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Proposed Regulatory Change of Treatment of a Guaranteed Payment from a Partnership to a Partner

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PROPOSED REGULATORY CHANGE OF TREATMENT OF A GUARANTEED PAYMENT FROM A PARTNERSHIP TO A PARTNER

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I. Introduction

A partnership pays no federal income tax.[1] Instead, its income, deductions, and credits are allocated among its partners at the end of its taxable year.[2] A partnership's distribution of cash or property in kind to a partner will be characterized as one of three distinct transactions, each of which has its own tax consequences.

The distribution may constitute a guaranteed payment under § 707(c). A guaranteed payment is made for services[3] performed in the capacity of being a partner in which the amount of payment is not dependent on the amount of the partnership's income. If a distribution is a guaranteed payment, it will be ordinary income to the distributee partner, and it will be deductible by the partnership unless it constitutes a capital expenditure.[4] If deductible by the partnership, that deduction will affect the amount of ordinary income allocated to the partners at the end of the partnership year under §§ 702 and 704.

The distribution may be characterized as a payment to the distributee partner for the transfer of property or the performance of services in a capacity other than that of being a partner.[5] Similar to the treatment of a guaranteed payment, if characterized as not having been received by the distributee in his capacity as a partner so that § 707(a) applies, the payment will be ordinary income to the distributee and will be deductible by the partnership unless it constitutes a capital expenditure. A payment need not be designated as a payment by the parties to fall under § 707(a); a partnership's purported operating distribution to a partner may be recharacterized as a disguised payment for services or property under § 707(a)(2). In essence, the disguised payment provision of § 707(a)(2) is a statutory version of the substance versus form doctrine. If characterized as a payment under § 707(a), the payment will be treated for all tax purposes as one made to the distributee in a non-partner capacity. One difference between the tax treatment of a § 707(a) payment and a guaranteed pay-

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1. I.R.C. § 701 (2012).
2. *See* § 702.
3. A guaranteed payment can also be made for the use of capital. § 707(c).
4. *Id.*
5. § 707(a).

ment under § 707(c) is the timing when the income is recognized by the distributee and when a deduction (if any) is allowable to the partnership.[6]

The third possibility is to treat the payment as an operating distribution of partnership assets to a partner. As such, it will not be taxable to the partner unless the distribution includes cash in an amount that is greater than the partner's basis in his or her partnership interest.[7] Whether the distribution is made in cash or property in kind, the partnership will not recognize any income.[8] The distribution will not necessarily affect the allocation of partnership income among the partners, but it will affect the amount distributed to the partner on liquidation of his or her partnership interest.

On July 23. 2015, the Department of Treasury ("Treasury") promulgated a set of proposed changes to its regulations concerning disguised and guaranteed payments.[9] In addition to the proposed regulations themselves, Treasury provided a preamble that discussed the proposed amendments and also obsoleted a 1981 revenue procedure. The preamble also added a factor to be taken into account in determining whether the receipt of a compensatory profits interest in a partnership is taxable to the recipient. The proposal would make the following changes which the author addresses in turn:

1. If finalized, there would be a change in the regulatory treatment of the situation where a partner who was given a right to a percentage of the partnership's profits for services performed in his partnership capacity is guaranteed that the amount payable to him in any year will not be less than a specified figure.

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6. A guaranteed payment is treated as a partnership operating distribution for many purposes including the timing of the recipient's recognition of income. A guaranteed payment is included in the recipient's gross income in the taxable year of the recipient within which ends the partnership taxable year in which the partnership deducted the item (or took it into account as a capital expenditure) under the partnership's accounting system. Treas. Reg. § 1.707-1(c) (2015). So, the timing of the recipient's recognition of income depends upon the time in which the partnership takes the payment into account under its accounting method.

In contrast, a recipient of a § 707(a) payment will report it as income by using the recipient's usual accounting method. So, if the recipient is on the cash receipts and disbursement method of accounting, he will report the item as income in his taxable year in which he received it. The partnership's deduction for the payment (if any) will arise at the same time that the recipient recognizes the income under the recipient's accounting method. I.R.C. §§ 267(a)(2), (e).

In sum, the timing of a guaranteed payment depends upon the date on which the partnership is allowed a deduction under its accounting system whereas the timing of a § 707(a) payment depends upon the date on which the recipient recognized it as income under his accounting system.

7. § 731(a). An exception to that general rule of exclusion from income arises when § 751(b) causes the distribution to be treated as a constructive exchange of assets between the partnership and the partner.

8. §§ 731(a)-(b).

9. Prop. Treas. Regs. §§ 1.707-1, -2, 1.736-1, 80 Fed. Reg. 43652, 43652 (July 23, 2015).

2. In the legislative history to the Tax Reform Act of 1984, Congress listed five factors to be employed in determining whether a service provider who is a partner received a putative allocation and distribution from the partnership in an attempt to disguise a payment for services as an operating distribution.[10] If a purported distribution is characterized as a disguised payment for services, and if the services were not performed by the service provider in his capacity as a partner, the payment will be ordinary income to the service provider under § 707(a). If the services for which the disguised payment was made were performed by the service provider in his capacity as a partner *and* if the amount of the disguised payment did not depend upon the partnership's income, the disguised payment will be treated as a guaranteed payment under § 707(c) and so will still be treated as ordinary income. Congress stated that the most important factor in making the determination whether a partnership allocation or distribution is made for services performed by the service provider in his partner capacity is the existence of a substantial entrepreneurial risk as to both the amount and fact of payment. The 2015 proposed regulation adopts the five factors that Congress listed and places special emphasis and weight on the question of entrepreneurial risk. The proposed regulation also adds a sixth factor that was not mentioned by Congress in the legislative history to the 1984 Act. The proposed regulation sets forth examples of the application of those six factors.

Contrary to the statements in the Committee Report, it is difficult to see how an absence of a substantial entrepreneurial risk can have any bearing on the question of whether the service provider was acting in the capacity of a partner. The prototypical guaranteed payment is a fixed amount payable without regard to the partnership's income. There is little or no risk as to the amount or likelihood of those payments. If the absence of substantial entrepreneurial risk prevents a payment from being a guaranteed payment under section 707(c), there could be no guaranteed payments at all. Yet, both the Committee Report and the 2015 proposed regulation deem section 707(c) to be a viable provision. The question of whether the service provider is acting in a partner capacity should turn on the nature of the work performed and the business of the partnership. The certainty of the payment has no bearing on the nature of the services provided.

3. In Rev. Rul. 81-300, the general partners received a right to 5% of the partnership's gross rentals as payment for their services in managing the shopping center that was the principal business of the partnership. This fee was in addition to the general partners' right to a share of partnership profits. The ruling concluded that the payments were guaranteed payments that are taxable under § 707(c). In the legislative history to the Tax Reform Act of 1984, Congress criticized that ruling's determination that the fee was a guaranteed payment and said that the fee should have been

10. Comm. of Fin. U.S. S., 98th Cong, Explanation of Provisions Approved by the Committee on March 21, 1984 226-28 (Comm. Print 1984).

treated as a § 707(a) payment.[11] The preamble to the proposed regulations obsoletes Rev. Rul. 81-300, which therefore no longer is viable.

While the services performed by the general partners in Rev. Ruling 81-300 clearly were performed in their partner capacity, Congress said that the fee they received was a § 707(a) payment. Congress must have treated the fee as having been paid for services that were not performed in their partner capacity. The inference from that conclusion is that the absence of a substantial entrepreneurial risk to the general partners' right to the fee caused that fee to be treated as having been paid to them for services performed as non-partners.[12] That is a highly questionable conclusion given that the services they performed were central to the business of the partnership.

Moreover, the absence of substantial entrepreneurial risk, a factor the 2015 proposed regulation uses in determining whether § 707(c) applies, is inconsistent with the function of that provision. Obviously, the right to a fixed dollar amount typically bears no entrepreneurial risk, and yet that type of right is the focus of § 707(c). The operative question for applying § 707(c) is whether the services were performed in a partnership capacity for a fee; typically that right to a fee bears no substantial entrepreneurial risk.

4. For some years, there has been a question as to whether the receipt of a profits partnership interest as compensation for past or future services constitutes taxable income to the service provider. A profits interest in a partnership gives the holder the right to share in subsequent income of the partnership but gives him no interest in the partnership's current capital. A profits partnership interest that is given to compensate the recipient for services is sometimes referred to as a compensatory profits partnership interest. In Rev. Proc. 93-27, the Service created a safe harbor in which the recipient of a compensatory profits interest will not recognize income if certain conditions are satisfied. This safe harbor listed three exceptions, the presence of any one of which would prevent the safe harbor from applying. Rev. Proc. 93-27 was modified by Rev. Proc. 2001-43 which clarified the former and added several additional requirements for its application. The preamble to the 2015 proposed regulation states that IRS plans to issue a revenue procedure that will add a fourth exception to the operation of Rev. Proc. 93-27. This new exception will prevent the application of the safe harbor if, in conjunction with the receipt of the profits interest, the service provider waived his right to a payment of a substantially fixed amount for the performance of services.

In 2005, Treasury promulgated proposed regulations that would change the treatment of the receipt of a compensatory profits partnership interest.

11. *Id.* at 230.

12. The facts stated in the revenue ruling do not state that the general partners performed substantial services to third parties in the regular course of their business. Consequently, the absence of substantial entrepreneurial risk seems to be the only factor on which the committee could have based its conclusion that § 707(a) applied.

Under that proposed regulation, a compensatory profits partnership interest would not be excluded from income. However, the proposed regulation provides a safe harbor that permits the parties to value the profits partnership interest by using its liquidation value, but only if certain conditions are satisfied. A profits partnership interest that is valued by using its liquidation value will have a zero value and consequently will not cause any tax liability to the service provider. The Service and Treasury then issued Notice 2005-43 to implement the changes made by the 2005 proposed regulation if it is finalized. The 2005 Notice is not currently effective. It consists of a proposed revenue procedure to become effective if and when the 2005 proposed regulation is finalized. The 2005 Notice contains three exceptions which set forth circumstances in which the safe harbor for using liquidation value will not apply. Those three exceptions are similar to the three exceptions set forth in Rev. Proc. 93-27, but they are not identical. The preamble to the 2015 proposed regulation states that if Notice 2005-43 is finalized, the fourth exception that is to be added to Rev. Proc. 93-27 will also be added to that new revenue procedure. The fourth exception applies when the profits interest is issued in conjunction with the service partner's foregoing the right to a payment that is substantially fixed in amount.

The 2005 Notice does not state how a compensatory profits interest is to be valued if the safe harbor does not apply. It is an open question as to whether there will be circumstances in which liquidation value will apply even though the safe harbor is not available. The author discussed the manner in which a profits interest might be valued when a safe harbor does not apply in a previous article.[13]

5. The so-called carried interest arrangement is one where an individual becomes a partner in an investment partnership in exchange primarily for the individual's managing the business of the partnership. The individual typically receives a profits partnership interest in exchange for the services he agrees to provide in managing the partnership's investments. In addition, the individual typically receives an annual fee based on a formula. The partnership's profits often consist of long-term capital gains, and so the managing partner's share of that income will also be long-term capital gains.[14] The additional fee that the service partner receives constitutes ordinary income. The carried interest arrangement has generated considerable criticism of the service partner's obtaining capital gain treatment for most of his share of partnership profits, and the 2015 proposed regulation was likely a product of Treasury's hostility to that benefit.

In some cases, a service partner has chosen to waive his right to an annual fee in exchange for an increased percentage interest in the partnership's profits. If this exchange were validated, the service partner will have converted what would have been ordinary income into capital gains. The

13. Douglas A. Kahn, *The Proper Tax Treatment* of *the Transfer of a Compensatory Partnership Interest*, 62 TAX LAW. 1, 24-56 (2008).

14. *See* I.R.C. § 702(b) (2012).

2015 proposed regulations address that issue and state that the receipt of a partnership distribution pursuant to such an increased profits interest will not be treated as an operating distribution unless the service partner bears substantial entrepreneurial risk concerning the amount he will receive. If not treated as an operating distribution, it will be ordinary income to the service partner. In addition, as noted above, the preamble states that the Service will issue a Revenue Procedure that will exclude from safe harbors the receipt of a compensatory profits partnership interest when such interest is issued in conjunction with the service partner's waiver of the right to a payment that is substantially fixed in amount.

This article focuses on one of the changes proposed by the 2015 proposed regulations. The change that the author considers to be questionable concerns the treatment of the situation in which a partner who is entitled to a percentage of partnership profits for services is guaranteed that his or her share in any year will not be less than a stated amount of dollars. The current treatment of that situation is described in Treas. Reg. § 1.707-1(c), which has been in place for more than 59 years. The 2015 proposal would change that treatment.

II. Reason for Adoption of Special Treatment for a Guaranteed Payment

The following discussion of the congressional adoption of specific treatment for guaranteed payments is drawn from an article that was co-authored by the author in 2004.[15]

Special statutory treatment of guaranteed payments was first adopted in the Internal Revenue Code of 1954. Prior to the 1954 Code, payments made to a partner for services rendered as a partner were treated the same as any operating distribution of partnership assets and so affected the allocation of partnership profits among the partners.[16] If the payment did not exceed partnership profits, they were treated as distributions of those profits and taxed accordingly. To the extent that the amount distributed was greater than partnership profits, the excess amount was treated as having been made from the partners' capital accounts. The amount deemed paid from the service partner's own capital account was not taxed to him and was treated as a return of capital. The amount deemed paid from the capital account of another partner was taxable to the service partner and deductible by the other partner whose capital account was reduced.[17] The application of this treatment became even more complex if the partnership had a net loss for the year.[18]

15. Douglas A. Kahn & Faith Cuenin, *Guaranteed Payments Made In Kind By A Partnership*, 6 Fla. Tax Rev. 405, 408-10 (2004).

16. *See* Lloyd v. Comm'r, 15 B.T.A. 82, 84-85 (1929).

17. Cagle v. Comm'r, 63 T.C. 86, 93 (1974), *aff'd* 539 F.2d 409 (5th Cir. 1976).

18. *See* Lloyd, 15 B.T.A. at 84-85.

Congress determined that the pre-1954 treatment of such payments was "unrealistic and unnecessarily complicated."[19] The 1954 Code established two separate treatments of partnership payments for a partner's services. If the services were not performed by the service partner in his capacity as a partner, § 707(a) treats the payment as one made between the partnership and a non-partner. In such cases, the normal rules of taxation apply to the payment.

On the other hand, if the services performed by the service partner were done in his capacity as a partner,[20] *and* if the amount of the payment did not depend upon partnership income, it was treated as a "guaranteed payment" by § 707(c). Section 707(c) provides that a guaranteed payment is "considered as made to one who is not a member of the partnership, but only for 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.)"[21] Thus, a guaranteed payment is treated as an operating distribution of partnership assets for all purposes except for those specifically identified to be treated differently. The Code states that it is treated specially only for purposes of three provisions – §§ 61(a), 162(a) and 263. This means that the payment is ordinary income to the service partner and deductible by the partnership unless the payment is characterized as a capital expenditure. The regulations, however, expand the special treatment to three other Code sections (§§ 706(b)(3), 707(b), and 708(b)). The regulations provide that for all purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of partnership profits.[22]

In essence, Congress considered guaranteed payments to be the same as other operating distributions of partnership profits, but gave them special treatment as ordinary income and deductions in order to avoid the complexity that arose when the partnership had no profits or whose profits were less than the guaranteed payment. This special treatment is applied only for the purposes of certain specified provisions of the Code, and a guaranteed payment is still treated as an operating partnership distribution for all other purposes of the tax law.

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19. H.R. Rep. No. 83-1377, at 68 (1954).

20. Section 707(c) does not state that the payment must be made for services performed by the service provider in his partner capacity. However §§ 707(a) and 707(c) would overlap were it not for the requirement in § 707(a) that the services for which the service provider is paid were performed in a non-partner capacity. Since § 707(a) has priority over § 707(c), the latter provision applies only when the services in question were performed in a partner capacity so that § 707(a) is inapplicable.

21. The clause relating to "section 263" was added in 1976 to clarify that guaranteed payments that constitute capital expenditures have to be capitalized. This amendment codified the result reached in *Cagle*. 63 T.C. at 93.

22. Treas. Reg. § 1.707-1(c) (as amended in 1983).

III. Service Partner's Interest in Profits Subject to a Minimum Guaranty

The question arose as to how to characterize the situation in which a partner is entitled to a share of partnership profits for services performed in his capacity as a partner when the service partner is guaranteed to receive a specified amount of dollars. A regulation that was promulgated in 1956, two years after the adoption of § 707(c), addresses that issue. Treas. Reg. § 1.707-1(c) sets forth four examples of the operation of the guaranteed payment provision. Example (2) is the relevant provision which the 2015 proposed regulation would change. Currently, Example (2) reads as follows:

> *Example (2).* Partner C in the CD partnership is to receive 30% of partnership income as determined before taking into account any guaranteed payments, but not less than $10,000. The income of the partnership is $60,000, and C is entitled to $18,000 (30% of $60,000) as his distributive share. No part of this amount is a guaranteed payment. However, if the partnership had income of $20,000 instead of $60,000, $6,000 (30% of $20,000) would be partner C's distributive share, and the remaining $4,000 payable to C would be a guaranteed payment.

Thus, under the current regulation, a guaranteed amount for services performed in a partnership capacity will be treated as a guaranteed payment only to the extent that the guaranteed amount exceeds the service partner's percentage share of partnership income. The 2015 proposed regulation would amend Example (2) to provide that the guaranteed amount will be treated as a guaranteed payment regardless of the amount of the service partner's share of partnership profits. Consequently, in Example (2), as amended by the proposed regulation, when the CD partnership had income of $60,000, $10,000 will be treated as a guaranteed payment; and the remaining $8,000 of the amount C received will be treated as his distributive share of the partnership's income. If the partnership's income were only $20,000, then all of the $10,000 that C received will be treated as a guaranteed payment.

Both the House Report and the Senate Report to the Internal Revenue Code of 1954 contain the following sentence in connection with a discussion of § 707(c): "A partner who is guaranteed a minimum annual amount for his services shall be treated as receiving a fixed payment in that amount. "[23] Only two years after § 707(c) was enacted, Treasury promulgated the regulation quoted above despite its apparent conflict with the statement in the Committee Reports. The proximity of the promulgation of the regulation to the date of the enactment of the statute gives greater weight to the regulation. Presumably, the staff at Treasury who wrote the regulation were fully informed as to the function Congress intended the statute to serve and had worked with Congress in drafting the provision. The likely reasons why Treasury considered the current regulation to be the proper treatment of the situation are those discussed in Part

23. H.R. Rep. No. 83-1337, at 227 (1954); S. Rep. No. 83-1622, at 387 (1954).

IV of this article, explaining the author's view that the treatment of this issue in the current regulation is proper.

IV. Reason for Rejecting the Proposed Change

In the preamble to its promulgation of the 2015 proposed regulation, Treasury stated that the current regulation (Example (2)) "is inconsistent with the concept that an allocation must be subject to substantial entrepreneurial risk to be treated as a distributive share under section 704(b)." "Accordingly, the proposed regulations modify Example (2) to provide that the entire minimum amount is treated as a guaranteed payment under section 707(c) regardless of the income allocation."[24] One problem with Treasury's reliance on the factors listed in the legislative history to the 1984 Act to characterize a distribution as a guaranteed payment is that Treasury does not accurately describe the function that Congress ascribed to those factors. Congress did not say that the factors were to be used to determine whether a partnership distribution qualifies as a distributive share under § 704(b). What Congress actually said was, "the factors described below should be considered in determining whether the partner is receiving the putative allocation in his capacity as a partner."[25] If the lack of substantial entrepreneurial risk causes the service partner to be acting other than in his capacity as a partner, then the "fee" would not be a guaranteed payment, but would be a § 707(a) transaction. The tax results will not be greatly different, but Treasury's characterization as a § 707(c) guaranteed payment seems unsupportable.

In addition, as previously noted, the Senate's committee report for the Tax Reform Act of 1984 criticized the Service's ruling in Rev. Rul. 81-300 that a payment of a fixed amount for services performed in a partner capacity was a guaranteed payment under § 707(c). Instead, the committee report said that the fee should be treated as a payment under § 707(a).[26] If correct, that determination would seem to mean that the absence of a significant risk as to the amount of a payment converts what otherwise would be a distribution of profits into a § 707(a) payment – not into a § 707(c) payment. Especially since the preamble to the 2015 proposed regulation obsoletes Rev. Rul. 81-300 in reliance on that statement in the committee report, it is difficult to see how Treasury could conclude that the absence of a substantial entrepreneurial risk causes the amount of minimum guaranty to be treated as a § 707(c) payment. In any event, it is the author's view that the absence of a substantial entrepreneurial risk should not cause a minimum guaranty to be treated as either a § 707(a) or a § 707(c) payment.

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24. Prop. Treas. Regs. §§ 1.707-1(c), 80 Fed. Reg. 43652, 43655 (July 23, 2015).

25. Comm. of Fin. U.S. S., 98th Cong, Explanation of Provisions Approved by the Committee on March 21, 1984 227 (Comm. Print 1984).

26. *Id.* at 230.

The current treatment of a partnership's guaranty of a minimum distribution is to treat the distribution to the service partner as an operating distribution to the extent of the service partner's percentage of the partnership's profits. Only the excess of a distribution over the service partner's share of profits is treated as a guaranteed payment. The basis of that treatment is that the guaranty of a minimum amount does not come into play unless the partner's percentage of profits is less than the guaranteed amount, and then only the amount distributed in excess of the partner's share of profits is derived from that guaranty. Consider the following fact: if the partner's share of profits exceeds the minimum guaranty, the service partner will receive the same amount from the partnership that he would have received if no guaranty had been given. The change proposed by Treasury would treat an amount of the distribution that equals the guaranteed figure to be a fixed fee that is not part of the service provider's share of profits. Now consider which of those competing constructions more accurately reflects the true circumstance.

If an amount distributed to the service partner equal to the guaranteed minimum is treated as not being part of the service partner's share of profits, then the service partner will not receive the share of partnership profits to which he is entitled. Consider Example (2) in the current regulation. Partner C is entitled to 30% of partnership income as determined before taking into account any deduction for guaranteed payments. C is guaranteed that his share in any year will not be less than $10,000. In Year One, the partnership earns $60,000 of net income, and C's share is $18,000, and that is the amount paid to C. The proposed regulation treats $10,000 of the $18,000 that C received as a guaranteed payment, so C received only $8,000 as his share of partnership profits. But C had a 30% interest in the partnership and was entitled to 30% of the partnership's profits, which comes to $18,000. The position adopted by the proposed regulation deprives C of $10,000 of his share of those profits.

Consider the consequence of Treasury's position if C is entitled to 30% of the partnership's profits after taking into account the deduction for a guaranteed payment. Before taking a deduction for a guaranteed payment, the partnership had a net profit of $60,000. Since, under the Treasury's proposal, the guaranteed payment to C is $10,000, the partnership will have a net profit of $50,000. C will therefore receive a payment of $15,000 from the partnership (30% of $50,000). For purposes of simplifying the calculation, let us assume that all of the partnership's profits are ordinary income; but note that Treasury's proposed position becomes more significant if some of that income is a capital gain. Since C is entitled to 30% of the net profits after taking the deduction into account, C will be entitled to $15,000 as his share of partnership profits. But under Treasury's proposal the amount distributed to C as his share of profits will be only $5,000. The effect of Treasury's position is that a guaranty of a minimum amount reduces the share of profits to which the service partner is entitled.

On the other hand, consider the treatment of C in this example under the position adopted in the current regulation. All of the amount distributed to C will be treated as a distribution of his share of the partnership's profits, and there will be no guaranteed payment. C will receive the full amount of partnership profits to which he is entitled. There would be no guaranteed payment because the condition under which the guaranty is to be invoked did not occur.

Consider this related situation. Jennifer is a skilled investor. The XYZ partnership offers Jennifer a 20% profits partnership interest if she will join the partnership and manage the investment of its funds. To induce Jennifer to accept, Ralph offers to guaranty that Jennifer will receive at least $15,000 of partnership distributions each year; and Ralph will make up any shortfall that might occur. Jennifer accepts the offer.

In Year One, the partnership has a net profit of $100,000; and Jennifer receives a partnership distribution of $20,000 as her share of that profit. None of the amount that Jennifer received is attributable to Ralph's guaranty. In Year Two, the partnership has a net profit of $50,000, and Jennifer's share of that profit is $10,000. Pursuant to his guaranty, Ralph pays Jennifer $5,000 to make up the shortfall she suffered. Only the $5,000 that Jennifer received from Ralph is attributable to the guaranty.

In the case of a partnership's guaranty of a minimum amount of distribution, the characterization of the amounts received by the service partner should be the same as they would be if the amount had been guaranteed by a third party. The guaranty has no effect except to the extent that there is a shortfall. It would be inappropriate to treat part of a partnership distribution to a service partner as a guaranteed payment merely because there was little risk that that amount of the distribution would be made.

There is another reason that the current regulatory treatment of such guarantees is correct. A guaranteed payment is treated as an operating distribution for most tax law purposes. The reason that it is treated differently for the limited purposes of income recognition and deduction is because of the administrative complexity that arose when a guaranteed payment was made by a partnership with inadequate income. To the extent that a distribution to a service partner is made from partnership profits, there is no complexity or difficulty in applying normal partnership tax rules. There is no reason, therefore, to carve out of a distribution of partnership profits a portion to be treated as a guaranteed payment.

Finally, the current construction of how to apply § 707(c) to this situation was adopted by regulations promulgated two years after the statute was enacted in 1954. This should be considered a contemporaneous construction of the statute, and so can be presumed to reflect the understanding of the staff at Treasury who were involved in the drafting and passage of the statute. That construction should be given great weight. Moreover, the regulatory construction of § 707(c) has remained intact for almost 60 years. A regulation becomes more formidable the longer it remains unaltered.

One might wonder why Treasury has proposed to change an established position which has been in place for so many years. While we can only speculate as to Treasury's motivation, there are reasons to suspect that the proposed change is derived from Treasury's hostility to carried interest arrangements rather than to a principled reappraisal of the appropriateness of its long-standing construction of the Code. When the entirety of the 2015 proposed regulation is examined, it seems clear that it is aimed at carried interests and seeks to reduce some of the tax benefits currently enjoyed by service partners.

For example, one of the objects of the proposed regulation is the exchange of a right to a fee for an increased partnership interest in profits. In a few cases, service partners of carried interest arrangements have made that exchange. The 2015 proposed regulation does not prevent a service partner from obtaining a tax benefit from such an exchange, but it makes it more difficult for him to obtain that benefit. Treasury also proposes to issue a revenue procedure making the waiver of a fee in conjunction with the receipt of a compensatory profits partnership interest an exception to the application of safe harbors concerning the tax treatment of the receipt of a compensatory profits partnership interest.

The proposed change of the treatment of minimum guarantees is designed to increase the amount of ordinary income that a service partner will recognize when a partnership distribution is characterized as a guaranteed payment. This could impact on some service partners in carried interest arrangements, but it will affect service partners in many other partnerships as well. It is inappropriate to change the tax treatment of an item in order to increase the tax on a small segment of service partners especially when there is no merit to the change as a matter of tax policy.

V. Conclusion

Treasury's proposed change of its application of § 707(c) to a distribution of partnership profits to a service provider who has a right to a minimum amount is unwarranted. The better construction of § 707(c) is the one that was adopted by Treasury shortly after the statue was enacted in 1954 and which has remained in effect for almost 60 years.