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Real Estate & Passthrough Planning Corner

Guaranteed Payments Under Code Sec. 199A

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I. Introduction

While the reduction of the corporate income tax rate from 35% to 21% was arguably the centerpiece of last year's tax reform legislation, the new 20% passthrough deduction (the "QBI Deduction") for "qualified business income"[1] ("QBI") set forth in Code Sec. 199A seems to have garnered the most attention among both tax professionals and the general media. While not as dramatic as the corporate tax rate cut, Code Sec. 199A has the potential to effectively reduce the highest marginal tax rate with respect to QBI from 37% to 29.6%. Given the complexity of the QBI Deduction and the speed with which it was cobbled together by Congress, there are many ambiguities in this statutory provision, and while some questions about the provision were answered by Proposed Regulations issued by the Treasury Department on August 8, 2018 (REG-107892-18) (the "Proposed Regulations"), many open issues remain.

The focus of this column is on one very narrow aspect to the QBI Deduction: its interaction with, and inapplicability to, guaranteed payments for services or the use of capital. Pursuant to Code Sec. 707(c), payments for services or the use of capital are considered "guaranteed payments," and thus subject to the special tax treatment described below, to the extent that they are determined without regard to the income of the partnership. Each of these types of guaranteed payments presents unique challenges and opportunities with respect to the QBI Deduction, and this column identifies some of the problems with respect to such payments, and also proposes some potential solutions and workarounds.

II. Guaranteed Payments for Services

A basic understanding of the function of W-2 wages in qualifying for the QBI Deduction is necessary before Code Sec. 199A's treatment of guaranteed payments for services can be analyzed. Code Sec. 199A(b)(2) and (3) applies a limit (the "Limit") on the use of the QBI Deduction for taxpayers with taxable incomes in excess of certain taxable income thresholds ($207,000 for a single filer, and $415,000 for a married couple filing jointly) (the "Upper Thresholds"), and a phase-in of the Limit for taxpayers with taxable income between certain lower thresholds [$157,500 for a single filer and $315,000 for a married couple filing jointly] and the Upper Thresholds. Under the Limit, the QBI Deduction generally cannot exceed the greater of (i) 50% of the W-2 wages paid with respect to the business, or (ii) 25% of the W-2 wages paid with respect to the business, plus 2.5% of the unadjusted basis (*i.e.*, original cost basis) of the business' "qualified property" (generally, depreciable tangible property). Because of the Limit, owners of a business that has invested little in depreciable tangible property will be unable to make much use of the QBI Deduction unless the business pays a significant amount of W-2 wages.

Code Sec. 199A strongly disfavors guaranteed payments for services, which, like wages, are generally intended to compensate a partner for services rendered to or on behalf of the partnership. While a comprehensive discussion of QBI is beyond the scope of this column, Code Sec. 199A(c)(4)(B) specifically excludes from QBI any guaranteed payments received by a partner/payee for services. The rationale for such exclusion is that such guaranteed payments are in the nature of compensation for services, which Congress clearly intended to exclude from QBI.

Notwithstanding the exclusion of guaranteed payments for services from QBI, such payments nonetheless are not considered W-2 wages for purposes of the Limit. The rationale for this rule is that only W-2 wages are taken into account in calculating the Limit, and under relevant IRS guidance, compensation paid by a partnership to any of its partners can never be classified as W-2 wages.[2] Although in the subchapter S context, "reasonable compensation" received by an S corporation shareholder/employee is also excluded from QBI, such payments at least qualify as W-2 compensation for purposes of the Limit. In the partnership context, in contrast, guaranteed payments for services benefit neither the partner/payee nor the partnership/payer. The partner/payee derives no Code Sec. 199A benefit from such payments because they do not qualify as QBI, and the partnership/payer derives no Code Sec. 199A benefit from such payments because they do not count towards the Limit.

In order to avoid the "whipsaw" effect described above, taxpayers should consider replacing guaranteed payments with priority cash flow distributions and priority income allocations. Although unlike a guaranteed payment, a priority cash flow distribution is not payable regardless of the partnership's income, a priority distribution/allocation approach should in many if not most cases achieve a very similar economic result.[3] Moreover, even where the partner may suffer some economic detriment from the conversion of a guaranteed payment to a priority cash flow distribution/income allocation, the tax savings resulting from qualification for the QBI Deduction may be greater than any such detriment.

If the partners do not want to use a priority distribution/allocation approach (because, for example, they want to achieve the absolute certainty of a guaranteed payment), a tiered ownership structure, which allows for W-2 payments to indirect partners (see discussion below), should be considered. The payments under this approach will not qualify as QBI to the recipient, but they will at least be treated as W-2 wages for purposes of the Limit with respect to the partnership making the guaranteed payment.

The following example illustrates how a tiered ownership structure can be used to increase W-2 wages, even when guaranteed payments are used to compensate a partnership's service providers. For purposes of this example, assume that (i) Tom, Dick and Harry are equal 1/3 owners of the TDH partnership, (ii) Tom and Dick, but not Harry, provide services to TDH, and (iii) TDH wants to use guaranteed payments to compensate Tom and Dick for their services to TDH. If Tom, Dick and Harry do not want to replace the guaranteed payments with priority cash flow distributions and income allocations, not only will the guaranteed payments received by Tom and Dick not qualify as QBI, they will also not count toward the Limit for TDH, resulting in the "whipsaw" discussed above.

Tom and Dick could avoid this "whipsaw" by (i) forming an upper-tier, 50/50 partnership, TD partnership, and (ii) transferring their TDH interests to TD. Under this structure, they would own their TDH interests through TD, rather than being direct owners of TDH. Any compensatory payments for services received by Tom and Dick from TDH (in which they own no direct interest) should qualify as W-2 wages and should therefore count towards the Limit. This would potentially permit Tom, Dick and Harry to qualify for the QBI Deduction with respect to their allocable share of any QBI generated by TDH.

III. Guaranteed Payments for the Use of Capital

The points made above regarding the unfavorable treatment of guaranteed payments for services in the Code Sec. 199A context may be familiar to many readers, as this issue has been raised by many practitioners. Code Sec. 199A's treatment of guaranteed payments for the use of capital, in contrast, has received far less attention from practitioners, but there are certainly hazards and "traps for the unwary" here as well.

The law is currently unclear as to whether guaranteed payments for the use of capital should be treated by the recipient partner[4] as a separate item of "interest income" or a distributive share of partnership income.[5] If distributive share treatment is appropriate, the guaranteed payment for capital would generally qualify as QBI to the extent that the partnership's income constituted QBI. If, however, interest treatment is appropriate, the guaranteed payment for capital would generally not qualify as QBI because Code Sec. 199A(c)(3)(B)(iii) excludes from QBI "interest income" which is not allocable to a trade or business.

While a full discussion of the proper characterization of guaranteed payments for capital (interest or distributive share) is beyond the scope of this column, there are certainly strong arguments from the legislative history, the Regulations, case law and IRS rulings to support the treatment of such payments as "interest" to the recipient. Moreover, in a number of other contexts, the IRS has clearly taken the position that such payments constitute "interest" in the hands of the recipient. Specifically, the passive loss rules of Code Sec. 469 treat guaranteed payments for the use of capital as interest income.[6] Similarly, the Proposed Regulations under the net investment income tax rules of Code Sec. 1411 treat guaranteed payments for the use of capital as interest income (and thus subject to the 3.8% tax on net investment income).[7]

Finally, and most importantly, Treasury has weighed in on this issue in the Proposed Regulations with a taxpayer-unfriendly position that is consistent with its position in the context of passive losses and net investment income. Specifically, Proposed Reg. §1.199A-3(b)(1)(ii) provides in pertinent part as follows:

> *Guaranteed payments for the use of capital*. Income attributable to a guaranteed payment for the use of capital is not considered to be attributable to a trade or business, and thus is not taken into account for purposes of computing QBI…

Assuming the above provision of the Proposed Regulations becomes law, partners receiving guaranteed payments for the use of capital will not be able to take advantage of the QBI Deduction with respect to such payments. It should be possible, however, to restructure guaranteed payments for the use of capital in a manner that permits them to qualify as QBI.

As set forth above, Code Sec. 707(c) provides that in order to be classified as a "guaranteed payment for the use of capital," such payment must be determined "without regard to the income of the partnership" (*i.e.*, it must be payable whether or not the partnership has sufficient income). Rather than using a guaranteed payment for the use of capital, however, a preferred return on such capital (which preferred return would depend on the income/cash flow of the partnership) can be used instead. The distributive share attaching to such preferred return would generally not be treated as "interest income" (which is carved out of QBI), but would rather take on the character of the partnership's income, which, in the case of an operating business, would normally constitute QBI.

Once again, the partner receiving the preferred return (which, unlike a guaranteed payment, is only payable to the extent of the partnership's income) may, depending on the circumstances, be harmed economically from replacing a guaranteed payment with a preferred return. In many if not most cases, however, the partner should be able to achieve very similar economic results.[8] Moreover, even where replacing a guaranteed payment with a preferred return causes some economic harm to the partner, the tax benefits of qualifying for the QBI Deduction may be greater than such harm.

IV. Conclusion

Code Sec. 199A's very unfavorable treatment of guaranteed payments, whether for services or for the use of capital, requires practitioners that practice in the partnership area to closely review the LLC/partnership agreements of their clients to determine whether they contain Code Sec. 707(c) "guaranteed payments." If they do, practitioners need to evaluate whether the same or similar economic results can be achieved by replacing guaranteed payments with other arrangements that avoid disqualification from the QBI Deduction. Where appropriate, timely amendments to LLC/partnership agreements should be made to achieve more tax-efficient results.

As a reminder, in order for an amendment to an LLC/partnership agreement to be effective for a given tax year, Code Sec. 761(d) requires such amendment to be made "no later than the time prescribed by law for the filing of the partnership's return for the taxable year (*not including extensions*) (emphasis added)." Thus, in order to maximize Code Sec. 199A applicability by amending an LLC/partnership agreement effective as of January 1, 2018 (the effective date of Code Sec. 199A), such amendment for calendar-year partnerships must be in place no later than March 15, 2019.

ENDNOTES

1 This term is defined in Code Sec. 199A(c)(1) of the Internal Revenue Code (the "Code"). All Code Sec. references used herein are to the Code and the treasury regulations promulgated thereunder (the "Regulations").

2 *See, e.g.,* Rev. Rul. 69-184, 1969-1 CB 256.

3 In this regard it should be noted that Code Sec. 761(d) generally permits partners to amend a partnership agreement as late as 2.5 months after the close of its taxable year. This should often give the partners sufficient time to be able to "crunch the numbers" so as to achieve through a priority cash flow distribution/income allocation approach the same economic outcome that would have resulted from a guaranteed payment approach.

4 It should be noted that while there is some ambiguity with respect to the treatment of the guaranteed payment by the partner/recipient, the Regulations are clear that with respect to the partnership/payer of the guaranteed payment, the guaranteed payment is deductible under Code Sec. 162 and not Code Sec. 163. As a result, the new limit on the deductibility of interest under Code Sec. 163(j) should not apply with respect to a partnership's deduction for guaranteed payments for the use of capital.

5 *See* Andrew Kreisberg, "*Guaranteed Payments for Capital: Interest or Distributive Share?,*" TAX NOTES 55 (July 4, 2011).

6 Reg. §1.469-2(e)(2)(ii).

7 Proposed Reg. §1.1411-4(g)(10).

8 *See* note 3, *supra*.