)(1).

The core principle of the Code's treatment of partnership operating distributions to a partner is to defer recognition of any gain or loss to the extent that it is feasible to do so.²⁹ The amount of the unrealized appreciation or depreciation of the partner's interest in the partnership is left intact, but is divided between his partnership interest and the distributed property. The shifting of part or all of the partner's outside basis in his partnership interest to the distributed property does not alter the net amount of the partner's potential gain or loss, but it transfers part of that potential to the distributed property so that the partnership's inside appreciation or depreciation of that property is taken over by the partner.

The treatment of distributions in liquidation of a partner's interest in the partnership is different. Distributions to a retiring or deceased partner are divided by section 736 into two categories: (1) payments for the partner's interest in partnership property (section 736(b)), and (2) all other payments (section 736(a)) which are categorized either as guaranteed payments or as distributions of partnership income. We will address the determination and treatment of section 736(a) payments in Part VI of this article. At this time, we will focus on liquidating distributions that are attributable to the partner's interest in partnership property and that are controlled by section 736(b).

You will recall that the same rules for operating distributions regarding the write-up or write-down of the book value of distributed property to its fair market value and the allocation of the change to the partners' capital accounts apply equally to liquidating distributions.³⁰

A partner will recognize gain to the extent that the amount of cash distributed to the partner exceeds the partner's outside basis in his partnership interest.³¹ A partner generally will not recognize a gain on receiving a liquidating distribution in kind unless one of the exceptions noted above is applicable.³² The principal exception is where section 751(b) applies to cause a constructive exchange of assets. A partner can recognize a loss on receiving a liquidating distribution, but that can occur only if the partner receives no assets other than cash, unrealized receivables, and inventory, or if there is a constructive exchange under section 751(b).³³ A partnership will not recognize any gain or loss except where there is a constructive exchange of assets under

29. For example, to the extent that a partner receives cash in excess of his outside basis, it is not feasible to defer the gain that the partner realized. It would be possible to defer that gain by reducing the partner's basis in some other asset that he owns, but that would entail more of an administrative burden than the benefit of nonrecognition warrants in that situation since there is little reason for nonrecognition when the partner has recouped all of his basis and realized a profit in cash.

30. See *supra* text accompanying notes 27-28.

31. IRC § 731(a)(1).

32. See *supra* text accompanying notes 17-21.

33. IRC § 731(a)(2).

section 751(b).³⁴ In examining liquidating distributions, we will deal with circumstances where section 751(b) does not apply, and so we will give only brief attention to that section.

A partner's basis in property received in liquidation is determined differently from the determination of basis in operating distributions. Since the partner's interest in the partnership is being terminated, there would be no usefulness to leave the partner with any remaining outside basis in his partnership interest. Accordingly, the partner takes all of his outside basis, less any cash received in the same transaction, and allocates that to the property he received under section 736(b).³⁵ However, the basis allocated to unrealized receivables and inventory cannot exceed the basis that the partnership had in those properties.³⁶ The definition of "unrealized receivables" and "inventory" for this purpose is the same as the definition employed in section 751.³⁷ After allocating outside basis to any unrealized receivables and inventory, any remaining outside basis is allocated to other properties the partner received;³⁸ but if the partner did not receive any other property, the partner is permitted to take a deduction for the remaining outside basis.³⁹ That rule explains why a partner is allowed to deduct a loss for any unallocated outside basis if the only properties the partner receives are cash, unrealized receivables, and inventory. If the partner receives more than one property, the manner in which basis is allocated among the properties is set forth in section 732(c).

V. NONLIQUIDATING GUARANTEED PAYMENTS MADE IN KIND

If an employer pays an employee's salary by paying the employee with property in kind, the employer will recognize gain or loss to the extent that the property is appreciated or depreciated.⁴⁰ The reason that gain or loss is recognized in such cases is that the employer is satisfying a debt with appreciated or depreciated property, and so there was an exchange of the property for the debt. Putting it differently, the transaction can be viewed as one in which the employer constructively paid the employee cash equal to the value

34. See IRC §§ 731(b), 751(b).

35. IRC § 732(b).

36. IRC § 732(c)(1)(A)(i).

37. *Id.* For this purpose, there is no requirement that the inventory be substantially appreciated. You will recall that the definitions of the terms "unrealized receivables" and "inventory" in IRC § 751 are broader than the usual definitions of those terms. See *supra* note 19.

38. IRC § 732(c)(1)(B)(i).

39. IRC § 731(a)(2).

40. See, e.g., *McKee*, *supra* note 2, ¶ 13.03[5] (citing cases therein); see also, *United States v. Davis*, 370 U.S. 65 (1962) (applying the same concept in a different context).

of the property, and the employee then constructively used that cash to purchase the property. In such circumstances, the employee's basis in the property is equal to its fair market value, i.e., the employee is treated as if he purchased the property for cash in an amount equal to its value. If the employee was not permitted to take a basis equal to value, there would be double taxation when the employee sold the asset if it were appreciated at the time the employee received it. A major issue then is whether, for purposes of gain or loss recognition and for determination of basis, a guaranteed payment made in kind to a partner for services is to be treated as if it were made by an employer (a separate entity) to an employee.

As noted above, section 707(c) states that a guaranteed payment is to be treated as having been made to a person who is not a member of the partnership "*but only for the purposes of* section 61(a) (relating to gross income) and, subject to section 263, for purposes of section 162(a)(relating to trade or business expenses)."⁴¹ In other words, a guaranteed payment constitutes ordinary income to the partner and is deductible by the partnership unless the payment constitutes a capital expenditure. The "*but only for the purposes of*" language of the statute strongly suggests that for all other purposes the payment is treated as a distribution to a partner. The regulations construing this provision reiterate the statutory language and state that the partner's income from the payment is to be reported in the partner's "taxable year within or with which ends the partnership taxable year in which the partnership deducted" the payment under its method of accounting.⁴² The regulation further states:

Guaranteed payments do not constitute an interest in partnership profits for purposes of sections 706(b)(3), 707(b), and 708(b). For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income. Thus, a partner who receives guaranteed payments for a period during which he is absent from work because of personal injuries or sickness is not entitled to exclude such payments from his gross income under section 105(d). Similarly, a partner who receives guaranteed payments is not regarded as an employee of the

41. IRC § 707(c) (emphasis added).

42. Regs. § 1.707-1(c). This timing rule is the same as the one for the timing of a partner's recognition of his distributive share of partnership income or other tax items. IRC § 706(a). So, the timing of recognition depends upon the accounting method used by the partnership. Note that IRC § 267(a)(2), deferring a deduction for accruals of obligations to a related person in certain circumstances, does not apply to guaranteed payments. IRC § 267(e)(4).

partnership for the purposes of withholding of tax at source, deferred compensation plans, etc.⁴³

Section 707(c) was first adopted as part of the 1954 Code. Prior to its adoption, guaranteed payments were treated as partnership distributions for all purposes. That treatment caused complexity and led to incongruous results when the guaranteed payments exceeded the partnership's income for that year. As previously noted, the "but only for the purposes of" language in the statute was first included in the provision by the Senate Finance Committee, which explained the reason for its insertion as follows:

In the case of guaranteed salary payments your committee followed the House bill but made it clear that such income is to be reported for tax purposes at the end of the partnership year in which it is paid and that this treatment is only provided for purposes of the reporting of the income by the partner and the deducting of the payments by the partnership.⁴⁴

The language employed in section 707(c) is in sharp contrast to the language of section 707(a) which treats a salary payment made to a partner in a capacity other than his position as a partner as a payment to one who is not a partner; and, unlike the section 707(c) provision, the section 707(a) treatment is not limited to several specified Code provisions.⁴⁵

Contrary to the restrictive language of section 707(c) limiting non-partner treatment to three Code provisions, the regulations describe several other statutory provisions for purposes of which a guaranteed payment is not

43. Regs. § 1.707-1(c). In a much criticized decision of the Fifth Circuit, the court held that a partner who deals with the partnership in a capacity other than that of a partner can be treated as an employee for purposes of other provisions of the Internal Revenue Code, but the decision relates to a IRC § 707(a) relationship rather than to a IRC § 707(c) relationship. *Armstrong v. Phinney*, 394 F.2d 661 (5th Cir. 1968). Even as to the Fifth Circuit's holding under § 707(a), the Service has stated that the court's decision is in error. General Couns. Mem. 34,173 (July 25, 1969). That General Counsel Memorandum further states that IRC § 707(c) treats a guaranteed payment to a partner as having been made to an employee only for the very limited purposes of applying the three statutory provisions listed in IRC § 707(c). See also, H.R. Conf. Rep. No. 83-2543, at 59 (1954), reprinted in 1954 U.S.C.C.A.N. 5280, 5319-20.

44. S. Rep. No. 83-1622, at 94 (1954), reprinted in 2 Internal Revenue Acts of the United States: The Revenue Act of 1954 with Legislative Histories and Congressional Documents (Bernard D. Reams, Jr. Ed., 1982).

45. Accordingly, the timing for reporting income and deductions from a § 707(a) salary payment is determined by the accounting method employed by the partner. IRC § 267(a)(2), (e)(1). See Lind, *supra* note 2, at 226-227.

treated as a distribution to a partner.⁴⁶ The regulation under section 707(c) itself states that a guaranteed payment is not taken into account in determining a partner's percentage interest in partnership profits for purposes of sections 706, 707, and 708, even though those sections are not mentioned in the statute.⁴⁷ A key question then is to what extent a guaranteed payment under section 707(c) is to be treated as made to one who is not a partner for purposes other than income recognition by the partner and deductibility by the partnership. That question incorporates the age-old conflict of whether a partnership should be treated as a separate entity or merely as a representative of the aggregate of interests of its partners. Under an aggregate approach, a partnership is treated as a mere conduit from which its tax items are allocated among its partners. To the extent that section 707(c) treats a guaranteed payment as a partnership distribution, it accords with the aggregate or conduit approach; whereas, to the extent it treats the payment as having been made to a stranger, it adopts a separate entity approach.

In adopting Subchapter K, Congress decided that it is not desirable to treat a partnership exclusively either as an entity or as an aggregate of interests. Instead, in Subchapter K, a partnership is treated as a separate entity for some purposes and as an aggregate of interests and a conduit for other purposes. Rather than slavishly adhering to consistency, Congress chose a pragmatic approach which adopted entity treatment when that suited its purpose and aggregate treatment when that did so.⁴⁸ Not only do different sections of the Code reflect this flexibility, but even a single section (e.g., section 751) can apply entity and aggregate treatment for different parts of the provision. Indeed, as noted above, section 707(c) itself reflects that dual approach. It treats the partnership as an entity to the extent that it requires the partner to recognize ordinary income and grants the partnership a deduction; and it applies aggregate or conduit treatment to the extent that the payment is treated as a partnership distribution.

There is no indication that Congress gave any thought to the question of the partnership's gain or loss recognition and the partner's basis when it adopted section 707(c). One likely reason for its failure to consider those issues is that Congress did not contemplate the possibility that guaranteed payments would be made in kind. Operating guaranteed payments typically are not made in kind, and Congress likely did not consider the consequence of including guaranteed payments in the characterization of liquidating distributions. To the

46. See *infra* text accompanying notes 49 and 50.

47. Regs. § 1.707-1(c).

48. In the Conference Report on the Internal Revenue Code of 1954, Congress indicated that its decision to apply entity or aggregate treatment depending upon which was more appropriate to the occasion applied also to transactions between a partnership and its partners. H.R. Conf. Rep. No. 83-2543, *supra* note 43, at 59, reprinted in 1954 U.S.C.C.A.N. at 5319-20.

extent that legislative intent can bear on the resolution of the instant questions, the intent will have to be extrapolated from the meager history that is available and from the assumption that Congress would wish the statute to be construed in a manner that arrived at results that conform to the broad policies that underlie Subchapter K.

It seems clear that the restriction in section 707(c) to treat a guaranteed payment as having been made from a separate entity only for purposes of three Code sections cannot be taken at face value. While there are many provisions for whose purposes a guaranteed payment is treated as a partnership distribution (and so not a payment from a separate entity),⁴⁹ there also are a number of circumstances, not listed in the statute, in which it is treated as a payment from a separate entity. As noted above, the regulations under section 707(c) list several provisions (not listed in the statute) for purposes of which the partnership is given entity treatment in making a guaranteed payment.⁵⁰ Other examples of entity treatment exist. For example, the regulatory rules under section 704, requiring for certain purposes that capital accounts of partners be maintained in a specified manner, state that a guaranteed payment to a partner is not treated as a partnership distribution, and so the payment reduces the partner's capital account only to the extent that a resulting deduction allowed to the partnership is allocated to that partner.⁵¹ If the payment were treated as a partnership distribution, which is an aggregate or conduit treatment, the amount of the distribution would reduce the partner's capital account.⁵²

Although there are exceptions to the statutory language limiting entity treatment for guaranteed payments to three Code sections, the statutory limitation creates a presumption that, for purposes other than those three Code sections, the payment will be treated as a partnership distribution; and so there is a burden on those who would seek to expand the entity treatment to demonstrate that there is a compelling reason to do so. One of the reasons, but not the only one, that the authors have concluded that a partnership does not recognize gain or loss on making a guaranteed payment in kind is that there is no compelling reason to depart from the statutory limitation on entity treatment in that case. That is, as we will show later, the non-entity treatment of not recognizing a gain or loss not only does not conflict with any of the policies of Subchapter K or provide a means for escaping from potential tax liability, but rather implements one of the prime principles of Subchapter K, i.e., the

49. For example, a guaranteed payment is not subject to employment taxes or withholding, and so is treated as a partnership distribution for those purposes. Regs. § 1.707-1(c). Instead, a guaranteed payment made for services is treated as self-employed income of the partner. IRC § 1402(a)(13); Regs. § 1.1402(a)-1(b).

50. Regs. § 1.707-1(c). See *supra* text accompanying note 43.

51. Regs. § 1.704-1(b)(2)(iv)(o).

52. Regs. § 1.704-1(b)(2)(iv)(b).

principle that in transactions between a partner and a partnership, recognition of gain or loss should be deferred to a later date.

Nonrecognition of gain does create one relatively minor potential for tax reduction that is discussed in Part V.B. In the view of the authors, that potential is not of sufficient significance to warrant departing from the normal Subchapter K design for nonrecognition or from the express statutory limitation in section 707(c).

A. Effect on Outside Basis of a Guaranteed Payment Made in Cash

As noted above, not all of the circumstances in which entity treatment is applied to guaranteed payments are set forth in the statute or the regulations. Entity treatment should prevail in circumstances where failure to do so would produce unsavory consequences. No statute should be construed in such manner as to lead to results that fly in the face of reason.

For example, consider the effect that a guaranteed payment that was made in cash has on the partner's outside basis in his partnership interest. Sections 705(a)(2) and 733 require that a partner's outside basis in his partnership interest be reduced (but not below zero) by the amount of cash the partner received as an operating partnership distribution. Since neither of those two sections is one of the three Code sections that section 707(c) states to be the *only* provisions for which entity treatment is to be applied, a literal application of section 707(c) and the regulations would require a partner to reduce his outside basis by the amount received. But, that would reach an anomalous result. Since the payment constitutes ordinary income to the partner, it would be wrong to reduce the partner's outside basis, the effect of which would be to treat the payment as a return of the partner's capital. Accordingly, the authors conclude that a partner's outside basis is not reduced by a guaranteed payment, whether made in cash or in kind, except to the extent of the partner's share of any deduction the partnership obtained from the payment. The effect on outside basis therefore will be identical to the effect that the regulations provide that the payment has on a partner's capital account.⁵³

In the area of partnership taxation, it frequently is the case that an examination of a partnership's financial balance sheet makes a problem more understandable and the correct results become easier to reach. While it is not necessary to examine a balance sheet to see that a partner's outside basis should not be reduced by a guaranteed payment because that is fairly obvious, let us see

53. See *supra* text accompanying note 51.

what a balance sheet displays. Throughout this article, the authors will use a “book/tax” type of balance sheet.⁵⁴

As of December 30, Year One, the P general partnership had three equal partners, X, Y, and Z. Apart from the effect of making the guaranteed payment described below, P had no net income or loss in Year One. P’s assets consisted of cash, Capital Asset # 1, and Capital Asset # 2. P had no liabilities, and the adjusted basis and book values of its assets and of its partners’ capital accounts were as follows:

Assets			Liabilities and Partners’ Capital		
	A.B.	Book		Liabilities – None	
				Partners’ Capital	
				A.B.	Book
Cash	\$60,000	\$60,000			
CA # 1	\$40,000	\$60,000			
CA # 2	<u>\$20,000</u>	<u>\$60,000</u>	X	\$40,000	\$60,000
Total	\$120,000	\$180,000	Y	\$40,000	\$60,000
			Z	<u>\$40,000</u>	<u>\$60,000</u>
			Total	\$120,000	\$180,000

On December 30, P made a guaranteed payment of \$12,000 cash to X for services performed by X in her capacity as a partner. The payment was ordinary income to X and was deductible by P under section 162 as a business expense. The guaranteed payment to X does not affect X’s capital account, which remains unchanged except for any effect that the deduction that P obtained from the payment will have. Let us leave open for the moment the effect that the payment will have on X’s outside basis of \$40,000 in her partnership interest.

Since, apart from the effect of the deduction for the guaranteed payment, P had no net income or loss for that year, the deduction caused P to have a loss of \$12,000 for the year. One-third of that loss (\$4,000) is allocated to each partner who can deduct it and whose outside basis and capital account are reduced by that amount.⁵⁵ Consequently, the capital accounts of each of the partners after the payment was made is \$56,000 (\$60,000 minus each’s \$4,000 share of the loss). Each partner’s outside basis would also be reduced by \$4,000,

54. A “book/tax” balance sheet is a financial statement that shows the book value and the adjusted basis of the partnership’s assets, the amount of the partnership’s liabilities, and the adjusted basis and book value of the partners’ capital accounts. See Lind, *supra* note 2, at 35, n. 5.

55. IRC § 705(a)(2), and Regs. § 1.704-1(b)(2)(iv)(b) (7), 1(b)(2)(iv)(o). Even if P had had net income that year, each partner’s share of the deduction would have reduced that partner’s outside basis and capital account since it would have reduced the amount by which their basis and capital account otherwise would have been increased by their share of P’s income. In this example, we have simplified the facts by making P have a loss, but the operation of the rule would be the same if P had net income.

and so each would have an outside basis of \$36,000. The question remaining is what effect the guaranteed payment has on X's outside basis, apart from the effect of her share of the deduction.

Before the guaranteed payment was made, each partner would have had a gain of \$20,000 if he had sold his partnership interest for its book value (i.e., \$60,000 book value minus \$40,000 outside basis). That is, each partner had unrealized appreciation of \$20,000 in his partnership interest. If no adjustment is made to X's outside basis for the guaranteed payment, each partner will continue to have unrealized appreciation of \$20,000 (i.e., \$56,000 book value minus \$36,000 outside basis). This is the correct result since nothing happened other than P's having incurred a loss of \$12,000; and since each partner can deduct his share of that loss, there is no reason that the amount of any partner's unrealized appreciation should have changed.

While X did recognize \$12,000 of ordinary income, her one-third interest in the \$60,000 of appreciation in partnership assets was unaltered; and so there should be no change in the amount of gain she will recognize on a sale of her partnership interest. The \$12,000 of income that X recognized has no relationship to her share of partnership assets.

If, contrary to the authors' view, the guaranteed payment to X were deemed to reduce her outside basis in her partnership interest, X would have an outside basis of only \$24,000; and so X would recognize a gain of \$32,000 on a sale of her partnership interest for its book value (\$56,000 book value minus \$24,000 outside basis). The \$12,000 that X received from P was included in her ordinary income, and so there is no justification for having that payment increase the amount of gain she would recognize on a sale of her interest.

It must be acknowledged that the tax scheme employed by Subchapter K will not always yield an optimum result. Since Congress chose not to apply exclusively either an entity or an aggregate approach, there will be some inconsistencies of treatment. However, the partnership tax provisions should be construed to avoid an obviously improper result when there is no statutory language requiring that result and there is no external reason for imposing it. To require X to reduce her outside basis in her partnership interest by the \$12,000 guaranteed payment would be capricious.

For the same reasons, a guaranteed payment made in kind will affect the service partner's outside basis only to the extent of the partner's share of the deduction allowed to the partnership under section 162. Since the amount of the partnership's deduction is equal to the fair market value of the property, the book value of the property must be changed to equal its fair market value immediately before the payment is made; and the difference between the property's new and old book values must be allocated among the partners' capital accounts according to their percentage interests in the partnership.

Consequently, the book value of property used to make a guaranteed payment will equal its fair market value at the time the payment takes place.⁵⁶

B. Partnership's Recognition of Gain or Loss

As noted above, if a partnership makes a guaranteed payment in kind, and the property is appreciated, the partnership will recognize income if that payment is treated as one made by an entity to an employee;⁵⁷ but it will not recognize income if the payment is treated as a partnership distribution (i.e., a non-entity treatment).⁵⁸ The problem is that the guaranteed payment is treated as a payment to an employee for some purposes but not for others. The literal language of section 707(c) would treat the payment as having been made to an employee only for purposes of three Code sections, one of which is section 61(a). It could be contended that the statutory reference to section 61(a) incorporates the provision in section 61(a)(3) that gross income includes "gains derived from dealings with property." While noting that possibility, the McKee treatise rejects it because section 61(a)(3) does not refer to losses, and so reliance on that approach would conflict with the case law treatment of payments in kind to employees where either gain or loss can be recognized.⁵⁹ More importantly, it seems clear that Congress referred to section 61(a) only for the purpose of causing the payment to be treated as ordinary income to the recipient, and Congress never gave any thought to the treatment to be accorded payments made in kind.

In addition to the suggestion in the language of the statute that a guaranteed payment is to be treated as a partnership distribution for all purposes other than the three mentioned in the statute, there are policy reasons for finding that the partnership does not recognize gain or loss on making a guaranteed payment in kind.

One of the prime principles of Subchapter K is to defer the recognition of income or loss when property is distributed to a partner to the extent that deferral is feasible and does not create an opportunity for significant tax evasion. Presumably, Congress chose a deferral system because it removes a tax deterrent to making a partnership distribution that a requirement of immediate recognition would impart and because it conforms to a non-entity

56. Since the partnership deducts the fair market value of the property, it is necessary to change its book value and the capital accounts of the partners so that the actual value of the partners' interests in the partnership will be reflected in those capital accounts. The treatment so accorded to guaranteed payments is the same in this respect as the treatment accorded to partnership operating distributions of property. See *supra* text accompanying notes 27 and 28.

57. See *supra* text accompanying note 40.

58. See *supra* text accompanying note 17.

59. McKee, *supra* note 2 at ¶13.03(5), n. 174.

characterization of a partnership. Prior to the adoption of section 707(c), in most circumstances, a salary payment to a partner in his capacity as such was treated as having come from a non-entity and having significance only in being a source for the allocation of partnership income among the partners; but that treatment was subject to arbitrary variations which sometimes were difficult to predict. Congress adopted section 707(c) to provide more consistent and predictable rules. It seems highly unlikely that in making that simplifying change, Congress would have wished to depart from its normal rule of deferral for the appreciated or depreciated element of distributed property. Moreover, as shown below, if the partnership were required to recognize gain or loss, that would cause a greater amount of complexity than that which Congress sought to remove by adopting the guaranteed payment provision.

Consider the circumstance described in Part III of this article where a partnership provides that a service partner is to receive a percentage of partnership income, computed before taking guaranteed payments into account, but no less than a specified dollar amount. As explained in Part III, if the service partner's percentage of income is less than the specified amount, the difference is a guaranteed payment. What if the payment to the service partner were made with appreciated property? Part of the property would then be a partnership distribution, on which the partnership would not recognize income,⁶⁰ and part would be a guaranteed payment. If the partnership were deemed to recognize gain on making a guaranteed payment, it would have to apportion the partnership's inside basis in the property between the part of the transaction that is a partnership distribution and the part that is a guaranteed payment; and then one portion of the property would not cause income recognition to the partnership and the remaining portion would cause income recognition. It seems highly unlikely that Congress would wish income recognition consequences to be split in that manner just because part of the payment is guaranteed. That would make income recognition turn on somewhat artificial distinctions, which would contravene one of the purposes for the adoption of section 707(c), namely, to eliminate the arbitrariness that existed in the pre-1954 Code's method of determining the extent to which a salary payment is included in a service partner's income.

Splitting income recognition between the two parts of a distribution could cause another complication unless excluded by the partnership agreement. The determination of the portion of the distribution that is treated as a guaranteed payment depends upon the dollar amount of the partner's share of partnership profits. An increase in partnership profits will reduce the share of the distribution that constitutes a guaranteed payment. Unless the partner's share of profits is to be determined by excluding any gain or loss incurred by the

60. IRC § 731(b).

partnership as a consequence of making the guaranteed payment,⁶¹ an increase in partnership income because of the gain recognized from making the guaranteed payment would reduce the amount of the guaranteed payment, which in turn would reduce the amount of gain the partnership recognized on the transaction and thereby would increase the amount of the guaranteed payment and thereby increase the gain recognized, and so on. The mutual dependency of the figures for the amount of the partnership's gain and the amount of its guaranteed payment can be solved by use of an algebraic formula; but nevertheless, in the interests of administrative ease, it is desirable to avoid a scheme of recognition that might require that calculation to be made.

The complexity of requiring income recognition for guaranteed payments is exacerbated if the partnership has an election under section 754 in effect. If a partnership makes a section 754 election, it triggers the operation of two Code provisions: sections 734(b) and (c), and 743(b) and (c). Once section 754 is elected, those two Code sections continue to apply to the partnership until the election is revoked by the partnership with the permission of the District Director.⁶² A partnership's basis in its assets is sometimes referred to as its "inside basis." Section 743(b) operates by providing a different inside basis for some partners' purposes when there has been a transfer of a partnership interest by death or by a sale or exchange. So, when a section 754 election is in effect, it is possible that each partner's share of the gain or loss recognized on a sale of a partnership asset may have to be determined by using a different inside basis for the asset. The operation of section 743(b) is illustrated in the following example.

The P partnership has three equal partners, A, B, and C. P has an inside basis of \$60,000 in Land, which had a value of \$210,000. If there had been no section 754 election, each partner's share of P's inside basis would be \$20,000; and a sale of Land for its value would cause each partner to recognize a \$50,000 gain. But, since P had made a valid section 754 election, and since each partner had either purchased his partnership interest from a prior partner or had inherited it on the death of a prior partner, the amount of each partner's share of P's inside basis in Land is different. By virtue of section 743(b), P's inside basis for one-third of the Land for purposes of A's interest is \$40,000; P's inside basis for one-third of the

61. The gain or loss from making the guaranteed payment would be excluded, for example, if the partnership provision that the partner is to receive a percentage of partnership income "computed before taking guaranteed payments into account" is construed to exclude a gain or loss recognized on the constructive sale of the distributed property as well as the deduction allowed for making that payment.

62. Regs. § 1.754-1(c).

Land for purposes of B's interest is \$60,000; and P's inside basis for one-third of the Land for purposes of C's interest is \$70,000. If P were to sell the Land for its value of \$210,000, A would have a gain of \$30,000 allocated to him (i.e., \$70,000 (one-third of the selling price) minus A's \$40,000 share of the inside basis); B would have a gain of \$10,000 allocated to him, and C would have no gain or loss.

In the circumstance where a payment of appreciated property to a service partner is partly a guaranteed payment and partly a partnership distribution, and where the amounts of the partners' share of inside basis in partnership assets differ because a section 754 election is in effect, if the partnership must recognize gain or loss on the guaranteed payment portion of the distributed property, not only will the inside basis of each asset that was distributed have to be apportioned between the guaranteed payment portion and the partnership distribution portion, but there would have to be a separate calculation and apportionment made for every partner's share.⁶³ Especially when there are a sizeable number of partners, all of whom have special shares of inside basis, that could be burdensome.

In opposition to the point made above, it might be urged that Congress accepted a bifurcation of income recognition when it adopted section 751(b) to require gain or loss recognition for some properties in certain circumstances involving partnership distributions. But, section 751(b) is an extraordinary provision that was adopted to prevent an abusive use of the partnership tax provisions by shifting the characterization of income among several partners. Congress considered that potential abuse to be of such importance that it justified a limited intrusion into its broadly utilized principle of deferring gain or loss when partnership distributions are made.

Let us look at the one potential abuse that arises from the authors' proposals for nonrecognition treatment and (as discussed in Part V.C.) for a basis in the distributed property equal to its fair market value.

63. It is true that, regardless of whether gain is recognized by a partnership on making a guaranteed payment in kind, the partnership's inside basis in each distributed asset will have to be split between the guaranteed and distributed portions in order to determine the basis that the service partner acquired in the property; and the service partner's special share of inside basis under IRC § 743(b) would have to be taken into account for that purpose. But, if gain is not recognized by the partnership, there is no need to calculate each of the other partners' share of inside basis. Also, as explained in Part VI, while a division of basis will be needed if the distribution part of the transaction is an operating distribution, no division will be needed for a liquidating distribution except for a distribution of unrealized receivables and inventory; and unrealized receivables will have a zero basis, which imposes no difficulties of division.

The potential abuse is that the character of a deferred gain can be changed by manipulation of the properties distributed as the guaranteed payment. If appreciated ordinary income property is used to make a guaranteed payment, and if, as the authors propose, the basis of that property in the hands of the service partner becomes its fair market value, then the potential ordinary income that the partnership had in that property will have been converted to a potential capital gain in the partners' interests in the partnership. As shown in Part V.C., the partnership's unrealized appreciation or depreciation in the distributed property is reflected in the unrealized appreciation or depreciation of the partners' interests, and that is why it is proper for there to be no appreciation or depreciation built in to the distributed property in the hands of the service partner. But, when appreciated property that would have produced ordinary income when sold is used to make a guaranteed payment, that does result in a change of the character of the deferred income. In the view of the authors, that possibility is not of sufficient significance to warrant both abandoning the principle of nonrecognition that plays such a prominent role in Subchapter K and embracing the administrative complexity that recognition will engender.

While Congress did address a similar type of potential abuse when it adopted section 751(b), that provision has been subjected to severe criticism for its complexity and for having made a mountain out of a mole hill. In adopting that provision, Congress was not willing to eliminate all nonrecognition for distributions of property in which section 751(b) was implicated; that would have been too draconic. Instead, Congress required recognition only to the extent needed to prevent the abuse. The problem is that by focusing only on the abusive element, Congress introduced a complex and cumbersome structure that has proven very difficult to administer. Given that no similar structure has been adopted for guaranteed payments (and none would appear to be desirable),⁶⁴ the choice available for the construction of the currently applicable provision is either to deny nonrecognition entirely to guaranteed payments or to accept the potential for shifting of characterization as a relatively minor cost of the benefit of having nonrecognition so that ordinary transactions of this nature are not deterred. The latter course seems far more desirable given the strong sentiment in Subchapter K to allow nonrecognition so as to prevent the tax law from unnecessarily influencing legitimate business transactions.

64. The complexity of IRC § 751(b) has generated severe criticism and spawned recommendations for its repeal. See Lind, *supra* note 2, at 316, (quoting a statement in 1986 to a subcommittee of the House Ways and Means Committee). A provision requiring recognition of gain on making a guaranteed payment to the extent of the property's appreciation that would be taxed as ordinary income if the property were sold could be adopted only by a legislative amendment, and it is doubtful that such an amendment is desirable given the complexity it would engender.

In contrast to the weight that Congress accorded, in adopting section 751(b), to a concern over the possibility of shifting potential ordinary income to a potential capital gain, Congress deemed the goal of nonrecognition to be more important when it deferred cancellation of indebtedness income for insolvent taxpayers. Under section 108(a)(1)(B), a taxpayer does not recognize income for a cancellation of a debt of the taxpayer to the extent of the taxpayer's insolvency at that time, but the realized income typically is deferred by reducing a favorable tax attribute of the taxpayer's under section 108(b). The income that is realized from a cancellation of a debt is ordinary income. In some instances, under sections 108(b)(2)(E) and 1017, the tax attribute that is reduced to defer the recognition of that ordinary income is the taxpayer's basis in property that the taxpayer owns. Treasury Regulation section 1.1017-1(a) establishes an order of priority for the taxpayer's properties whose basis is to be reduced; and generally the basis of property that would produce a capital gain (or a comparable section 1231 gain) is reduced first. While that provision is less vulnerable to manipulation by the taxpayer, it does constitute a situation where it is possible for a taxpayer's ordinary income to be converted to a potential capital gain to be recognized at a later date. It does indicate that Congress is willing to allow ordinary income to be converted to capital gain in order to implement a system of nonrecognition.

The legislative history of section 707(c) demonstrates that Congress intended guaranteed payments to continue to be treated as partnership distributions, as they had been treated before section 707(c) was adopted, except that the determination of income to the partner and deductibility for the partnership were simplified and given more consistent treatment. It was only for those limited purposes that a guaranteed payment was to be treated as a payment from a separate entity. Entity treatment is applied in a few other circumstances, but only where it was needed to prevent results that would contravene basic tax principles.⁶⁵ This is in contrast to the treatment Congress proscribed for section 707(a) transactions, where Congress treated them as having been made between an entity and a third person for all purposes. A rule providing nonrecognition of gain or loss for the property used by the partnership to make a guaranteed payment to a partner is better attuned to the Congressional view of those payments.

Once a partner has received a guaranteed payment in kind, it is necessary to determine the basis that the partner will obtain in that property. Let us now turn to the basis issue.

65. For example, as noted above, a guaranteed payment does not reduce a partner's capital account or outside basis because that reduction would leave the partner with a capital account that is less than the value of his actual interest in the partnership and an outside basis that is less than the amount of capital that the partner still has invested in his partnership interest.

C. Basis of Property Received As A Guaranteed Payment.

The determination of basis of the property received is important not only for its own sake, but also because that determination could influence the decision whether the partnership should recognize a gain or loss.

If a section 707(c) guaranteed payment in kind were treated as an entity payment to a non-partner for the purpose of requiring the partnership to recognize gain or loss, the basis of the property in the hands of the partner would equal its fair market value. The partner's basis would be determined in the same manner as is the basis of property in the hands of an employee who received it as compensation from his employer.⁶⁶

But, what if, as the authors contend, the partnership does not recognize gain or loss; what is the partner's basis? The authors conclude that the partner nevertheless acquires a basis in the property equal to its fair market value. To see the consequences of the several alternative choices for basis, let us once again examine the problem from the perspective provided by a book/tax balance sheet approach.⁶⁷

P general partnership has three equal partners: A, B, and C. A is a service partner. In Year One, before taking into account the tax consequences of the guaranteed payment that P made to A and which is described below, P had neither a net income nor a net loss. As of December 31, Year One, P had \$35,000 cash, two capital assets, Land 1 and Land 2, and no liabilities. The book value of each of P's assets equals its fair market value. The book/tax balance sheet for P shows the following:

Assets			Liabilities and Partners' Capital		
	A.B.	Book		Liabilities – None	
				Partners' Capital	
				A.B.	Book
Cash	\$35,000	\$35,000			
Land 1	\$10,000	\$25,000			
Land 2	<u>\$15,000</u>	<u>\$30,000</u>	A	\$20,000	\$30,000
Total	\$60,000	\$90,000	B	\$20,000	\$30,000
			C	<u>\$20,000</u>	<u>\$30,000</u>
			Total	\$60,000	\$90,000

Note that the book value of the capital account for each partner equals that partner's share of the book value of the partnership. Thus, the appreciation in Land 1 and Land 2 that is reflected in the asset side of the balance sheet has already been included in the partners' capital accounts.⁶⁸ Consequently, a gain

66. See *supra* text accompanying note 40.

67. See *supra* note 54.

68. Under certain specified circumstances, the book value of partnership assets and of the partners' capital accounts can be written up or down to reflect a revaluation of the partnership's assets. Regs. § 1.704-1(b)(2)(iv)(f).

recognized by P on the disposition of either of those assets will not cause an increase in the partners' capital account if the gain does not exceed the appreciation already reflected in those accounts.

On December 31, Year One, P gave Land 2 to A as a guaranteed payment which qualified for a deduction for P under section 162. A recognized \$30,000 ordinary income, and P was allowed a deduction of \$30,000. The payment to A did not reduce his capital account except for his \$10,000 share of the \$30,000 deduction that P obtained. For reasons explained in Part VA of this article, the transaction did not reduce A's outside basis in his partnership interest except for the \$10,000 reduction caused by A's share of the deduction allowed to P. Let us consider what basis A obtained in Land 2 if, as the authors contend, P did not recognize a gain on making the payment to A.

The limiting language of section 707(c) suggests that a guaranteed payment should be treated as a partnership distribution for purposes of applying statutes other than the three listed in that subsection. However, as we showed in Part V.A., despite the language of the statute, a guaranteed payment will not be treated as a partnership distribution in circumstances where that treatment would contravene a fundamental tax principle. No tax principle could be of greater importance or more fundamental than the principle that gain should be measured accurately. As shown below, if the limiting language of section 707(c) were applied to the determination of a service partner's basis in property received as a guaranteed payment, that would greatly exaggerate the amount of gain that the service partner ultimately will recognize. Consequently, in the interest of measuring correctly the amount of a taxpayer's gain, the limiting language of section 707(c) should not be controlling.

As noted in Part IV of this article, the general rule is that when an operating partnership distribution is made in kind, an amount of the partner's outside basis in his partnership interest equal to the basis that the partnership had in that property immediately before the distribution is shifted to the property that the partner received.⁶⁹ Since, as we demonstrated in Part V.A. of this article, a guaranteed payment will not change a partner's outside basis (other than a reduction for the partner's share of the partnership's deduction for making the payment), that approach is not available for property received as a guaranteed payment. How then should the partner's basis in such property be determined? There are two principal choices:⁷⁰ either the partner's basis should

69. See *supra* text accompanying notes 23-26.

70. A third possibility would give the partner a zero basis in the property; but there is no justification for that position. A zero basis would leave the partner with a built-in gain for the property equal to its entire value (i.e., the entire value of the property would constitute appreciation), and that would be justified only if there were a tax reason to imbue the property with a potential gain because a gain that the taxpayer or someone else had realized had not been recognized. The only unrecognized gain here is the gain that the partnership realized, but did not recognize, on making the payment;

equal the fair market value of the property, or it should be equal to the basis that the partnership had in that property immediately before giving it to the partner. To make the proper choice, it is necessary to consider the principles that underlie the scheme that the Code employs to determine a partner's basis in property received as an ordinary operating partnership distribution.

A partner's outside basis reflects the appreciation or depreciation of the partner's interest in the partnership. To the extent that the value of a partner's interest is greater than his basis, the interest is appreciated. Ideally, a partner's share of the net unrealized appreciation of properties held by the partnership should be the same as the appreciation of the partner's interest in the partnership; but that will not always be the case because of a glitch in Subchapter K which is caused by sections 743(a) and 734(a).⁷¹ To cure that glitch, the Code provides an election in section 754, which provision is discussed in Part V.B.⁷²

A key aspect of the method that Congress employed to determine a partner's basis in property that was received as an operating distribution is that, immediately after receiving the distribution, the net appreciation or depreciation of the distributed property and of the partner's interest in the partnership will equal the amount of appreciation of the partner's interest in the partnership immediately before the distribution was made. The nonrecognition granted to partnership distributions is a deferral provision. The total amount of gain or loss that the partner potentially will recognize should not be altered because of the distribution of partnership property to him. The partner's potential gain or loss is kept intact, but is divided between his partnership interest and the distributed property.

When a partner receives property as a guaranteed payment, the partner is taxed on the entire value of that property, and the appreciation or depreciation of his interest in the partnership is unchanged. If the partner were given a basis in the property he received that is less than its value, then the net amount of aggregate appreciation of the partner's property and his partnership interest would be increased (or the net amount of depreciation would be decreased).

While granting nonrecognition for the partnership means that the appreciation or depreciation of the property in the partnership's hands is not recognized, that amount of appreciation or depreciation either is reflected in the

and so no appreciation in A's hands should exceed the amount of appreciation the property had in the hands of the partnership.

71. For example, unless an election is made under IRC § 754, a person buying a partnership interest from a former partner will have as his share of the partnership's inside basis in its assets the same amount that the former partner had even though the new partner paid an amount for that share of the partnership's assets that was greater or less than the former's partner's share of the inside basis for those assets. IRC § 743(a).

72. See *supra* text accompanying note 62. When IRC § 754 has not been elected, the Code provides limited relief in IRC § 732(d), under certain circumstances.

partners' interests in the partnership (and so potentially will be recognized by the partners at a later date);⁷³ or, if not reflected in the partners' interests, that is because there was no section 754 election in effect and the difference is caused by a glitch in the tax law.⁷⁴ The reason that this is so is explained later in this Part V.C. There is no reason to strain the application of the basis rules to perpetuate a glitch.

The reason for choosing fair market value for the partner's basis in the property is illustrated by examining the set of facts set forth above in the context of a book/tax balance sheet. The book/tax balance sheet for P just before P made the guaranteed payment of Land 2 to A was:

Assets			Liabilities and Partners' Capital		
	A.B.	Book		Liabilities – None	
Cash	\$35,000	\$35,000		Partners' Capital	
Land 1	\$10,000	\$25,000		A.B.	Book
Land 2	<u>\$15,000</u>	<u>\$30,000</u>	A	\$20,000	\$30,000
Total	\$60,000	\$90,000	B	\$20,000	\$30,000
			C	<u>\$20,000</u>	<u>\$30,000</u>
			Total	\$60,000	\$90,000

You will recall that P gave A Land 2 as a guaranteed payment, and A recognized \$30,000 ordinary income. We will assume that P did not recognize any of the \$15,000 gain it realized on that transaction. The book value of each of P's assets equals its fair market value. P received a deduction of \$30,000, which is divided equally among the three partners. As a result of that deduction, each partner's capital account and outside basis is reduced by \$10,000 (one-third of the deduction). The book/tax balance sheet for P immediately after the payment is as follows.

Assets			Liabilities and Partners' Capital		
	A.B.	Book		Liabilities – None	
Cash	\$35,000	\$35,000		Partners' Capital	
Land 1	<u>\$10,000</u>	<u>\$25,000</u>		A.B.	Book
Total	\$45,000	\$60,000	A	\$10,000	\$20,000
			B	\$10,000	\$20,000
			C	<u>\$10,000</u>	<u>\$20,000</u>
			Total	\$30,000	\$60,000

73. If another partner has an appreciated partnership interest that reflects his share of the partnership's appreciation in its inside assets, the appreciation of that partner's partnership interest will continue to reflect his share of the partnership's inside appreciation in the property that was used to make the guaranteed payment. So, the other partner will not escape the recognition of the deferred gain.

74. See *supra* note 71 and accompanying text (describing the glitch).

The \$10,000 amount of appreciation of each partner's interest in P is the same after the guaranteed payment was made (\$20,000 book value minus each partner's \$10,000 outside basis) as it was before that payment was made (\$30,000 book value minus each partner's \$20,000 outside basis). If, as the authors contend, A's basis in Land 2 equals its fair market value of \$30,000, then A's potential gain on a sale of both Land 2 and his partnership interest will be \$10,000. But, if instead A were given a \$15,000 basis in Land 2 (i.e., an amount equal to P's basis therein), A would have a potential gain of \$25,000 on the sale of both Land 2 and his partnership interest. Clearly, a gain of \$25,000 would be excessive.

Note, however, that the aggregate outside basis of the partners (\$30,000) is no longer equal to P's inside basis in its assets (\$45,000). Prior to the making of the guaranteed payment, there was \$30,000 appreciation in both P's inside assets and in the partners' partnership interests. The appreciation in the partners' partnership interests was unchanged by the payment, but \$15,000 of P's inside appreciation in Land 2 was removed from P and exists only as it continues to be reflected in the partners' appreciation in their partnership interests. The total potential amount of gain to be recognized was not changed. There was \$30,000 of potential gain before the payment was made, and the same amount afterwards. As we will see, the payment may change the timing of recognition and the character of the gain in certain circumstances.

Giving A a basis of \$30,000 in Land 2 provides A with the same overall amount of gain that he would have had if P had sold Land 2 to a stranger and then paid the proceeds to A as a guaranteed payment. In the case of a sale to a stranger, P would recognize a gain of \$15,000 of which \$5,000 would be apportioned to each partner. Each partner's outside basis would be increased by \$5,000, but his capital account would not be increased since the appreciation of Land 2 was already reflected in that account. The partnership would receive a deduction of \$30,000 for making the cash guaranteed payment to A of which \$10,000 would be apportioned to each partner. Each partner's capital account and outside basis would be reduced by \$10,000 for their share of the deduction. Each partner had an outside basis of \$20,000 before the sale took place; each would add \$5,000 for his share of the gain on the sale and deduct \$10,000 for his share of the deduction P obtained from making the guaranteed payment. So, after the guaranteed payment was made, each partner would have an outside basis of \$15,000 in his partnership interest, which would have a value of \$20,000. The net result for A is that A would have recognized \$5,000 on P's sale of Land 2 and another \$5,000 if he subsequently sells his partnership interest for its \$20,000 value. Thus, A would have the same amount of total income as is the case when Land 2 was paid to him as a guaranteed payment and he received a basis equal to its fair market value. Similarly, B and C would each continue to have \$10,000 of gain B \$5,000 recognized on the sale, and another potential \$5,000 when they dispose of their partnership interests.

While the amount of all of the partners' potential gain is the same whether P used Land 2 to make the guaranteed payment or sold Land 2 and paid the cash proceeds to A, the timing of recognition is different, and the character of the income could be different in some cases. In the case of the payment of Land 2 as a guaranteed payment, neither A nor the other partners will recognize income until they dispose of their partnership interest; whereas each would currently recognize \$5,000 of that potential gain if P instead sold Land 2. Perhaps that difference in the timing of recognition was a factor in the conclusion of the McKee treatise that P should recognize gain or loss on making a guaranteed payment in kind.⁷⁵ But, Congress went to great lengths in Subchapter K to prevent the recognition of income on a distribution to a partner to the extent that it is feasible to do so, and instead to defer any gain or loss. Only when there was a potential abuse, the prevention of which Congress deemed to be so important that it warranted abandoning the normal rule of deferral, did Congress impose recognition.⁷⁶ Since the nonrecognition of P's gain does not pose a significant risk of abuse,⁷⁷ the position adopted by the authors to adhere to the Congressional scheme of deferral is appropriate.

In the examples above, the book values of the assets that P held were the same as those assets' fair market values. What would be the consequence if the actual fair market value of the property used to make the guaranteed payment were different than its book value? In that case, immediately before the payment was made, the book value of the property would be changed to equal its fair market value, and the amount of the change would be allocated among the partners' capital accounts in accordance with their percentage interests in the partnership.⁷⁸ Consequently, the book value of the property will always equal its fair market value at the time the payment is made. To illustrate how this scheme operates, let us reexamine the example above after changing the facts so that the actual fair market value of Land 2 is \$39,000 even though its book value is only \$30,000. The book/tax balance sheet, prior to the making of the guaranteed payment, and showing actual values as well as book values, would be:

75. McKee, *supra* note 2 at ¶13.03[5].

76. See, e.g., IRC § 751(b).

77. One possible area of abuse was noted in Part V.B. If a partnership were to use appreciated ordinary income property to make a guaranteed payment, then the deferral of the ordinary income on that property by reflecting it in the partners' partnership interests will alter the character of the income from ordinary to capital gain. As stated in Part V.B., that possibility should be regarded as a minor cost of obtaining the otherwise wholly desirable goal of nonrecognition. Ordinary income conversion likely will occur infrequently and is such a minor element of the picture, it should not be deemed to be of sufficient importance to warrant a distortion of what otherwise is the proper treatment of the transaction. In other words, the tail should not wag the dog.

78. See *supra* note 56 and accompanying text.

	Assets			Liabilities and Partners' Capital			
	A.B.	Book	FMV	Liabilities – None			
Cash	\$35,000	\$35,000	\$35,000	Partners' Capital			
Land 1	\$10,000	\$25,000	\$25,000	A.B. Book FMV			
Land 2	<u>\$15,000</u>	<u>\$39,000</u>	<u>\$39,000</u>	A	\$20,000	\$30,000	\$33,000
Total	\$60,000	\$90,000	\$99,000	B	\$20,000	\$30,000	\$33,000
				C	<u>\$20,000</u>	<u>\$30,000</u>	<u>\$33,000</u>
				Total	\$60,000	\$90,000	\$99,000

P gives Land 2 to A as a guaranteed payment. A has \$39,000 ordinary income, and P is allowed a deduction of \$39,000 for making that payment. One-third of the deduction (\$13,000) is allocated to each partner and will reduce each partner's outside basis and capital account. Immediately prior to the payment, the book value of Land 2 will be increased to \$39,000; and one-third of the \$9,000 increase in book value (\$3,000) will be allocated to each partner's capital account. Before taking into account the actual making of the guaranteed payment and the resulting deduction allowed to P, the book/tax balance sheet for P would be:

	Assets			Liabilities and Partners' Capital			
	A.B.	Book	FMV	Liabilities – None			
Cash	\$35,000	\$35,000	\$35,000	Partners' Capital			
Land 1	\$10,000	\$25,000	\$25,000	A.B. Book FMV			
Land 2	<u>\$15,000</u>	<u>\$30,000</u>	<u>\$39,000</u>	A	\$20,000	\$33,000	\$33,000
Total	\$60,000	\$99,000	\$99,000	B	\$20,000	\$33,000	\$33,000
				C	<u>\$20,000</u>	<u>\$33,000</u>	<u>\$33,000</u>
				Total	\$60,000	\$99,000	\$99,000

The balance sheet shows that each partner has \$13,000 of appreciation in their partnership interest. This is the actual amount of their appreciation since the book value of Land 2 now equals its actual value.

If Land 1 also had a different value than its book, that difference will not be reflected in the partners' capital accounts until the item is sold or some event occurs to permit a change of its book value.

P now makes the payment of Land 2 to A. The \$39,000 deduction allowed to P is allocated among the three partners, and each partner reduces his outside basis and his capital account by \$13,000 (one-third of the deduction). Consequently, each partner has an outside basis of \$7,000, and a capital account of \$20,000. The \$13,000 of appreciation that each partner had in his partnership interest was not changed by the payment of the guaranteed payment. Each partner continues to have the same \$13,000 potential gain that he had before the payment was made. After the payment, P's balance sheet would be:

Assets			Liabilities and Partners' Capital		
	A.B.	Book	Liabilities – None		
			Partners' Capital		
			A.B.	Book	
Cash	\$35,000	\$35,000			
Land 1	<u>\$10,000</u>	<u>\$25,000</u>			
Total	\$45,000	\$60,000	A	\$7,000	\$20,000
			B	\$7,000	\$20,000
			C	<u>\$7,000</u>	<u>\$20,000</u>
			Total	\$21,000	\$60,000

If P then sold Land 1 for its \$25,000 value, each partner would recognize a \$5,000 gain and would increase his outside basis by that amount. If a partner then sold his partnership interest for its \$20,000 value, he would have a gain of \$8,000. The partner's total gain would be \$13,000 (\$5,000 from P's sale of Land 1 and \$8,000 from the sale of his partnership interest).

Let us turn to the situation where a partner's outside basis does not correspond with the partnership's inside basis. One circumstance in which that can occur is when a person purchased a partnership interest from a former partner or inherited a partnership interest.⁷⁹ In those circumstances, the new partner's outside basis will equal what the partner paid for it or, in the case of an inheritance, will be the basis determined by section 1014. Consider again the facts of the P partnership that are discussed above with the changes that: (1) before the guaranteed payment was made, D had purchased A's partnership interest for \$30,000, and (2) the guaranteed payment of Land 2 was made to D for her services. Before the guaranteed payment was made, the book/tax balance sheet for P was as follows.

Assets			Liabilities and Partners' Capital		
	A.B.	Book	Liabilities – None		
			Partners' Capital		
			A.B.	Book	
Cash	\$35,000	\$35,000			
Land 1	\$10,000	\$25,000			
Land 2	<u>\$15,000</u>	<u>\$30,000</u>	D	\$30,000	\$30,000
Total	\$60,000	\$90,000	B	\$20,000	\$30,000
			C	<u>\$20,000</u>	<u>\$30,000</u>
			Total	\$70,000	\$90,000

The disparity between D's \$30,000 outside basis and her \$20,000 share of P's inside basis would be cured if a section 754 election were in effect, but no election has been made. This is one of the circumstances where a glitch in Subchapter K arises. If P were to sell Land 2 for its value of \$30,000, each partner, including D, would recognize one-third of the \$15,000 gain that P had. But, of the \$30,000 that D paid for the partnership interest, \$10,000 was paid

79. See supra note 71.

for her one-third share of Land 2; and so D should have no gain when P sold the Land. If a section 754 election were in effect, D would not have a gain from P's sale; but no election was made.

Instead of selling Land 2, P gave it to D as a guaranteed payment for services. Following the conclusions described above, P will not recognize any gain; and D will take a basis of \$30,000 in Land 2. D's outside basis will be reduced by her one-third share of P's \$30,000 deduction to \$20,000, which also is the value of her one-third share of the partnership after Land 2 was removed from the partnership's assets. Thus, D will have no appreciation either in Land 2 or in her partnership interest. That is the proper result since D had no appreciation in her partnership interest before receiving the payment and would have recognized a gain from a sale of the land by P only because of a glitch in the tax law. There is no reason to feel aggrieved when that glitch is avoided by P's having used Land 2 to make the guaranteed payment.

The nonrecognition of P's gain on giving Land 2 to D means that B and C will not recognize income at that time. Will each's \$5,000 share of P's realized gain ever be recognized? The answer is that their share of the appreciation of P's properties is reflected in the appreciation of their partnership interest, and so the deferred gain will be recognized when they sell their partnership interest. Take B's situation for example. B had appreciation of \$10,000 in his partnership interest before the guaranteed payment was made (\$30,000 book value minus his \$20,000 outside basis). P's delivery of Land 2 to D as a guaranteed payment does not relieve B of any of his potential gain. B's outside basis of \$20,000 is decreased by his \$10,000 share of the \$30,000 deduction that P obtained from making the guaranteed payment, and B's capital account is reduced by the same amount. B then has an outside basis of \$10,000, and the value of his partnership interest (i.e., his capital account) is reduced to \$20,000. Consequently, B continues to have a potential gain of \$10,000.

VI. LIQUIDATING DISTRIBUTIONS

The same reasons that are described above for providing nonrecognition to the partnership for making operating guaranteed payments in kind and providing the service partner with a basis in the property equal to its fair market value apply equally to guaranteed payments made in kind in conjunction with a liquidating distribution (i.e., a distribution in liquidation of a partner's interest in the partnership). Guaranteed payments in kind will occur far more frequently in connection with a liquidation of a partner's partnership interest than in the context of an operating payment. This is especially true when the partnership itself is liquidated so that all of its assets are distributed to its partners. Consequently, liquidating distributions are where the issues and disputes are most likely to arise.

You will recall that when the property distributed in liquidation, whether under section 736(a) or (b), has a book value that differs from its fair

market value, the book value will be changed to equal its fair market value; and the difference in values is allocated proportionately among partners' capital accounts.⁸⁰

Liquidating distributions are divided by section 736 into two camps, with a subdivision within one of the camps. Section 736(b) applies to distributions that are made to a retiring or deceased partner in exchange for the partner's interest in partnership property. Distributions in exchange for two classes of partnership property are excluded from section 736(b), but only if the distributee was a general partner and if capital was not a material income-producing factor for the partnership. In general then, payments for those two classes of property are excluded from section 736(b) only in the case of a liquidation of a general partner's interest in a service partnership. The two classes of property that are excluded in such cases are: unrealized receivables (as defined in section 751(c)) and good will unless the partnership agreement provides for a payment for good will.

All liquidating payments that do not fall within section 736(b), including payments for the two classes of property mentioned above, are treated by section 736(a) either as a guaranteed payment if determined without regard to partnership income or as a distributive share of partnership income if determined with regard to partnership income. A guaranteed payment will be ordinary income to the partner and deductible by the partnership.⁸¹

It is common for the liquidation of a partner's interest to include a premium, that is, a payment in excess of the amount of the indicated value of the partner's share of partnership property. If the amount of the premium is not determined by reference to partnership income, it will be a guaranteed payment.

If a partnership distributes more than one item of property to a service partner as a liquidating distribution, and if only part of the distribution is a guaranteed payment, how are the several distributed properties to be assigned between the portion of the distribution that is a guaranteed payment and the portion that is not? The Willis treatise addresses that issue and raises three alternative solutions, which we will not discuss. The parties might be able to finesse that issue by expressly agreeing beforehand as to the assignment of the properties. There is a reasonable prospect that the Service will accept the parties agreement.

In Part V.B. of this article, we described the administrative complexity that the imposition of gain recognition on the partnership would cause when a payment is partly a partnership distribution and partly a guaranteed payment, and when a section 754 election is in effect, because of the need to determine each partner's share of the partnership's inside basis for the distributed property

80. See *supra* text accompanying notes 27, 28, and 30.

81. IRC § 707(c).

and then apportion it between the two types of payments.⁸² We noted that even if gain is not recognized, some apportionment of inside basis is required in order to determine the service partner's basis in the distributed property. That latter point is applicable only to a very limited extent in the context of a liquidating distribution. Except for unrealized receivables and inventory, a partner's basis in property received under section 736(b) in exchange for his interests in partnership property is determined without regard to the partnership's inside basis in those properties, and so no determination of inside basis need be made for them.⁸³ Even as to the two exceptions, the partnership's inside basis in unrealized receivables will be zero, so that property will not cause any computational problems.

A significant factor in favor of providing a rule of nonrecognition for a partnership's gain or loss in such cases is the relative simplicity of its administration. It is true that complexity will be reintroduced if section 751(b) applies to the payment for the property portion of the distribution; but section 751(b) is rarely invoked. Moreover, there is no virtue to exacerbating the complexity that section 751(b) creates. The administrative ease of providing nonrecognition shows the wisdom of Congress in favoring that treatment in Subchapter K.

V. CONCLUSION

The question of whether a partnership should recognize gain or loss on making a guaranteed payment in kind cannot be resolved definitively merely by pointing to a specific statutory or regulatory provision. While the language of section 707(c) strongly points towards nonrecognition, that is not conclusive. The regulations themselves demonstrate that there are circumstances and tax provisions, in addition to the three listed as exclusive in section 707(c), in which entity partnership treatment will be applied to a guaranteed payment. And, there are circumstances not mentioned in the regulations in which that is so. For example, in this article, the authors demonstrate that a guaranteed payment should be treated as having been made from a separate entity for the purpose of determining that the outside basis of a partner in his partnership interest is not reduced by the amount of the payment whether the payment is made in cash or in kind.

The most that the authors can claim, and that is what we do claim, is that the weight of considerations favor nonrecognition for the partnership. The

83. IRC § 732 (b) and (c). Note that since the service partner's basis is property received as a guaranteed payment is not determined by IRC § 732 and since the service partner's income from the receipt of the guaranteed payment is not dictated by IRC § 731, the guaranteed payment will not necessitate a change of the partnership's inside basis in its assets under IRC § 734(b)(1) even if an IRC § 754 election is in effect.

statutory language of section 707(c) pointing to non-entity treatment for the partnership, other than for the three listed exceptions, while not conclusive, means that entity treatment should be imposed only if it can be demonstrated that non-entity treatment would frustrate a principle of the existing tax law or would create a significant risk that parties could abuse that status. As to the question of whether non-entity treatment, which results in providing nonrecognition for the partnership, conflicts with basic tax policy for partnerships, it seems clearly not to do so. The basic approach of Subchapter K is to defer recognition of gain or loss in transactions between a partner and a partnership. Moreover, the deferral system that applies to the guaranteed payment is one that actually would cure a glitch in Subchapter K in some circumstances,⁸⁴ and so can be said to further tax policy rather than to hinder it.

The question of whether nonrecognition lends an opportunity to parties to distort their tax posture is a more difficult one. It does not permit the parties to reduce the amount of income they potentially will recognize. All nonrecognition provisions possess some potential for escaping from tax if, for example, basis is later increased on the death of the person holding the property in which the deferral is imbedded. But, nonrecognition is one of the fundamental principles of the income tax system, and so the possibility of a basis step-up at death has not been deemed of sufficient importance to induce Congress to require immediate recognition of gain when there are good reasons for deferral.

The relevant potential for abuse here is that the character of a deferred gain can be changed by manipulation of the properties distributed as the guaranteed payment. In the view of the authors, that possibility is not of so great a significance as to warrant both abandoning the principle of nonrecognition that plays such a prominent role in Subchapter K and embracing the complexity that requiring recognition would engender. By way of analogy, in the area of the realization of ordinary income from a cancellation of indebtedness, Congress has chosen to allow nonrecognition of that income for an insolvent taxpayer even when the deferral of that income will be recognized as a capital gain.

The case for providing a partner with a basis in distributed property equal to its fair market value is very strong. If, contrary to the authors' view, the partnership is required to recognize gain or loss, than a fair market value basis obviously is correct. But, even if nonrecognition is allowed, as the authors maintain it should be, the partner's basis in the property should nevertheless be equal to its fair market value. If a different figure were employed for the partner's basis in the property, such as the basis that the partnership had therein, the aggregate amount of gain or loss that the partner will eventually incur will be different than the amount of the deferred gain or loss that the partner had

84. This glitch occurs when a partner's outside basis is out of sync with his share of the partnership's inside basis. See n. 71, *supra*, and the text thereto.

imbedded in his partnership interest just before receiving the guaranteed payment. Since the partner recognized income for the full value of the guaranteed payment, there is no justification for changing the amount of his potential gain or loss.

Some persons, having decided that the proper basis for property received as a guaranteed payment is its fair market value, might perhaps jump to the conclusion that the partnership must therefore recognize gain or loss so that there need be no deferral built into the basis of that property. But, a basis of fair market value is just as appropriate when the partnership does not recognize its realized gain or loss. The reason that deferral need not be built into the property received as a guaranteed payment even when the partnership's gain or loss is unrecognized is that the deferral already is imbedded in the partner's partnership interest, and it will continue to be there after the partner receives the payment.