American Institute of CPAs
1455 Pennsylvania Avenue, NW
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November 2, 2012

The Honorable Douglas H. Shulman, Commissioner
Internal Revenue Service
1111 Constitution Avenue, Room 3000
CC:PA:LPD:PR (REG-109564-10), Room 5203
Washington, DC 20024

Re: Comments on Proposed Regulations Withdrawing the Section 704(b) *De Minimis* Exception (REG-109564-10) on Partner's Distributive Share

Dear Commissioner Shulman:

The American Institute of Certified Public Accountants (AICPA) submits the below comments in response to the above mentioned proposed regulations published on December 12, 2011, withdrawing the *de minimis* exception of Treas. Reg. § 1.704-1(b)(2)(iii)(*e*) (the "*De Minimis* Exception") regarding a partner's distributive share. The proposed regulations remove prior regulations under §1.704-1(b)(2)(iii)(e) (the *de minimis* partner rule) because the rule may have resulted in unintended tax consequences. The proposed regulations affect partnerships and their partners. Our comments address the withdrawal of the *De Minimis* Exception and suggest an alternative that will reduce the burden of complying with the substantial economic effect rules without diminishing the safeguards that the current rules provide. We believe that partnerships that pose little to no risk to the underlying policies of section 704(b) should be excluded from the complicated substantial economic effect rules.

The AICPA is the world's largest member association representing the accounting profession, with nearly 386,000 members in 128 countries and a 125-year heritage of serving the public interest. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

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If you have any questions about these comments, please contact me at (304) 522-2553 or jporter@portercpa.com; Sarah I. Staudenraus, Chair of the AICPA Partnership Taxation Technical Resource Panel, at (202) 533-4574 or sarahstaudenraus@kpmg.com; or Eileen Sherr, AICPA Senior Technical Manager, at (202) 434-9256 or esherr@aicpa.org.

Sincerely,

Jeffrey A. Porter, CPA
Chair, AICPA Tax Executive Committee

cc: Jennifer Alexander, Attorney-Advisor, Department of the Treasury
Curtis Wilson, Associate Chief Counsel (P&SI), Internal Revenue Service
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THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

COMMENTS ON PROPOSED REGULATIONS WITHDRAWING THE REGULATIONS SECTION 1.704(b) *DE MINIMIS* EXCEPTION

I. GENERAL COMMENTS ON WITHDRAWAL OF *DE MINIMIS* EXCEPTION

The American Institute of Certified Public Accountants (AICPA) agrees with the Internal Revenue Service (IRS) that the *de minimis* exception of Treas. Reg. § 1.704-1(b)(2)(iii)(e) (the "*De Minimis* Exception") as currently drafted creates an overly broad exception to the partnership allocation rules. However, because the partnership allocation rules are extensive and complex, we believe that some form of *de minimis* rule is appropriate for certain partnerships and urge the IRS to consider our proposed alternative.

A. Background

In general, if a partnership agreement does not provide for the allocation of a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) or if an allocation provided in the partnership agreement does not have "substantial economic effect," the partner's distributive share is determined in accordance with the "partner's interest in the partnership."[1] For an allocation to have substantial economic effect, the allocation must have (i) economic effect and (ii) the economic effect must be substantial.[2] For an allocation to have economic effect, the partnership agreement must comply with the rules in the section 704(b) regulations, which ensure that the allocation is consistent with the partners' underlying economic arrangement.[3] An allocation's economic effect is substantial if there is a reasonable possibility that the allocation will affect substantially the dollar amounts received by the partners from the partnership, independent of tax consequences.[4]

Under current regulations, the *De Minimis* Exception allows partnerships to disregard the tax attributes of certain partners in applying the substantiality rules. Specifically, partnerships are not required to take into consideration the tax attributes of *de minimis* partners. A *de minimis* partner is defined as any partner, including a look-through entity, which owns, directly or indirectly, less than 10 percent of the capital and profits of a partnership, and who is allocated less than 10 percent of each partnership item of income, gain, loss, deduction, and credit.[5]

The preamble to the proposed regulations withdrawing the *De Minimis* Exception states that "the intent of the *de minimis* partner rule was to allow partnerships to avoid the complexity

[1] Treas. Reg. § 1.704-1(b)(1)(i).
[2] Treas. Reg. § 1.704-1(b)(2).
[3] Treas. Reg. § 1.704-1(b)(2)(ii).
[4] Treas. Reg. § 1.704-1(b)(2)(iii)(a). Treas. Reg. § 1.704-1(b)(2)(iii)(a), (b), and (c) provide three tests to determine whether the economic effect of an allocation is substantial. These tests are whether the allocation is a "shifting" allocation, whether the allocation is a "transitory" allocation, and the overall tax effect test.
[5] Treas. Reg. § 1.704-1(b)(2)(iii)(e).

of testing the substantiality of insignificant allocations to partners owning very small interests in the partnership" and not "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."[6]

B. The Need for a *De Minimis* Rule

We recognize that the flexible allocation regime available in subchapter K is vulnerable to abuse. We agree with the preamble to the proposed regulations that in some inappropriate situations, the *De Minimis* Exception, as written, can be used to entirely avoid the application of the substantiality regulations. Nevertheless, we think a *de minimis* rule is essential. Instead of abandoning the concept of a *de minimis* exception to section 704(b), the rules should be modified to prevent unintended tax consequences. We think crafting appropriate exceptions will continue to allow a significantly reduced burden of compliance with the substantial economic effect rules while still providing the safeguards that ensure appropriate allocations.

The section 704(b) regulations are extremely complex and roughly 100 pages in length. The regulations require a separate set of books for capital account maintenance intended to ensure compliance with the substantial economic effect rules. The section 704(b) rules require each desired special allocation to pass various tests, and each partnership to calculate and apply a hypothetical liquidation value of assets and liabilities at least once a year, to obtain professional valuations, and to ensure allocations are made based on positive capital account balances. These "section 704(b) books" are kept separately from any tax basis records for gain/loss purposes. Many practitioners avoid special allocations because most small clients whose partnership agreements would otherwise allow for special allocations are unwilling or unable to pay for expertise in this area to fully comply with the existing regulations

There are many everyday situations where the regulations result in a significant burden to the taxpayer without an offsetting benefit to the government. For example, a small partnership may have no allocations that are questionable under the current section 704(b) rules but which, without a *de minimis* rule, must still be properly tested to ensure that the allocations are not later nullified by the government. However, the partnership, or its tax preparer, may not have extensive knowledge of the complex partnership allocation rules. In these situations, the preparer may need to perform extensive research and analysis – which is time consuming and expensive – in order to confirm that the allocations comply with the section 704(b) rules.

A clearly defined *de minimis* rule or safe harbor helps minimize compliance burdens with little or no revenue impact to the government. Some of the benefits of a *de minimis* rule are that client costs are reduced, preparers who are not per se specialists in partnership taxation are able to advise their clients with certainty, and the partnership is placed in a situation the

[6] REG-109564-10, 76 Fed. Reg. at 66013 (Oct. 25, 2011).

IRS agrees is not abusive. Compliance costs should be commensurate with the abilities, business sophistication, and resources of the affected taxpayers.

Accordingly, we urge the IRS to retain an appropriate *de minimis* rule to simplify compliance without compromising the interests of the government.

II. SPECIFIC RECOMMENDATION

The AICPA proposes amending the section 704(b) regulations to provide that in a limited number of situations, the partnership will be deemed to satisfy the partnership allocation regulations. As we detail below in draft regulatory text, these common situations or arrangements include *pro rata* partnerships, *de minimis* service partnerships, and *de minimis* partnerships with *de minimis* partners. In each of these arrangements, we believe the section 704(b) rules are unnecessary either because the partnership will almost certainly satisfy the rules (in the case of *pro rata* partnerships) or the partnership is not likely to abuse the rules considering the amount of dollars involved.

Accordingly, we recommend that the rule in the proposed regulation be modified to read as follows:

1.704-1(b)(6)– *Allocations Deemed to Satisfy Section 704(b)*

(i*) In general*. A partnership's allocation of an item of income, gain, loss, deduction, or credit will not be challenged under section 704(b) by the Commissioner if the circumstances described in clauses (ii), (iii), or (iv) of this subparagraph exist for the current tax year and all prior tax years of the partnership.

(ii) *Pro rata partnership.* (*a*) A partnership qualifies under this subparagraph if:

(*1*) all contributions from partners to the partnership are cash;

(*2*) all items of partnership income, gain, loss, deduction, and credit are allocated *pro rata* based on the partners' relative contributions;

(*3*) all partnership liabilities are shared under section 752 *pro rata* based on the partners' relative contributions; and

(*4*) all partnership distributions, including liquidating distributions, are made *pro rata* based on the partners' relative contributions.

(*b*) *Exception for pro rata partnership with small disparity property.* If a partnership to which assets other than cash are contributed would otherwise qualify under this subparagraph, the partnership will qualify if all contributions to the partnership satisfy the small disparities rule of section 1.704-3(e)(1).

(iii) *De minimis service partnerships*.

(*a*) A partnership qualifies under this subparagraph if it and any predecessor partnership:

(*1*) has gross receipts (as defined in Treas. Reg. § 1.448-1T(f)(2)) of $5 million or less in each taxable year;
(*2*) 95 percent of the partnership's gross receipts is derived from services; and
(*3*) all partners are individuals who materially participate in the service activity(ies) of the partnership within the meaning of subsection 469(h).

(*b*) For purposes of this clause (iii), the gross receipts of any two or more partnerships will be aggregated if 80 percent or more of the capital or profits interests in each partnership are owned by the same persons (or related persons).

(iv) *De minimis partnerships with de minimis partners*. (*a*) A partnership qualifies under this subparagraph if:

(*1*) the aggregate fair market value (net of partnership liabilities) or tax basis of partnership property is $5 million or less at all times during each partnership taxable year,
(*2*) the partnership has gross receipts of $5 million or less in each taxable year, and
(*3*) no partner is allocated more than 10 percent of any partnership item.

(*b*) For purposes of this clause (iv), the property, liabilities, and gross receipts of any two or more partnerships will be aggregated if 80 percent or more of the capital or profits interests in each partnership are owned by the same persons (or related persons).

(v) *Expiration of rule*. In the first year, and all subsequent years, that the requirements of clauses (ii), (iii), or (iv) of this subparagraph are no longer satisfied, the partnership will not qualify under section 1.704-1(b)(6)(i) and all partnership allocations for the current and future years starting with the initial year in which the rule is not met may be challenged by the Commissioner under section 704 and the regulations thereunder.

(vi) *Definitions*. For purposes of this subparagraph (b)(6),

(*a*) a person is related to another person if the relationships between such persons is described in sections 267(b) or 707(b), (*b*) a partnership is a predecessor partnership to the extent it is a prior partnership of a resulting partnership within the meaning of section 1.708-1(d)(4)(iv).

III. REASONABLE PRESUMPTIONS NEEDED FOR LOOK-THROUGH PARTNERS

The AICPA also believes that simplifying provisions for application of the substantiality tests of Treas. Reg. § 1.704-1(b)(2)(iii) is appropriate with respect to partners that are look-through entities within the meaning of Treas. Reg. § 1.704-1(b)(2)(iii)(d)(2). If the partnership does not have knowledge of, or reason to know of the tax attributes of the owner of the look-through entity, we encourage the IRS to consider reasonable presumption standards that the partnership would apply in its substantiality analysis in situations such as (1) where the look-through entity partner holds a *de minimis* interest in the partnership and (2) where the look-through entity partner holds a significant interest in the partnership, but the look-through entity partner is itself widely-held.

Presumptions in these and similar situations would not negate the substantiality analysis, but would provide a reasonable basis for complying with section 704(b) given the likely *de minimis* tax attributes of the owners of the look-through entity partner.