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COMMENT

GUARANTEED PAYMENTS OF PARTNERSHIPS: DEDUCTIBILITY UNDER SECTION 707(c)

by Andrew F. Spalding

Many practitioners have been assuming that one method to increase the tax dollar benefits of an investment tax shelter¹ is to form a partnership in such a way as to give the investing partners an income tax deduction for the payments made to the managing partner for organizing or syndicating the investment. This assumption has been based upon the theory that a guaranteed payment such as a management fee or salary is automatically deductible by the partnership under sections 707(c) and 162(a) of the Internal Revenue Code.² In a case of first impression, however, the Tax Court has held and the Fifth Circuit affirmed that section 707(c) guaranteed payments are not automatically deductible by the partnership if they are in the nature of a capital expenditure; rather, they must meet the requirements of a section 162(a) business expense to be deductible.³

This Comment discusses guaranteed payments under section 707(c) with special emphasis on recent judicial and Revenue Service developments. The impact of these developments on other areas of the tax law, possible alternative methods of obtaining deductions for management fees, and, finally, proposed and recently enacted legislation to remedy the confusion that may still remain in this area of tax law are also examined.

I. SECTION 707(C) GUARANTEED PAYMENTS: BACKGROUND

Guaranteed payments in the partnership context are those payments made by the partnership to a partner which are guaranteed in the same sense that the payments are made regardless of the amount of income, if any, of the partnership. Typically, guaranteed payments function as salaries to service partners or as interest payments to capital-contributing partners. If the

1. This Comment examines the real estate tax shelter in particular. The analysis and concept of deductibility of guaranteed payments, however, applies to all major tax-shelter plans, such as cattle feeding and breeding, vintaging and farming, equipment leasing, and others. For an analysis of the guaranteed payment issue as it applies to oil and gas drilling see Klein, *Are Deductions for Guaranteed Payments in Fact Guaranteed? An Analysis of the Cagle Decision*, 23 OIL & GAS TAX Q. 264 (1975). For an examination of the issue as it applies to real estate investment see S. MORRIS, REAL ESTATE TAX PLANNING § 4.23 (to be published by Little, Brown & Co. in mid-1977).

2. INT. REV. CODE OF 1954, § 707(c) provided:

GUARANTEED PAYMENTS.—To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purpose of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses).

This section has been recently amended. See text accompanying note 106 *infra*. INT. REV. CODE OF 1954, § 162(a) provides:

IN GENERAL.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—(1) a reasonable allowance for salaries or other compensation for personal services actually rendered

Unless otherwise stated, all Code references are to the Internal Revenue Code of 1954, with amendments, hereinafter referred to in the text as "Code."

3. Jackson E. Cagle, Jr., 63 T.C. 86 (1974), *aff'd*, 539 F.2d 409 (5th Cir. 1976).

partnership has no income or income less than the amount of the guaranteed payments, then generally the difference will be covered by a deduction from the partnership's contributed capital.

Section 707(c) was first enacted as part of the Internal Revenue Code of 1954. The 1939 Code did not provide for the deductibility as a business expense of guaranteed payments from the partnership to the partner. Salaries for services rendered by a partner to the partnership and interest payments for the use of a partner's capital by the partnership were treated as distributions of partnership income rather than as business expenses.⁴ Complications arose under this approach when the guaranteed payments in a given year exceeded partnership earnings. In that situation the recipient of the guaranteed payment was not taxed to the extent that the payment represented a return of his contributed capital, and each other partner could deduct as a business expense the amount by which his capital account was diminished by reason of the guaranteed payment. To the extent that a payment was received from another partner's capital, it was taxable to the recipient partner.⁵

To eliminate the complications of this approach Congress enacted section 707 as part of subchapter K of the 1954 Code. Section 707(a)⁶ adopts the principle that in transactions where a partner does not act in his capacity as a partner, the partnership should be regarded as a separate entity. These transactions between a partner and the partnership include, for example, loans of money or property, the sale or purchase of property, or the rendering of services.⁷ Section 707(c) provides that payments for services or the use of capital made by the partnership to a partner which are determined without regard to partnership income are considered as made to a person who is not a partner.⁸ These payments represent fixed consideration in addition to the partner's distributive share of partnership profits or losses. Under both section 707(a) and section 707(c) the transaction or the payment is treated as though it occurred between the partnership and an outsider.⁹ The primary effect of section 707, therefore, is to treat the partner who transacts with the partnership as an outsider and the partnership itself as a separate entity.¹⁰ This allows the partnership to take ordinary business expense deductions resulting from transactions with a person who also happens to be a partner, whereas before the Code change these same business expenses were permitted as deductions only in transactions with one who was in fact an outsider.

4. Treas. Reg. 118, § 39.183-1(b) (1953) reads: "Payments made to a partner for services rendered and for capital contributions are not deductible in computing the net income of the partnership, such payments being held to represent a division of partnership profits." See also 1 A. WILLIS, PARTNERSHIP TAXATION 213 (2d ed. 1976).

5. See *Rogers v. Commissioner*, 31 T.C. 1199 (1959), *aff'd in part and remanded*, 281 F.2d 233 (4th Cir. 1960); *Augustine M. Lloyd*, 15 B.T.A. 82 (1929); Treas. Reg. 118, § 39.183-1(b) (1953).

6. INT. REV. CODE OF 1954, § 707(a) provides:

PARTNER NOT ACTING IN CAPACITY AS PARTNER.—If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner.

7. Treas. Reg. § 1.707-1(a) (1958).

8. *Id.* § 1.707-1(c).

9. In *Jackson E. Cagle, Jr.*, 63 T.C. 86, 91 (1974), the Tax Court noted that it was not necessary to determine whether the payment in question was a subsection (a) or subsection (c) payment because, in either case, it had to meet the requirement of § 162(a) to be deductible.

10. The treatment of a partnership as a separate entity is discussed at note 27 *infra*.

The purpose of subchapter K of the 1954 Code was to eliminate the existing confusion and discrepancies in partnership tax law.¹¹ At the time of enactment of subchapter K, however, none of the previous case law had dealt with the problem of a salary payment to a partner which was in the nature of a capital expenditure.¹² As a result, this problem was not clearly confronted by the drafters of section 707. The House Report accompanying section 707(c) stated only that "[t]he bill provides that payment of a fixed or guaranteed amount for services shall be treated as salary income to the recipient and allowed as a business deduction to the partnership."¹³ Similarly, the report of the Senate Finance Committee did not mention any requirements as to the nature of the payment to a partner, stating only that "the partnership shall be allowed a deduction for a business expense."¹⁴ Thus, the Tax Court, when called upon to interpret section 707(c), was confronted with an issue which had not been considered by Congress at the time the section was enacted.¹⁵

II. THE CAGLE CASE

In *Jackson E. Cagle, Jr.*¹⁶ petitioners were the two investor partners in a partnership formed to build an office showroom complex. The partnership agreement provided that the investors would each contribute \$100,000 cash while the managing partner was to contribute, subject to an outstanding loan commitment, the section of land to be developed. All interest, taxes, commissions, management fees, and other expenses were to be allocated exclusively to the investor partners. The net profits or gains and the losses of the partnership were to be divided among all three partners. No partner was to receive any salary or drawings for services rendered to the partnership in his capacity as a partner.¹⁷

Two weeks after the partnership agreement was signed, the partnership entered into an agreement with the managing partner¹⁸ which provided that he

11. The Senate discussion on partners and partnerships states:

It is difficult, if not impossible, to determine the actual tax treatment of many ordinary, everyday transactions [under the old Code] . . . [Subchapter K] assumed the task of comprehensive clarification and reformation, so as to provide clear, rational, but flexible, rules for handling partnership transactions.

100 CONG. REC. 8998 (1954) (remarks of Senator Millikin).

12. *Disproportionate Profits, Losses and Capital Interests, Special Allocations, Guaranteed Payments, Timing Problems, Cash Flow*, N.Y.U. 32D INST. ON FED. TAX. 1541, 1568 (1974).

13. H.R. REP. NO. 1337, 83d Cong., 2d Sess. 68 (1954).

14. SENATE FINANCE COMM. REPORT, S. REP. NO. 1622, 83d Cong., 2d Sess. 387 (1954).

15. *Jackson E. Cagle, Jr.*, 63 T.C. 86 (1974), *aff'd*, 539 F.2d 409 (5th Cir. 1976).

16. *Id.*

17. 63 T.C. at 88.

18. The management agreement read in pertinent part:

WHEREAS: Company . . . desires to avail itself of Manager's . . . capacity, knowhow, expertise, past general experience, and over-all knowledge of all aspects of the development and management of real property in connection with Company's development of its property located in the Great Southwest Industrial District, Arlington, Texas. IT HAS BEEN AGREED by the parties hereto as follows:

1. Manager will assist and advise Company with respect to economic planning, feasibility, market analysis and the approach and appeal with respect to development of the above property.

2. Manager will provide Company with techniques regarding financial, accounting and other technical aspects applicable to the development and operation of such property.

would receive a \$110,000 fee for services to the partnership, \$90,000 of which was to be paid before the end of the year. The services actually performed by the manager included a feasibility study, work with the architects, work with the general contractors on the preliminary plans, and the arranging of financing. The management fee was for work done during the development stages of the project; no portion of the fee was for managing the complex after it was completed. The partnership reported no gross income at the end of the year but did deduct the \$90,000 paid as a management fee. This deduction was allocated in accordance with the partnership agreement to the two investor partners. The Commissioner subsequently gave notice of deficiencies to the investor partners. The deduction was disallowed because the management fee was not paid "for ordinary and necessary business expenses or . . . incurred in carrying on an existing trade or business."¹⁹

In the Tax Court the taxpayers contended first that the management fee was a section 707(c) guaranteed payment and "automatically deductible by the partnership as a section 162(a) expense without regard to the requirements of the latter section,"²⁰ and second that, in any event, they had shown that the payment had met the requirements of section 162(a). The Tax Court rejected the taxpayer's first argument and agreed with the Government that whether the fee was a section 707(a) payment²¹ or a section 707(c) payment was not important to the facts of this case; the payment must still meet the requirements of section 162(a) to be deductible by the partnership.²² Rejecting petitioner's second argument, the court noted the particular facts of the case and held that the cost of the managing partner's services was in the nature of a capital expenditure and, therefore, not deductible.²³

To decide whether a guaranteed payment is automatically deductible under section 707(c), the Tax Court compared the problem before it with the situation in which the partnership transacts with a third party. Noting that expenditures to third parties which are capital in nature are not currently deductible by the partnership even though they must be included in the recipient's gross income,²⁴ the court in *Cagle* concluded that a "different result should not obtain where the transaction happens to be with one who is a partner."²⁵ In addition, the court considered the legislative history²⁶ of section 707(c) and found that Congress did not intend to treat partnerships more favorably than other taxpayers by allowing deductions for capital expenditures. By enacting section 707 Congress was adopting the entity theory rather than the aggregate approach to control transactions between a

3. Manager will assist in the general supervision and administration of Company's operation from the date hereof through October 31, 1969.

Id. at 89.

19. *Id.* at 90.

20. *Id.* at 91.

21. See note 6 *supra* and accompanying text. The Government argued primarily that the payment in question was a § 707(a) payment and alternatively that, even if determined that the payment fell within § 707(c) as argued by the taxpayers, it must still meet the requirements of § 162 to be deductible.

22. 63 T.C. at 91.

23. *Id.* at 96-98.

24. See Herbert Shainberg, 33 T.C. 241 (1959); A. Rhett du Pont, 19 T.C. 377 (1952).

25. 63 T.C. at 92.

26. See notes 13, 14 *supra* and accompanying text.

partner and the partnership.²⁷ Under the entity theory the guaranteed payment would be viewed as coming from the partnership entity, not from the aggregate of the partners as it had been viewed under the previous Codes. Thus, the character of the payment, whether business or capital in nature, must be viewed at the partnership level as well. If the payment is an ordinary business expense to the partnership entity, then each partner, including the partner receiving the payment, may deduct his proportionate share. Even when partnership expenses exceed partnership income and the guaranteed payment partially represents a return of the recipient partner's contributed capital, he may deduct his proportionate share as a business expense of the partnership. If the payment is a capital expenditure at the partnership level, it is not deductible by the partners, and even if the expenditure is greater than the partnership income, the partner receiving the payment must treat it as ordinary income to himself, regardless of the fact that the payment represents a partial return of his capital contribution. This differs from pre-1954 Code treatment where a partner was not allowed a business deduction for any partner-partnership transactions, nor was he taxed for receiving a guaranteed payment to the extent that the payment reduced his own capital.²⁸ The court also relied on the literal language of section 707(c) to show that there is no requirement that the payment be deductible "automatically." The Code provides that the payment will qualify for deduction "but only for purposes of . . . section 162(a)" ²⁹ Finally, the court reasoned that a deduction as an ordinary and necessary business expense for a guaranteed payment for services that were capital in nature would be the only instance in which the Code would allow a current deduction for a capital expenditure, and Congress obviously could not have intended such "an anomaly in tax law."³⁰

Having concluded that the management fee was not automatically deductible, the court turned to the factual determination of whether the payment qualified as a business expense. Holding that the management fee was capital in nature, the court considered several factors important. The feasibility study in *Cagle* was found analogous to a land use survey in *Godfrey v. Commissioner*.³¹ Since the study, like the use survey, was the first step in the

27. See A. WILLIS, WILLIS ON PARTNERSHIP TAXATION 8-9 (1971). In general, the aggregate theory treats the partnership as an aggregate of participants who have pooled their property or resources for a joint purpose. The entity approach deals with the partnership as a separate entity, distinct from its members. The two concepts, with respect to partnership taxation, were developed by case law. The 1954 Code adopted neither theory exclusively but rather applied one or the other in various situations to produce a desired result. For example, under the aggregate concept the partners, not the partnership, pay income taxes (INT. REV. CODE OF 1954, § 701) and take deductions (*id.* § 702). The entity approach applies, on the other hand, to dealings between a partner and the partnership (*id.* § 707) and taxation of capital gain or loss at the time of the partner's sale of his partnership interest (*id.* § 741).

28. See Augustine M. Lloyd, 15 B.T.A. 82, 88-89 (1929), in which guaranteed payments were treated under the pre-1954 Code aggregate approach as received partly from other partners' capital (taxable) and partly from the recipient partner's own capital (non-taxable).

29. INT. REV. CODE OF 1954, § 707(c).

30. 63 T.C. at 95.

31. 335 F.2d 82, 85 (6th Cir. 1964). The use survey was conducted for the purpose of determining the best commercial use of the property. The court of appeals held that the purpose of the use survey was to benefit the land in a permanent way so that the owners could derive income from the land on the basis of its best use. Since the benefit was not exhausted within a year, it was a capital expenditure.

acquisition of a capital asset, the cost incurred was a capital expenditure.³² Also important was the fact that the benefits of the study were expected to extend beyond the year in which the study was made.³³ Finally, the court held that the managing partner's services in obtaining the loan for the project were also capital expenditures which should be capitalized and deducted pro rata over the life of the loan.³⁴

On appeal the Fifth Circuit affirmed the Tax Court.³⁵ The contention that a guaranteed payment is automatically deductible was specifically rejected as being against congressional intent.³⁶ The court of appeals held that if a payment would be a capital expenditure under section 263(a) when made to a non-partner, then such a payment should not be treated differently if made to a partner.³⁷ In addition, the court confirmed the earlier finding that the payment involved was in the nature of a capital expenditure since it was made for the acquisition of an asset with a useful life extending beyond the year in which the cost was incurred.³⁸

Although section 707(c) and its legislative reports could have been interpreted as either (1) limiting the income tax deductions to those costs relating to trade or business expenses or (2) simply allowing tax deductions for all guaranteed payments,³⁹ the better view, and that taken by most commentators, supports the *Cagle* interpretation.⁴⁰ In addition, earlier analogous cases support the result reached in *Cagle* on both the issue of statutory interpretation of section 707(c) and the issue of the nature of the payment. In *Andrew O. Miller, Jr.*⁴¹ the controversy surrounded the statutory interpretation of section 707(c) with respect to the tax treatment of the guaranteed payment of compensation by a partner rather than a partnership. There the Tax Court held that the "but only for purpose of section 61(a)" limitation did

32. 63 T.C. at 95. The court relied upon a series of cases holding that an expenditure in connection with the acquisition of a capital asset was a capital investment and, therefore, not deductible as an ordinary and necessary business expense. See *Acer Realty Co. v. Commissioner*, 132 F.2d 512, 514 (8th Cir. 1942), *aff'g* 45 B.T.A. 333 (1941); *Ben Perlmutter*, 44 T.C. 382, 403-05 (1965), *aff'd*, 373 F.2d 45 (10th Cir. 1967); *Herbert Shainberg*, 33 T.C. 241 (1959).

33. 63 T.C. at 95.

34. *Id.* at 97.

35. *Cagle v. Commissioner*, 539 F.2d 409 (5th Cir. 1976).

36. "[W]e view it as most improbable . . . that Congress intended to provide deductions to a partnership not permitted any other taxpayer." *Id.* at 414.

37. *Id.* The Fifth Circuit specifically equated "capital expenditures" with § 263(a) capital expenditures. The Tax Court had created some uncertainty by making no reference to § 263 in its opinion. See Stein, *Guaranteed Problems with Guaranteed Payments*, 49 FLA. B.J. 531, 532 (1975).

38. 539 F.2d at 415.

39. The arguments in favor of the deductibility of the guaranteed payment in *Cagle* and in similar situations were based on the ambiguity of § 707(c)'s language and the fact that the legislative history did not expressly state that § 707(c) is limited by § 263, relating to capital expenditures. This has recently been remedied with the enactment of the Tax Reform Act of 1976. See text accompanying notes 100-08 *infra*.

40. See I. A. WILLIS, *supra* note 4, at 222; Kaster, *Real Estate Limited Partnerships Special Tax Allocations*, N.Y.U. 31ST INST. ON FED. TAX. 1799, 1810, 1811 (1973); Katten, *Deductibility of Guaranteed Payments to Partners*, 19 THE NATIONAL PUBLIC ACCOUNTANT, NOV. 1974, at 28. See also Holdsworth, *Tax Losses and Cash Flow: How to Treat Partners' Drawings and Salaries When There are Losses*, N.Y.U. 20TH INST. ON FED. TAX. 721, 731 (1962); Sexton, *Guaranteed Payments of a Partnership: Are They Automatically Deductible?*, 41 J. TAX. 312 (1974). But see Stein, *Guaranteed Problems with Guaranteed Payments*, 49 FLA. B.J. 531 (1975); *Disproportionate Profits, Losses and Capital Interests, Special Allocations, Guaranteed Payments, Timing Problems, Cash Flow*, N.Y.U. 32D INST. ON FED. TAX. 1541, 1570 (1974) (remarks of Mr. Leder).

41. 52 T.C. 752 (1969).

not preclude consideration of other Code provisions relating to the tax treatment of the compensation.⁴² In *Miller* the taxpayer was disputing the automatic includability in gross income of his guaranteed payment. In *Cagle*, however, the Revenue Service was disputing the automatic deductibility as a business expense of the guaranteed payment. By analogy the holding that the payment in *Miller* was subject to other Code provisions before inclusion in gross income opened the way for the holding in *Cagle* that the guaranteed payment was subject to other tax provisions, specifically the capital expenditure limitations, before deduction as a business expense.

With respect to the determination of the nature of the payment, the case of *Herbert Shainberg*⁴³ involved payments by a partnership to an accounting firm for auditing construction contracts and preparing initial property depreciation schedules in connection with the partnership's shopping center project. The Tax Court held that the accounting services were incurred as part of the construction and preparation of the shopping center and that such an integral part of the total cost of the buildings was not deductible as a business expense.⁴⁴ In *A. Rhett du Pont*⁴⁵ the partnership acquired a going stock brokerage business. In addition to the purchase price the partnership agreed to pay the former owner ten percent of the gross income of the business for the first year. This payment was held to be for the intangible value of the going business independent of the value of its component parts. Thus, the payment was a capital, not a business, expense.⁴⁶ Finally, in *Commissioner v. Idaho Power Co.*⁴⁷ the taxpayer claimed a deduction for depreciation on equipment used in construction of capital assets. The Supreme Court held that the equipment must be depreciated over the longer life of the capital assets rather than over the shorter life of the equipment because the depreciation expense was part of the cost of acquisition of the capital expense and "not an expense to the taxpayer of its day-to-day business."⁴⁸ Thus, considering prior case law, the conclusion that the management fee expenditure in *Cagle* was not automatically deductible but rather was capital in nature could not be avoided.

III. IMPACT OF THE CAGLE CASE

The Pratt Case and Revenue Ruling 75-214. *Cagle* may be affected by another case which arose under section 707(c). *Edward T. Pratt*,⁴⁹ a potentially significant case in partnership tax law,⁵⁰ involved taxpayers who were general partners in two limited partnerships formed to develop and operate a shopping center. The partnership agreement provided that the general partners were to receive a management fee based on a percentage of gross partnership

42. In this case the Tax Court was referring to § 911 which relates to the exclusion of foreign earnings from gross income. *Id.* at 762.

43. 33 T.C. 241 (1959).

44. *Id.* at 250.

45. 19 T.C. 377 (1952).

46. *Id.* at 381.

47. 418 U.S. 1 (1974).

48. *Id.* at 14.

49. 64 T.C. 203, 208 (1975).

50. See Weidner, *Realty Shelter Partnerships in a Nutshell*, 8 IND. L. REV. 899, 929-32 (1975).

income for their services in managing the partnership. The Tax Court denied any deduction to the partnership for the management fees paid to the general partners. The deduction was disallowed under section 707(a), which relates only to a partner not acting in his capacity as a partner,⁵¹ because the partners receiving the fee were "performing services within the normal scope of their duties as general partners and pursuant to the partnership agreement."⁵² More importantly, the Tax Court disallowed the deduction as a section 707(c) guaranteed payment because the fee, based on a percentage of *gross* income, did not meet the requirement that the payments be "determined without regard to the income of the partnership."⁵³ The taxpayer in *Pratt* contended that because the payments of the management fees were based on gross partnership income, the partnership was still obligated to pay the fee, even if other expenses exceeded the partnership's gross income. The fee would be "guaranteed" contingent upon the production of some partnership income.⁵⁴ Notwithstanding, the Tax Court in effect determined that the fee must be guaranteed even in the absence of any partnership income in order to be deductible by the partnership under section 707(c). Thus, the court equated "guaranteed" with "fixed amount." This holding would seem to conform to the literal language of section 707(c)⁵⁵ which speaks of payments made "without regard to the income of the partnership,"⁵⁶ but not necessarily to the expectations of some practitioners.⁵⁷

The *Pratt* case may be important as a means of partially diminishing the cost to the taxpayer of the *Cagle* restrictions on deductibility of guaranteed payments which at the same time are included as ordinary income to the recipient partner.⁵⁸ After denying deductions in *Pratt* to the partnership under sections 707(a) and 707(c), the court concluded that the management fees should be treated as "part of the partners' distributive income from the partnership."⁵⁹ In the event that, as in *Cagle*, partnership expenses exceed partnership income, the management fee based on a percentage of gross income would necessarily be paid to the recipient partner out of all the partners' contributed capital. To the extent that this payment represents a return of his capital, the recipient partner is not taxed,⁶⁰ assuming also that the fee was paid for services performed within the scope of his partnership duties. If the payment had been a guaranteed fee within the meaning of section 707(c) or a fee for services performed not as a partner within the meaning of section 707(a), it would be taxable as ordinary income. To some

51. INT. REV. CODE OF 1954, § 707(a); see note 6 *supra* and accompanying text.

52. 64 T.C. at 212.

53. INT. REV. CODE OF 1954, § 707(c). This result was surprising to at least one commentator. See Weidner, *supra* note 50, at 930.

54. If the payment of the fee was based on a percentage of the partnership's net income it would be contingent upon partnership income exceeding partnership expenses. Thus, the payment clearly would not be guaranteed.

55. See I A. WILLIS, *supra* note 4, at 214.

56. INT. REV. CODE OF 1954, § 707(c).

57. See Sexton & Charyk, *Does the Recent Pratt Case Provide a Method of Insuring Guaranteed Payment Deductions?*, 43 J. TAX. 66 (1975).

58. *Id.*

59. 64 T.C. at 210.

60. Thus, the result is the same as under the pre-1954 Codes. See text accompanying note 5 *supra*.

extent the *Pratt* case allows tax planners to avoid the result in *Cagle* by giving the recipient partner a non-taxable return of capital, notwithstanding that there remains no deduction to the partnership if the payment is in the nature of a capital expenditure.⁶¹

The impact of *Cagle* was felt by its incorporation into Revenue Ruling 75-214.⁶² In that ruling the Revenue Service examined a limited partnership formed to develop real estate with capital obtained through a public offering. The general partner was paid a fixed fee for his services in organizing the partnership. Relying on *Cagle*, the Revenue Service advised that:

[E]ven though the payments to the general partner for his services rendered in organizing the limited partnership are payments described in section 707 of the Code, they are not deductible by the partnership under section 162 because they constitute capital expenditures within the meaning of section 263.⁶³

In addition to the aforementioned developments, the *Cagle* decision has been incorporated into legislation in the area of partnership guaranteed payments.⁶⁴

Economic Costs of Cagle to the Taxpayer. The most obvious impact of the ruling in *Cagle* is that the investor will incur less economic benefit due to the disallowance of the "front-end loss"⁶⁵ of the guaranteed payment. Although the current deduction was disallowed, the courts determined that the cost of the management fee was part of the cost of development of a capital asset. As such, the cost may be deducted as depreciation over the useful life of the asset. If the court had determined that the guaranteed payment was either an intangible organizational expense or an additional cost of the land, then the tax benefits would not be realized until disposition of the asset or land. At that time the amount of the guaranteed payment would be considered as part of the basis of the asset or land to reduce any capital gain or increase any capital loss. Requiring the amortization of the payment is costly to the taxpayer for the simple reason that the present value of a dollar of deduction to be taken in the future is worth less than the present value of a dollar of deduction to be taken at once. How much less depends upon the current interest rate, the method of depreciation, and the useful life of the asset.

Tax Planning Alternatives. Unfortunately for investors seeking tax shelters, the section 707(c) guaranteed payment method of increasing the initial losses of a real estate investment appears to have been effectively eliminated by the *Cagle* case and by recent legislation⁶⁶ so far as the payments represent

61. This analysis is adopted from Sexton & Charyk, *supra* note 57, at 67-70.

62. Rev. Rul. 75-214, 1975-1 CUM. BULL. 185.

63. *Id.* at 186. For further discussion of organizational expenses see text accompanying notes 68, 92-98 *infra*. See also new Code § 709 discussed at note 102 *infra*.

64. See text accompanying notes 100-08 *infra*.

65. "Front-end loss" is artificial or non-economic loss which is available as a deduction under the tax laws. This type of artificial loss is realized in the situation where taxpayers are permitted to take deductions or accelerate depreciation in the early years, or "front-end," of an investment before the investment produces any income. This bunching of deductions in the early years offsets or "shelters" the individual's other income. See HOUSE COMM. ON WAYS AND MEANS, REPORT ON H.R. 10612, H.R. REP. NO. 94-658, 94th Cong., 1st Sess. 25 (1975).

66. See text accompanying notes 100-08 *infra*.

expenses incurred in the acquisition of capital assets. Management fees to the extent paid in connection with the actual management of an existing enterprise are business expenses, however, and may be deducted.⁶⁷ One alternative means to help assure deductibility might be to delay the payment of the management fee until the asset has been acquired and then pay the fee for the actual managing of the property. This would meet the court's objection in *Cagle* that the benefits of the fee would extend for longer than the year in which the fee was paid. If the fee paid to manage the property was sizeable, however, it would undoubtedly be necessary to prove that the fee was also "reasonable compensation" within the meaning of section 162(a)(1) of the Code, and was paid for managing the property in the year of the deduction only.

If the syndication incorporates, the organizational expenses are deductible over not less than five years under section 248.⁶⁸ "Organizational expense" might include the feasibility study and other expenses in the *Cagle* case.⁶⁹ Since a corporation is a taxable entity, however, the tax incidents of its operation remain at the corporate level and do not pass through to shareholders. Since the tax losses that are the real motivation for many investors do not flow through the corporation to the investors, the corporate form is not popular for tax shelters.

A final alternative is the subchapter S corporation.⁷⁰ Many of the tax incidents of a subchapter S corporation's operations pass through to shareholders. Although organization expenses are governed by section 248⁷¹ and may be amortized as in a corporation,⁷² there are limitations to the subchapter S corporation not found in the partnership form. One limitation is that losses cannot be allocated to some shareholders of the subchapter S corporation in proportions different from their shareholdings in the corporation. In a partnership items of loss or profit can be allocated to partners in any proportion agreed upon⁷³ so long as tax avoidance is not the principal purpose.⁷⁴ In the subchapter S corporation this limitation would prevent the shift of greater proportions of front-end loss to the capital-contributing shareholders and away from the service-contributing shareholders.⁷⁵ A more important limita-

67. A particularly relevant problem is to what extent a management fee may be broken down into business and capital expenses when one payment or a series of payments represents both. One suggestion is to keep accurate accounting data showing the allocation of the management fee between capital and non-capital services. See Klein, *supra* note 1, at 272. Another suggestion is to keep detailed lists of duties which the partner receiving the guaranteed payment is required to perform. If these duties conform with those facts which would allow a § 162 deduction, the list can be used to support the deductibility of the guaranteed payment. See Stein, *supra* note 37, at 533.

68. Section 248 permits a corporation to treat organizational expenditures as deferred expenses and deduct them ratably over five years. See note 94 *infra* and accompanying text. Recently enacted Code § 709 allows a partnership to do substantially the same thing. See text accompanying notes 102-05 *infra*.

69. It is not entirely clear that a "feasibility study" would be included in § 248. "Expenditures connected with the transfer of assets to a corporation" are not organizational expenses. Treas. Reg. § 1.248-1(b)(3)(ii) (1956). This may include the *Cagle* expenditures.

70. INT. REV. CODE OF 1954, §§ 1371-79.

71. *Id.* § 1373(d)(2); see I. GRANT, SUBCHAPTER S TAXATION 78 (1974).

72. See note 68 *supra* and accompanying text.

73. INT. REV. CODE OF 1954, § 704(a).

74. *Id.* § 704(b)(2).

75. See I. GRANT, *supra* note 71, at 26.

tion is that the amount of loss deduction of the shareholder is limited by the individual's adjusted basis in the subchapter S corporation, and the basis does not include any portion of the corporation's liabilities; only the amount of the shareholder's actual investment and loans to the corporation is included.⁷⁶ In a partnership, the principal activity of which involves real property, the amount of loss deductible by the partner is again limited by his adjusted basis,⁷⁷ but the partner's adjusted basis in the partnership includes cash investment plus a share of any nonrecourse liability of the partnership.⁷⁸ Thus, if the partnership borrows money or incurs other liabilities at the outset, a partner can deduct any operating loss to the extent of his share of the liability; if the subchapter S corporation incurs the same liability, the shareholder cannot deduct operating loss.⁷⁹

Other limitations to subchapter S corporations are enumerated in the Code.⁸⁰ Particularly discouraging to the real estate investment syndicate is section 1372(e)(5) which limits the subchapter S corporation's gross receipts from "passive investments," which include rents, to no more than twenty percent.⁸¹ This would eliminate many real estate syndications from subchapter S classification.

Other Areas of the Code Affected by Cagle. Two sections of the Code may well be affected by the Tax Court's interpretation of section 707(c) in *Cagle*. Section 736 provides that payments made by the partnership in liquidation of the interest of a retiring or deceased partner shall be considered as a 707(c) guaranteed payment if the amount is determined without regard to the income of the partnership.⁸² The Regulations provide that the payments to the extent considered guaranteed payments are "deductible by the partnership under section 162(a)."⁸³

One commentator suggests that either the writers of the section 736 Regulations have fallen into the trap of assuming deductibility without analyzing the problem, or section 736 was based upon an entirely different principle not really affected by section 707(c).⁸⁴ In any event, the Tax Court in *Cagle* expressly reserved determination of a similar issue under section 736, stating that no inference should be drawn from the *Cagle* decision.⁸⁵ Thus, *Cagle* should not be used as authority to determine that section 736 payments are not automatically deductible.⁸⁶

76. INT. REV. CODE OF 1954, § 1374(c)(2).

77. *Id.* § 704(d).

78. *Id.* § 752. Note that this difference applies only to real estate investing partnerships. Code § 704(d) was recently amended to limit a partner's interest in partnership liability to that portion for which the partner is personally liable. Thus, the deductions passed through to the partner may not exceed the amount of investment he actually has at risk in the partnership, similar to subchapter S corporation provisions. Real estate investing partnerships, other than mineral property, are not subject to this limitation. See Tax Reform Act of 1976, Pub. L. No. 94-455, § 213(e), 90 Stat. 1548; H. CONF. REP. NO. 94-1515, 94th Cong., 2d Sess. 423 (1976).

79. See I. GRANT, *supra* note 71, at 37.

80. See INT. REV. CODE OF 1954, §§ 1371-75.

81. *Id.* § 1372(e)(5).

82. *Id.* § 736(a)(2).

83. Treas. Reg. § 1.736-1(a)(4) (1965).

84. Sexton, *supra* note 40, at 313.

85. 63 T.C. at 96.

86. See Sexton, *supra* note 40, at 313: "[T]he concept of deductibility of guaranteed payments described in the Section 736 Regulations should not be carried over to automatic

Section 83(h), added to the Code in 1969, deals with property transferred in connection with performance of services.⁸⁷ The section allows the person who transferred the property in exchange for the services rendered to claim a deduction under section 162. Whether this deduction is automatic or dependent upon the capital expenditure distinction is not clear.⁸⁸ Proposed Regulation 1.83-6(a)⁸⁹ provides that "no deduction is allowed under section 83(h) to the extent that property transferred in connection with the performance of services constitutes a capital expenditure." Until the Proposed Regulation is adopted the reasoning in *Cagle* may, by analogy, be determinative of a dispute arising under section 83(h) by requiring that the transfer of property in connection with performance of services must be in the nature of an ordinary business expense to be deductible.

One new Code section, section 709, and an amendment to section 707(c) have been the direct result of the holding in *Cagle*.⁹⁰ These legislative developments are described in the next section of the Comment.⁹¹

IV. PROPOSED AND ENACTED LEGISLATION

Since the enactment of section 707 several legislative proposals have been made to make subchapter K more specific with respect to the treatment of guaranteed payments. The primary purpose of the proposed legislation has been providing or eliminating tax breaks, rather than clarifying interpretive problems under section 707. Both early and recent unsuccessful attempts to provide tax breaks for taxpayers in a partnership have centered around proposed amendments to section 703 that would allow deductions for the organizational expenses of a partnership. Whether the problem of automatic deduction of guaranteed payments as found in the *Cagle* case would have been affected by these proposals depends upon the interpretation of the definition of "organizational expenses."

Under a 1959 proposal of the House Ways and Means Committee Advisory Group⁹² the amendment to section 703 would have permitted a partnership to deduct organizational expenses over a period of five years. This proposal was patterned after the existing approach to corporate organizational expenditures under section 248.⁹³ Unlike section 248, however, the definition of

deductibility under Section 707(c)." *But see* Rev. Rul. 75-154, 1975-1 CUM. BULL. 185, 186, which advised that payments made by partners in satisfaction of the liability to a retired partner are deductible by them as a trade or business expense under § 162(a) (no mention of the nature of the payment), and 6 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 35.25 (1975), which states: "While 'guaranteed payments' must qualify as an ordinary and necessary expense under Section 162 in order to be deductible to the partnership the Regulations [§ 1.736-1(a)(4)] indicate that payments under Section 736(a) are to be treated as a business expense of the partnership and hence deductible."

87. INT. REV. CODE OF 1954, § 83(h).

88. *See* Sexton, *supra* note 40, at 313: "Section 83(h) indicates that payments to which that Section is applicable are deductible under Section 162 regardless of the nature of the services rendered." *But see* 2 J. MERTENS, *supra* note 85, at § 11.11 (1974), which states: "The amount of deduction is subject to the restrictions otherwise applicable to Section 162 deductions . . ."

89. Proposed Treas. Reg. § 1.83-6(a), 36 Fed. Reg. 10793 (1971).

90. *See* S. REP. NO. 94-938, 94th Cong., 2d Sess. 93 (1976).

91. *See* text accompanying notes 100-08 *infra*.

92. *Advisory Group Recommendations on Subchapters C, J, and K of the Internal Revenue Code—Hearings Before the House Comm. on Ways and Means, 86th Cong., 1st Sess. 129 (1959) (Arthur Willis, Chairman).*

93. *Id.* at 130.

“organizational expenses” in proposed section 703 was expressly broadened to include “expenses not necessarily related to the formation of the partnership,”⁹⁴ such as “costs of obtaining capital contributions.”⁹⁵ The proposal of the Advisory Group appears to have been prompted by two Tax Court decisions holding that legal fees incurred in organizing a partnership are capital expenditures and are not deductible,⁹⁶ as well as by a desire to lessen the difference between tax treatment of the same expense for partnerships and corporations. Thus, it cannot be said with certainty that the treatment of a management fee as a guaranteed payment, the problem in *Cagle*, was considered in the drafting of the 1959 amendment.

Another unsuccessfully proposed amendment to section 703, almost identical to the one proposed in 1959, was included in Senate Bill 1119 introduced on March 10, 1975.⁹⁷ The purpose of the part of the bill amending section 703 was to “do something to encourage the formation of new firms by allowing amortization [over five years] of organizing expenses of new partnerships”⁹⁸ at a time of deepening recession. The question once again left for resolution was whether a guaranteed payment for managing the partnership in its early stages would have been encompassed by this proposal. The amendment would certainly have made more persuasive an argument in favor of automatic deductibility than did the present Code, especially in light of the purpose of the bill. Nevertheless, the “anomaly in tax law”⁹⁹ of allowing a current deduction for what is essentially a capital expenditure would have been difficult to circumvent.

The question of deductibility of guaranteed payments to a partner in connection with organizing the partnership or for acquiring assets which are capital in nature appears to have been settled by Congress in recent legislation. The House and Senate adopted the Revenue Service’s position in *Cagle* and Revenue Ruling 75-214 by passing the Tax Reform Act of 1976¹⁰⁰ on September 16, 1976.¹⁰¹ Section 213(b) of the Act makes two Code changes.

94. *Id.* The pertinent part of § 248 reads:

(b) ORGANIZATIONAL EXPENDITURES DEFINED.—The term ‘organizational expenditures’ means any expenditure which—

(1) is incident to the creation of the corporation;

(2) is chargeable to capital account; and

(3) is of a character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life.

Compare the pertinent part of proposed § 703:

(3) DEFINITION OF ORGANIZATIONAL EXPENSES . . . [T]he term ‘organizational expenses’ includes any expenditure which is incident to—

(A) the creation of a new partnership,

(B) the preparation of a partnership agreement on an existing partnership,

(C) the amendment of an existing partnership agreement, or

(D) the preparation or amendment of any agreement relating to the purchase or retirement of the interest of a withdrawing or deceased partner.

95. *Advisory Group Recommendations*, *supra* note 92, at 130.

96. *Meldrum & Fewsmith, Inc.*, 20 T.C. 790, *aff’d on other grounds*, 230 F.2d 283 (6th Cir. 1956); *Abe Wolkowitz*, 8 CCH Tax Ct. Mem. 754 (1949).

97. S. 1119, 94th Cong., 1st Sess. § 7 (1975). The only difference between this bill and the 1959 proposal was in the last section of “Definitions of ‘organizational expenses.’” The term in the 1975 bill included expenses incident to “(D) the preparation or amendment of any agreement relating to the transfer or retirement of an interest in a partnership.” *See also* note 94 *supra*.

98. 121 CONG. REC. 3488 (daily ed. March 10, 1975) (remarks of Senator Nelson).

99. 63 T.C. at 95; *see* note 30 *supra* and accompanying text.

100. Pub. L. No. 94-455, 90 Stat. 1520.

101. President Ford signed the Act into law on Oct. 4, 1976.

First, the section adds new Code section 709 which disallows deductions for payments to a partner for syndicating or organizing the partnership, subject to the exception that certain organizational expenditures may be amortized.¹⁰² This adopts the Revenue Service's position in Revenue Ruling 75-214 that organizing expenses are not currently deductible by the partnership under section 162.¹⁰³ Notwithstanding, the new section brings partnership tax law closer to corporate tax law by allowing organization fees to be amortized over sixty months, similar to section 248.¹⁰⁴ The question still remains as to exactly what organizational expenses are deductible. Interpretive problems concerning the scope of section 709(b)(2) are easily foreseeable, and the solutions will most likely be similar to those to section 248 problems.¹⁰⁵ Second, Code section 707(c) is amended by section 213(b) of the Act to make guaranteed payments "subject to section 263, for purposes of section 162(a)." ¹⁰⁶ This adopts the Revenue Service's position in *Cagle* and clearly indicates that guaranteed payments which are capital in nature are not deductible. Moreover, the House Report on the Act takes the position that these proposals are not a change in the law, but merely a declaration and clarification of existing law.¹⁰⁷ This would subject taxpayers in positions similar to that of the taxpayers in *Cagle* to tax assessments for previously deducted section 707(c) payments if made for capital expenditures.¹⁰⁸

V. CONCLUSION

The tax law applicable to the deductibility of partnership guaranteed payments has been less than clear since section 707 was enacted with the

102. Pub. L. No. 94-455, § 213(b), 90 Stat. 1547 (1976). Section 709 provides:
 (a) GENERAL RULE.—Except as provided in subsection (b), no deduction shall be allowed under this chapter to the partnership or to any partner for any amounts paid or incurred to organize a partnership or to promote the sale of (or to sell) an interest in such partnership.

(b) AMORTIZATION OF ORGANIZATION FEES.—

(1) DEDUCTION.—Amounts paid or incurred to organize a partnership may, at the election of the partnership (made in accordance with regulations prescribed by the Secretary), be treated as deferred expenses. Such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the partnership (beginning with the month in which the partnership begins business), or if the partnership is liquidated before the end of such 60-month period, such deferred expenses (to the extent not deducted under this section) may be deducted to the extent provided in section 165.

(2) ORGANIZATIONAL EXPENSES DEFINED.—The organizational expenses to which paragraph (1) applies, are expenditures which—

(A) are incident to the creation of the partnership;

(B) are chargeable to capital account; and

(C) are of a character which, if expended incident to the creation of a partnership having an ascertainable life, would be amortized over such life.

See also S. REP. NO. 94-938, *supra* note 90, at 94.

103. See text at notes 62-63 *supra*.

104. Section 709 does not apply to organizational fees unless incurred after Dec. 31, 1976. Pub. L. No. 94-455, § 213(f)(3), 90 Stat. 1549 (1976). See also H. CONF. REP. NO. 94-1515, *supra* note 78, at 421.

105. For discussion of § 248 problems see generally Carruthers, *How to Treat the Expenses of Organization, Reorganization and Liquidation*, N.Y.U. 24TH INST. ON FED. TAX. 1055, 1061 (1966); Weissman, *Allowable Deductions on the Formation, Reorganization and Liquidation of a Corporation*, 53 NW. U.L. REV. 681, 697 (1959).

106. Pub. L. No. 94-455, § 213(b), 90 Stat. 1547 (1976).

107. HOUSE COMM. ON WAYS AND MEANS, REPORT ON H.R. 10612, H.R. REP. NO. 94-658, 94th Cong., 1st Sess. 122 (1975).

108. In general the statute of limitations runs three years after the income tax return was filed. INT. REV. CODE OF 1954, § 6501(a).

Internal Revenue Code of 1954. The lack of clarity can be attributed to several factors: (1) the ambiguity of the Code language itself; (2) the absence of pertinent legislative history due to the fact that the specific problem of guaranteed payments that were capital in nature had not been litigated before 1954; and (3) the practice, over the years, of partnerships' deducting section 707(c) payments regardless of their nature. *Jackson E. Cagle, Jr.* is the first decision by the courts to confront the problem directly. The position of the courts is supported by the few tax authorities and commentators who have written on the subject. Other cases by analogy are consistent and the result has been made even more concrete in Revenue Ruling 75-214. Policy and reason combine to warrant reliance upon this case in the future.

In addition, the position of the Revenue Service has been incorporated into new tax legislation. By the passage of the Tax Reform Act of 1976 Congress has made an effort to clear the uncertainty of this area of the law. With the exception of foreseeable minor interpretive questions, the new Code provisions should prevent disputes resulting from future guaranteed payments in partnerships. Whether the new legislation will prevent further disputes and litigation arising from those guaranteed payments made in the past and subject to Revenue Service assessment is a different question. The *Cagle* case, however, should provide the answer that section 707(c) guaranteed payments are not automatically deductible unless they meet the same requirements of a business expense.

