# Senate Finance Chairman Wyden discussion draft to reform taxation of passthrough entities

## KPMG summary and analysis

**NOTE: This report reflects developments as of 9:00 AM EDT on September 17, 2021.**

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Senate Finance Committee Chairman Ron Wyden (D-OR) on September 10, 2021, released a discussion draft of legislation intended to reform the taxation of passthrough entities (the "Wyden Discussion Draft)." He also released a one-page summary and a section-by-section summary of the draft proposed legislation.

- Read the **discussion draft** [PDF 78 KB]
- Read the **one-page summary** [PDF 115 KB]
- Read the **section-by-section summary** [PDF 296 KB]

According to a **press release** that unveiled the draft, the proposed legislation is intended to "close loopholes that allow wealthy investors and mega-corporations to use passthough entities, primarily partnerships, to avoid paying their fair share of taxes." The section-by-section summary further explains that "the provisions of the discussion draft remove optionality that is unnecessary for business ends and close certain tax loopholes that allow investors and corporations to pick and choose when to pay tax."

At this time, Chairman Wyden's proposal is not scheduled for legislative action. Further, none of the proposals in his draft were included in the tax proposals the House Ways and Means Committee recently recommended be included in the "Build Back Better Act" that Congressional Democrats are currently putting together.

Read a 203-page **KPMG report** [PDF 2.3 MB] that includes analysis and observations regarding the proposals approved by the Ways and Means Committee, including the significant revenue-raising proposals relating to passthrough entities (the "KPMG Report on Ways and Means Tax Proposals").

Nonetheless, as explained in the KPMG Report on Ways and Means Tax Proposals, the legislative process for the Build Back Better Act is still evolving and it is possible that changes could be made as legislation potentially moves through the House and Senate, including changes to revenue-raising measures. Thus, it is possible that the Wyden Discussion Draft, or some components of it, could be the subject of discussions as Congress continues its effort with respect to that legislation. Moreover, even if proposals in the Wyden Discussion Draft are not advanced in the near future, they might be considered in other possible future legislation.

Also keep in mind that the proposals are still in the form of a discussion draft. Further, in the event the proposals were to advance through the legislative process at some point in time, some of the details in the current draft could change, including (possibly) proposed effective dates. It is also possible, but far from certain, that grandfather rules might be added in some cases.

This report describes the proposals in the Wyden Discussion Draft and provides initial observations and analysis. This report is organized as follows:

# Contents

Coordination of partnership audit rules .......... 2
Determination of partner's distributive share .......... 3
Mandatory remedial method .......... 6
Mandatory revaluations .......... 7
The built-in loss rules .......... 8
Repeal of time limitation on the anti-mixing bowl rules .......... 9
Modification to alternative rule for determination of partner's basis in interest .......... 10

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Rules relating to transactions between partners and the partnership, guaranteed payments, and liquidating distributions ........ 11
Repeal of section 736 ........ 13
Application of rules relating to payments to partners for property or services ........ 14
Make self-executing disguised sale of partnership interest rules ........ 14
Remove capital expenditure exception to disguised sale treatment ........ 15
Partnership terminations ........ 15
Repeal of requirement that inventory be substantially appreciated in certain partnership distributions treated as sale or exchange ........ 16
Treatment of partnership debt ........ 17
Mandatory adjustments to basis of partnership property in case of transfer of partnership interests ........ 20
Mandatory adjustments to basis of undistributed partnership property ........ 21
Business interest expense and partnerships ........ 23
Treatment of a partnership's disallowed business interest expense ........ 23
Allocation of section 163(j) excess items ........ 25
Excess business interest expense ........ 26
Gross receipts aggregation rules ........ 26
Repeal of exceptions for treatment of publicly traded partnerships ........ 27
Recognition of gain on certain distributions by regulated investment companies ........ 28

# Coordination of partnership audit rules

The Wyden Discussion Draft proposes to amend the general statement in section 701[1] that a partnership is not subject to the income tax imposed by chapter 1 and that the persons carrying on business as partners are liable for income tax only in their separate or individual capacities. The amendment would qualify section 701's general statement by prefacing it with the language, "[e]xcept as otherwise provided in this title" to reflect that, as explained in the section-by-section summary, "following enactment and implementation of the centralized partnership audit regime, partnerships can, at times, be subject to entity-level taxation."

This proposal does not include a proposed effective date.

## KPMG observation

As noted above, this draft proposal currently lacks a proposed effective date. If the proposal were to advance through the legislative process, an effective date presumably would be provided. The section-by-section summary explains that the amendment to section 701 "should allow the IRS to enhance reporting requirements of partnership tax positions by aligning tax reporting with Financial Accounting Standards Board (FASB) reporting" relating to uncertain tax positions that could give rise to an entity-level liability. It is unclear, however, from the discussion draft, how that tax reporting would be aligned with FASB reporting.

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[1] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

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Although the language of section 701, as proposed to be amended by the draft, would contemplate the possibility of circumstances under the Internal Revenue Code under which a partnership is subject to an entity-level liability, the language of the discussion draft does not currently specifically refer to the centralized partnership audit regime. Section 6225 provides that, if an adjustment by the IRS under the centralized partnership audit regime results in an imputed underpayment, the partnership shall pay an amount equal to such imputed underpayment. In turn, section 6232 provides that an imputed underpayment shall be assessed and collected in the same manner "as if it were a tax" imposed by subtitle A of the Code. The Code does not indicate whether an imputed underpayment is a tax imposed by either subtitle A or chapter 1 (which falls within subtitle A). Both the existing language in section 701, and in the proposed amendment, provide only that a partnership is not subject to chapter 1 income tax. Furthermore, the statutory framework allows for the liability arising upon a partnership audit to be "pushed out" to its partners and, thus, not borne at the partnership level.

## Determination of partner's distributive share

Section 704(a) currently provides that a partner's distributive share of income, gain, loss, deduction, or credit is generally determined by the partnership agreement. Section 704(b) provides an exception that states the partner's distributive share will be determined in accordance with the partner's interest in the partnership ("PIP") if either (1) the partnership agreement does not provide as to the partner's distributive share or (2) the allocation to a partner under the partnership agreement lacks substantial economic effect ("SEE"). Regulations under Section 704(b) currently include a detailed safe harbor (the "SEE Safe Harbor") for determining whether allocations have SEE and include a short list of factors to consider in determining PIP.

The draft proposal would replace current sections 704(a) and (b) with a new framework in proposed Section 704(a) that would eliminate SEE and, by implication, the SEE Safe Harbor. Under the proposal, a partner's distributive share generally would always be determined in accordance with PIP taking into account several specific factors, the first three of which are reflected in the current Treasury regulations: (1) the partner's contributions to the partnership, (2) the partner's interest in cash flow and other non-liquidating distributions, (3) the partner's entitlements to distributions upon liquidation, (4) the partnership agreement, and (5) any other factor prescribed by the Secretary.

Proposed section 704(b) would set out the only exception in the proposal to the general use of PIP in testing allocations. The proposed exception generally would apply only to "controlled partnerships" and would require that such partnerships use the "consistent percentage method" ("CPM"). For purposes of this exception, a controlled partnership is one in which two or more members of a controlled group (within the meaning of Section 267(f)) own (within the meaning of section 267(e)(3)) 50% or more of the capital or profits of such partnership. The IRS would have the authority to identify other partnerships that would also be required to adopt the CPM.

Under the CPM, a partner's distributive share of "applicable items" (i.e., any item of partnership income, gain, deduction, loss, or credit) would be based on the partner's "net contributed capital" to the partnership and the partnership generally would have to allocate the same percentage of each applicable item to each partner. A partner's net contributed capital is generally the excess of (1) the sum of the fair market value and the amount of cash contributed by the partner over (2) the amount of liabilities assumed by the partnership in connection with any contribution by the partner. A partnership that is subject to the CPM would be required to report that it is subject to the CPM.

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If the economics of a controlled partnership are inconsistent with the CPM, the draft proposal would treat the inconsistent economics (or "excess share") as a deemed taxable transfer between the partners. A partner's taxable excess share would be the amount by which the partner's interest in partnership property distributable to such partner upon liquidation of the partnership exceeds the interest in such property that the partner would have if the partner's interest were determined based on the partner's net contributed capital. Whether a partner has an excess share would be determined at the end of each tax year of the partnership as well as on the date of any revaluation of the partnership's assets (each, an "applicable date"). If a partner has an excess share on any applicable date, then the partner effectively would be treated as receiving an additional interest in the partnership from the other partners and would be required to include the value of such interest in its gross income. No other partner would be permitted a corresponding deduction or loss for the deemed transfer of such interest.

The proposal also includes several conforming changes and would authorize the Secretary to prescribe regulations to carry out the purpose of the section, including regulations or guidance to "simplify the application of the section" and for the application of the section to tiered partnerships.

Under the discussion draft, the proposed revisions relating to sections 704(a) and (b) would apply to tax years of partnerships beginning after December 31, 2023.

## KPMG observation

If enacted in its current form, the impact of the proposal on any given partnership would vary depending on whether that partnership currently relies on the SEE Safe Harbor to support its allocations or is a controlled partnership.

## KPMG observation

**Partnerships that rely on the SEE Safe Harbor**

If enacted, the proposal could significantly affect the determination of a partner's distributive share for any partnership that currently relies on the SEE Safe Harbor. This would be particularly true for any partnership that makes special allocations in reliance on existing presumptions within the SEE Safe Harbor, such as the "value-equals-basis" presumption and the "five-year rule." Those presumptions relate to the current substantiality test for determining whether certain special allocations are respected and many current special allocations may not be respected under the proposed PIP standard. In this regard, we note that the draft effective date, while delayed, does not currently include any grandfathering provision for existing partnerships. The potential lack of any grandfathering provision means that the potential impact of the proposal may need to be taken into account in negotiating and drafting future partnership agreements or amendments to existing agreements.

For example, the proposed elimination of SEE creates new potential risks for so-called tax equity "flip" partnerships. These partnerships are often used to make investments in renewable energy projects and their economics rely in part on the presumptions in the SEE Safe Harbor to support special allocations of depreciation and renewable energy tax credits to the so-called tax equity partner. In existing deals, it is typical for the tax equity partner to assume the risk that the anticipated allocations will be respected only once they fund their contribution to the partnership. Until the funding is actually contributed, however, it has been customary to include a change-in-law provision to allow the partner to opt out of funding. Participants in such transactions may need to

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consider whether the release of the Wyden Discussion Draft could impact any existing change-in-law provisions.

Similarly, partnerships that hold real estate may endeavor to manage the risk of unrelated business taxable income from debt-financed real property for certain tax-exempt investors by entering into arrangements that fit into an exception that requires allocations that satisfy the so-called "fractions rule" and that meet the SEE standard. However, it appears that conforming changes for this rule were anticipated as the proposal includes a change to Section 514(c)(9)(E)(i)(II) from requiring that allocations satisfy the SEE standard to requiring that allocations be in accordance with PIP.

## KPMG observation

**Partnerships that do not rely on the SEE Safe Harbor**

Many partnerships do not currently rely on the SEE Safe Harbor and may not be significantly impacted if the proposal were to be enacted. For example, many investment and asset management partnerships make distributions and liquidate in accordance with a cash distribution waterfall rather than the partners' positive capital accounts. Such partnerships typically adopt a "target" allocation approach and as such are generally already subject to the PIP standard.

## KPMG observation

**Controlled partnerships**

If enacted, the draft's proposed requirement for controlled partnerships to use the CPM could have a substantial impact on many existing controlled partnerships, especially those with partnership agreements that provide for special allocations, such as tracking allocations, as well as those that have economics other than a straight-up sharing based on relative contributed capital, such as partnerships with a preferred member and a common member. Under the proposal, such special allocations and varying economics appear to be currently taxable and revising or unwinding such existing partnerships could be difficult or costly. It is also unclear to what extent the proposal for controlled partnerships relates to or otherwise overrides existing section 482 principles.

It is worth noting that the determination of whether a partnership is a controlled partnership would be difficult. The draft proposal looks to whether two or more members of a controlled group (within the meaning of section 267(f) own (within the meaning of section 267(e)(3)) 50% or more of the capital or profits in such partnership. Questions have existed for years as to how a partnership determines a partner's share of capital (is it based upon fair market value, section 704(b) capital, or tax basis capital accounts?), and a partner's share of profits (is it determined at a specific moment in time, on an annual basis, or over the life of the partnership?). Absent clarification to the proposal, regulations would be needed to address these questions. The proposal also includes a special reporting rule that would require each controlled partnership to submit a statement that such partnership is a partnership to which the new rules apply. The purpose of this special reporting rule, and any potential impact a failure to comply with it could have under the centralized partnership audit regime, is unclear.

The proposed definition of "net contributed capital" could give rise to some unusual, and potentially unintended, consequences. For example, a partner's net contributed capital is not

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reduced by disproportionate distributions to the partner or increased by unrealized appreciation resulting from revaluations which may be mandatory under other provisions in the Wyden Discussion Draft. As such, it appears that a partner who is partially redeemed out of the partnership may retain its original net contributed capital for purposes of applying the CPM even though the distribution may have changed the partners' relative economic share of the partnership. The failure to account for revaluations could also result in potentially unusual required allocations if partners make disproportionate contributions over time. For example, assume A, B and C are members of a controlled group within the meaning of Section 267(f) and that in Year 1, A and B each contribute $50 to a newly formed partnership, PRS. In Year 2, when the overall value of PRS has increased from $100 to $200, C contributes an additional $100 for a 1/3rd economic interest. Notwithstanding the pro rata economic sharing of A, B and C following C's contribution, the proposed statutory definition of "net contributed capital" would appear to require that allocations among A, B and C be made 25%, 25% and 50% rather than a third to each because A and B each only contributed $50 whereas C contributed $100. While the IRS and Treasury might address these and other circumstances (for instance the potential impact of section 734 adjustments, which may be mandatory in all events under other proposals in the Wyden Discussion Draft) through regulation, it might take some time for them to issue such regulations.

### KPMG observation

Overall, although there may be improvements that could be made to Section 704 as it currently stands, eliminating the SEE Safe Harbor and adopting PIP as the standard for respecting partnership allocations would be a foundational change. The entire framework of subchapter K was built on this foundation and changes to this fundamental could have unanticipated ramifications. Many partnerships today comprise complex and contingent economic arrangements that raise difficult and unanswered questions under the current Section 704(b) regime as to how to properly determine the partners' distributive shares outside of the SEE Safe Harbor. In eliminating the SEE Safe Harbor, the proposal would not resolve these questions. The proposal does contemplate new regulations to "simplify the application of the section," but it is not clear what form such new regulations would take.

## Mandatory remedial method

Under current law, when allocating items to its partners, a partnership is required under section 704(c)(1)(A) to take into account the difference between the fair market value and tax basis of any property contributed to, or revalued by, the partnership. In making these allocations, the partnership may use any method that is reasonable taking into account the purpose of section 704(c). The regulations under section 704(c) provide for the following three methods—the use of which is generally considered reasonable: the traditional method, the curative method, and the remedial method.

The proposal in the Wyden Discussion Draft would mandate the use of the remedial method in all cases. The traditional method and the curative method would be eliminated.

As currently drafted, the proposal would apply to contributions and revaluations occurring after December 31, 2021.

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### KPMG observation

If adopted, the required use of remedial allocations would result in a partner often recognizing income with respect to contributed property. Although such income would be deferred, it could be viewed as putting contributions to a partnership at a disadvantage compared to a corporation.

Currently, the selection of the section 704(c) method for a particular item of property may be negotiated by the partners. Restricting all partnerships to use the remedial method would reduce the flexibility that the partners currently enjoy in negotiating their arrangements. Although requiring use of the remedial method could be viewed as a simplification, it is likely that regulations would be needed to address issues that arise for partnerships that currently take section 704(c) into account under one of the other methods, and for partnerships that currently use aggregation under section 704(c).

Mandatory adoption of the remedial method may also impact the tax distributions required under a partnership agreement. A contributing partner may want to receive tax distributions to cover the tax cost of the remedial allocation, resulting in potential non-prorata distributions.

Finally, it is important to note that the potential effective date of the draft proposal should be considered by taxpayers that are considering transactions – such as property contributions - that could occur in 2021 or 2022.

## Mandatory revaluations

The current regulations under section 704(b) generally allow, but do not require, a partnership to revalue its assets upon the occurrence of certain events, each a “revaluation event.” Revaluation events currently include disproportionate contributions to the partnership, disproportionate distributions by the partnership, the issuance of a partnership profits interest, and the issuance of non-compensatory options to acquire an interest in the partnership.

The proposal in the Wyden Discussion Draft would require revaluations upon the occurrence of a revaluation event currently described in the regulations. The proposal would also require revaluations upon a change in the economic arrangement of the partners, such as recapitalization transactions in which a partner’s share of income and loss is altered. Under the proposal, revaluations at an upper-tier partnership would require a revaluation of the assets in a lower-tier partnership, if the upper-tier partnership owns more than 50% (by capital or profits) of the lower-tier partnership.

### KPMG observation

If the draft proposal were enacted, the complexity of partnership compliance would increase significantly—particularly for tiered partnerships that hold majority owned lower-tier partnerships that use multiple preparers as part of the compliance process. As a result, the cost of compliance would increase for partnerships that would be required to revalue and to determine the value of the partnership assets on a property-by-property basis and to track section 704(c) layers through tiers for purposes of compliance. Additional costs would also likely be incurred by the partnership to determine the value of assets for purposes of the revaluation at each entity.

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## KPMG observation

Consistent with the current regulations, the proposal in the Wyden Discussion Draft provides a de minimis exception to the requirement to revalue a partnership's assets. Practitioners often struggle to determine what should be considered "de minimis" in a particular context. For example, is "de minimis" defined by a specific amount or is it relative to the particular context? If a partnership has a value of $500 million, is a contribution of $100,000 de minimis? If, instead, the value of the partnership was $500,000 at the time of the new contribution, is the same $100,000 contribution still de minimis? Given the mandatory nature of the proposal, additional guidance would be needed on this issue if the draft proposal were enacted in its current form.

## KPMG observation

Under the draft proposal, where an upper-tier partnership owns 50% or more of the capital or profits of a lower-tier partnership, a revaluation event at the upper-tier partnership level would require the lower-tier partnership to revalue its assets even when the lower-tier partnership has no change in the economic sharing among its partners. The revaluation could have a significant impact on the allocations under the lower-tier partnership's waterfall provisions and may entitle a partner, such as a general partner in a fund, to a carried interest allocation when it otherwise would not be. As a result, the revaluation could affect both the timing and character of the lower-tier partnership's income allocations.

## KPMG observation

Query as to whether a majority-owned standard is proper for identifying the lower-tier partnerships which would also be subject to revaluation. It is often the case the one partner may hold a majority of the capital or profits in a partnership, but the control of the partnership may rest with another partner (such as a general partner) or a board in the case of a limited liability company. Is it appropriate to require a revaluation of a lower-tier when the upper-tier may not have any ability to control the lower-tier?

# The built-in loss rules

Under current law, if a partner contributes to a partnership property the fair market value of which is less than its tax basis (i.e., loss property), the partnership is required to take into account the loss only in determining the amount of items allocated to the contributing partner. In determining the amount of items allocated to any other partner, the partnership's basis in the contributed property is considered to be its fair market value.

This special rule in section 704(c)(1)(C) specifically applies to loss property contributed to a partnership. The Wyden Discussion Draft would require that rules similar to the loss property rule in section 704(c)(1)(C) apply to property that is revalued by the partnership.

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### KPMG observation

It is worth noting that when drafting proposed regulations to implement section 704(c)(1)(C), the Treasury Department specifically declined to extend the application of the rule to revalued property. Additional guidance would be needed to address the proper application of this rule to revalued property.

As currently drafted, the proposal would make certain conforming changes and would apply to revaluation events occurring after December 31, 2021.

### KPMG observation

Finally, it is important to note that the potential effective date of the draft proposal should be considered by taxpayers that are considering transactions that may result in a revaluation in 2021 but would result in a required revaluation in 2022.

## Repeal of time limitation on the anti-mixing bowl rules

Under current law, when a partner contributes built-in gain or loss property to a partnership, the partner must recognize the gain or loss if the property is distributed to another partner within seven years of the contribution. Similarly, the contributing partner must recognize the gain if other property is distributed to him or her within seven years of the contribution. Together these rules are commonly referred to as the anti-mixing bowl rules.

The proposal in the Wyden Discussion Draft would eliminate the seven-year time limitation on the application of the anti-mixing bowl rules. Accordingly, these rules would apply indefinitely while the partnership owns the contributed property. In addition, the draft proposal would limit the application of the anti-mixing bowl rules in both cases to the recognition of gain by the contributing partner. A distribution of contributed loss property to a partner other than the contributing partner under the proposal would not accelerate the recognition of the loss. Finally, while the proposal contemplates that the anti-mixing bowl rules would not apply to revaluations, it would give discretion to the Secretary to issue regulations to the contrary.

Under the discussion draft, the proposal would apply to property contributed to a partnership after December 31, 2021.

### KPMG observation

The contribution (or deemed contribution) of property results in the potential application of the anti-mixing bowl rules. The partnership is required to track section 704(c) (and any successor asset) and a taxpayer who acquires a contributing partner's interest in the partnership "steps into the shoes" as the contributing partner. To the extent that the anti-mixing bowl rules would apply indefinitely, they could raise significant concerns any time the partnership distributes any property to its partners. Moreover, the proposal would increase the due diligence required when evaluating the acquisition of an interest in the partnership.

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### KPMG observation

The potential effective date of the draft proposal should be considered for any partnership transactions that may involve actual or deemed contributions or distributions of property to a partnership—including certain mergers, divisions, and transactions that result in a "springing" partnership under Rev. Rul. 99-5 or "disappearing" partnerships under Rev. Rul. 99-6.

## Modification to alternative rule for determination of partner's basis in interest

The proposal would amend section 705(b), which provides an alternative rule for computing a partner's outside basis in its partnership interest. Current section 705(b) requires the Secretary to prescribe by regulation the circumstances under which the adjusted basis of a partner's interest in a partnership may be determined by reference to his proportionate share of the adjusted basis of partnership property upon a termination of the partnership.

The proposal would strike "upon a termination of the partnership" from the statute, effective on the date of enactment. The stated intent of the draft's proposed amendment is to afford greater flexibility to prescribe rules for determining outside basis by allowing the alternative rule to be applied in scenarios other than partnership terminations.

### KPMG observation

The intended import of the draft proposal is unclear. If the proposal is intended to allow the use of the alternative method any time it is necessary to determine a partner's adjusted tax basis in its partnership interest, the proposal seems unlikely to have a material impact on taxpayers because current regulations under section 705(b) interpret the alternative rule as allowing a partner's outside basis in its partnership interest to be determined by reference to the partner's share of the basis of partnership property which would be distributable upon termination of the partnership. In other words, the regulations do not expressly limit the use of the alternative method solely to partnership terminations, but rather employ a hypothetical liquidation approach to determining a partner's outside basis any time a partner's basis must be determined. If the amendment is intended to permit the Secretary to use methodologies other than the hypothetical liquidation approach, it is unclear what other methodologies are intended.

As a practical matter, the ability to use the alternative method may have become much more limited by the advent of mandatory tax capital reporting effective for tax years beginning on or after January 1, 2020. Under current regulations, use of the alternative method is permitted in two situations: (i) where the general rule of section 705(a) cannot be practically applied and (ii) where the Service determines that use of the alternative method would not produce a substantially different result than the historical approach of section 705(a). Under the general rules of section 705(a), a partner's outside basis in their partnership interest is computed using a historical transactional approach that takes into account contributions and distributions of cash or property and the partner's share of partnership income and loss. Compliance with the tax capital reporting

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rules necessitates the tracking and reporting of the items taken into account under the general rule of section 705(a).

## Rules relating to transactions between partners and the partnership, guaranteed payments, and liquidating distributions

Current law distinguishes between transactions between a partnership and one of its partners based on whether the partner is acting in a partner or non-partner capacity. Under section 707(a), payments made to a partner acting in a non-partner capacity are treated as occurring between the partnership and one who is not a partner. Payments made to a partner acting in a partner capacity are treated either as part of the partner's distributive share or, to the extent determined without regard to income of the partnership, as a guaranteed payment for services or the use of capital under section 707(c). Implicit in this distinction is that payments for services rendered in a **partner capacity** that are determined **with regard to partnership income** are subject to the distributive share rules of section 704(b) and not section 707.

The proposal would amend section 707 to repeal the rules relating to guaranteed payments for services and the use of capital under section 707(c) and expand the scope of section 707(a) to include such payments. According to the section-by-section summary, section 707(a) would govern any payments "that are not actual or in substance distributions under section 731, treating them as payments to a partner not acting in its capacity as a partner."

As currently drafted, the proposal would apply to transactions and payments after December 31, 2021.

### KPMG observation

At first blush, the import of this proposal would seem primarily to change the timing of the income recognition and deduction of payments currently governed by section 707(c). Under current law, one primary consequence of the distinction between a section 707(a) payment and a section 707(c) payment is the timing of the income recognition to the recipient partner and the deduction to the partnership. A partner includes a section 707(c) guaranteed payment in income according to the partnership's method of accounting. Thus, if a partnership uses the accrual-basis method of accounting for U.S. federal income tax purposes, a partner using the cash-basis method of accounting is required to include a section 707(c) guaranteed payment from the partnership in income when accrued by the partnership under the partnership's method of accounting. In contrast, a partner includes a section 707(a) payment in income according to its method of accounting, and the partnership cannot deduct the section 707(a) payment until the partner includes the payment in income.

The draft's proposed change is consistent with the recommendation of a 2001 Joint Committee on Taxation study on simplifying the Code, cited in the section-by-section summary. However, if enacted, the proposal could have significant implications beyond conforming the timing the differences between section 707(a) and 707(c) payments, would raise significant new issues not otherwise addressed in the current draft of the proposal, and might do little to address existing uncertainties in the law.

It appears the proposal to repeal section 707(c) is based largely on the recommendations of a 1999

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report prepared by members of the American Bar Association, Section of Taxation, cited in the section-by-section summary (the "1999 ABA Report"). The 1999 ABA Report recommended the repeal of section 707(c) for three primary reasons: (i) it is often impossible to distinguish when a partner is acting in a partner vs. non-partner capacity, (ii) it is often difficult to determine when payments should be considered to be determined without regard to partnership income and (iii) the treatment of guaranteed payments for the use of capital ("GPUCs") under other Code sections is unclear (i.e., is the payment interest or something else?). The 1999 ABA Report concludes that the treatment of nearly all payments currently governed by section 707(c) could be adequately determined under the distributive share rules of section 704(b) or section 707(a).

Distinguishing between when a partner is acting in a partner capacity vs. non-capacity has been a source of confusion in the tax law, primarily related to payments for services. In today's world, however, the more relevant issue regarding partnership compensation of service providers is whether the compensation constitutes a section 707 payment and thus ordinary income, or a distributive share of partnership income the character of which is determined by the underlying income and activities of the partnership.

Distinguishing between a distributive share of partnership income and ordinary compensation income is largely controlled by the principles of section 707(a)(2), which are intended to distinguish between disguised payments for services in the form of an allocation and corresponding distribution and a partner's distributive share. The technical rule of section 707(a)(2) states that, if the performance of services and an allocation and corresponding distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership, the allocation and distribution will be treated as a section 707(a) payment. Under proposed regulations issued in 2015, the overriding factor in this determination is whether the payment is subject to significant entrepreneurial risk. While section 707(a)(2) literally does not apply to, or result in, guaranteed payments for services under section 707(c), it is the same functional analysis that would be applied under section 707(c) to determine whether a payment for services is determined without regard to the income of the partnership. Thus, reclassifying section 707(c) payments for services as section 707(a) payments for services is unlikely to have any meaningful impact on the substantive inquiry of when compensation is an ordinary income payment vs. distributive share.

The more meaningful impact of the proposal seemingly would be the treatment of partner compensation under section 707 for other purposes of the Code. Treating all compensatory payments to partners as section 707(a) payments would implicate the long-standing position of the Service that a partner cannot also be an employee of the partnership. If the payment of a partner's salary is to be treated as made to one who is not a partner, it begs the question of whether such payment should be considered wage income or, perhaps, made to an independent contractor. If the draft proposal is not fleshed out to address the impact of eliminating guaranteed payments on other code sections, it could create confusion and additional complexity.

Historically, the capacity issue has been less meaningful for GPUCs because the partner is clearly acting in a partner capacity when it contributes capital to a partnership in return for a preferential return on that equity. Conversely, when a partner makes a bona fide loan to a partnership, the partner is clearly acting as a lender in a non-partner capacity. Thus, interest on a bona fide partner loan is a section 707(a) payment and is treated as interest for other purposes of the Code. In contrast, preferential returns on partnership equity currently must be characterized either as a distributive share of partnership or a GPUC. The draft proposal currently leaves uncertain how GPUCs should be taken into account – as interest, an interest "equivalent" or as a distributive share (even if determined without regard to income).

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For the reasons above, the potential elimination of section 707(c) as of December 31, 2021 (depending on whether the proposal advances in the legislative process and, if so, when) should be considered in virtually all partnership transactions as it could have implications for any entitlements—either for capital or services—going forward.

# Repeal of section 736

In tandem with the amendments to section 707, the draft proposal would repeal section 736 in its entirety. Section 736 classifies payments made to a retiring or withdrawing partner or a deceased partner's estate or successor-in-interest (unless the estate or successor continues as a partner in its own right under local law). To the extent such payments are made in exchange for the partner's interest in partnership property under section 736(b), the payments are treated as distributions subject to the general rules of sections 731, 732 and 751(b). All other payments are treated under section 736(a) either as part of the partner's distributive share of partnership income or as a section 707(c) guaranteed payment, depending on whether the payment is determined with or without regard to the partnership's income.

The discussion draft proposes to repeal section 736 with respect to successors-in-interest and partners retiring after December 31, 2021.

## KPMG observation

The dichotomy between section 736(a) and 736(b) payments is primarily relevant to service partnerships. As a general matter, the amount paid in redemption of a partner's interest in a partnership should reflect the value of (and be treated as in exchange for) the partner's interest in the assets of the partnership. However, certain payments made in liquidation of a partner's interest in partnership property are expressly excluded from section 736(b) and thus treated as section 736(a) payments. This limited exclusion applies only to payments (i) by a partnership in which capital is not a material income-producing factor (ii) to a retiring or deceased general partner (iii) in exchange for the general partner's interest in unrealized receivables of the partnership (as defined in section 751(c), but excluding recapture and similar items) and goodwill of the partnership, except to the extent that the partnership agreement provides for payment with respect to goodwill. In light of the potential effective date, this change should be considered by eligible retiring partners in 2021 or 2022.

Treating a payment to a retiring or deceased partner as a section 736(a) payment typically provides an immediate tax benefit to the remaining partners. Section 736(a) payments, to the extent treated as a distributive share of partnership income, generally will result in a corresponding allocation of income to the retiring or deceased partner that reduces the amount of income allocated to the remaining partners. To the extent treated as a guaranteed payment under section 707(c), a section 736(a) payment will be treated as ordinary income to the retiring partner and will result in an ordinary deduction to the partnership that reduces the amount of income allocable to the remaining partners.

The effect of repealing section 736 would be to treat all payments in exchange for a retiring or deceased partner's interest in a partnership as liquidating distributions under the general distribution rules of section 731 and the exceptions thereto, including section 751(b). To the extent a retiring or deceased partner recognizes income or gain under section 731, under current law, the

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partnership would be entitled to adjust the basis in its remaining assets under section 734 if a section 754 election is in effect. As discussed below, section 734 adjustments are proposed to be mandatory. To the extent a distribution is treated as a sale or exchange of property between the retiring or deceased partner and the partnership under section 751(b), the basis in the property deemed sold would be adjusted to equal its fair market value. In either case, the adjustment may not provide the same immediate benefit of reduced taxable income to the remaining partners.

# Application of rules relating to payments to partners for property or services

The Wyden Discussion Draft makes two proposals with respect to section 707(a)(2), which relates to disguised sales and disguised payments involving partnerships.

## Make self-executing disguised sale of partnership interest rules

In general, contributions to, and distributions from, partnerships are subject to nonrecognition treatment. Several exceptions, however, prevent nonrecognition treatment under certain circumstances. Section 707(a)(2) provides an exception relating to payments to partners for property or services. This provision is intended to prevent nonrecognition treatment in circumstances in which a contribution to, and distribution from, a partnership are more properly characterized as (1) a payment for services, or (2) a sale of property or a partnership interest. The Wyden Discussion Draft would amend section 707(a)(2), relating to disguised sales and disguised payments for services, to make it self-executing without Treasury regulations, by revising the provisions to be applicable "[e]xcept as provided by the Secretary" rather than "[u]nder regulations prescribed by the Secretary," as provided in the current statute.

This provision would apply to services performed or property transferred after the date of the enactment of the provision.

### KPMG observation

The section-by-section summary makes clear that this potential change is aimed at addressing disguised sales of partnership interests and is intended to foreclose recent assertions by certain commentators that the disguised sale of partnership interest provisions cannot be applied absent the promulgation of Treasury regulations. Many practitioners and taxpayers, however, already viewed the disguised sale of partnership interest rules to be applicable without Treasury Regulations. Although not discussed in the section-by-section summary, the change would apply also to disguised payments for services. In the preamble to proposed Treasury regulations issued in 2015 that addressed disguised payments for services, including arrangements known as "fee waivers," the Treasury Department and the IRS made clear their view that, in the absence of final regulations, "the determination of whether an arrangement is a disguised payment for services under section 707(a)(2)(A) is made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 707(a)(2)."

The section-by-section summary describes the proposal as intended to "correct" certain asserted "ambiguities." However, a rule of construction included in the proposal would preclude any

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inference regarding the proper treatment under section 707(a) with respect to payments from a partnership to a partner for property transferred or services performed on or before the enactment of the provision.

## Remove capital expenditure exception to disguised sale treatment

Treasury regulations under section 707 allow a partner to receive a reimbursement of preformation capital expenditures in connection with a contribution of property to a partnership without triggering disguised sale treatment under certain circumstances.[2] The Wyden Discussion Draft would amend section 707(a)(2)(B) to expressly provide that "a transfer of money or other property by a partnership to a partner or by a partner to a partnership will not fail to be characterized as part of a sale or exchange of property because such transfer is made to reimburse the partner or partnership for an expenditure chargeable to capital account."

This draft provision is proposed to apply to property transferred after the date of its enactment. However, the proposal includes an exception for transfers of property made pursuant to a binding contract in effect on the proposal's enactment date and at all times through the property's transfer.

### KPMG observation

Partnerships across many industries (real estate in particular) rely upon this exception to reimburse partners for property and expenditures made prior to the partnership's formation. The inability to be reimbursed for actual outlays would not only limit the ability to extract cash (and potentially fund new investments) without incurring tax, but also may cause a portion of "qualified liabilities" to be treated as additional disguised sale proceeds. Under the disguised sale regulations, the contribution of property subject to qualified liabilities generally does not give rise to disguised sale consideration unless the transfer is otherwise treated as part of a sale. If the transfer is otherwise treated as part of a sale (e.g., because the exception for reimbursement of preformation capital expenditures is not available), then, to the extent provided in the regulations, the partnership's assumption of the liability or taking the property subject to a liability is treated as sale consideration.

The proposal's effective date would be determined by reference to the date property is transferred to the partnership (not the date of a subsequent distribution). Therefore, taxpayers should consider the impact of the potential enactment of this proposal on property that has been or may be contributed to a partnership.

# Partnership terminations

Under current law, a partnership is considered terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership. The proposal in the Wyden Discussion Draft adds to the current rule providing that a termination also does not occur if the partnership continues to be carried on by a person related (under sections 267 or 707(b)) to any of its partners.

[2] Treas. Reg. § 1.707-4(d).

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The rule would apply to tax years beginning after the date of enactment.

### KPMG observation

There is a dispute among practitioners whether, under current law, a continuation of a partnership requires at least one of its historic partners to continue to be a partner. For example, if A and B, sole partners in the Partnership AB, sell their entire interests to C and D, some practitioners take the position that the partnership does not terminate because its business operations continue to be conducted in partnership form. By adding related parties to this rule, the draft proposal appears to reflect the view that a partnership terminates unless a historic partner (or, under the proposal, a person related to a historic partner) continues to be a partner. That is, under this view, when A and B sell their interests to C and D, the partnership would terminate.

## Repeal of requirement that inventory be substantially appreciated in certain partnership distributions treated as sale or exchange

Under current law, section 751(b) requires the recognition of ordinary income or loss in connection with a distribution that results in a shift in the partners' interests in ordinary income assets of the partnership (so-called, "hot assets"). The intended purpose of section 751(b) is to prevent a distribution of property from converting the character of a partner's share of the unrealized appreciation in the partnership's assets from ordinary to capital in nature. Section 751(b) applies to a distribution if a partner receives (i) a disproportionate distribution of hot assets in exchange for all or part of the partner's interest in other partnership property (so-called, "cold assets") or (ii) a disproportionate distribution of cold assets in exchange for all or part of the partner's interest in hot assets of the partnership. If section 751(b) applies to a distribution, the distribution of property will be treated, in part, as a taxable sale of hot assets for cold assets between the distributee partner and the partnership.

For purposes of section 751(b), hot assets include unrealized receivables and substantially appreciated inventory. Inventory is broadly defined as (i) stock in trade of the partnership, or other property of the partnership that would be considered inventory if on hand at the close of the partnership tax year, or property held by the partnership primarily for sale to customers in the ordinary course of its trade or business (so-called "dealer property"), (ii) any other property, which on sale or exchange by the partnership, would be considered property other than a capital asset or section 1231 property (generally, depreciable or amortizable property and real property held for more than one year and used in connection with a trade or business), and (iii) any other property retained by the partnership that if held by the distributee partner would be described in the foregoing clauses.

Inventory is considered substantially appreciated if the aggregate fair market value of all inventory items of the partnership exceeds 120% of the aggregate adjusted tax basis of such property in the hands of the partnership (without regard to any special basis adjustment of any partner under section 743(b)). Thus, the distribution of specific inventory items which are substantially appreciated in value will not trigger the application of section 751(b) if the inventory items of the partnership prior to distribution, as a whole, are not substantially appreciated in value. Conversely, the distribution of specific inventory items

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which are not substantially appreciated in value will be subject to section 751(b) if the inventory items of the partnership prior to distribution, as a whole, are substantially appreciated in value.

The draft proposal would remove the substantial appreciation component for inventory for 751(b) purposes for distributions occurring after the date of enactment. Thus, any distribution of property that alters the partners' interests in inventory items of the partnership would trigger the application of section 751(b).

As currently drafted, the proposal would apply to distributions after the date of enactment.

### KPMG observation

In contrast to section 751(b), section 751(a) does not have a "substantial appreciation" requirement with respect to inventory items. Rather, under section 751(a), if a partner sells their interest in a partnership, the partner is required to recognize ordinary income (or loss) equal to the amount of ordinary income (or loss) that would be allocated to partner if the partnership had sold all of its asset for fair market value immediately prior to the transfer of the interest. Thus, section 751(a) looks to the partner's share of unrealized gain (or loss) in the partnership's hot assets, rather than the partner's share of the value of the partnership's hot assets.

## Treatment of partnership debt

The Wyden Discussion Draft proposes to dramatically change the rules for allocating partnership liabilities owed to unrelated lenders among partners for all purposes. Section 752 would be amended to provide that partnership liabilities generally are allocated among the partners in the partnership in accordance with each partner's share of partnership profits. The proposal contains an exception applicable to bona fide indebtedness owed to a partner (or a person related to a partner applying the relatedness tests of sections 267 and 707(b)); however, the exception would not apply to a partner's guarantee or other similar arrangement.

As currently drafted, the proposed amendment would apply to tax years beginning after December 31, 2021 and does not include a grandfathering provision for liabilities existing at that time. However, a separate provision would create an election to pay the "net tax liability" arising by reason of the provision's enactment in eight equal, annual installments, beginning with the first tax year beginning after December 31, 2021. The first payment would be due on the due date of the return for the tax year beginning after December 31, 2021, without regard to extensions. Succeeding installments would be due each year after that, also on the due date for the return for that tax year, determined without regard to extensions. The election must be made not later than the due date for the tax return for the first tax year beginning after December 31, 2021 and must be made in such manner as the Secretary shall provide.

The taxpayer's "net tax liability" is effectively the excess of the taxpayer's regular tax liability, reduced by certain credits for the tax year in which an amount is included, over the taxpayer's regular tax liability without taking into account the amount arising from the enactment of the provision.

Upon certain events, payment of the unpaid portion of the net tax liability would be accelerated. These events would include an addition to tax for failure to timely pay any installment required under the provision, a liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 or similar case), a cessation of business by the taxpayer, or any similar circumstance. Acceleration would

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not apply in the case of a sale of substantially all the taxpayer's assets to a buyer if the buyer enters into an agreement with the Secretary to be liable for any remaining installments in the same manner as if such buyer were the taxpayer. The proposal also includes a provision that would generally allow a deficiency assessed with respect to a net tax liability for which an election to pay in installments was made to be prorated among, and paid together with, future installments. This provision would not apply if the deficiency was due to negligence or to intentional disregard of rules or regulations or to fraud with intent to evade tax.

The proposal also contains a provision that generally would provide that, in the case of a request for credit or refund, an installment is not to be taken into account as a liability for purposes of determining whether an overpayment exists before the date on which such installment is due. The proposal would also provide that an installment shall not be treated as a tax imposed by the Code for purposes of section 6425 (relating to adjustments of overpayments of estimated income tax by corporations) or sections 6654 and 6655 (relating to failures by individuals and corporations to pay estimated income taxes). The proposal would also provide that the first sentence of section 6403 does not apply to an installment made under the provision. Section 6403 states that in the case of a tax payable in installments, if the taxpayer has paid as an installment of the tax more than the amount determined to be the correct amount of such installment, the overpayment shall be credited against the unpaid installments, if any.

In addition to changes to the allocation of liabilities, the proposal also would amend section 752(c). Currently, that section provides that a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property. Under the proposal, that language would be revised to provide that a liability to which property is subject shall be considered as a liability of the property's owner and that "the amount of any such liability shall not exceed the fair market value of such property."

As currently drafted, this proposal also would apply to tax years beginning after December 31, 2021.

## KPMG observation

The Wyden Discussion Draft's proposal to allocate liabilities in accordance with each partner's share of partnership profits essentially treats all debt (but for loans from partners or related parties) as nonrecourse debt for all purposes. The section-by-section summary expresses the concern that the current recourse debt allocation regime permits partnerships to manipulate a partner's basis in the partnership and loss allocations, avoid the disguised sale rules, and generate tax-deferred cash distributions. However, the proposed rule would eliminate not only many of the recourse liability rules, but would also appear to override the existing three-tier allocation methodology in the nonrecourse liability regulations that allocates debt in accordance with minimum gain, section 704(c) minimum gain, and excess section 704(c) gain designed to (1) support debt allocations to match nonrecourse deductions, (2) prevent the immediate triggering of gain upon a contribution of property with nonrecourse debt in excess of basis to a partnership, and (3) provide general flexibility in allocating nonrecourse debt among partners. It is unclear how the three-tier allocation methodology implicates the stated concerns.

As noted above, the provision as currently drafted is proposed to be effective for tax years beginning after December 31, 2021 and contains no grandfather clause for existing debt. The section-by-section summary, however, indicates that the election to pay the resulting net tax liability under the proposal's amendments in installments is intended as a "transition rule." If enacted as currently drafted, this change to the liability allocation rules potentially could cause substantial and widespread shifts in debt in partnerships across various industries and across different types of investment funds. The most immediately apparent consequence of such a

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change in the allocation regime would be gain resulting from debt shifting away from partners with negative tax capital accounts that rely on guarantees and other similar credit support arrangements, which would be disregarded under the new rules. However, debt shifts also could arise where partners currently rely upon the three-tier nonrecourse allocation scheme to support deductions and negative tax capital accounts. This proposal would also largely curtail the ability to effect tax-free, leveraged distributions or to avoid generating sale proceeds under the disguised sale rules in the event of a shift of nonqualified liabilities.

Interestingly, the proposal's exception for bona fide indebtedness advanced by a partner or person related to a partner utilizes a more-than 50% threshold under sections 267 and 707(b), unlike the threshold under the current recourse liability rule applicable to related persons, which substitutes 80% or more for "more than 50 percent each place it appears in those sections." This lower threshold potentially could pull into the exception more liabilities than would have been subject to allocation under the current related partner rule under the recourse liability regulations. If liabilities qualifying under the exception were required to be allocated to the partner or related person under the new rule, the lower threshold could create an unexpected debt shift in partnerships in which a related party lender would satisfy the 50% threshold, but did not satisfy the 8% threshold under the current rule.

Such a substantial change to a fundamental aspect of partnership taxation might be anticipated to result in significant uncertainty, particularly in the event the proposal were enacted as currently drafted quickly and with no grandfathering of existing arrangements or transition rules. First, the methodology of allocating liabilities in accordance with partners' respective shares of partnership profits is, itself, inherently uncertain. Numerous commentators have observed that there is no clear definition of (and many possible methods for determining) a partner's interest in partnership profits. A partner's interest in partnership profits could be determined in any number of ways and over different timeframes. Furthermore, under some economic arrangements, partnership profits (and thus, liability allocations) could vary widely on a year-over-year basis. For example, a partnership with a preferred return may earn profits in a given year sufficient only to pay the preferred return, such that 100% of the profits go to a single partner, and in the subsequent year, earn profits sufficient to pay not only the preferred return, but substantial amounts in the ratio of the residual sharing, resulting in partnership profits being shared very differently among the partners.

Second, many aspects of the draft proposal remain unaddressed. If these issues are not further addressed and the proposal were to advance through the legislative process in its current form, guidance would need to be developed in Treasury regulations, which would likely not be available for a significant time period. For instance, it is currently unclear whether the exception's application would be mandatory and whether, for instance, a de minimis exception would prevent certain lender partners with a de minimis percentage interest from being allocated the entire liability.

Third, partnerships and partners may have little time to prepare for the significant consequences that could ensue if the proposal were to move through the legislative process quickly as currently drafted. Partners potentially could seek to refinance liabilities to try to avail themselves of the exception for bona fide partner indebtedness, but the currently proposed effective date and the current lack of transition period might leave little time to affect such arrangements. Debt shifts in a tiered partnership structure could ripple through the entire structure, with a lower-tier partnership debt shift triggering, in turn, a debt shift among the partners of the upper-tier partnership. Depending upon the gain allocation through the tiers, some partners could effectively bear duplicative tax from debt shifts at different tiers. If feasible, partners might consider amending partnership agreements to adjust allocations to manage this issue.

Whereas the provision prescribing the timing of an installment payment refers specifically to the

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due date of the return for the tax year (without regard to any extensions), the provision prescribing the timing of the election refers simply to the due date of the return, and is silent regarding extensions.

The proposal clarifies that if an election is made to pay the net tax liability in eight equal installments, the amount of an installment would not be taken into account as a liability in determining whether an overpayment exists prior to the date on which such installment is due. The proposal also clarifies that if an election is made, the amount of an installment would not be taken into account for purposes of determining estimated tax. The proposal is silent, however, as to the treatment for purposes of determining estimated tax if no election is made.

With regard to the amendment to section 752(c), no explanation of the change has been provided. Thus, its potential impact is uncertain. However, it may be designed to revise the treatment of the portion of a liability that exceeds the fair market value of property securing it at the time it is contributed to a partnership.

# Mandatory adjustments to basis of partnership property in case of transfer of partnership interests

Under present law, a transfer of a partnership interest only gives rise to a section 743 special basis adjustment where the partnership has made an election under section 754 or where there is a substantial built-in loss in the partnership's assets. The Wyden Discussion Draft proposes to repeal section 754 and to make section 743 special basis adjustments mandatory for all transfers of partnership interests.

As currently drafted, the proposal would apply to transfers of partnership interests made after December 31, 2021.

## KPMG observation

Whether or not a partnership will make a section 754 election is a topic frequently negotiated by the partners. A purchasing partner may want a section 743 adjustment to shield it from the built-in gains and losses in the partnership's property, as well as to enjoy the benefit of any cost recovery that results from the additional tax basis. However, the burden of making a section 743 adjustment on the partnership can be significant, requiring it to determine the fair market value of its assets, allocate the basis adjustment among the assets, and then track the recovery of the basis adjustment for the benefit of the transferee partner. As such, many partnerships would prefer to avoid having to make section 743 adjustments, particularly where transfers are expected to be infrequent and only with respect to smaller interests in the partnership.

By proposing to make section 743 adjustments mandatory, the Wyden Discussion Draft (in its current form) would impose a burden on partnerships that otherwise have chosen to not make section 754 elections. However, it is difficult to assess the size of that burden without considering it in the context of the other proposals made in the discussion draft. For example, the proposals to make revaluations under section 704(b) mandatory and to require the use of the remedial method under section 704(c) would appear to reduce the incremental burden of making section 743

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mandatory, particularly in cases where the transfer is coupled with a recapitalization or other change in the sharing of the partners.

If the proposal becomes law in its current form, additional guidance may be needed to address the application of mandatory basis adjustments through tiered partnerships.

Taxpayers should consider the potential of such a change on tax distribution provisions. It is also important to note that, if the proposal were to advance through the legislative process, the potential effective date could have implications for when a taxpayer decides to close a transaction (e.g., in 2021 or 2022).

# Mandatory adjustments to basis of undistributed partnership property

The Wyden Discussion Draft proposes to significantly change the operation of section 734. Similar to the discussion draft proposal with respect to section 743, the discussion draft proposes to repeal section 754 and make section 734 special basis adjustments mandatory for all partnership distributions. However, the discussion draft would also change the methodology for determining the amount of a section 734 basis adjustment to significantly expand its application.

Under present section 734, a partnership that has made a section 754 election (or has a substantial basis reduction to distributed property) will adjust the tax basis of the partnership's property if the distribution to a partner results in:

- The distributee partner recognizing gain or loss under section 731; or
- An increase or decrease to the tax basis of the distributed property under section 732.

The Wyden Discussion Draft would adopt a section 704(c)-style approach and change the focus of section 734 to the remaining built-in gain or loss in the partnership's assets following the distribution. Under the proposal, a partnership would be required to adjust the tax basis of its assets following a distribution to make sure that each partner's "net liquidation amount" remains unchanged by the distribution. Specifically, each partner's net amounts of tax gain or loss allocated to the partner in hypothetical liquidations of the partnership before and after the distribution are compared to arrive at the amount of any section 734 adjustment. With respect to the distributee partner in a non-liquidating distribution, this comparison would also take into account any gain recognized on the distribution under section 731 and the built-in gain or loss in any distributed property in the distributee partner's hands.

As currently drafted, the proposal would apply to distributions made after December 31, 2021.

## KPMG observation

By making section 734 mandatory, the Wyden Discussion Draft proposal (if enacted in its current form) would impose similar additional burdens on partnerships as would the section 743 proposal discussed above. However, the proposed change to the methodology of section 734 also has the possibility of significantly expanding the scope of section 734.

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While utilizing a different methodology, the proposed amended version of section 734 in the Wyden Discussion Draft essentially looks to address the same issue as the current version of section 734. Section 734 looks to maintaining parity between the partnership's inside tax basis in its assets and the partners' outside tax basis in their partnership interests to prevent a distribution of too much or too little tax basis to a partner from shifting built-in gains or losses in the remaining partnership property to the other partners.

However, under current law, a non-liquidating distribution of property by a partnership will only trigger a section 734 basis adjustment in limited circumstances. Under section 732, a distributee partner takes a carryover basis in non-liquidating distributions of property, which means that a partnership can often make a non-liquidating distribution of property with a substantial built-in gain to a partner without triggering a section 734 adjustment to the remaining partnership property. Chairman Wyden may be concerned that this could be used as a tool to effectively shift built-in gains to tax indifferent partners by removing those gains from the partnership. Economically, the other partners would be able to defer recognizing their shares of those gains until the partnership is liquidated.

By proposing to apply a section 704(c)-style approach, the Wyden Discussion Draft appears to be aimed at preventing potential shifts in the built-in gains or losses in partnership property upon non-liquidating distributions. Where a distribution would cause a change in any partner's "net liquidation amount," the proposed section 734 would create an offsetting basis adjustment to the remaining partnership property such that the partner's total share of the net built-in gain or loss in the partnership's property remains unchanged. However, the adoption of such a broad approach could also raise the possibility of a section 734 adjustment resulting from any non pro rata distribution by a partnership.

Although not explicitly stated in the Wyden Discussion Draft, the proposal would seemingly make section 734 adjustments partner specific. Under current law, a section 734 adjustment is made to the common tax basis of partnership property to the benefit of all of the partners. However, by tying the section 734 adjustment to maintaining each partner's total share of partnership built-in gain or loss, the proposal appears to require separate adjustments for each partner. For example, where partners do not share equally in the economics of all partnership property, the section 734 adjustment needed to maintain the net liquidation amount status quo for one partner may look very different than those of other partners.

Also, the proposal has the potential to avoid an unintended increase in gain that may result upon a non-liquidating distribution of section 704(c) property to a partner without a corresponding reduction to the share of section 704(c) gain in the remaining partnership property.

The possible expanded scope of the proposed redesign of section 734 is best illustrated by a simple example. Assume that A, B, and C are equal partners in a partnership. For purposes of simplicity, assume that the partnership only owns two capital assets, which were both acquired by the partnership. At a time when Asset 1 has a fair market value and tax basis of $900 and Asset 2 has a fair market value of $100 and a tax basis of $0, the partnership makes a non-liquidating distribution of Asset 2 to A. A short time later the partnership sells Asset 1.

Immediately before the distribution, we can assume that A, B, and C each have an outside tax basis in the partnership of $300 and a net liquidation amount of $33. Because the distribution to A is not in liquidation of A's interest, under section 732 A would take a carryover $0 basis in Asset 2. With no change to the basis in Asset 2 under section 732, the distribution would not result in a basis adjustment to Asset 1 under the current version of section 734. However, immediately after the distribution, B and C would see their net liquidation amounts reduced to $0, while A's net

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liquidation amount will have increased to $100 ($0 inside the partnership plus $100 to take into account the full built-in gain in Asset 2 in A's hands).

Under existing law, the distribution would allow B and C to economically exchange their shares of Asset 2 for additional shares of Asset 1 while deferring the recognition of their shares of the gain in Asset 2 indefinitely. However, the proposed version of section 734 would look to the changes to the net liquidation amounts of the partners and require basis adjustments to Asset 1 to preserve each partner's pre-distribution net built-in gain or loss. The result would be that B and C would each have a negative section 734 adjustment of $33 in Asset 1. Meanwhile, it appears that the proposal would require a positive $66 section 734 adjustment in Asset 1 for A, creating a possible capital loss inside the partnership for A to offset the "excess" capital gain that A would recognize on the sale of Asset 2 outside the partnership.

As illustrated by the example, the expanded scope of section 734 in the proposal has the potential to create significant complexity upon any disproportionate distributions. If enacted as currently drafted, the proposal could prompt partnerships to put greater restrictions on when the partnership will make non-pro rata distributions, and particularly distributions in-kind. It may also result in greater tension among partners in negotiating the terms of partial redemptions or draw-downs of equity.

Further, if enacted, the proposed redesign of section 734 would likely require the Treasury Department and IRS to issue regulations to provide guidance on the questions that would be raised by this change in approach. Some of the possible areas for guidance could be:

- More complex illustrations of the expected operation of the new section 734 methodology than provided above would be invaluable in clearing up ambiguities in the proposed statutory language.
- Coordinating the definition of a partner's "net liquidation amount" with the proposal to make section 704(b) revaluations mandatory.
- Addressing whether a partner specific section 734 would carry over in the event of a transfer of a partnership interest and whether it would enter into the calculation of the transferee partner's section 743 adjustment.

Given that the provision could potentially be effective for distributions after December 31, 2021 depending upon what happens with the legislative process, the Treasury Department and IRS could be facing a short timeframe in which to draft guidance on an entirely new section 734.

If the proposal were to move forward and the proposed effective date were to remain unchanged, taxpayers should consider the potential impact on any series distributions that are not yet complete and any distributions that could close either in 2021 or 2022.

# Business interest expense and partnerships

## Treatment of a partnership's disallowed business interest expense

Under current law, if a partner is allocated disallowed business interest expense (currently defined as "excess business interest expense" or "EBIE")) by a partnership in a tax year, the partner would treat that EBIE as paid or accrued by the partner in a subsequent tax year only to the extent of the partner's

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allocable share of excess business interest income and excess taxable income from the same partnership. The partner would then apply section 163(j) at the partner level to determine how much of the paid or accrued EBIE and other business interest expense of the partner is deductible in such tax year, taking into account the partner's allocable share of excess taxable income and any other unrelated business interest income and other business income and loss of the partner in the partner's adjusted taxable income for such tax year. Any paid or accrued EBIE that is not deductible by the partner is thereafter treated as business interest expense of the partner and the partner's own business income items can support the deductibility of the paid or accrued EBIE without regard to the partnership's allocation of additional excess taxable income. Further, because excess taxable income is included in a partner's adjusted taxable income, the excess taxable income can be used to allow for a deduction of business interest expense that is unrelated to the partnership.

The proposal would adopt a stricter entity approach to the application of section 163(j) to partnerships. Specifically, the proposal would provide that disallowed business interest expense (no longer defined as "excess business interest expense") of a partnership that is allocated to a partner would be deductible (rather than paid or accrued) by the partner in a subsequent tax year to the extent of the partner's allocation of excess business interest income plus 30% of the partner's allocable share of excess taxable income.

The proposal would eliminate the inclusion of excess taxable income in the partner's adjusted taxable income. As such, no items that comprise the adjusted taxable income of a partnership would be included in the computation of a partner's own section 163(j) limitation.

## KPMG observation

The proposal is more closely aligned with the discussion of section 163(j)(4) in the Conference Report to the Tax Cuts and Jobs Act ("TCJA") and in the Joint Committee on Taxation's General Explanation of Public Law 115-97 issued on December 20, 2018 (the "Blue Book"). Both of these discussions were inconsistent with legislative text of section 163(j)(4), and the Blue Book noted that technical corrections may be needed. The proposals with respect to section 163(j) are not described as technical corrections and are not drafted to be retroactive to the date of enactment of the TCJA.

## KPMG observation

Under the proposal, a partner would not include an allocation of excess taxable income in the partner's adjusted taxable income. This proposed change may be adverse to any partner that incurs debt to invest in a partnership that is engaged in a trade or business, in particular if the partner has no other source of adjusted taxable income or business interest income. For example, a leveraged C corporation blocker that is solely invested in a fund partnership that holds interests in passthrough portfolio companies or real estate would have no source of adjusted taxable income to deduct the blocker's business interest expense during the life of the fund. In addition, if the fund sells all of its assets and liquidates, the blocker would likely not generate any adjusted taxable income from the liquidation of the blocker's interest in the fund despite the fact that the fund's sale of its assets may produce substantial excess taxable income. In that case, the blocker's business interest expense would never be deductible. Taxpayers would need to reevaluate the placement of debt in partnership ownership structures. Further, qualification for an exception from the application of section 163(j), such as the exceptions for an electing real property trade or business or for a regulated utility trade or business (including an electing regulated utility trade or business

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under the 2020 final section 163(j) regulations) will be more important under the proposal.

### KPMG observation

Under the existing rules, if a partner disposes of a partnership interest, any EBIE allocated to the partner that has not been treated as paid or accrued by the partner is added back to the partner's basis in the partnership interest immediately prior to the disposition. This has the effect of reducing the capital gain or increasing the capital loss recognized by a partner in connection with a taxable disposition of the partnership interest, or increasing the basis of replacement property in a non-recognition disposition (for example, a section 721 contribution to a partnership or section 351 contribution to a corporation). However, to the extent the partner has previously been allocated excess business interest income or excess taxable income from the partnership that causes the partner's share of EBIE to be treated as paid or accrued by the partner, the partner would not be entitled to increase the basis of the partner's interest immediately prior to a disposition, even if the paid or accrued EBIE has not been able to be deducted by the partner. This can be detrimental to some taxpayers, including C corporation blockers that are invested in only one partnership.

Under the proposal, an allocation of excess business interest income or excess taxable income to a partner would no longer cause the partner's allocable share of the partnership's disallowed business interest expense to be treated as paid or accrued by the partner. As such, the amount of any disallowed business interest expense that has not been deducted by the partner prior to a disposition would be included in the increase to the partner's basis in the partnership immediately prior to a disposition. This could be beneficial in the case of a partner that has no other source of adjusted taxable income.

## Allocation of section 163(j) excess items

The proposal would modify the allocation of disallowed business interest expense, excess business interest income and excess taxable income ("section 163(j) excess items") that is currently provided for in the 2020 final section 163(j) regulations under the "11 step" process. Under the 2020 final regulations, section 163(j) excess items are generally allocated to partners in a manner that reflects their allocation of items that support the deductibility of the partnership's business interest expense. Under the proposal (1) disallowed business interest would be allocated to partners in the same manner as the items of business interest expense of the partnership, (2) excess business interest income would be allocated in the same manner as items of business interest income of the partnership, and (3) excess taxable income would be allocated in the same manner as items comprising the partnership's adjusted taxable income. Treasury is given authority to issue regulations or guidance as necessary to implement these changes.

### KPMG observation

The proposed change to the allocation of section 163(j) items is presumably intended to provide a simpler allocation regime than the complex "11 step" process in the 2020 final section 163(j) regulations. However, the proposed change could result in an allocation of excess section 163(j) items that may be viewed as a misallocation based on the economic positions of the partners.

For example, assume that A and B are equal partners and the partnership allocates the partnership's $30 of business interest expense $15 to A and $15 to B for the current tax year.

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However, under the partnership agreement, A is allocated $50 of business income and B is allocated $50 of investment income for the year. Under these facts, the partnership's section 163(j) limitation is $15 (30% x $50 of business income) and the partnership has $15 of disallowed business interest expense. Under the 2020 final section 163(j) regulations and the "11 steps," A is allocated the $15 of deductible interest expense (because A is allocated 100% of the partnership's items that comprise the partnership's adjusted taxable income) and B is allocated the $15 of disallowed business interest expense (because B is not allocated any of the partnership's items that comprise the partnership's adjusted taxable income).

However, under the proposed change to the allocation of section 163(j) excess items as applied to the facts described above, A and B would each be allocated disallowed business interest expense in the same manner as the allocation of items of business interest expense. Accordingly, $7.50 of deductible business interest expense and $7.50 of disallowed business interest expense would be allocated to each of A and B, despite that fact that A is allocated 100% of the partnership's items that support the $15 of deductible business interest expense.

## Excess business interest expense

The proposal would codify the definition of excess business interest income that is currently only provided in the 2020 final section 163(j) regulations.

# Gross receipts aggregation rules

The proposal would modify the text of the aggregation rules under section 52(b), which is currently applied to determine the gross receipts of a non-C corporation taxpayer for a number of provisions in the Internal Revenue Code, including qualification for the small business exemption under section 163(j)(3), and the ability to use the cash method of accounting under section 448(b)(3), among many others. Specifically, the proposal would provide that the reference to "trades or businesses" under common control that may be aggregated under section 52(b) includes a trade or business as defined in section 469(c)(5) or (6). Section 469(c)(5) provides that the term "trade or business" includes any activity involving research or experimentation, within the meaning of section 174. Section 469(c)(6) provides that the term "trade or business" includes any activity in connection with a trade or business and any activity with respect to which expenses are allowable as a deduction under section 212.

### KPMG observation

The proposed change would clarify the activities that are taken into account as commonly controlled trades or businesses for purposes of aggregating gross receipts. For example, under the proposal, a private equity fund that owns passthrough or C corporation portfolio companies that is treated as engaged in a section 212 activity rather than a section 162 trade or business would clearly be included in the determination of whether a "parent-subsidiary group under common control," "brother-sister group under common control" or "combined group under common control" exists under the section 52 regulations. In addition, the gross receipts of such an entity would be included in the aggregated group's gross receipts. Accordingly, qualification for the small business exemption under section 163(j)(3) or the ability to use the cash basis method of accounting may be more difficult under the proposal.

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**Proposed effective date**

The changes to sections 163(j) and 52(b) are proposed to apply to tax years beginning after December 31, 2021. The draft proposal currently does not contain any transition rules.

# Repeal of exceptions for treatment of publicly traded partnerships

The Wyden Discussion Draft proposes to repeal the exemption from the corporate income tax for publicly traded partnerships (PTPs) which meet the qualifying income test of section 7704(c). The repeal is proposed to be effective for tax years beginning after December 31, 2022.

## KPMG observation

PTPs generally are classified as corporations for tax purposes. However, section 7704 provides an exception for PTPs that derive at least 90% of their gross income either from certain industries that had traditionally organized as partnerships or from passive investment assets that the investors could have acquired directly. Historically, the natural resources extractive industries have made up the largest share of PTPs whose activities allow them to satisfy the gross income test and continue to qualify as passthrough entities under section 7704. However, a significant number of financial services PTPs have entered the market, as well.

In addition to the lack of a corporate-level tax on the business, investors in PTPs have also benefitted from the flow through of cost recovery deductions as an offset to their allocations of operating income. This has been particularly true in the case of natural resources PTPs. The public investors in these PTPs have received reliable distributions of the cash generated by partnership operations, with relatively small allocations of net taxable income.

The impact of the possible repeal of the qualifying income exception is difficult to assess in isolation. If corporate rates remain low, many PTPs may find that they will remain attractive investment opportunities to the public market despite the loss of passthrough status. Particularly in the financial services space, the reduction in corporate rates already prompted many PTPs to convert to corporate structures for various reasons. However, if corporate rates are raised as part of the budget reconciliation process, many PTPs could determine that they would not be viable as public corporations and may consider either going private to retain their partnership status or otherwise seeking to be acquired.

In the real estate context, some UpREIT operating partnerships and open-ended real estate funds do not conform (or do not commit to conforming) to the other available safe harbors under the section 7704 regulations for avoiding publicly-traded partnership status under section 7704 because these entities generally expect to generate sufficient qualifying passive income (e.g., rent and gain from the sale of real estate). The possible elimination of the qualifying income exception could increase the risk of corporate status for these partnerships.

Chairman Wyden's proposal to repeal the qualifying income exception is similar to earlier proposals seeking to eliminate the qualifying income exception. Most notably, the administration's FY2022

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budget proposal released in May 2021 proposed a repeal of the qualifying income exception for PTPs in the fossil fuel industry. However, the Wyden Discussion Draft provision differs from the administration's FY 2022 budget proposal in two important ways. First, the administration's FY2022 budget proposal did not recommend a complete repeal of the qualifying income exception, and only sought to repeal the exception with respect to PTP's with qualifying income and gains from activities relating to fossil fuels. This would allow have allowed PTP's with qualifying income and gains from real estate and qualifying investment activities to continue to be classified as partnerships. Second, the administration proposed that its FY2022 proposal not be effective until tax years beginning after December 31, 2026, which would have given natural resources PTPs four additional years to prepare for the repeal than is provided by the Wyden Discussion Draft. Therefore, while the Wyden Discussion Draft proposes a longer horizon for repeal of the qualifying income exception than it does for many of the other proposed changes in the discussion draft, it is much less generous as currently drafted than the administration's proposal from earlier this year.

Lastly, consideration should be given to the impact the proposal might have on the financial statements of publicly traded partnerships if enacted in its current form.

# Recognition of gain on certain distributions by regulated investment companies

Corporations generally must recognize gain when distributing appreciated property to their shareholders. However, section 852(b)(6) provides that a regulated investment company ("RIC") is exempt from this rule when distributing property to a shareholder in redemption of its stock upon the demand of the shareholder. The Wyden Discussion Draft would repeal the section 852(b)(6) exemption for RICs, thereby treating RICs in the same manner as other corporations when distributing appreciated property to redeeming shareholders. The repeal is proposed to be effective for tax years beginning after December 31, 2022.

## KPMG observation

Under current law, a RIC that distributes securities with built-in gain to redeem a shareholder effectively disposes of the securities but does not recognize any gain due to the operation of section 852(b)(6). Because RICs generally distribute annually their net capital gain as dividends to avoid an entity level tax, an in-kind redemption can be more tax efficient for non-redeeming shareholders than cash redemptions funded by the proceeds of sales of portfolio securities. Although the in-kind redemption is taxable to the redeeming shareholder, the absence of gain recognition for the RIC limits the need to pay capital gain dividends and thereby facilitates the ability of the remaining shareholders to defer economic gains until they liquidate their investments in the RIC. Exchange traded funds ("ETFs") that are treated as RICs use in-kind redemptions in the normal course of their operations due to the way they are structured, and they may rely on section 852(b)(6) by delivering appreciated assets to redeeming shareholders to minimize the recognition of fund-level capital gains and the resulting need to pay capital gain dividends. The proposed repeal of section 852(b)(6) could have a significant impact on these ETFs.

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