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Uncertainty Prevalent in Treatment of Investment Fund Clawbacks by [Matthew Dalton](#)



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Uncertainty abounds when determining how to characterize and report investment fund clawbacks for tax purposes, practitioners said October 24 at a District of Columbia Bar Taxation Section luncheon.

Investment funds generally contain clawback agreements when the general partners who manage the fund receive a share of the profits. If a fund recognizes profits initially and makes distributions to the general partner, some of that distribution may be repaid to the limited partners so that the general partner receives the appropriate share of profits over the life of the fund. Those clawbacks occur either because the fund later has losses that reverse profits the general partner received or, over the life of the fund, the limited partners did not receive a specified minimum preferred return on their invested capital.

If a clawback obligation accrues because there were losses following earlier profit distributions, the clawback can be treated as a loss allocation under section 704(b), said Steven R. Schneider of Goulston & Storrs.

However, if the clawback is needed to satisfy a priority return obligation that has arisen through the passage of time, and there are no losses to allocate to the general partners, that treatment is unavailable. "From a tax standpoint, that is much more difficult to handle," Schneider said.

The panelists suggested that a clawback payment under those circumstances might be treated as a guaranteed payment under section 707(c), but that section requires guaranteed payments to be determined without regard to the income of the partnership. "It's not quite so clean that it's a guaranteed payment," because the amount is arguably determined with regard to partnership income over the life of the partnership because the clawback is capped at the prior income distributions received by the general partner, said Schneider.

If the clawback is treated as a guaranteed payment, there is also a question of how to characterize the payment. Steven A. Schmoll of Ernst & Young LLP said that while it is relatively clear that the payment is ordinary income to the limited partners, the characterization for the general partners depends on the initial source of the funding and how the payment is allocated from the general partnership to the individual partners.

Guaranteed payment treatment may allow the general partnership to characterize the payment as an ordinary deduction, even though the prior-year income associated with the clawback was capital gains. Schneider said the so-called relation back doctrine from *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), may apply to characterize the clawback payment based on the character of the underlying profits the general partner is returning, so the character of the payment would be capital gains, "but there's nothing in the guaranteed payment rules that would say that."

If the clawback is not considered a guaranteed payment, for income purposes it would likely fall under the definition of gross income under section 61. However, that does not answer how the loss should be treated by the general partners, Schneider said.

Tax Analysts Information

Code Sections: Section 707 -- Related Interest Transactions
Section 704 -- Partner's Distributive Share
Section 61 -- Gross Income Defined

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