February 26, 2019

Internal Revenue Service
CC:PA:LPD:PR (REG-106089-18)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: REG-106089-18—Comments on the Proposed Regulations for the Limitation on Deduction of Business Interest Expense

Dear Sir or Madam:

The Master Limited Partnership Association ("MLPA") is pleased to submit comments on the proposed regulations promulgated on December 28, 2018 (the "Proposed Regulations") relating to the limitation on deduction of business interest expense under Section 163(j) of the Internal Revenue Code.

The MLPA is the nation's only trade association representing MLPs.[1] For more than three decades, the association has represented the interests of MLPs in Washington, D.C. and the states. MLPs are an integral way our nation's private sector finances the infrastructure needed to fully utilize newly discovered domestic energy resources –

[1] As used herein, the term "MLP" refers to a publicly traded partnership as defined under Section 7704.

leading to greater energy independence for the United States – and to ensure that a wide variety of energy products make their way efficiently and safely from the production fields to American homes, businesses and communities.

We commend the efforts of the IRS and Treasury to provide taxpayers with guidance on the implementation of Section 163(j).[2]

Background

MLPs have been part of the American energy infrastructure industry since 1981. As of December 31, 2018, there were more than 80 energy MLPs representing a market capitalization of $300 billion.[3]

MLPs are publicly traded partnerships within the meaning of Section 7704 that are not subject to entity-level taxation, because 90 percent or more of their income is natural resource or passive-type income within the meaning of Section 7704(c). Common interests in MLPs, generally referred to as "units," are traded on an established security exchange, such as the NYSE or NASDAQ. In order to trade publicly, MLPs must meet certain requirements that are unique among partnerships. Because MLP units are equity interests in partnerships, they differ in important ways from other types of

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[2] Unless otherwise indicated, all "Section," or "subchapter" references are to the Internal Revenue Code of 1986, as amended (the "Code"). All references to the "IRS" are to the Internal Revenue Service and references to "Treasury" are to the U.S. Department of the Treasury.

[3] *See Establishment of the Energy MLP* (Table), available at https://www.alerian.com/education/figures-and-tables/

publicly traded equity interests. The factors that distinguish MLPs from other types of partnerships and other types of publicly traded companies cause MLPs to be uniquely affected by some aspects of the Proposed Regulation's rules for allocation of excess items and adjusted taxable income (ATI) among partners in a partnership.

In addition to common equity, many MLPs raise capital through issuance of preferred equity.[4] In many cases, distributions on the preferred equity are treated for tax purposes as guaranteed payments for the use of capital ("GPUCs") under Section 707(c). The Proposed Regulations treat GPUCs as "interest" potentially subject to disallowance under Section 163(j), which adversely affects MLPs and other partnerships.

Summary of Recommendations

Our recommendations address the allocation of excess items and adjusted taxable income of a partnership among its partners and the treatment of GPUCs as "interest."

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[4] In some cases, the preferred equity is traded on an exchange and in others it is held by private investors. These preferred equity interests generally do not raise the kind of Section 163(j)-related fungibility issues that arise with respect to publicly traded common units ("MLP units"). Accordingly, references herein to MLP units in the discussion of Section 163(j)-related fungibility issues are limited to units representing common equity units.

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Recommendation Regarding the Allocation of Section 163(j) Items Among Partners

When allocating Section 163(j) items of a partnership that elects the remedial allocation method under Section 704(c), the final regulations should permit such partnership to:

- Allocate its Section 163(j) excess items in accordance with the partners' shares of corresponding Section 704(b) items that comprise ATI;
- Determine each partner's "remedial items," as defined in Prop. Reg. § 1.163(j)-6(b)(3), based on an allocation of the partnership's inside basis items among its partners in proportion to their share of corresponding Section 704(b) items (rather than applying the traditional method, described in Treas. Reg. § 1.704-3(b)); and
- Treat the amount of any purchaser's Section 743(b) adjustment that relates to a remedial item that it inherits from a transferor as an offset to that remedial item.

Recommendation Regarding Treatment of GPUCs

The final regulations should not treat GPUCs as "interest" for purposes of Section 163(j). Any abusive attempts by taxpayers to use GPUCs to thwart Section 163(j) can be addressed through existing guidance.

Application of Section 163(j) to Partnerships

In general, Section 163(j) limits a taxpayer's deduction for business interest to an amount equal to the sum of the taxpayer's business interest income for the taxable year and 30 percent of the adjusted taxable income ("ATI") of the taxpayer for the taxable year.[5] In the case of a partnership, Section 163(j)(4) provides that Section 163(j) is applied at the partnership level. Under the statute, the adjusted taxable income of each partner in a partnership is determined without regard to the partner's distributive share of any items of income, gain, deduction, or loss of the partnership but is instead increased by the partner's distributive share of the partnership's excess taxable income ("ETI"). The flush language in Section 163(j)(4)(A) provides that each partner's distributive share of partnership excess taxable income is determined in the same manner as the partner's distributive share of "nonseparately stated taxable income or loss of the partnership."

Consistent with Section 163(j)(4), the Proposed Regulations provide that the Section 163(j) limitation applies at the partnership level. If a partnership has deductible business interest expense, the deductible business interest expense is not subject to

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[5] In general, ATI is defined by Section 163(j)(8) as taxable income without regard to (i) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business, (ii) any business interest or business interest income, (iii) the amount of any net operating loss deduction under Section 172, (iv) the amount of any deduction allowed under Section 199A, and (v) in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion, and computed with such other adjustments as provided by the Secretary. *See also*, Prop. Reg. § 1.163(j)-1(b).

further Section 163(j) limitations at the partner level. However, excess business interest expense ("EBIE") of the partnership retains its character at the partner level.

Partner basis adjustments (such as Section 743(b) adjustments and Section 704(c)(1)(C)(i) built-in loss amounts) and remedial items of income or loss are taken into account at the partner level in determining a partner's ATI and separate Section 163(j) limitation. After a partnership has calculated its Section 163(j) limitation, the Proposed Regulations provide an 11-step process to allocate the partnership's "excess items," *i.e.*, its ETI, deductible business interest expense, EBIE, and business interest income, among its partners. The 11-step process does not alter the partnership's allocation of business interest expense, business interest income, or items comprising ATI for purposes of Section 704(b) generally. Rather, the 11-step process determines each partner's amount of deductible business interest expense and amount of any Section 163(j) excess items.

A partner's share of Section 163(j) excess items affects the tax treatment and economic consequences of the partner. For example, a greater share of ETI enables a partner subject to Section 163(j) to deduct more interest, while a greater share of a partnership's EBIE reduces a partner's basis in its partnership interest, which can affect the taxation of distributions to the partner. As discussed below, each MLP unit must have the same economic consequences in the hands of a buyer in order to trade publicly, making the application of the rules for sharing of Section 163(j) excess items of critical importance to MLPs.

Discussion of Recommendations

I. Fungibility Considerations for MLP Units

Public trading of MLP units is possible only because publicly traded MLP units are "fungible," *i.e.*, each publicly traded unit of an MLP has identical tax and economic characteristics in the hands of a buyer. Among other things, this fungibility requirement means that the Section 704(b) capital account associated with each MLP unit must be economically equivalent to the Section 704(b) capital account of all other units of the same class. In addition, this fungibility requirement means that a buyer should receive equivalent tax allocation regardless of the specific unit purchased.

Generally, for tax purposes a purchasing partner steps into the shoes of a selling partner with respect to the seller's Section 704(b) capital accounts and for purposes of Section 704(c). In an MLP, selling partners will have different Section 704(c) allocations due to the acquisition of interests that were issued at various points in time. As a result, MLPs that make an election under Section 754 must use the remedial allocation method under Section 704(c) to ensure that the tax characteristics of their units are fungible. In the case of cost recovery deductions, the combination of the depreciation or amortization of the Section 743(b) adjustment that results from the Section 754 election and the remedial allocation with respect to the partnership's Section 704(c) property results in the purchasing partner being in the same economic and tax position regardless of which units he is deemed to purchase from a transaction effectuated on an exchange.

This result occurs because Treas. Reg. § 1.743-1(j)(4)(i)(B)(2) coordinates the recovery period of any inherited Section 704(c) item and any associated Section 743(b) adjustment attributable to the inherited Section 704(c) if the partnership uses the remedial allocation method. The rule provides that:

> If a partnership elects to use the remedial allocation method described in § 1.704-3(d) with respect to an item of the partnership's recovery property, then the portion of any increase in the basis of the item of the partnership's recovery property under Section 743(b) that is attributable to Section 704(c) built-in gain is recovered over the remaining recovery period for the partnership's excess book basis in the property as determined in the final sentence of § 1.704-3(d)(2). Any remaining portion of the basis increase is recovered under paragraph (j)(4)(i)(B)(1) of this Section.

Absent this rule for inherited Section 704(c) items, the general rule in Treas. Reg. § 1.743-1(j)(4)(i)(B)(1) would require any basis increase to a partnership's recovery property to be taken into account as if it were newly-purchased property placed in service at the time of the transfer. Thus, a purchaser of a partnership interest would not be indifferent as to which partnership interest he purchased if the partnership had Section 704(c) property. The rule in Treas. Reg. § 1.743-1(j)(4)(i)(B)(2) resolves this issue. By ensuring that the Section 743(b) recovery matches the timing of the Section 704(c) remedial allocation, the two offset each other, thereby preserving the fungibility of the interests.

The Proposed Regulations present three challenges to maintaining the fungibility of publicly traded MLP units. Each can be addressed with relatively minor changes to the Proposed Regulations.

A. With respect to the allocation of excess items, non-pro rata sharing of inside basis under the Section 704(c) remedial method may cause MLP units to be non fungible

Because the remedial method applies the traditional method to contributed ("inside") basis, inside basis is not shared pro rata among the partners. Under the traditional method, the allocation of tax items follows the allocation of book items to the extent possible. A remedial item is only created if there is a ceiling rule limitation, i.e., there are insufficient tax items to provide the non-contributing partner with tax items equal to its Section 704(b) book items. As illustrated in the first example in the Section 704(c) remedial regulations (Treas. Reg. § 1.704-3(d)(7), Example 1, attached hereto as Appendix A, the “Remedial Allocation Example”), the application of the traditional method to inside basis will result in an allocation of cost recovery deductions with respect to inside basis that differs between contributing and non-contributing partners.

In the Remedial Allocation Example, in each of the first four years, the partnership has sufficient tax basis in contributed property to provide the non-contributing partner (M) with cost recovery deductions for tax purposes that match partner M’s Section 704(b) deduction ($800); no remedial item is created. The cost recovery deductions are allocated first to M ($800/year), with the remainder ($200) to the contributing partner (L).

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For purposes of Section 163(j) and the allocation of a partnership's excess items, a non-pro rata allocation of cost-recovery deductions, such as that illustrated in the Remedial Allocation Example, could result in a non-pro rata allocation of excess items (at least for taxable years after 2021, when depreciation and amortization are not added back to ATI). Under the Proposed Regulations, the allocation of the components of ATI dictate the allocation of a partnership's deductible business interest expense and excess items (*i.e.*, ETI, EBII, and EBIE). Because a buyer of M's interest in the example would get more inside cost recovery items than a buyer of L's units, it could receive less ETI or more EBIE, even though the interests are otherwise economically equivalent. This unequal allocation of excess items is not necessarily corrected by any partner basis items (*i.e.*, remedial items or Section 743(b) adjustments). The unequal sharing of inside basis merely affects the ratio in which excess items are shared and is independent of the effect of any partner basis items. In the case of an MLP, the difference in tax allocations for different partnership interests that would result from the Proposed Regulations means that the units are not fungible and could not trade publicly.

Because all MLP units of the same class receive the same allocations of the Section 704(b) items used to determine the corresponding Section 704(c) items, the simplest way for Treasury to ensure that publicly traded units remain fungible is to permit a publicly traded partnership using the remedial method under Section 704(c) to allocate all of its Section 163(j) excess items in accordance with the partners' shares of corresponding Section 704(b) items that comprise ATI (*i.e.*, solely for purposes of allocating excess items, ignore the application of Section 704(c) and the non pro rata sharing of inside basis required by the remedial method).

In order to align the regulations with the statutory requirement in the flush language of Section 163(j)(4) that partners share ETI and EBIE "in the same manner as the partner's distributive share of nonseparately stated taxable income or loss of the partnership," Treasury could require a partnership electing to share excess items in this manner to determine the taxable income allocations of the partners based on a pro rata sharing of inside basis in the manner described below. As illustrated below, for partnerships using the remedial method, such requirement has no effect on a partner's taxable income, determined after partner basis items are taken into account.

B. With respect to partner basis items affecting partner ATI, non-pro rata sharing of inside basis may cause MLP units to be non fungible

A non-pro rata sharing of inside basis under the Section 704(c) remedial method also results in a difference in the partner basis items (*i.e.*, Section 743(b) items and Section 704(c) remedial items) that affect ATI under the Proposed Regulations. This issue also can be illustrated by reference to the facts of the Remedial Allocation Example. A buyer of partner L's units immediately after formation of the LM partnership would have a Section 743(b) adjustment of $6,000 (which would offset the Section 704(c) gain the buyer would recognize if LM sold all its assets for fair market value). Under the Proposed Regulations, for years after 2021, the amortization of the buyer's Section 743(b) adjustment would reduce its ATI by the amount of the Section 743(b) adjustment. However, if the same purchaser acquired M's units immediately after formation of the partnership, it would have no Section 743(b) adjustment with respect to its LM interest and the Proposed Regulations would require no reduction to its ATI. Because L's units and M's units would produce different tax allocations for a buyer under the Proposed Regulations, they would not be fungible.

We suggest resolving this issue by permitting any partnership using the remedial allocation method to determine each partner's "remedial items," as defined in Prop. Reg. § 1.163(j)-6(b)(3), based on an allocation of the partnership's inside basis items among its partners in proportion to their share of corresponding Section 704(b) items (rather than applying the traditional method, described in Treas. Reg. § 1.704-3(b)). This rule would apply solely for purposes of determining remedial items under the Section 163(j) regulations. On the facts of the example, this rule would permit partnership LM to recalculate the remedial allocation by treating partner L as if it were entitled to a share of the inside basis equal to its share of the Section 704(b) items of the partnership (50 percent in this case, or $2,000). If this rule applied in the example, upon sale of the asset contributed to the partnership by L, tax gain of $6,000 would be allocated equally between L and M ($3,000 each). To avoid shifting built-in gain to the non-contributing partner (M) in a manner consistent with the rule in Section 704(c), a remedial deduction of $3,000 would be allocated to M (leaving M with no net tax gain), and remedial income of $3,000 would be allocated to L (leaving L with total tax gain of $6,000).

If the Section 743(b) adjustment to a buyer were determined based on this elective, pro-rata sharing of inside basis, a buyer of L's units or M's units would have the same net Section 743(b) and Section 704(c) amount. The buyer of L's units would step into $3,000 of remedial Section 704(c) income and have a Section 743(b) adjustment of $6,000 (for a net $3,000 of deductions that are partner basis items). The buyer of M's units would step into $3,000 of Section 704(c) remedial deductions and have a Section 743(b) adjustment of zero (making $3,000 of deductions that are partner basis items).

For reporting purposes, a partnership electing to use this method should be entitled to report to each partner a net Section 704(c)/743(b) amount, which would be taken into account at the partner level for purposes of determining the partner's ATI.

C. Treatment of Section 704(c) remedial income allocations for years before 2022 may cause MLP units to be non fungible

For years 2018-2021, when depreciation and amortization are added back to taxable income for purposes of determining ATI, a buyer acquiring MLP units with Section 704(c) remedial income allocations (and an offsetting Section 743(b) adjustment) will have an increase to its ATI that exceeds that of a buyer of the same number of otherwise fungible units that is not stepping into Section 704(c) remedial income (with no corresponding Section 743(b) deduction).

For example, assume that the asset contributed by L in the Remedial Allocation Example had zero basis. For each of the 10 years following the contribution, there would be $500 of Section 704(c) remedial income allocated to L and $500 of remedial deductions allocated to M with respect to the contributed asset. A buyer of M's units would step into M's shoes with respect to the $500 of annual remedial deductions. A buyer of L's units would step into L's shoes with respect to the $500 of annual remedial income and would have an annual Section 743(b) deduction of $1,000 (net $500 of deductions). While the net amount of the Section 743(b) and Section 704(c) remedial items is the same to both buyers, for years 2018-2021, different units would affect a buyer's ATI differently. The Section 704(c) remedial income of a buyer of L's units would be included in its ATI, while the 743(b) deductions would not be. Thus, a buyer of L's units would increase its ATI by $500 each year (before 2022). A buyer of M's

units, however, would add back the remedial depreciation deductions before 2022 and its ATI would be unaffected by the remedial deductions for such years.

In order to maintain the fungibility of units, we recommend that partnerships using the remedial method to make Section 704(c) allocations be permitted to elect to treat the amount of any purchaser's Section 743(b) adjustment that relates to a remedial item that it inherits from a transferor as an offset to the related Section 704(c) remedial item. In this example, if partnership LM made such election, a buyer of L's units immediately after formation would offset its $500 annual 704(c) remedial income allocation with $500 of annual Section 743(b) adjustment (leaving the buyer with net $500 of 743(b) deduction). As a result, such buyer would be in the same position as a buyer of M's units. Each buyer would have net deductions of $500/year, which would not affect ATI before 2022.

For purposes of calculating the remedial items, we would propose here as well to permit a partnership that allocates all Section 704(b) items that enter into the calculation of Section 704(c) items in the same proportions to allocate items related to inside basis in the same manner.

II. Guaranteed Payments for the Use of Capital Should Not be Treated as Interest for Purposes of Section 163(j)

A. Background

Section 163(a) provides a deduction for "all interest paid or accrued within the taxable year on indebtedness." Section 163(j) provides a limit on the deduction otherwise permitted by Section 163(a) for "business interest." Notwithstanding these statutory

provisions, the Proposed Regulations provide an expansive definition of interest that includes items that in the eyes of the Service are "commonly understood to produce interest income and expense, including transactions that may otherwise have been entered into to avoid the application of section 163(j)."[6] To that end, the Proposed Regulations treat as interest certain amounts that are "closely related to interest and that affect the economic yield or cost of funds of a transaction involving interest, but that may not be compensation for the use or forbearance of money on a stand-alone basis."[7] As noted by the Preamble to the Proposed Regulations, "[a]s a consequence of these rules, however, in some cases certain items could be tested under section 163(j) that are not treated as interest under other provisions that interpret the definition of interest more narrowly. Thus, for example, in certain cases, an amount that was previously deductible under section 162 without limitation could now be tested as business interest expense under section 163(j)."[8] Prop. Reg. § 1.163(j)-1(b)(20) provides that GPUCs under Section 707(c) are treated as interest for purposes of Section 163(j).

Partnerships can be funded either through contributions of capital in exchange for a partnership interest, or through loans (from third party lenders or partner loans to the partnership). In certain circumstances, partners who contribute capital to a partnership will receive some form of a return on their investment. Returns can be structured in

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[6] Notice of Proposed Rulemaking, 83 Fed. Reg. at 67,493 (Dec. 28, 2018).

[7] Notice of Proposed Rulemaking, 83 Fed. Reg. at 67,493 (Dec. 28, 2018).

[8] Notice of Proposed Rulemaking, 83 Fed. Reg. at 67,493 (Dec. 28, 2018).

many ways, and to the extent a return on contributed capital is determined without regard to the income of the partnership, such returns are treated as GPUCs under Section 707(c). For the reasons below, we do not believe that a GPUC is interest nor is it commonly understood to produce interest income and expense. Instead, a GPUC is a return on an equity investment. Accordingly, we believe that GPUCs should not be treated as interest for purposes of Section 163(j).

B. Section 163(j) Should Be Limited to Interest

Section 163(j)(5) defines "business interest" as "any interest paid or accrued on indebtedness properly allocable to a trade or business." The statutory language is clear and there is no indication that Section 163(j) should apply to anything other than interest paid or accrued on indebtedness. Additionally, in the legislative history to Section 163(j), Congress specifically and unambiguously referred to interest and indebtedness, and made no mention of interest equivalents or transactions that are indebtedness in substance. However, the Proposed Regulations adopt a broad definition of both business interest, by including "interest equivalents" and amounts that are not interest such as GPUCs, and of indebtedness by including transactions that are indebtedness in substance although not in form. The proposed regulatory language is inconsistent with the statutory language and history of Section 163(j), does not reflect Congressional intent behind Section 163(j), and is an improper expansion of Section 163(j).

1. Legislative History to Section 163(j)

Congress intended that Section 163(j) apply only to amounts that are interest for federal tax purposes that are paid or accrued on indebtedness properly allocable to a trade or

business. The Joint Committee on Taxation Staff, General Explanation of Public Law 115-97, 115th Cong., (2018) (the "Blue Book") discussion of Section 163(j) addresses the deductibility of "interest paid or accrued by a business" and provides that "business interest" means "any interest paid or accrued on indebtedness" and includes "any amount treated as interest for purposes of the Code."[9] Unlike former Section 163(j)[10], which explicitly granted Treasury the authority to issue regulations that would adjust net interest expense by income items not denominated as interest but appropriately characterized as equivalent to interest, new Section 163(j) and the Blue Book make no mention of "interest equivalents." [11] There is no indication in the statutory language or in legislative history thereto that Congress intended a broad definition of interest be adopted.[12] Instead, Congress clearly intended that the term "interest" include only those

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[9] Bluebook p. 174.

[10] Section 163(j) as added to the Code by the Omnibus Budget Reconciliation Act of 1989.

[11] Conference Committee Report to the Omnibus Budget Reconciliation Act of 1989.

[12] We note that there are other Code provisions in which Congress has made it clear that interest was intended to include interest equivalents. For instance, Section 954(c) provides for "any income equivalent to interest. In this instance, a GPUC would generally be considered to be an "interest equivalent." Similarly, in Section 199A (which was enacted by the same Congress as new Section 163(j)) the statute provides that a Section 199A benefit is not available for dividends or "income equivalent to a dividend." The absence of such language suggests that this same Congress did not intend "interest" to include interest equivalents for purposes of Section 163(j). If Congress had intended to include interest equivalents in Section 163(j) we believe they would have used language that was more expansive as had been done in the past and as part of Section 199A. It is also curious that in the Preamble to the Section 199A regulations, the IRS acknowledges that guaranteed payments generally are not equivalent to salaries

amounts that are interest or treated as interest for purposes of Section 163(a) and should not be expanded to include other concepts such as GPUCs.

In another expansion inconsistent with Congressional intent and the statute, the Proposed Regulations apply Section 163(j) to payments associated with "transactions that are indebtedness in substance although not in form."[13]

2. Interest paid or accrued on indebtedness

In order for amounts to be subject to Section 163(j), such amounts must be interest paid or accrued on indebtedness and properly allocable to a trade or business. GPUCs are returns on equity investment and not interest paid or accrued on a loan to the partnership. The Proposed Regulations broadly classify all GPUCs as interest expense subject to Section 163(j). This view is in direct conflict with existing authorities, circumventing Section 707(a) and Section 707(c) governing transactions between partners and partnerships, and also circumventing established case law and IRS guidance addressing whether an arrangement is debt or equity for federal tax purposes.

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and wages and yet for purposes of Section 163(j) the IRS is of the mind that GPUCs are the equivalent of interest. There is no basis for such distinction between guaranteed payments for services and capital given that Section 707(c) does not view a guaranteed payment for services as different from a guaranteed payment for capital.

[13] Preamble to the Proposed Regulations.

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a. GPUCs are not interest

Section 707 provides a clear delineation between the federal income tax rules applicable to payments by the partnership to a partner depending upon whether the payments relate to equity contributed by the partner or a loan by the partner to the partnership. Under Section 707(a), amounts paid by a partnership to a partner with respect to a loan by the partner are interest payments deductible under Section 163.[14] By contrast, if a partner makes an equity contribution to the partnership and receives payments from the partnership for the use of the capital contributed, Section 707(c) provides that such payments are deductible under Section 162, not Section 163.[15] Treas. Reg. § 1.707-3(c)

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[14] *See* Treas. Reg. § 1.707-1(a) (providing that a loan of money from a partner to a partnership is treated as a transaction between the partnership and a person that is not a member of the partnership); PLR 8304059 (Oct. 25, 1982).

[15] Section 707(c) was enacted in 1954 to provide certainty with respect to the treatment of circumstances in which "payments" to partners for services, or for the use of capital, might exceed income of the partnership. *See* S. Rep. No. 1622, 83rd Cong., 2d Sess. at 22 (1954). Prior to the enactment of Section 707(c), if a payment made to a partner acting in a partner capacity exceeded the income of the partnership in the year of payment, the tax treatment of the payment amount in excess of partnership income depended upon whether the capital account of the partner receiving the payment or the capital accounts of other partners was charged with the excess. *See Augustine Lloyd*, 15 BTA 82 (1929); Rev. Rul. 55-30, 1955-1 CB 430. Section 707(c) brought clarity to the treatment of such payments by providing that the full amount of the payment (not just the amount in excess of partnership income) was deductible by the partnership and includible in income by the partner.

provides, in relevant part, that "[f]or a guaranteed payment to be a partnership deduction, it must meet the same tests under Section 162 as it would if the payment had been made to a person who is not a member of the partnership, and the rules of section 263 (relating to capital expenditures must be taken into account." Case law[16] and IRS guidance[17] confirm that GPUCs are deductible under Section 162 and subject to the rules and requirements thereof. Treating GPUCs as interest subject to Section 163(j) is inconsistent with those authorities and with Congressional intent underlying the enactment of Section 707(c).

In its current form, Section 707(c) provides that "[t]o 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, but only for purposes of section 61(a) (relating to gross income) and, subject to section 263, for purposes of section 162(a) relating to trade or business expenses."

[16] *See Cagle v. Comm'r*, 63 T.C. 86 (1974), *aff'd* 539 F.2d 409 (5th Cir. 1976); *Mallary v. United States*, 238 F. Supp. 87 (1965). Notably, The legislative history of the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1525, approves the *Cagle* decision and states that for a section 707(c) payment to be deductible by a partnership, the payment must meet the same tests under section 162(a) as if it had been made to a person who was not a member of the partnership, and the normal rules of section 263 (relating to capital expenditures must be taken into account. Staff of Joint Committee on Taxation, 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976, 90 (Comm. Print 1976).

[17] *See* Notice 2004-31, 2004-1 C.B. 830 (2004).

b. GPUCs are not paid or accrued on indebtedness

GPUCs arise under Section 707(c) when a partner contributes capital to the partnership by a partner in his capacity as a partner.[18] A contribution of capital to a partnership by a partner in his capacity as a partner is by its terms not a loan and does not give rise to indebtedness unless traditional debt/equity principles would recharacterize the contribution of capital as a loan to the partnership for tax purposes.

The existing rules under established case law, Notice 94-47 and Notice 2004-31 are more than sufficient to determine whether a purported equity interest is properly treated as debt and a GPUC with respect to that equity interest should be treated as interest for federal tax purposes.

i. Case Law

Under long-held and well-established case law, whether an investment should be treated as equity or debt depends on a facts and circumstances test that is used not just

[18] Compare Section 707(a), which governs transactions between a partner and a partnership where the partner is not acting in capacity as a partner. Section 707(a) generally applies the entity theory to transactions between a partnership and a partner acting in a role other than as a partner. Thus, when a partner loans capital to a partnership, interest payments for the use of that capital would be treated as payments to a non-partner.

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for GPUCs but for all financial instruments.[19] The majority of cases dealing with the characterization of a financial instrument as debt or equity stress a multi-factor analysis, taking into account numerous aspects of the instrument.

The Fifth Circuit, for example, applies a thirteen-factor analysis examining (i) the name given to the instrument, (ii) the presence or absence of a fixed maturity date. (iii) the source of repayment, (iv) the right to enforce payment of principal and interest, (v) participation in management or voting rights, (vi) the status of the interest in relation to other creditors, (vii) the intent of the parties, (viii) "thin" or adequate capitalization of the entity, (ix) identity of interest between creditor and stockholder, (x) the provision for and source of interest payments, (xi) the ability of the corporation to obtain loans from outside lending institutions on similar terms, (xii) the extent to which the advance was

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[19] *See* Rev. Rul. 2003-97, 2003-2 C.B. 380, 383; *See also In re Hedged-Invs. Assocs., Inc.,* 380 F.3d 1292, 1298 (10th Cir. 2004) (adopting a 13-factor test); *Stinnett's Pontiac Serv., Inc. v. Comm'r,* 730 F.2d 634, *638* (11th Cir. 1984) (same); *see also Hardman v. United States,* 827 F.2d 1409, 1412 (9th Cir. 1987) (considering eleven factors); *ln re Official Comm. of Unsecured Creditors for Dornier Aviation (N. Am.), Inc.,* 453 F.3d 225, 233 (4th Cir. 2006); *Roth Steel Tube Co. v. Comm'r,* 800 F.2d 625, 630 (6th Cir. 1986); *see also Matter of Uneco, Inc.,* 532 F.2d 1204, 1208 (8th Cir. 1976) (considering security and sinking funds, but also considering "whether the repayment of the loan was predicated on the success of the venture"); *Elec. Modules Corp. v. United States,* 695 F.2d 1367, 1371 (Fed. Cir. 1982); *Gilbert v. Commissioner,* 262 F.2d 512, 514 (2d Cir. 1959); *Seaboard Realty v. District of Columbia,* 184 F.2d 269, 270 (D.C. Cir. 1950).

used to acquire capital assets, and (xii) the failure of the debtor to repay on the due date or to seek a postponement.[20]

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[20] *See Estate of Mixon v. United States,* 464 F.2d 394, 402 (5th Cir. 1972). Other circuits consider similar factors. *See In re Hedged-Invs. Assocs., Inc.,* 380 F.3d 1292, 1298 (10th Cir. 2004) (adopting an identical 13-factor test); *Stinnett's Pontiac Serv., Inc. v. Comm'r,* 730 F.2d 634, *638* (11th Cir. 1984) (same); *see also Hardman v. United States,* 827 F.2d 1409, 1412 (9th Cir. 1987) (considering the first eleven factors). The Fourth Circuit and Sixth Circuit adopt an 11-factor test, which includes many Fifth Circuit factors but also adds the following three factors: (1) the presence or absence of a fixed rate of interest and interest payments; (2) the security, if any, for the advances; and (3) the presence or absence of a sinking fund to provide repayments. *See ln re Official Comm. of Unsecured Creditors for Dornier Aviation (N. Am.), Inc.,* 453 F.3d 225, 233 (4th Cir. 2006); *Roth Steel Tube Co. v. Comm'r,* 800 F.2d 625, 630 (6th Cir. 1986); *see also Matter of Uneco, Inc.,* 532 F.2d 1204, 1208 (8th Cir. 1976) (considering security and sinking funds in addition to many Fifth Circuit factors, but also considering "whether the repayment of the loan was predicated on the success of the venture"). The Third Circuit adopts a 16-factor test, which includes many Fifth Circuit factors but also adds the following eight factors: (I) the risk involved; (2) formal indicia of the arrangement; (3) the voting power of the holder of the instrument; (4) the provision of a fixed rate of interest; (5) a contingency on the obligation to repay; (6) the provision for redemption by the corporation; (7) the provision for redemption at the option of the holder; and (8) the timing of the advance with reference to the organization of the corporation. *Fin Hay Realty* v. *United States,* 398 F.2d 694,696 (3d Cir. 1968). As compared to the Fifth Circuit, the Seventh Circuit considers an almost completely separate set of factors: (1) the intent of the taxpayer to repay the advances; (2) the extent of shareholder control of the corporation; (3) the retained earnings and dividend history of the corporation; (4) the size of the advances; (5) the presence of conventional indicia of debt, such as promissory notes, collateral, and provision for interest; (6) the treatment of the advances in corporate records; (7) the history of repayment; and (8) the taxpayer's use of the advances. *Busch v Comm'r,* 728 F.2d 945,948 (7th Cir. 1984); *see also Crowley v. Comm'r,* 962 F.2d 1077, 1079 (1st Cir. 1992) (adopting all the Seventh Circuit

ii. Notice 94-47 provides a non-exclusive list of debt-equity factors

The IRS issued Notice 94-47, 1994-1 C.B. 1994-1 C.B. 75, which, similar to Section 385(b) (applicable to interests in corporations), provides a non-exclusive list of factors that may be considered in determining whether an advance constitutes debt or equity. These factors are similar to those developed through case law, and include: (a) whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future; (b) whether holders of the instruments possess the right to enforce the payment of principal and interest; (c) whether the rights of the holders of the instruments are subordinate to rights of general creditors; (d) whether the instruments give the holders the right to participate in the management of the issuer; (e) whether the issuer is thinly capitalized; (f) whether there is identity between holders of the instruments and stockholders of the issuer; (g) the label placed upon the instruments by the parties; and (h) whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.

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factors, some Fifth Circuit factors, and its own factor, "the existence of restrictions on the amounts of the disbursements"). The Second Circuit, D.C. Circuit, and Federal Circuit have not adopted enumerated tests but rather evaluate each case based on the facts and circumstances, with no one factor being determinative. *See Elec. Modules Corp. v. United States,* 695 F.2d 1367, 1371 (Fed. Cir. 1982); *Gilbert v. Commissioner,* 262 F.2d 512, 514 (2d Cir. 1959); *Seaboard Realty v. District of Columbia,* 184 F.2d 269, 270 (D.C. Cir. 1950).

Partnership equity interests that do not meet the facts and circumstance tests described in case law and Notice 94-47 are not indebtedness and GPUCs in respect of such equity interests should not be subject to Section 163(j).

iii. Notice 2004-31 polices inappropriate conversions of amounts from debt to equity

The Proposed Regulations assert that Treasury intends to provide a complete definition of interest that addresses all transactions that are commonly understood to produce interest income and expense, including transactions that may otherwise have been entered into to avoid the application of Section 163(j). As discussed above, GPUCs are not commonly understood to produce interest income and expense but are typically properly characterized as equity under current law. Further, the mere fact that a partnership arrangement includes a GPUC does not mean that the transaction was entered into to avoid the application of Section 163(j). Although some taxpayers may enter into transactions that include a GPUC in order to avoid Section 163(j), the Proposed Regulations should not broadly include all GPUCs as interest but should instead look to current authorities and tools to police abusive transactions.

For example, in Notice 2004-31, the IRS addressed an abusive transaction intended to convert interest payments that would not be currently deductible under former Section 163(j) into deductible payments.[21] There, a taxpayer used GPUCs combined with special allocations to avoid the application of former Section 163(j). The IRS stated that

[21] 2004-1 C.B. 830.

it intended to challenge such transactions on various grounds, including arguing that the transaction lacked economic substance and that the partnership's allocations lacked substantial economic effect under Section 704(b). The Notice also provided that the transaction, and similar transactions, would be "listed transactions" and subject to disclosure. Appropriately, however, the IRS did not treat the GPUC as debt subject to the limitations of former Section 163(j). Instead, the IRS acknowledged that the guaranteed payment right did not constitute debt, and that a partnership would not be subject to an interest limitation under Section 163(j).[22]

Absent recharacterization under debt/equity principles, the partnership interest received by the partner in exchange for the contribution of capital is equity and not indebtedness. Without "indebtedness" the free standing payments should not be subject to Section 163(j). Consistent with Treas. Reg. § 1.163(j)-1(b)(20)(i), interest should be limited to an amount paid, received, or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement, including a series of transactions, that is treated as a debt instrument for purposes of Section 1275 and Treas. Reg. § 1.1275-1(d) and not treated as stock under Treas. Reg. § 1.385-3 or an amount that is treated as interest under other provisions of the Internal Revenue Code or the Treasury Regulations.

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[22] *See* Notice 2004-31, 2004-1 C.B. 830 (2004): "If the guaranteed payment right … were instead debt [of the partnership to the partner], then interest on such indebtedness would be subject to the limitations imposed by Section 163(j)."

C. A GPUC May Be Attributable to Capital Other than Money

Section 163(j) is applicable to interest which is compensation for the use or forbearance of money. However, a GPUC may be earned by a partner in connection with any capital contribution to the partnership. Such capital may include money, but it also commonly includes other assets including real property, tangible and intangible property, and equity interests in corporations or other partnerships. Although Treas. Reg. § 1.163(j)-1(b)(20)(i) is limited to compensation for the use or forbearance of money, Treas. Reg. § 1.163(j)-1(b)(20)(iii), which includes guaranteed payments, is not similarly limited. Even if the application of Section 163(j) could be limited to GPUCs earned solely on money contributed to a partnership, there are no rules that apply to determine what portion of capital may be attributable to money – either directly or through tiered entities. Furthermore, even if a set of rules was developed to determine the portion of a GPUC attributable to money, the existing tracing rules of Treas. Reg. § 1.163-8T (which provide for the tracing of proceeds among different activities) are not workable to trace a contribution of money to an activity to determine if the related GPUC should be treated as business interest under Section 163(j), investment interest under Section 163(d), or personal interest Section 163(h). It would also seem beyond the authority of Section 163(j) to treat any GPUC that could be traced to an investment or personal expenditure as investment interest expense or personal interest expense subject to Section 163(d) or Section 163(h).

It should be noted that the existing tracing rules of Treas. Reg. § 1.163-8T are already difficult to apply to that which is stated interest in a partnership context. For instance, if debt is borrowed by a partnership and the proceeds are distributed to a partner, the characterization of the interest expense is reserved under Treas. Reg. § 1.163-8T.

Notices were issued in the late 1980s that take an aggregate approach to the tracing of the interest expense creating a conflict with Section 163(j), which applies an entity approach.[23] To treat GPUCs as interest expense would only further exacerbate the problem. Lastly, the regulations under Section 707(c) are clear that the default is that a GPUC is treated as a distributive share. To require taxpayers to treat GPUCs as interest subject to Section 163(j) creates an irreconcilable conflict between two final regulations.

D. Guaranteed Payments for the Use of Capital-Recipient Consequences

If GPUCs are treated as interest for purposes of Section 163(j), consideration must also be given to the recipient's tax consequences. Most of the issues are the same as above. For instance, there would be a conflict between the treatment as ordinary income in the Section 707 regulations and as interest income for purposes of Section 163(j). The contributing partner would presumably need to be able to determine if the GPUC generated business interest income or investment interest income (and whether it would be subject to limitations under Section 163(d)). To the extent that the GPUC was treated as business interest income it would seem that such business interest income would provide the partner with more capacity to deduct interest expense under Section 163(j) than the guaranteed payment. Also, there could be situations where the treatment of a GPUC as interest income rather than ordinary income could have collateral tax

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[23] See generally, Notice 88-20, 1988-1 C.B. 487, Notice 88-37, 1988-1 C.B. 522, and Notice 89-35, 1989-1 C.B. 675.

consequences to the contributing partner. For example, a publicly traded partnership must meet certain income qualifications in order to be taxed as a partnership for federal tax purposes under Section 7704(d). Whereas a GPUC may generate qualifying income to the extent that the underlying investment generates qualifying income, interest income is per se qualifying income.

E. Self-Charged Guaranteed Payments for the Use of Capital

The Proposed Regulations reserve on the proper treatment of business interest income and business interest expense with respect to lending transactions between a passthrough entity and an owner of the entity (self-charged lending transactions). By definition, every contribution of capital to a partnership in exchange for a guaranteed payment is, either in whole or in part, a self-charged lending transaction. The Proposed Regulations seem to acknowledge that, similar to consolidated groups, it is not appropriate to disallow the deduction of one taxpayer and require the inclusion of the related income by the same taxpayer for federal tax purposes. It seems inconsistent with the sound administration of tax policy to create rules to treat GPUCs as interest subject to disallowance under Section 163(j) to simply turn around and promulgate additional rules to perhaps allow at least the portion of the GPUC allocated to the contributing partner.

Lastly, if despite our comments above, final regulations continue to treat a GPUC as interest, taxpayers will decide to restructure old arrangements and will enter into new arrangements in the future by which a partner does not earn a GPUC but rather earns a return on such capital contribution that is determined based upon the income of the partnership. Although this is a different economic arrangement and should be

respected as such, it will invariably create uncertainties and issues similar to those where taxpayers have endeavored to convert a fee for services to a distributive share resulting in the promulgation of the proposed "fee waiver regulations."[24] Thus, although the IRS may indicate in the Preamble to the Proposed Regulations that including GPUCs in the definition of interest was in the interest of taxpayer certainty and acknowledged an "unavoidable degree of detail," the reality is that such an expansion of the definition of interest for purposes of Section 163(j) creates more uncertainty and complexity that is unwarranted and avoidable.

F. Recommendation Regarding GPUCS

The MLPA recommends that GPUCs not be treated as interest under any final Section 163(j) regulations. Furthermore, we recommend the IRS modify the anti-avoidance rule for amounts predominately associated with the time value of money to limit such provision to situations in which the instrument is in substance debt. We believe the existing guidance as noted in the Preamble to the Proposed Regulations is sufficient to address the characterization of money contributed by a partner to a partnership as debt or equity. However, an alternative anti-abuse provision (similar to Section 199A in the

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[24] 80 F.R. 43652-01 (Jul. 23, 2015). Similar concerns were also addressed in the recent final Section 199A regulations. Specifically, the IRS included a rebuttable presumption to address situations in which taxpayers may attempt to convert that which is a fee (not eligible for the Section 199A deduction) to a distributive share from a partnership (which may be eligible for the Section 199A deduction). To the extent that the IRS is concerned about a conversation of a debt to equity to avoid Section 163(j) a similar anti-abuse provision could be introduced to place a burden on taxpayers to confirm that the instrument would be classified as equity rather than debt.

context of a fee or distributive share) could be considered to create a rebuttable presumption with respect to the classification as debt or equity for purposes of Section 163(j). Lastly, as discussed above, Notice 2004-31 already adequately polices taxpayers that attempt to convert interest expense to a GPUC through the use of tiered partnerships.

If you have any questions, please do not hesitate to contact our external advisors on this letter, Robert Baldwin and Michael Hauswirth.

Sincerely,

Master Limited Partnership Association

Appendix A

Example (1). Remedial allocation method.

(i) Facts. On January 1, L and M form partnership LM and agree that each will be allocated a 50 percent share of all partnership items. The partnership agreement provides that LM will make allocations under Section 704(c) using the remedial allocation method under this paragraph (d) and that the straight-line method will be used to recover excess book basis. L contributes depreciable property with an adjusted tax basis of $4,000 and a fair market value of $10,000. The property is depreciated using the straight-line method with a 10-year recovery period and has 4 years remaining on its recovery period. M contributes $10,000, which the partnership uses to purchase land. Except for the depreciation deductions, LM's expenses equal its income in each year of the 10 years commencing with the year the partnership is formed.

(ii) Years 1 through 4. Under the remedial allocation method of this paragraph (d), LM has book depreciation for each of its first 4 years of $1,600 [$1,000 ($4,000 adjusted tax basis divided by the 4-year remaining recovery period) plus $600 ($6,000 excess of book value over tax basis, divided by the NEW 10-year recovery period)]. (For the purpose of simplifying the example, the partnership's book depreciation is determined without regard to any first-year depreciation conventions.) Under the partnership agreement, L and M are each allocated 50 percent ($800) of the book depreciation. M is allocated $800 of tax depreciation and L is allocated the remaining $200 of tax depreciation ($1,000 - $800). See paragraph (d)(1) of this Section. No remedial allocations are made because the ceiling rule does not result in a book allocation of depreciation to M different from the tax allocation. The allocations result in capital accounts at the end of LM's first 4 years as follows:

	L		M	
	Book	**Tax**	**Book**	**Tax**
Initial contribution	$10,000	$4,000	$10,000	$10,000
Depreciation	<3,200>	<800>	<3,200>	<3,200>
	$ 6,800	$3,200	$ 6,800	$ 6,800

(iii) Subsequent years.

(A) For each of years 5 through 10, LM has $600 of book depreciation ($6,000 excess of initial book value over adjusted tax basis divided by the 10-year recovery period that commenced in year 1), but no tax depreciation. Under the partnership agreement, the $600 of book depreciation is allocated equally to L and M. Because of the application of the ceiling rule in year 5, M would be allocated $300 of book depreciation, but no tax depreciation. Thus, at the end of LM's fifth year L's and M's book and tax capital accounts would be as follows:

	L		M	
	Book	**Tax**	**Book**	**Tax**
End of year 4	$6,800	$3,200	$6,800	$6,800
Depreciation	<300>		<300>	
	$6,500	$3,200	$6,500	$6,800

(B) Because the ceiling rule would cause an annual disparity of $300 between M's allocations of book and tax depreciation, LM must make remedial allocations of $300 of tax depreciation deductions to M

under the remedial allocation method for each of years 5 through 10. LM must also make an offsetting remedial allocation to L of $300 of taxable income, which must be of the same type as income produced by the property. At the end of year 5, LM's capital accounts are as follows:

	L		**M**	
	Book	**Tax**	**Book**	**Tax**
End of year 4	$6,800	$3,200	$6,800	$6,800
Depreciation	<300>		<300>	
Remedial allocations		300		<300>
	$3,500	$6,500	$6,500	$6,500

(C) At the end of year 10, LM's capital accounts are as follows:

	L		**M**	
	Book	**Tax**	**Book**	**Tax**
End of year 5	$6,500	$3,500	$6,500	$6,500
Depreciation	<1,500>		<1,500>	
Remedial allocations		1,500		<1,500>
	$5,000	$5,000	$5,000	$5,000