MLPA
The Voice of America's
Master Limited Partnerships

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Re: Treatment of Guaranteed Payments for Use of Capital as Qualifying Income

Mr. Wilson and Mr. West:

On November 3, 2015, Internal Revenue Service ("IRS") and Department of Treasury ("Treasury") personnel met with representatives of the Master Limited Partner Association ("MLPA") to discuss the potential impact of recently proposed regulations under § 7704 and § 707 on publicly traded partnerships ("PTPs").[1] We greatly appreciate your time and attention to our concerns.

We write today to illustrate an issue which is made more significant by the potential application of the two sets of proposed regulations discussed below, and a

[1] *See* Qualifying Income from Activities of Publicly Traded Partnerships With Respect to Minerals or Natural Resources, 80 Fed. Reg. 25970 (2015) (the "Proposed Qualifying Income Regulations") and Disguised Payments for Services (the "Proposed Disguised Payment Regulations") 80 Fed. Reg. 43652 (2015). All "Section" or "§" references herein are to the Internal Revenue Code (the "Code") or the Treasury Regulations ("Reg. §___") promulgated thereunder.

recommendation for resolving this issue. Our particular concern relates to a proposed change to Example 2 in Reg. § 1.707-1(c) relating to guaranteed payments and the possible impact of that change on a PTP's "qualifying income" (within the meaning of § 7704(d)). As discussed, this change is of considerable importance because the Proposed Qualifying Income Regulations are intended, when finalized, to provide an exclusive list of what constitutes qualifying income with respect to mineral or natural resource activities.[2] The proposed change to Example 2 causes considerable uncertainty regarding the proper characterization of guaranteed payments for the use of capital ("GPUCs") for purposes of § 7704(d).

We request that, when the Proposed Qualifying Income Regulations are finalized, those regulations contain guidance regarding the proper characterization of GPUCs for purposes of satisfying the gross income requirement of § 7704(c)(2).[3] Specifically, we recommend that the IRS and Treasury adopt a rule that either – (i) provides that the determination of whether a GPUC is qualifying income is made by treating the GPUC as a distributive share of the payor partnership's income, such that the GPUC is qualifying income to the extent the activities of the payor partnership generate qualifying income; or (ii) treats a GPUC as the equivalent of the type of income that it essentially "replaces" (*i.e.*, as interest if it is paid with the respect to cash, rent if paid with respect to use of real

[2] *See* Preamble to the Proposed Qualifying Income Regulations, which provides that "the proposed regulations provide an exclusive list of operations that comprise the section 7704(d)(1)(E) activities for purposes of section 7704."

[3] Section 7704(c)(2) requires that 90 percent or more of the gross income of a PTP for any taxable year must consist of qualifying income in order for the PTP to be treated as a partnership – as opposed to a corporation – for federal tax purposes (the "Qualifying Income Test").

property, *etc.*). We describe the support for each of these possibilities in more detail below.

Issue

Although § 7704(d) provides a fairly broad list of income sources that constitute qualifying income, it does not expressly provide for the treatment of a guaranteed payment received by a partner in a partnership for the use of the partner's capital contributed to the partnership. Payments for the use of capital are often similar in nature to interest or rents, both of which are potentially qualifying income sources. Moreover, to the extent the partnership making these payments is in a business that would generate qualifying income, the payments arguably should be qualifying income. However, GPUCs are not expressly included as a type of qualifying income under the statute. Thus, there is uncertainty regarding their proper treatment.

The uncertainty surrounding and importance of the characterization of GPUCs for purposes of the Qualifying Income Test increased when the IRS and Treasury promulgated the Proposed Disguised Payment Regulations. If finalized as proposed, the Proposed Disguised Payment Regulations would revise Example 2 in Reg. § 1.707-1(c) (referred to herein as simply "Example 2"). As currently in effect, Example 2 provides:

> Partner C in the CD partnership is to receive 30 percent 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 percent 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 percent of $20,000) would be partner C's distributive share, and the remaining $4,000 payable to C would be a guaranteed payment.

According to the current version of Example 2, a partner's right to receive the $10,000 described in the Example is a guaranteed payment only if and to the extent the partner's distributive share of partnership income is insufficient to satisfy the partner's right to $10,000.

The Proposed Disguised Payment Regulations would revise Example 2 to provide as follows:

> Partner C in the CD partnership is to receive 30 percent of partnership income, but not less than $10,000. The income of the partnership is $60,000, and C is entitled to $18,000 (30 percent of $60,000). Of this amount, $10,000 is a guaranteed payment to C. The $10,000 guaranteed payment reduces the partnership's net income to $50,000 of which C receives $8,000 as C's distributive share.

Thus, if finalized as proposed, Example 2 would provide that all of the $10,000 minimum payment to which C is entitled is treated as a guaranteed payment, regardless of the partnership's income for the year in question.

It is worth noting that although the Proposed Disguised Payment Regulations were focused on payments for services, the change to Example 2 does not relate solely to payments for services. Further, the reason for the change to Example 2 would seem to apply equally to payments for the use of capital. Thus, if the Proposed Disguised Payment Regulations are finalized in their current form, it is likely that the change to Example 2 would apply to GPUCs. As a result, it is likely the revision to Example 2 will increase the number of these types of payments that are characterized as GPUCs.

Because of its revised characterization of certain payments, the proposed revision of Example 2 could have significant implications for PTPs. Many PTPs own interests in lower-tier partnerships. Typically, investments may be made as a contribution of capital that is entitled to a preferred return or entitlement to a payment similar to that described in the current Example 2 (although the entitlement is for the use of capital as opposed to payments for services). Relying on the current version of Example 2, PTPs have generally treated the preferred return or payment received as a guaranteed payment only to the extent the income of the partnership making the payment was insufficient to support the return. In many situations, this resulted in no GPUC to the PTP. Rather, the PTP reported a distributive share of the lower-tier partnership's income. Provided the income of the lower-tier partnership was "qualifying income" under § 7704(d), such distributive share was qualifying income in the hands of the PTP. Thus, the receipt of the

GPUC would not cause the PTP to fail to qualify for the exception to corporate treatment for publicly traded partnerships found in § 7704(c).

If the proposed version of Example 2 is finalized, it is likely that all of a PTP's return from a lower-tier partnership would be recharacterized as a guaranteed payment in many situations. This recharacterization raises significant issues for PTPs if a guaranteed payment of the type described is not qualifying income under § 7704(d).

We note that the IRS recently faced and resolved a similar question as to whether cancellation of indebtedness ("COD income") realized by a PTP should be treated as qualifying income under § 7704(d). Revenue Procedure 2012-28[4] provides a safe harbor under which the IRS will not challenge a determination by a PTP that COD income is qualifying income under § 7704(d) provided the COD income is attributable to debt incurred in direct connection with the activities of a PTP that generate qualifying income (qualifying activities). Revenue Procedure 2012-28 provides that a PTP may demonstrate that COD income is attributable to debt incurred in direct connection with the PTP's qualifying activities by any reasonable method. One reasonable method for demonstrating that COD income is attributable to debt incurred in direct connection with the PTP's qualifying activities is a direct tracing approach. Other methods may be reasonable, but the Revenue Procedure provides that a method that allocates COD

[4] 2012-2 C.B. 4.

income based solely on the ratio of qualifying gross income to total gross income ordinarily will not be considered reasonable.

Revenue Procedure 2012-28 is helpful in that it provides that in the context of COD income, PTPs may use any reasonable method to demonstrate that such income is qualifying income. Similarly, there may be several reasonable methods to demonstrate that the GPUC income is qualifying for purposes of § 7704(d). In our view, most GPUCs received by PTPs should be qualifying income under one of two theories: 1) the GPUC is a distributive share of the payor partnership's income, such that the GPUC is qualifying income to the extent the activities of the payor partnership generate qualifying income; or 2) the GPUC is treated as interest or rent (depending on the type of capital for which the GPUC is paid). We analyze both possibilities below.

Discussion

Under § 707(c) and the regulations thereunder, guaranteed payments for the use of capital are considered made to one who is not a member of the partnership, but only for purposes of § 61(a) (relating to gross income) and § 162(a) (relating to trade or business expenses). Thus, for purposes of § 61(a), the characterization of a GPUC in the recipient's hands should not depend on the nature of the partnership's income. However, Reg. § 1.707-1(c) provides that for purposes of provisions of the Code other than § 61 and § 162, guaranteed payments are regarded as a partner's distributive share of ordinary income. Under § 702(b) and the regulations thereunder, the source and character of any item

included in the partner's distributive share of an item of income is determined as if the item were realized directly from the source from which realized by the partnership. Thus, if a guaranteed payment is treated as a partner's distributive share of ordinary income, the specific nature of the guaranteed payment should be determined with reference to the partnership's income.

Consistent with Reg. § 1.707-1(c), we request that the IRS and Treasury issue guidance indicating that a GPUC received by a PTP should be treated as the PTP's distributive share of the payor partnership's income, such that a GPUC is qualifying income to the extent the activities of the payor partnership generate qualifying income. Alternatively, we request that the IRS and Treasury issue guidance indicating that a GPUC received by a partner is characterized by reference to the type of income that it replaces, *e.g.*, interest or rent. We include below support for both of these alternatives.

GPUC as a Distributive Share of the Payor's Income

As previously indicated, guaranteed payments for the use of capital are considered made to one who is not a member of the partnership, but only for purposes of § 61(a) (relating to gross income) and § 162(a) (relating to trade or business expenses). Thus, for purposes of § 61(a), the characterization of a GPUC in the recipient's hands should not depend on the nature of the partnership's income. However, § 1.707-1(c) provides that for purposes of provisions of the Code other than § 61 and § 162, guaranteed payments

are regarded as a partner's distributive share of ordinary income. The determination of whether a guaranteed payment is qualifying income under § 7704 should not depend on how that payment is characterized for purposes of § 61(a) or § 162(a).

Section 702 and the regulations promulgated thereunder provide that the source and character of any item included in a partner's distributive share of an item of income is determined as if the item were realized directly from the source from which realized by the partnership. Thus, if a GPUC is treated as a distributive share of the payor partnership's income, then in the hands of the recipient that GPUC should have the same character as the partnership's underlying income. This treatment is consistent with the treatment applied to guaranteed payments received by a real estate investment trust (a "REIT") in certain private letter rulings.

In both Private Letter Ruling 8639035[5] and Private Letter Ruling 8728033,[6] a REIT was a partner in a partnership and entitled to a GPUC. The IRS concluded that, for purposes of § 856 (relating to the types of "good" income for a REIT), a GPUC retained its character as a distributive share of partnership ordinary income. Because Reg. § 1.856-3(g) treats a REIT that is a partner in a partnership as owning its proportionate share of each of the partnership assets attributable to that share, the guaranteed payment

[5] June 27, 1986. The facts of Private Letter Ruling 8639035 were subsequently amended in Private Letter Ruling 8713031. We are aware that, pursuant to § 6110(k)(3), written documentation such as private letter rulings represent the IRS's analysis of the law as applied to a taxpayer's specific facts, and they are not intended to be relied upon by third parties and may not be cited as precedent. They do, however, provide an indication of the IRS's position on the issues addressed.
[6] April 13, 1987.

represented qualifying rental income under § 856 in the same proportion as the partner's overall distributive share of partnership income represents qualifying rental income under § 856.

The IRS has also treated a guaranteed payment for services as a partner's distributive share for purposes of the: (i) § 613 limitation on percentage depletion;[7] (ii) exclusion for employer-provided meals and lodging under § 119;[8] and (iii) § 106 exclusion for accident and health insurance payments.[9] The Tax Court and later the Court of Appeals for the Second Circuit also concluded that a guaranteed payment for services is treated as a partner's distributive share for purposes of § 1348.[10]

If the distributive share approach is adopted, thought must be given to how the relevant income percentages should be determined. Consider an example in which a calendar year payor partnership accrues a GPUC of $1 million to a PTP for the 2014 calendar year, but makes the payment in 2015. In 2014, the payor partnership had $20 million in gross income, and $1 million in net income. Of the $20 million in gross income, $18 million (90 percent) was from income sources that would constitute qualifying income for purposes of satisfying the Qualifying Income Test. Of the $1 million in net income, however, only $100,000 (10 percent) was from qualifying income sources.

[7] GCM 34151 (June 25, 1969).
[8] GCM 34173 (July 25, 1969).
[9] Rev. Rul. 91-26, 1991-1 C.B. 184.
[10] *See Kampel v. Comm'r*, 72 T.C. 827 (1973), *aff'd* 634 F.2d 708 (1980).

Under Reg. § 1.707-1(c), a partner must include a GPUC as ordinary income in the partner's taxable year within which the partnership accrues the deduction. Section 7704(c)(2) looks to the gross income of a partnership for purposes of determining the extent of its qualifying income. Consistent with these provisions in the example above, we recommend that the characterization of a GPUC be determined based on the 2014 gross income of the payor partnership resulting in the PTP accruing $900,000 of qualifying income and $100,000 of non-qualifying income in 2014.

GPUC as Type of Income It Replaces

For purposes of the Qualifying Income Test, a GPUC may also be characterized by reference to the type of income it "replaces." Under this standard, a GPUC received by a PTP for the use of a partner's cash would be treated as interest for purposes of § 7704(c). Similarly, a GPUC received by a PTP in exchange for real property contributed to the payor partnership would be treated as rent with respect to that property for purposes of § 7704(c). As discussed below, we believe this characterization is also supported by existing law.

As noted above, § 707(c) and the regulations thereunder provide that guaranteed payments made by a partnership are considered as made to one who is not a member of the partnership for purposes of § 61(a). That section provides that income means all income from whatever source derived, including (but not limited to) several specific

items listed in the statute. As relevant here, that list includes: (i) interest (listed in § 61(a)(4); and (ii) rent (listed in § 61(a)(5)). Neither the Code nor the regulations provide guidance as to the specific character of GPUCs in the recipient partner's hands. In several instances, however, the IRS has interpreted the statute and regulations to provide that guaranteed payments for the use of capital should be treated as interest for purposes of §§ 61 and 162. Specifically, in GCM 36702,[11] the IRS analyzed the tax treatment of advances by a partner to a partnership and concluded that the money "loaned" to the partnership was in fact an equity contribution. In analyzing the consequences of payments made on the "debt," the IRS discussed § 707(c). Citing the legislative history accompanying the enactment of § 707(c), which is discussed in more detail below, the IRS stated its belief that "[a]lthough section 707(c) contains no reference to Code section 163, we believe that guaranteed payments for the use of capital constitute interest income under section 61(a)(4)."[12] The IRS reached the same conclusion in GCM 38133,[13] again treating guaranteed payments for the use of capital as interest income without regard to the nature of the payor partnership's income.

Moreover, § 1.469-2(e)(2)(ii) generally provides that any payment to a partner for the use of capital that is described in § 707(c) is characterized as a payment of interest and not as a distributive share of partnership income.[14] When the capital contributed by the partner

[11] GCM 36702 (April 12, 1976).
[12] *Id.* at 6 (citing O.M. 17746 (August 4, 1972)).
[13] GCM 38113 (October 10, 1979) (citing GCM 36702).
[14] The IRS also refers to guaranteed payments for capital as interest payments in the instructions for filing a partnership tax return. *See* 2015 Instructions for Form 1065, U.S. Partnership Return of Income. First, the specific instructions for Line 15 – Interest provides that "*interest* paid by a partnership to a partner for the use of capital ...should be entered on

is cash, this treatment of a GPUC as interest is consistent with the definition of that term provided by the Supreme Court in *Deputy v. Dupont*.[15] In that case, the Supreme Court provided that the term "interest" generally means compensation for the use or forbearance of money. A GPUC is a payment by the partnership to a partner for the use or forbearance of the partner's money if the capital with respect to which the GPUC relates is money.

Treatment of a GPUC as interest is also consistent with the legislative history accompanying the enactment of the guaranteed payment rules in 1954. The House bill that proposed the original version of § 707(c) provided only that the payment of a fixed or guaranteed amount for services was to be treated as salary income to the recipient. The Senate version of the bill, however, extended the application of the statute to a GPUC. The Senate report provides that the Senate Committee on Finance "extended [the] treatment to guaranteed *interest* payments on capital."[16]

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line 10 as guaranteed payments" (emphasis added). Second, the specific instructions for Line 4 of Schedule K-1 provide that guaranteed payments to partners include "*interest* deducted by the partnership and reported on Form 1065, page 1, line 10 ...." (emphasis added). Finally, later in the same section, the IRS provides that guaranteed payments for personal services to a partner would not be passive activity income. Similarly, "*interest* paid to any partner is not passive activity income" (emphasis added).

[15] 308 U.S. 488 (1940).

[16] *See* S. Rep. No. 1622, 33d Cong., 2d Sess. 94 (1954) (emphasis added). *See also* page 92 of the same report, which provides that the committee extended the rules applicable to guaranteed payments for services to "*interest* payments" (emphasis added). The Tax Court and the Court of Claims addressed the treatment of guaranteed payments for services – as opposed to capital – for purposes other than §§ 61 and 162 in *Miller v. Comm'r*, 52 T.C. 752 (1969) and *Carey v. U.S.*, 427 F.2d. 1014 (Cl. Ct. 1970). In both cases, the courts concluded that the guaranteed payment for services was not a distributive share of the partnership's income for purposes of § 911. Underlying the courts' reasoning in each ruling was the legislative intent of § 911 to increase foreign trade by removing tax disadvantages for U.S. citizens working abroad.

The authorities above indicate that in several instances the IRS has treated GPUCs as "interest" for federal tax purposes. Consistent with that treatment, we believe that the IRS and Treasury could issue guidance indicating that, for purposes of the Qualifying Income Test, a GPUC received by a PTP is characterized by reference to the type of income it replaces.[17]

Characterizing a GPUC as the type of income it replaces has two advantages. First, determining the nature of the GPUC received without regard to the underlying activities of the payor partnership is arguably more consistent with the change to Example 2 in § 1.707-1(c). This approach is also less burdensome for a PTP than the "distributive share" approach described above. If a PTP receives a GPUC in exchange for cash contributed to a partnership, then under the "income it replaces" approach the PTP would know without further investigation that the GPUC is interest for purposes of the Qualifying Income Test; the same would be the case with respect to a GPUC received in exchange for real property contributed to the payor partnership. In contrast, if the GPUC is received in exchange for something else – such as personal property contributed to the partnership – the PTP would know that the GPUC was not qualifying income. Thus, the PTP would not be dependent on further information from the payor partnership for purposes of determining its qualifying income status.

[17] Applying an approach like this to guaranteed payments is similar to the approach taken by the IRS in determining whether other types of income are qualifying income. For example, under § 1.7704-3(a)(1), income derived from a notional principal contract will be considered qualifying income if the property, income, or cash flow upon which the contract is based would have given rise to qualifying income if they were held or received directly by the partnership. In other words, the income from the notional principal contracts effectively "replaced" qualifying income and thus was treated as qualifying income for purposes of the Qualifying Income Test.

Conclusion

Given the potential change in Example 2, the current focus on what constitutes qualifying income for purposes of § 7704(d), and the lack of clear guidance regarding the treatment of a GPUC, the issue of whether GPUC income is qualifying income for purposes of the Qualifying Income Test requires guidance. We request that guidance be issued making it clear that, in the hands of the recipient partner, a GPUC has the same character as the income of the payor partnership. Alternatively, we suggest that the IRS and Treasury adopt a rule characterizing a GPUC by reference to the type of income it replaces for purposes of determining whether the Qualifying Income Test is satisfied.

We appreciate your consideration of our views and recommendations with regard to the characterization of GPUCs as qualifying income for purposes of § 7704(d). If you have any questions or would like to discuss this issue further, please do not hesitate to contact Deborah Fields (dafields@KPMG.com; 202-533-4580) or Linda Carlisle (lcarlisle@milchev.com; 202-626-5850).

Respectfully submitted,

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