May 22, 2012

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on Proposed Regulations Removing the Substantial Economic Effect De Minimis Rule

Dear Commissioner Shulman:

Enclosed are comments on proposed regulations removing the substantial economic effect de minimis rule. 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,

William M. Paul
Chair, Section of Taxation

Enclosure

cc: Emily S. McMahon, Assistant Secretary (Tax Policy), Department of the Treasury
     William J. Wilkins, Chief Counsel, Internal Revenue Service
     Michala Irons, Attorney, Internal Revenue Service
ABA SECTION OF TAXATION
COMMENTS ON PROPOSED REGULATIONS REMOVING THE
SUBSTANTIAL ECONOMIC EFFECT
DE MINIMIS RULE

These comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation (the "Section") 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 Adam M. Cohen and Dawn M. Duncan of the Partnerships & LLCs Committee of the Section of Taxation. Substantive contributions were made by Steven Dixon. The Comments were reviewed by Bahar Schippel, Committee Chair. The Comments were further reviewed by William H. Caudill of the Section’s Committee on Government Submissions and by Eric Sloan, Council Director for the Partnerships & LLCs Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, 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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Date: May 22, 2012
EXECUTIVE SUMMARY

On October 25, 2011, the Internal Revenue Service (the “Service”) and the Treasury Department (“Treasury”) issued proposed regulations under section 704(b)\(^1\) (the “2011 Proposed Regulations”)\(^2\) that would remove the substantial economic effect de minimis rule in Regulation section 1.704-1(b)(2)(iii)(e) (the “SEE De Minimis Rule”) that was promulgated on May 19, 2008, as part of final section 704(b) regulations with respect to partners that are look-through entities (the “2008 Final Regulations”).\(^3\) The SEE De Minimis Rule provides that for purposes of applying the substantiality rules, the tax attributes of de minimis partners need not be taken into account. A de minimis partner is defined as any partner, including a look-through entity that owns, directly or indirectly, less than ten percent of the capital and profits of a partnership, and who is allocated less than ten percent of each partnership item of income, gain, loss, deduction, and credit. In the preamble to the 2011 Proposed Regulations, the Service and Treasury stated that they “have determined that the de minimis partner rule should be removed in order to prevent unintended tax consequences.”\(^4\) This determination appears to have been based on an observation that the application of the SEE De Minimis Rule may allow certain partnerships to entirely avoid the application of the substantiality rules if the partnership is owned by partners each of whom owns less than ten percent of the capital or profits, and who are allocated less than ten percent of each partnership item of income, gain, loss, deduction, and credit. The Service and Treasury specifically requested “comments on how to reduce the burden of complying with the substantial economic effect rules, with respect to look-through partners, without diminishing the safeguards the rules provide.”\(^5\)

The Section appreciates the opportunity to respond to this specific request for comments on the 2011 Proposed Regulations. In these Comments, we respectfully recommend that the Service and Treasury retain the SEE De Minimis Rule to ensure the administrability of the substantiality rules, but modify it in order to preserve the safeguards that the rules provide and prevent any unintended tax consequences. In this regard, we discuss several alternatives for consideration that would amend the scope and application of the SEE De Minimis Rule. Of these alternatives, we have made the following two principal recommendations:

1. Amend the SEE De Minimis Rule by adding a single sentence to Regulation section 1.704-1(b)(2)(iii)(e) that would specify that the SEE De Minimis Rule applies only if (i) de minimis partners own less than a specified aggregate

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


\(^3\) T.D. 9398, 2008-1 C.B. 1143.


\(^5\) Id.
percentage of the partnership and (ii) the partnership has at least two non-de minimis partners. The maximum specific aggregate percentage chosen for de minimis partners might be 25%, 50%, 80% or some other percentage.

2. Establish certain “safe harbor” presumptions (e.g., a presumed set of taxpayer attributes) that could be relied upon by partnerships when applying the substantiality rules in circumstances where, after making reasonable inquiries, insufficient or no information is available to apply the substantiality tests for allocations made to de minimis partners that are not eligible for the SEE De Minimis Rule and persons that own, directly or indirectly, through a look-through entity less than 10% of the capital and profits of the allocating partnership and are allocated less than 10% of each partnership item.

In these Comments, we also discuss the following additional alternatives, which are not necessarily mutually exclusive, for your consideration in conjunction with our principal recommendations:

1. Lower the de minimis percentage interest threshold and the income allocation percentage threshold in the SEE De Minimis Rule.

2. Include a limitation or threshold on the amount of net taxable income (indexed for inflation) that is reasonably expected to be earned by the partnership or allocated to the de minimis partner each year in order to qualify for the SEE De Minimis Rule.

3. Retain the SEE De Minimis Rule, but do not allow reliance on the SEE De Minimis Rule in situations where the partnership knows (or has reason to know) of the relevant tax attributes of the de minimis partner and such attributes would cause the allocations not to have substantial economic effect.

**BACKGROUND**

**1. Overview of Substantial Economic Effect Rules**

Section 704(b) requires partnership allocations either to have substantial economic effect or to be in accordance with the partners’ interests in the partnership. To determine whether an allocation has substantial economic effect, Regulation section

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6 As discussed below, the rationale for requiring at least two non-de minimis partners is to ensure that the substantiality regulations apply to at least two of the partners of the partnership.

7 As an alternative, this amendment could be stated in the inverse and instead specify that the SEE De Minimis Rule applies only if two or more non-de minimis partners own a specified minimum aggregate percentage of the partnership. For example, the SEE De Minimis Rule could be limited to partnerships where at least 50% of the partnership is owned by two or more non-de minimis partners or where 20% or more of the partnership is owned by two or more non-de minimis partners.

8 Indirect ownership for this purpose would be determined under the principles of section 318, substituting 10% for 50%.
1.704-1(b)(2)(i) provides a two-part analysis: the allocation must have economic effect within the meaning of Regulation section 1.704-1(b)(2)(ii); and the economic effect must be substantial within the meaning of Regulation section 1.704-1(b)(2)(iii).

An allocation of income, gain, loss, or deduction to a partner will have economic effect if throughout the term of the partnership, the partnership agreement provides for the determination and maintenance of the partners’ capital accounts in accordance with Regulation section 1.704-1(b)(2)(iv). The partnership agreement also must require liquidating distributions to be made in accordance with the positive capital account balances of the partners, and each partner must be unconditionally obligated to restore the deficit balance in the partner’s capital account following the liquidation of the partner’s interest. In lieu of requiring the partners to restore the deficit balance, the partnership may satisfy the qualified income offset rules in Regulation section 1.704-1(b)(2)(ii)(d).

Under Regulation section 1.704-1(b)(2)(iii)(a), the economic effect of an allocation is substantial if there is a reasonable possibility that the allocation will substantially affect the dollar amounts to be received by the partners, independent of tax consequences. However, even if the allocation substantially affects the dollar amounts, the economic effect may not be substantial if, at the time the allocation becomes part of the partnership agreement:

(1) The after-tax economic consequences of at least one partner may be enhanced compared to such consequences if the allocation were not contained in the partnership agreement; and

(2) There is a strong likelihood that the after-tax economic consequences of no partner will be substantially diminished compared to such consequences if the allocation were not contained in the partnership agreement.

Finally, the economic effect of an allocation is not substantial in two situations described in Regulation section 1.704-1(b)(2)(iii)(b) and Regulation section 1.704-1(b)(2)(iii)(c) (i.e., “shifting” and “transitory” allocations, respectively).

2. Final 2008 Section 704(b) Regulations (“Look-Through Rule”)

On May 19, 2008, the Service and Treasury issued the 2008 Final Regulations, which provide rules for testing the substantiality of partnership allocations under section 704(b) when the partners are look-through entities or members of a consolidated group. The 2008 Final Regulations adopt, with certain modifications, the proposed regulations that were published in the Federal Register on November 18, 2005 (the “2005 Proposed Regulations”). The 2008 Final Regulations apply to partnership tax years beginning on or after May 19, 2008.

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The 2008 Final Regulations require that the tax consequences of the interaction between an allocation and the tax attributes of any person that is an owner or beneficiary (in the case of an estate or trust) of a partner must be taken into account when applying the after-tax, shifting, and transitory tests to a partner that is a look-through entity (“look-through rule”).\(^\text{11}\) A look-through entity is defined for this purpose as a partnership, S corporation, trust, estate, disregarded entity (including a qualified REIT subsidiary and a qualified subchapter S subsidiary), or certain controlled foreign corporations (“CFCs”).\(^\text{12}\)

The 2008 Final Regulations limit the look-through rule for CFCs by providing an ownership threshold that must be met in order to trigger look-through treatment for CFCs (“CFC look-through rule”). The CFC look-through rule is limited to situations in which U.S. shareholders (within the meaning of section 951(b)) of the CFC in the aggregate own, directly or indirectly, at least 10% of the capital or profits of the partnership on any day during the partnership’s taxable year.\(^\text{13}\) The final regulations also clarify that a CFC is considered a look-through entity only with respect to allocation of items that (1) enter into the calculation of a U.S. shareholder’s inclusion under section 951(a); (2) enter into any person’s income attributable to a U.S. shareholder’s inclusion under section 951(a); or (3) would enter into the calculation of a U.S. shareholder’s inclusion under section 951(a) if those items were allocated to the CFC.\(^\text{14}\) The preamble to the 2008 Final Regulations states that the Service and Treasury are considering whether a CFC partner should be treated as a look-through entity in all cases and how any impact on the tax liability of a direct or indirect owner of the CFC partner resulting from actual or anticipated distributions of property by the CFC partner under section 301 should be taken into account in testing the substantiality of an allocation.

To address concerns regarding the burden of the substantiality test on partnerships with look-through entity partners, the 2008 Final Regulations also include the SEE De Minimis Rule, under which the tax attributes of de minimis partners need not be taken into account for purposes of determining substantiality.\(^\text{15}\) The final regulations define a de minimis partner as any partner, including a look-through entity, that owns, directly or indirectly, less than 10% of the capital and profits of a partnership and is allocated less than 10% of each partnership item.\(^\text{16}\) Indirect ownership for this purpose is determined under the principles of section 318, substituting 10% for 50%.\(^\text{17}\)

\(^{11}\) Reg. § 1.704-1(b)(2)(iii)(d)(1).
\(^{13}\) Reg. § 1.704-1(b)(2)(iii)(d)(2)(v). Indirect ownership for this purpose is determined under the principles of section 318, substituting 10% for 50%. Id. See also Reg. § 1.704-1(b)(2)(iii)(d)(6).
\(^{14}\) Id.
\(^{15}\) Reg. § 1.704-1(b)(2)(iii)(e).
\(^{16}\) Id.
\(^{17}\) Id. See also Reg. § 1.704-1(b)(2)(iii)(d)(6).
3. The 2011 Proposed Regulations

On October 25, 2011, the Service and Treasury published the 2011 Proposed Regulations, proposing to remove the SEE De Minimis Rule. The 2011 Proposed Regulations are proposed to be effective the date final regulations are published in the Federal Register. The preamble to the 2011 Proposed Regulations indicates that the Service and Treasury have determined that the SEE De Minimis Rule should be removed to avoid unintended tax consequences. In the preamble to the 2011 Proposed Regulations the Service and Treasury requested comments on how to reduce the burden of complying with the substantial economic effect rules without diminishing the safeguards the rules provide.

4. Additional Background

In response to the 2005 Proposed Regulations, the Section and others (“commentators”) expressed some reservations about the look-through rule, particularly as it related to foreign partnerships in which taxpayers owned relatively insubstantial shares.18 In those cases, commentators argued, sufficient information to apply the substantiality test usually was not available to either the partner or the partnership. In response, the SEE De Minimis Rule was included in the 2008 Final Regulations. As indicated in the preamble to the 2011 Proposed Regulations, “[t]he intent of the de minimis partner rule was to allow partnerships to avoid the complexity of testing the substantiality of insignificant allocations to partners owning very small interests in the partnership.”19 The preamble further indicates that the SEE De Minimis Rule “was not intended to allow partnerships to entirely avoid the application of the substantiality regulations if the partnership is owned by partners each of whom owns less than 10 percent of the capital or profits, and who are allocated less than 10 percent of each partnership item of income, gain, loss, deduction, and credit.”20

COMMENTS / RECOMMENDATIONS

1. General Comments and Recommendations

One of the observations in the preamble to the 2011 Proposed Regulations is that the SEE De Minimis Rule may have unintended results. In this regard, we agree and acknowledge that the SEE De Minimis Rule may be too broad in scope. The SEE De Minimis Rule appears to render the substantiality test irrelevant in partnerships owned entirely by less than ten percent partners. However, many practitioners have been

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20 Id.
reluctant to rely on the SEE De Minimis Rule, except in cases where limited or no information is available to test for substantiality or where the test for substantiality otherwise imposes an undue burden on the partners or the partnership.

Even though the current SEE De Minimis Rule may be too broad, we believe that removing the rule altogether would impose undue administrative burdens on many partnerships and partners in complying with the substantial economic effect rules. In this regard, the proposed removal of the SEE De Minimis Rule would reintroduce the reservations previously expressed by commentators after the issuance of the 2005 Proposed Regulations.21 Thus, we recommend that the Service and Treasury amend the SEE De Minimis Rule (rather than remove it altogether) in a way that balances administrability with safeguarding the substantiality rules.

2. Specific Comments and Recommendations

a. Principal Recommendations

While we discuss several alternatives below, we respectfully offer for your consideration the following two principal recommendations:

1. Amend the SEE De Minimis Rule so that it applies only if (i) de minimis partners own less than a specified aggregate percentage of the partnership and (ii) the partnership has at least two non-de minimis partners

We recommend that the concern raised by the Service and Treasury in the preamble to the 2011 Proposed Regulations regarding the SEE De Minimis Rule be addressed by adding a single sentence to Regulation section 1.704-1(b)(2)(iii)(e) that

21 For example, the ABA Section of Taxation previously observed the following in its comments on the 2005 Proposed Regulations:

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.

would specify that the SEE De Minimis Rule applies only if (i) de minimis partners own less than a specified aggregate percentage of the capital and profits of the partnership and (ii) the partnership has at least two non-de minimis partners. The maximum specific aggregate percentage chosen for de minimis partners might be 25%, 50%, 80% or some other percentage. The former portion of this approach would limit the SEE De Minimis Rule to situations where the substantiality requirement is applicable to much, if not a majority or more, of the allocations of income, gain, loss, deduction, and credits made by the partnership. The latter portion of this approach would ensure that at least two partners of a partnership are subject to the substantiality regulations and, thus, prevent partnerships from entirely avoiding the application of the substantiality regulations if the partnership is owned by partners each of whom owns less than 10% of the capital or profits, and who are allocated less than 10% of each partnership item of income, gain, loss, deduction, and credit.

2. Establish “safe harbor” presumptions for the tax attributes of de minimis partners that do not qualify for the SEE DE Minimis Rule and persons that own, directly or indirectly, through a look-through entity less than 10% of the capital and profits of the allocating partnership and are allocated less than 10% of each partnership item.

Whether the SEE De Minimis Rule is removed or amended, we also recommend that the Service and Treasury establish certain “safe harbor” presumptions (e.g., a presumed set of taxpayer attributes) in future regulations that could be relied upon by partnerships when applying the substantiality rules in circumstances where, after making reasonable inquiries, insufficient or no information is available to apply the substantiality tests for allocations made to (i) de minimis partners that are not eligible for the SEE De Minimis Rule and (ii) persons that own, directly or indirectly, through a look-through entity less than 10% of the capital and profits of the allocating partnership and are allocated less than 10% of each partnership item.

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22 Unless the context otherwise requires, the use of the term “de minimis partners” below refers to the current definition of “de minimis partner” in Reg. § 1.704-1(b)(2)(iii)(e) (i.e., any partner, including a look-through entity, that owns, directly or indirectly, less than 10% of the capital and profits of a partnership and is allocated less than 10% of each partnership item). However, the Service and Treasury could also lower the de minimis percentage interest threshold and the income allocation percentage threshold for purposes of defining a “de minimis partner” in conjunction with the Principal Recommendations described herein. See “Additional Alternatives For Consideration” section below.

23 As an alternative, this amendment could be stated in the inverse and instead specify that the SEE De Minimis Rule applies only if two or more non-de minimis partners own a specified minimum aggregate percentage of the capital and profits of the partnership. For example, using this alternative way of stating the recommended amendment, the SEE De Minimis Rule could be limited to partnerships where at least 50% of the partnership is owned by two or more non-de minimis partners or where 20% or more of the partnership is owned by two or more non-de minimis partners.

24 For example, the “overall-tax-effect rule” contained in Regulation section 1.704-1(b)(2)(iii)(a) necessarily requires at least two partners in order to determine if the allocation (or allocations) in question, on a present value basis, makes at least one partner better off after taxes and leaves no partner worse off after taxes.

25 Indirect ownership for this purpose would be determined under the principles of section 318, substituting 10% for 50%.

26 See note 25.
allocated less than 10% of each partnership item (in either case, “presumption eligible partners”). In this regard, a partnership that is unable to determine the relevant tax attributes of a specific presumption eligible partner after making reasonable inquiries could instead apply certain “safe harbor” presumptions regarding the relevant tax attributes of such partner (e.g., highest marginal federal income tax rate) based on the type of partner (e.g., a nonresident alien) and the type of income that the partnership earns (e.g., effectively connected income) for purposes of testing substantiality.

In order to meet the “insufficient or no information” condition precedent to the partnership’s reliance on the “safe harbor” presumptions, we recommend that the partnership would be required to first make reasonable inquiries regarding the tax attributes of its presumption eligible partners. Thus, if, after making reasonable inquiries, the partnership does not obtain sufficient information or any information regarding all of the tax attributes of one or more of its presumption eligible partners, the partnership could rely on the “safe harbor” presumptions for such presumption eligible partner(s) as to those tax attributes as to which it has insufficient or no information. Hence, the partnership would not have the undue burden of performing the due diligence necessary to determine the actual tax attributes of such presumption eligible partner(s) for purposes of testing substantiality. Importantly, it is inherent to the “insufficient or no information” condition precedent for relying on the “safe harbor” presumptions for such presumption eligible partner(s) that the partnership does not know (or have reason to know) of the relevant tax attributes of a particular presumption eligible partner. In this regard, the presumption(s) relied upon by the partnership could be rebutted by the Service by establishing facts and circumstances that show that the partnership knew (or had reason to know) of the relevant tax attributes of any presumption eligible partner as to whom the partnership relies on the “safe harbor” presumptions.

Defining the “safe harbor” presumptions regarding the tax attributes of potential presumption eligible partners would necessarily require the Service and Treasury to perform a detailed analysis regarding the types of presumption eligible partners that a partnership may have (e.g., individuals, corporations (foreign and domestic), tax-exempt entities, and foreign governments) and to consider other factors such as the type of income that partnerships may earn (e.g., foreign source and/or effectively connected income). As an example, the “safe harbor” presumptions in future regulations could provide presumed federal rates of tax that could be relied on by the partnership for purposes of testing substantiality based on whether the presumption eligible partner is

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27 While the Service and Treasury could limit a partnership’s reliance on “safe harbor” presumptions by permitting the partnership to rely on the “safe harbor” presumptions about the tax attributes of presumption eligible partners only if those partners do not own more than a specified aggregate percent interest in the capital and profits of the partnership, we generally do not recommend this approach because it would unnecessarily limit the utility and overall administrability of the “safe harbor” presumptions for presumption eligible partners of many widely-held partnerships, which otherwise bear an undue burden of performing the due diligence necessary to determine the actual tax attributes of such presumption eligible partner(s) for purposes of testing substantiality.
determined by the partnership to be one of the following types of direct and indirect partners: (i) United States citizens and residents aliens; (ii) domestic subchapter C corporations; (iii) organizations exempt from tax under section 501(a); (iv) the United States or any of its agencies or instrumentalities; (v) States, the District of Columbia, a possession of the United States, or any of their political subdivisions or instrumentalities; (vi) nonresident aliens; (vii) foreign corporations that are not controlled foreign corporations (within the meaning of section 957); (viii) controlled foreign corporations (within the meaning of section 957); and (ix) foreign governments and international organizations. In addition, the “safe harbor” presumed federal rate of tax by type of partner could vary, as appropriate, for each of the types of income that is reasonably expected to be earned by the partnership. As an example, if the presumption eligible partner is a section 501(c)(3) tax-exempt organization, the presumed federal income tax rate could be the highest marginal rate of tax for corporations under section 11 for any unrelated business taxable income (as defined in section 512(a)(1)) (“UBTI”) reasonably expected to be earned by the partnership and zero percent for any non-UBTI reasonably expected to be earned by the partnership. It is expected that many partnerships with presumption eligible partners would in most cases be able to adequately determine the appropriate “safe harbor” presumption for such presumption eligible partners to apply based on certain other information that is already provided to it (e.g., Form W-9, Form W-8BEN, Form W-8IMY, and Form W-8-EXP).28

b. Additional Alternatives For Consideration

We also respectfully offer for your consideration the following additional alternatives, which are not necessarily mutually exclusive:

28 Importantly, while the “safe harbor” presumptions recommendation outlined herein has similar underlying policies and principles to the “reasonable assumptions rule” outlined by the New York State Bar Association Tax Section in the “Report on Proposed Regulations Withdrawing the De Minimis Exception From the Section 704(b) Regulations” (2012 Tax Notes Today 15-22 (January 23, 2012)) (the “NYSBA Report”), we generally believe that the “safe harbor” presumptions approach provides a more administrable rule. In this regard, we believe that the “safe harbor” presumptions approach outlined herein is more administrable and predictable for both partnerships and the Service because it provides a more objective approach to dealing with the practical problems that partnerships have in obtaining information on and the undue burdens of determining the tax attributes of its de minimis partners. Specifically, we believe that the “safe harbor” presumptions approach outlined herein would generally prove more administrable and predictable for both partnerships and the Service in that it would avoid (i) the Service’s having to determine the assumptions made by the partnership, (ii) potential controversies regarding the “reasonableness” of any assumptions made by the partnership, and (iii) the partnership being required to determine assumptions as to each partner and to test the reasonableness of those assumptions. In many situations, the administrability of retaining a de minimis rule and providing “safe harbor” presumptions (over a “reasonable assumptions” rule) is even more evident because (a) the partnership would be able to apply the substantial-economic-effect rule without regard to any de minimis partners that can rely on the SEE De Minimis Rule or could apply it to any presumption eligible partner without having to make its own assumptions, test those assumptions or defend those assumptions and (b) the Service would not have to identify those assumptions, test those assumptions or litigate against those assumptions.
1. Lower the de minimis percentage interest threshold and the income allocation percentage threshold in the SEE De Minimis Rule

While this alternative would result in fewer instances where the SEE De Minimis Rule is applicable, it would still have the flaw of allowing partnerships owned entirely by partners that have small percentage interests and small income allocation percentages to completely avoid the substantiality requirement. Thus, this alternative may not adequately address the concern raised by the Service and Treasury in the preamble to the 2011 Proposed Regulations. However, this approach may prove more viable when considered in conjunction with one or more of the other alternatives outlined herein.

2. Include a limitation or threshold on the amount of net taxable income (indexed for inflation) that is reasonably expected to be earned by the partnership or allocated to the de minimis partner each year in order to qualify for the SEE De Minimis Rule. For example, the application of the SEE De Minimis Rule could be limited to (i) de minimis partners in partnerships where the total net taxable income of the partnership is reasonably expected to be less than a specified dollar amount each year or (ii) de minimis partners where the total amount of all tax allocations of income, gain, loss, deduction, and credits to those partners each year is reasonably expected to be less than a specified dollar amount. Because this alternative is tied to a specific amount, we believe any such rule should be tied to inflation.

This alternative may result in a ceiling on the amount of annual tax revenue that might be lost due to the existence of the SEE De Minimis Rule, but also necessarily requires reliance on reasonable estimates or projections of partnership taxable income, which may not align with actual annual net taxable income amounts earned by the partnership or allocated to its partners. In addition, while this alternative would limit the application of the SEE De Minimis Rule, it may still allow certain partnerships owned entirely by partners that have small percentage interests, small income allocation percentages and sufficiently small income to completely avoid the substantiality requirement. Thus, this alternative may not adequately address the concern raised by the Service and Treasury in the preamble to the 2011 Proposed Regulations. However, this approach may prove more viable when considered in conjunction with one or more of the other alternatives outlined herein.

3. Retain the SEE De Minimis Rule, but not allow reliance on the SEE De Minimis Rule in situations where the partnership knows (or has reason to know) of the relevant tax attributes of the de minimis partner and such attributes would cause the allocations not to have substantial economic effect.

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29 Because substantiality is tested at the time the allocations become part of the partnership agreement, the income thresholds or limitations in this alternative would necessarily be measured based on a similar timing requirement.
This alternative is similar to a recommendation made by the ABA Section of Taxation in response to the 2005 Proposed Regulations. Similar to that prior recommendation, a partnership would not have a duty to investigate the tax attributes of de minimis partners, but would be precluded from applying the SEE De Minimis Rule to a de minimis partner if the partnership actually knew (or had reason to know) of the relevant tax attributes of the de minimis partner and such attributes would cause the allocations not to have substantial economic effect. This alternative would avoid situations of willful blindness, but would also increase the burden on the Service to prove knowledge (or a reason to know) (e.g., clearly establish that the partnership knew of such tax attributes). This increased burden, however, would likely not come with any significant added benefit on the tax return preparation side of the administration equation. Further, because this alternative is premised on the existing rule being retained, the infirmity identified in the preamble to the 2011 Proposed Regulations (i.e., that certain partnerships may be able to entirely avoid the application of the substantiability requirements) would still exist.

c. Alternatives Considered But Not Recommended

We have also considered the following two additional alternatives, but, as discussed below, have specifically rejected these alternatives as we do not think they serve a useful purpose either in the context of ensuring the administrability and predictability of the substantiability rules or in preserving the safeguards that the substantiability rules provide. Thus, we identify these alternatives here to indicate our view that the Service and Treasury should not adopt these alternatives.

1. Limit the SEE De Minimis Rule to “look-through entities” and/or provide that the look-through rule is not required for “look-through entities” that are de minimis partners, expanding on the current limitations under the CFC portion of the look-through rule.

30 The ABA Section of Taxation comments to the 2005 Proposed Regulations specifically provided the following comment / recommendation:

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. [endnotes omitted.]

While this alternative would seemingly be consistent with the original purpose and intent of the SEE De Minimis Rule, we would not recommend this alternative. Specifically, there are a large number of partnerships with partners owning small interests that are not look-through entities but, nonetheless, bear an undue burden in obtaining sufficient information to comply with the substantiality requirements. Thus, this alternative would cause the SEE De Minimis Rule, if retained, to have a negligible effect on taxpayer and government administration burdens for a significant number of partnerships not owned by look-through entities.

2. Treat de minimis partners as a group.

We considered, but would not recommend this alternative. This alternative would group de minimis partners together for purposes of testing allocations for substantial economic effect. However, it would be very difficult to determine the tax attributes of a group for such purposes and would likely not address the burden of ascertaining the tax attributes of the members of the group. If this approach were adopted, caution should be utilized before adopting any grouping procedures that could necessitate having multiple groups, as this would likely complicate matters significantly.

3. Add an anti-abuse rule.

We considered, but would not recommend this alternative. The intent of the SEE De Minimis Rule is to increase the administrability and predictability of the substantiality rules. An anti-abuse rule, while potentially eliminating the unintended consequences of the SEE De Minimis Rule, would have a significant negative impact on administrability and predictability.

d. Other Policy Considerations for Specific Situations

In considering all of the above alternatives (and perhaps others, as the Code and Treasury Regulations are replete with de minimis rules), the Service and Treasury should also consider whether there should be more than one de minimis rule. For example, the Service and Treasury could promulgate one de minimis rule for small partnerships and a different one for other partnerships. Similarly, there may be certain circumstances where the de minimis rule should apply more broadly. For example, query whether a publicly traded partnership (treated as a partnership for U.S. federal tax purposes) with a 20% general partner and with the remaining 80% owned broadly by small partners due to the public trading, should be required to investigate (or is even capable of investigating) the tax attributes of its public unitholders.
CONCLUSION

We respectfully recommend that the SEE De Minimis Rule be retained but amended to address the concern that it may allow certain partnerships to entirely disregard the substantiality requirements of section 704(b) and the Treasury Regulations. The SEE De Minimis Rule, in some form, is necessary to ensure administrability of the substantiality rule. However, some changes to the SEE De Minimis Rule are required to ensure that partnerships make allocations that have substantial economic effect, at least with respect to most of the partnership’s income, gains, losses, and deductions or with respect to the largest of its owners.