WYDEN UNVEILS PROPOSAL TO CLOSE LOOPHOLES ALLOWING WEALTHY INVESTORS, MEGA-CORPORATIONS TO USE PARTNERSHIPS TO AVOID PAYING TAX

Washington, D.C. –Senate Finance Committee Chair Ron Wyden, D-Ore., today unveiled draft legislation to close loopholes that allow wealthy investors and mega-corporations to use pass-through entities, primarily partnerships, to avoid paying their fair share of taxes.

Seventy percent of partnership income accrues to the top 1 percent. Current partnership tax rules are too complicated for the IRS to enforce, turning partnerships into a preferred tax avoidance strategy for wealthy investors and mega-corporations. Although computers can check a wage earner's return, the IRS needs highly-skilled specialists to audit partnerships. It audited only about 0.03 percent of the partnership returns filed for tax year 2018.

Wyden's bill would remove the complexity in current partnership rules by closing loopholes that essentially allow partners to pick and choose how, and whether, to pay tax. Simply closing these loopholes would raise at least $172 billion, without raising tax rates.

"The constant theme running through our tax code is paying taxes is mandatory for working people, but optional for wealthy investors and mega-corporations. That's especially true when it comes to pass-through businesses and partnerships, the preferred tax avoidance tools for those at the top," said Wyden. **"On the one hand, the rules are too complex for working people who don't have armies of lawyers and accountants. On the other hand, complexity allows the wealthiest individuals and most profitable corporations to decide when, and whether, to pay taxes at all. This proposal simply reduces complexity by closing loopholes that allow those at the top to pick and choose when, and whether, to pay tax. Raising more than $172 billion for priorities like child care and paid leave by closing off these loopholes is a no-brainer."**

Examples of loophole closures in Wyden's bill:

- Contributions and distributions of appreciated (or depreciated) property are generally tax free. Partnerships are supposed to allocate built-in gains and losses on contributed property in a way that limits abuse, but they get to choose among three or more allocation methods. Only one—the "remedial method"—actually prevents tax from being shifted between the partners. The discussion draft would require partnerships to use the remedial method making sure gain, and the related tax liability, cannot be shifted.
- Upon a change in the interests of the partners, a partnership can elect—but is not required—to revalue its assets to prevent the shifting of built-in gain and loss. The discussion draft would require such revaluations.
- The partnership tax rules afford tremendous flexibility in the allocation of partnership income and losses among partners. The discussion draft would remove options to decide when and whether to pay tax, and in doing so, simplify administration and curtail abuse. For certain related-party partnerships, the discussion draft would require all income and loss to be allocated pro-rata.

A one-page summary is available here.

A section-by-section summary is available here.

Overview

The discussion draft would reform major areas of tax law that are abused by sophisticated taxpayers by removing ambiguity and closing tax loopholes for pass-through entities, primarily partnerships, that allow investors and corporations to pick and choose when to pay tax. The complexity and ambiguity of the partnership tax rules make them nearly impossible for the IRS to administer, to the detriment of taxpayers who play by the rules and to the benefit to wealthy individuals and mega-corporations.

Because of this complexity, average taxpayers struggle to comply and sophisticated taxpayers can avoid tax with little (or no) fear of detection. Mega-corporations often form partnerships with their own subsidiaries or tiers of partnerships for the sole purpose of lowering their tax bills. For example, about 52 percent of all partnership income flows through to other partnerships and corporations. Partnerships are highly concentrated among the wealthiest households, and pass-through income accounts for much of the rise in the top 1 percent income share. Without reform, partnerships will continue to be one of the primary ways the wealthiest individuals and most profitable corporations avoid paying their fair share.

Why is partnership tax complexity a problem?

Current partnership tax rules are too complicated for the IRS to enforce. Although computers can check a wage earner's return, the IRS needs highly-skilled specialists to audit partnerships. It audited only about 0.03 percent of the partnership returns filed for tax year 2018.

When the IRS does audit partnerships, tax complexity, combined with tiered and circular ownership makes its job more difficult. One study found that 15 percent of partnership income was circular—the income flowed endlessly between partnerships that owned each other—and the authors couldn't trace 20 percent, even with access to IRS data. Not surprisingly, a recent study found "random audits do not capture most tax evasion … [by] pass-through businesses." The IRS Commissioner recently acknowledged that the agency gets "outgunned" by private sector experts, citing partnership tax complexity.

These loopholes make taxes optional for the top 1 percent. So it is not surprising that partnerships are increasingly popular among that group. The share of all net business income running through partnerships has increased nearly tenfold since 1980 – and partnership income is highly concentrated among big businesses and the wealthiest households. About 58 percent of businesses with more than $50 million in receipts are pass-throughs, and 70 percent of partnership income accrues to the top 1 percent. By comparison, only about 45 percent of C corporation income accrues to the top 1 percent. By closing loopholes, the proposal will make compliance easier for taxpayers who follow the rules, allow the IRS to more successfully audit tax cheats, and raise revenue in a progressive manner.

What are some examples of partnership tax loopholes and how would the discussion draft fix them?

- Contributions and distributions of appreciated (or depreciated) property are generally tax free. Partnerships are supposed to allocate built-in gains and losses on contributed property in a way that limits abuse, but they get to choose among three or more allocation methods. Only one—the "remedial method"—actually prevents tax from being shifted between the partners. The discussion draft would require partnerships to use the remedial method making sure gain, and the related tax liability, cannot be shifted.
- Upon a change in the interests of the partners, a partnership can elect—but is not required—to revalue its assets to prevent the shifting of built-in gain and loss. The discussion draft would require such revaluations.
- The partnership tax rules afford tremendous flexibility in the allocation of partnership income and losses among partners. The discussion draft would remove optionality and in doing so, simplify administration and curtail abuse. For certain related-party partnerships, the discussion draft would require all income and loss to be allocated pro-rata.

Wyden Pass-through Reform Discussion Draft
Section-by-Section Summary

In General

The discussion draft makes changes to the rules applicable to pass-through entities, primarily in the rules governing partnerships in Subchapter K of the Internal Revenue Code (IRC).

The provisions of the discussion draft remove optionality that is unnecessary for business ends and close certain tax loopholes that allow investors and corporations to pick and choose when to pay tax. The original policy intent of Subchapter K—to provide significant flexibility to taxpayers in arranging business affairs through partnerships—has been, and continues to be, at odds with the Internal Revenue Service's (IRS) need to administer the IRC. This problem was explicitly noted by the Commissioner of the IRS in his testimony before the Senate Finance Committee on June 8, 2021.[1] Furthermore, the complexity of the partnership tax rules makes it difficult for well-meaning taxpayers to comply and allows aggressive taxpayers with sophisticated advisors to exploit them with little-to-no fear of detection.[2] This is concerning as the popularity of partnerships has grown over the past three decades while IRS audit rates remain at essentially zero (0.03%).[3] Partnership income is highly concentrated among the wealthiest households.[4] In addition, more than 50 percent of all partnership income now accrues to other partnerships and corporations.[5] The increase in the use of partnerships and other pass-

[1] Charles P. Rettig, Oral Testimony, *The IRS's Fiscal Year 2022 Budget*, Hearing before the Senate Finance Committee (June 8, 2021), https://www.finance.senate.gov/hearings/the-irss-fiscal-year-2022-budget.
[2] See Monte A. Jackel, *Is It (Finally) Time? Reforming Subchapter K*, 170 Tax Notes Federal 2031 (Mar. 29, 2021) ("Meanwhile, the published regulations in the partnership area are mostly addressed to an audience that is largely made up of the most sophisticated partnership practitioners and large corporate CFOs, leaving the average CPA, business tax lawyer, and corporate tax company adviser to flounder around trying to understand and comply with the rules. How much more of this can a tax system that relies on self-assessment and efficient tax audits stand? Time is running out. Subchapter K should be reformed and simplified now. The more time that elapses without reform, the more the treasury is drained of financial resources to fund the government."); Andrea Monroe, *Making Tax Law Work: Improvisation and Forgotten Taxpayers in Partnership Tax*, Forthcoming, U. MICH. J. L. REFORM 101 (Draft 2021) ("There is a growing awareness that federal tax law caters to a small number of wealthy and well-advised taxpayers without regard for the rest of the taxpaying public, and partnership tax is a prime example. This article explains how complexity and indeterminacy have transformed partnership tax, harming millions of forgotten taxpayers who struggle to comply with their annual filing obligations. A root cause of this phenomenon is the professional culture of elite practitioners, policymakers, and scholars at the heart of the partnership tax system.")
[3] Internal Revenue Service Data Book, 2020, Pub. 55-B, at 36 (June 2021) (Table 17), https://www.irs.gov/pub/irs-soi/15otidb1.xls. These extremely low audit rates are *after* implementation of the centralized partnership audit procedures meant to simplify auditing procedures for the IRS.
[4] Michael Cooper et al., *Business in the United States: Who Owns It and How Much Tax Do They Pay?*, Working Paper 21651, at 36 (Oct. 2015) (Figure 6A), https://www.nber.org/papers/w21651.pdf.
[5] *Id.,* at 33 (Figure 3B).

through entities has severely depleted corporate revenues and has resulted in a more regressive tax system.[6]

The provisions of the discussion draft, in removing ambiguity and closing loopholes, will make compliance easier for well-meaning taxpayers, allow the IRS to more successfully audit aggressive taxpayers, and raise revenue in a progressive manner.

The discussion draft also includes changes that remove existing areas of uncertainty and align the language and policy of existing IRC provisions. Subchapter K has remained largely untouched for decades, with well-known oversights unaddressed and long-standing questions unanswered. More-recent changes to the taxation of partnerships have given rise to new questions. Legislative changes to remove uncertainty and better effectuate policy ends will assist both well-meaning taxpayers and the IRS.

Provisions Amending Subchapter K

Section 1 of the Discussion Draft – IRC Section 701

The provision provides a technical clarification that following enactment and implementation of the centralized partnership audit regime,[7] partnerships can, at times, be subject to entity-level taxation. The change would allow the IRS to enhance reporting requirements of partnership tax positions by aligning tax reporting with Financial Accounting Standards Board (FASB) reporting, which may require the reporting of uncertain tax positions that could trigger an entity-level liability.

Section 2 of the Discussion Draft – IRC Sections 704(a) and 704(b)

The partnership tax rules afford tremendous flexibility in the allocation of partnership items among partners. The IRC and regulations provide two sets of rules circumscribing the allocation of partnership items – the "partners interest in the partnership" (PIP) standard and the "substantial economic effect" (SEE) safe harbor. Both are based on the general principle of economic substance, and both are intended to align tax allocations with the underlying economic arrangement. However, the flexibility of current law has resulted in complexity for taxpayers and the IRS. The following provisions will substantially simplify the administration of partnership allocations and will as a result reduce taxpayer flexibility in this area, thereby curtailing abuse.

Require Allocations in Accordance with Partner's Interest in the Partnership

The concept of SEE was added to the IRC to prevent abuse while preserving flexibility in the allocation of partnership items. However, the SEE regulations contain presumptions that can divorce tax and economics.[8] The regulatory process has been unable to provide administrable

---

[6] *Id.,* at 23.
[7] Enacted as part of the Bipartisan Budget Act of 2015 (Pub. L. No. 114-74).
[8] *See e.g.*, Philip F. Postlewaite, *I Come to Bury Subchapter K, not to Praise It*, 54 Tax Law. 451 (2001) (citing American Law Institute, *Taxation of Private Business Enterprises-Reporters' Study*, July 1999); Mark Gergen, *Reforming Subchapter K: Special Allocations*, 46 TAX L. REV. 1, 19 (1990), https://lawcat.berkeley.edu/record/1113765/files/fulltext.pdf (noting that presumptions in the SEE regulations "create safe harbors for shifting gains and losses").

rules that prevent tax-motivated allocations under the SEE standard.[9] Moreover, neither the tax policy aims of simplicity nor administrability justify the disconnect between tax and economics. The safeguard itself has been the cause of complexity and proven difficult for the IRS to properly audit and administer.[10]

The provision removes the SEE test for partnership allocations under Subchapter K and, except as provided below under the consistent allocation method for certain taxpayers, requires that all partnership allocations be made in accordance with the PIP.[11] PIP exists under current law and is based on the facts and circumstances of the economic deal (e.g., each partner's contributions and rights to distributions). The provision directs the Secretary to issue updated and simplified regulations addressing PIP.[12] The Secretary is also directed to issue rules to apply this proposal to tiered entities. The provision would be effective for tax years beginning after December 31, 2023.

The provision will remove the optionality of current law, better prevent the shifting of tax attributes between partners, simplify the rules governing partnership allocations, and allow the IRS to better focus audit and enforcement efforts.

Consistent Allocation Method Required for Certain Partnerships

When partners are not independent and do not have sufficient competing interests, it is not appropriate to rely solely on the purported economic deal between them for the purpose of

---

[9] Over twenty-five years ago, Treasury identified the value equals basis rule in the SEE regulations (Treas. reg. sec. 1.704-1(b)(2)(iii)(c)) as an example of a rule which produces tax results that do not properly reflect income. T.D. 8588, 60 Fed. Reg. 27 (Jan. 3, 1995). The value equals basis rule effectively allows for transitory allocations where a partner is specially allocated depreciation with respect to property whose economic value is unlikely to decline (e.g., a building). *See* Treas. reg. sec. 1.704-1(b)(5) Example (1)(xi). *See also* McKee, Nelson & Whitmire, Federal Taxation of Partnerships & *Partners (WG&L)*, 11.02 (2021) (describing the "protection afforded by the value-equals-basis rule" and noting the "curious result" in Treas. reg. sec. 1.704-1(b)(5) Example (1)(xi)).

[10] Andrea Monroe, *Making Tax Law Work: Improvisation and Forgotten Taxpayers in Partnership Tax*, Forthcoming, U. MICH. J. L. REFORM 111, 114 (Draft 2021) ("It took the Treasury nearly a decade to write the section 704(b) regulations, and the result is a transformative set of rules unmatched in their complexity, indeterminacy, and dysfunctionality"; "everything about the safe harbor is complicated, including its architecture.")

[11] Variations of this idea have existed for thirty years. *See* Jere D. McGaffey, *ABA Committee Members Advocate Simplification Of Partnership Deduction Allocation Regs.*, 91 Tax Notes 147 (Jun 26, 1991) ("[I]t would be appropriate to replace the voluminous technical regulations under Sections 704 and 752 with regulations that simply require allocations to be made in accordance with the underlying economic realities of the partnership arrangement. While regulations containing general precepts usually provide less guidance in specific situations, we believe that both business people and Internal Revenue Service agents could more efficiently comprehend and apply general regulations requiring that allocations follow economic reality than the complicated partnership capital accounting rules presently contained in the regulations.").

[12] By making this change, as well as the consistent allocation method change described herein, it is recognized that a number of other rules in the current regulations under section 704(b), as well as under other regulations under the IRC (such as the "fractions rule" under section 514) may need to be modified or otherwise changed (such as the QIO (qualified income offset) and minimum gain chargeback rules). The provision directs the Secretary to review the current regulations under section 704(b) and corollary regulation provisions elsewhere to conform these proposals with those regulations.

determining tax allocations (under PIP or SEE) because, in substance, those partners act in unity and as a single economic person.[13]

The provision creates a special allocation rule for certain related-party partnerships. Such rule is premised on the assumption that certain related parties do not have sufficiently adverse interests. As such, relative contributed capital is a better indicator of their economic interests in the partnership. Under the proposal, if partners are members of a controlled group (within the meaning of section 267(f)) and together own more than 50 percent of partnership capital or profits,[14] the provision would require the partnership to consistently allocate all items based on partner net contributed capital.[15] The Secretary is granted authority to require the use of the consistent allocation method by other partnerships to prevent abuse.[16]

Because the IRC cannot force partners to agree to only certain economic arrangements, the special allocation rule contains a provision which applies when the partners do not allocate partnership items pro rata (i.e., not proportionate to net contributed capital). The rule is intended to discourage non-proportional allocations. Any distribution or right to partnership property not proportional to partner net contributed capital would be treated as a transaction directly between partners. The partner receiving such distribution or right would be treated as receiving an interest in the partnership from one or more other partners. The receiving partner would recognize income or gain and any loss or expense would be nondeductible and non-capitalizable by the other partner(s). The consistent allocation method would be effective for tax years beginning after December 31, 2023. The Secretary is directed to provide transition rules and has authority to provide exceptions to the general rule.

Section 3 of the Discussion Draft – IRC Section 704(c)(1)(A)

In general, property can move into and out of partnerships tax free under sections 721 and 731. Current law section 704(c) attempts to prevent the shifting of gain or loss between partners by requiring that the tax items of contributed property be shared between the partners so as to take into account the built-in gain or loss at the time of contribution (i.e., the variation between the value and basis at the time of contribution). However, current rules provide significant flexibility for partnerships in choosing how to take into account that variation. Notwithstanding the intent to prevent it, the current rules still allow for gain to be shifted between partners.[17] The regulations provide several "reasonable" methods

---

[13] Gregg D. Polsky & Emily Cauble, *The Problem of Abusive Related-Partner Allocations*, 16 FLA. TAX. REV. 479, 479 (2014), https://digitalcommons.law.uga.edu/fac_artchop/1086 ("Because the section 704(b) regulations are premised on the assumption that partners deal with each other at arm's length, they are ill-suited to deal with related-partner allocations. As a result, these regulations can easily be abused by related partners").
[14] Treas. reg. sec. 1.706-1(b)(4)(ii) and (iv).
[15] Essentially, these partnerships would be subject to a single class of partnership interest allocation scheme, similar to S corporation allocation rules.
[16] The Secretary has authority to require use of the consistent percentage method by other ownership structures designed to avoid the purpose of section 704 including, for example, through the use of other related-party arrangements, ownership by tax-indifferent parties, or through the use of intermediaries.
[17] Stuart L. Rosow and Rachel A. Hughes, *Reforming Subchapter K: The Partnership Tax Simplification Act of 20__*, 94 Taxes: The Tax Magazine 3 (March 2016); American Bar Association Section of Taxation, *Comments on Proposed*

for accounting for the variation,[18] but only one – the "remedial method" – fully prevents shifting of built-in gain between partners in all cases.[19] While Subchapter K has attempted to allow for partners to deal with this issue flexibly, it is no longer sustainable.

The provision would require that all partnerships use the remedial method for section 704(c) allocations (described in Treas. reg. sec. 1.704-3(d)). This would cure the so-called "ceiling rule" problem in all instances. The provision would be effective for property contributions and revaluation events occurring after December 31, 2021.[20]

Section 4 of the Discussion Draft – New IRC Section 704(f)

An opportunity to shift built-in gain and loss arises in connection with a change in a partner's interest in a partnership (e.g., as a result of a contribution of money or other property to a partnership in exchange for an interest in the partnership). The regulations generally allow, but do not require, a partnership to revalue the partnership assets prior[21] to such transactions (commonly referred to as "book-ups"). Revaluations prevent the shifting of partnership built-in gain and loss away from the partners who accrued such economic gain or loss. However, the optionality allows partnerships to shift gains and losses between partners.

The provision would make revaluations of partnership property (as described in Treas. reg. sec. 1.704-1(b)(2)(iv)(f), commonly known as "reverse" section 704(c) allocations) mandatory upon a change in the economic agreement of the partners,[22] preventing partners from shifting built-in gain and loss. The rules of sections 704(c)(1)(B) and 737 would not apply to these reverse section 704(c) allocations unless the Secretary issues regulations to the contrary. The provision would apply to revaluation events occurring after December 31, 2021.

Section 5 of the Discussion Draft – IRC Sections 704(c)(1)(B) and 737

Generally, when a partner contributes property with a built-in gain, the partner must recognize gain if such property is subsequently distributed to any other partner within seven years of the original contribution. Similarly, if other property is distributed to the contributing partner within seven years of the original contribution the contributing partner generally recognizes gain. These "mixing bowl" rules attempt to prevent taxpayers from engaging in tax-free transactions involving contributions and related

---

Regulations Under Section 751(b), 70 Tax Lawyer 3 (Spring 2017) ("Certain section 704(c) methods may allow for the shifting of built in gain or loss.")

[18] Treas. reg. sec. 1.704-3(a)-(d).

[19] Leigh Osofsky, *Unwinding the Ceiling Rule*, 34 VA. TAX REV. 63 (2014), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2417279.

[20] Allocations under section 704(c) of pre-contribution amounts are commonly referred to as forward section 704(c) allocations. Allocations under section 704(c) of gain or loss economically accrued while property is owned by a partnership are commonly called reverse section 704(c) allocations. *See* Treas. reg. sec. 1.704-3(a)(6)(i). While the IRC currently does not explicitly reference reverse 704(c) allocations, it is intended that this proposal apply to both forward and reverse section 704(c) allocations.

[21] The revaluation occurs immediately *following* an issuance of a non-compensatory option.

[22] Revaluations would be mandatory upon occurrence of any event described in Treas. reg. sec. 1.704-1(b)(2)(iv)(f) or Prop. Treas. reg. sec. 1.704-1(b)(2)(iv)(f)(5) or identified by the Secretary.

distributions that are not otherwise recharacterized as sales or exchanges. However, partnerships are able to avoid these rules due to the limited time period of application (currently seven years).

The provision would repeal the seven-year time period for the application of the mixing bowl rules. The mixing bowl rules would apply to contributed property regardless of the time since contribution. The provision would apply to property contributed after December 31, 2021.

Section 6 of the Discussion Draft – IRC Section 705(b)

The provision would afford greater flexibility to the Secretary in prescribing rules for the determination of outside basis by allowing the alternative rule under section 705(b) to be applied in scenarios other than partnership terminations. The change would be effective on the date of enactment.

Section 7 of the Discussion Draft – IRC Sections 707(a), 707(c), 736, 753, and 761

A partner's distributive share of partnership income can serve as compensation for the partner's services on the partnership's behalf as well as for the use of the partner's capital. However, a partner can receive a payment from the partnership in addition to its distributive share.

Partnership to Partner Payments

Under current law, such payments are generally treated as a payment between the partnership and one who is not a partner under section 707(a) or, alternatively, as a payment to a partner that is determined without regard to the income of the partnership under section 707(c).[23] Section 707(c) has created confusion and uncertainty since its enactment.[24] Furthermore, taxpayers can choose to treat certain payments to partners as distributive share or as section 707(c) payments under current law.

The provision repeals section 707(c). Section 707(a) would govern any such payments by the partnership that are not actual or in substance distributions of partnership income under section 731, treating them as payments to a partner not acting in its capacity as a partner.[25] The provision would be effective for payments made after December 31, 2021.

Payments to Retiring and Successor-in-Interest Partners

Partnerships may structure payments to withdrawing or retiring partners in a variety of ways. Instead of following one consistent regime, some partnerships selectively choose the rules that minimize their tax liability.[26] Because the IRC has subsequently been amended to create general

[23] Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, *Volume Ii: Recommendations of the Staff of the Joint Committee on Taxation to Simplify the Federal Tax System*, 291 (Report JCS-3-01, April 2001).
[24] *See* American Bar Association, Section of Taxation, Report to the ABA House of Delegates (1999), https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/relatedpolicy/0299-hd-resolution-707.pdf.
[25] Except payments treated as part of a disguised sale under section 707(a)(2)(B).
[26] Howard E. Abrams, *Wherefore Code Sec. 736?*, 96 Taxes 119 (2018).

rules for payments to retirees and successors-in-interest, the provision repeals[27] sections 736 and 753 to align payments to retirees and successor-in-interest partners with the general rules of subchapter K specifically and the IRC generally (such as section 409A). Section 761 is amended to provide that a retiring or successor-of-interest partner remains a partner until complete liquidation of the partnership interest. The provision would apply to successors-in-interests and partners retiring after December 31, 2021.

Sections 8 and 9 of the Discussion Draft – IRC Section 707(a)(2)

Partners are generally permitted to contribute property to, and receive distributions from, a partnership without recognition of gain. However a number of provisions exist to prevent taxpayers from using partnerships to exchange one type of property for another type, or even for cash, without recognition of gain. In addition to sections 704(c)(1)(B) and 737 discussed above, section 707(a)(2)(B) was enacted to prevent such abuses by directing the Secretary to identify circumstances under which a contribution and related distribution should be characterized as a sale of property or a partnership interest. The following provisions correct two possible ambiguities that may limit the effectiveness of the "disguised sale" rules.

Make Self-executing Disguised Sale of Partnership Interest Rules

Section 707(a)(2)(B) includes sales of partnership interests that take the form of a contribution by one partner and a related distribution to another partner. However, some taxpayers have taken the position that such transactions are never considered sales of a partnership interests because the Secretary has not yet issued regulations.[28] The provision would clarify that the disguised sale rules are self-executing.

Remove Capital Expenditure Exception to Disguised Sale Treatment

The regulations provide an exception from treatment as sale proceeds for certain reimbursements from the partnership to a partner for capital expenditures.[29] The provision would remove this exception, treating proceeds for reimbursement of capital expenditures as disguised sale proceeds. The provision would apply to property transfers occurring after the date of enactment.

The provisions would apply to services performed or property transferred after the date of the enactment.

Section 10 of the Discussion Draft – IRC Section 708

Under current law, a partnership is considered as terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a

---

[27] Commentators have long called for the repeal of section 736. *See e.g.*, John A. Lynch, Jr., *Taxation of the Disposition of Partnership Interests: Time to Repeal I.R.C. Section 736*, 65 NEB. L. REV. 450 (1986), https://core.ac.uk/download/pdf/33140306.pdf; Philip F. Postlewaite & Adam H. Rosenzweig, *Anachronisms in Subchapter K of the Internal Revenue Code: Is It Time to Part with Section 736?*, 100 N.W. U. L. REV. 379 (2006), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=764504.

[28] *See e.g.,* Samuel Grilli, *Can the IRS Currently Contend That There Has Been a Disguised Sale of a Partnership Interest?*, 123 J. TAX'N 289 (Dec. 2015).

[29] Treas. reg. sec. 1.707-4(d).

partnership. Some view section 708(a) to incorporate a historic partner requirement. This, after the repeal of technical terminations in 2017, appears to allow taxpayers to structure into termination treatment, even if the business is still operating.[30]

The provision would clarify the statute by providing that a partnership is not terminated if any part of the business is carried on by a person or persons who was a partner in the prior partnership or by a person related to any of those partners. The provision would be effective for tax years beginning after date of enactment.

Section 11 of the Discussion Draft – IRC Section 751(b)

Current law attempts to prevent the shifting of ordinary income between partners of a partnership. If the partnership holds certain ordinary income assets ("hot assets"), a partnership distribution is treated as a sale or exchange. This rule prevents partners from converting what should be ordinary income into lower-taxed capital gain. However, inventory is only treated as an ordinary income asset to the extent it is "substantially appreciated." The provision would remove the requirement that inventory be substantially appreciated to be treated as ordinary income property. The provision would apply to distributions occurring after the date of enactment.

Section 12 of the Discussion Draft – IRC Section 752

The current rules for determining whether a partner of a partnership has recourse debt under section 752 and reg. secs. 1.752-1 and 1.752-2 assume that all partnership property is worthless regardless of actual value and that the partner will fulfill any obligation, generally regardless of a partner's ability to do so. In practice, a lender typically expects that credit extended to a partnership will be repaid with partnership profits.[31] The flexible recourse debt rules of current law permit partnerships to manipulate a partner's basis in the partnership, manipulate the allocations of losses, avoid disguised sale rules, and generate tax-deferred cash distributions. The rules are also enormously complex, difficult to administer, and rife with abuse.

The provision would require that all debt be shared between the partners in accordance with partnership profits.[32] An exception to this provision is provided in cases where the partner (or a person related to the partner) is the lender and where the Secretary identifies opportunities to prevent abuse. The provision would be effective for tax years beginning after December 31, 2021. A transition rule is provided allowing taxpayers to pay any tax liability that arises as a result of the enactment of the provision over eight years.

---

[30] *See* Jennifer Ray & Dina Wiesen, *Partnership Continuations After the Tax Cuts and Jobs Act*, 164 Tax Notes Federal 1215 (Aug. 19, 2019); New York State Bar Association Tax Section, Rept. No. 1432, *Report on Partnership Terminations Following the Tax Cuts and Jobs Act* (Jan. 17, 2020), https://nysba.org/app/uploads/2020/03/Report-1432.pdf.

[31] Steven C. Todrys, *Recourse Debt is Usually Nonrecourse: A Comment*, 84 Taxes 251 (2006).

[32] It is intended that if a partnership is unable to service a partnership liability and a partner is called upon to make (and makes) a payment to service the liability, the payment be treated a contribution to the capital of the partnership, which would increase the partner's basis in its interest. *See* Eric B. Sloan & Jennifer H. Alexander, *Economic Risk of Loss: The Devil We Think We Know*, 84 Taxes 217 (2006). Treasury regulations would be needed to effectuate this intent.

Sections 13 and 14 of the Discussion Draft – IRC Sections 734, 743, and 754

Under current law, a partnership can elect to adjust the basis of partnership property for disparities between the partnership's basis in its property and the partners' basis in their partnership interests. The following provisions make these basis adjustments mandatory, limiting opportunities for tax planning through deferral and shifting of tax liability.[33]

Make Mandatory Basis Adjustments Arising from Partnership Distributions

Partnership distributions create disparities between inside and outside basis when (1) a partner recognizes gain or loss on the distribution or (2) a partner takes basis in distributed property that is different than the basis in the hands of the partnership. Current law only requires a partnership to adjust basis in partnership assets to correct such disparity in the case of substantial basis reductions under sections 734(d) and 743(d). Basis adjustments are otherwise optional, leading to tax planning opportunities.[34]

The provision would make basis adjustments mandatory at the time of a partnership distribution of money or other property. The provision would also revise the calculation of each partner's basis adjustment to preserve each remaining partner's[35] gain or loss that would be recognized if the partnership had sold all partnership property at fair market value (i.e., each partner's pre-distribution built-in gain or loss would equal its post-distribution built-in gain or loss). This provision has the effect of aligning the partners' shares of tax gain or loss with their economic shares of book gain or loss in the partnership.

Make Mandatory Basis Adjustments Arising from Transfers of Partnership Interests

Sales of partnership interests create disparities between inside and outside tax basis of a partner when a transferee partner has basis in its partnership interest that is different than the transferee partner's proportionate share of basis in partnership assets. Current law allows a partnership to elect to adjust basis in partnership assets with respect to the transferee partner. Such basis adjustments are only mandatory in the case of a "substantial" built-in loss with respect to the transfer of an interest.

The provision would make basis adjustments resulting from transfers of partnership interests mandatory to prevent deferral of tax liabilities.

Section 754 would be repealed as obsolete. The provisions would be effective for transfers occurring after December 31, 2021.

---

[33] William D. Andrews, *Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions*, 47 Tax Law Review 1 (Fall 1991); Noel B. Cunningham, *Needed Reform: Tending the Sick Rose*, 47 Tax Law Review 1 (Fall 1991).

[34] Cunningham, Laura E. and Cunningham, Noël B., "The Logic of Subchapter K : a Conceptual Guide to the Taxation of Partnerships" (2011). ("Although it may have once seemed unduly burdensome to require partnerships to make the adjustments, today the elective nature of section 734(b) if very difficult to justify.")

[35] Including a partner who is not completely redeemed out of the partnership by the distribution.

Other Provisions

Section 15 of the Discussion Draft – IRC Section 163(j)(4)

The deduction for business interest is limited to the sum of (1) business interest income, (2) 30 percent of the adjusted taxable income, and (3) the floor plan financing interest. The amount of business interest not allowed as a deduction for any taxable year is treated as business interest paid or accrued in the succeeding taxable year.

In the case of any partnership, this limitation is only partially applied at the partnership level. Special rules allow a partner to use its share of excess partnership limitation (i.e., the partner's share of business interest income plus 30 percent of adjusted taxable income over the partner's share of the partnership's interest expense) to deduct business interest from other sources. Similar rules apply in the case of S corporations.

The provision would revise section 163(j)(4) so that the interest limitation rule applicable to partnerships and S corporations would become a true entity-level limitation. It provides that excess limitation (i.e., excess business interest income and excess taxable income) cannot be used to deduct interest expense from other sources, as it does under present law. The provision would be effective for tax years beginning after December 31, 2021.

Section 16 of the Discussion Draft – IRC Section 7704(c)

Current law permits certain publicly traded companies to opt into partnership status. Such partnerships often have hundreds of thousands of partners and it is nearly impossible for the IRS to properly administer these entities. Furthermore, these entities do not pay corporate taxes and thereby erode the corporate tax base. The provision would repeal the exception from corporate tax treatment for all publicly traded partnerships. The provision would be effective for tax years beginning after December 31, 2022.

Section 17 of the Discussion Draft – IRC Section 852(b)(6)

In general, corporations must recognize gain when distributing appreciated property to their shareholders. However, Regulated Investment Companies (RICs) are exempt from this rule when distributing property in kind to a redeeming shareholder. This exception has led to a significant rise in the distribution of assets with built-in gain in redemption of a shareholder in order to significantly reduce the future tax burden of current and future shareholders. Typically, a firm will make a strategic investment in a mutual fund with the intention that it will be redeemed with appreciated assets. The investment and related redemptions permit the fund to eliminate unrealized gain on the distributed assets completely tax free, allowing the mutual fund's shareholders to defer economic gains until they liquidate their investments in the mutual fund.[36]

---

[36] Jeffrey Colon, *The Great ETF Tax Swindle: The Taxation of In-Kind Redemptions*, 122 Penn St. L. Rev. 1 (2017) Available at: https://ir.lawnet.fordham.edu/faculty_scholarship/722 ("The exemption in section 852(b)(6) from the recognition of gain on the distribution of appreciated property by RICs should be eliminated. It provides an unfair tax subsidy for ETFs and encourages the transfer of capital from other kinds of investment vehicle to ETFs. It also unfairly benefits high-net-worth owners of ETFs.")

The provision would repeal the exception for RICs, aligning RICs with the general requirement that gain be recognized upon distribution by a corporation of built-in gain property. The repeal would be effective for tax years beginning after December 31, 2022.

Section 18 of the Discussion Draft – IRC Section 52

The IRC aggregates certain business entities in order to apply various limitations (e.g., the gross receipts limitation in the use of the cash method of accounting under section 448(c), the exemption from interest deductibility limitations under section 163(j)). Section 52(a) addresses corporate entities and section 52(b) provides similar rules for corporate and non-corporate entities. Section 52(b) refers to "trades or business (whether or not incorporated)" and the treatment of certain for-profit activity is unclear.

The provision would provide that a taxpayer engaged in any activity in connection with a trade or business or any for-profit activity is subject to the aggregation rules under section 52(b). The provision would further clarify that foreign entities are also subject to the section 52 aggregation rules. The provision would be effective for tax years beginning after December 31, 2021.