American Institute of CPAs
1455 Pennsylvania Avenue, NW
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July 14, 2015

The Honorable James Renacci
House Committee on Ways and Means
328 Cannon House Office Building
Washington, DC 20515

The Honorable Ronald Kind
House Committee on Ways and Means
1502 Longworth House Office Building
Washington, DC 20515

Re: H.R. 2821 – Partnership Audit Simplification Act of 2015

Dear Representative Renacci and Representative Kind:

The American Institute of Certified Public Accountants (AICPA) appreciates your efforts to address the current rules on the Internal Revenue Service's (IRS's) audit of partnerships. We are a long-time advocate[1] for an efficient and effective tax system and appreciate the intent of H.R. 2821, the Partnership Audit Simplification Act of 2015 ("Act" or "Proposal"). However, the AICPA is concerned about several provisions in the Proposal.

While we believe the Proposal may improve certain aspects of IRS audit administration, we have serious concerns regarding this legislation, as currently drafted. This Proposal focuses on isolated problems within the audit of large partnerships while failing to address more problematic issues regarding the overall tax simplification and compliance of these entities. Although we are still in the process of reviewing and analyzing all of our members' input on potential policy, legal and administrative concerns, we would like to highlight a few of the major issues which we have initially identified.

Specifically, our comments in this letter address the following issues:

1. Overall Increase in U.S. Income Tax Due;
2. Significant and Unprecedented Impact on Small Partnerships;
3. Stifling of Investments in Partnerships;
4. Inequities Resulting from Changes in Partners; and
5. Significant Tax Cost/Penalties on U.S. Taxpayers Investing Abroad.

The AICPA strongly urges Congress to consider the issues we have outlined in this letter in order to better focus on developing processes that will do more to improve tax compliance than simply trading certain smaller tax administrative complexities for larger and likely more burdensome complexities in the future. We intend to continue our work to provide Congress with comments about additional issues regarding this Proposal, along with detailed examples and recommended solutions, in the near future. We hope that this initial message, from the AICPA, is able to strongly

[1] AICPA Comment Letter to House Committee on Ways and Means on the Tax Reform Act of 2014, Submitted January 12, 2015; https://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/AICPA-Comments-on-2014-Camp-Draft-General-Comments-Final.pdf.

communicate our most significant concerns regarding the Proposal. Congress should take the necessary additional time to research and examine legislative provisions for simplifications and improvements to the partnership audit process in order to avoid any inequitable, unfair, and possibly unforeseen consequences to U.S. partnership businesses, both small and large.

AICPA CONCERNS

1. Overall Increase in U.S. Income Tax Due

The Proposal disregards any tax attributes of the partners (e.g., tax exempt or foreign partners not otherwise subject to federal income tax) and apparently disregards the character of items generated at the partnership level (i.e., ordinary income/deduction vs. capital gain/loss), which is determined at the partner level. For those partners, this Proposal would go well beyond raising revenue through tax compliance or closing the "tax gap";[2] this Proposal would increase taxes by having certain partners overpay their otherwise legally-required share of taxes – an unfair and disparate tax increase.

The Proposal results in an increase in federal income tax that extends well beyond the goal of audit simplification and collection of tax otherwise due. However, it does allow the partnership to reduce the imputed underpayment to the extent a partner amends and pays tax due on its tax return (within a limited timeframe), but the Proposal does not provide what happens in circumstances in which the partner on which the tax was imposed (1) would not otherwise need to file a U.S. income tax return or (2) is required to file a U.S. income tax return, but owes no tax (tax-exempt investors with no unrelated business taxable income ("UBTI")). Moreover, we believe that many partners may choose not to file an amended return to seek a tax refund, even if one is due, because the cost to file may outweigh the refund or the partner/partner's advisor may not have knowledge of this provision. Therefore, although the Proposal provides the mechanism for a refund, the failure to file amended returns ultimately results in a net increase in income tax due.

2. Significant and Unprecedented Impact on Small Partnerships

To our knowledge, each proposal leading up to the Act focused on a certain subset of the partnership population – large partnerships. Similarly, the Government Accountability Office ("GAO") report,[3] released in September of 2014, focused on audits of large partnerships. Despite the focus and attention on audits of large partnerships, the Proposal, as currently drafted, reaches beyond large partnerships to harmfully and automatically affect small partnerships (i.e., small businesses) as well. Section 6221(b) of the Proposal does allow certain small partnerships to elect out of the audit regime. However, most small partnerships may not have timely knowledge of this provision and receive the fair opportunity to elect out of its application as the election is only valid if made on a timely filed tax return for the subject year. Moreover, many small businesses are owned by entity types that automatically disqualify the small partnership from electing out of the

[2] See IRS "tax gap" definition: http://www.irs.gov/uac/The-Tax-Gap.
[3] GAO Report, "With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency," Released September 18, 2014; http://www.gao.gov/assets/670/665886.pdf.

audit regime such as having at least one partner that is also a partnership or other type of passthrough entity (i.e., S-Corporation). This Proposal would apply to those small businesses, without exception, and the provision allowing an opt-out right would not apply.

3. Stifling of Investments in Partnerships

We are extremely concerned that this Proposal may create economic and legal barriers to new potential investors/partners. These obstacles will undoubtedly impact the economy by creating a reduction in capital market transactions among partners and businesses owned by partnerships in the United States. This could likely lead to the stifling of:

a. Investments by Prudent Investors, Tax-Exempts and Foreign Investors
A major flaw with the Proposal is assessment of tax at the partnership level combined with the assignment of joint and several liability for any imputed underpayment to the partnership, any direct and indirect partner during a reviewed year (a "Reviewed Year Partner"), and any direct or indirect partner during the adjustment year (an "Adjustment Year Partner"). The Proposal shifts the collection of federal income tax due, as a result of an audit examination, not only to the partnership but also to each Reviewed Year Partner and each Adjustment Year Partner (regardless of whether they were owners during the "review year"). Under the Proposal, a partner's potential obligation for the underpayment is not limited to the partner's current allocation of expenses, but potentially for the entire amount of the tax assessed against the partnership for any open year. As such, we believe prudent investors, tax-exempt investors and foreign investors will less likely invest in assets held by partnerships as a direct result of the increased and unquantifiable costs and risks forced by this Act. We believe prudent investors, tax-exempts investors and foreign investors would deem the possibility of this unlimited and unquantifiable risk as unacceptable and less likely choose to invest in U.S. partnerships.

b. Investments by All Other Partners
Additionally, by assessing tax at the partnership level and requiring joint and several liability of the partners, the Proposal creates a potential contingent liability with respect to every partnership interest that will require contractual deals by potential investors in partnerships. The Proposal will undoubtedly suppress investments in passthrough entities because a contingent liability will always exist in on-going partnerships. If this Proposal is approved, a potential new partner to an existing partnership is obligated to assume the contingent federal tax liability related to years prior to this new partner's admittance into the partnership. This assumption of risk would likely generate a valuation discount on the purchase price of the partnership interest. Potential new partners may have little or no access to prior tax returns or financial records and must assume unknown and unquantifiable risks as a condition of purchasing an existing partnership interest in the business.

A new partner could arguably negotiate for a set of tax representations and warranties and also require some type of contractual indemnity and/or escrow arrangement (either in a contribution agreement or a purchase agreement, depending on how the partner acquired the partnership interest). However, our members are concerned about the practicality of such provisions. Also, since the IRS is not a party to any agreement between the partners, the IRS can still pursue action against each Reviewed Year Partner and each Adjustment Year Partner. The long-term nature of IRS audits likely makes it impractical or unrealistic to negotiate an agreement that is enforceable for as long as, for example, 10 years after the purchase transaction. Large partnership tax issues are often complex and it may take a decade or more to come to agreed-upon resolutions for some issues raised in an IRS audit. During that period of delay, some partners will exit the partnership while new partners will join, thus increasing the complexity and burden for businesses to properly calculate and allocate audit adjustments.

In the meantime, partners that wish to sell or redeem their interests may not have the extra cash to pay the taxes incurred on the exit transaction due to holdbacks and escrows (or discounts). Similarly, partnerships that sell their businesses may not have the ability to fully liquidate and terminate due to holdbacks and escrows. At a minimum, the long-term tie-up of funds in escrows and holdbacks prevents already-limited capital from redeploying into other viable investments.

Additionally, assessing tax at the partnership level, combined with joint and several liability for any Reviewed Year Partner or any Adjustment Year Partner, would put partners in partnerships in a worse position (from a U.S. income tax liability viewpoint) than shareholders in a corporation.

4. <u>Inequities Resulting From Changes in Partners</u>

The Proposal does not contemplate changes in partners (or changes in partners' ownership amounts) from the audit year to the adjustment year and it does not prevent potential taxpayer abuse or inequitable outcomes in such circumstances. Assessing tax on partners other than those partners who were members of the partnership during the tax year under examination, and other than in proportion to the partners' respective shares of partnership items during the year under examination, may contradict the holding in *Burnet, Commissioner of Internal Revenue, v. Sanford & Brooks Co.,* 282 U.S. 359 (1931).

The Proposal assumes that the partners' percentages of ownership do not change between the audit and adjustments year, which is a simplification that is impractical. It is common to have partnership identity and percentage ownership amongst existing partners change from year to year. It is not appropriate tax policy to affect the partnership asset basis for partners no longer in the partnership. This provision will have a detrimental effect on the value of the partnership and thus the value of partnership investments.

Partnership accounting method adjustments, or adjustments affecting timing, will provide a mismatch if partners or partner percentages change midstream. Some partners may take the

opportunity to amend their partnership income tax returns,[4] while other partners may choose to not amend returns.

For example, payments are likely non-recoverable when there is a change in ownership percentage. If a partner had a 10% ownership interest in the audited tax year and has 20% ownership in the tax adjustment year, the partner's share of the adjustment is 20% rather than the 10% equitable amount attributable to the audit tax year. Often this increase in ownership can occur simply by the partner making non-pro-rata contributions to the partnership and diluting her existing partners. This partner may not have the ability to recover the extra 10% of tax burden from any prior departed partners as there departed partners may not exist.

Additionally, the Proposal may create audit payments that are non-deductible[5] and for some situations, also non-recoverable. A non-deductible payment presumably reduces the partner's outside tax basis in the partnership interest.

5. Significant Tax Cost/Penalty for U.S. Taxpayers Investing Abroad

The AICPA is concerned about the potential and significant tax burden placed on U.S. taxpayers that invest in a foreign partnership. The Proposal includes a special rule[6] where no deductions, losses, or credits are allowed to any partner unless the partnership is in compliance with the Internal Revenue Code ("IRC") section 6031[7] for the taxable year. In other words, a partner – who presumably does not have any control over decisions at the partnership level – will suffer severe tax consequences if the partnership makes the financial or business decision not to file a U.S. tax return.

The intention of section 6241(f) of this Proposal is not clear. It seems uncertain whether deductions are denied to members of (1) all foreign partnerships that fail to file U.S. tax returns; or (2) only to members of foreign partnerships that meet the criteria of IRC section 6031(e)(2) (i.e., those taxpayers that have gross U.S. source income or gross income effectively connected with a U.S. trade or business).

Foreign partnerships with no U.S. effectively connected income often decide to not file a U.S. tax return due to the cost of compliance. As evidenced by foreign investors and foreign bank reactions to U.S. tax rules, increasing foreign partnership compliance costs will detract investments in U.S. businesses. Furthermore, many partnerships do not allow for partners to terminate their interest in the partnership at any time. Therefore, current investors in foreign partnerships caught by the new rule could find themselves unable to claim losses or deductions, but also unable to disassociate with the partnership as well.

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[4] See H.R. 2821, Section 6225(c)(2).
[5] See H.R. 2821, Section 6241(e).
[6] See H.R. 2821, Section 6241(f).
[7] All section references in this letter are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated there under, unless otherwise specified.

CONCLUSION

The AICPA welcomes the opportunity to work together with Congress to discuss improvements and recommendations for the significant concerns we have discussed above, along with other tax technical and policy improvements. We believe that Congress should take more time to research, examine, and carefully study this Proposal in an effort to avoid any inequitable, unfair, and possibly unforeseen consequences from this effort to simplify the audits of partnership.

We strongly urge Congress to consider the issues we have raised as we continue to develop comments on additional issues regarding this Proposal, along with detailed examples and recommendations, in the near future. While we believe the Proposal may improve certain aspects of IRS audit administration for some limited partnership audit situations, we have serious concerns regarding this legislation, as currently drafted. We believe additional time is needed to study the Proposal to consider all the substantial impacts and unintended consequences before it is enacted.

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The AICPA is the world's largest member association representing the accounting profession, with more than 400,000 members in 145 countries and a history of serving the public interest since 1877. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We appreciate your consideration of our concerns and welcome the opportunity to discuss these items further. If you have any questions, please feel free to contact me at (801) 523-1051, or tlewis@sisna.com; or you may contact Noel Brock, Chair, AICPA Partnership Taxation Technical Resource Panel, at (619) 300-1207, or noel@noelpbrock.com; or Amy Wang, AICPA Senior Technical Manager, at (202) 434-9264, or awang@aicpa.org.

Sincerely,

Troy K. Lewis, CPA
Chair, AICPA Tax Executive Committee

cc: The Honorable Paul Ryan, Chairman, House Committee on Ways and Means
The Honorable Sander Levin, Ranking Member, House Committee on Ways and Means
The Honorable Orrin Hatch, Chairman, Senate Committee on Finance
The Honorable Ronald Wyden, Ranking Member, Senate Committee on Finance
Members of the House Committee on Ways and Means
Members of the Senate Committee on Finance