Testimony Before the

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Introduction

Chairman Tiberi, Ranking Member Neal, and distinguished Members of the Subcommittee, thank you for the opportunity to testify today regarding the recently released Ways and Means Committee Discussion Draft on the Reform of the Taxation of Small Businesses and Passthrough Entities (the "Discussion Draft").

My name is Blake Rubin, and I am Global Vice-Chair of the U.S. & International Tax Practice at McDermott Will & Emery LLP. McDermott is a law firm of approximately 1100 lawyers with 18 offices in the United States, Europe and Asia. I have been a practicing tax lawyer for 33 years. Early in my career, I worked at the U.S. Treasury Department Office of Tax Policy, where I worked on the Tax Reform Act of 1986 and the Treasury Department proposals that preceded it. Apart from that, I have worked in the private sector, and have spent a substantial portion of my time working with the tax rules affecting passthrough entities. The views I express here today are my own and do not necessarily represent the views of McDermott or any of its clients.

General Observations

I would like to start by saying that I support the effort to reform the Internal Revenue Code to make it simpler and more rational, and to lower tax rates and broaden the base. I also applaud the Committee for the robust and transparent process that it is following in developing a tax reform bill, including working groups, hearings, discussion drafts and substantial stakeholder input. Finally, I congratulate the Committee leadership and staff for producing a detailed and thoughtful set of options in a difficult and important area of the tax law.

I will focus my comments primarily on the proposed changes to the taxation of partnerships.

Option One

Option 1 sets forth proposed targeted changes to the existing partnership tax rules. I believe that many of the changes to the taxation of partnerships proposed in Option 1 of the Discussion Draft

will help simplify and rationalize the partnership tax rules and should be enacted. Specifically, I believe that the proposed repeal of the guaranteed payment rule of section 707(c) and the rules relating to the liquidation of a retiring or deceased partner's interest in sections 736 and 753 are sensible changes that further the goal of simplification. Indeed, I would go a step further and adopt the proposed change from Option 2 that would overrule the IRS's position in Revenue Ruling 69-184[1] and allow a partner to be treated as an employee of the partnership for withholding, FICA and FUTA tax purposes.

I also believe, however, that some of the proposed changes are not warranted because they will add additional complexity in many cases where the existing rules serve their intended purpose. I focus on these changes below.

- **Mandatory Adjustments to Basis of Partnership Property (Secs. 242 and 243 of the Discussion Draft and Secs. 734 and 743 of the Code)**

Sections 242 and 243 of Option 1 would require adjustments to the tax basis of partnership property under sections 734(b) and 743(b) for all partnership distributions and transfers of partnership interests regardless of whether the partnership makes an election under section 754 to adjust the basis of its property under these provisions. The Summary accompanying the release of the Discussion Draft states that the intended purpose of this provision is to prevent abuses that occur when (1) property distributions shift the character of gains and losses among partners, and (2) acquisitions result in the duplication of gains or losses.[2] I believe that current law satisfies these goals while avoiding the unwarranted imposition of significant complexity and expense on partners and partnerships that choose not to take advantage of a step-up in the basis of partnership property. As a result, I do not think that the proposed changes to sections 734(b) and 743(b) should be enacted.

Prior to 2004, in some cases, the failure to make a section 754 election could have resulted in the duplication of a loss recognized by a distributee partner or a transferor partner because a corresponding downward adjustment would not be made to the tax basis of the partnership's remaining property. In order to prevent this potential abuse, the American Jobs Creation Act of 2004 (the "Jobs Act") generally provided for mandatory downward basis adjustments to partnership property in cases where the potential basis adjustment would exceed $250,000 regardless of whether the partnership makes an election under section 754.

A section 734(b) or section 743(b) adjustment to partnership property can impose a substantial administrative burden and expense on a partnership, particularly a partnership that holds many assets. In order to implement the adjustment, the partnership must value its property, allocate the adjustment and keep track of the adjustment in future years in order to compute the depreciation, amortization and gain or loss on disposition of its assets. As a result, in a significant number of cases, a partnership will decline to make a section 754 election and forgo the benefit of a positive basis adjustment because of this administrative burden and expense. This is particularly true when the adjustment is small or would benefit only a minority of the partners. The $250,000

[1] 1969-1 C.B. 256.
[2] *See* http://waysandmeans.house.gov/uploadedfiles/small_biz_summary_description_03_12_13_final.pdf (hereinafter the "Summary").

threshold for mandatory downward basis adjustments provided in the Jobs Act acknowledges this burden and prevents the imposition of a mandatory basis adjustment in cases where the adjustment would be small. In addition, by not requiring a positive basis adjustment to partnership property, the Jobs Act maintained the flexibility to forgo such a positive adjustment if it is determined that the associated complexity is not commensurate with the benefit.

Because the mandatory downward basis adjustment under existing law already addresses the potential for abuse that could result from the failure to make a section 754 election, the burden that would be imposed on partnerships by the proposed imposition of basis adjustments in all cases is unwarranted and would result in more complexity for partnerships than exists under current law.

- **Revisions Related to Unrealized Receivables and Inventory Items (Sec. 246 of the Discussion Draft and Sec. 751 of the Code)**

Section 246 of Option 1 would eliminate the requirement that inventory items be substantially appreciated in order for such items to be subject to section 751(b).

Section 751(b) is intended to prevent a partner from in effect exchanging a share of ordinary income property held by the partnership for a share of capital gain property held by the partnership, or vice versa. To achieve this goal, if a partner receives a disproportionate distribution of capital gain or ordinary income property, section 751(b) creates a dizzyingly complex constructive exchange of assets between the distributee partner and the partnership, potentially triggering gain or loss for both the distributee partner and the partnership. There are many uncertainties regarding exactly how the provision applies in particular fact patterns, and it is widely acknowledged that the existing regulations are seriously flawed. In 2006, the IRS itself acknowledged the serious problems in the section 751(b) regulations in Notice 2006-14, which proposed various alternative approaches that might be taken in revised regulations and solicited public comments. Seven years later, the IRS is continuing to work on new regulations under section 751(b).

The saving grace under current law is the requirement that "inventory items" (which are broadly defined to include all ordinary income property) be "substantially appreciated" in order for section 751(b) to apply. For this purpose, "substantially appreciated" means that the inventory items have value in excess of 120 percent of adjusted tax basis. The proposed elimination of this requirement would dramatically expand the number of transactions that would be subject to this burdensome provision.

I have sometimes heard elimination of the substantial appreciation requirement in section 751(b) advocated on grounds of simplicity, because it would conform the section 751(b) rule to the section 751(a) rule. Section 751(a) generally treats gain or loss on the sale of a partnership interest as ordinary to the extent it is attributable to ordinary income property held by the partnership. Until 1997, section 751(a), like current section 751(b), applied only to a partnership's inventory items were substantially appreciated. In 1997, section 751(a), but not section 751(b), was amended to eliminate the substantial appreciation requirement. Section 751(a) is a much simpler rule in both theory and application than section 751(b), and the elimination of the "substantial appreciation" requirement in that context has not created any

particular compliance issues. Repealing the substantial appreciation requirement in the context of section 751(b), however, would require application of this enormously complex provision to every distribution of property or cash by a partnership, greatly expanding its scope.

In addition, there are many cases where the application of this complex rule is simply not justified from the government's perspective. For example, if a partnership has only C corporation partners, the abuse that section 751(b) is targeting is not at issue because there is no rate differential between ordinary income and capital gain for C corporations. Similarly, to the extent all of the partners of a partnership are individuals with similar tax profiles, the partners have no incentive to shift ordinary income and capital gains among themselves, and any such shift will not reduce the aggregate amount of taxes collected from the partners. In order to avoid subjecting taxpayers to the complexity of section 751(b), I believe the provision should be amended so that it applies only when there is a likelihood that a disproportionate distribution of ordinary income or capital gain property will result in an aggregate reduction in tax liability among all of the partners.

- **Repeal of Time Limitation on Taxing Precontribution Gain (Sec. 247 of the Discussion Draft and Secs. 704(c) and 737 of the Code)**

Section 247 of Option 1 would eliminate the seven-year period for the application of section 704(c)(1)(B) and section 737, the so-called "anti-mixing bowl rules," with respect to built-in gain property contributed to a partnership. I believe this change should not be enacted because the current rules adequately police the abuse that the anti-mixing bowl rules are intended to address.

Currently, under the anti-mixing bowl rules, if a partner contributes built-in gain property to a partnership, such property is deemed to be sold and the built-in gain is recognized if such partner receives a distribution of other property from the partnership, or the contributed property is distributed to another partner, within seven-years of the contribution. Prior to June, 1997, the anti-mixing bowl rules applied for the five-year period following the contribution of built-in gain property to a partnership.

The anti-mixing bowl rules are intended to prevent a property owner from avoiding the recognition of gain by exchanging the property for other property through a partnership where the exchange could not otherwise qualify for non-recognition treatment. The current seven-year post-contribution period for the application of the anti-mixing bowl rules achieves this goal. In my experience, property owners simply do not structure contributions to partnerships with the intent to exchange that property for different property seven years later. In addition, a permanent application of the anti-mixing bowl rules would impose a significant burden on partnerships because they would be required to track the acquisition history of all of their property and analyze the potential application and consequences of the anti-mixing bowl rules whenever a property distribution is contemplated.

Option Two

Option 2 provides a single unified set of rules for "passthrough corporations" and partnerships, in effect merging the current law tax regimes for partnerships and S corporations. This is an

approach that has been championed by a number of academic commentators over the years, primarily for reasons of simplicity. There is no denying the conceptual appeal of a single unified regime for passthrough entities, and if one were designing a tax system from scratch rather than reforming a tax system that is now 100 years old, a single unified regime might well be the way to go. Given where we are today, however, I believe that Option 2 would significantly increase complexity, upset settled expectations of taxpayers and cause substantial economic dislocations.

Under current law, businesses that want a relatively simple passthrough regime and that wish to avoid the complexity of partnership capital accounts, basis adjustments, the inclusion of debt in the basis of the ownership interest, "hot assets" and the like can operate as S corporations. In the main, the S corporation rules allow businesses to operate without incurring an entity level tax and without a great deal of complexity – but without the flexibility that the partnership regime provides.

Other businesses need greater flexibility – perhaps because debt is a bigger part of their capital structure and it is important to have it included in the basis of the ownership interest, perhaps because the owners want a more complicated economic sharing arrangement such as different classes of ownership interests, perhaps because they anticipate the need to distribute property in kind, perhaps because they foresee transfers or redemptions of ownership interests. For those businesses, the partnership tax regime provides the needed flexibility and allows them to operate without incurring an entity level tax – but at the cost of greater complexity and compliance burdens.

Option 2 would eliminate this choice. Worse, it would do so by creating a single unified regime that effectively combines the complexity of the current partnership regime with the inflexibility of the current S corporation regime. Thus, businesses currently operating happily as S corporations would have to master the complexity of capital accounts, mandatory basis adjustments, the inclusion of debt in the basis of the ownership interest, "hot assets" and the like. Businesses currently taxable as partnerships would continue to have to deal with the complexity occasioned by those provisions but would have reduced flexibility: distributions of property in kind would trigger taxable gain without receipt of cash, and significant restrictions would be placed on the ability to effectuate complex economic sharing arrangements. In many respects, from the practitioner and taxpayer perspective, Option 2 seems to combine the worst of both regimes.

I also believe that any simplification benefit from Option 2 is illusory. As noted above, many of the provisions of the current partnership tax regime that create the greatest complexity are retained and even expanded, including the need to maintain and adjust capital accounts, mandatory basis adjustments, the inclusion of debt in the basis of the ownership interest, allocations with respect to contributed property, the "anti-mixing bowl" rules and rules relating to "hot assets." Moreover, if the policy choice in Option 2 to trigger gain on the distribution of appreciated property is adopted, a complex set of reorganization provisions will need to be

developed and added to Option 2 to allow tax-free mergers, divisions, subsidiary liquidations and the like.[3] This will add further to the complexity, as will the need for significant transition rules.

I would now like to address some of the most significant changes proposed by Option 2.

- **Pass-thru of Items to Owners (Sec. 231 of the Discussion Draft and New Sec. 711 of the Code)**

The Summary suggests that the reason for the proposed rule is to "reduce the use of complex structures to engage in tax avoidance." As I understand the provision, most of the principles of current section 704(b) and the regulations thereunder would be retained, with an additional restriction overlaid that would require that the passthrough owner's distributive share of items in each of the three "baskets" be the same as its share of other items in the same "basket" for the taxable year. I believe that the existing regulations under section 704(b) adequately police this area, and that this change would create unwarranted restrictions on the ability of taxpayers to effectuate non-abusive commercial arrangements.

It appears that the "three basket" restriction is intended to disallow changes in the percentage interest from year to year. Thus, in theory, an owner could be allocated 20% of all items in Year 1 and 50% of all items in Year 2.

However, it may be difficult to effectuate such an economic sharing arrangement under Option 2 if the increase in percentage interest is not attributable to an additional capital contribution that increases the partner's interest in capital to 50%. For example, assume Partner A contributes 20% of capital and receives 20% of all profits and losses until Partner B receives a specified return on capital, at which point Partner A's interest in all profits "promotes" to 50%. Assume the "promote" is a "carried interest" attributable to the performance of services. Regardless of one's view on whether carried interest ought to be taxed as ordinary income or capital gain, my point here is that it will be difficult to effectuate this economic deal under the new regime. That is because under existing partnership tax allocation principles that presumably would carry over under the Option 2 regime, Partner A generally cannot be allocated more than 20% of the losses after the "flip," but is supposed to be allocated 50% of profits. That apparently would violate the requirement that items of profit *and loss* in each basket be allocated in the same percentage. In order to validate the 50% allocation of profit, Partner A would have to be allocated 50% of losses, which would require a "capital account deficit restoration obligation" and would expose Partner A to additional economic risk.

To take an even simpler case, assume a key employee of a partnership is granted a 1% profits interest in exchange for services. Again, putting aside the carried interest debate regarding whether the service partner should have ordinary income or capital gain from the interest, it appears that the economic arrangement cannot even be effectuated under Option 2 unless the service partner is willing to fund 1% of potential losses through the mechanism of a deficit restoration obligation.

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[3] The Committee acknowledged the need for reorganization rules in the Summary at page 7.

Another possible unintended consequence relates to real estate partnerships. It is reasonably common in real estate partnerships to have special allocations of depreciation deductions that are in a different percentage than other ordinary items. The existing regulations under section 704(b) allow and even facilitate such allocations, which presumably are viewed as non-abusive. This kind of allocation would be prohibited under Option 2.

- **Extent of Gain or Loss on Distribution (Sec. 231 of the Discussion Draft and New Sec. 731 of the Code)**

Certainly, this would be a sea change in the taxation of partnerships. The recognition of gain on the distribution of appreciated property is, of course, the current rule in the corporate context, including for S corporations. I believe, however, that the rule makes more sense in the context of enforcing a double tax regime for C corporations than it does in the passthrough context. I believe it should not be extended to partnerships.

In the partnership context, distributions of property have historically been treated as a "mere change in form" rather than as an occasion to impose tax. Part of the rationale for this treatment is that the distribution of property does not result in the receipt of any cash with which to pay tax on the gain. That rationale is as valid today as it was when the partnership tax rules were enacted in 1954.

One can, perhaps, legitimately debate whether a distribution of property is an appropriate occasion on which to impose a tax. However, it is beyond debate that in many cases, the Option 2 approach will result in the taxation of non-economic gains.

To illustrate, assume that Partner C is a 50% partner in a partnership that has property with a $200 value and a $0 adjusted tax basis. Partner C has a $0 adjusted tax basis in his interest, and it is worth $100. The partnership distributes property with a $50 value and $0 adjusted tax basis to Partner C in redemption of half his interest. Under the provision, the partnership recognizes $50 of gain on the distribution, of which $25 is allocated to Partner C, increasing the adjusted tax basis of his interest to $25. Partner C recognizes an additional $25 of gain on the distribution (the excess of the $50 value of the distributed property over Partner C's adjusted tax basis in the interest of $25). Thus, a distribution of property with a $0 adjusted tax basis and $50 value triggers $75 of taxable gain. C and his partners have to pay tax on $25 of noneconomic gain.

In addition, the most mundane partnership restructuring transactions would generate gain without receipt of cash. For example, assume the DE Partnership owns a 99% interest in the FG Partnership. In order to reduce the number of tax returns required to be filed, DE Partnership liquidates and distributes out the 99% interest in FG Partnership. Gain is recognized at both the DE Partnership level and by D and E. Alternatively, assume that the DE Partnership causes the FG Partnership to liquidate and distribute 99% of its assets and liabilities to the DE Partnership. Gain is recognized at the FG Partnership level and at the DE Partnership level.

Similarly, under existing principles, a merger of Partnership HI into Partnership JK is generally treated as an "assets over" transfer of HI's assets into JK in exchange for an interest in JK, followed by a distribution of the JK interest in liquidation of HI. Again, gain will be recognized at the HI level and then by H and I. Likewise, a "division" of a partnership (the partnership

analogue of a corporate spin-off) will involve a distribution of appreciated property and gain recognition. As noted above, the Summary acknowledges the need for reorganization rules, but the difficulty of crafting them and their complexity should not be underestimated.

- **Adjustments to Basis of Undistributed Property (Sec. 231 of the Discussion Draft and New Secs. 734 and 743 of the Code)**

For the reasons discussed above in the context of Option 1, I do not think that the proposed changes to sections 734(b) and 743(b) should be enacted.

- **Unrealized Receivables and Inventory Items (Sec. 231 of the Discussion Draft and New Sec. 751 of the Code)**

For the reasons discussed above in the context of Option 1, I do not think that the proposed elimination of the substantial appreciation requirement in section 751(b) should be enacted. Indeed, taking into account the proposal in Option 2 to trigger gain on the distribution of appreciated property, the expansion of section 751(b) is even more unwarranted.

- **Withholding on Distributive Share of Passthrough Income (Sec. 231 of the Discussion Draft and New Secs. 33A and 3411 of the Code)**

Although styled as a "withholding tax," the provision as described does not require withholding on distributions to owners, but rather requires payment of tax at the passthrough level coupled with a credit on the owner's return for the tax paid by the entity. In that respect, it appears similar to the regime under section 1446, which requires payment by the partnership of tax on income attributable to a foreign partner, together with a credit allowable to the foreign partner.

It appears that the tax payment required from the passthrough would be based on a uniform percentage of the amount allocable to the owner, possibly taking into account any applicable rate differential between capital gains and ordinary income. Any separate tax attributes of the owner apparently would not be taken into account.

The provision is presumably intended to ensure that passthrough owners report their distributive share of income. As described, the provision would require tax-exempt charities and pension funds that invest in passthroughs to file income tax returns in order to obtain refunds of the tax paid at the entity level. A similar issue would arise with respect to RICs and REITs, which typically do not pay Federal income tax because of the dividends paid deduction that they receive. Moreover, taxpayers with other tax attributes that offset passthrough income would be subject to "withholding" and would be required to wait until after the end of the tax year to receive a benefit from the credit. While certification procedures similar to those contained in the current regulations under section 1446 could be developed to address these issues, those procedures would likely be complex and not entirely efficient.

The withholding requirement is particularly problematic when viewed in conjunction with the Option 2 proposal to trigger tax on the distribution of appreciated property. Taking into account both provisions, the passthrough would incur an obligation to pay tax on behalf of its owners as a

result of the distribution in kind, but would have no cash proceeds from the transaction with which to do so.

An alternative to the proposed withholding regime that would ensure that passthrough owners report their distributive share of income is matching by the IRS of Schedule K-1 filed by the passthrough with respect to each owner with the tax reporting at the owner level. It is not self-evident why a Schedule K-1 matching program could not be implemented, and of course such document matching has been extremely effective in ensuring reporting of interest income and other items reflected on IRS Form 1099.

Transition Rules Under Option 2

Given the sweeping changes proposed in Option 2, transition rules will be extremely important if Option 2 is adopted. Many existing partnerships have contractual restrictions on their operations including restrictions on investment types, time horizons and the like. These partnerships and contractual restrictions were structured with certain legitimate expectations regarding current law, for example assuming the continued ability to distribute assets or liquidate in kind without triggering taxable gain. The fairest transition rule would be to permanently grandfather existing partnerships from at least the most far-reaching changes in Option 2, such as the restrictions on allocations and the recognition of gain on distributions of property. Of course, the need to have the Option 2 regime operating side-by-side with existing law for grandfathered entities for an extended period of time would further undermine the goal of simplifying the tax rules in this area.

Conclusion

I thank you again for the opportunity to present my views on this important subject, and I again commend Committee leadership and staff for advancing the debate in this area. While I have offered much constructive criticism in this testimony, I would like to reiterate my appreciation and respect for the impressive work that the Discussion Draft represents. I would be pleased to answer any questions you may have at this time or in the future.