Guaranteed Payments Made in Kind by a Partnership

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By Douglas A. Kahn and Faith Cuenin

“Guaranteed payments” are payments made by a partnership to a partner for services performed in his partnership capacity or for the use of capital to the extent that the amount of the payment is not determined by reference to the partnership’s income. In addition, some distributions made by a partnership in liquidation of a partner’s interest in the partnership are treated as guaranteed payments. A guaranteed payment constitutes ordinary income to the partner, and the partnership is allowed a deduction for the payment unless it constitutes a capital expenditure. While guaranteed payments typically are made in cash, it is possible to make them with property in kind. Payments in kind will occur more frequently in the context of liquidating distributions, but nonliquidating guaranteed payments are possible.

The principal focus of this article is on whether a partnership will recognize a gain or loss if it uses appreciated or depreciated property to make a guaranteed payment. There is no case or ruling that deals with that question. The authors conclude that: (1) the partnership does not recognize gain or loss on making a guaranteed payment in kind, (2) the partner’s basis in the distributed property nevertheless equals its fair market value, and (3) the payment has no effect on the partner’s basis in his partnership interest other than the reduction of that basis for the partner’s share of the deduction allowed to the partnership for making the guaranteed payment.

The first four parts of the article describe the relevant provisions of the Internal Revenue Code and the regulations and discuss the history of those provisions. The article then analyzes the three issues listed above.

A partnership does not recognize gain or loss on making a distribution of property to a partner. On the other hand, if an employer uses appreciated property to pay an employee for services, the employer will recognize gain in the amount of the appreciation. The code states that a guaranteed payment is treated as having been made to a person who is not a partner, but only for the purposes of three code sections (sections 61, 162, and 263). The purpose of that provision is to treat the payment as ordinary income to the partner and either as a deductible expense or a capital expenditure to the partnership; in other words, it is treated as if made to a nonpartner. The “but for” language in the statute indicates that for all other tax purposes, a guaranteed payment is treated as a distribution to a partner. Despite that indication, there are some additional tax provisions for which nonpartner treatment will be applied. The question of a partnership’s recognition of gain turns on whether the payment is treated as having been made to a nonpartner even though gain recognition is not one of the provisions to which nonpartner characterization is made applicable in either the code or in the regulations. The authors contend that, given the restrictive statutory language, a guaranteed payment should be treated as having been made to a nonpartner for tax purposes, other than the ones listed in the statute, only when that characterization is necessary to prevent the frustration of a significant tax principle. The authors contend that not only does granting nonrecognition to the partnership in the instant situation not conflict with any significant tax principle, it actually furthers a major tax principle of the partnership tax provisions.

The authors note that a principal objective of subchapter K (the portion of the code that contains the rules for partnerships and partners) is to defer the recognition of any gain or loss realized on a distribution of partnership property to a partner. Granting nonrecognition to a partnership for guaranteed payments conforms with that basic principle. Since the partnership’s nonrecognition does not contravene any tax principle and conforms to the overarching congressional preference for deferral, there is no justification for departing from the statutory scheme of treating guaranteed payments as made to a partner for all but a few limited purposes.

But nonrecognition is appropriate only if gain or loss is deferred. The need for deferral would seem to point towards giving the partner a basis in the distributed property equal to the basis that the partnership had therein, and thereby retaining any potential gain or loss for that property. It would seem improper to give the partner a basis equal to the FMV of the property. The authors examined that issue and, using a balance sheet approach, demonstrate that the potential gain or loss is reflected in the partner’s basis in his partnership interest and thereby is deferred. If the partner is given a basis in the distributed property that is less than its FMV, his potential aggregate gain on the disposition of the property and his partnership interest will be excessive. Only by giving the partner a basis equal to the property’s FMV will the partner’s aggregate gain be accurately measured.
As to the partner's basis in his partnership interest, the authors demonstrate that the only effect that a guaranteed payment has on that basis, whether the payment is made in cash or in kind, is to reduce it by the partner's share of the deduction that was allowed to the partner for making the payment.

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