



November 02, 2021

The Honorable Ron Wyden  
Chairman  
U.S. Senate Committee on Finance  
219 Dirksen Senate Office Building  
Washington, DC 20510

The Honorable Richard Neal  
Chairman  
U.S. House Committee on Ways and Means  
1102 Longworth House Office Building  
Washington, DC 20515

The Honorable Michael Crapo  
Ranking Member  
U.S. Senate Committee on Finance  
219 Dirksen Senate Office Building  
Washington, DC 20510

The Honorable Kevin Brady  
Ranking Member  
U.S. House Committee on Ways and Means  
1139 Longworth House Office Building  
Washington, DC 20515

**RE: Additional Comments Analyzing Proposed Reform(s) to Subchapter K (Partnership Taxation)**

Dear Chairmen Wyden and Neal, and Ranking Members Crapo and Brady:

The AICPA is pleased to submit additional comments analyzing the *Pass-through Reform Discussion Draft*<sup>1</sup> (“proposal”) to supplement our initial comments submitted on October 1, 2021.<sup>2</sup> The AICPA encourages the Senate to follow the House and not include Subchapter K changes in the reconciliation legislation.

The AICPA consistently champions good tax policy and effective administration.<sup>3</sup> Pass-through entities, and specifically partnerships reporting under Subchapter K of the Internal Revenue Code (IRC), generate significant business income. Partnerships also serve as the structure for many small businesses and newly formed businesses. The partnership<sup>4</sup> is the ubiquitous business structure for private equity investment, personal service firms, and many start-up businesses (which naturally grow and employ more individuals as they mature). Good tax policy related to partnerships and effective administration of that system should provide fairness, simplicity, neutrality, and certainty.

The nature of Subchapter K presents an inherent conflict of flexibility in some instances and strict rules in others – it is an intricate regime with many moving pieces that *must* align to provide a cohesive structure that can be applied by the tax system at large for businesses, individuals, and the IRS. Many issues being faced today by Congress have been addressed by prior Congresses. For example, the American Law Institute (ALI) engaged in a Tax Project during the 1954 IRC

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<sup>1</sup> Released by Senate Finance Committee Chairman Wyden on September 10, 2021.

<sup>2</sup> See AICPA letter, “[Tax Provisions in House Reconciliation Legislation or Being Considered](#)” (October 1, 2021).

<sup>3</sup> See generally [AICPA Principles of Good Tax Policy](#) (12 principles providing objective framework to evaluate policy proposals).

<sup>4</sup> Limited liability companies (LLCs) formed between two or more members are taxed under Subchapter K by default under the check-the-box regulations. See Reg. § 301.7701-2 and Reg. § 301.7701-3.

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restructuring suggesting several changes and commentary on what would become Subchapter K in Congress's effort to overhaul the 1939 IRC.<sup>5</sup>

Regarding contributed property, the ALI noted, "... the tax treatment of contributed property relates essentially to the relationship between the partners, *rather to an issue between Treasury and the partners, the paramount consideration should be a set of rules permitting sufficient flexibility* in consummating partnership arrangements." [emphasis added]. Commenting on the carryover basis approach (ultimately enacted in the 1954 IRC), the ALI further noted, "... despite the possibility of shifting potential gains and losses among the partners under a carry-over-of-basis rule, that the partners, *each looking out for his own interest*, could be depended upon to eliminate possible tax inequities among themselves" [emphasis added].<sup>6</sup>

The AICPA raises the 1954 ALI Tax Project due to *historia ipsa repetit*.<sup>7</sup> The paramount consideration remains to provide sufficient flexibility to organize businesses and operate them efficiently. If enacted by the Senate, the proposals would fundamentally alter the relationships between partners and partnerships that have been relied upon by the tax system for nearly 70 years.

The AICPA is significantly concerned that the proposals to reform Subchapter K to target perceived (and actual) abuses and in an effort to close the tax gap do not conform to the AICPA's principles of good tax policy objective framework and misconstrue the history regarding Subchapter K dating back to the 1954 IRC.

The AICPA recommends considering fundamental and structural changes to Subchapter K only after comprehensive study and sufficient input in order to smooth out policy considerations and mitigate unforeseen consequences due to the intricacy of Subchapter K. Introducing significant changes to Subchapter K would also require the Department of the Treasury (Treasury) to provide additional guidance that could create uncertainty for the time prior to when (or if) regulations are issued or finalized. The below comments raise several practical concerns and specifically address the following:

- I. Safe Harbor Allocations of Income
- II. Section 704(c) Remedial Method and Mandatory Revaluations
- III. Nonrecourse Liabilities under Section 752
- IV. Mixing Bowl Transactions under Section 704(c)(1)(B) and Section 737
- V. Mandatory Basis Adjustments under Section 734 and Section 743
- VI. Partnership Continuations
- VII. Section 163(j) Limitation on Business Interest

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<sup>5</sup> See ALI Tax Project, J. Paul Jackson et al., "A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners-American Law Institute Draft" 9 TAX L. REV. 109 (1954).

<sup>6</sup> *Id.*

<sup>7</sup> History repeats itself. The past can provide useful context to inform present circumstances and considerations.

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We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. If you have any questions, please contact Jose Ramon Carrasco, Chair, AICPA Partnership Taxation Technical Resource Panel, at (202) 521-1552 or [jose.carrasco@us.gt.com](mailto:jose.carrasco@us.gt.com); or Lauren Pfingstag, Director, AICPA Congressional or Political Affairs, at (407) 257-0607 or [lauren.pfingstag@aicpa-cima.com](mailto:lauren.pfingstag@aicpa-cima.com); or me at (601) 326-7119 or [JanLewis@HaddoxReid.com](mailto:JanLewis@HaddoxReid.com).

Sincerely,

A handwritten signature in black ink, appearing to read "Jan Lewis". The signature is fluid and cursive, with a large initial "J" and "L".

Jan F. Lewis, CPA  
Chair, AICPA Tax Executive Committee

cc: The Honorable Charles P. Rettig, Commissioner, Internal Revenue Service  
Ms. Lily Batchelder, Assistant Secretary for Tax Policy, Department of the Treasury  
Mr. Thomas Barthold, Chief of Staff, Joint Committee on Taxation

## AMERICAN INSTITUTE OF CPAs

### Additional Comments Analyzing Proposed Reform(s) to Subchapter K (Partnership Taxation)

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#### I. Safe Harbor Allocations of Income

Allocations of gain and loss among the partners that utilize a “safe harbor” methodology are allowable under section 704(b)<sup>1</sup> if those allocations reflect the actual business arrangement of the partners and are not primarily tax motivated.<sup>2</sup> One of the benefits of Subchapter K is the flexibility in structuring business affairs between the partners to reflect the economics of the deal – by deviating from a pure pro-rata allocation to one where tax follows the economics.

The proposal generally eliminates the ability to use existing safe harbor rules under section 704(b) and in some cases would decouple economics from the tax considerations, even for businesses that are not engaging in nefarious transactions. This proposed decoupling would not allow tax to follow the actual business decisions and operations; rather, it would drive business to focus on tax as the paramount concern rather. This, in turn, could lead to tax planning to exploit the differences between business economics and the tax code. Eliminating existing safe harbor methods would also affect many partnership agreements and change the relative legal statuses of those agreements, which are typically highly negotiated to properly conduct business operations.

Reforming Subchapter K and the regulations under section 704(b) to align it closer to Subchapter S alternatively presents Subchapter S’s currently existing complexity as opposed to a situation for which simplification is the end result. The safe harbor rules under the Substantial Economic Effect (SEE) doctrine are generally well understood while the Partner’s Interest in the Partnership (PIP) is the general “fallback” provision when allocations do not comply with the safe harbor rules. PIP is an amorphous and subjective area that is not well defined. Changing the allocation rules to PIP may remove the complexity traditionally associated with the section 704(b) regulations, but in turn, would upend current economic arrangements, completely modify the regime with and under which partnerships are currently familiar and operate, and introduce *new* complexity to the tax system. Removing safe harbors and forcing taxpayers to rely on general rules are frequently a detriment to taxpayers.

The proposal also would mandate pro-rata allocation for certain controlled partnerships (the “consistent percentage method”). The AICPA notes that the proposal assumes that all parties in a controlled partnership do not have any competing economic interests, an assumption that in many cases may not be accurate. In addition, the income inclusion mechanism to deal with non-pro rata situations in a controlled partnership could result in the assessment of overall tax in an amount that is greater than appropriate or intended. There are existing regulations under section 704(b) that address allocations that do not have SEE (e.g., the PIP provision noted above). The consistent

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<sup>1</sup> Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations promulgated thereunder.

<sup>2</sup> The regulations under section 704(b) are voluminous and address abuses in the special allocation regime.

percentage method as drafted is inappropriately broad in both scope and mechanics, and further study is needed to: (1) identify the specific related party situations that the rule should address, and (2) refine the mechanics of the rule to address those specific situations.

Tax rules are generally complex – however, the AICPA notes that they need not be unduly *complicated*. Modifying these rules does not remove the complexity in Subchapter K, it merely changes the form of complexity. The AICPA acknowledges that many purported economic arrangements that tend to abuse the tax system do happen to take the form of a partnership taxed under Subchapter K. However, this reality should not color *all* partnerships as evading tax. The use of Subchapter K in these well-known abusive tax devices either misrepresented or outright violated the rules under Subchapter K and were the subject of numerous audits with associated penalties.<sup>3</sup>

The IRS's authority to audit and properly assess tax<sup>4</sup> exists under the current anti-abuse rules. The lack of IRS resources to properly enforce the rules is not a valid reason to change the provisions for the many compliant partnerships. The change(s) presents the same enforcement issues due to new complexity and the need to revise the voluminous regulations – creating a new, unknown, and similarly complex and amorphous regime.

## II. Section 704(c) Remedial Method and Mandatory Revaluations

Currently, partnerships may choose one of the three allocation methods<sup>5</sup> regarding contributed property with a built-in gain or loss. The regulations apply complex anti-abuse rules to prevent improper allocation of gain or loss to another partner.<sup>6</sup> The proposal would mandate the remedial method for all partnerships in an effort to prevent any potential shifting in gain or loss to another partner. There are valid non-tax reasons for partnerships using one of the other section 704(c) methods, or any other reasonable method. Similar to the special allocations noted above, most partnerships comply with the current tax rules and do not inappropriately shift tax liabilities between partners.

The perceived abuses in using the section 704(c) rules to improperly shift gain or loss is properly nullified by current IRS authority to audit and reallocate those section 704(c) items. The AICPA also notes that the revenue raised by mandating the remedial method is likely outweighed by the total costs imposed to the tax system by the proposal.<sup>7</sup> In the alternative, the AICPA recommends a tailored anti-abuse rule which could require disclosure and notification by taxpayers where the IRS has identified situations in which the remedial method is mandated. With the centralized partnership audit regime now in effect, the IRS has the capability to comprehensively audit those

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<sup>3</sup> See generally section 7701(o); Reg. § 1.701-2; case law regarding economic substance, substance over form, and step-transaction doctrine(s).

<sup>4</sup> Substantial penalties are imposed on tax shelters and promoters of those arrangements.

<sup>5</sup> See generally Reg. § 1.704-3. The remedial method is one of three section 704(c) allocation methods provided for in the regulations thereunder.

<sup>6</sup> See, e.g., Reg. § 1.704-3(a)(1), (10) and section 707(c).

<sup>7</sup> Any shifting occurring under the “ceiling rule” likely washes out as the partner to whom gain (or loss) is shifted to would pay tax on that gain (or deduction) (perhaps subject to certain rate differentials). As noted, improper allocations (such as to a tax-exempt partner or non-U.S. taxpayer) are not respected for tax purposes and the IRS has the authority to reallocate those items.

partnerships. Further, Congress has appropriated resources allowing the IRS to specifically identify and, if need be, audit, those partnerships that are of concern (or perceived to have engaged in abusive transactions). Congress could achieve its intended goal regarding section 704(c) by taking a more tailored approach rather than pursuing the draconian results that the mandated remedial method produces.

The remedial method could be complex to apply in certain situations. The administrative burden to properly maintain the necessary records is, at times, a significant factor for taxpayers to use one of the other two methods provided for in the regulations. Unrelated parties often agree to the use of the other two methods, not in an attempt to shift built in gains, but instead to decrease compliance burdens and simplify reporting. This process is particularly true regarding the choice of section 704(c) methods and section 704(b) revaluation layers.

Mandating the remedial method significantly increases compliance costs for partnerships, disproportionately affecting small businesses who may not have sophisticated software and advisors to properly track the remedial allocations, with little benefit of the tax system at large. Increased and more complicated compliance does not necessarily beget more compliant partnerships. Businesses that are well-advised and sophisticated may become another class, creating unfairness for other partnerships who attempt to comply but may ultimately not correctly do so. Similarly, the IRS would likely have difficulty in auditing the substantial administrative records to determine whether the remedial method was properly applied.

The proposal also affects partnership agreements and the business arrangements of those partners. Retroactively modifying Subchapter K to mandate the remedial method affects the negotiated economics of the deal. The AICPA recommends further study and consideration in modifying the section 704(c) methods.

Similar analysis applies to the proposal regarding mandatory revaluations in all circumstances (new section 704(f)). The proposal would also require a partnership that must revalue its assets to push the revaluation down to any majority-owned lower-tier partnerships. Mandatory revaluations coupled with the mandatory application of the remedial method will result in increases in complexity, record-keeping, and compliance costs. Many now compliant partnerships may not have the resources to track all the revaluations that would take place during the lifetime of the business. The proposal would disproportionately affect small businesses and may well be un-administrable for large ones.

The IRS would likely have similar difficulty in auditing the revaluations to ensure compliance, possibly imposing penalties on taxpayers making a good faith effort to comply. The administrative burden for properly tracking revaluations (and all historical records which may not exist or be easily accessible) introduces more complication to partnership taxation in an effort to simplify and curtail abuses. Again, the result is not simplification, but rather increased costs for marginal benefit.

### III. Nonrecourse Liabilities under Section 752

The proposal would modify the allocation of both recourse and nonrecourse debt in accordance with a partner's share of partnership profits. The proposal contains a transition rule to allow partners an eight-year period to pay any associated tax liability due to the loss of debt allocations (similar to the section 965 repatriation tax adjustment spread).<sup>8</sup> The functional rules of debt allocations are contained in the section 752 regulations. The regulations contain many cross-references and were revised to target perceived abuses in partnership debt allocations. The proposal would unravel most of the section 752 regulations and require Treasury and IRS to implement a new guidance regime in which the complexity changes form – but debt allocation is not simplified.

The AICPA acknowledges the complexity and length of the current section 752 regulations. However, these regulations have existed (with various revisions) for decades. Replacing this regime with an “allocation of partnership profits” wields a cudgel in lieu of a scalpel in modifying the intricate sets of interlocking regulations that create the fabric of Subchapter K.<sup>9</sup> Partners who have currently allocated recourse liabilities and a negative capital account could recognize significant gain, and the proposal contemplates such gain by providing an eight-year period to pay any associated tax. Treasury and the IRS have the tools to combat any abusive use of allocating liabilities via existing anti-abuse regulations; instituting a new regime would almost assuredly contain the same level of complexity as current section 752.

A well administered tax system should be based on the principles of certainty and fairness. The proposal to revoke and replace the section 752 liability allocation codification and regulations thereunder undermines both principles. There are business reasons, such as personal guarantees required by financial institutional lenders, for partners to have the economic risk of loss. The proposal could trigger significant gain under section 731 to those partners who were required to have the section 752 liability allocated to them due to business and economic reasons. These partners may not have specifically benefited from the liability allocation due to other loss limitation rules but were required to adjust their outside basis due to the suspended deduction (e.g., the loss was not limited under section 704(d)). The proposal would shift the section 752 liabilities in such a manner that these partners could be whipsawed into both not benefiting from prior deductions<sup>10</sup> and recognizing gain due to the mandated reallocation. This reallocation of liabilities produces further basis shifting and does not achieve the proposal's intended result.<sup>11</sup>

The AICPA encourages Congress to comprehensively address any changes to the liability allocation rules after careful consideration and study in conjunction with Treasury.

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<sup>8</sup> Although the proposal is not clear in this regard, the AICPA suspects it will operate similar to a section 965 adjustment.

<sup>9</sup> The uncertainty and differing, but appropriate, methods in calculating a “partner's share of partnership profits” coupled with the proposed “partner's interest in the partnership” confounds even the most experienced practitioners and nearly all taxpayers. *See, e.g.*, Banoff, “Identifying Partners' Interests in Profits and Capital: Uncertainties, Opportunities and Traps” *Taxes – The Tax Magazine* 197 (2007).

<sup>10</sup> As noted, the partner may not have deducted a loss against outside basis due to loss limitation rules (e.g. passive activity losses under section 469 or at-risk under section 465).

<sup>11</sup> A partner may incur the economic risk of loss for a partnership liability (such as under state law), but the proposal would shift basis to other partners who are not ultimately responsible.

#### IV. Mixing Bowl Transactions under Section 704(c)(1)(B) and Section 737

Under section 704(c)(1)(B) and section 737 (mixing bowl rules), partnerships may not distribute contributed built-in gain or loss property to another partner without recognizing gain or loss. Under these rules, partnerships also may not distribute other property to the contributing partner within seven years of the contribution without the contributing partner of a built-in gain property properly recognizing that gain. The rules cease to apply after seven years, permitting application of the general rules regarding distributions. The proposal would remove the seven-year applicability period from the mixing bowl rules, thus disallowing *any* distribution of built-in gain property to another partner without the original contributing partner recognizing that gain.

Enacted as part of the Omnibus Budget Reconciliation Act of 1987,<sup>12</sup> the mixing bowl rules address situations in which “partners [were able] to circumvent the rule requiring pre-contribution gain on contributed property to be allocated to the contributing partner.”<sup>13</sup> The originally enacted five-year limitation was revised to the current seven-year limitation as part of the Taxpayer Relief Act of 1997.<sup>14</sup> It appears from the legislative history that the drafters did not intend for the mixing bowl rules to apply in perpetuity.

The proposal would significantly modify the pass-through concept of Subchapter K in which distributions are generally not taxed to the extent of outside basis and represents a fundamental shift in partnership taxation. The AICPA acknowledges that the mixing bowl rules are a necessary piece of Subchapter K related to disguised sales that are either: (1) not recharacterized as disguised sales under section 707(a)(2)(B); or (2) do not appear as disguised sales due to a reasonable amount of time passing between the initial contribution and the subsequent distribution. However, the seven-year limitation is a sufficient deterrent to individuals whose intent in organizing a partnership is solely to exchange property at some future time. There are more efficient means of exchanging property rather than waiting nearly a decade to exchange property by means of Subchapter K.<sup>15</sup>

The proposal assumes that an operating business has the same partners for the entirety of the business’s life. Prior partners may be deceased or retired and new partners may have been admitted. The revaluation proposals coupled with the mandatory remedial method nearly precludes effective compliance due to the record-keeping burden imposed on partnerships. Small businesses are disproportionately affected due to the high cost of attempted compliance and large partnerships are burdened with a punitive compliance burden.

#### V. Mandatory Basis Adjustments under Section 734 and Section 743

The proposal would require basis adjustments of partnership property upon any sale or exchange of partnership interest or any distribution of money or other property to a partner. Currently, if an interest in the partnership is transferred, section 743 provides that a partnership must adjust the basis of partnership property with respect to the transferee partner if the partnership has either a

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<sup>12</sup> P.L. 101-386.

<sup>13</sup> H.C.R. 101-386.

<sup>14</sup> P.L. 105-34; H.C.R. 105-220.

<sup>15</sup> *See, e.g.*, section 1031 (like-kind exchanges).



section 754 election in effect or the partnership has a substantial built-in loss.<sup>16</sup> Similarly, section 734 requires a partnership to adjust the basis of its property upon a distribution to a partner if the partnership either has a section 754 election in effect or there is substantial basis reduction with respect to the distribution.<sup>17</sup> To require a partnership to adjust the basis of its property for all transfers of interest and distribution events would create administrative burden that could outweigh the benefit to the partnership and its partners in certain situations. The AICPA recommends no expansion of required basis adjustments. Instead, the AICPA recommends providing Treasury express authority to issue regulations to identify situations perceived as abusive for which a partnership is not adjusting its basis due to a transfer of an interest, or a distribution event that would generate a positive adjustment (or a so-called “step-up”) under section 734 or section 743, if there is a concern.

## VI. Partnership Continuations

The proposal to clarify termination events raises ancillary issues related to partnership continuations. The AICPA agrees that further guidance is needed regarding partnership terminations and continuations. However, modifying the situations in which a partnership may terminate without addressing issues relating to the continuation of a partnership creates further uncertainty for taxpayers who attempt good faith compliance where there are varying views regarding partnership continuations – most of which have a reasonable basis based on the current rules. Therefore, the AICPA recommends modifying section 708 directing Treasury to issue regulations providing for special rules and exceptions in lieu of the proposal. The AICPA notes that a grant of specific legislative authority to issue regulations under section 708 would allow Treasury the flexibility to address the myriad of business situations that arise. Clarity providing Treasury’s express authority to issue regulations to properly address partnership continuations and terminations is more effective administratively.

## VII. Section 163(j) Limitation on Business Interest

The AICPA recommends that the Senate either adopt the House provision regarding section 163(j) modifying it to a pure aggregate treatment or maintain the current regime. The proposal would create additional complexity and administrative burden for partnerships to track it purely at the entity level and deny partners the ability to use a partnership’s excess capacity to deduct partner level business interest expense. Many businesses operate in tiered partnership structures where the debt funding is obtained by upper-tier partnerships that hold the underlying operating assets in lower-tier partnerships where the excess capacity for interest deductions is generated. This proposal can upend the economic relationships and operations of many businesses.

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<sup>16</sup> Section 743(d) provides that a partnership has a substantial built-in loss if the adjusted basis of the partnership’s property exceeds by more than \$250,000 the fair market value of such property.

<sup>17</sup> Section 734(d) provides that a substantial basis reduction exists with respect to distribution if the sum of (1) a loss recognized under section 731(a)(2); and (2) the excess of basis of distributed property in the hands of the distributee over the basis of such property in the hands of the partnership exceeds \$250,000.