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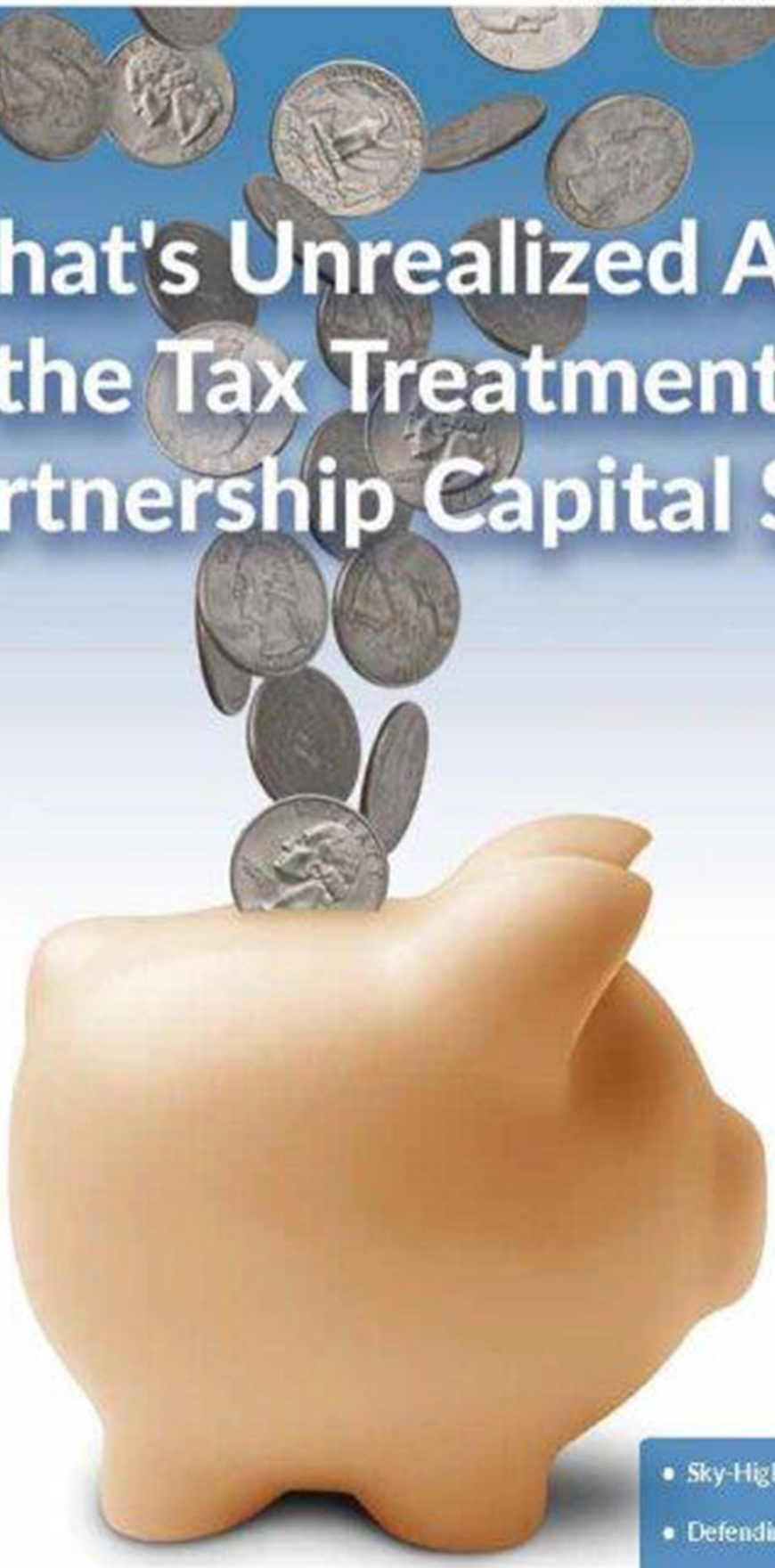

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In this report, Paul analyzes examples of partnership capital shifts and demonstrates that neither the *Lehman* theory, nor the guaranteed payment rules, nor the income allocation rules squarely address their proper tax treatment.

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I. Introduction

Partnerships offer immense flexibility to parties intending to engage in a collaborative business or investment enterprise. Accordingly, they have long been a vehicle of choice. The federal income tax system seeks to facilitate the partnership form by imposing only a single layer of tax on partnership income — a noble but challenging endeavor.

Partnership income must be allocated annually among the partners even though not all the facts may be known as to which partner will ultimately enjoy the benefit of that income. As well, the fundamental concept that formation of a partnership is tax free under section 721 means that on formation of a partnership, a partner can, without current taxation, dispose of an economic interest in an asset that partner owns in favor of acquiring an economic interest in an asset owned by another partner. Two visions of a partnership's nature have mediated these tensions: the entity theory and the aggregate theory. Both weave their way through subchapter K. The analysis of partnership capital shifts implicates the many tensions inherent in the noble project of subchapter K.

A partnership capital shift occurs when a partner's economic interest in partnership capital increases and, correspondingly, another partner's economic interest decreases. This report discusses three contexts: preferred partnership interest accruals, preferred partnership interest discount, and contingent increases in common equity.[1]

Capital shifts implicate a host of concepts fundamental to federal income tax, including the

[1]Capital shifts may also occur, for example, when a partner forfeits a partnership interest for failing to perform services over a prescribed period or defaulting on a capital call.

realization requirement, bargain purchases, and the accrual method. They also implicate concepts fundamental to subchapter K, such as section 704(b) accounting, guaranteed payments, and the hybrid nature of partnerships as aggregates and entities. Not surprisingly, the treatment of capital shifts is unclear. Perhaps surprisingly, little authority on the subject exists outside the compensatory context.[2] In that context, regulations treat a capital shift in exchange for services as taxable to the service provider. But policies concerning compensation may differ from policies outside the compensatory context. As we shall see, competing intuitions come into play in the noncompensatory context.

Capital shifts often occur without a realization event in the traditional sense. Thus, in those cases, one could conclude that the capital shift does not give rise to income (or loss) at that time. But a competing view would deem a realization event generally under an aggregate theory of the partnership. Under yet another view, relying on an entity theory of partnerships, the capital shift would represent a guaranteed payment. But that view, too, could be questioned, both from the point of view of the realization requirement and the technical workings of the guaranteed payment rules. The section 704(b) regulations could require an allocation of income to address a capital shift — yet another aggregate theory approach. But capital shifts can occur in a partnership that does not earn income, raising a question about reliance on income allocations to address capital shifts. While each of these theories and approaches has merit, none squarely puts to rest the proper treatment of capital shifts.

II. Preferred Accretions

A fixed accretion on preferred partnership equity presents a paradigmatic case of a potential capital shift. That accretion may well represent an increase in wealth for the holder of the preferred partnership interest, implying taxable income for that partner. But because of the realization requirement, not all increases in wealth constitute taxable income. Thus, the observation that the accretion represents an increase in wealth does not resolve the question whether the accretion is or should be currently taxable. Consider the following case of an accreting return on a preferred partnership interest:

Example 1: Suppose A contributes $90 to Partnership AB for a preferred interest with a 10 percent cumulative return, and B contributes $10 to AB for a common interest. These rights are reflected in a distribution waterfall providing that the partnership is not required to make distributions but that any distributions must be made in accordance with the following priority: first to Partner A in the amount of its cumulative return, then to A in the amount of $90, and then to Partner B. B is thus entitled to the entire residual. At the end of year 1 (assuming no distributions have been made), A is entitled to the first $99 (equal to 110 percent of $90) of distributions. At the end of year 2 (assuming no distributions have been made), A is entitled to the first $108.90 (equal to 110 percent of $99) of distributions. Assume no distributions are made in either year 1 or year 2, and assume that neither partner has any deficit restoration obligation. Does A have any income inclusion, and does B have any deduction in year 1 or year 2 because of the 10 percent accretions?

Commentators have discussed this basic scenario, but no clear answer is availing.[3] Partner A appears to have an accretion to wealth each year as the 10 percent cumulates. At the end of year 1, it would appear that A is $9 wealthier than at the beginning of year 1 because A's claim on partnership assets has increased by $9. At the end of year 2, A appears at first blush to be even wealthier by year 2's 10 percent cumulation of $9.90. But this would not be the case (assuming

[2] Reg. section 1.721-1(b)(1) ("The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61."). *See also* Rev. Proc. 93-27, 1993-2 C.B. 343 (distinguishing a receipt of profits interests for services from a receipt of capital interests).

[3] *See* Terence Floyd Cuff, *Drafting and Understanding Partnership and LLC Allocation and Distribution Provisions*, section 9:16 (May 2021 update); Zhiyuan Zuo, *infra* note 13; New York State Bar Association Tax Section, *infra* note 20; Robert J. Gaughan Jr., Stephen A. Good, and Gregg Hanks, *infra* note 21; Richard M. Lipton, "Preferred Returns and 'Phantom' Income," 19 *J. Passthrough Entities* 7 (2016); Noel P. Brock, *infra* note 8; Todd D. Golub, *infra* note 32; Jonathan R. Flora, "Venture Capital, Meet Capital Shift," *The M&A Tax Report* 1 (Feb. 2008); Simon Friedman, "Noncompensatory Capital Shifts: Rethinking Capital Accounts," *Tax Notes*, May 2, 2005, p. 597; Lewis R. Steinberg, *infra* note 26; and Steven R. Schneider and Brian J. O'Connor, "LLC Capital Shifts: Avoiding Problems When Applying Corporate Principles," 92 *J. Tax'n* (Jan. 2000). *See also* Brad Martinson, *infra* note 5.

the value of partnership assets has not changed) because aggregate contributions to the partnership were $100. If values have not changed, A's $108.90 claim on partnership assets at the end of year 2 would exceed the $100 value of partnership assets. Indeed, even A's apparent $9 increase in wealth in year 1 might not be factual if the value of partnership assets has decreased.

Increases in wealth themselves generally do not give rise to taxation because of the realization requirement. Indeed, one of the rationales for the realization requirement is that revaluing property every year would be burdensome. The determination whether Partner A has had an accretion to wealth in year 1 or year 2 depends on the value of the partnership's assets. Thus, the case is a fair one for application of the realization requirement. It would appear that no realization event has occurred in year 1 or year 2 in connection with A's annual increase in its claim on the partnership. No sale, exchange, distribution, or any other form of transaction or change in legal ownership of any asset has occurred. The analysis might stop at this point and conclude that A should not have an income inclusion resulting from the 10 percent accretions in year 1 and year 2. Yet that conclusion would be too quick because several counterarguments must be considered.

A. *Lehman*: Deemed Payment Theory

First, arguably, a deemed transfer of partnership assets or a partnership interest occurs in connection with a capital shift. *Lehman*,[4] the leading case addressing capital shifts, posits that an increase in one partner's capital account and a corresponding decrease in another partner's capital account are a realization event resulting in a deemed indirect transfer of partnership assets.

Under the partnership agreement, the taxpayers, husband and wife Harry and Florence Lehman, were each entitled to a $5,000 increase in their capital accounts once the other partners earned or received a specified amount of profits from the business. In that case, the same amount, a total of $10,000, was to be deducted from the capital accounts of the other partners. Harry was the sole general partner of the partnership, while Florence was one of four limited partners. Harry operated the business.

Analyzing the predecessor of section 61(a), the Tax Court acknowledged that the aggregate $10,000 increase to the taxpayers' capital accounts resulted from "the managerial efforts of Harry combined with good business conditions." But the court stepped away from the notion that compensatory elements influenced its decision, stating that the court did not view it as "crucial whether the transfer to petitioners' capital accounts was in fact 'compensation' for Harry's services," because "the increase resulted in a gain or profit" to the taxpayers. Thus, the court's expressed concern was the taxpayers' accession to wealth, regardless of any compensatory element.

Further, based on deemed steps, the court decided that a realization event had occurred. It distinguished the taxpayers' case from a scenario involving "the unrealized increase in the value of a capital asset." Instead, the court viewed the act of crediting the taxpayers' capital accounts "by reason of transfers from" the other partners as a realization event. From the court's perspective, the consequences should be the same as if three steps had occurred: (1) the partnership distributed $10,000 to the other partners; (2) those partners transferred the funds to the taxpayers; and (3) the taxpayers contributed the funds to the partnership. As stated by the court, "We think this situation should be no different in its tax consequences than if the partners had paid over to petitioner the $10,000 under an arrangement whereby petitioners agreed to use that sum to increase their investment in the partnership with a corresponding reduction in the capital shares of the other partners."[5]

Notably, as described, the *Lehman* theory would apply regardless of whether a partnership has gross or net income. Further, the theory does not depend on the occurrence of any transaction among the partners; it instead deems steps to occur. Finally, the *Lehman* theory does require that the partners from whom the capital is shifted have a proportionate share of partnership assets with a

[4] *Lehman v. Commissioner*, 19 T.C. 659 (1953).

[5] *Compare* Martinson, "Taxation of Noncompensatory Capital Shifts," *Tax Notes*, Dec. 5, 2011, p. 1256, at 1259 (a capital shift constitutes a realization event but should not give rise to income until the partner to whom capital has been shifted has "complete dominion" over the shifted capital).

value equal to at least the amount of capital shifted. Otherwise, there would be no assets to deem to be transferred.[6]

Applied to Example 1, the *Lehman* theory would deem that in year 1, $9 of capital was distributed to Partner B, transferred from B to Partner A in a taxable transaction, and then contributed by A to the partnership. In year 2, presumably only $1 of the accreted $9.90 would be deemed so transferred because (absent any change in the value of the partnership's assets) only $1 of partnership capital remains for B's benefit after year 1. Partnership capital would not be sufficient at the end of year 2 to pay A the full $9.90 of accretion (assuming values have not changed) because A's claim, which would be $108.90 at that point, would exceed the partnership capital of $100.

One could challenge the *Lehman* theory. First, fair market values may differ from book capital.[7] The *Lehman* theory would seem to require an annual valuation to determine whether values have increased or decreased and thus whether partnership capital is available to shift. Suppose in Example 1 that at the end of year 1, the value of the partnership's assets is only $60. Partner A already has a 100 percent proportionate interest in the $60 of partnership assets. It would seem that A should not have income under the *Lehman* theory despite the $9 increase in its claim on the partnership when there is no partnership capital for the benefit of other partners to shift to A.

One might counter that in many cases values remain unchanged or even increase, and that uncertainty in values should not prevent the government from collecting tax on what is often an accession to wealth. However, that argument assumes that the realization requirement should not apply. The very uncertainty about values is a rationale for the realization requirement. It is true that if realization has occurred, uncertainty about values does not prevent taxation. But that does not mean that realization should be deemed to occur, as under the *Lehman* theory, in the face of valuation challenges that the realization requirement was intended to avoid.

Second, the observation that preferred accretions can outstrip partnership capital available to be shifted, as occurs in year 2 in Example 1, further undercuts the premise that an accretion is an appropriate time to tax, because it highlights a disconnect between the business arrangement and the *Lehman* theory. In cases like Example 1, other partners' contributed capital is generally not intended to be the source of payment of the preferred accretion. As a business matter, a preferred investor would not normally invest to obtain the other partners' contributed capital, because the other partners' contributed capital would often be insufficient to fund the preferred accretions over the long haul. In Example 1, Partner A is not looking to B's $10 of capital to fund A's annual 10 percent accretions over time, because B's contributed capital is woefully insufficient to that task. Instead, business models for a preferred partnership investment would normally anticipate that the preferred accretions would be paid out of business profits, or a sale or other exit scenario.[8] This further throws into question an approach that would override the realization requirement. A simple-minded application of *Lehman* to the preferred accretion does imply current inclusion for the preferred holder in an amount up to the other partners' capital (perhaps with an annual book-up or book-down), but it is not clear that the *Lehman* theory is appropriately applied.

B. Guaranteed Payment Theory

An alternative theory for the preferred accretions is that they represent guaranteed payments. Guaranteed payments are treated as ordinary income to the recipient and generally as an ordinary deduction to the partnership (which

[6] The *Lehman* court deemed cash, as distinguished from partnership assets, to move in a circle and thereby sidestepped a question whether the partners from whom capital is shifted should recognize gain or loss on the deemed transfer to the partners to whom capital is shifted.

[7] Sheldon I. Banoff, "Partnership Ownership Realignments via Partnership Reallocations, Legal Status Changes, Recapitalizations and Conversions: What Are the Tax Consequences?" 83 *Taxes* 105, 167 (2005) (guidance is "nearly nonexistent" on the question whether capital, for purposes of analyzing capital shifts, is the partner's tax basis capital, section 704(b) capital account, or mark-to-market value of its partnership interest).

[8] *See* Brock, "Targeted Partnership Allocations: Part II," *The Tax Adviser*, July 1, 2013 (if a partnership is expected to have ample profits to support preferred accretion, liquidation in accordance with capital accounts eliminates the capital shift issue).

deduction may in turn be allocated among the partners).[9] Section 707(c) provides that to "the extent determined without regard to the income of the partnership, payments to a partner for . . . the use of capital shall be considered as made to one who is not a member of the partnership."[10]

Section 707(c) reflects an entity theory under which the partnership interacts with a partner that is a provider of capital just as the partnership would interact with a non-partner.[11] The *Lehman* theory, by contrast, relies on an aggregate theory under which one partner's claim to partnership assets is shifted to another partner.

The guaranteed payment rules, like the *Lehman* theory, do not neatly resolve the treatment of the preferred accretion. Further, the partnership deduction (or capitalized expense) arising from a guaranteed payment may deter the IRS from embracing the guaranteed payment theory.

1. Entity theory of partnerships.

The legislative history of section 707(c) highlights the provision's rejection of an aggregate theory in favor of an entity theory. Before the enactment of section 707(c), partnerships had difficulty accounting for compensatory payments to partners that exceeded partnership income. Those payments would be treated as withdrawals of capital. Insofar as it was a withdrawal of the partner's own capital, the payment would be tax free, but insofar as it was a withdrawal of another partner's capital, the payment would be taxable to the recipient and deductible to the other partners — a capital shift theory similar to *Lehman* except that in *Lehman*, cash winds up in the partnership, whereas in the basic scenario addressed by section 707(c), partnership cash is paid to, and winds up in the hands of, a partner.

Section 707(c) was intended to eliminate the complicated accounting associated with the prior-law capital shift approach by creating a partnership item of deduction and a partner item of income. As explained by the Senate Finance Committee:

> The payment of a salary by the partnership to a partner for services again raises the problem as to whether the partnership is to be viewed as an entity or merely as an aggregate of the activities of the members. Under present law, fixed payments to a partner are not recognized as a salary but considered as a distributive share of partnership earnings. This creates obvious difficulties where the partnership earnings are insufficient to meet the salary. The existing approach has been to treat the fixed salary in such years as a withdrawal of capital, taxable to the extent that the withdrawal is made from the capital of other partners. Such treatment is unrealistic and unnecessarily complicated. The House bill provides that payment of a fixed or guaranteed amount for services is to be treated as salary income to the recipient and allowed as a business deduction to the partnership . . . [The Senate Finance] committee also extended this treatment to guaranteed interest payments on capital.[12]

Thus, the guaranteed payment rules reject the aggregate theory underlying *Lehman* in favor of the entity theory of partnerships. Further, the guaranteed payment rules conceive a partnership

[9] Reg. section 1.707-1(c). A guaranteed payment is not automatically deductible, however, because it is subject to the usual rules for capitalization. Section 707(c) states that the treatment of a guaranteed payment as a trade or business expense under section 162(a) is "subject to section 263." *See also Cagle v. Commissioner*, 539 F.2d 409 (5th Cir. 1976) (a guaranteed payment for services concerning a real estate partnership must be capitalized). Capitalization by the partnership does not result in deferral of the income inclusion. *See* Rev. Rul. 80-234, 1980-2 C.B. 203 (inclusion of a guaranteed payment may not be deferred simply because the partnership was required to capitalize and amortize the payment).

[10] Under section 707(c), this treatment applies only for purposes of sections 61(a) and 162(a). An investment partnership holding fixed-rate bonds and issuing preferred interests and common interests arguably does not give rise to a guaranteed payment if the coupon on the preferred partnership interest is payable only out of income on the underlying bonds. James M. Peaslee and David Z. Nirenberg, *Federal Income Taxation of Securitization Transactions and Related Topics*, at 75, 418 (2018) (so-called tender option bonds are payable solely out of interest on underlying municipal bonds; a preferred interest coupon payable only out of income earned by a securitization partnership is not a guaranteed payment).

[11] The aggregate theory also comes into play, however, in that the determination whether a payment is a guaranteed payment appears to depend on whether there is partnership income. See the discussion of reg. section 1.707-1(c), Example (2), in Section II.B.4, *infra*.

[12] S. Rep. No. 83-1622, at 92-94 (1954). *See also Lloyd v. Commissioner*, 15 B.T.A. 82, 88 (1929) (salary paid out of a partner's own capital is a nontaxable return of capital, but salary paid out of other partners' capital is taxable to the recipient partner).

item of deduction (or a partnership item that must be capitalized) that is in a sense notional. The partnership item characterizes an actual payment, but if the payment were conceived instead as a partnership distribution (either a distribution to the recipient of the guaranteed payment, as under the prior law described by the Finance Committee, or to the other partners, as under the *Lehman* theory), no such item of deduction would arise. A partnership distribution does not give rise to a partnership item of deduction, whereas a guaranteed payment does.

In this sense, the guaranteed payment rules are an exception to the ceiling rule, which limits allocations of income and loss to items actually realized by the partnership.[13] The view of guaranteed payments as exceptions to the ceiling rule should perhaps give one pause in finding guaranteed payments, because the partnership form is not generally intended to give rise to notional items. Further, introducing notional deductions into the system (along with notional income items) might give taxpayers unanticipated planning opportunities (for example, if the recipient of the guaranteed payment is tax-indifferent but the other partners are profitable and can benefit from the notional deduction).

2. Payments.

Section 707(c) does not apply in the absence of payments. In most discussions of guaranteed payments, the existence of a payment is clear and the question is whether the payment was guaranteed. But in Example 1, a threshold question is whether the preferred accretion constitutes a payment for purposes of section 707(c). At a minimum, a payment in the form of cash, a cash equivalent, or another type of partnership asset should be viewed as a payment for this purpose. Further, a payment in the form of partnership debt should also presumably be viewed as a payment for this purpose. But no such form of payment is made in the case of a preferred accretion. The only viable argument for a payment is that the partnership paid in the form of a partnership interest, but this argument is in tension with the realization requirement.

The term "payment" is not defined for purposes of section 707(c), but it is defined in other contexts. For example, for purposes of the economic performance rules, a payment has:

> the same meaning as is used when determining whether a taxpayer using the cash receipts and disbursements method of accounting has made a payment. Thus, for example, payment includes the furnishing of cash or cash equivalents and the netting of offsetting accounts. Payment does not include the furnishing of a note or other evidence of indebtedness . . . payment does not include a promise . . . to provide services or property in the future.[14]

Likewise, for purposes of the installment sale rules, under section 453(f)(3), payment does not include the receipt of evidence of indebtedness.

Those definitions of payment, excluding the payment or receipt of debt obligations, seem overly constrained for purposes of the guaranteed payment rules. Presumably, if the partnership furnished a note or other evidence of indebtedness to the preferred equity holder for the accretions, that would constitute a payment for purposes of section 707(c).[15]

In Example 1, not only does the partnership not pay Partner A cash or a cash equivalent, but the partnership also does not accrue a debt obligation to the partner. The partner does not have a creditor's claim to the accretion. Instead, the amount that the preferred interest holder would be entitled to receive under the distribution waterfall is increased if the partnership chooses to make a distribution. When distributions are at the discretion of the board, as is typical, this increased tranche of the distribution waterfall is not a payable of the partnership. Economically, the preferred holder's equity claim, albeit for a larger amount, remains

[13] *See* Zuo, "A Gain Must Lie Where It Falls: Matching Tax With Economics in Subchapter K," 11 *Colum. J. Tax L.* 103, 138 (2019) (an unlimited ability to designate guaranteed payments would repeal the ceiling rule and undermine "substantial economic effect" rules).

[14] Reg. section 1.461-4(g)(1)(ii)(A).

[15] William McKee, William Nelson, and James Whitmire, *Federal Taxation of Partnerships and Partners*, para. 14.03[2] (2022) (the recipient's inclusion of a guaranteed payment hinges on the partnership accruing a deduction, not on payment).

subject to entrepreneurial risk and subject to a partnership decision on whether to pay distributions at all.[16]

Presumably, a payment could also include a payment in the form of property other than cash or a partnership debt obligation. Payment could occur in kind in the form of a transfer of a partnership asset to the partner. But no such transfer has occurred in the case of the preferred accretion. All partnership assets remain in the partnership. Partner A has received only an increased claim on partnership assets. The notion that the increased claim on partnership assets could constitute a payment while the assets remain in the partnership seems inconsistent with the entity theory that underpins section 707(c) because it appeals to the partners' interests in partnership assets.

Perhaps another way to put the argument for guaranteed payment treatment — in a manner more consistent with the entity theory — is that the partnership has paid Partner A in the form of an additional or increased partnership (capital) interest.[17] However, this argument seems hard to square with the realization requirement in the absence of a clearer statutory hook. It is not clear that a contingent right to receive partnership assets represented by an equity claim should constitute a payment for these purposes. Further, even if it could, the fact that the expansion of A's rights comes about unilaterally and under the terms of the partnership interest undercuts the view that the accretion is a payment, because the right to the accretion was inherent in the instrument from the start.[18] Indeed, the argument for guaranteed payment treatment seems to presuppose that the expanded rights of the preferred partner represented by the accretion are a separate property right capable of being paid or transferred independently of the other rights inherent in the partnership interest — a debatable position.

3. Accrued.

The accrual method of accounting, too, undercuts the view that the accretion represents a payment. The timing for a partnership's deduction of a guaranteed payment controls the timing for inclusion of the guaranteed payment by the partner that receives it.[19] Reg. section 1.707-1(c) stipulates that a "partner must include such payments as ordinary income for his taxable year within or with which ends the partnership taxable year in which the partnership deducted such payments as paid or accrued under its method of accounting."

Further, if an accrual-method partnership makes a guaranteed payment, the usual tests apply to determine the timing of the partnership's deduction. Reg. section 1.461-1(a)(2) provides that a:

> liability (as defined in section 1.446-1(c)(1)(ii)(B)) is incurred, and generally is taken into account . . . in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

It is unclear when the all-events test would be treated as satisfied under the guaranteed payment theory in the case of a preferred

[16] Reg. section 1.721-1(b)(1) arguably provides a clue as to what constitutes a payment for section 707(c) purposes. That regulation's main import is that a capital shift in exchange for services is treated as income under section 61. But it also applies to capital shifts in "satisfaction of an obligation." The scant reference to obligations does not resolve the question, however. From the context, the reference to "obligation" might only be to obligations regarding services, because the other relevant sentences in that regulation address only services. Moreover, the preferred accretion is at best a highly contingent obligation because the partnership has no obligation to make a distribution.

[17] Similarly, one could deem the partnership to have paid the partner a guaranteed payment in cash (or partnership assets) and the partner then to have recontributed the funds (or partnership assets), thus increasing the partner's capital account. But a question is whether the guaranteed payment rules contemplate such deeming. Further, if partnership assets are deemed transferred, a question would arise as to whether the partnership recognizes gain or loss on the deemed transfer of its assets. *See supra* note 6.

[18] *Cf.* reg. section 1.1001-3(c)(1)(ii) (an "alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument is not a modification" and hence is not a realization event). Further, the disguised sale regulations contemplate the possibility of a guaranteed payment that is retained by the partnership, rather than paid — a concept that seems inconsistent with guaranteed payments being paid in the form of additional preferred equity. *See* reg. section 1.707-4(c) (referring to guaranteed payments for capital that are "retained for distribution in a later year").

[19] Section 706(a) (the inclusion required by section 707(c) for a tax year of a partner is based on partnership items for the tax year of the partnership ending within or with the tax year of the partner).

partnership accretion.[20] First, putting aside for the moment the argument that the partnership has already paid by virtue of delivering a partnership interest, it appears that the partnership would not be entitled to deduct the preferred accretion currently, given the contingencies regarding whether the partnership will actually have to pay.[21] Not all the events have occurred to establish the fact of the liability because the partnership has not determined to make a distribution to reflect the accretion.[22] The partnership might never pay the accretion.

Further, the accretion does not appear to be a liability for purposes of the accrual rules. A liability includes "any item allowable as a deduction, cost, or expense," as well as amounts required to be capitalized or taken into account in the cost of goods sold.[23] The regulations further provide:

> The term "liability" is not limited to items for which a legal obligation to pay exists at the time of payment. Thus, for example, amounts prepaid for goods or services and amounts paid without a legal obligation to do so may not be taken into account by an accrual basis taxpayer any earlier than the taxable year in which those amounts are incurred.[24]

Thus, although a liability can include something that has not yet crystallized into a legal obligation at the time of payment, the concept appears to cover only something that will eventually become a legal obligation, because the regulations refer to amounts for which a legal obligation does not exist "at the time of payment."[25] The preferred partnership interest accretion will never crystallize into a legal obligation (other than perhaps for a brief period between the time it is declared and paid) because it is a claim in equity. Further, the distributions envisioned by the accretion depend on partnership assets remaining valuable enough to cover the accretion and on the partnership determining to pay distributions.

Thus, apart from the theory that payment is made in the form of a partnership interest, it appears that if the accretion represents a guaranteed payment, satisfaction of the all-events test might not occur before the partnership determines to distribute partnership assets to the preferred interest holder; no liability arises before then, and the determination to distribute is the fact that establishes liability. Under this view, the guaranteed payment theory would also defer the partner's inclusion until the time of that distribution — a result that might seem counterintuitive to advocates of the theory.[26]

But what of the argument that the partnership pays the preferred interest holder currently in the form of additional or increased capital interests in the partnership? Under that view, no liability need be found, because payment has already occurred in kind in the form of partnership equity. Indeed, as an analogy, corporations can deduct some payments made in the form of corporate stock. However, the argument that a partnership can make a guaranteed payment in the form of its own equity might seem circular. It gives one pause to apply such a strong version of the entity

[20] Commentators have also questioned when economic performance occurs. Any of three rules could potentially apply: section 461(h)(2)(A)(iii) and reg. section 1.461-4(d)(3) (for a liability arising out of the taxpayer's use of property, economic performance occurs ratably over the period the taxpayer is entitled to use the property); reg. section 1.461-4(e) (economic performance occurs as interest cost economically accrues); reg. section 1.461-4(g)(7) (when no other rule applies, economic performance occurs as payments are made in satisfaction of the liability). *See* NYSBA Tax Section, "Report on Guaranteed Payments and Targeted Allocations," at 12-15 (Nov. 14, 2016) (the interest rule likely does not apply).

[21] *See* Gaughan, Good, and Hanks, "Targeted Allocations," 43 *Real Est. Tax'n* 140, 145 (2016) (a guaranteed payment would not create a current deduction in many situations).

[22] *See id.*, at 145 (the rights on distribution of a partner to whom capital is shifted may be subject to entrepreneurial risks preventing the all-events test from being satisfied for an accrual-method partnership).

[23] Reg. section 1.446-1(c)(1)(ii)(B).

[24] *Id.*

[25] The definitions of obligation and liability in the section 752 regulations are also not limited to debt. An obligation for section 752 purposes is "any fixed or contingent obligation to make payment" and includes, for example, contract obligations and obligations under a short sale. Reg. section 1.752-1(a)(4)(ii). A liability for section 752 purposes is narrower, arising "only if, when, and to the extent that incurring the obligation" creates basis, gives rise to an immediate deduction, or gives rise to a nondeductible expense that is also not chargeable to capital. Reg. section 1.752-1(a)(4)(i). The contingent rights inherent in the preferred accretion might qualify as an obligation under these terms but would not qualify as a liability. *Cf. supra* note 16, regarding the term "obligation."

[26] Treating the payment as a guaranteed payment, rather than a partnership distribution, could still have implications for character and source. *See* Steinberg, "Fun and Games With Guaranteed Payments," *57 Tax Law.* 533, 546-554 (2004) (the characterization of guaranteed payments is relevant for withholding purposes when paid to non-U.S. persons).

theory. To say that a partnership equity claim, which is weaker than a liability, can represent a payment seems inconsistent with the elaborate rules regarding when a partnership liability accrues. That is, if the partnership must work its way through the accrual rules to claim a deduction for a non-equity claim on the partnership, it seems inconsistent that an equity claim itself satisfies the tests for deductibility (subject to the economic performance requirements).

4. Guaranteed.

Section 707(c) applies to guaranteed payments, but guidance on what makes a payment guaranteed is scarce. Reg. section 1.707-1(c), Example (2), implies a wait-and-see approach under which a partnership can earn its way out of guaranteed payment status. In Example 1 of this report, the requirement that a payment be guaranteed raises a further hurdle to applying the guaranteed payment theory to the preferred interest accretion.

In Example (2) of reg. section 1.707-1(c), Partner C is entitled to receive 30 percent of partnership income (determined before taking into account any guaranteed payment) but not less than $10,000. In a year in which partnership income is $60,000, C is therefore entitled to receive $18,000 (the greater of $10,000 and 30 percent of $60,000) as C's distributive share. None of the payment is considered a guaranteed payment. However, if partnership income were only $20,000, C would be entitled to $10,000 (the greater of $10,000 and 30 percent of $20,000), of which $6,000 is C's distributive share of partnership income and $4,000 is a guaranteed payment.

Example (2) presupposes a single relevant tax year. In that year, the partnership earns income and makes a payment to the relevant partner. Its implications for more complex cases have been debated. For instance, is it appropriate under the reasoning of Example (2) to consider income over a multiyear period? Is only net income relevant, or also gross income? And for purposes of that reasoning, is it relevant whether the partner's entitlements are expressed as a "greater of" formula, as distinguished from a fixed number or percentage, if the amount to which the partner is entitled exceeds partnership income?

Those questions are pertinent to the analysis of Example 1 of this report. Considered over the period during which the preferred equity is outstanding, the preferred interest accretions may well be less than aggregate partnership income, even if they exceed partnership income during the particular year of accretion.[27] Example (2) supports a wait-and-see approach under which the tax consequences of the accretion are analyzed in the year in which a distribution is in fact made, rather than in the year of the accretion. At the time of distribution, one would consider whether the distribution exceeds partnership income (whether for that tax year or perhaps cumulatively). The wait-and-see approach arguably reflects the business reality that the parties are waiting to see whether the preferred interest holder will get paid. Eventually, it will be known whether the payment to the preferred partner exceeds partnership income. Partnership assets might not be available to pay the accretion, because it is only a claim, albeit a senior claim, in an equity distribution waterfall. The preferred interest holder does not have creditors' rights, and its claim is subject to significant entrepreneurial risk. Thus, one approach would be to wait until the preferred interest holder is paid (in cash or partnership assets) to determine whether that payment of the accretion is a guaranteed payment.[28]

One could argue that it proves too much to say that the accretion is not a guaranteed payment for the use of capital on the basis that it is an equity claim, not a debt claim, on the partnership. The view that the accretion cannot be a guaranteed payment because it is not debt arguably undermines the very concept of a guaranteed payment for the use of capital because the premise of section 707(c) is that the payment is in fact to a partner. But a partnership can issue debt to a partner. Accretions could be so styled. The argument that the accretion is not a guaranteed

[27] Gaughan, Good, and Hanks, *supra* note 21, at 145 (whether a shift actually occurs will not be known until disposition of the partnership assets).

[28] Of course, the preferred partnership interest holder might not be paid all at once, which could complicate the inquiry. Further, although a wait-and-see approach would conform the timing of inclusion of a guaranteed payment to the timing of the receipt of cash or other partnership assets, guaranteed payment treatment would still affect character and source differently from distributive share treatment.

payment because it is not a debt obligation does leave open the possibility that the guaranteed payment rules would apply to a scenario in which the return accretes as a debt obligation (or is paid annually in cash or with other partnership assets), even though the preferred partner's claim to receive its original capital is equity. That is, if Partner A's right to the 10 percent accretions in Example 1 was a debt claim and its right to receive the original $90 was an equity claim, the right to accretions could be seen as a guaranteed payment. However, A's 10 percent accretions are simply an increased right in the distribution waterfall.

If one believes that a payment occurred at the time of the accretion in the form of additional partnership interests, the analysis is presumably different. Future income would arguably be irrelevant, and instead, if one believes that Example (2) of reg. section 1.707-1(c) applies at all, the analysis would seem to be whether the partnership had income in the year of the accretion. But this approach disregards that there may be something unique about a payment in the form of partnership equity. The theory that payment occurs in the form of a partnership interest is arguably in tension with the concept that the payment could be guaranteed. The term "guaranteed" under section 707(c) means "determined without regard to the income of the partnership," but the value of the partnership interest that is the putative means of payment is entirely dependent on partnership income in that its present value depends on expectations of future partnership income. Thus, it is questionable whether a payment in the form of partnership equity should be viewed as guaranteed.

C. Income Allocation Approach

Another approach to addressing the preferred accretion relies on an aggregate theory and would require special allocations of partnership income — perhaps only net income, perhaps gross income — to reflect the accretion. Neither the *Lehman* theory nor the guaranteed payment theory depends on the partnership earning any partnership income. As its name suggests, the income allocation approach does rely on partnership income.[29] Like the *Lehman* theory, the income allocation approach does not require a payment to a partner, but unlike the *Lehman* theory, it does not deem a payment to be made to a partner.

The income allocation approach finds support in the section 704(b) regulations. Those regulations seek to allocate income to a partner to reflect the partner's rights on liquidation of the partnership. Under the "substantial economic effect" safe harbor, a partnership is required to liquidate in accordance with capital accounts.[30] Thus, in Example 1 of this report, because Partner A's rights under the distribution waterfall increase by $9 in year 1 and those rights would apply in the event of a liquidating distribution, the substantial economic effect safe harbor implies that any partnership income should be allocated to A up to the amount of A's accretion. By the same token, the "partners' interest in the partnership" (PIP) test allocates income based on the difference between (1) distributions that would be made if all partnership property were sold at book value and the partnership were liquidated at the end of the tax year and (2) distributions that would be made if all partnership property were sold at book value and the partnership were liquidated at the end of the prior tax year.[31] If Partnership AB in Example 1 were to liquidate at the end of year 1, A would receive $99, whereas if AB were to have liquidated a year earlier, A would have received only $90. This implies that under PIP, A should be allocated $9 of partnership income for year 1.

The income allocation approach seems like a middle ground, an attempt to handle a thorny issue using existing techniques. But it is not clear that it properly addresses the issue. If the concern is a capital shift, the response should not depend on the existence of partnership income, because the capital shift arises independently of partnership income.

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[29] Analogously, section 305 generally requires income inclusions only if the corporate issuer has earnings and profits. Section 305(b) treats some distributions of stock as distributions of property to which section 301 applies. Section 301 would treat a distribution as a dividend only if the corporate issuer has E&P. Section 301(c)(1). A distribution exceeding E&P and basis also gives rise to gain under section 301. Section 301(c)(3).

[30] Reg. section 1.704-1(b)(2)(ii)(b)(2).

[31] Reg. section 1.704-1(b)(3)(iii).

Based on the substantial economic effect safe harbor or the PIP test, one might be tempted to allocate gross income to Partner A each year in the amount of A's accretion. But that approach illustrates the disconnect between capital shifts and partnership income. Suppose that in Example 1, the partnership breaks even in year 1, incurring $9 of income and $9 of deduction. And suppose that partnership asset values have not changed. Allocating all the gross income to A equal to A's accretion ($9 in year 1) would result in current taxation of A on the accretion and the equivalent of a deduction for Partner B in an equal amount.[32] But the rationale for doing this is unclear. Allocating all the gross income to A equal to A's accretion would result in capital accounts equal to liquidating distributions if the partnership were to liquidate at the end of year 1. But whether that result is appropriate is the same debate this report has been discussing. The existence of gross income and gross deduction is incidental to the fundamental question whether, in a case in which A's return is expected to arise from growth in the business, A should nonetheless be taxed currently. Gross income could well be less than $9 in year 1. Indeed, it could be zero, in which case the income allocation approach allocates no amount to A. The income allocation approach, at least in reference to gross income allocations, is a mechanism for creating an income inclusion to A, but it does not seem to add anything new to the analysis.

The income allocation approach in relation to gross income allocations is further highlighted by examining year 2 in Example 1. Partner A's accretion is $9.90 in year 2. Suppose that Partnership AB breaks even in year 2 as it did in year 1, but that in year 2 AB has $9.90 of gross income and $9.90 of deductions. Under both the substantial economic effect safe harbor (assuming no deficit restoration obligation for Partner B) and PIP, it appears that only $1 of gross income could be allocated to A, because B's capital account is only $1 after year 1 (and the book value of the partnership assets remains $100). A would have the right on liquidation to all $100 of partnership assets. This result — that only $1 of gross income is allocated to A, and $1 of gross deduction is allocated to B — is consistent with the underlying *Lehman* theory of a deemed distribution of capital from B that is transferred to A. Still, even though the income allocation approach does not give rise to an allocation to A that exceeds B's capital account, the approach, dependent as it is on the existence of gross income — which has nothing to do with the basic issue — seems to assume the conclusion.

If the partnership earns net income, the application of the section 704(b) regulations seems more straightforward, and it seems appropriate to allocate net income to Partner A to reflect the accretion. Indeed, in that circumstance, there may well have been no capital shift at all. Suppose that in year 1, Partnership AB has $9 of net income. The PIP test would allocate that $9 to A on the basis that A would receive $99 on a liquidation at the end of year 1 and only $90 on a liquidation a year earlier. The substantial economic effect safe harbor presumably would respect an allocation of $9 to either A or Partner B but would require liquidating in accordance with capital accounts. To reflect A's right to $99 on liquidation, the partnership likely would allocate the $9 of partnership net income to A. The $9 net income for year 1, at least in theory, would be reflected in a $9 increase in the value of the partnership. That is, the value of the partnership would be $109 at the end of year 1. Similarly, if the partnership earns $9.90 of net income in year 2, the value of the partnership would, at least in theory and if values have otherwise not changed, be $118.90 at the end of year 2. Thus, there would appear to be no capital shift in these circumstances but rather a conventional application of the section 704(b) regulations.

D. OID and Preferred Stock Discount

Arguments for and against current inclusion of preferred partnership interest accretions can be made by reference to the original issue discount regime for debt instruments and the section 305(b)(4) and (c) regime for preferred stock. Although these comparisons provide context, none are dispositive.

[32] *Cf.* Golub, "Target Allocations: The Swiss Army Knife of Drafting (Good for Most Situations — But Don't Bet Your Life on It)," 87 *Taxes* 157, 166 (2009) (no authorities directly address whether gross income allocations are required).

The OID regime mandates current inclusion of OID on debt instruments on a constant yield basis. By analogy, one might argue that preferred partnership accretions should also be currently included. But the distinction between debt and equity seems pertinent and suggests that current inclusions might be inappropriate on preferred partnership equity because no legally enforceable right to the fixed accretions arises.[33]

This then leads to an analogy to preferred stock subject to section 305(b)(4) and (c) because the claims of a preferred holder in a partnership and a holder of preferred stock are equity claims. Equity claims are more subject to the entrepreneurial risks of the business than debt claims and have no creditors' rights, such as the right to force the issuer into bankruptcy. Section 305(b)(4) and (c) mandates current inclusion of specified accretions for preferred stock. Arguably, the same should be true for preferred partnership equity.

But a deeper look at section 305 reveals limitations on the requirement of current inclusion for preferred stock that may undercut the argument for current inclusion for partnership preferred equity accretions. Section 305 does not require current inclusions if the corporate issuer does not have earnings and profits.[34] Nor does section 305 require current inclusions for an excess of liquidation preference over issue price if the preferred stock has a perpetual term (and the issuer does not have a call right that is more likely than not to be exercised, and the holder does not have a put right).[35] Moreover, dividends are generally not taxable until declared. For cumulative preferred stock, section 305(c) arguably does not mandate current inclusions if at the time of issuance there was no intention to refrain from paying the preferred coupon on a current basis.[36] Thus, the regime applicable to preferred stock is weaker than the OID regime — perhaps an acknowledgment that a preferred stockholder has a weaker claim on the issuer than a debt holder.[37]

Further, the notion that section 305(b)(4) and (c) does not apply to perpetual preferred (without a holder put or an issuer call) is pertinent to partnership preferred equity. The OID rules, applicable as they are to debt, presuppose a maturity of the instrument. The accreting OID will eventually be paid to the holder. The OID rules seek to smooth the income inclusions for debt instruments rather than bunch them all at the end, because the payday — the maturity date — draws closer over time. For perpetual preferred stock, the payday might never come. Instead, the receipt of payment for the accretions hinges on unanticipated conditions, such as a negotiated redemption of the preferred instrument or a sale or liquidation of the company. Likewise, preferred partnership equity often has no term, nor do holders generally have put rights. Issuers do have call rights in the sense that they can make distributions on the preferred, but when or whether that will occur will often be unknown and in any event not a decision of the preferred holder. In many cases, a preferred partnership interest holder has no real prospect of getting paid any time soon after issuance. Thus, the appropriate analogy may be to perpetual preferred stock, for which section 305 does not mandate current inclusions.

III. Preferred Discount: Bargain Purchase Doctrine

A fixed-income senior financial instrument is sometimes purchased together with an equity kicker in the form of a common interest or a warrant. If that so-called investment unit includes a debt instrument, section 1273(c)(2) determines an issue price for the investment unit and allocates that issue price between the debt instrument and the equity kicker. Although section 1273(c)(2) is not applicable to preferred partnership interests purchased together with

[33] The OID accretions may or may not precisely match the accreting legal claim of a holder of a debt instrument with OID.

[34] *See supra* note 29.

[35] Reg. section 1.305-5(b)(2) (a redemption premium is a section 305(c) constructive distribution if the issuer is required to redeem the stock at a specified time).

[36] H.R. Rep. No. 101-964, at 1095 (1990) (Conf. Rep.) ("if at the time of issuance of cumulative preferred stock there is no intention for dividends to be paid currently, the IRS may treat such dividends as a disguised redemption premium").

[37] Consistently, not all increases in the proportionate interest of a common stockholder of a corporation are taxed. Section 305(b)(2) taxes disproportionate distributions of equity, but only if some shareholders receive cash or other property while others increase their proportionate interest. Reg. section 1.305-3(a).

other property, one would expect some form of allocation of the purchase price to apply. Thus, for a preferred partnership interest purchased together with a common interest in the partnership, the investor's purchase price would be allocated between the preferred and the common interests. This can result in a potential capital shift at inception, raising questions similar to those discussed earlier about a preferred partnership interest accretion. But this scenario raises an additional twist concerning a bargain purchase, because the potential capital shift occurs at the moment of investment rather than with the passage of time.

Example 2: Suppose A contributes $9,000 to Partnership AB for a preferred interest and a common interest. Partner A's preferred interest has a senior claim of $9,000 and a 7 percent cumulative accretion. A's common interest represents 10 percent (say, one unit) of the common equity of the partnership. Suppose B contributes $1,000 to AB for 90 percent (nine units) of the common equity. These rights are reflected in a distribution waterfall providing that the partnership is not required to make distributions but that any distributions must be made in accordance with the following priority: first to A in the amount of the accumulated accretion on the preferred, then to A in the amount of $9,000, and then 10 percent to A and 90 percent to B. Thus, A pays $9,000 for a preferred interest with a senior claim of $9,000 and 10 percent of the common, while B pays $1,000 for 90 percent of the common.

If the preferred interest is worth $9,000 and the one common unit purchased by Partner A is worth $100, then, consistent with the allocation principle of section 1273(c)(2)(B), A's purchase price should be allocated 99 percent to the preferred interest (equal to $9,000 divided by $9,100) and 1 percent to the common interest (equal to $100 divided by $9,100), or $8,901 to the preferred and $99 to the common.

If Partnership AB were to liquidate immediately after it was formed, Partner A would receive $9,100 under the distribution waterfall (equal to A's senior claim of $9,000 plus 10 percent of the remaining $1,000), while Partner B would receive $900. Does A have any income inclusion, and does B have any deduction, as a result of these arrangements?

In Example 2, Partner A appears to receive the benefit of a bargain purchase. A paid $9,000 for preferred and common interests worth $9,100 in the aggregate. As in Example 1, there seems to be a capital shift from Partner B to A. But in Example 2, the shift occurs immediately upon formation of the partnership rather than with the passage of time. One might be tempted to apply the *Lehman* theory, the guaranteed payment theory, or the income allocation approach to require A to include an amount in income at the time of the partnership's formation. Upon contribution, the preferred holder's rights in the preferred interest ($9,000) are greater than the amount of purchase price allocated to the preferred interest ($8,901).

But bargain purchases are generally not taxable.[38] If a taxpayer is fortunate enough to buy something at a discount, the discount generally does not give rise to income until or unless the asset is sold. In *Palmer*,[39] the Supreme Court concluded that a purported sale of property by a corporation to its shareholders should be respected as a sale rather than recharacterized as a distribution of corporate earnings. The corporation had distributed stock subscription rights entitling shareholders to buy the underlying property at a price representing its value at the time the rights were issued. The value of the underlying property increased between the time the rights were issued and the time they were exercised. The Court held that the bargain purchase did not give rise to income to the bargain purchaser, stating that profits:

> derived from the purchase of property, as distinguished from exchanges of property, are ascertained and taxed as of the date of its sale or other disposition by the purchaser. Profit, if any, accrues to him only upon sale or disposition, and the taxable income is the difference between the amount thus realized and its cost, less allowed deductions. It follows that one does not subject himself to income tax by

[38] Bargain purchases in the compensatory context are an exception. *See* section 83(a) and (b).

[39] *Palmer v. Commissioner*, 302 U.S. 63 (1937).

> the mere purchase of property, even if at less than its true value, and that taxable gain does not accrue to him before he sells or otherwise disposes of it. Specific provisions establishing this basis for the taxation of gains derived from purchased property were included in the 1916 and each subsequent revenue act and accompanying regulations.[40]

Applying the principle of *Palmer* to Partner A, A should not be taxed on the receipt of preferred and common interests worth more than what A paid. *Palmer* rejects taxation of a purchaser at the time of purchase.

Absent a specific statutory regime changing the *Palmer* result, it seems difficult to rationalize an income inclusion for Partner A as a bargain purchaser.[41] Some statutory regimes do have that effect in other contexts. For debt purchased at a discount to its FMV, a holder may elect to accrue the discount into income.[42] But that is a specific statutory regime. The only potential statutory provision in subchapter K that could override *Palmer*'s treatment of bargain purchasers is section 707(c). As discussed earlier, the section 707(c) regime is an awkward fit for addressing capital shifts. The same issues would arise in this context as arise in Example 1 for preferred partnership interest accretions.

One could take the view that although Partner A has no inclusion upfront, income should be allocated to A each year to bring its capital account up to the amount A would receive on liquidation. As discussed, the section 704(b) regulations could so apply. Again, however, the rationale is questionable, especially for gross income allocations. If the concern is a capital shift, independent of whether the partnership earns income in any particular year, income allocations arguably should not be used to address the situation, although net income allocations could be more easily justified than gross income allocations.

IV. Increasing Common Interest

Another scenario involves a common interest that grows over time.

Example 3: Suppose that A and B enter into a partnership, with A getting 25 percent of the common equity in exchange for $25 of cash and B getting 75 percent of the common equity in exchange for assets with an FMV of $75. Further, under the partnership agreement, if a specified contingency occurs, A's percentage interest increases to 30 percent. Suppose that after several years, the contingency does occur, and A's percentage interest therefore increases to 30 percent.

It would seem that a capital shift occurs in Example 3 when the contingency occurs. As discussed regarding Example 1, one could argue for income inclusion for Partner A under a *Lehman* theory, a guaranteed payment theory, or an income allocation approach. The same counterarguments can be made with some variations.

The argument to the effect that there is no realization event and that, as a result, the open transaction doctrine should apply, seems, if anything, even more forceful in Example 3. The shift happens unilaterally under the terms of the partnership agreement, with no action on the part of A, B, or the partnership.[43] The possibility that A's partnership interest could grow to 30 percent was inherent in the partnership interest that A held from inception.

Similarly, the guaranteed payment theory seems less apposite in Example 3 than in Example 1, because the latter involved a fixed return. The guaranteed payment theory might apply to

[40] *Id.* at 68-69. A narrower reading of *Palmer* would be that increases in value of underlying property between the time of contract and the time of closing do not give rise to income to a purchaser. *See* Brock, *supra* note 8 (*Palmer* did not involve a bargain purchase because the strike price equaled the value at the time of contract). But the quoted language implies a broader reading to the effect that bargain purchases are in general not taxable events for the purchaser. Indeed, intuition supports that conclusion. Taxing bargain purchases would impose significant administrative burdens because arm's-length purchases would routinely need to be analyzed to ascertain whether they were made for less than FMV.

[41] Only in rare cases does a buyer have income upon purchase. *Cf. James M. Pierce Corp. v. Commissioner*, 326 F.2d 67 (8th Cir. 1964) (the seller was allowed a deduction, or reduction in amount realized, for deferred subscription income includable because of a sale, as if the seller paid that amount to the purchaser).

[42] Section 1278(b). The market discount rules can apply to debt purchased upon issuance, because the issue price of debt issued for money is the "first price at which a substantial amount" of the debt instrument is sold for money. Reg. section 1.1273-2(a)(1). Some purchasers might pay less than the issue price to acquire the debt upon issuance.

[43] *See supra* note 18.

Example 3 if the additional or increased partnership interest is viewed as the payment. In that case, the value of the payment is (at least in theory) known, because it is the value of the additional or increased partnership interest at the time Partner A becomes entitled to it, and that amount is "paid" without regard to partnership income in that year. But this analysis highlights the uneasy fit between capital shifts and the guaranteed payment rules because it would treat a common partnership interest — whose value is unpredictable and dependent on partnership income — as a guaranteed payment.

Example 3 also raises an analogy to an option on a partnership interest. In the case of an option, the contingency that gives rise to an additional or increased partnership interest is the exercise of the option. An option holder would generally exercise the option if the value of the underlying partnership interest exceeds the strike price of the option. Because of the similarity to an option, an examination of the regime for taxing noncompensatory partnership options is warranted.

Indeed, the IRS applied an income allocation approach to address capital shifts in connection with the exercise of a noncompensatory option to acquire a partnership interest. Building on the historic treatment that exercise of an option is not a taxable event to the option holder,[44] the noncompensatory option regulations generally treat the exercise of a noncompensatory option as a nontaxable event.[45] However, for capital accounts to be considered to have economic effect, the partnership must revalue its assets immediately after the exercise of the option rather than before exercise.[46] Then the partnership must allocate unrealized items of income, gain, or loss to the exercising partner so that the capital account of that partner reflects the partner's right to share in partnership capital (and the partnership must allocate any remaining unrealized items to the other partners to reflect the manner in which those items would be allocated among them if there were a taxable sale of partnership property).[47] If allocations of unrealized items are insufficient to cause the exercising partner's capital account to equal that partner's share of capital under the partnership agreement, the partnership reallocates partnership capital from the historic partners to the exercising partner.[48] Finally, the partnership makes corrective allocations to reflect all those capital account reallocations.[49] Those corrective allocations may well constitute taxable items.

Thus, in the absence of sufficient unrealized built-in gain, taxable items may be allocated to the exercising partner in the year of exercise or subsequent years. The noncompensatory option regulations therefore rely on an income allocation approach, first allocating items of built-in gain and then making further corrective allocations if needed.

In relying on an income allocation approach, those regulations reject the *Lehman* theory because they do not deem a taxable transfer of partnership assets to occur, and they reject a guaranteed payment theory because they do not deem a payment to be made in the form of a partnership interest or otherwise. Indeed, while the rejection of the guaranteed payment theory to address partnership options does not seem surprising, it also highlights that treating a payment to be made, for section 707(c) purposes, in the form of additional or increased partnership interest is an awkward fit. That payment could be deemed to have occurred in the case of the exercise of an option to acquire a partnership interest, but the IRS did not go in that direction. Presumably, the mechanics of the noncompensatory option regulations could be applied to Example 3 if one believed that an income allocation approach was appropriate in that situation. Indeed, as a potential model for addressing capital shifts, the mechanics of those regulations could be applied

[44] *See Helvering v. San Joaquin Fruit and Investment Co.*, 297 U.S. 496 (1936) (an option holder does not acquire underlying property until exercise of the option); and Rev. Rul. 84-121, 1984-2 C.B. 168 (payment of the option exercise price using property other than cash is a taxable disposition of property for the option holder).

[45] Reg. section 1.721-2(a)(1). *See* American Bar Association Section of Taxation (individual members), "Comments in Response to Notice 2000-29," at 12 (Jan. 28, 2002) (exercise of an option to acquire a partnership interest from the partnership should be nontaxable regardless of whether the exercise results in a capital shift).

[46] Reg. section 1.704-1(b)(2)(iv)(s)(1).

[47] Reg. section 1.704-1(b)(2)(iv)(s)(2).

[48] Reg. section 1.704-1(b)(2)(iv)(s)(3).

[49] Reg. section 1.704-1(b)(2)(iv)(s)(4).

in other scenarios as well, but the administrative challenges could impede that wider application.

V. Conclusion

Capital shifts are increases in wealth to the partner to whom capital is shifted. But as observed at the outset, not all increases in wealth are taxed currently. As demonstrated, none of the conventional concepts for addressing capital shifts fits neatly. The realization requirement puts into question both the *Lehman* theory and the guaranteed payment theory. Moreover, the technical workings of the guaranteed payment rules seem ill-fitted to capital shifts. The income allocation approach depends on realization of income (perhaps a weak form of realization in the nature of a book-up) at the partnership level, but its rationale is questionable precisely because it addresses the phenomenon of capital shifts through a mechanism reliant on income in the partnership that is generally independent of the capital shift. ■