# PARTNERSHIPS

## THE WYDEN DRAFT PARTNERSHIP PROPOSALS: NOT MUCH GOOD BUT LOTS OF BAD AND UGLY

RICHARD M. LIPTON and MAHER HADDAD

RICHARD M. LIPTON is a partner in the Chicago office of the law firm of Baker & McKenzie LLP, and is a past chair of the ABA Tax Section. He is a regular contributor to THE JOURNAL as well as co-editor of its Shop Talk column.

MAHER HADDAD is a partner in Baker & McKenzie LLP's Global Tax Practice Group in Chicago.

*The Draft states that it was intended to remove ambiguity from subchapter K and to close loopholes, and promote simplification for taxpayers and the IRS. It likely fails to accomplish any of these goals. But more importantly, the Draft runs counter to the entire fabric of subchapter K.*

On September 10, 2021, at the same time as the House Ways and Means Committee was considering tax increases in its Reconciliation Bill, Senator Wyden, Chair of the Senate Finance Committee, issued a detailed "discussion draft" (the "Draft") which would substantially revise the rules of the road for partnership taxation. The Draft states that the "problem" with partnership taxation is that 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. According to the Draft, its proposals are intended to remove ambiguity, close loopholes, make compliance easier for taxpayers and aid the IRS in auditing aggressive taxpayers, and also raise revenue in a "progressive" manner.

Unfortunately, the Draft completely misses the target. Although there are a few praiseworthy suggestions in the Draft, most of its proposals are misguided. At the threshold, several of the provisions would cause prior transactions to become taxable on a retroactive basis, which would result in adverse tax results to many otherwise-compliant taxpayers. In addition, the Draft runs contrary to one of the most fundamental concepts of subchapter K, which is that under Section 721, property can be contributed to a partnership without gain recognition to the contributing partner. Furthermore, the ambiguities created by several of the proposals in the Draft will make the partnership tax rules even more complicated to apply than current law. The cost of compliance for some taxpayers will also be substantially higher under the rules set forth in the Draft. Moreover, as often is the case in tax legislation, when the Draft attempts to close some loopholes, the result will likely be that it opens even greater loopholes in other situations.

The following discussion addresses each of the sections of the Draft in order. As will be explained below, although several of the proposals in the Draft are helpful, they are far outweighed by the harmful (let alone retroactive) changes in subchapter K that are envisioned by the Draft.

### Draft Section 1 - Section 701

The first section of the Draft amends Section 701, which generally provides that partnerships are not subject to tax. Section 1 of the Draft clarifies that a partnership could be subject to tax as a result of the enactment of the centralized partnership audit regime in the Bipartisan Budget Act of 2015. This change is in the nature of a technical clarification, but it is suggested by the Draft in order to allow the IRS to enhance reporting requirements for partnerships. Unlike the immediately-succeeding provisions in the Draft, this is a reasonable suggestion and should be considered for enactment in the future.

### Draft Section 2 - Section 704(b)

After addressing a potential technical clarification in Section 1, Section 2 of the Draft jumps into the deep end of the pool by proposing a complete overhaul of Section 704(b), which provides that allocations of income made in accordance with the allocations of income, gain, loss, deductions and credits in a partnership agreement will be respected if such allocations have substantial economic effect; otherwise, items will be allocated in accordance with the partners' interests in the partnership. The Draft notes that the rules of partnership taxation afford tremendous flexibility in the allocation of partnership items to the partners. Generally, allocations made in the partnership agreement are respected if they have substantial economic effect (SEE). The regulations provide detailed guidance concerning the determination whether allocations satisfy the SEE test, including rules for determining whether allocations have economic effect as well as rules for determining whether that economic effect is "substantial." If the allocations in the partnership agreement fail the

SEE test, then items of income, gain, loss, deduction and credit must be allocated in accordance with the partners' interest in the partnership (PIP).

The Draft would eliminate the SEE rule. According to the Draft, the SEE Regulations contain presumptions that can divorce tax and economics, and in order to address those situations, the Draft throws out the entire SEE concept — the baby is thrown away because there was a little soap in the bath water. Under the Draft, all allocations by a partnership would be subject to the PIP rules (and only the PIP rules) for tax years beginning after 12/31/23, except that certain partnerships between related parties would be required to use the "consistent percentage method" (described below).

There are layers and layers of problems in the elimination of the SEE standard and its replacement with PIP. First, this proposal will not result in any simplification because determining PIP is as hard and complicated (perhaps even more complicated) than applying the SEE rules. This complexity arises because business deals are usually very complex — without regard to any tax motivation whatsoever. The Draft implies that most partnerships contain simple economic distribution formulas, whereas in reality, it is most common for partnership distributions to be made in tiers reflecting economic results. For example, a real estate developer wants to develop a property, and the developer has identified two financial investors who are willing to put up 95% of the capital required; the developer will contribute 5% of the capital. The "business deal" is that distributions are made first in accordance with capital contributed until the partners receive an 8% return on their capital; then, distributions will be made 90% to the partners in proportion to capital contributed and 10% to the developer partner until the partners who contributed capital have received a 12% return on their capital; thereafter, distributions will be made 80% to the partners in proportion to capital contributed and 20% to the developer partner. What is the "partner's interest in the partnership" of the developer partner (or, for that matter, of the financial investor)? Is it 5%, 10% or 20%? Does it vary over time? When is it measured?

Eliminating the SEE standard takes away the flexibility the current rules provide partners to allocate a partnership's items of income and loss in the manner that best suits their needs, as long as those allocations affect their economic consequences. Perhaps this is the goal of the proposal because there is a perception that this flexibility allows too much opportunity for tax avoidance. However, the current SEE already contains a mechanism to prevent tax avoidance, namely the requirement that the economic effect of allocations must be "substantial." Under that requirement, a partnership item cannot be reallocated from one partner to another unless the reallocation makes one of the partners economically worse off on an after-tax present value basis. Thus, if a reallocation provides tax savings to one partner, it should result in the other partner paying more tax, all else being equal. The present value of the tax savings of the former could theoretically be higher than the present value of the additional tax cost to the latter because the partners are subject to different rates of tax, or because the tax savings may be current while the additional tax cost could be deferred. However, this is a small price to pay for the flexibility that the rules afford taxpayers to conduct joint business enterprises in the manner that best fit their particular circumstances. It is questionable whether the modest amount of additional revenue that may be generated by eliminating the SEE standard is worth the constraints that it would place on the manner in which businesses can be organized.

Using only a PIP standard almost forces the partners to predetermine the manner in which they want to share partnership profits in the aggregate, regardless of when these profits arise and to what specific subset of partnership assets they relate. The change would severely limit the ability to conduct business in a manner that allows partners the flexibility to share certain streams of profits (for example, profits and losses that arise during a specific time period) in a manner that varies over the course of the life of the business, as long as that variation sufficiently affects their economic results.

The difficulty of changing to a PIP standard is highlighted when Congress enacted tax incentives. Taxpayers utilize partnerships, together with allocations that satisfy the SEE test, to allocate tax benefits to investors so as to achieve Congress' goals. For example, under current law, the tax equity investor in a solar project, will be allocated 99% of income, gain, loss, deductions and (most importantly) credits from the project until a "flip date," after which the tax equity investor will be allocated only 5% of such items (and the balance will go to the developer of the project). What is the "partner's interest in the partnership" of the tax equity investor? Because its residual share is only 5%, it appears that its interest in the partnership is far below the 99% needed to provide for an allocation of tax credits to the tax equity investor. And without that allocation, there will be no tax equity financing - and no solar project.

There is the related practical problem of determining a partner's interest in the partnership over time. Is it determined each year on a "snapshot" basis, so that a partner's interest is based on how money will be distributed that year? Or is it based on a partner's interest in the partnership over the life of the partnership? And if PIP takes into account the entire life of the partnership, given that economic results are uncertain, would PIP change as a result of operating the partnership over time?

And the current regulations under PIP focus not only on how income is distributed but also on contributions to a partnership. If PIP were the only test, a partnership that generates tax losses could easily be converted into a tax shelter by having wealthy taxpayers make contributions to increase their share of capital (and, hence, their share of PIP) even though the plan would be to distribute income to partners who have a much lower share of partnership capital.

A related issue is how these rules would apply to existing partnerships. There are thousands and thousands (if not millions) of partnerships and entities taxable as a partnership (such as LLCs) in existence, and many of them have been allocating income, gain, loss, deductions and credits according to the SEE regulations. The Draft implies that all of these allocations will become void as of 1/1/24, and the SEE rules will be replaced with PIP at that time, even if the agreement has been in effect for decades.

The SEE rules are complex, and there are some aspects of the rule (such as the "value equals basis" presumption in Treas. Reg. § 1.704-1(b)(2)(iii)(c)) that probably are worthy of a second look. But overall, the rules have provided both clarity and certainty for decades. Replacement of these rules with a mandatory PIP test will not accomplish either of these goals, but it will open the door to tax avoidance and substantial confusion.

In addition to its frontal assault on the SEE rules, the Draft also contains a special rule for certain partnerships between related persons. The Draft recognizes that when partners are not independent and do not have competing interests, it may not be appropriate to rely solely on their purported economic arrangement. The Draft proposes a special allocation rule for certain related-party partnerships. This 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,[1] the provision would require the partnership to consistently allocate all items based on partner net contributed capital.[2] The Secretary is granted authority to require the use of this consistent percentage method by other partnerships to prevent abuse.[3]

Because the IRC cannot compel taxpayers to agree to only certain economic arrangements, the consistent percentage method contains a provision which applies when the partners do not provide distributions on a pro rata basis (i.e., not proportionate to net contributed capital). The rule is intended to discourage non-proportional allocations and distributions. Any distribution or right to partnership property not proportional to partner net contributed capital would be treated as a transaction directly between the 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 gross income and any loss or expense would be nondeductible and non-capitalizable by the other partner(s). The consistent percentage method would be effective for tax years beginning after December 31, 2023. The Secretary is authorized to provide transition rules and to provide exceptions to the general rule.

This consistent percentage method also places unreasonable limitations on the ability of taxpayers to organize business arrangements with flexible economics, allowing economic resources and investment to be allocated in the most efficient manner. Consider a situation in which two related corporations want to enter into a joint venture with an unrelated party, to which the related corporations will jointly contribute more than half of the capital. Under the consistent percentage requirements, the parties would be unable to agree to share the profits from such a venture other than in proportion to their contributed capital. Instead of allowing taxpayers the flexibility to agree to an economic arrangement

1 Treas. Reg. § 1.706-1(b)(4)(ii) and (iv).

2 Essentially, these partnerships would be subject to a single-class-of-partnership interest allocation scheme, similar to S corporation allocation rules.

3 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.