Overview

The discussion draft would reform major areas of tax law that are abused by sophisticated taxpayers by removing ambiguity and closing tax loopholes for pass-through entities, primarily partnerships, that allow investors and corporations to pick and choose when to pay tax. The complexity and ambiguity of the partnership tax rules make them nearly impossible for the IRS to administer, to the detriment of taxpayers who play by the rules and to the benefit to wealthy individuals and mega-corporations.

Because of this complexity, average taxpayers struggle to comply and sophisticated taxpayers can avoid tax with little (or no) fear of detection. Mega-corporations often form partnerships with their own subsidiaries or tiers of partnerships for the sole purpose of lowering their tax bills. For example, about 52 percent of all partnership income flows through to other partnerships and corporations. Partnerships are highly concentrated among the wealthiest households, and pass-through income accounts for much of the rise in the top 1 percent income share. Without reform, partnerships will continue to be one of the primary ways the wealthiest individuals and most profitable corporations avoid paying their fair share.

Why is partnership tax complexity a problem?

Current partnership tax rules are too complicated for the IRS to enforce. Although computers can check a wage earner’s return, the IRS needs highly-skilled specialists to audit partnerships. It audited only about 0.03 percent of the partnership returns filed for tax year 2018.

When the IRS does audit partnerships, tax complexity, combined with tiered and circular ownership makes its job more difficult. One study found that 15 percent of partnership income was circular—the income flowed endlessly between partnerships that owned each other—and the authors couldn’t trace 20 percent, even with access to IRS data. Not surprisingly, a recent study found “random audits do not capture most tax evasion … [by] pass-through businesses.” The IRS Commissioner recently acknowledged that the agency gets “outgunned” by private sector experts, citing partnership tax complexity.

These loopholes make taxes optional for the top 1 percent. So it is not surprising that partnerships are increasingly popular among that group. The share of all net business income running through partnerships has increased nearly tenfold since 1980 – and partnership income is highly concentrated among big businesses and the wealthiest households. About 58 percent of businesses with more than $50 million in receipts are pass-throughs, and 70 percent of partnership income accrues to the top 1 percent. By comparison, only about 45 percent of C corporation income accrues to the top 1 percent. By closing loopholes, the proposal will make compliance easier for taxpayers who follow the rules, allow the IRS to more successfully audit tax cheats, and raise revenue in a progressive manner.

What are some examples of partnership tax loopholes and how would the discussion draft fix them?

- Contributions and distributions of appreciated (or depreciated) property are generally tax free. Partnerships are supposed to allocate built-in gains and losses on contributed property in a way that limits abuse, but they get to choose among three or more allocation methods. Only one—the “remedial method”—actually prevents tax from being shifted between the partners. The discussion draft would require partnerships to use the remedial method making sure gain, and the related tax liability, cannot be shifted.
- Upon a change in the interests of the partners, a partnership can elect—but is not required—to revalue its assets to prevent the shifting of built-in gain and loss. The discussion draft would require partnerships to use the remedial method making sure gain, and the related tax liability, cannot be shifted.
- The partnership tax rules afford tremendous flexibility in the allocation of partnership income and losses among partners. The discussion draft would remove optionality and in doing so, simplify administration and curtail abuse. For certain related-party partnerships, the discussion draft would require all income and loss to be allocated pro-rata.