December 29, 2006

The Honorable Mark W. Everson
Commissioner of Internal Revenue
Internal Revenue Service
Room 5226
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on Proposed Regulations Concerning Substantiality of Partnership Allocations Made to “Look-Through” Partners

Dear Commissioner Everson:

Enclosed are comments on proposed regulations concerning substantiality of partnership allocations made to “look-through” partners. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Susan P. Serota
Chair, Section of Taxation

Enclosure

cc: Donald L. Korb, Chief Counsel, Internal Revenue Service
Eric Solomon, Deputy Assistant Secretary (Tax Policy), Treasury Department
Michael Desmond, Tax Legislative Counsel, Treasury Department
Clarissa C. Potter, Deputy Chief Counsel (Technical), Internal Revenue Service
William Bowers, Office of Assistant Secretary of Tax Policy, Treasury Department
William O’Shea, Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service
Beverly Katz, Senior Technician Reviewer, Associate Chief Counsel (Passthrough & Special Industries) Branch 2, Internal Revenue Service
Tim Leska, Attorney, Associate Chief Counsel (Passthroughs & Special Industries) Branch 1, Internal Revenue Service
COMMENTS
ON
PROPOSED REGULATIONS CONCERNING
SUBSTANTIALLY OF PARTNERSHIP ALLOCATIONS
MADE TO “LOOK-THROUGH” PARTNERS

These comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these comments was exercised by Robert Schachat of the Partnerships and LLCs Committee of the Section of Taxation. Substantive contributions were received from Paul Carman and others from the Committee. The comments were reviewed by James Wreggelsworth, Committee Chair, Eric Sloan, Committee Vice-Chair, and Steven Schneider, Chair of the Subcommittee on Continuing Legal Education. The comments were also reviewed by Victor Penico, Chair of the Committee on Affiliated and Related Corporations, and Don Leatherman, a member of that Committee. Mark Harris, Vice-Chair of the Committee on the Foreign Activities of U.S. Taxpayers, and Michael Cornett and Kevin Rowe, members of that Committee reviewed the comments as well. The comments were further reviewed by Richard Lipton of the Section’s Committee on Government Submissions and by Barbara de Marigny, Council Director of the Committee on Partnerships and LLCs.

Although many of the members of the Section of Taxation who participated in preparing these comments have clients who would be affected by the federal income tax rules applicable to the subject matter addressed by these comments, or have advised clients on the application of such rules, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

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December 29, 2006
EXECUTIVE SUMMARY

On November 18, 2005, the Internal Revenue Service (“IRS”) and the Treasury Department (“Treasury”) issued proposed regulations under section 704(b) (the “Proposed Regulations”).¹ The Proposed Regulations provide rules for testing the “substantial economic effect” of partnership allocations where one or more of the partners is a “look-through” entity, which, under the Proposed Regulations, would include other partnerships, S corporations, members of a consolidated group, and, in certain cases, controlled foreign corporations (“CFCs”).² The Proposed Regulations are the product of the IRS and Treasury’s concern that, in determining whether partnership allocations have substantial economic effect within the meaning of section 704(b), taxpayers have not been taking into account the interaction of partnership allocations with the tax attributes of the owners of look-through entities that are partners.

In the preamble to the Proposed Regulations, the IRS and Treasury requested comments regarding specific issues related to the Proposed Regulations. The Section appreciates the opportunity to respond to those specific requests and to comment on other aspects of the Proposed Regulations.

The following comments are respectfully offered regarding the Proposed Regulations:

1. We agree with the basic approach of the Proposed Regulations that the interaction of partnership allocations and the tax attributes of owners of look-through entity partners should be taken into account in testing the substantiality of an allocation to a partner that is a look-through entity.

2. We agree that regulated investment companies (“RICs”) and real estate investment trusts (“REITS”) should not be treated as look-through entities for purposes of the substantial economic effect rules because the burdens to taxpayers from extending the rules of the Proposed Regulations to such entities would outweigh the benefits of such a rule.³ We also suggest that publicly traded partnerships classified as partnerships for federal tax purposes and electing large partnerships under section 771, et seq., not be treated as look-through entities for this purpose.

3. With respect to CFCs, in order to be consistent with the information reporting required of US partners in foreign partnerships under section 6038, we recommend that the new look-through rule should apply only to partnerships that are

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¹ Unless otherwise indicated, all “section” references are to the Internal Revenue Code of 1986, as amended (the “Code”), and all “Reg. §” and “regulation” references are to the Treasury regulations promulgated under the Code.

² REG-144620-04; 70 F.R. 69919-69922. A foreign corporation is a CFC if it satisfies the ownership tests set forth in section 957(a).

³ A corporation is a RIC if it satisfies the requirements of section 851 and is a REIT if it satisfies the requirements of section 856.
controlled foreign partnerships as defined in section 6038 and the regulations thereunder, and that have at least one partner that is a CFC. We further suggest that this definition should be applied to any partnership, regardless of whether the partnership is domestic or foreign. Further, we believe that only the tax attributes of a U.S. shareholder (as defined in section 951(b)) of the CFC should be considered provided such U.S. shareholder owns at least 10 percent of the controlled foreign partnership as determined under section 6038. (Again, this provision would apply regardless of whether the partnership is domestic or foreign.)

4. We agree that the Proposed Regulations, when finalized (the “Final Regulations”), should also provide that the interaction of partnership allocations with the tax attributes of a consolidated group must be taken into account in testing the substantiality of an allocation to a partner that is a member of a consolidated group. We believe, however, that the Final Regulations should include a more detailed explanation of the intended application of the rule in such situations.

5. We do not agree with what is styled as a proposed clarification that, for purposes of Reg. § 1.704-1(b)(2)(iii)(a)(1), the after-tax economic consequences to a partner resulting from a partnership allocation or allocations must be compared with the after-tax economic consequences to that partner if the allocation or allocations were instead made in accordance with the partners’ interests in the partnership (“PIP”). This “clarification” is inconsistent with the existing regulations and would lead to circularity in the required legal analysis.

6. We agree that the per capita presumption in Reg. § 1.704-1(b)(3)(i) reaches the correct result in very few cases and should be eliminated.

7. We agree that, as stated in Prop. Reg. § 1.704-1(b)(5), Example 29(ii), section 482 can override section 704(b).

8. Consistent with Principal Recommendation # 3, above, we suggest that the Final Regulations include a presumption that a partnership does not know and a rule that a partnership need not investigate the applicable tax attributes of a partner unless that partner owns (directly, indirectly, and through attribution) a 25 percent or greater interest in partnership capital or profits. (The presumption could be overcome if the IRS were to clearly establish that the partnership knew of such tax attributes.)

9. Finally, we recommend that the Final Regulations provide guidance regarding timing issues and address, for instance, situations in which the status of a partner as a look-through entity is not determined until after the partnership year-end.
BACKGROUND

Under section 704(a), a partner’s distributive share of the income, gain, loss, deduction, or credit of a partnership generally is determined by the partnership agreement. Section 704(b), however, provides that, if the partnership agreement does not provide for the allocation of the partner’s distributive share (or item thereof), or the allocation provided in the partnership agreement lacks “substantial economic effect,” the partner’s distributive share will be determined in accordance with the partner’s interests in the partnership.

The regulations contain a two-part test for determining substantial economic effect. Under the first prong, an allocation is required to have economic effect. In order for an allocation to have economic effect, the partner to whom an allocation is made must receive the economic benefit or burden associated with the allocation.\(^4\) Generally, the economic effect requirement is satisfied where the partners’ capital accounts are maintained in accordance with the section 704(b) regulations and certain other “mechanical” requirements are satisfied. Under the second prong, the economic effect of an allocation must be substantial. The economic effect of an allocation is substantial if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences.\(^5\)

Notwithstanding the foregoing, the economic effect of an allocation is not substantial if, at the time the allocation becomes part of the partnership agreement, the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation were not contained in the partnership agreement, and there is a strong likelihood that the after-tax consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation were not contained in the partnership agreement.\(^6\) In determining the after-tax economic benefit or detriment to a partner, tax consequences which result from the interaction of the allocation and the tax attributes of such partner that are unrelated to the partnership are considered.

In addition to the after-tax effect provision, the economic effect of an allocation is not substantial if, at the time the allocation becomes part of the partnership agreement, there is a strong likelihood that the net increases and decreases to be recorded in the partners’ respective capital accounts for such taxable year will not differ substantially from the net increases and decreases that would be recorded in such partners’ respective capital accounts for such year if the allocations were not contained in the partnership agreement.

\(^4\) Reg. § 1.704-1(b)(2)(ii)(a).
\(^5\) Reg. § 1.704-1(b)(2)(iii)(a).
\(^6\) Id.
agreement, and the total tax liability of the partners for relevant taxable years would be less than if the allocations were not contained in the partnership agreement.\footnote{Reg. \S 1.704-1(b)(2)(iii)(b).}

The economic effect of an allocation is, furthermore, not substantial where a partnership agreement provides for the possibility that one or more allocations (“original allocations”) will be significantly mitigated by one or more offsetting allocations, and, if at the time the allocations became part of the partnership agreement, there was a strong likelihood that the net increases and decreases that would be recorded in the partners’ respective capital accounts for the relevant taxable years would not differ substantially from the net increases and decreases that would be recorded in such partners’ respective capital accounts for such years if the original allocations and offsetting allocations were not contained in the partnership agreement, and the total tax liability of the partners would be less than if the allocations were not contained in the partnership agreement.\footnote{Reg. \S 1.704-1(b)(2)(iii)(c).}

To avoid potential unintended negative effects of this rule in the case of dispositions of partnership property, there is a presumption that the value of an asset equals its adjusted section 704(b) book basis.\footnote{Id.}

\section*{Detailed Comments}

\section{Introduction.}

Fundamentally, the Proposed Regulations provide that the interaction of a partnership allocation with the tax attributes of owners of look-through entities must be considered when testing substantiality for allocations to a partner that is a look-through entity.

Generally, look-through entities are entities that pass through to their owners certain tax consequences. Such entities include partnerships, S corporations, trusts, certain CFCs, and entities that are disregarded for income tax purposes, such as qualified subchapter S subsidiaries and qualified REIT subsidiaries. Because the tax consequences of partnership allocations generally apply only to the ultimate owners, rather than to the look-through entities themselves, we generally agree with the basic approach of the Proposed Regulations.

\section{RICs and REITs Should Not be Treated as Look-through Entities, Nor Should Publicly Traded Partnerships and Electing Large Partnerships.}

The Proposed Regulations do not include RICs and REITs within the meaning of look-through entity. The preamble to the Proposed Regulations indicates that this decision was made because the IRS and the Treasury believe that, although RICs and REITs have certain flow through characteristics, the burdens associated with treating such entities as look-through entities, specifically, requiring taxpayers to look through
such entities to determine the substantiality of partnership allocations, would generally outweigh the benefits potentially derived by the promulgation of such a rule.\textsuperscript{10} We agree that RICs and REITs should not be treated as look-through entities for this purpose for the reason set forth in the preamble. It would be extremely burdensome – and perhaps impossible – for RICs and REITs to determine the individual tax attributes of all their owners. Additionally, we would suggest that for the same reasons that it is appropriate not to treat RICs and REITs as look-through entities, it is appropriate that publicly traded partnerships classified as partnerships for federal tax purposes and electing large partnerships under section 771, \textit{et seq.}, not be treated as look-through entities for this purpose.

III. \textbf{Treatment of CFCs.}

The Proposed Regulations require the tax attributes of a US shareholder in a CFC partner to be taken into account for purposes of determining the substantiality of a partnership allocation without any limitations. We believe this approach is inconsistent with the reporting requirements of section 6038 and could be unduly burdensome to both taxpayers and the IRS. In order to be consistent with the information reporting required of US partners in foreign partnerships, we recommend that the new look-through rule should apply only to partnerships that are controlled foreign partnerships as defined in section 6038 and the regulations thereunder, and that have at least one partner that is a CFC. We further suggest that this definition should be applied to any partnership, regardless of whether the partnership is domestic or foreign. Further, we believe that only the tax attributes of a U.S. shareholder (as defined in section 951(b)) of the CFC should be considered provided such U.S. shareholder owns at least 10 percent of the controlled foreign partnership as determined under section 6038. (Again, this provision would apply regardless of whether the partnership is domestic or foreign.)

Additionally, because, as a theoretical matter, any allocation can affect subpart F income, we suggest that, to avoid interpretative difficulty, the Final Regulations make clear that a CFC is treated as a look-through entity with respect to any item allocated to the CFC.

IV. \textbf{Treatment of Members of a Consolidated Group.}

The IRS and Treasury have specifically requested comments concerning the application of the proposed rules in the context of a partner that is a member of a consolidated group. We agree that the Final Regulations should provide that the interaction of a partnership allocation with the tax attributes of a consolidated group must be taken into account when testing the substantiality of an allocation to a partner that is a member of a consolidated group. In this regard, we have two specific comments. First, we believe, that the Final Regulations should be expanded to include a broader explanation of the intended new rule.

\textsuperscript{10} 70 F.R. 69919-69922.
Second, it would be helpful if the Final Regulations included an example illustrating the application of this rule, such as the following example:

(i) **Facts.** P is the common parent of an affiliated group of U.S. corporations that includes S-1 and S-2. The P group files a consolidated return. S-1, S-2, and X, an unrelated third party classified as a corporation for federal tax purposes, are equal members of LLC, which is classified as a partnership for federal tax purposes. The P group has a net operating loss ("NOL") carryover that is attributable solely to S-1 and that is subject to the separate return limitation year ("SRLY") rules of Reg. § 1.1502-21(c). As a result, such SRLY losses can be deducted only against the net income of S-1. The LLC agreement satisfies the three-part safe harbor for economic effect.

(ii) **Allocation lacks substantial economic effect.** The LLC agreement provides that, for years 1-5, $100 of LLC’s net operating income will be allocated to S-1, and $200 of tax-exempt income will be allocated equally to S-2 and X. Remaining net income (and all net loss) will be allocated equally among the members. Beginning in year 6, all net profits and losses are allocated equally among the members. Taking into account the P group’s ability to utilize the SRLY NOL’s only to the extent of S-1’s income, the offsetting allocations provided in the LLC agreement are insubstantial under Reg. § 1.704-1(b)(2)(iii)(a) and will be reallocated in accordance with the partners’ interests in the partnership under Reg. § 1.704-1(b)(3).

(iii) **Allocation has substantial economic effect.** The LLC agreement allocates the net operating income of LLC to S-1 for 5 years and then allocates net operating income and loss equally among the LLC members for the balance of the existence of LLC. Gain on the sale of substantially all of LLC’s assets is allocated to S-2 and X first in an amount equal to the prior net operating income previously allocated disproportionately to S-1; second, such gain is allocated to S-2 and X to compensate S-2 and X for their subordinated position vis-à-vis S-1 in receiving allocations of profits from LLC; and finally, such gain is allocated equally among the members. In testing the substantiability of LLC’s allocations, LLC is required to take into account the fact that the SRLY NOLs are available only to S-1. Because, however, the allocation of operating net income to S-1 will be offset, if at all, by gain on the sale of substantially all of the assets of LLC, the value-equals-basis rule of Reg. § 1.704-1(b)(2)(iii)(c) provides that there
V. Making PIP the Baseline is Inconsistent with the Current Regulations and Leads to Circularity.

The Proposed Regulations provide that, for purposes of Reg. § 1.704-1(b)(2)(iii)(a)(1), the after-tax economic consequences of a partner which result from an allocation or allocations must be compared with the after-tax economic consequences to that partner if the allocation or allocations were instead made in accordance with the partners' interests in the partnership. We are troubled by this proposal for two reasons.

First, the existing section 704(b) regulations do not use PIP as the “baseline” against which allocations are tested for substantiality. See, for example, example (5) under Reg. § 1.704-1(b)(5). Second, we are concerned that such determination would itself require an additional determination of PIP. Such determination is often very difficult to make and often can be avoided only by adoption of the special allocations that are proposed to be examined under this new test.

In this regard, although the concept of PIP is incorporated in the language of section 704(b), there is surprisingly little authority interpreting the phrase. The substantial economic effect test of the section 704(b) regulations is a “safe harbor” that allows taxpayers to avoid the uncertainties related to the determination of PIP. Thus, if PIP were adopted as the base-line for determining the substantiality of allocations, the determination would become somewhat circular and, thus, the usefulness of the substantial economic effect rules would be substantially reduced, if not eliminated. If, notwithstanding our recommendation to the contrary, the Final Regulations retain PIP as the baseline against which the substantiality of allocations is tested, example (5) under Reg. § 1.704-1(b)(5) would need to be revisited.

VI. The Per Capita Presumption Should be Removed.

The Proposed Regulations would remove the existing per capita presumption in Reg. § 1.704-1(b)(3)(i) which, as noted in the preamble to the Proposed Regulations, reaches the correct result in very few cases. Because we agree with the statement in the preamble, we agree that this presumption should be eliminated.

VII. Other Code Sections Can Override Section 704(b).

The Proposed Regulations include an example intended to illustrate a fact pattern to which, apart from the application of section 704(b), other sections could apply. We

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11 The principles of this example apply with equal force to other look-through entities, such as CFCs.

12 70 F.R. 69919-69922.
concur that, as stated in Prop. Reg. § 1.704-1(b)(5), Example 29(ii), section 482 can override section 704(b), as is made clear by Reg. § 1.704-1(b)(1)(iii) of the existing regulations.

VIII. The Need for a “No Knowledge Presumption” and a De Minimis Test.

From a practical perspective, neither the Code nor the regulations currently provide any mechanism for a partnership to collect information concerning the tax positions of its partners. In certain other situations in which the tax reporting obligations of a partnership may be impacted by the nature or residence of its partners, the regulations provide for a system of certifications upon which the partnership is entitled to rely (Forms W-8, W-9). There is no such system of certification currently included in the Proposed Regulations for purposes of determining the substantiality of allocations in the context of look-through ownership. Thus, it would appear that a partnership would be required to make an intrusive due diligence investigation into the tax affairs of direct and indirect partners. It likely would be problematic for a partnership to determine the information necessary to comply with the Proposed Regulations without actually reviewing the tax returns of its direct and indirect partners.

In view of the potential unintended complexity of such a requirement, we respectfully request that the Final Regulations include a presumption that a partnership does not know and a rule that a partnership need not investigate the tax attributes of any partner unless that partner owns (directly, indirectly, and through attribution) more than a 25 percent interest in the capital and profits of the partnership, subject to an appropriate anti-abuse rule. The presumption could be overcome if the IRS were to clearly establish that the partnership knew of such tax attributes.13

Alternatively, we respectfully recommend that the Proposed Regulations provide for a certification procedure that would provide a partnership with the information that it may need to make a determination whether any direct or indirect partner is likely to obtain an after-tax benefit or to suffer a substantial after-tax detriment, and upon which the partnership would be entitled to rely absent actual knowledge that the information provided was false.

IX. Additional Guidance.

Finally, we respectfully recommend that the Final Regulations provide guidance regarding timing issues, for instance, situations in which the status of a partner as a look-through entity is not determined until after the partnership year-end. This situation may arise, for example, if (i) the partner has a different taxable year than the partnership or (ii) the classification of an entity can be changed retroactively, e.g., under Reg. § 301.7701-3(c)(1)(v)(B), which allows an eligible entity to elect corporate status retroactive to January 1 of year one by making a REIT election on its return by September 15 of year two.

CONCLUSION

As discussed above, with the exception of the proposed adoption of PIP as the baseline against which allocations are tested for substantiality, we generally agree with the provisions set forth in the Proposed Regulations under section 704(b), with certain modifications regarding guidelines, procedures, and, perhaps, certifications.