



Passthrough Reform

**Summary of Senate Finance Committee
Chairman Wyden's (D-OR) Proposed Changes
to Subchapter K of the Internal Revenue Code
and Certain Related Provisions**



September 15, 2021

Passthrough Reform Discussion Draft

Background

- On September 10, 2021, Senate Finance Committee Chairman Wyden released a Passthrough Reform Discussion Draft, including a [section-by-section summary](#) (the “summary”) and [legislative text](#).
 - On August 5, 2021, Senate Finance Committee Chairman Wyden introduced the Ending the Carried Interest Loophole Act, including a [detailed summary](#) and [legislative text](#).
 - Chairman Wyden estimated the draft proposals would raise at least \$235.1 billion, but no Joint Committee of Taxation score has been released.
 - All references to “section” are to the Internal Revenue Code of 1986, as amended.
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Key Provisions

Provision	Description of Proposal	Effective Date
Section 701	<p><i>Technical clarifications due to the partnership audit regime</i></p> <ul style="list-style-type: none">• Amends section 701, given the enactment of the centralized partnership audit regime, to clarify that partnerships can, at times, be subject to entity-level taxation.• Allows the IRS to align tax reporting positions with the Financial Accounting Standards Board, which may require the reporting of uncertain tax positions that could trigger an entity-level liability.	There is no effective date on this provision
Section 704(a)	<p><i>Requires allocations be in accordance with a partner's interest in the partnership</i></p> <ul style="list-style-type: none">• Removes the “substantial economic effect” safe harbor test for partnership allocations and requires that all partnership allocations be made in accordance with the “partners’ interest in the partnership,” which would generally be in accordance with each partner’s contributions and rights to distributions.• Grants Treasury authority to add any other factors to determine the partner’s distributive share.	Taxable years beginning after 12/31/2023

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Section 704(b)	<p data-bbox="555 394 1770 546"><i>Requires pro rata allocations and distributions under the “consistent percentage method” for certain partnerships with related parties</i></p> <ul data-bbox="555 579 1880 1203" style="list-style-type: none"><li data-bbox="555 579 1880 715">• Creates a special allocation rule for certain partnerships with related parties that, according to the summary, “do not have sufficiently adverse interests.”<li data-bbox="555 748 1880 986">• If partners of a controlled group (as determined under section 267(f)) own 50% or more of the partnership’s capital or profits (as determined under section 267(e)(3)), this provision would require the partnership to consistently allocate all partnership items according to a partner’s “net contributed capital.”<li data-bbox="555 1019 1880 1203">• “Net contributed capital” is generally the excess of the sum of the fair market value of all property and money contributed by the partner over the amount of liabilities assumed in connection with any contribution by the partner to the partnership.	Taxable years beginning after 12/31/2023

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Section 704(b) (continued)	<ul style="list-style-type: none">• Defines this allocation method as the “consistent percentage method.” According to the summary, this method is intended to “discourage non-proportional allocations and distributions.”• Any distribution or right to partnership property not proportional to the partner’s net contributed capital would be treated as a transaction directly between partners, resulting in immediate income recognition without recovery of any basis a partner may have in its partnership interest.• Grants Treasury broad authority to require the use of the consistent percentage method by other partnerships in order to prevent abuse.• Requires additional reporting, subject to penalties, for these related party partnerships.	
Section 704(c)(1)(A)	<p><i>Makes remedial allocations mandatory</i></p> <ul style="list-style-type: none">• Requires that all partnerships use the remedial method for section 704(c) allocations, as described under Treas. Reg. § 1.704-3(d).	Effective for property contributed to a partnership after 12/31/2021

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Section 704(f)	<p><i>Requires revaluations of partnership property</i></p> <ul style="list-style-type: none">• Requires revaluations of partnership property upon the occurrence of any event described in Treas. Reg. § 1.704-1(b)(2)(iv)(f) and Prop. Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5) or identified by Treasury, as in the case of tiered partnerships.• The summary states that “the rules of section 704(c)(1)(B) and 737 would not apply to reverse section 704(c) allocations <i>unless</i> the Secretary issues regulations to the contrary” (emphasis added).	Applicable to revaluation events (as defined under new section 704(f)(2)) occurring after 12/31/2021
Sections 704(c)(1)(B) and 737	<p><i>Permanent extension of the anti-mixing bowl rules</i></p> <ul style="list-style-type: none">• Repeals the seven-year time period for the application of the anti-mixing bowl rules and, therefore, according to the summary, “would apply [the anti-mixing bowl rules] to contributed property regardless of the time since contributed.”	Applicable to property contributed to a partnership after 12/31/2021

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Section 705(b)	<p><i>Clarifications to the alternative rule in determining outside basis</i></p> <ul style="list-style-type: none">• Grants Treasury the authority to apply the “alternative rule” to the determination of outside basis in situations other than partnership terminations. The “alternative rule” generally requires that the adjusted basis of a partner’s interest in a partnership is determined by reference to its proportionate share of the adjusted basis of partnership property.	Effective as of date of enactment
Sections 707, 736, 753, and 761	<p><i>Repeals guaranteed payments; repeals rules relating to payments to retiring and deceased partners</i></p> <ul style="list-style-type: none">• Repeals guaranteed payments under section 707(c), with section 707(a) generally governing the tax treatment of such payments.• Repeals section 736 in order, as the summary states, to better “align payments to retirees and successors-in-interest partners with the general rules under Subchapter K.”• Amends section 761 to provide that a retiring or deceased partner’s successor in interest remains a partner until there is a complete liquidation of such partner’s or successor’s interest in the partnership.	Section 707: Effective for transactions and payments made after 12/31/2021 Section 761: Effective for partners retiring or dying after 12/31/2021

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Section 707(a)(2)	<p data-bbox="555 394 1844 494"><i>Clarifications to the disguised sale rules, including removal of the capital expenditures exception</i></p> <ul data-bbox="555 522 1844 843" style="list-style-type: none"><li data-bbox="555 522 1844 608">• Clarifies that the rules under section 707(a)(2) apply to disguised sales of partnership interests.<li data-bbox="555 636 1844 722">• According to the summary, the intent of this provision is to “clarify that the disguised sale rules are self-executing.”<li data-bbox="555 751 1844 843">• Removes the exception to the disguised sale rules for reimbursements of capital expenditures (Treas. Reg. § 1.707-4(d)).	Generally effective for services performed or property transferred after the date of enactment. An exception for the capital expenditures proposal is provided for binding contracts by a partner in effect on the date of enactment
Section 708	<p data-bbox="555 936 1870 979"><i>Clarifications to the partnership termination rules</i></p> <ul data-bbox="555 1008 1870 1200" style="list-style-type: none"><li data-bbox="555 1008 1870 1200">• Clarifies, according to the summary, “that a partnership is not terminated if any part of the business is carried on by a person or persons who was a partner in the prior partnership or by a person related to any of those partners.”	Effective for taxable years beginning after the date of enactment

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Section 751(b)	<p><i>Removes requirement that inventory must be “substantially appreciated” under the “hot asset” rules</i></p> <ul style="list-style-type: none">• Treats all inventory items as ordinary income property.	Applicable to distributions made after the date of enactment
Section 752	<p><i>Requires that all debt is allocated between partners in accordance with the partnership profits</i></p> <ul style="list-style-type: none">• Applies a limited exception where the partner or a related person (under sections 267 and 707(b)) to the partner is the lender.• Provides a transition rule that allows taxpayers to pay a liability that results from this proposal over eight years.<ul style="list-style-type: none">• Special rules apply to these payments in the case of an acceleration event.	Effective for taxable year beginning after 12/31/2021

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Provision	Description of Proposal	Effective Date
Sections 734, 743, and 754	<p><i>Requires mandatory basis adjustments in the case of transfers and distributions; changes the basis adjustment rules</i></p> <ul style="list-style-type: none">• Repeals section 754 and mandates basis adjustments, regardless of the amount, in the case of all distributions and transfers of partnership interests.• Changes how an adjustment under section 734 is computed. This change would result in the need to determine—upon every distribution—whether any partner has had a change in its share of partnership gain or loss, no matter how small.	Effective for distributions or transfers occurring after 12/31/2021

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Other Provisions

Provision	Description of Proposal	Effective Date
Section 163(j)(4)	<p data-bbox="552 394 1717 494"><i>Revises the business interest limitation to apply only at the partnership level</i></p> <ul data-bbox="552 522 1870 843" style="list-style-type: none"><li data-bbox="552 522 1870 679">• Generally, limits the ability of partners to use items from a partnership to deduct business interest from other sources.<ul data-bbox="647 636 1615 679" style="list-style-type: none"><li data-bbox="647 636 1615 679">• Applies similar rules for shareholders in S corporations.<li data-bbox="552 708 1870 843">• Specifically, excess business interest income and excess taxable income from a partnership could be used only to deduct business interest from the partnership that previously allocated those items to the partner.	Effective for taxable years beginning after 12/31/2021
Section 7704	<p data-bbox="552 893 1658 993"><i>Repeals the corporate tax exemption for publicly traded partnerships</i></p> <ul data-bbox="552 1022 1773 1115" style="list-style-type: none"><li data-bbox="552 1022 1773 1115">• Also includes a conforming amendment to repeal the special rules for publicly traded partnership under section 199A.	Effective for taxable years beginning after 12/31/2022

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Other Provisions

Provision	Description of Proposal	Effective Date
Section 852(b)(6)	<p data-bbox="555 394 1824 489"><i>Repeals the gain recognition exception for regulated investment companies</i></p> <ul data-bbox="555 522 1854 611" style="list-style-type: none"><li data-bbox="555 522 1854 611">• Gain would be recognized upon a distribution of appreciated property to a redeeming shareholder by a regulated investment company.	Effective for taxable years beginning after 12/31/2022
Section 52(b)	<p data-bbox="555 711 1735 753"><i>Trade or business not required for certain aggregation rules</i></p> <ul data-bbox="555 786 1854 1039" style="list-style-type: none"><li data-bbox="555 786 1854 925">• Clarifies that a taxpayer, including a foreign entity, is subject to the section 52(b) aggregation rules, if the taxpayer is engaged in any activity in connection with a trade or business or any for-profit activity.<li data-bbox="555 951 1854 1039">• For purposes of this provision, a trade or business includes any activity under section 469(c)(5) or (6).	Effective for taxable years 12/31/2021

Carried Interests

Provision	Description of Proposal	Effective Date
Sections 83, 1061, and 1299	<p data-bbox="555 394 1773 486"><i>Repeals section 1061 and provides new rules for treatment of carried interests</i></p> <ul data-bbox="555 522 1862 1215" style="list-style-type: none"><li data-bbox="555 522 952 558">• Repeals section 1061.<li data-bbox="555 589 1849 725">• Intent is to treat the service partner as having deemed compensation income equal to foregone interest, as if the general partner had borrowed an amount necessary to invest in the partnership.<li data-bbox="555 756 1862 996">• Introduces new section 1299 to provide that a taxpayer holding an “applicable partnership interest” is treated as recognizing ordinary income equal to the partner’s deemed compensation amount. A taxpayer with a deemed compensation amount is concurrently treated as realizing a long-term capital loss in equivalent amount.<li data-bbox="555 1028 1862 1215">• The deemed compensation amount is calculated and recognized annually (at each “measurement date”) based on a specific rate of return on an applicable percentage (<i>e.g.</i>, the carry percentage) of the investment capital of all partners over the service partner’s invested capital.	Effective for taxable years beginning after date of enactment, with or within which ends the taxable year of a partnership which begins after such date.

Carried Interests

Provision	Description of Proposal	Effective Date
Sections 83, 1061, and 1299 (continued)	<ul style="list-style-type: none">• The provision applies through the applicable period, which is <i>generally</i> a 10-year period beginning on the date the taxpayer acquired the “applicable partnership interest” (subject to exceptions).• Amends section 83 to value at issuance a compensatory partnership based on its liquidation value.• Rev. Procs. 93-27 and 2001-43 will not apply to the transfer of a partnership interest to which section 1299 applies.	Effective for taxable years beginning after date of enactment, with or within which ends the taxable year of a partnership which begins after such date.



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