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# Modernizing partnership taxation

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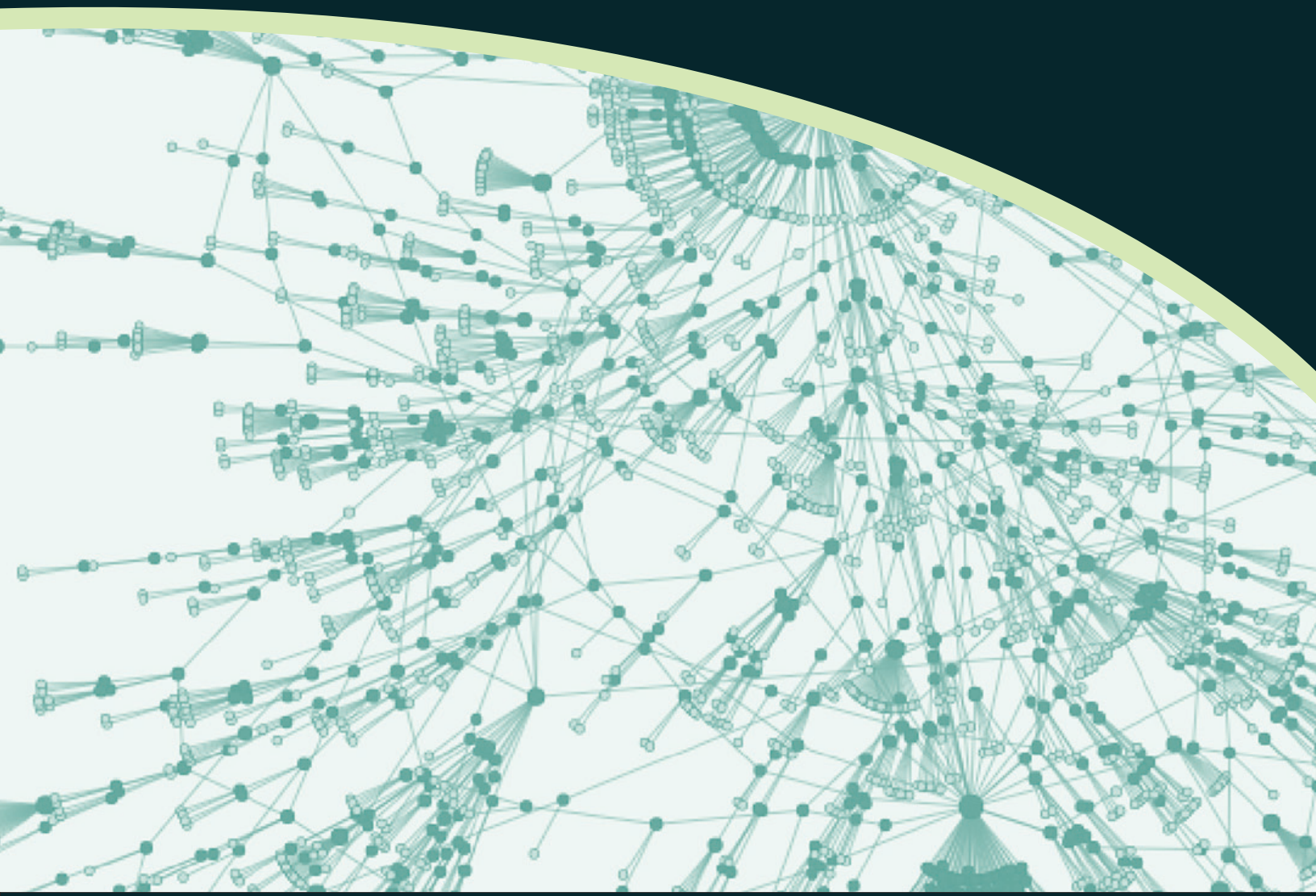

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# Modernizing partnership taxation


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# Abstract

Partnership tax reform should be a key part of the current and upcoming tax policy debate, with large parts of 2017's Tax Cuts and Jobs Act (TCJA) set to expire at the end of 2025. Partnerships are a large and growing slice of the economy, now representing almost 30 percent of all business income in the United States and far outstripping corporate entities by tax returns filed. However, due to deliberate policy choices, drafting accidents where the rules do not achieve what lawmakers might have had in mind, and neglect in updating or fixing outdated rules, partnership tax rules are in need of modernization. This paper focuses on ways to modernize the current partnership tax system within the core of existing partnership tax rules, particularly ways that are feasible as part of the 2025 tax debate. However, larger and more fundamental reforms that change the nature of pass-through taxation should also be considered and are discussed briefly. The paper has three parts: Part I provides background on partnerships and other pass-through entities, including data on their increasing prevalence and key changes in the business landscape. Part II describes the impact of these changes and the budget and tax challenges that partnerships create. Finally, Part III offers both principles and a selection of specific proposals for modernizing partnership taxation, focusing on options most relevant to the 2025 tax debate.

# Contents

# Introduction

Partnership tax reform should be a key part of the current and upcoming tax policy debate, with large parts of 2017's Tax Cuts and Jobs Act (TCJA) set to expire at the end of 2025. Partnerships are a large and growing slice of the economy and now represent almost 30 percent of all business income in the United States—more than double the share in the 1980s—while other similar pass-through entities represent another 30 percent of business income (see discussion in Part I).[1] Yet the tax treatment of partnerships has not attracted attention proportionate to their growing prevalence—partnership tax rules have been revised around the edges since 1954 but have not been the subject of larger changes.

Most partnerships are small, but a small number of partnerships account for the lion's share of total partnership income and assets. The finance and real estate industries dominate partnership income and assets, dwarfing more traditional partnership industries such as medical or law practices. Partnership income is more concentrated among high-income filers than are corporate dividends or other forms of business income.

Partnerships are a mechanism to tax individuals directly on their share of an organization's income without separate entity-level taxes. The basic task of partnership tax law is to determine how a partnership's economic results are recognized by the tax system and shared by the owners. But there are many ways to implement such a single-layer tax regime. Policymakers must decide between approaches that offer more or less precision in tracking the economics of the partnership's activities and its owners, flexibility versus rigidity in how partners share partnership items, and simplicity versus complexity.

Today, due to deliberate policy choices, drafting accidents where the rules do not achieve what lawmakers might have had in mind, and neglect in updating or fixing outdated rules, partnerships and partners enjoy high levels of flexibility and optionality in determining their tax treatment. This outcome has trade-offs. Enhanced flexibility and optionality can allow partnership taxation to reflect the complex economics of many modern business organizations. But it can also produce complex and opaque structures that do not reflect economic reality (whether intentionally or not), that are designed only to generate tax benefits, or that tax similar transactions and owners inconsistently. Partners can escape or delay taxation on their economic income. The resulting tax planning and noncompliance has revenue and economic efficiency costs.

Partnership tax rules today have some critical weaknesses that generate wasteful planning, undermine equity, and reduce revenue. Tax benefits for partnerships plus opportunities for noncompliance result in significant reductions in federal revenue at a time when the nation faces long-term fiscal and federal investment deficits. Weaknesses in partnership taxation also undermine vertical and horizontal equity in the tax system. Reforms of existing partnership law should focus on reducing those costs and ensuring that partnerships are serving their purpose in the current economy, including by retaining the core benefits of partnership taxation where appropriate.

This paper focuses on ways to modernize the current partnership tax system within the core of partnership tax rules, particularly ways that might be feasible as part of the 2025 tax debate. However, larger and more fundamental reforms that change the nature of pass-through taxation should also be considered and are discussed briefly. This paper has three parts: Part I provides background on partnerships and other pass-through entities, including data on their increasing prevalence and key changes in the business landscape. Part II describes the impact of these changes and the budget and tax challenges that partnerships create. Finally, Part III offers both principles and a selection of specific proposals for modernizing partnership taxation, focusing on options most relevant to the 2025 tax debate.

# Part I. Background: Partnerships and their growth

Partnerships originate as contractual arrangements in which two or more persons team up to conduct a joint enterprise for profit. Historically, partnerships have been regarded as aggregates of their owners for most purposes—i.e., as "conduits" through which owners do business rather than separate entities such as corporations.

The taxation of partnerships has generally followed that logic, imposing a single layer of tax on partnership owners (i.e., partners). Accordingly, partners are taxed directly on their share of the partnership's income and activities; the partnership itself is not a separate taxable entity and partners are not subject to two layers of tax. In contrast, owners of "C corporations" (i.e., taxable entities governed by the rules comprising "Subchapter C" of the Code)[2] are subject to two layers of tax on their share of corporate income: First is the corporate income tax, and second is the owner-level tax on dividends or capital gains.[3] As a result, any change in income tax rates—individual or corporate—affects any income flowing through partnerships.

For a simple example illustrating an "allocation" of partnership economic and tax results, suppose two persons, A and B, decide to go into business together by forming a partnership. They will form, and co-own equally (i.e., each owning 50 percent), a joint enterprise that makes and sells furniture. The business will require capital, incur costs and liabilities, and generate profits and, as a partnership for tax purposes, each of these items will be shared equally by A and B by virtue of their 50–50 ownership. The AB partnership will not be taxed on its items of business expense or profit; rather, each partner will be taxed on its own 50 percent share of such items. If the AB partnership sells a chair and earns $100 of taxable income, A and B will each earn (and pay individual-level tax on) $50. The economic results of AB's business operations are shared by (and "passed through" to) the partners, and they are taxed accordingly.

So, originally, partnership taxation was—and still can be—an efficient way to tax simple arrangements such as small businesses that more closely represent an aggregation of their owners. But such simple arrangements are now only a small slice of the activity that flows through partnerships.

Partnership tax law is more flexible than the tax rules that govern other types of pass-through businesses. For example, partnerships allow essentially infinite variety in the number and types of owners; they allow significant ability to divide up tax items generated by the business (such as income, deductions, and credits) and then to allocate them to the particular owners to whom they are most useful; and they allow more favorable tax treatment for owners when they contribute property or receive distributions, or when the business incurs liabilities. In contrast, other pass-through entities (such as "S corporations," which are corporations permitted to be taxed under a simplified pass-through regime contained in "Subchapter S" of the Code) permit less flexibility on these features.[4] This means that partnership taxation can accommodate many ways of tracking and sharing the economics of complex arrangements in which multiple parties pool labor, capital, and other sources of funding and engage in business. The increasing complexity of the economy and large businesses has made partnerships attractive to a wider range of businesses and taxpayers.[5] But, as Part II of this paper explains, the flexibility and complexity of partnership tax rules can also generate unintended tax results.

Furthermore, both state business law and federal tax law have evolved to allow arrangements treated as partnerships for U.S. federal tax purposes to take on more of the historic characteristics of C corporations. Throughout the 1980s and 1990s, states increasingly enacted laws creating new entity types, such as limited liability companies (LLCs) and limited liability partnerships (LLPs), that give their owners "limited liability" (i.e., no personal liability for the entity's obligations), which is a historic benefit of the corporate form.[6] But while state laws allowed these businesses to have a greater number of "corporate" characteristics, the U.S. Department of the Treasury (Treasury) issued the "check-the-box" regulations in 1996 that formally allowed them to elect to be taxed as partnerships.[7] Alongside 1986 tax reforms that set individual tax rates well below top corporate tax rates, these developments meant that pass-through tax treatment (in addition to being more widely available) has provided tax savings compared to corporate tax treatment.[8]

As a result of these developments, partnerships have surged in popularity across all types of businesses. Thus, while the conduit tax treatment of partnerships was initially a reflection of the way simple joint venture arrangements operated, the bulk of economic activity flowing through partnerships is now in very

BOX 1

## "Pass-through entities" and "partnerships" under US tax rules

"**Pass-through entities**," which includes partnerships, S corporations, and sole proprietorships, are entities that are transparent in the U.S. federal tax system. This means that pass-through entities generally do not pay tax at the entity level. Rather, they "pass through" their income, losses, and other tax items to their owners, who then report the items directly and pay the associated taxes. In contrast, C corporations face a federal statutory tax rate of 21 percent on their taxable income (with an additional layer of tax at the owner level on distributed income or capital gains).

A "**partnership**" in the U.S. federal tax system is a specific type of pass-through entity. A business entity is treated as a partnership if it (1) is a pass-through entity for U.S. federal income tax purposes (including via election) and (2) has more than one economic owner. Eligible foreign entities may elect pass-through treatment under the "check-the-box" rules.

**Types of business entities that can be partnerships for tax purposes.** Businesses in the United States can organize under various legal entity types established under state law. These state laws determine the entity's legal characteristics, such as whether and to what extent the owners have "limited liability" (i.e., do not have personal liability for the entity's obligations). Various entities are treated as partnerships for U.S. federal income tax purposes, including some that are not "partnerships" under state law, such as limited liability companies (LLCs). Accordingly, state law classification and U.S. tax classification may not always align. This paper uses the term "partnership" for any entity treated as a partnership for federal tax purposes, regardless of its state law legal form (e.g., an LLC taxed as a partnership).

large businesses that have many of the historic characteristics of corporations, and in industries such as finance and real estate.[9] See Box 1 for a brief overview of the tax and state law features of pass-through entities and partnerships.

Today, partnerships outnumber C corporations and account for roughly as much business income. Figure 1 illustrates that the number of partnerships has more than tripled since 1978, overtaking the number of C corporations in 2002. In 2020, there were 4.3 million partnership tax returns filed—almost three times the 1.5 million C corporation returns for the same period. While C corporation returns have decreased significantly, pass-through returns have only increased. As of 2021, Internal Revenue Service (IRS) data show that partnerships hold more than $50 trillion in total assets.[10]

Additionally, by 2015, as shown in Figure 2, partnerships represented almost 30 percent of all business income in the United States, more than double their share in the 1980s; other pass-through entities represented another 30 percent.[11]

Figure 3 illustrates that entities providing some form of limited liability under state law (such as LLCs) drove recent growth in the number of partnerships.

Most partnerships are small, but large partnerships represent most partnership income and assets. As Figure 4 shows, in 2021 the largest partnerships (by assets) represented fewer than 2 percent of all partnerships by number but about 66 percent of all partnership net income.[12] This is significant, given the complexity and opacity of large partnership structures that will be discussed in Part II.

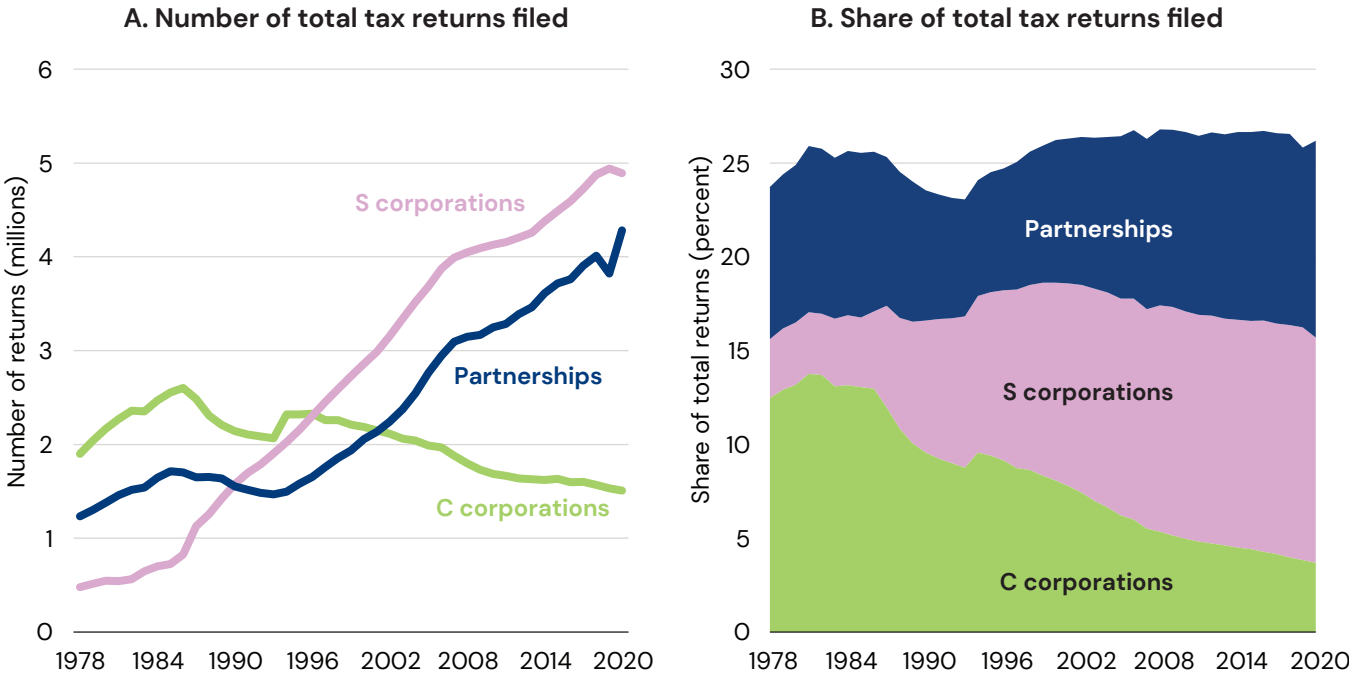
High-income filers receive most partnership income. In 2021, partnership income was more concentrated among high-income filers than were corporate dividends or other forms of business income; approximately 68 percent of partnership net income (less partnership net loss) accrued to filers with more than $1 million in adjusted gross income (AGI), while only about 46 percent of corporate dividends accrued to the same group (see Figure 5).[13] Partnership income is also a greater share of total income for high-income filers than it is for lower-income filers; in 2021 partnership net income (less partnership net loss) was approximately 6 percent of total income for filers with more than $1 million of AGI, but less than 1 percent of total income for filers with less than $1 million of AGI.[14] And, as shown in Figure 6, a much larger share of partnership income flows to high-income filers than does income from other types of business entities. High-income filers are also especially likely to receive income—and a greater share of their income—from complex partnership structures.[15]

Figure 7 illustrates that finance and insurance, as well as real estate firms, dominate pass-through income and assets, dwarfing more traditional partnership industries such as medical or law practices or other small businesses.[16] These industry sector categories are broad but illustrate how partnerships are frequently used for large-scale investment activities of institutional and high-income filers in areas such as real estate and private equity.

Consistent with an industry distribution skewed toward finance and real estate, larger partnerships tend to have fewer employees than their corporate counterparts. Among firms with more than 500 employees, the average number of employees was about 1,100 per partnership in 2015, but about 4,100 per C corporation.[17]

FIGURE 1

## Total tax returns filed by each entity type, 1978–2020




Source: Joint Committee on Taxation (JCT), Overview of the Federal Tax System as in Effect for 2023, JCX-9R-23, Table A-4, May 11, 2023.

Note: The number of partnerships has more than tripled since 1978, overtaking the number of C corporations.

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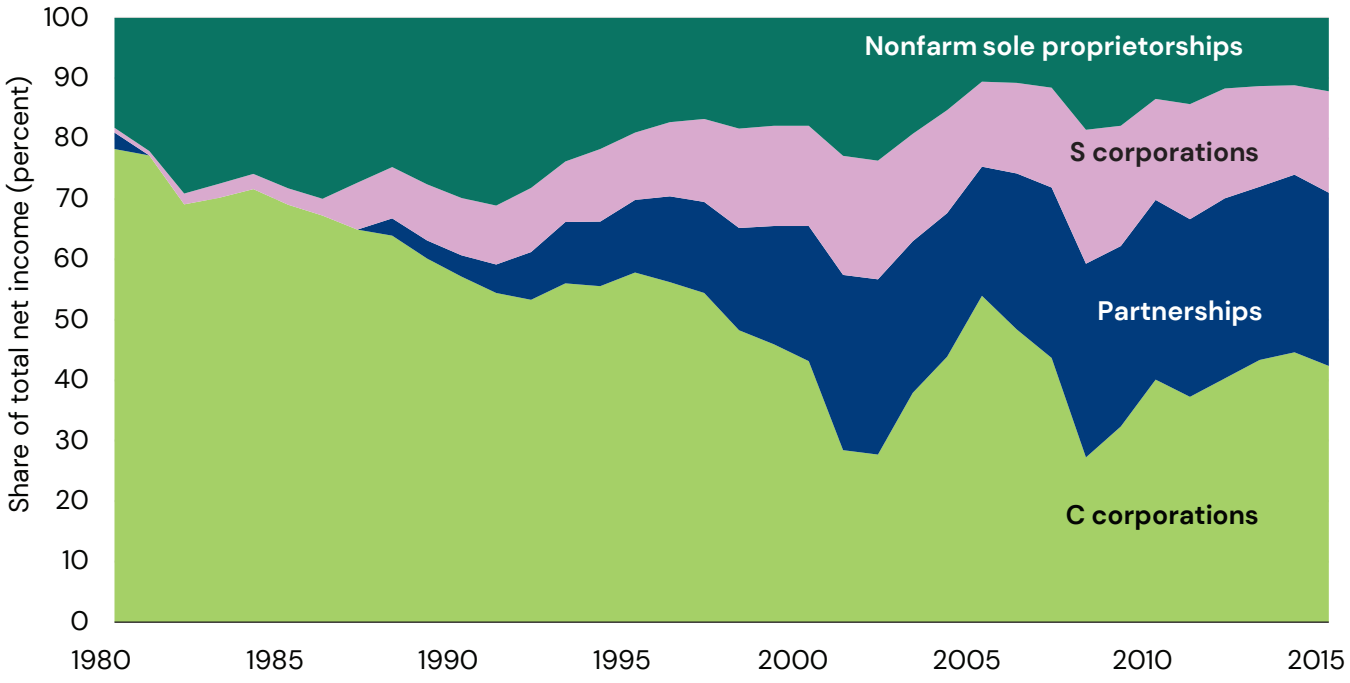
FIGURE 2

## Share of total net income, by entity type, 1980–2015




Source: IRS, SOI Tax Stats—Integrated business data, Table 1.

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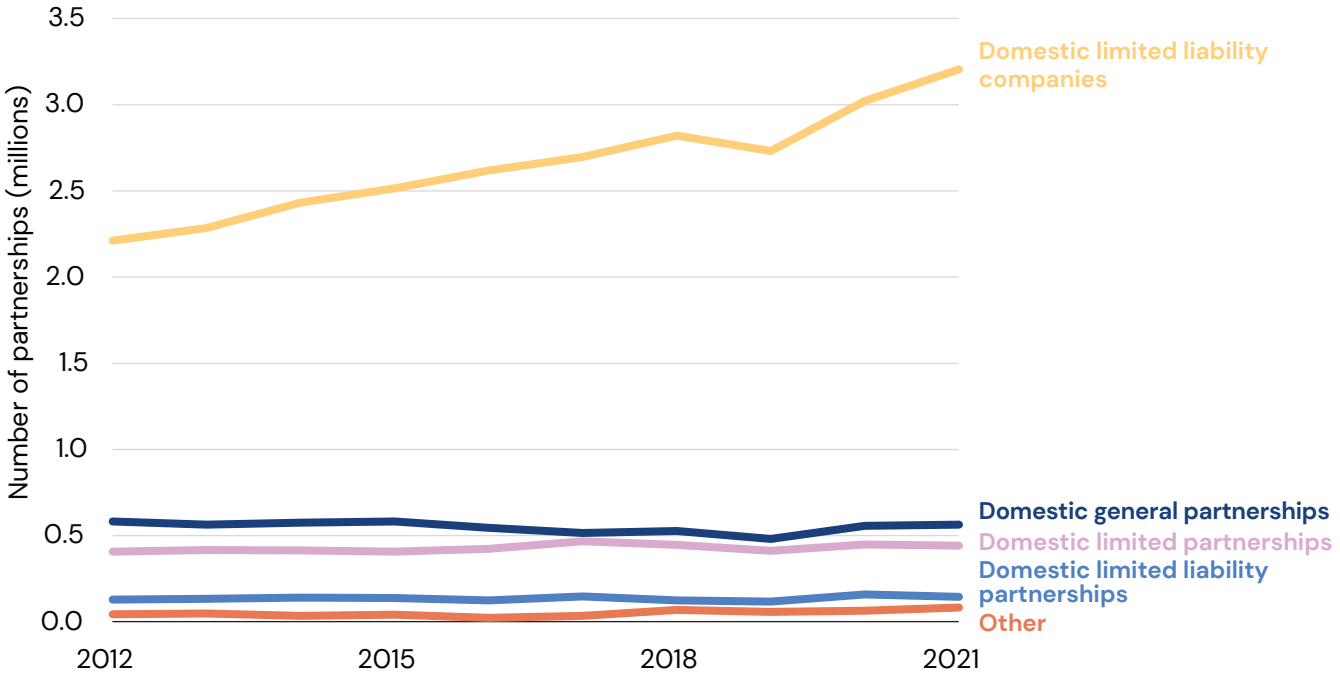
FIGURE 3

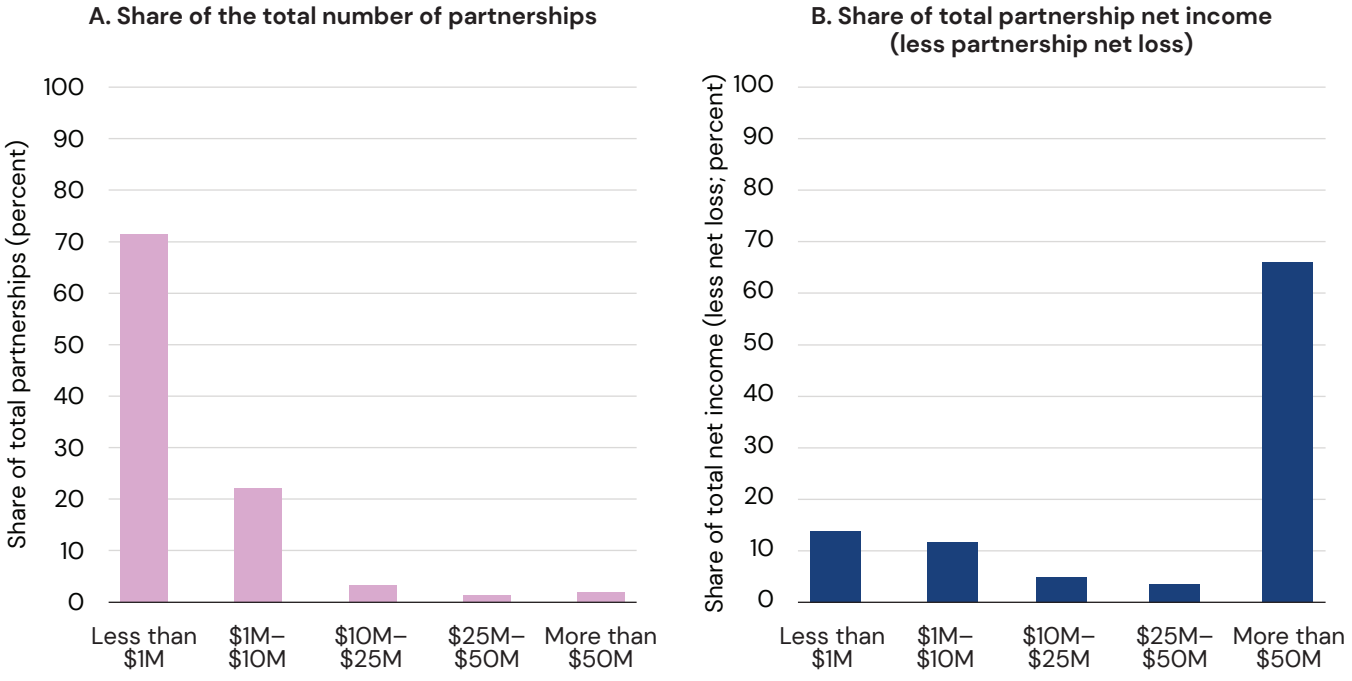
## Number of partnerships, by state law entity type, 2012–2021




Source: IRS, SOI Tax Stats—SOI Tax Stats - Partnership statistics by entity type, table 9a, published May 2023.

FIGURE 4

## Share of partnerships, by partnership size

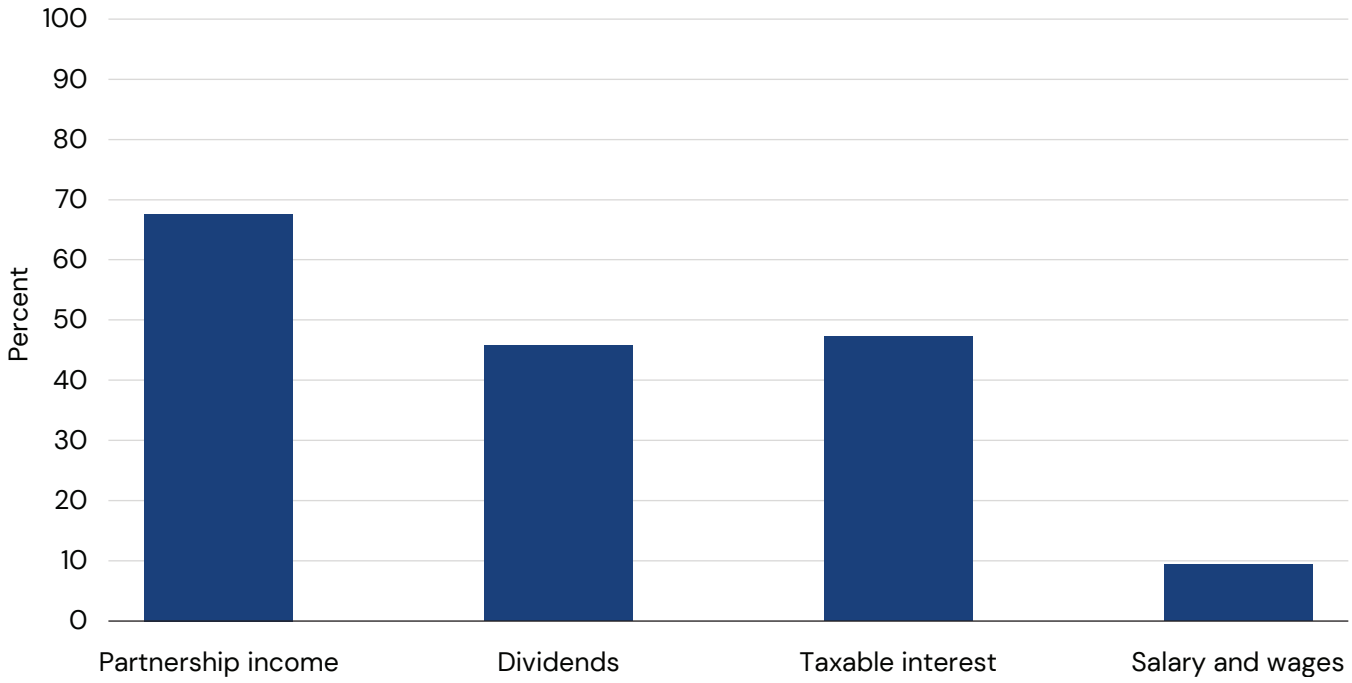



Source: IRS, SOI Tax Stats—Partnership data by size of total assets, 2021, table 15.

Note: M = million.

FIGURE 5

## Share of income (by type) accruing to filers with AGI above $1M, 2021 tax year




Source: IRS, SOI Tax Stats— Individual statistical tables by size of adjusted gross income, Table 1.4.

Note: Dividends includes ordinary and qualified dividends.

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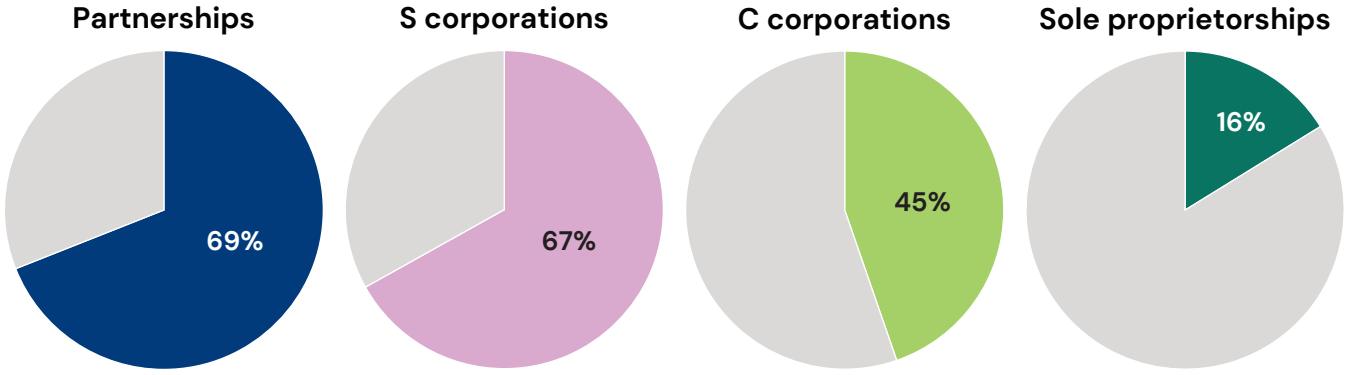
FIGURE 6

## Share of income going to the top 1 percent of households, by entity type, 2011 tax year




Source: Alexandra Thornton and Brendan V. Duke, Ending the Pass-Through Tax Loophole for Big Business, Center for American Progress, August 2016 (hereinafter "Thornton and Duke") (using data from Cooper et al.).

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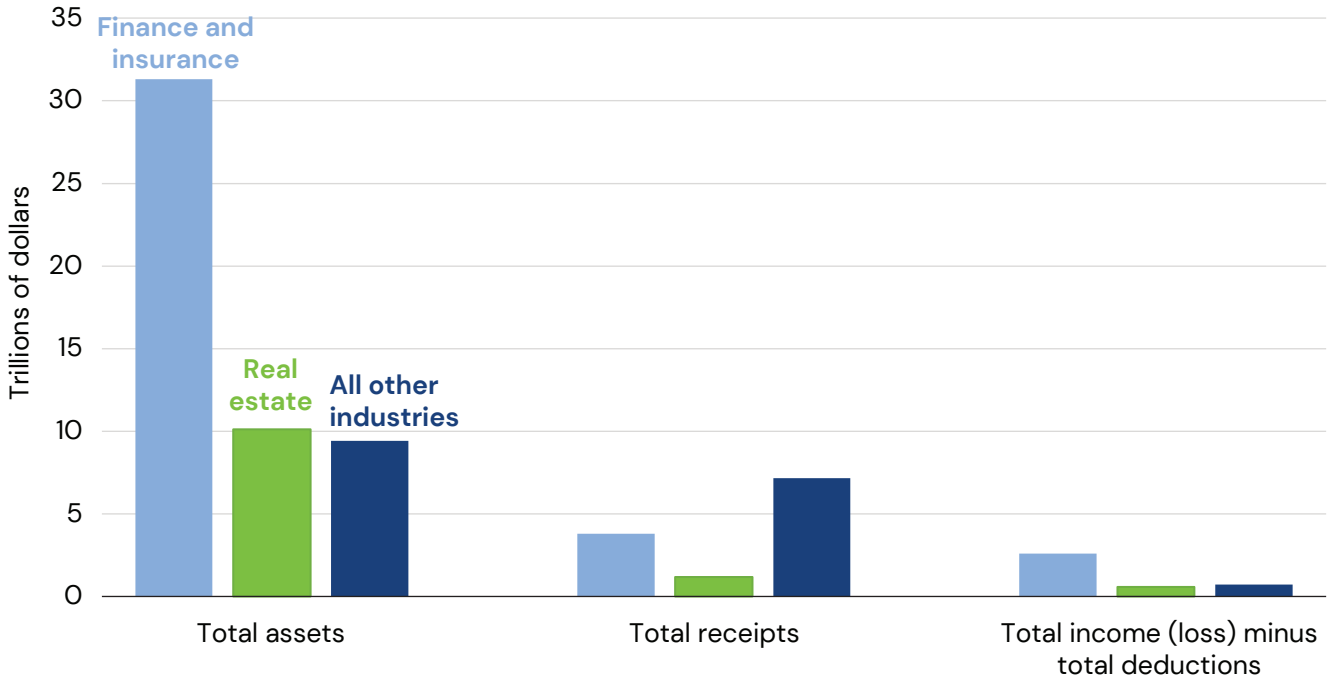
FIGURE 7

## Total assets, receipts, and net income of partnerships, by industry, 2021 tax year




Source: DeCarlo et al., Figure D.

Note: Real estate includes rental and leasing.

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# Part II. The challenge

Part II describes how certain features of partnership tax law add complexity and opacity to the tax system and have significant revenue costs, including by encouraging tax avoidance, evasion, and other noncompliance.

## A. Complexity in partnership structures and tax returns

Partnership taxation is notoriously complex, especially when applied to partnerships with large amounts of income or assets. Large partnerships often involve complicated webs of ownership and tax returns that are difficult to decipher. Partnership tax rules have fed into this complexity, combining flexibility for owners with highly technical tax rules. While this flexibility can be useful for taxing the economics of many modern businesses, they can also facilitate wildly complex structures that are engineered to minimize tax or even facilitate illegal tax evasion. Additionally, mere complexity, if it is significant enough, could itself generate noncompliance if some taxpayers or their advisors lack the resources, time, or capacity to fully understand and apply the rules.

Some 85 percent of partnership structures are simple—a single partnership owned directly by individuals—but many of the others are exceedingly complex.[18] Complex structures can involve partnerships owned by chains of other entities (including other partnerships) and could even include circular ownership, where one entity owns a stake in another, which then owns the first entity, creating an ownership loop.[19] Figure 8 shows an IRS illustration of a representative complex partnership web.[20] From 2002 to 2019, the number of partnerships that qualify as "large" (i.e., $100 million or more in assets and 100 or more total partners) and "complex" (i.e., 20 or more tiers of ownership) increased from 36 to more than 6,000.[21]

Potential reasons for the growth of complexity in partnership structures include the following:

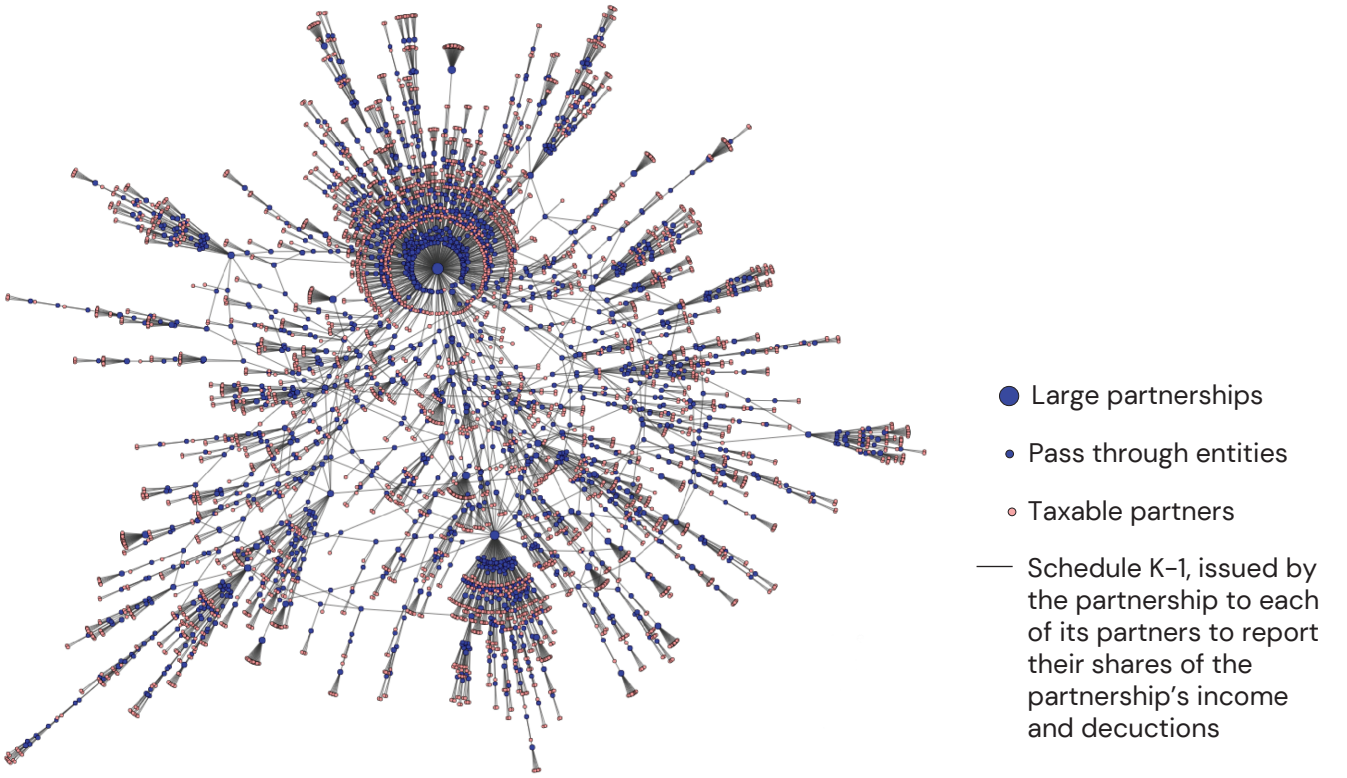
- **Complex economic and commercial arrangements.** Paradoxically, many partnership structures become complex to "simplify" the administration of a complicated business deal. In any situation with a split of economic sharing between two "groups" of owners, a partnership can be an efficient way to implement that split and thus silo the different economic and commercial arrangements. In these cases, complex tiers generally reflect the economics of the relevant arrangements, albeit in a way that may save owners tax and reduce tax revenue overall when compared to ownership through fewer corporate entities.
- **Tax benefits, planning, and avoidance.** In some cases, partnerships may be added primarily for tax reasons. For example, an extra partnership may allow for tax-free contributions of property in connection with future acquisition transactions, may shift the incidence (or amount) of withholding taxes, or may create other desirable tax results.[22]
- **Accident and lack of information.** Complex and circular structures can arise unintentionally. Multiple large investment partnerships, for example, may have significant overlapping ownership that remains invisible to one another, and investors (which could include other partnerships) may show up in multiple chains of ownership without realizing it. As separately managed partnerships invest in each other and accept different investors, an overlapping ownership network proliferates. When overlapping ownership is spread across disparately controlled entities, it is often difficult or impossible for owners and their advisors to understand the overlaps. Additionally, the proliferation of tiered structures—partnerships owning interests in other partnerships—makes the reporting and tracing of information to ultimate owners increasingly difficult.
- **Obfuscation and evasion.** Some filers use partnerships to conceal ownership and tax liability. For example, in one high-profile case a high-net-worth individual organized a complicated network of offshore entities that included LLCs, trusts, and other pass-through entities to own various investments and conceal the income from those investments.[23]

Partnership tax returns are complex for similar reasons. They must reflect not only the complexity of these ownership structures, but also the application of partnership tax law.

The basic task of partnership tax law is to determine how a partnership's economic results are recognized by the tax system and shared by the owners.

FIGURE 8

## Partnership complexity in visual form




Source: GAO, Tax Enforcement: IRS Audit Processes Can Be Strengthened to Address a Growing Number of Large, Complex Partnerships, 2023.

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No single approach to this task is inevitable; indeed, U.S. tax rules reflect several pass-through regimes with differing features.[24] Rather, policymakers must balance trade-offs such as more versus less precision in tracking the economics of the partnership's activities and its owners, flexibility versus rigidity in how partners share partnership items, and simplicity versus complexity.[25]

"Subchapter K" refers to the portion of the Code that provides the current U.S. federal income tax rules governing partners and partnerships.[26] Subchapter K developed, and in many cases was designed, to set the dial toward tremendous flexibility for owners.[27] At the same time, the rules have been revised around the edges over the years to address specific abuses and to implement mechanical fixes,[28] leading to a combination of significant flexibility and complexity. Box 2 provides a summary of some basic tax concepts relevant to Subchapter K that will be useful for understanding the following discussion as well as the proposals in Part III.

Partners generally have significant flexibility to do the following:

- **Contribute or remove assets from a partnership without triggering tax obligations.** Partners generally have more flexibility than is provided for other entities (both C corporations and other pass-throughs). This has created a need for various complicated exceptions that target specific abuses, such as rules designed to prohibit the use of this flexibility to purchase and sell property without triggering tax obligations.
- **Determine how a partnership's tax and economic features (such as income, deductions, liabilities, and other tax items) are allocated among partners.** This flexibility can prompt structuring that is driven largely by tax results, especially when partners are related or face different tax situations (such as different tax rates) that can affect the relative value of these items to different partners.

This flexibility can allow and encourage the creation of complicated structures and transactions to reduce tax in ways that are inconsistent with business reality. Rules designed to address specific abuses (or sanction specific activities) then add layers of complex exceptions that often end up simply creating additional planning opportunities.

BOX 2

## Partnership tax—basic concepts

**Tax basis**. Generally, the "cost" of an asset for tax purposes—its purchase price. In a partnership, each partner has a tax basis in its partnership interest ("outside" basis) and the partnership also has a tax basis in its assets ("inside" basis).

**"Nonrecognition" transactions**. A general tax concept that is not specific to partnerships, it nevertheless features significantly in the taxation of partnership transactions. The term refers broadly to a transaction in which taxable gain or loss is not required to be recognized—i.e., a transaction in which the Code permits property to be transferred or exchanged on a "tax-free" basis. An example is the contribution of property to a partnership. Generally, when a partner transfers property to a partnership in exchange for a partnership interest, that trade (i.e., property for equity) does not trigger a tax obligation for the partner on any gain inherent in the contributed property. Instead, the inherent gain is preserved, to be taxed later. (In contrast, if the partner sold the property for cash, the partner would pay tax on such gain.)

**Allocation of partnership items**. Partnerships pass through (or "allocate") both their tax results and their economic (or "book") results to their owners. Recall the discussion of the AB furniture business: If the AB partnership sells inventory and earns $100 of income for both book and tax purposes, then AB must allocate that $100 to its partners. Here, each of A and B has $50 of economic income and $50 of taxable income to report on its own tax return—tax results line up with economic results.

**Book-tax differences**. Book-tax differences arise when tax treatment of a partnership item differs from economic treatment of such item. For example, gains (or losses) can be recognized and/or allocated to partners for economic purposes before they are recognized and/or allocated for tax purposes. A typical case is a partner's contribution of built-in gain property to a partnership: That case results in an economic gain to the partner (since the partner exchanges property for partnership equity based on the value of the property) but no tax gain to the partner (since the contribution is a nonrecognition transaction). Partnership tax rules under section 704(c) are designed to ensure that any such deferred tax gains or losses from such property, when eventually recognized, are allocated to the partner(s) who received (or incurred) the economic gains (or losses)—i.e., to ensure that tax aligns with economic results.

**Remedial allocation method**. Subchapter K provides three different allocation methods for addressing book-tax differences under section 704(c), but some of them are subject to limitations that can result in the shifting of gains or losses between partners and associated disparities. One section 704(c) method (the "remedial method") eliminates such shifting in all cases by creating notional tax items (e.g., taxable income or deduction) that completely offset each other at the partnership level but that force each partner to receive tax allocations equal to its book allocations.

**Inside-outside basis differences**. Inside-outside basis differences can illustrate the potential for shifting or distortion of gains and losses. A partnership's inside basis affects the tax items it allocates to its partners (and thus, the partners' own taxable income). To minimize distortions (such as the recognition of the same tax gain or loss twice or the shifting of tax gain or loss to partners that did not recognize the related economic gain or loss), it is generally desirable for owners to maintain parity between outside basis and inside basis. For example, if each of A and B in AB furniture business has an outside basis of $50 in its partnership interest, then inside-outside basis parity means that the inside basis of partnership AB's assets should be $100. A higher or lower inside basis means that A or B (or both) will end up overtaxed or undertaxed for a period (and perhaps permanently) relative to economic reality.

Transfers of partnership interests and distributions of assets by a partnership can create disparities between inside basis and outside basis. In these cases, partnership tax rules generally permit a partnership to adjust its inside basis to eliminate the disparity: The partnership can elect to adjust its inside basis or can accept the (potential) distortion. And while inside-outside basis disparities are often undesirable for partners, they can also be created and exploited to shift basis among related parties.

**Aggregate vs. entity theories**. A key tension in partnership tax is whether (and when) to treat a partnership as a mere aggregate of its owners or whether (and when) to treat it as a separate entity. Under an aggregate theory, a partnership is nothing more than a co-ownership arrangement among partners. Under an entity theory, a partnership is a separate entity, which can result in treatment for the partners that differs from the treatment that would apply if they simply co-owned partnership property directly. Subchapter K rules reflect aspects of both theories, applying each approach in different contexts.

### 1. Planning opportunities under partnership "disguised sale" rules

The "disguised sale" rules are a specific exception to the general tax-free nature of partnership contributions and distributions. Without a special rule, the flexible partnership contribution and distribution rules could permit taxpayers to effectively sell assets without triggering tax by funneling them through a partnership—a result that would not be permitted in a sale directly to a third party. For example, suppose Partner A contributes property to a partnership and Partner B contributes cash to the partnership, in each case in exchange for partnership equity; in either case the contributions are not taxable exchanges under partnership tax rules. Suppose that, immediately thereafter, the partnership distributes some or all the cash that Partner B contributed to Partner A—another transaction that, on its own, would generally be tax-free to the extent of Partner A's basis. If viewed separately, the transactions look like two separate nonrecognition transactions, but when viewed together (and in substance), Partner A has effectively sold some or all of the contributed property for cash. The disguised sale rules thus try to guard against taxable sales that are "disguised" as tax-free partnership transactions.

However, the disguised sale rules have holes that allow certain transactions that are functionally similar to sales to be done tax-free. For one, under current rules, a partner can effectively avoid disguised sale treatment by creating tax basis in its partnership interest that does not necessarily reflect economic reality; such basis can be used to achieve the economics of a taxable sale without triggering tax (see Appendix A for additional detail). In another case, current partnership rules provide a specific exception to taxable disguised sale treatment for distributions that reimburse expenditures incurred by the taxpayer in advance of contributing the property to the partnership, even though the economics of the transaction otherwise remain equivalent to a sale.

### 2. Related party issues and tax avoidance

Several tax experts have noted that partnership tax rules are not well-suited for partnerships among related parties since the rules generally operate based on an implicit assumption that partners are unrelated and that they act at arm's length.[29] An example that has attracted recent attention is related-party basis shifting. In a basis-shifting transaction, related partners rely on mechanical partnership tax rules to transfer assets between each other in a manner that does not trigger tax or change economic ownership but that nevertheless generates valuable tax deductions. Affirmatively planning into such a transaction is typically feasible only for large businesses, since it generally requires an organization made up of multiple entities with a mix of significant assets that have different tax characteristics (e.g., high basis nondepreciable assets and low basis depreciable assets), a long tax-planning horizon, and resources to obtain sophisticated and complex tax advice. Such transactions illustrate how two corporations owned by the same parent can form a partnership with each other to take advantage of certain partnership tax rules, even though such a partnership might have no overall impact on actual economics, ownership, or business operations.

Similarly, when partners are related to each other, they can more easily allocate a partnership's income, deductions, and credits to the partners that will find them the most valuable, even if that allocation does not reflect each partner's share in the underlying economics of the business. Imagine a partnership in which one partner (A) has a large net operating loss (which can be used to reduce its taxable income) and the other partner (B) has no available losses to use. If A and B are related and their economic interests are aligned (e.g., they are members of the same overall organization or family), then it will not matter economically whether partnership income is allocated to A or B—the income will be wholly owned by (and thus benefit) the single unit that comprises both A and B. However, a disproportionate allocation of partnership income to Partner A means a lower tax bill due to A's tax losses. The related partners thus have an incentive to divide up partnership economics based solely on tax results and without regard to what partners acting at arm's length might agree to—i.e., to push the partnership's income or profits toward A, at least until A's losses are used up; these actions are generally permitted under existing rules.[30]

Proposals to adjust Subchapter K rules that apply to each of the above situations are discussed further in Part III.

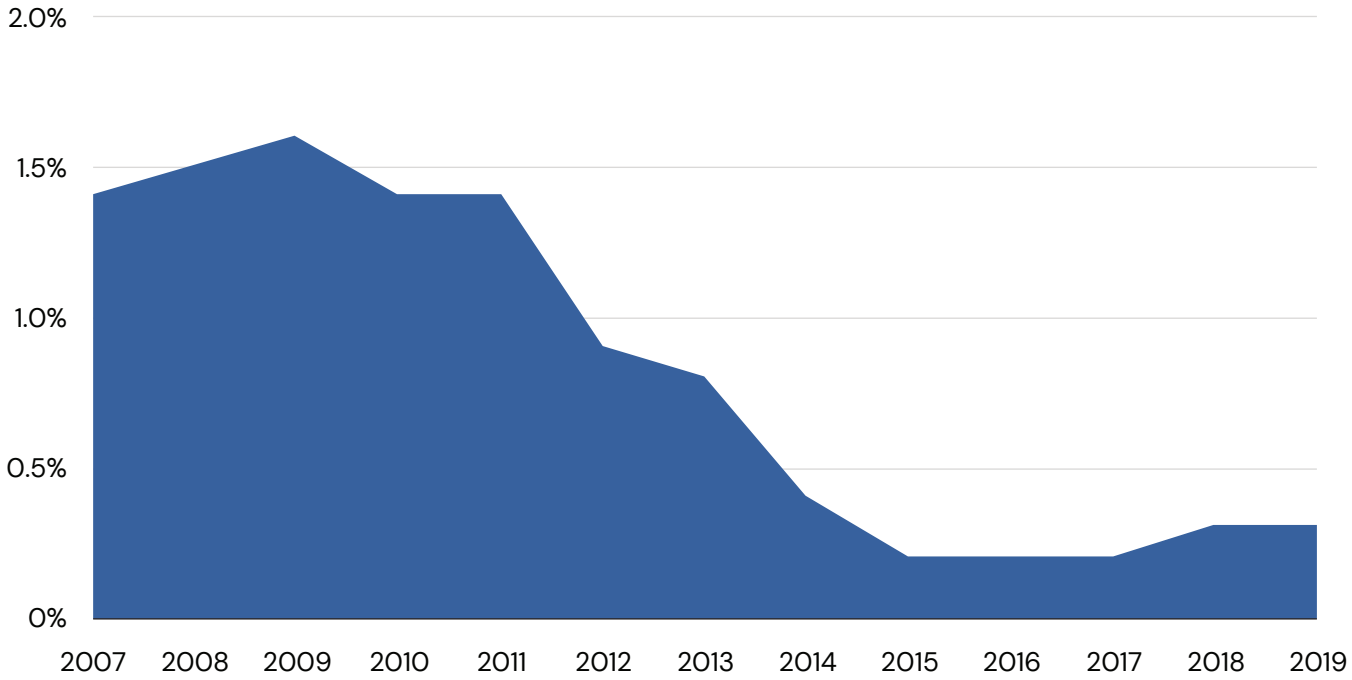
## B. Opacity in partnership structures

Despite their growing role in the economy and the tax system, tax administrators, researchers, and policymakers have found it difficult to obtain some of the most basic information about partnerships, such as the number and identity of partnership owners.

One key reason is the complexity of partnership structures and tax returns discussed in Part II.A. Research with IRS data found that more than 20 percent of partnership income could not be readily traced to known types of entities or individuals.[31] GAO notes that circular and complex structures can make basic information such as the number of total partners of U.S. partnerships hard to pin down, and recent research

FIGURE 9

## Audit rate for large partnerships




Source: GAO, Tax Enforcement: IRS Audit Processes Can Be Strengthened to Address a Growing Number of Large, Complex Partnerships, 2023.

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notes that "[s]ome of even the most basic descriptive facts about partnerships remain largely unknown."[32]

Weaknesses in the laws governing partnership tax administration also contribute to difficulties in fully understanding partnerships and how they are taxed:

### 1. Income reporting holes

Some reporting requirements apply to partnerships,[33] but there is little third-party reporting that allows the IRS to verify partnership income (and other tax attributes) independently of owners' and partnership tax returns. Tax noncompliance occurs more frequently with respect to sources of income for which there is limited third-party information to verify claims. The Congressional Research Service (CRS) notes, "[I]f taxpayers know the IRS has no information on a form of income, they may be more likely to underreport income from that source."[34]

### 2. Ownership reporting holes

The Corporate Transparency Act (CTA), which went into effect in 2024 and is currently being implemented, requires certain domestic and foreign entities to report their beneficial owners to the Financial Crimes Enforcement Network (FinCEN). This information is made available to the IRS and Treasury for tax administration and law enforcement purposes. This has promise for allowing the IRS to more quickly—rather than return-by-return in audits—understand entire ownership structures which, as explained in Part II.A., can be very complex.

Determined tax evaders have many routes to escape CTA ownership reporting requirements by using partnership structures, which risks making some partnerships a magnet for the most egregious forms of tax evasion. The CTA applies only to reporting companies "created" by filing with a secretary of state or similar authority, so the overwhelming majority of general partnerships are not required to report their beneficial owners.[35] Other tax partnerships, such as LLCs, that currently file with a state on creation, could escape the CTA by converting into nonreporting entities, or taking advantage of differences in state laws.[36] Even tax partnerships that meet the general definition of a CTA reporting company may escape under one of 23 statutory exceptions.[37] Current rules also do not require reporting of owner taxpayer identification numbers, further reducing usefulness for the IRS.[38]

### 3. Underfunded compliance and research

IRS budget cuts from 2010 until the passage of the Inflation Reduction Act (IRA) in 2022 have meant a lack of operational and research audits on partnership returns in recent years, limiting insight into partnership

tax issues including noncompliance. Partnership compliance activity may have been especially affected by IRS funding cuts because audits of large partnerships require significant expertise due to their complexity,[39] and funding cuts left the IRS unable to replace expertise lost through retirements and turnover.[40] The IRS has also had to implement and administer a new partnership tax audit regime effective in 2018.[41]

Over the decade roughly coinciding with the IRS budget cuts discussed in the preceding paragraph, partnership operational audit rates plummeted (Figure 9). While the IRS also conducts random research audits, the most recent random audit that focused on partnership tax returns was in 1982—and there is no regular program of such audits.[42] Partnership income may be examined during random research audits of individual tax returns, but these audits often do not review the partnership return or other entities or individuals in the partnership structure.[43]

The quality of operational audits may have also suffered due to resource cuts. GAO found that, between 2010 and 2018, the average adjustment resulting from audits of large partnerships (i.e., those with at least 100 partners and more than $100 million in assets) was negative and that more than 80 percent of those audits resulted in no change to the return.[44] This no-change rate is almost twice the no-change rate that applies in audits of C corporations,[45] raising concerns that partnership audits are either poorly targeted toward fully compliant filers or are missing compliance issues (or both).

Resource constraints may have also made it more difficult for the IRS to assess and use the partnership reporting it actually receives.[46] For example, partnerships report each partner's share of income and associated tax information on Schedule K-1, but this information is not systematically compared to the amount reported by each partner, despite ongoing IRS attempts to implement a successful Schedule K-1 document matching program over the past few decades.[47] Instead, complete Schedule K-1 information can only be matched manually and as part of an audit.[48] A redacted 2019 Treasury Inspector General for Tax Administration (TIGTA) report on the use of Schedule K-1 data seems to confirm that the IRS is unable to verify or correct a number of returns with compliance issues.[49]

With IRA funding, the IRS has announced several initiatives to improve partnership compliance and enforcement. The IRS Strategic Operating Plan for the IRA includes initiatives to expand both enforcement for large partnerships and IRS and Treasury capacity to issue guidance in priority areas.[50] Other initiatives call for prioritizing research to better understand the tax gap and to identify noncompliance, including noncompliance in partnerships.[51] The most recent update to the IRS Strategic Operating Plan indicates that the IRS has opened 76 examinations of the largest partnerships, up from 54 in 2019.[52] The IRS has also announced a new unit focused on large and complex pass-through entities, with a target launch in 2024.[53] Finally, the IRS has also created a new Associate Office (within the Office of Chief Counsel) that will draw from the existing Passthroughs and Special Industries (PSI) Office and will focus exclusively on partnerships, S corporations, trusts, and estates.

These improvements are welcome and important, but additional tools (discussed in Part III) will be needed to address the opacity and compliance problems in partnerships adequately.

## C. Sizing the revenue losses from partnerships

The preferential nature of partnership taxation (compared to corporate taxation) results in significant reductions in federal revenues; this is a particularly important issue when the nation faces long-term fiscal and federal investment deficits.[54] There are three main sources of revenue loss: (1) tax rate preferences relative to C corporations, (2) avoidance of taxes on capital and labor income, and (3) noncompliance. Data limitations (including those outlined in Part II.B.) mean that making precise estimates is difficult and that sometimes available estimates or statistics cover all pass-through entities (rather than only partnerships). The lines between these categories can be blurry. These revenue losses are also associated with erosion of vertical and horizontal equity in the tax system, as well as other economic costs.

Mechanical estimates suggest that, over recent decades (and before the TCJA's major tax changes), pass-through entities generally provided lower overall tax obligations on business income relative to C corporations:[55]

Using 2007 data, the Congressional Budget Office (CBO) estimated that, if the tax rules for C corporations had applied to LLCs (i.e., tax partnerships) and S corporations that year, with no behavioral responses, total federal revenues would have been about $76 billion higher.[56]

Using 2011 data, Cooper et al. found that "[t]he average federal income tax rate on U.S. pass-through business income is 19 percent, much lower than the average rate on traditional corporations. If pass-through activity had remained at 1980's low level, strong but straightforward assumptions imply that the 2011 average U.S. tax rate on total U.S. business income would have been 28 percent rather than 24 percent, and tax revenue would have been approximately $100 billion higher."[57] In 2023 dollars, that revenue increase would be approximately $130 billion. These data are telling, given the increasing prevalence of pass-through entities compared to C corporations.

To be sure, the TCJA reduced or reversed some of the effective marginal tax rate advantages for pass-through businesses for some investment categories but left others (such as intellectual property and other intangible property) still facing lower tax rates than in C corporations.[58] This means that, before and after the TCJA, effective marginal tax rates on new investments made through pass-through entities vary greatly by asset type and financing.[59]

Partnerships also reduce revenue by facilitating reduced tax on both capital and labor income. For example, Treasury's Office of Tax Analysis (OTA) has estimated that the classification of labor income as a distributive share in partnerships may have removed upward of $18 billion of income from the self-employment tax base as of 2016.[60] Additionally, a comprehensive partnership tax reform proposal in 2021 has been publicly estimated to raise at least $172 billion over 10 years (and may raise more) by modifying partnership rules and removing flexibility, though it is unclear how much of this number is attributable to reducing specific abuses versus, e.g., clarifying gray areas.[61]

Noncompliance in partnerships also carries significant revenue costs. The IRS estimates that partnerships, along with S corporations and some trusts and estates, contribute about $40 billion annually to the "tax gap" (i.e., taxes owed but not paid).[62] This is attributable in significant part to the information and resource gaps discussed in Part II.B. above. Recent research also suggests that IRS tax gap estimates are too low due to IRS difficulties in understanding partnership income and ownership.[63] That same lack of information makes the true size of the problem controversial and difficult to estimate.[64] Significant gray areas and other ambiguities in partnership tax law allow well-advised taxpayers to push the law's boundaries and make it more difficult to distinguish noncompliance from lawful tax planning. And, as discussed in Part II.A., the complexity of the rules may itself increase noncompliance.

Each of these sources of revenue loss is also associated with potential economic costs. For instance, in 2020, Furman explained the implications of tax rate differentials between C corporations and pass-through status:[65]

> As corporate and individual taxes have shifted over time this choice [between entity taxation regimes] has resulted in companies shifting their forms to whatever is more favorable (Goolsbee 1998; Mackie-Mason and Gordon 1997; Prisinzano and Pearce 2018). This election reduces revenue, increases complexity, and results in companies making decisions about business form for tax reasons and not for economic reasons.

Similarly, to the extent that specific partnership tax rules encourage (and thus push resources and talent toward) tax avoidance and evasion as opposed to bona fide economic behavior, this shift away from more-productive activities represents another economic cost.

Against these clear revenue, equity, and economic costs, and as further reviewed briefly in Appendix B, there is little evidence that the tax savings for partnership owners (and potentially lower transaction costs for structuring complex commercial arrangements) have benefits for the broader economy. Indeed, if anything, research suggests that tax benefits for partnership owners may be less likely to translate into broader economic gains than in other business forms. Mainstream models of nonpartisan tax estimators indeed assume that broad-based tax rate cuts for pass-throughs are less likely to result in investment than in corporate rate cuts.[66]

# Part III. The proposal: Principles and illustrative options for reform

Part III provides principles and illustrative options for modernizing partnership taxation in a manner aimed at reducing costs and better aligning the rules with the current economy. Options for modernization raise trade-offs; for example, simpler and less-flexible tax rules might not perfectly track economic results in each case, especially when commercial arrangements are complex, but they might do a better job of reducing inefficient planning or undesirable outcomes.

In our view, reforms consistent with the following principles will help modernize partnership taxation to better balance its trade-offs:

- **Ensure that tax consequences tie closely to economic reality, and focus especially on cases that incentivize inefficient tax planning or significant distortions**. Partnership tax rules should be aimed at ensuring that partners are taxed in accordance with their economic benefits and burdens: In simple terms, if one partner bears the economic brunt of a partnership expense, the partnership's tax deduction for that expense should flow the same way.[67] Reforms implementing this principle should nevertheless focus on fixing rules that allow significant tax planning opportunities or lead to large distortions. That is, our approach to reform is not necessarily to seek the tax treatment that is "correct" relative to the economics of the business in every single circumstance, but rather to focus where possible on cases where current law produces the largest distortions (i.e., tax results that do not reflect reality), or where current law invites the potential for abuse.
- **Reduce inappropriate optionality**. High levels of optionality can motivate taxpayers to expend resources on tax planning that results in businesses organizing themselves to minimize tax burdens rather than to maximize efficiency. High levels of optionality can also make tax rules overly complex and harm equity by allowing well-advised taxpayers to choose the better tax result where multiple results are permitted for the same economic arrangement. While some optionality might be appropriate to make rules administrable, it should be limited to minimize inefficiency, arbitrariness, and planning opportunities. This principle is especially appropriate within partnership tax rules, given that overall tax treatment of a business entity (i.e., as a partnership or C corporation) is currently almost entirely elective under the "check-the-box" regime.
- **Improve visibility**. Reforms should improve visibility into partnership income, assets, ownership, and noncompliance. Such reforms support voluntary compliance and ensure that IRS compliance efforts are both more effective and more focused on truly noncompliant filers. Better visibility can also help evaluate these efforts and inform future tax reforms.
- **Account for the largest and most complex partnerships**. Partnerships range from two-person small businesses to the nation's largest enterprises. Reforms should consider this heterogeneity. To be clear, that does not necessarily mean that we need to craft separate rules for different types of partnerships. For example, if particular partnership tax rules could be applicable to any partnership but are in practice relevant only for the largest and most well-resourced partnerships, then new or modified rules in that area might appropriately be more complex than if those rules were also typically relevant to very small businesses.[68] Creating separate rules based on some measure of entity size is also discussed in Part III.D. and has other potential benefits and costs.[69]
- **Address outdated items and implement regular upkeep.** Many issues in partnership tax result from stale or unclear rules.[70] The omnibus package of regulations that the Tax Law Center has previously recommended is an example of the type of consistent clean-up and housekeeping that policymakers should pursue regularly.[71] Such maintenance should ideally be a regular focus of the legislature.

The remainder of Part III offers a noncomprehensive list of concrete reform options, focusing first on substantive partnership tax laws and then on information reporting and enforcement proposals. Part III ends with a brief discussion of pass-through reforms

outside of Subchapter K. In 2025, policymakers debating tax reform will have to grapple with how the various elements of the tax system work together, including corporate and individual tax rate structures; due to their pass-through nature, partnerships will therefore play a key role in that process.[72]

# A. Partnership tax law proposals

To help policymakers assess and prioritize reform proposals, we have grouped them into four broad categories organized roughly in ascending order of the proposal's breadth and impact on existing Subchapter K: (1) clean-ups and similar fixes, (2) targeted reforms, (3) broader and more-complex reforms, and (4) fundamental reform ideas that go beyond modernizing Subchapter K. Revenue estimates are provided where publicly available, though readers should take care when using and comparing these estimates because some have been created using different assumptions about the tax law in place (the "baseline"), by different estimators, and over different periods. For the other cases where estimates are not available, we have focused on reforms that address transactions and strategies that (based on the authors' direct experience, as well as discussions with practitioners and other experts) are broadly used and thus would be expected to have significant revenue effects over the next 10 years relative to current law. Accordingly, where we have not specified a publicly available estimate we expect the proposal could raise revenue in the tens of billions or more, with certain proposals having the potential to raise hundreds of billions depending on the specifics of the adopted policy (and in each case over a 10-year period). However, the authors are neither economists nor revenue estimators, and these expectations are driven by extrapolation from transactions seen in practice and discussions with other current and former practitioners.

Some of these proposals might be achieved in whole or in part through regulation. However, except where noted specifically, we do not focus here on whether legislative or regulatory reform is best as that is highly context-dependent. Finally, as many of the proposals have been (and will continue to be) discussed even more extensively elsewhere, we provide a relatively brief overview of each.

## 1. Clean-ups and similar fixes[73]

### *a. Disguised sales: Legislative clean-up of section 707(a)(2)(B)*

As with assets such as stocks and bonds, when a taxpayer sells its stake in a partnership, the taxpayer pays tax on any gains. However, a taxpayer can arguably achieve more favorable tax treatment by "disguising" what is economically a sale as a different, more-tax-favored transaction (specifically, by treating the sale as a liquidation of its interest in the partnership rather than as a sale). The best reading of the statute is that it prevents this result, but this should be clarified to foreclose any doubt.

Section 707(a)(2)(B) contemplates that a contribution to, and related distribution from, a partnership can be characterized as a purchase of interests in the partnership from an existing partner—i.e., a "disguised sale" of partnership interests. The most straightforward example is one in which a new partner contributes cash to a partnership and the partnership distributes such cash to an existing partner in reduction of the existing partner's interest. Such a transaction is economically equivalent to a purchase by the new partner of a partnership interest from the existing partner; if treated as a liquidation (rather than a sale), however, the tax consequences could be more favorable to the existing partner (e.g., lower taxes or deferral of tax obligations). However, the statute states that sale treatment will apply "[u]nder regulations prescribed by the Secretary" and so the statute should be updated to confirm the existing state of the law—i.e., that the statute applies even in the absence of those regulations.[74]

Such reform could go further by providing additional clarity on when disguised sales of partnership interests will occur (or providing safe harbors for when they will not), but this additional detail is likely best handled in regulations.[75] Relatedly, the proposed regulations addressing disguised payments for services under section 707(a)(2)(A) should be finalized.[76] Together, these clean-up reforms would ensure that existing rules (in both statute and regulations) reflect how current law already operates, thus reducing inappropriate optionality (whether perceived or actual) that might otherwise allow taxpayers to choose the better tax treatment for a transaction.

### *b. Adopt clear rules regarding worthless partnership interests*

Arguing there is ambiguity in current law, some taxpayers have claimed that declaring that their interest in a partnership has become "worthless" is not the same as giving up such interest. This position effectively allows them to accelerate tax benefits associated with the declaration of worthlessness while delaying associated tax costs. The statute should be modified to make clear that declaring a partnership interest worthless is treated as giving up such partnership interest to ensure that tax benefits are appropriately timed with associated tax costs.

Under longstanding tax rules, taxpayers are generally able to take a tax deduction for the loss of their investment when certain property becomes worthless. However, when the property at issue is a partnership interest, the ability to take a deduction can create illogical and unintuitive results and the potential for abuse, as others have recently highlighted.[77] In particular, the law is unclear on whether the worthlessness of a partnership interest is treated as a disposal of the interest. This ambiguity can allow taxpayers to accelerate tax benefits from the declaration of worthlessness in a manner inconsistent with both economic reality and tax principles that apply outside the partnership context, particularly when the partnership interest includes an allocation of partnership debt.

By not treating worthlessness as a disposition, the taxpayer takes a tax deduction attributable to its basis in the interest, including its basis arising from an allocation of partnership debt, but defers recognition of the corresponding gain associated with such debt. That is, the taxpayer achieves the economic equivalent of a sale of the interest for no value without recognizing fully the tax consequences that would apply in an actual sale for no value. If the declaration of worthlessness were instead treated as a sale for no value, the taxpayer would still get the deduction for the basis but would have a corresponding (and offsetting) tax gain from the reduction in its share of partnership liabilities—recognition of the tax basis and corresponding tax gain would be timed appropriately. Accordingly, Congress can and should address this issue by enacting simple legislation that treats the worthlessness of a partnership interest as a disposition of the interest. Such a proposal was recently included in the Build Back Better Act.[78] Joint Committee on Taxation (JCT) estimate from 2021: With related changes, $1.8 billion over 2022–31.[79]

### *c. Extend or modify the "mixing bowl" period under sections 704(c)(1)(B) and 737*

If a taxpayer exchanges property for other property, it pays tax on the gain in its exchanged property. Without special rules, however, partnerships offer an opportunity to avoid this result by running the exchange indirectly through the partnership rather than directly between the taxpayers. Current rules prevent this use of a partnership as a "mixing bowl" as long as the property remains in the partnership for at least seven years, after which the restrictions fall away. The seven-year period is arbitrary, and extending it would better ensure that gain on contributed property is taxable to the partner who contributed the property.

The term "mixing bowl" refers to the use of a partnership to effectuate a taxable exchange property in an impermissible tax-free manner (similar to a disguised sale)—i.e., to sidestep taxable treatment by running the exchange indirectly through a partnership. Subchapter K prevents mixing bowl transactions but only where the purported exchange occurs within a specific seven-year period (the "mixing bowl period"). This seven-year period (increased from five years) is arbitrary, and extending it—including by making it indefinite—would better ensure that gain on contributed property is always taxable to the partner to whom it accrued.[80] As a policy matter, an indefinite mixing bowl period is more conceptually sound (and more consistent with existing Subchapter K principles) than a further extension to, say, 10 years.[81]

### *d. Codify and refine partnership anti-abuse rule(s)*

Partnership tax regulations include broad anti-abuse rules meant to prevent aggressive transactions that reduce tax liability and run counter to the intent of Subchapter K. Some have questioned Treasury's authority to issue these anti-abuse regulations. While there is ample statutory authority, legislative clarification could be helpful simply to avoid onerous and unnecessary taxpayer lawsuits.

To ensure an appropriate anti-abuse overlay to Subchapter K (and to foreclose any doubt about the validity of its existing anti-abuse rules), legislation could incorporate a general partnership anti-abuse rule similar to Treasury Regulation section 1.701-2, explicitly setting out authority for Treasury to issue additional specific regulations under such a rule, as others have suggested.[82] While there is ample authority under current law to address abuse, more-explicit language would help forestall onerous and unnecessary taxpayer lawsuits challenging such authority.[83] Such a change could also be considered with respect to other relevant anti-abuse rules, and would provide general support to the IRS in enforcing Subchapter K's rules in a manner that satisfies the principles laid out at the beginning of Part III, particularly tying substantive outcomes closer to economic reality and reducing inappropriate effects of optionality. It would also serve as an opportunity to make any necessary refinements or updates to the existing partnership anti-abuse rule.

## 2. Targeted reforms

### *a. Modify liability sharing solely for disguised sale purposes*

The partnership disguised sale rules are aimed at preventing taxpayers from effectively selling assets without triggering tax by funneling them through a partnership. But the disguised sale rules have holes that allow certain

transactions similar to sales to be done tax-free. For example, under current rules, a partner may be able to avoid disguised sale treatment through engineered tax planning that increases its share of the partnership's debt. This "debt basis" can be used to achieve the economics of a taxable sale without triggering tax. The rules could be updated to better target and prevent this result.

Part II (and Appendix A) discuss how taxpayers can potentially use a partnership to avoid taxable "disguised sale" treatment in a manner inconsistent with economic reality and the general intent of the disguised sale rules. In lieu of a broader legislative modification of partnership liability sharing rules (which is discussed in Part III.A.3.), a targeted fix would be to modify how the partnership liability sharing rules apply solely in the context of disguised sales.[84] This could be accomplished by reviving rules that calculate a partner's liability share for disguised sale purposes by looking only to the partner's share of partnership profits (i.e., the current rule for allocating partnership nonrecourse debt). Legislation could either require this result or it could direct and authorize Treasury to issue regulations under sections 707 and 752 that adjust liability shares for disguised sale purposes only. Such a reform would generally align with prior temporary regulations that were issued in 2016 and that accomplished this result by allocating all liabilities as "excess nonrecourse liabilities" under Treasury Regulation section 1.752-3(a)(3) for disguised sale purposes.[85] Those 2016 temporary regulations were repealed in 2019 and replaced with the current regulations (which reverted to the rules in place prior to the 2016 temporary regulations). While the 2019 regulations included certain features that help curtail abusive planning,[86] this proposal to revert to something like the 2016 temporary regulations would do a better job of reducing optionality and targeting avoidance.

### *b. Repeal capital expenditure reimbursement exception to disguised sale treatment*

As discussed in Part II, the disguised sale rules have holes that allow certain transactions similar to sales to be done tax-free. For example, a partner wishing to sell property that it improved can potentially get a better tax result by transferring the property to a partnership for cash than by transferring the property to a third party for cash. The rules could be updated to foreclose this different treatment of similar transactions.

Part II highlighted another hole in the disguised sale rules—the exception to disguised sale treatment for reimbursements of pre-contribution capital expenditures. Consistent with existing proposals, partnership rules should provide that a distribution from a partnership that represents a reimbursement of these capital expenditures triggers taxable sale treatment in the same manner as other distributions.[87] This would help ensure that taxpayers cannot achieve better tax treatment by funneling a sale of improved property through a partnership (rather than doing the sale directly)—the key goal of the disguised sale rules. This reform could also be addressed through updated regulations since the current exception is provided by regulation.

### *c. Supplement related party basis shifting proposals with additional legislation*

A large business that controls several entities including a partnership can trade assets among them to generate tax savings, taking advantage of specific quirks of partnership tax law.[88] This generates tax savings for the owner even though no real economic transaction has taken place: The assets are under the same ownership before and after the transaction. Treasury and the IRS have announced welcome guidance to address certain basis shifting transactions, which we have commented on, including highlighting the sources of existing authority for such approach.[89] Legislation could support and simplify this guidance.

Congress should supplement and strengthen recent proposed guidance on related party basis shifting by modifying applicable statutory provisions.[90] For example, Congress could modify sections 731 and 732 to trigger tax on any gains in distributed partnership property to the extent the distribution creates a basis shift between related partners. That is, if a distribution to a related partner would reduce basis in the distributed property from $200 to $100 under current section 732 (and thus result in a $100 basis step-up for the remaining related partners under section 734(b)), then, instead of the reduction in basis, the distributee partner could simply recognize $100 of taxable gain and take the property with a full $200 basis. The $100 basis step-up under section 734(b) would be permitted (and would be "paid for" by the distributee's taxable gain).[91] This change could be achieved only through legislation, and is therefore not a feature of Notice 2024-54 and its related proposed guidance. Such an approach would be administratively simpler than requiring partnerships to track dispositions of distributed property outside the partnership, or to modify their basis recovery schedules. Legislation could also further implement, support, and authorize other features of the recently proposed guidance to ensure that abusive transactions are appropriately curtailed. For example, legislation could also prescribe (or authorize regulations to prescribe) situations in which a

nonrecognition transaction is not treated as an "exchange" for section 743(b) purposes to the extent the section 743(b) adjustment would otherwise arise as a result of inappropriate shifting between related partners. We estimate that this proposal would have a moderate to large revenue effect that is generally in line with the proposed guidance. Treasury estimated the proposed basis shifting guidance as raising more than $50 billion over a 10-year period; it is likely that this proposal would be on a similar (or perhaps even larger) scale because it would involve triggering upfront tax on distributions rather than denying or delaying tax deductions taken over time.[92]

### *d. Update section 704(c) rules to ensure appropriate allocation of built-in gains and losses*

A core principle of partnership tax is that tax consequences should follow economic realities. Because transfers of property to a partnership do not trigger tax on the property's gains or losses, rules are needed to ensure that those gains and losses are eventually allocated to the correct partner (typically, the partner who contributed the property to the partnership). For example, if a partner transfers property with built-in (untaxed) gain to a partnership, that partner (rather than another) should eventually pay tax on that gain when the property is sold. The rules are intended to achieve this result but, due to certain technical features (including optionality for taxpayers to choose between multiple allocation methods), they do not always do so. Updating the rules to correct these features would better ensure that gains and losses are allocated to the correct partners.

As described in Box 2, contributions of property to a partnership do not trigger tax on the property's gains or losses, and accordingly such contributions create book-tax differences. These book-tax differences require special rules to ensure that tax gains and losses are eventually allocated and taxed to the partners to whom they accrued economically (and thus are not shifted between partners). Section 704(c) and the regulations thereunder are intended to achieve this result by allocating partnership tax items in a manner that follows how the corresponding book item was allocated. However, current rules do not always achieve this result. In particular, taxpayers may elect from several permissible section 704(c) allocation methods. Under one such method (the traditional method), the ceiling rule places a limit on allocations that would reduce or eliminate book-tax differences in a manner that can create both temporary and permanent shifting. This creates complexity as well as the opportunity to plan into advantages that can arise from such shifts.

Another of section 704(c)'s permissible allocation methods (the remedial method) essentially forces tax allocations to follow economics (and thus eliminates shifting and distortions) by creating notional tax items that affect partner-level tax results without affecting the partnership's overall income or loss.[93] Accordingly, a legislative or regulatory change that requires all partnerships to use the remedial method under section 704(c) (rather than allowing an election between section 704(c) methods that produce different results) would both (1) eliminate distortions permitted to arise under existing rules and (2) eliminate a source of optionality and complexity that arises from such an ability to elect among allocation methods.[94] Such a requirement could also help to minimize the impact of other difficult-to-identify tax planning techniques that can take advantage of shifts caused by the ceiling rule, such as transactions targeted by the recent basis shifting guidance. Furthermore, the proposal has the advantage of working within existing well-known section 704(c) rules. That said, other options for updating and fixing section 704(c) could be considered, such as simply triggering (and potentially deferring) taxable gain on the transfer of property to a partnership.[95]

### *e. Limit opportunities for abuse in related party partnerships*

Partners have tremendous flexibility in deciding how to allocate the partnership's assets and activities among themselves. As the IRS has written, when partners are unrelated "the opportunity for abuse is limited because each party" negotiates based on its "separate, and often competing economic and tax interests."[96] However, when partners are related, they can manipulate tax allocations to maximize tax benefits without affecting the overall economics. Removing this flexibility, or otherwise minimizing the use of partnerships among certain related parties, could address many of these concerns.

Recall the related partner examples discussed in Part II of this paper. Just as other tax rules prevent tax benefits in transactions between related parties,[97] partnership tax rules should seek to do the same. One option, consistent with recent legislative proposals, is to require partnerships to use a consistent (i.e., "pro rata" or "straight up") sharing of economics as between related partners.[98] That is, related partners that do not transact at arm's length would be limited in their flexibility to agree to share partnership economic results based solely on tax considerations. In the example in Part II, A and B would share partnership income proportionately (e.g., based on capital), and their interests would represent identical economic rights (similar to the result that would apply under the

S corporation rules). Such a restriction would generally simplify partnership taxation by limiting opportunities for taxpayers to engage in planning through complicated "special" allocations, but it does add some complexity since it must define the tax treatment of related partner allocations that do not follow the required "pro rata" approach. Such complexity, however, can be addressed, and existing proposals have already begun to include features that would do so.[99] However, it should be noted that requiring consistent allocations might not address all opportunities for related partner tax planning or abuse; for example, related taxpayers could potentially still benefit from holding assets through a partnership even where the partnership's allocations satisfy the consistency or "pro rata" requirement.[100] Accordingly, it is also worth exploring reforms that would disregard, consolidate, or otherwise take an "aggregate" approach to partnerships between corporate consolidated group members or other specific related parties.[101] This would more broadly limit opportunities to take advantage of formal partnership tax rules to achieve tax benefits without affecting economic sharing or ownership among the partners.

### *f. Modernize section 721(b) investment partnership rules*

> Because contributions of property to a partnership are tax-free, Congress was concerned that wealthy investors could pool their passive investments such as stocks and bonds to diversify their holdings without paying tax, mimicking the effect of converting their portfolio into an ordinary diversified stock or bond fund without triggering a taxable sale. To eliminate these "exchange" or "swap" funds, Congress enacted rules that make contributions taxable when too much of the partnership's assets consist of passive investments. Unfortunately, the rigidity of the rules has allowed the market to develop simple workarounds. For example, exchange funds advertise themselves as achieving the exact goal the statute was intended to prevent. Updating the statute would ensure it achieves its original policy goals.

Current law seeks to prevent the use of partnerships to achieve a tax-free diversification of appreciated passive investments through "exchange" or "swap" funds. These rules were enacted because Congress believed "that the tax-free diversification of stock investments should not be permitted through the use of the partnership form when the same result cannot be achieved under present law through a corporation or a direct exchange of portfolio stocks for other similar stocks."[102] Accordingly, section 721(b) triggers taxable gain upon the contribution of assets to a partnership (1) where the partnership holds a certain amount of specific investment assets (which are listed in regulations), and (2) where the contribution results in diversification for the contributor.

However, the rigidity and specificity of these rules has allowed exchange funds to continue to achieve the result the statute was intended to prevent (and therefore to market their funds as doing so).[103] The rules should therefore be tightened to reduce or prevent exchange funds from achieving tax-free diversification in a manner inconsistent with the statute's purpose. A targeted approach would be to extend the specific regulatory list of investment assets, such as by adding certain real estate investments that are currently not listed and thus can be used to sidestep the rules. A broader approach would be to adopt a more generalized and qualitative definition of "investment asset," either in addition to or in lieu of a specific list.[104] This reform would ultimately address an outdated item by ensuring the statute applies to current market transactions in a manner consistent with its intent and purpose.

It should also be noted that the issue of tax-free investment diversification applies equally in the corporate context: The rules applicable to partnership investment companies currently operate by cross-reference to the corporate rules under section 351(e). Accordingly, this reform will need to consider the extent to which corporate and partnership investment companies should continue to be subject to the same rules. Since the partnership investment company rules were added to eliminate an opportunity that, at the time, existed in partnerships but not in corporations (and thus to create parity), it would make sense for this reform to maintain such parity. This could be done by modifying the existing section 351(e) rules and allowing them to continue to apply for both corporate and partnership purposes, instead of creating new standalone partnership rules.

## 3. Broader and more-complex reforms

### *a. Modernize section 752 liability allocation rules*

> In some circumstances, the current partnership tax rules allow too much flexibility in allocating debt among partners. At times, this creates tax results that are at odds with the economics of the partnerships, especially when partners are acting in concert rather than at arm's length. A broader reform should reconsider how debt is allocated, with a goal of more accurately reflecting the economic deal among the partners.

As discussed in Part II, a partner can potentially avoid disguised sale treatment through engineered tax planning that increases its share of partnership debt; in such a case, the resulting debt basis can be used to

achieve the economics of a taxable sale without triggering tax. But an increased allocation of debt (and thus debt basis) to a partner can also provide tax benefits beyond the disguised sale context.[105] For example, it can allow a partner to reduce its taxes through an increased allocation of partnership losses that would otherwise be suspended under section 704(d) in the absence of the debt basis. It could also facilitate a reduction in tax by increasing the amount of operating cash flow distributions that can be received without triggering tax (i.e., that do not exceed the partner's outside basis) under section 731. Accordingly, broader legislative reforms should be considered that update the liability sharing rules for all of Subchapter K (rather than solely for disguised sales). Recent legislative proposals would achieve this by requiring all partnership liabilities to be allocated based on profit shares.[106] On the one hand, this type of broader reform would avoid the complexity of creating different liability sharing rules for disguised sale purposes and other purposes. On the other hand, however, it would be a larger and more fundamental change to current well-known Subchapter K rules (and thus would have a larger impact on taxpayers). For example, such an approach would require transition rules to address whether (and to what extent) it could trigger immediate tax (e.g., as a result of deemed distributions under section 752(b)) for partners whose liabilities are shifted. And, as others have noted, a rule that simply allocates liabilities based on profit shares may substitute new conceptual difficulties for those that exist under current rules.[107] Accordingly, a more precise (or different) approach may be needed, either to reflect economic reality or to create a simpler and more administrable regime.[108] Finally, if more fundamental pass-through reform is being considered, it is worth exploring bigger reforms that would largely eliminate partnership liability allocations by applying rules similar to current S corporation rules.

### *b. Section 734(b) reforms*

> Distributions of cash or property from a partnership can create the opportunity to shift income and losses between partners in ways that produce tax results at odds with the economics of the partnerships—for example, by moving current income to a partner with lower tax rates or enabling other tax gaming. This creates footfaults as well as planning opportunities. Lawmakers created rules that permit partnerships to elect to eliminate these shifts through basis adjustments, but the rules do not fully prevent shifts. Work needs to be done to determine if modification to the rules would prevent these shifts in a fair and administrable way.

Under sections 734(b) and 754, partnerships can elect to make basis adjustments that are designed to eliminate shifting and distortions that arise when distributions create an inside-outside basis disparity. But, as others have raised, the manner in which the adjustments are calculated—in the aggregate rather than per partner—means they can still create and allow shifting in certain cases.[109] In contrast, similar basis adjustments arising under section 743(b) from transfers of partnership interests (rather than from partnership distributions) are calculated and applied in a partner-specific manner. This creates opportunities for taxpayers to take advantage of tax benefits from shifts and distortions caused by partnership distributions (while avoiding those that are detrimental) and can also create traps for the unwary. Accordingly, existing and prior proposals to make section 734(b) basis adjustments mandatory and partner-specific should continue to be pursued and refined as appropriate.[110]

An alternative to recent mechanical proposals that seek to preserve each partner's pre- and post-distribution share of built-in gains and losses could be accomplished through a broader reform of the partnership distribution rules. For example, reforms might revive and pursue a simpler "partial liquidation" approach that avoids partner-specific adjustments (and coordination with complicated section 704(c) allocation rules) and instead seeks to preserve each partner's share of gains and losses through proportionate basis recovery on distribution.[111] Another approach would be to seek a more fundamental change to partnership distributions, such as by simplifying partnership distribution rules to trigger current tax on certain (or all) property distributions (which could be accomplished in a manner similar to current S corporation rules).[112] This latter option would essentially be a broader version of the proposal discussed in Part III.A.2. with respect to related-party basis shifting transactions. Ultimately, reforms in this area will need to balance the potentially significant complexity of eliminating inappropriate shifting within the current tax-free distribution framework against a simpler (but less flexible) rule that triggers current tax.

### *c. Update, modernize, and clarify section 704(b) allocation rules*

> As discussed elsewhere, partnerships pass through their income and deductions to their partners. The rules governing how income and deductions are allocated to partners are therefore at the core of partnership tax. The current rules are designed to permit allocations as long as they are consistent with the economics of the partnership. However, these rules are arguably too permissive and have features that permit inappropriate tax planning, including allocations that are not in fact consistent with the economics. Those specific features should be fixed, and other updates

should be studied and pursued that would better reflect appropriate sharing and current market practices.

Section 704(b)—arguably the cornerstone of Subchapter K—governs the allocation of a partnership's income and deductions among its partners and how to measure and maintain each partner's "capital account" (i.e., its equity interest) in the partnership. The rules govern when an allocation of a partnership's economic items will be respected. Specific reforms within section 704(b) worth pursuing include the refinement, expansion, and clarification of the "partners' interest in the partnership" (PIP) standard under Treasury Regulation section 1.704-1(b)(3). This is particularly important given that so many partnerships no longer opt to satisfy the "substantial economic effect" (SEE) safe harbor of Treasury Regulation section 1.704-1(b)(2). Worthwhile PIP-related reforms would include rules (1) confirming that "targeted allocations," when done properly, satisfy the PIP standard; (2) addressing other commonly used allocation methods that do not comply with the SEE safe harbor but may comply with PIP (such as anticipatory allocations or income allocations that simply follow cash distributions rather than target capital account balances); and (3) limiting or addressing the ability to switch between different allocation methods year-to-year based on tax results even where both allocation methods may satisfy PIP (i.e., shifting between pure targeted allocations and other approaches based on the tax results of different methods).

Section 704(b) reforms should also provide clarity on the ability to shift income or other tax items between partners using waivers and "catch-ups" (including clarifying that the "value-equals-basis" presumption in the SEE safe harbor rules does not apply for such purposes). This is similar to the issues addressed by the 2015 disguised payments for services regulations under section 707 but would address the potential to use existing section 704(b) rules to allocate items to particular partners based on tax characteristics. Reforms would clarify what is permissible and what aggressive variations of such strategies are not permissible—e.g., what level of economic risk is needed to support the desired allocation.

Finally, section 704(b) reforms could seek to eliminate specific problematic aspects of the SEE safe harbor rules such as the "value-equals-basis" presumption. In adopting such an approach, policymakers would need to evaluate whether (and to what extent) the rules should retain such provisions but limit them to specific scenarios, such as retaining aspects relevant or necessary to tax-equity partnerships—i.e., certain tax credit partnership arrangements—contemplated in specific IRS guidance.

Updating the section 704(b) rules could be done as a broad overhaul or as a set of more-targeted reforms.[113]

## 4. Fundamental reform ideas: Beyond modernizing Subchapter K

While the above sections of Part III focus on ways to modernize existing Subchapter K rules, this section discusses briefly (and for completeness) some broader options that would represent a more significant overhaul of the taxation of partnerships and other pass-through entities.

### *a. Limit favorable Subchapter K treatment only to certain businesses or entities*

A fundamental overhaul would limit partnership tax treatment only to certain entities—e.g., those below a threshold based on size or complexity. Entities ineligible for partnership tax treatment would be taxed under a different regime—e.g., as C corporations.[114] As explored in Parts I and II, the reality of large partnerships has moved further away from a regime intended to reflect the co-ownership nature of simple joint ventures—this tension between "aggregate" and "entity" concepts (see Box 2) creates complexity and thus creates planning opportunities. Additionally, the ability to elect between business tax regimes as relative rates change leads to large revenue losses and economic inefficiencies. For these and other reasons, over several decades others have discussed treating all large pass-throughs as C corporations.[115]

A particular challenge of this reform is setting and measuring the threshold that divides "large" from "small" businesses. Current tax law contains many different (and largely uncoordinated) definitions for "large" and "small" businesses, and it is not immediately obvious that one would be better than another for this purpose.[116] However, these various rules rely on common features to measure size—most such rules measure size based on assets, receipts, or employees (or a combination). Policymakers would also need to consider whether some other criteria should also be considered (such as some measure of "complexity"—e.g., by number of partners or tiers). Additionally, such an approach would require aggregation rules to ensure that organizations could not simply elect their desired regime by splitting into multiple entities.[117]

Requiring an entity to shift between different tax regimes (e.g., between Subchapter K and Subchapter C treatment) has significant tax consequences for the entity and its owners; any such reform would also need to determine and address (1) whether it is appropriate for an entity to fall in or out of partnership taxation based on certain characteristics and (2) if so, the appropriate transition mechanisms. One potential transition rule (simply intended to allow entities to manage any tax on "phantom" income as a result of forced conversions from Subchapter C to Subchapter K) could be

to allow an entity that shrinks below the threshold to re-enter Subchapter K only on affirmative election.

The increase in revenue from such a reform would depend significantly on where corporate and individual tax rates are set relative to each other, but is likely to be large.

### *b. Implement a dual (or new) pass-through regime*

Another fundamental reform could implement a "simplified" and less flexible pass-through regime only for electing small partnerships.[118] Alternatively, the simplified pass-through regime could be the default with an ability for certain large or complex partnerships to elect into a more complex regime based on Subchapter K. The latter approach would raise some of the same difficulties discussed in the immediately prior proposal (e.g., how to assess size or complexity and how to manage transitions between regimes) but would have the benefit of limiting the more complex and more flexible rules to those partnerships affirmatively seeking to benefit from them. It would therefore raise such partnerships to the attention of the IRS, thus potentially assisting in enforcement targeting efforts. That said, a multiplicity of "pass-through" regimes already exist in the Code; adding another, without broader simplification, would complicate the choice of regime and the tax system as a whole. Accordingly, another potential option could be to pursue a new single pass-through regime with a combination of features, such as aspects of both Subchapters S and K.[119]

The very many ways this broad approach could be implemented means that there is a risk that it could be implemented in ways that result in large revenue losses. Avoiding that outcome would require ensuring that any simplified regime is in fact focused on simplification, rather than creating new net tax cuts for qualifying pass-throughs.

## B. Information reporting and compliance proposals

The following proposals are aimed at increasing information about partnership income, assets, and noncompliance to support increased voluntary compliance and to ensure that IRS efforts are more efficient and better targeted. Such reforms could help in the evaluation of compliance efforts over time as well as improve the development and evaluation of future policy changes.

### 1. Expand electronic filing for partnership returns

Expanding the percentage of partnership returns that are filed electronically could help improve Schedule K-1 matching by minimizing transcription errors from paper returns and improving the coverage of IRS compliance systems. Currently, section 6011(e)(6) requires partnerships with more than 100 partners during a taxable year to file electronically regardless of the number of returns the partnership is required to file during the year. For partnerships with fewer than 100 partners, electronic filing is required only if the partnership files more than 10 returns in a year (excluding attached schedules such as Schedule K-1s). Eliminating the 10-return floor would increase electronic filing coverage for partnerships with fewer than 100 partners.

### 2. Improve existing partnership tax return reporting

These improvements should include requiring better and more-detailed reporting on partnership assets and ownership percentages and updating existing partnership tax returns to ensure they include relevant and helpful information provided in a consistent format. Existing partnership reporting warrants reexamination and updates so that partnership returns minimize IRS legwork in piecing together and connecting complicated returns. For example, some commentators have suggested improving reporting on section 704(b) "book" capital accounts, section 704(b) allocation approaches, section 704(c) methods and layers, and disguised sales.[120] Additional reporting on partnership structures (e.g., tiers of ownership and comprehensive structure diagrams) would also be helpful.

### 3. Improve partnership beneficial ownership reporting

Legislators should fill ownership reporting holes in the CTA to require reporting for certain pass-through entities such as general partnerships, and to require reporting of taxpayer identification numbers. CTA reporting companies could also be required to report estimated ownership percentages for beneficial owners, and clarifying rules could be added to cover potential avoidance strategies (including entity conversion or renewal). An alternative, though more cumbersome, approach would be to create a parallel tax-only ownership reporting scheme for pass-throughs in order to obtain this information.

### 4. Maintain and improve IRS compliance funding

As noted elsewhere, the IRA (enacted in 2022) provided a significant improvement in IRS mandatory funding, though this was subsequently reduced. Lawmakers should restore and continue IRA mandatory funding, as well as maintain base IRS appropriations levels. Doing

so will support already-announced efforts to improve partnership compliance through up-front guidance, improved audit staffing, and targeting.[121] The IRS and Treasury should also consider additional improvements to audit targeting and research.[122]

## C. Pass-through reforms outside of Subchapter K

Finally, while this proposal has been focused on core Subchapter K rules, there are several additional areas of reform affecting all pass-through entities. These include (1) clarifying that a functional, activity-based test applies to prevent owners of all pass-through entities (partnerships and S corporations) from claiming an exemption from Self-Employment Contributions Act (SECA) taxes on earnings from work; (2) eliminating section 199A, which provides a 20 percent deduction on "qualified business income" earned by a partnership or other pass-through; and (3) addressing the cap on deductibility of state and local taxes (SALT), including by limiting or revoking federal permissions for state SALT cap "workarounds."[123] Additionally, while not implicating partnerships, much has been written about how best to eliminate or narrow the unintended tax benefits that section 852(b)(6) provides to exchange-traded funds, a type of "pseudo" pass-through entity.[124]

Combined, the revenue impact of these four reforms would be significant. The current rules grant (or arguably grant) specific and significant tax benefits to a large array of pass-through entities and their owners, including many (and mostly) high-income taxpayers. Accordingly, they result in reduced taxes for a very large majority of pass-through owners. Overall, we would generally expect that together these reforms could increase revenues by as much as $1 trillion over 10 years.

# Appendix A

Further detailed example—liability allocations and disguised sale rules.

Partnership liabilities are allocated among partners, and each partner's share of liabilities increases its outside basis. Conceptually, it is as if the partner borrowed its share of a partnership liability and contributed cash to the partnership. Since liability allocations affect outside basis, such allocations are very important to each partner's actual individual tax results; in particular, they affect the deductibility of partnership losses as well as the gain or loss a partner recognizes in many scenarios.[125]

Under current law, partnership liabilities are characterized as "recourse" or "nonrecourse," with recourse liabilities allocated to those partners that bear "economic risk of loss" (EROL).[126] In determining a partner's EROL, the rules ask whether the partner would bear the liability in a hypothetical scenario that assumes all partnership property (including cash) is worthless and the partner can fulfill its obligations regardless of actual creditworthiness. This hypothetical scenario is sometimes called the "atom bomb test." Certain refinements have been made to these rules over the years, but they remain based on this key hypothetical.

The rules have thus been criticized as applying a mechanical test that does not reflect economic reality (i.e., does not reflect how partners "actually" bear partnership liabilities as an economic matter), thus creating electivity to minimize tax by manufacturing EROL and outside basis.[127] This has wide-ranging effects, but a key example of this flexibility arises in the context of disguised sales, where the liability sharing rules may be used to avoid taxable sale treatment in transactions that closely resemble taxable sales.

A simplified example is as follows:[128]

As a baseline, assume a taxpayer holds significantly appreciated property with a tax basis of $10 million and a fair market value of $100 million. The taxpayer could monetize the asset by selling all or a portion of it for cash (and being taxed on the built-in gain) or by borrowing against the property (generally not triggering tax on the gain). The taxpayer in this case does a combination—it borrows $4.75 million against the property and it sells a large interest in the property for $90.25 million in cash. The taxpayer has thus monetized $95 million of the $100 million value in a way that triggers a taxable gain on $90.25 million of that value (and is thus taxed on about $81 million of gain). Assuming a maximum capital gains tax rate of 23.8 percent, the tax liability would be $19.3 million.

However, if the taxpayer instead were to monetize the property "through" a partnership, it would have more flexibility to achieve a similar economic result without recognizing any significant taxable gain. Suppose the taxpayer instead contributes the asset to a partnership in exchange for a 5 percent interest and the partnership then borrows $95 million and distributes the cash from the borrowing to the taxpayer. The taxpayer agrees to guarantee the debt, primarily because it never expects the guarantee to be called (though it is commercially reasonable to assume the taxpayer would be able to satisfy at least some of the guarantee in the unlikely case it was called). Rather, the $95 million liability is expected (by both partnership and lender) to be paid off with cash from profitable partnership operations. In this scenario, the taxpayer will actually bear something like 5 percent of the $95 million liability—i.e., $4.75 million, or its share of the partnership profits from which the debt is repaid. But, due to the guarantee, existing partnership rules allow the taxpayer to be treated as bearing the entire $95 million of debt, as if it had borrowed the full $95 million outside the partnership.

Thus, in the partnership transaction, the taxpayer has effectively monetized $95 million of the asset value "through" the partnership with only $4.75 million of that cash attributable to a liability the taxpayer is likely to actually bear as an economic matter. Again assuming a maximum capital gains tax rate of 23.8 percent, the tax liability would be $1.1 million. This is the same economic result as in the non-partnership transaction, but recall the non-partnership transaction triggered $81 million of taxable gain and a tax liability of $19.3 million. Because existing partnership rules apply a mechanical test to the guarantee that does not necessarily reflect economic reality, the taxpayer is able to avoid taxable sale treatment yet still achieve the result of borrowing $95 million against the property. To be sure, the taxpayer must still agree to guarantee the debt (and thus be on the hook in a downside scenario), but if the downside scenario is highly unlikely, then doing so may be entirely worth it to save $18 million in tax.

This example is admittedly simplified. But it still shows how existing rules can allow for more-favorable treatment when transactions occur through a partnership versus outside a partnership—a result that should

at minimum generate questions about whether there are better ways to assess a partner's liability share, particularly for disguised sale purposes.

The proposed reform (discussed in the main text) to modify liability sharing solely for disguised sale purposes would address this example by allocating only 5 percent of the liability to the partner regardless of the guarantee. As a result, taxable gain would be recognized the same as in the non-partnership transaction. In this case, such a reform would line up nicely with economic reality (and, at minimum, would eliminate a disguised sale transaction about which the IRS has previously expressed concern). However, crafting alternative liability allocation rules based on how each partner is most likely to bear partnership-level debt (or based on profit sharing in all cases) creates its own difficulties and trade-offs, as discussed in Part III.A.3. of the main text.

# Appendix B

In the short run, taxes on pass-through income are more concentrated among the highest-income filers than other types of business income, given the concentrated ownership of pass-throughs.

In the long run, JCT assumes that taxes on pass-through income are more likely to be borne by the business owners than to be shifted to workers (through lower investment, productivity, and wages) in comparison to taxes on C corporations. That is, labor bears about 25 percent of a corporate tax increase (or cut), but only 5 percent of a pass-through income tax increase (or cut). When JCT adopted this assumption in 2013, it noted "the paucity of empirical and theoretical literature on incentive effects on passthroughs," but grounded its assumption in evidence that pass-through owners are less able than corporate investors to invest offshore to avoid U.S. taxation.[129]

Consistent with that assumption, recent research has suggested that tax benefits for pass-throughs may encourage use of a legal form that reduces access to public capital (compared to C corporations), thereby reducing investment and employment.[130]

OTA assumes that, in pass-throughs as in C corporations, about 60 percent of capital income comes from supernormal returns.[131] However, this assumption is based on research on C corporations, not on pass-throughs specifically. Specific research is needed to test whether this assumption is appropriate, and Treasury highlights pass-throughs as an area in particular need of further research.

Indeed, there are several areas where further research could inform reforms beyond those suggested in this paper. As the main text discusses, the prevalence of partnerships (and the amount of income and assets running through partnerships) has increased significantly over the past several decades. The size of this shift of income into partnership structures, and the concentration of that income in the hands of the highest-income taxpayers, mechanically explains a large share of income inequality, some research notes, without showing causation.[132] Recent research has also found that partnership-heavy private equity ownership in the health-care industry has been associated with higher societal costs and worse health outcomes.[133] But the role, if any, of the taxation of these structures has not been addressed, and could be another area for potential future research focus.

# Endnotes

1. See Ron DeCarlo, Tuba Ozer-Gurbuz, and Nina Shumofsky, Partnership Returns, Tax Year 2021, IRS SOI (hereinafter "DeCarlo et al.").
2. As used herein, "Code" refers to the U.S. Internal Revenue Code of 1986, as amended, "Treasury Regulations" or "Treas. Reg." refers to the Treasury regulations promulgated thereunder, and "section" or "§" refers to those sections of the Code or Treasury regulations cited, as applicable.
3. However, see Steven M. Rosenthal and Livia Mucciolo, Who's Left to Tax? Grappling with a Dwindling Shareholder Tax Base, Tax Policy Center, April 1, 2024 (discussing the increasing share of income not taxed at any level).
4. As an example, S corporations are prohibited from making the types of "special" allocations of tax items commonly seen in partnerships, are not permitted to have more than 100 owners, and are not permitted to have owners that are other entities (save for certain trusts, estates, or tax-exempt organizations). See Code § 1361(b)(1).
5. See Congressional Budget Office (CBO), Taxing Businesses Through the Individual Income Tax, Pub. No. 4298, December 2012 (hereinafter "CBO 2012"), at pp. 10–14.
6. Some common legal entities that are generally taxed as partnerships include general partnerships (offering no limited liability for partners), limited partnerships (generally requiring at least one general partner with unlimited liability but offering limited liability to the limited partners), limited liability companies (LLCs; offering limited liability for all owners, similar to a corporation), and limited liability partnerships (LLPs; generally offering limited liability in manner similar to LLCs). Due to the significant protections and flexibility they offer, LLCs have become the most common type of tax partnership used in the United States, and now represent more than 70 percent of all tax partnerships. See Sebastian Dyrda and Benjamin W. Pugsley, The Rise of Pass-Throughs: an Empirical Investigation (March 11, 2024, last revised March 15, 2024).
7. See Treas. Reg. §§ 301.7701-1, -2, and -3. Additionally, a similar difficulty that Subchapter K faces is mixing "entity" and "aggregate" theories of partnership taxation. Compare, e.g., § 741 (treating the sale of a partnership interest in accordance with "entity" principles) and § 751 (adopting a partial "aggregate" approach to a sale of partnership interests for purposes of characterizing income). This mix of approaches to address different issues created by an aggregate or entity theory can create confusion and complexity.
8. See CBO 2012, supra, also noting that non-tax drivers may include a shift in the economy toward services-based businesses for which corporate tax classification may carry fewer non-tax benefits. Part II discusses tax rates applicable to pass-through income.
9. See Elliott Manning, Bloomberg BNA Portfolio 710-3rd T.M., *Partnerships—Conceptual Overview* (noting the simple features of the "general partnership" and that "many partnership legal and tax principles have their origin in this simple form of business entity").
10. See DeCarlo et al., supra. For completeness, this $50 trillion number reflects only partnerships required to report balance sheet information with the IRS and includes all relevant partnership assets, such as partnership assets indirectly attributable to foreign and tax-exempt partners.
11. See Tax Policy Center Briefing Book, Key Elements of the U.S. Tax System, What are pass-through businesses? at Figure 2.
12. See IRS, SOI Tax Stats—Partnership data by size of total assets for tax year 2021 at Table 15. See also DeCarlo et al., supra.
13. See IRS, SOI Tax Stats—Individual statistical tables by size of adjusted gross income for tax year 2021, at Table 1.4. Such data also show, similarly, that about 47 percent of taxable interest income accrues to filers with AGI above $1 million, while only 9.4 percent of salary and wage income accrues to such a group. See also Michael Cooper, John McClelland, James Pearce, Richard Prisinzano, Joseph Sullivan, Danny Yagan, Owen Zidar, and Eric Zwick, Business in the United States: Who Owns It and How Much Tax Do They Pay?, NBER Working Paper Series, Working Paper 21651 (hereinafter "Cooper et al.") (making the similar determination based on 2011 data that 69 percent of partnership income accrues to the top 1 percent of filers, compared to approximately 45 percent of corporate dividends).
14. Data drawn from IRS, SOI Tax Stats—Individual statistical tables by size of adjusted gross income for tax year 2021, at Table 1.4.
15. See John Guyton, Patrick Langetieg, Daniel Reck, Max Risch, and Gabriel Zucman, Tax Evasion at the Top of the Income Distribution: Theory and Evidence, Online Appendix (hereinafter "Guyton et al."), at Figure A8.
16. See also Cooper et al., supra.
17. Mark P. Keightly and Joseph S. Hughes, Congressional Research Service (CRS), Pass-Throughs, Corporations, and Small Businesses: A Look at Firm Size, CRS Report R44086, March 15, 2018. For differences in economic characteristics of partnerships by state law type, see Jason DeBacker and Richard Prisinzano, The Rise of Partnerships, Tax Notes Today Federal, July 2, 2015.
18. Emily Black, Ryan Hess, Rebecca Lester, Jacob Goldin, Daniel E. Ho, Mansheej Paul, Annette Portz, The Spiderweb of Partnership Tax Structures, February 24, 2023 (hereinafter "Spiderweb Paper").
19. The extent to which these circular ownership loops actually occur, and the extent to which they actually result in income escaping taxation, is not clear. Researchers have shown that true partnership loops, where income flows endlessly between partnerships and is never taxed, may be somewhat rare. See Chris William Sanchirico and Reed Shuldiner, Circular Partnerships, U of Penn, Inst. For Law & Econ Research Paper No. 23-46, December 17, 2023 (hereinafter "Sanchirico and Shuldiner").
20. U.S. Government Accountability Office (GAO), Report to the Chairman, Committee on Finance, U.S. Senate, Tax Enforcement: IRS Audit Processes Can Be Strengthened to Address a Growing Number of Large, Complex Partnerships, July 2023 (hereinafter "GAO 2023 Audit Report").
21. GAO 2023 Audit Report, supra.
22. Examples of noneconomic avoidance transactions include previously used Subpart F blocker techniques, which are now shut down. See Rose Jenkins, The Gnarly Business of Taxing Partnership-Held Foreign Corporations' Income, Blog Post at The Tax Law Center at NYU Law (Medium), May 23, 2022.
23. See Office of Public Affairs, U.S. Department of Justice, Press Release: CEO of Multibillion-dollar Software Company Indicted for Decades-long Tax Evasion and Wire Fraud Schemes, October 15, 2020 (high profile case in which investments and income were run through complicated pass-through structures in which ownership and management was obscured to evade tax).
24. See Subchapter S of the Code (Code §§ 1361 through 1379) or the "regulated investment company" regime of Subchapter M of the Code (Code §§ 851 through 855).
25. While a reasonable goal of partnership taxation would be to impose the same tax treatment whether someone does

business on their own or through a joint arrangement with a partner, such pure "neutrality" is often achievable only in the simplest partnership structures and thus can be at odds with other goals, such as minimizing complexity and creating administrable rules, particularly for larger and more complex arrangements.

26. Code §§ 701 through 761.
27. See William S. McKee, William F. Nelson, Robert L. Whitmire, and Sarah Brodie, *Federal Taxation of Partnerships and Partners* (Thomson Reuters/Tax & Accounting, 5th ed. 2024, with updates through June 2024) (hereinafter "McKee et al.") at ¶ 1.03 (citing "the need—explicit in the legislative history [of Subchapter K]—to allow partnerships considerable flexibility to conform the allocation of the partnership's tax items to the partners' economic deal" and noting that Subchapter K provides "broad flexibility to move property in and out of partnership solution without recognizing gain or loss" and that this "necessary" flexibility in partnerships "provides unusually fertile opportunities for tax avoidance").
28. See, e.g., Code §§ 704(c)(1)(C) and 743(d) (and other similar rules).
29. See, e.g., McKee et al., supra, at ¶1.03 (noting that, in enacting the current form of subchapter K in 1954, Congress was relying, at least outside the narrow family partnership context of§ 704(e), on the fact that "the adverse tax interests of partners would discipline collusive and abusive exploitation of subchapter K's flexibility"); Kristen A. Parillo, Related-Party Basis-Shifting Guidance Anticipated, Tax Notes Today Federal, May 9, 2024 (quoting Cliff Warren of the IRS Office of Associate Chief Counsel [Passthroughs and Special Industries] stating that existing "partnership tax rules 'just don't work well for related parties'"); Emily Cauble and Gregg D. Polsky, The Problem of Abusive Related-Partner Allocations, Florida Tax Review Vol. 16, Article 9 (2023) (hereinafter, "Cauble and Polsky") (noting that the partnership income allocation rules—arguably the cornerstone of subchapter K—"are premised on the assumption that partners deal with each other at arm's-length"). Similarly, the partnership anti-abuse rule at Treas. Reg. § 1.701-2 also reflects this notion, including as one of its indicative factors of abuse the fact that "[s]ubstantially all of the partners [in a partnership] … are related (directly or indirectly) to one another."
30. See Cauble and Polsky, supra, for several similar examples of potentially abusive related partner allocations that would be permissible under existing partnesrhip tax allocation rules.
31. Cooper et al., supra. However, see Sanchirico and Shuldiner, supra, noting that the negative tax impact of income running through circular ownership structures may be overstated.
32. Spiderweb Paper, supra, at p. 1.
33. At the partnership level, partnerships report their incomes and associated tax information on Form 1065, U.S. Return of Partnership Income, while other schedules require individual partners to report their claimed shares of these items, among other details. At the individual level, several separate forms require reporting of individual income, net tax liability, and more.
34. Brendan McDermott, CRS, The Federal Tax Gap: Overview, Analysis, and Policy Options, CRS Report R47858, November 30, 2023.
35. Sophia Yan, Minding the Gaps?: Corporate Transparency Act Rules Highlight Need for Legislative Improvements, Blog Post at The Tax Law Center at NYU Law (Medium), November 11, 2022 (hereinafter "Yan").
36. See Yan, supra.
37. 31 U.S.C. 5336(a)(3)(b). The Secretary of the Treasury may also extend reporting exceptions to additional entities by regulation, with the written concurrence of the Attorney General and the Secretary of Homeland Security. 31 U.S.C. 5336(a)(3)(b)(xxiv).
38. See preamble to final beneficial ownership reporting regulations at 31 C.F.R. Part 1010, RIN 1506-AB49 (noting that, while proposed rules would have permitted voluntary reporting of owner taxpayer identification numbers, such voluntary reporting was removed from the final regulations and flagging comments received arguing that FinCEN lacked the authority to permit even voluntary reporting of owner taxpayer identification numbers).
39. GAO 2023 Audit Report, supra.
40. Note that the IRS generally struggles to recruit specialists and to offer compensation that is competitive with the private sector. Agency employee attrition rates were about 7.3 percent in 2023 (nearly 26 percent higher than the federal average). See Jonathan Curry, IRS Banking on Public Service Pitch to Draw New Hires, Tax Notes Today Federal, June 15, 2023; and Paul Bonner, IRS seeks transformation in new 5-year plan, Journal of Accountancy, July 20, 2022.
41. GAO 2023 Audit Report, supra.
42. See Guyton et al., supra, at p. 21.
43. See Daniel Reck, Max Risch, and Gabriel Zucman, Response to a Comment by Auten and Splinter on "Tax Evasion at the Top of the Income Distribution: Theory and Evidence," October 22, 2021 (hereinafter "Reck et al."), at footnote 6. Two authors also note the following (at footnote 14): "[o]ur conversations with practitioners also led us to believe that there is likely substantial heterogeneity in the character of partnership under-reporting by the type of partnership, and much more ambiguity in the lawfulness of some tax positions adopted via partnership structures. We have limited data to speak to these factors empirically and hope that future research can quantify them." This is consistent with our practice experience, with our conversations with practitioners, and with the heterogeneity of partnerships.
44. GAO 2023 Audit Report, supra, at pp. 23–25.
45. GAO 2023 Audit Report, supra, at p. 24. A 2022 report by the Treasury Inspector General for Tax Administration (TIGTA) found similar unchanged audit percentages for all partnership audits between 2016 and 2018. See Treasury Inspector General For Tax Administration, Centralized Partnership Audit Regime Rules Have Been Implemented; However, Initial No-Change Rates Are High and Measurable Goals Have Not Been Established, Report Number 2022-30-020, March 17, 2022 (hereinafter "2022 TIGTA Report") at p. 6. Partnerships can opt out of the centralized audit partnership regime only if they have fewer than 100 partners who are all individuals, estates of individuals, S corporations, C corporations, or foreign entities that would be treated as C corporations if they were domestic.
46. See Chuck Marr, Samantha Jacoby, Jabari Cook, and David Reich, Center on Budget and Policy Priorities (CBPP), Congress Needs to Take Two Steps to Fund the IRS for the Short and Long Term, February 1, 2022. After adjusting for inflation, the IRS budget in 2021 was approximately 20 percent below 2010 levels.
47. Valeriya Avdeev, The Need for Tax Reform: Schedule K-1 Document Matching Program and Effective Revenue Collection, 59 N.Y.L. Sch. L. Rev. (2014–2015).
48. Testimony of Charles O. Rossotti, Former IRS Commissioner (1997–2002) before the Senate Committee on Finance Subcommittee on Taxation and IRS Oversight, May 11, 2021.
49. Treasury Inspector General For Tax Administration, The Use of Schedule K-1 Data to Address Taxpayer Noncompliance Can Be Improved, Report Number 2019-30-078, September 27, 2019.
50. See Internal Revenue Service (IRS), Inflation Reduction Act Strategic Operating Plan, FY2023–FY2031 (hereinafter "IRS IRA SOP"), at initiatives 1.7 and 3.3.
51. See IRS IRA SOP, supra, at initiatives 4.7 and 4.8.
52. See IRS News Release, IRS ramps up new initiatives using Inflation Reduction Act funding to ensure complex partnerships, large corporations pay taxes owed, continues to close millionaire tax debt cases, IR-2024-09, January 12, 2024. See also, GAO 2023 Audit Report, supra.
53. IRS News Release, IRS to establish special pass-through organization to help with high-income compliance efforts; new workgroup to blend current employees and new hires to focus on complex partnerships, other key areas, IR-2023-76, September 20, 2023; Kristen A. Parillo, LB&I Eyes End of Fiscal Year for Launch of Passthrough Unit, Tax Notes Today Federal, March 26, 2024.
54. See Brian Deese and David Kamin, Principles for the 2025 Tax Debate, Tax Notes Today Federal, October 18, 2023 (hereinafter "Deese and Kamin"); Chye-Ching Huang, Strengthening

the Tax Base, Written Testimony for Hearing "Medicare Forever: Protecting Seniors by Making the Wealthy Pay Their Fair Share," U.S. Senate Committee on the Budget, September 27, 2023. See also Chye-Ching Huang, Written Testimony for Hearing, "Examining How the Tax Code Affects High-Income Individuals and Tax Planning Strategies," U.S. Senate Committee on Finance, November 9, 2023 at page 8.

55. Cooper et al., supra.
56. CBO 2012, supra.
57. Cooper et al., supra. Exact tax rates on income earned through partnerships depends on the tax rate of the ultimate individual owners, but see discussion in Part II regarding the difficulty identifying who ultimately owns many partnerships.
58. Such average estimates likely obscure differences between entity and even partnership types, and are sensitive to methodology and data sources. See and compare, e.g., Tracy Foertsch, U.S. Cost of Capital Model Methodology, U.S. Department of the Treasury Office of Tax Analysis (OTA), Technical Paper 10, May 2022 (which imputes data on pass-throughs from corporate and all-firm data); Paul Burnham and Dorian Carloni, CBO's Model for Estimating the Effect That Federal Taxes Have on Capital Income From New Investment, CBO Working Paper Series, Working Paper 2022-01, February 2022 (which notes, at footnote 5, "the term pass-through entities should be interpreted as averaged-sized (relatively small) pass-through entities, and C corporations should be understood as average-sized (relatively large) C corporations. Relatively large pass-through entities and relatively small C corporations are not represented in the model's results"); Kyle Pomerleau, Section 199A and Tax Parity, American Enterprise Institute, September 12, 2022 (which, compared to other sources, highlights the importance of assumptions about the share of corporate equity held by non-taxable entities and individuals when comparing pass-through and C corporation effective tax rates).
59. See CRS, Marginal Effective Tax Rates on Investment and the Expiring 2017 Tax Cuts, CRS Report R48153, August 13, 2024. Compare, e.g., the 2017 (pre-TCJA), 2018, and 2024 columns for corporate and noncorporate entities shown in Tables 4 and 5 (pp. 8–11). These tables not only show that marginal effective tax rates (METRs) on investments through pass-through (i.e., noncorporate) entities are generally lower than those made through corporate entities, but also that METRs within the noncorporate category vary greatly across both asset and financing types both pre- and post-TCJA.
60. See U.S. Department of the Treasury, OTA, Gaps between the Net Investment Income Tax Base and the Employment Tax Base, April 14, 2016, at Table A.
61. See U.S. Senate Committee on Finance Press Release, Wyden Unveils Proposal To Close Loopholes Allowing Wealthy Investors, Mega-Corporations To Use Partnerships To Avoid Paying Tax, September 10, 2021 (hereinafter "Wyden 2021 Partnership Proposals").
62. This estimate does not decompose the partnership component. IRS, Research, Applied Analytics & Statistics (RAAS), Federal Tax Compliance Research: Tax Gap Projections for Tax Years 2020 & 2021, Publication 5869, October 2023. The IRS notes that "[t]he tax gap estimates may be understated with respect to flow-through income (S corporation and partnership income) and income from offshore accounts because of the difficulty in detecting sophisticated forms of noncompliance by NRP examinations."
63. Guyton et al., supra. See also Reck et al., supra, at p. 15.
64. Guyton et al., supra. See also Reck et al., supra, at p. 15. Compare Gerald Auten and David Splinter, Comment: Tax Evasion at the Top of the Income Distribution: Theory and Evidence, August 15, 2021.
65. See Jason Furman, How to Increase Growth While Raising Revenue: Reforming the Corporate Tax Code, The Hamilton Project, January 2020 (hereinafter "Furman").
66. See, e.g., sources cited and discussed in Appendix 2, infra.
67. To be sure, existing partnership rules aim to (and do) achieve this type of result in many cases. But this should remain a principle on which further reforms continue to be based.
68. For example, many of the most complex partnership tax rules are easily applied to small and simple partnerships—their complexity is less relevant in those cases. Even though the§ 704(b) regulations are enormously complex and detailed, they typically present no issues (and much of their detail is irrelevant) for a simple arrangement such as a small partnership business owned and shared proportionately. This dynamic generally remains true across Subchapter K. See also, e.g., Karen C. Burke, Reassessing the Administration's Proposals for Reform of Subchapter K, Tax Notes Today Federal, Special Reports, March 6, 2000 (discussing a specific proposal to expand§§ 704(b) and 704(c) allocations as a way to address § 734(b) reform, and noting that such a proposal would be overly complex in general but may be easily implemented by large and complex partnerships since it largely tracks complexity that large partnership arrangements are familiar with already).
69. This could also mean transition rules whereby certain partnership reforms do not apply to smaller partnerships. See Monte A. Jackel, The (Hopefully) Upcoming 2025 Tax Reform Debate, Tax Notes Today Federal, November 20, 2023 (arguing that Wyden's proposals would "need a two-tiered system for small and larger partnerships to limit the application of the more complex Wyden proposals to the larger partnerships").
70. See Wyden 2021 Partnership Proposals, supra, Section-by-Section Summary (noting that "Subchapter K has remained largely untouched for decades, with well-known oversights unaddressed and long-standing questions unanswered").
71. See John Rooney and Grace Henley, Now holding 30 trillion dollars in assets, partnerships require increased scrutiny and broad reforms, Blog Post at The Tax Law Center [TLC] at NYU Law (Medium), December 13, 2023. See also the accompanying comment letter providing additional detail here (such comment letter, hereinafter "TLC Omnibus Recommendations").
72. For broader principles for 2025 tax changes, see Deese and Kamin, supra.
73. See TLC Omnibus Recommendations, supra, for some additional specific clean-ups.
74. See Wyden 2021 Partnership Proposals, supra, Section-by-Section Summary at sections 8 and 9.
75. Such a regulatory project may already be in the works. See Kristen A. Parillo, Disguised Sale Rules May Include Partnership Interests, Tax Notes Today Federal, June 10, 2024. It should also be noted that regulations on disguised sales of partnership interests were previously proposed in 2004 (see 26 C.F.R. Part 1, REG-149519-03, RIN 1545-BC63), received significant criticism, and were withdrawn in 2009 (see Amy S. Elliott, IRS Withdraws 'Deeply Flawed' Proposed Regs on Disguised Sales of Partnership Interests, Tax Notes Today Federal, January 21, 2009). Any new regulatory project should consider and reflect Treasury's experience with these prior proposed regulations.
76. See proposed Treas. Reg. § 1.707-2, 80 FR 43652.
77. See Walter D. Schwidetzky, The Worthlessness Deduction for Partnership Interests: An Unguided Missile, Tax Notes Today Federal, Special Reports, April 17, 2024; and Russ Buettner and Paul Kiel, Trump May Owe $100 Million From Double-Dip Tax Breaks, Audit Shows, New York Times, May 11, 2024.
78. See section 138142 of proposed (but not enacted) H.R. 5376, the "Build Back Better Act."
79. See Joint Committee on Taxation, Estimated Budget Effects of the Revenue Provisions of Title XIII — Committee on Ways and Means, of H.R. 5376, the "Build Back Better Act," As Passed by the House of Representatives, JCX-46-21, November 19, 2021.
80. Note that such a proposal appears in both the Wyden 2021 Partnership Proposals, supra (see Section-by-Section Summary at section 5) as well as in House Ways and Means Committee Chairman Dave Camp's (R-MI) 2014 comprehensive tax reform proposals (hereinafter "Camp reform proposal"). Precise revenue estimates from JCT at a variety of time lengths as well as input from both IRS and taxpayers on any differentials in administrative burden could help determine an appropriate time period (if any) with greater precision.
81. While it could be argued that applying the mixing bowl rules in perpetuity creates administrative difficulties for taxpayers (such as tracking mixing bowl gains and distributions in perpetuity), such concerns are overstated. When a partner

contributes built-in gain property to a partnership, the contribution creates a § 704(c) "layer" that the partnership must keep track of and allocate back to the contributing partner when appropriate—for as long as the property stays within the partnership. Accordingly, a perpetual mixing bowl period generally should not require partnerships to track § 704(c) layers on contributed property in a manner meaningfully different from what is already required.

82. See Monte A. Jackel, Two Peas in a Pod: Partnership Tax Reform and the Antiabuse Rule, Tax Notes Today Federal, Viewpoint, February 5, 2024.
83. See, e.g., the recent Otay Project case (in which the taxpayer argued that the partnership anti-abuse rule was invalid and exceeded Treasury's authority).
84. See Miles Johnson, Thalia Spinrad, Chye-Ching Huang, and Mike Kaercher, Recent Regulatory Announcements on Foreign Trusts and Partnerships Reflect Key Tax Law Center Recommendations, Blog Post at Tax Law Center at NYU Law (Medium), May 29, 2024 (hereinafter "TLC Disguised Sale Post") (discussing proposals to address liability sharing for purposes of disguised sales through regulation).
85. See prior temporary regulations under Code § 707 at 26 C.F.R. Part 1, T.D. 9788, RIN 1545-BM84.
86. For example, the 2019 regulations at 26 C.F.R. Part 1, T.D. 9877, RIN 1545-BM83 tightened the rules by requiring a "commercially reasonable expectation that the payment obligor will have the ability to make the required payments" in order to assume the obligor will perform its obligations.
87. See Wyden 2021 Partnership Proposals, supra, Section-by-Section Summary at sections 8 and 9.
88. See Tax Law Center staff and Miles Johnson, How large businesses use partnerships to create tax deductions out of thin air: An explainer on related party basis shifting, July 26, 2024 (providing background information on the structure and strategy of these transactions).
89. See Tax Law Center at NYU Law, TLC Comment on Notice 2024-54, July 17, 2024.
90. See IRS, Forthcoming Guidance Regarding Certain Partnership Related-Party Transactions, Notice 2024-54 (hereinafter "Notice 2024-54"), and related guidance issued in June 2024.
91. Notably, the 1954 legislative history of Subchapter K shows that such a feature was originally how the distribution rules were proposed to operate. The 1954 House Report describes a rule in which distributions of property would trigger gain to the partner to the extent the basis of the property exceeded the partner's outside basis in its partnership interest. See H. R. Rep. No. 1337, 83d Cong., 2d Sess. (1954) at A227-A228. However, the Senate Report revised this approach. See S. Rep. No. 1662, 83d Cong.., 2d Sess. (1954) at 389.
92. See IRS News Release, IRS announces new steps to combat abusive use of partnerships; agency's focus intensifies as new guidance closes loopholes worth tens of billions, IR-2024-166, June 17, 2024 (noting the $50 billion estimate).
93. See Wyden 2021 Partnership Proposals, supra, Section-by-Section Summary at section 3.
94. See, e.g., Leigh Osofsky, *Unwinding the Ceiling Rule,* 34 Va. Tax Rev. 63 (2014) (discussing the various distortions and planning opportunities that can arise simply by virtue of the ceiling rule's existence and arguing the ceiling rule should be eliminated).
95. Such a "sale" approach has been considered (and dismissed) in the past—e.g., the "deferred sale" method. These discussions eventually produced the remedial method. However, since so much of Subchapter K comes back to complications resulting from§ 704(c)'s attempt to address the tax-free nature of transferring property to a partnership, these previously discussed alternatives are worth reconsidering.
96. See Notice 2024-54, supra.
97. See, e.g., Code §§ 267 and 707 as well as Code § 482 and the recent regulatory proposals on related party basis shifting transactions.
98. See Wyden 2021 Partnership Proposals, supra, Section-by-Section Summary at section 2.
99. See Wyden 2021 Partnership Proposals, supra, Section-by-Section Summary at section 2.
100. For example, two corporations that are part of the same consolidated group might form a partnership (using consistent or pro rata allocations) to implement a basis shifting transaction or otherwise take advantage of other features of partnership tax rules such as engaging in a "mixing bowl" exchange outside of the current seven-year window.
101. See, e.g., Notice 2024-54's proposal for regulations under Code § 1502.
102. S. Rep. No. 938, 94th Cong., 2d Sess., pt. 2, at 42.
103. See Diversify without a giant tax bill for a current exchange fund marketing tax-free investment diversification.
104. See New York State Bar Association (NYSBA), Tax Section, Report on Investment Company Provisions: Section 351(e) and 368(a)(2)(F), Report No. 1252, December 28, 2011 (recommending a similar approach that would conform to the broader rule under section 368(a)(2)(F) that treats any asset held "for investment" as a listed investment asset).
105. See Eric B. Sloan and Jennifer H. Alexander, Economic Risk of Loss: The Devil We Think We Know, 84 Taxes 217 (2006) (hereinafter "Sloan and Alexander") (providing a list of examples of how outside basis from debt allocations can affect a partner's tax liability).
106. See Wyden 2021 Partnership Proposals, supra, Section-by-Section Summary at section 12.
107. See Sloan & Alexander, supra.
108. See Sloan and Alexander, supra; Steven C. Todrys, Recourse Debt is Usually Nonrecourse: A Comment, 84 Taxes 251 (2006) (hereinafter "Todrys"); Monte A. Jackel, The Liability Recognition Antiabuse Quandary, Tax Notes Tax Practice Expert, Practice Articles, June 19, 2023. See also, e.g., Monte A. Jackel, More Considerations for Partnership Tax Reform, Tax Notes Today Federal, Viewpoint, July 8, 2024 (discussing the application of Code § 357(d) principles to Code § 752).
109. See, e.g., Howard E. Abrams, The Section 734(b) Basis Adjustment Needs Repair, 57 Tax Law 343 (2004) (hereinafter "Abrams").
110. See Wyden 2021 Partnership Proposals, supra, Section-by-Section Summary at sections 13 and 14.
111. See Abrams, supra; Karen C. Burke, Repairing Inside Basis Adjustments, 58 Tax Law 639 (2007); and Karen C. Burke, Unified Passthrough Reform Misses the Mark, Tax Notes (March 16, 2015) (hereinafter "Burke") (discussing various options for reforming the § 734(b) basis adjustment rules).
112. See House Ways and Means Committee Chairman Dave Camp's (R-MI) 2013 unified pass-through reform proposals (hereinafter "Camp unified pass-through reform"). See also Burke, supra.
113. See also, Monte A. Jackel, More Considerations for Partnership Tax Reform, supra (recommending that § 704(b) rules be "reviewed, revised, and simplified" through a broad directive to issue regulations addressing particular aspects of such rules).
114. Whether existing Subchapter C is the appropriate alternative regime should be considered further and may warrant additional reforms that are beyond the scope of this discussion.
115. See CBO 2012, supra, at p. 23. See also The President's Economic Recovery Advisory Board, The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation, August 2010, at pp. 74–76. See also Furman, supra.
116. See Gary Guenther, CRS, Small Business Tax Benefits: Current Law, CRS Report RL32254, (updated January 25, 2023).
117. Current aggregation rules under Code § 52 and related regulations are used throughout the Code for various purposes but need reforms and likely do not work properly for this purpose in their current form and could be another area of focus for future reform.
118. See Kurt R. Magette, Subchapter K-2: A Proposal to Simplify Partnership Taxation, Tax Notes Federal, Viewpoints, June 17, 2024. See also Walter D. Schwidetzky, Integrating Subchapters K and S—Just Do It, 62 Tax Law. 749 (2009).
119. Such an approach has been considered before; see, e.g., Camp unified pass-through reform, supra.
120. For some suggested approaches, see Monte A. Jackel, Partnership Tax Reform: Enhanced Information Reporting, Tax Notes Today Federal, Viewpoint, June 10, 2024.

121. See Chye-Ching Huang, Thalia Spinrad, and Kathleen Bryant, The Tax Law Center at NYU Law, Debt Ceiling Deal's Cuts to IRS Funding Bring the IRS Funding Cliff Closer: Appropriators Should Not Compound Harm, June 28, 2023.
122. Increased research: There is little public information on current Schedule K-1 matching efforts and obstacles, and so developing and assessing legislative reforms in this area is challenging. As the IRS rebuilds capacity with IRA funding, to support efforts to improve its partnership compliance tools it could prioritize increasing the granularity and regularity of its publication on the state of partnership information reporting and matching. These publications could include more detail on the current state of Schedule K-1 matching, research to support improving tax gap estimates for partnerships (disaggregated from other entities), and more regular updates to research publications including descriptive statistics on partnerships such as the Integrated Business Database. While in some cases the IRS will need to continue to be sensitive to not disclose holes in its compliance regimes that unscrupulous filers could seek to exploit, generally improving the publication of such information could support efficient tax administration and inform policy proposals. Improve targeting of partnership audits: No-change rates in audits of partnerships are almost twice as high as in audits of corporations. A 2022 TIGTA report on the implementation of the centralized partnership audit regime recommended that the IRS formulate an action plan to reduce no-change rates and potentially engage in study to identify and address factors contributing to the high rate if no-change rates did not fall, as well as a recommendation that the IRS establish overall partnership examination goals and measurements addressing expected outcomes from the implementation of the centralized partnership audit regime. See 2022 TIGTA Report, supra, at pp. 14–15. The IRS disagreed with these recommendations largely due to its interpretation of section 1204 of the IRS Restructuring and Reform Act of 1998, which prohibits the IRS from using records of tax enforcement results to "impose or suggest" production quotas or goals. However, as TIGTA indicated in its response, the IRS can utilize records of tax enforcement results for use in "forecasting, planning, management, and the formulation of selection case criteria" under Treas. Reg. § 801.6(d)(2); the IRS can also engage in study to identify contributing factors to its high no-change rates without violating section 1204 of the IRS Restructuring and Reform Act—which, it should be noted, was formerly codified at Code § 7804 but has since been repealed (note that TIGTA is still required to evaluate IRS compliance with section 1204 of the IRS Restructuring and Reform Act under Code § 7803(d)(1)(A)(i)). The IRS should implement these recommendations and other measures to improve its partnership audit targeting and reduce no-change rates.
123. For further discussion of these issues, see New York State Bar Association Tax Section, Comments on the Application of Employment Taxes to Partners and on the Interaction of the Section 1401 Tax with the New Section 1411, Report 1247 (2011); and Andrew W. Needham, Bloomberg BNA Portfolio 735-3rd T.M., *Private Equity Funds* at Section VI.K.1. (providing a good summary of the history and current state of the limited partner SECA exception); Gary Guenther, CRS, Section 199A Deduction: Economic Effects and Policy Issues, CRS Report 46650 (updated February 28, 2024); Chuck Marr and Samantha Jacoby, CBPP, The Pass-Through Deduction Is Tilted Heavily to the Wealthy, Is Costly, and Should Expire as Scheduled, June 8, 2023; Lucas Goodman, Katherine Lim, Bruce Sacerdote, and Andrew Whitten, How Do Business Owners Respond to a Tax Cut? Examining the 199A Deduction for Pass-through Firms, NBER Working Paper 28680, November 2022; David S. Mitchell, Washington Center for Equitable Growth, 2017 tax cut for pass-through business owners exacerbated inequality and failed to deliver economic benefits, May 1, 2024 ; and The Tax Law Center at NYU Law, Policy Options, Base Broadeners (SALT workarounds). See also Daniel J. Hemel, The Passthrough Entity Tax Scandal, 26 Florida Tax Review 87 (2023), NYU Law and Economics Research Paper No. 23-01, NYU School of Law, Public Law Research Paper 23-01.
124. See Steven Z. Hodaszy, "ETFs Use Section 852(b)(6) for Tax Avoidance, Not Just Tax Deferral: So Why Is This Loophole Still Open?" Tax Lawyer, Vol. 75, No. 3, pp. 489–600 (Spring 2022); Jeffrey M. Colon, "Unplugging Heartbeat Trades and Reforming the Taxation of ETFs," University of Chicago Business Law Review, Vol. 2.1
125. See Sloan and Alexander, supra (describing in detail the ways in which a partner's outside basis affects the partner's actual tax results).
126. At a very high-level, nonrecourse liabilities are generally allocated based on how partners share partnership profits.
127. See Wyden 2021 Partnership Proposals, supra, Section-by-Section Summary at section 12. See also Sloan and Alexander, supra, and Todrys, supra.
128. The example is based loosely on the recent Tribune Media disguised sale case. See *Tribune Media Co. v. Commissioner* (T.C. Memo 2021-122). See also Karen C. Burke, How Abusive Was Tribune Media's Disguised Sale?, Tax Notes Today Federal, Viewpoint, January 30, 2024; Monte A. Jackel, The Liability Recognition Antiabuse Quandary, supra; and TLC Disguised Sale Post, supra. Note that final liability allocation regulations were issued in 2019 that may have affected the outcome of *Tribune Media* had they applied to the relevant transactions. Those regulations tightened some of the rules regarding liability allocations and made transactions such as this example more difficult, though they did not account for the primary issues identified here.
129. For more discussion, see JCT, Modeling the Distribution of Taxes on Business Income, JCX-14-13, October 16, 2013; William G. Gale, Surachai Khitatrakun, and Aaron Krupkin, Winners and Losers After Paying for the Tax Cuts and Jobs Act, Tax Policy Center, December 8, 2017; and Greg Leiserson, Distribution Analysis as Welfare Analysis, Washington Center for Equitable Growth, June 9, 2020.
130. See Katarzyna Bilicka and Sepideh Raei, Output Distortions and the Choice of Legal Form of Organization, CESifo Working Paper, No. 8756, Center for Economic Studies and Ifo Institute (CESifo), Munich; See also David S. Mitchell, Factsheet: What the research says about taxing pass-through businesses, Washington Center for Equitable Growth, April 30, 2024 (providing a discussion of emerging research in this space more generally).
131. See Julie-Anne Cronin, U.S. Treasury Distributional Analysis Methodology, U.S. Department of the Treasury, OTA, May 2022 at footnote 14.
132. See Thornton and Duke, supra; Sebastian Dyrda and Benjamin Pugsley, Taxes, Private Equity, and the Evolution of Income Inequality in the US, August 15, 2019.
133. See, e.g., Sneha Kannan, Joseph Dov Bruch, and Zurui Song, Changes in Hospital Adverse Events and Patient Outcomes Associated With Private Equity Acquisition, JAMA-Journal of the American Medical Association, Volume 330, Issue 24, December 26, 2023; and Alexander Borsa, Geronimo Bejarano, Moriah Ellen, and Joseph Dov Bruch, Evaluating trends in private equity ownership and impacts on health outcomes, costs, and quality: systematic review, British Medical Journal, June 11, 2023.

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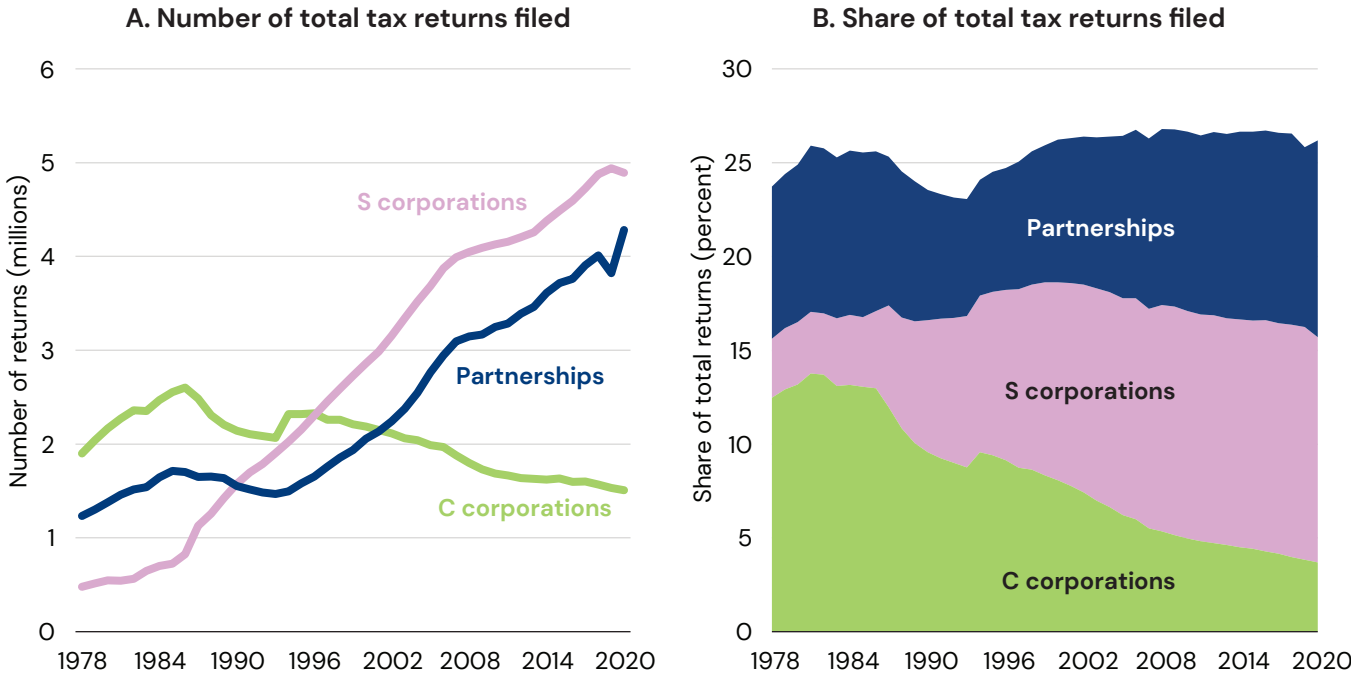
Partnership tax reform should be a key part of the current and upcoming tax policy debate, with large parts of 2017's Tax Cuts and Jobs Act (TCJA) set to expire at the end of 2025. Partnerships are a large and growing slice of the economy, now representing almost 30 percent of all business income in the United States and far outstripping corporate entities by tax returns filed. However, due to deliberate policy choices, drafting accidents where the rules do not achieve what lawmakers might have had in mind, and neglect in updating or fixing outdated rules, partnership tax rules are in need of modernization. This paper focuses on ways to modernize the current partnership tax system within the core of existing partnership tax rules, particularly ways that are feasible as part of the 2025 tax debate. However, larger and more fundamental reforms that change the nature of pass-through taxation should also be considered and are discussed briefly. The paper has three parts: Part I provides background on partnerships and other pass-through entities, including data on their increasing prevalence and key changes in the business landscape. Part II describes the impact of these changes and the budget and tax challenges that partnerships create. Finally, Part III offers both principles and a selection of specific proposals for modernizing partnership taxation, focusing on options most relevant to the 2025 tax debate.

## Total tax returns filed by each entity type, 1978–2020




Source: Joint Committee on Taxation (JCT), Overview of the Federal Tax System as in Effect for 2023, JCX-9R-23, Table A-4, May 11, 2023.

Note: The number of partnerships has more than tripled since 1978, overtaking the number of C corporations.

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