NEW YORK STATE BAR ASSOCIATION
TAX SECTION

REPORT ON

PROPOSED REGULATIONS WITHDRAWING THE *DE MINIMIS* EXCEPTION FROM THE SECTION 704(b) REGULATIONS

REPORT NO. 1256

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Report No. 1256

NEW YORK STATE BAR ASSOCIATION TAX SECTION

PROPOSED REGULATIONS WITHDRAWING THE *DE MINIMIS* EXCEPTION FROM THE SECTION 704(b) REGULATIONS

Introduction

This report[1] of the New York State Bar Association Tax Section provides comments on regulations proposed on October 25, 2011 (the "Proposed Regulations") concerning the withdrawal of the *de minimis* exception of Treas. Reg. § 1.704-1(b)(2)(iii)(*e*) (the "*De Minimis* Exception") from the section 704(b) regulations.[2] Under the Proposed Regulations, the tax attributes of *de minimis* partners no longer would be disregarded when testing whether a partnership allocation is "substantial" for federal tax purposes. This report also responds to the request for comments in the preamble to the Proposed Regulations on how to reduce the burden of complying with the substantial economic effect rules, with respect to look-through partners, without diminishing the safeguards that the rules provide.

This report is divided into three parts. Part I contains a general summary and background of the current law relating to the issues described above. Part II contains a list of our recommendations. Part III contains a detailed discussion of our recommendations.

I. Current Law

Section 704(a) provides that the partnership agreement generally governs the determination of each partner's distributive share of the partnership's tax items. Under section 704(b), however, if the partnership agreement does not provide for 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."[3] The section 704(b) regulations provide a two-part test for determining whether an allocation has substantial economic effect: (1) the allocation must have "economic effect"; and (2) the

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[1] The principal authors of this report are Eric Sloan and Matthew Lay, with substantial assistance from Linda Hui and Michael Kohler. Significant contributions were made by David Mayo, Joel Scharfstein, and David Schnabel. Helpful comments were received from Stephen Land, Krista Lindhard, Vadim Mahmoudov, Andrew Needham, Peter Connors, and Michael Schler. This report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or its House of Delegates.

[2] REG-109564-10, 76 Fed. Reg. 66012 (Oct. 25, 2011). Unless indicated otherwise, all "section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" references are to the Treasury regulations promulgated under the Code, both as in effect on the date of this report.

[3] Treas. Reg. § 1.704-1(b)(1)(i).

economic effect must be "substantial."[4] For an allocation to have economic effect, the partnership agreement generally must comply with detailed rules contained in the section 704(b) regulations that are intended to ensure that the allocations made by the partnership are "consistent with the underlying economic arrangement of the partners."[5]

The regulations provide that 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."[6] The section 704(b) regulations contain three tests for determining whether the economic effect of an allocation is substantial.

First, the economic effect of an allocation is not substantial if the allocation is a "shifting" allocation.[7] Under the regulations, a "shifting" allocation is an *intra*-year allocation that allocates varying types of income or loss to the partners to take advantage of the partners' differing tax positions.[8] An allocation will be a "shifting" allocation if, at the time the allocation becomes a part of the partnership agreement, there is a "strong likelihood" that (i) the partners' capital accounts will not be substantially different from what they would have been without the special allocation (*i.e.*, under a baseline allocation) and (ii) the aggregate tax liability of the partners is lower than it would have been without the special allocation.[9]

Second, the economic effect of an allocation is not substantial if the allocation is a "transitory" allocation.[10] In contrast to shifting allocations, transitory allocations are *inter*-year allocations.[11] Similar to the test regarding shifting allocations, though, an allocation will be a "transitory" allocation if, at the time the allocation becomes a part of the partnership agreement, there is a "strong likelihood" that (i) the partners' capital accounts will not be substantially different at the end of the period during which the allocations were made than they would have been without the special allocations and (ii) the aggregate tax liability of the partners is lower than it would have been without the special allocations.[12]

Finally, the economic effect of an allocation is not substantial under the "overall tax effect" test if,

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4 Treas. Reg. § 1.704-1(b)(2).

5 Treas. Reg. § 1.704-1(b)(2)(ii)(*a*). The regulations contain three alternative tests to determine whether this requirement is satisfied: (1) the "primary" test (Treas. Reg. § 1.704-1(b)(2)(ii)(*b*)); (2) the "alternate" test (Treas. Reg. § 1.704-1(b)(2)(ii)(*d*)); and (3) the "economic equivalence" test (Treas. Reg. § 1.704-1(b)(2)(ii)(*i*)).

6 Treas. Reg. § 1.704-1(b)(2)(iii)(*a*).

7 Treas. Reg. § 1.704-1(b)(2)(iii)(*b*).

8 *Id*.

9 *Id*.

10 Treas. Reg. § 1.704-1(b)(2)(iii)(*c*).

11 *Id*.

12 *Id*.

> at the time the allocation becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement.[13]

In determining the after-tax economic benefit or detriment to a partner, "tax consequences that result from the interaction of the allocation with the partner's tax attributes that are unrelated to the partnership will be taken into account."[14] As is the case with shifting and transitory allocations, an allocation is tested for substantiality under the overall tax effect test "at the time the allocation becomes part of the partnership agreement."[15]

On April 21, 2004, the Treasury Department ("Treasury") and the Internal Revenue Service (the "IRS") issued temporary regulations relating to the proper allocation of partnership creditable foreign tax expenditures.[16] In the preamble to those regulations, Treasury and the IRS expressed concern that some partnerships were taking the position that, in determining whether the economic effect of a partnership allocation is substantial, they need not consider the tax consequences to an owner of the partner that result from the allocation. Treasury and the IRS indicated in the preamble that they believed that this position was "inconsistent with the policies underlying the substantial economic effect rules, because it would allow a partnership to make tax-advantaged allocations if the tax advantages of the allocations accrue to an *owner* of a partner, rather than to the partner itself."[17]

On November 18, 2005, Treasury and the IRS proposed regulations (the "Look-Through Regulations") providing that, when testing the substantiality of an allocation to a partner that is a look-through entity, the interaction of the allocation with the tax attributes of

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13 Treas. Reg. § 1.704-1(b)(2)(iii)(*a*).

14 *Id.*

15 *Id.*

16 T.D. 9121, 69 Fed. Reg. 21405 (Apr. 21, 2004).

17 *Id.* at 21407. We are aware of two other situations in which the tax attributes of a partnership's partners may need to be considered. First, Treas. Reg. § 1.704-3(a)(10), as amended in 2010, provides that, for purposes of applying the anti-abuse rule under the section 704(c) regulations, the tax effect of an allocation method (or combination of methods) on both direct and indirect partners must be considered. Treasury and the IRS expressly declined to adopt a *de minimis* partner rule for purposes of this rule. T.D. 9485, 75 Fed. Reg. 32659 (June 9, 2010). Second, proposed regulations on noncompensatory options contain a rule that would recharacterize an option as a partnership interest if certain conditions are satisfied, including a substantial reduction in the tax liability of a partnership's partners and the holder of the option. As drafted, this rule does not expressly require the partnership to examine the tax attributes of indirect owners. Prop. Reg. § 1.761-3(a); REG-103580-02, 68 Fed. Reg. 2930 (Jan. 22, 2003). Whether any changes should be made to the anti-abuse rule in the section 704(c) regulations and the recharacterization rule in the proposed noncompensatory option regulations is beyond the scope of this report.

owners of look-through entities must be taken into account.[18] For this purpose, look-through entities generally include partnerships, S corporations, trusts and estates, disregarded entities, and controlled foreign corporations.[19] Comments submitted in response to the proposed Look-Through Regulations noted the practical and administrative difficulties of obtaining the information necessary to comply with the regulations.[20] One commentator remarked that:

> 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. . . . 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.[21]

On May 19, 2008, final Look-Through Regulations were promulgated that adopted the proposed regulations with certain modifications.[22] In response to comments, the final Look-Through Regulations added the *De Minimis* Exception, which provides that, in determining whether an allocation is substantial, "the tax attributes of *de minimis* partners need not be taken into account."[23] For this purpose, a "*de minimis* partner" is "any partner, including a look-through entity that 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."[24] Indirect ownership of stock or another equity

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18 REG-144620-04, 70 Fed. Reg. 69919 (Nov. 18, 2005).

19 Prop. Reg. § 1.704-1(b)(2)(iii)(*a*)(*2*)(*ii*) (Treas. Reg. § 1.704-1(b)(2)(iii)(*d*)(*2*) in the final regulations). The proposed regulations also provided that if a partner is a member of a consolidated group, the tax consequences that result from the interaction of the allocation with the tax attributes of the consolidated group and with the tax attributes of another member with respect to a separate return year must be taken into account. Prop. Reg. § 1.704-1(b)(2)(iii)(*a*)(*2*)(*i*) (Treas. Reg. § 1.704-1(b)(2)(iii)(*d*)(*2*)).

20 *See, e.g., Attorneys Comment on Proposed Partnership Allocation Regs*, 2006 TNT 47-23 (Feb. 22, 2006) (McDermott Will & Emery, Comments on Proposed Regulations Under Section 704(b)) (noting the difficulty of obtaining information through tiers of investment partnerships and stating that, in the commentators' experience, the tax attributes of partners in upper tier partnerships "have no bearing" on the allocation provisions contained in investment partnerships).

21 American Bar Association Tax Section, *Comment on Proposed Regulations Concerning Substantiality of Allocations Made to "Look-Through" Partners, reprinted in* 2007 TNT 2-12 (Dec. 29, 2006).

22 T.D. 9398, 73 Fed. Reg. 28699 (May 19, 2008). The final regulations modified the proposed regulations by, among other things, expanding the definition of look-through entities to include estates and limiting the application of the controlled foreign corporation look-through rule to cases in which "U.S. shareholders" of the controlled foreign corporation in the aggregate own, directly or indirectly, at least 10 percent of the capital or profits interests of the partnership.

23 Treas. Reg. § 1.704-1(b)(2)(iii)(*e*).

24 *Id*. If a look-through entity owns at least 10 percent of the capital or profits of a partnership or is allocated at least 10 percent of any partnership item, that look-through entity would not itself be a *de minimis* partner. Based on the "indirectly" language of the regulation, however, the existing *De Minimis* Exception apparently could apply

interest (such as an interest in a partnership) is determined in accordance with the principles of section 318, substituting the phrase "10 percent" for the phrase "50 percent" each time it appears.[25]

II. Principal Recommendations

The principal recommendations of this report are as follows:

1. The *De Minimis* Exception should be withdrawn.

2. The provisions of the Proposed Regulations, when finalized, should apply to all allocations made for partnership taxable years ending on or after the effective date of those regulations, regardless of when the provisions requiring those allocations became a part of the relevant partnership agreement.

3. Treasury and the IRS should publish a notice providing that the provisions of the Proposed Regulations, when finalized, will be effective for partnership taxable years ending on or after the date of the notice.

4. In place of the *De Minimis* Exception, Treasury and the IRS should adopt a rule permitting partnerships, when applying the substantiality tests of Treas. Reg. § 1.704-1(b)(2)(iii), to make reasonable assumptions about the tax attributes of a limited number of partners that own relatively small interests and about the identity and tax attributes of partners that own interests in the partnership indirectly through look-though entities ("*De Minimis* Partners" and "Indirect Partners," respectively, as defined below). Whether a partnership's assumptions about the identity and tax attributes of these partners are reasonable should be determined based on all of the facts and circumstances. If a partnership relies on this rule, then, provided the partnership's assumptions are reasonable, allocations that would be substantial on the basis of those reasonable assumptions would be respected even if those assumptions later are determined to have been incorrect.

5. Future regulations should require the partnership to make reasonable inquiries regarding the tax attributes of all of its *De Minimis* Partners and the identity and tax attributes of its Indirect Partners, if the partnership desires to rely on the reasonable assumptions rule.

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to a person that owns an interest in that entity if that person indirectly owns less than a 10 percent indirect interest in the capital and profits of the partnership and is allocated less than 10 percent of each partnership item. If, however, the indirect owner owns (or is treated as owning) interests in more than one look-through entity or owns a combination of direct and indirect interests, then all of the indirect partner's interests apparently should be combined in determining whether that partner qualifies as a *de minimis* partner.

[25] Treas. Reg. § 1.704-1(b)(2)(iii)(*d*)(*6*).

III. Detailed Discussion

A. The *De Minimis* Exception Should Be Withdrawn

As discussed below, we agree that the *De Minimis* Exception should be withdrawn.

The preamble to the Proposed Regulations explains that "the 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."[26] It 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."[27]

The potential for abuse is demonstrated by the following example.

> **Example 1**.[28] Eleven individuals and one tax-exempt organization form Partnership. The tax-exempt organization contributes 50 percent of Partnership's initial capital, and each of the individuals contributes equal amounts of the remaining 50 percent of the initial capital. Partnership acquires tax-exempt and corporate bonds. Over the next several years, the eleven individuals expect to be in the 35 percent marginal tax bracket.
>
> The partners agree to share the gains and losses from the sale of Partnership's bonds in proportion to their contributed capital. The partners agree, however, to allocate all of Partnership's taxable interest income to the tax-exempt partner and all of Partnership's tax-exempt interest income to the individual partners (*pro rata* in accordance with their contributed capital). The partnership agreement complies with the alternate test for economic effect.
>
> There is a strong likelihood that in each of the next several years Partnership will recognize between $450 and $550 of tax-exempt interest and between $450 and $550 of taxable interest from its investments.[29] The allocation of taxable interest and tax-exempt interest has economic effect, and that economic effect would not be substantial under the rules set forth in Treas. Reg. § 1.704-1(b)(2)(iii).

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

27 *Id*.

28 This example is based on Treas. Reg. § 1.704-1(b)(5), *Example* 5.

29 With the allocation, the individual partners would receive aggregate after-tax income of between $450 and $550. If, instead, all interest income were allocated to all the partners *pro rata*, the individual partners would receive aggregate after-tax income of between $371.25 and $453.75.

> Thus, at the time the allocations became part of the partnership agreement, the individual partners are expected to enhance their respective after-tax economic consequences as a result of the allocations. On the other hand, there is a strong likelihood that none of the partners will substantially diminish their after-tax economic consequences as a result of the allocations. The allocation of tax-exempt interest income and taxable interest income is not expected to result in allocations that substantially affect the dollar amounts to be received by the partners.
>
> Nevertheless, it appears that the *De Minimis* Exception applies to the individuals in this situation. Each of the individuals owns less than 10 percent of the capital and profits of Partnership. Each individual also is allocated less than 10 percent of each partnership item: 9 percent of the tax-exempt interest income and 4.5 percent of every other item. Accordingly, the tax attributes of the individual partners are not taken into account in testing for substantiality. As a result, the allocations of tax-exempt and taxable income are substantial and would not be reallocated in accordance with the partners' interests in the partnership under Treas. Reg. § 1.704-1(b)(3).

The results reached in Example 1 are inconsistent with sound tax policy. Although the stated objective of the *De Minimis* Exception – to allow partnerships to avoid the complexity of testing the substantiality of insignificant allocations to partners owning very small interests in the partnership – is laudable, the rule in the current regulations is easily abused. Further, as discussed below, a rule allowing partnerships to make certain reasonable assumptions can accomplish the goal of reducing the burden of testing substantiality with respect to partners owning small interests without opening the door to abusive tax planning. For this reason, we agree that the *De Minimis* Exception should be withdrawn.

B. Taxpayers Should Not Be Permitted to Rely on the *De Minimis* Exception to Sustain the Substantiality of Allocations Made From and After the Effective Date of Final Regulations, Even with Respect to Allocations Made Pursuant to Allocation Provisions Adopted Before the Effective Date of Final Regulations

As noted above, whether an allocation is considered to be substantial is determined "at the time the allocation [provision] becomes part of the partnership agreement."[30] Consequently, allocations that are substantial because of the *De Minimis* Exception will continue to be substantial even after the *De Minimis* Exception is withdrawn.

For the same reasons that we believe that the *De Minimis* Exception should be withdrawn promptly, we recommend that the provisions of the Proposed Regulations, when finalized, should apply to all allocations made for partnership taxable years ending on or after the effective date of those regulations, regardless of when the provisions requiring those allocations

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[30] Treas. Reg. § 1.704-1(b)(2)(iii)(*a*).

became a part of the relevant partnership agreement. In making this suggestion, we are mindful that when the section 704(b) regulations have been amended in the past, transition rules were provided with respect to allocations made pursuant to existing partnership agreements.[31] Nevertheless, we believe that the *De Minimis* Exception is sufficiently flawed as a matter of tax policy that no transition rule is warranted.[32]

C. Treasury and the IRS Should Publish a Notice Providing that the Provisions of the Proposed Regulations, When Finalized, Will Be Effective as of the Date of the Notice

The Proposed Regulations will be effective on "the date final regulations are published in the Federal Register."[33] Thus, partnerships may continue to rely on the *De Minimis* Exception until final regulations are issued.[34] For the reasons discussed above, we believe that the *De Minimis* Exception is inconsistent with sound tax policy and should be withdrawn promptly. Therefore, we recommend that the provisions of the Proposed Regulations, when finalized, be effective for partnership taxable years ending on or after the date of the notice.[35]

D. Reasonable Assumptions Rule for *De Minimis* and Indirect Partners

1. The Reasonable Assumptions Rule

To determine whether a partnership's allocations are substantial, a partnership must know the tax attributes of its partners. Because partnerships (such as real estate partnerships and other investment partnerships) typically are comprised of partners that are themselves partnerships or other passthrough entities, however, it is often difficult or impossible

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[31] *See*, *e.g*., Treas. Reg. § 1.704-1(b)(1)(ii)(*b*)(*2*) (providing transition relief regarding the allocation of creditable foreign tax expenditures by partnerships whose partnership agreements were entered into before April 21, 2004).

[32] If this recommendation is adopted, consideration should be given to providing guidance regarding the impact on allocations made pursuant to existing partnership agreements. For example, assume that a partnership agreement provided for an allocation in 2008 to be reversed in year 2 (after the effective date of the Proposed Regulations, when they are finalized). Assume further that the economic effect of that allocation was not insubstantial because of the *De Minimis* Exception, but would have been insubstantial without the benefit of the *De Minimis* Exception. In this case it is not entirely clear how the partnership would properly allocate its income in year 2.

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

[34] *See generally* "IRS Official Discusses Changes in Final Rules on Partnership Indebtedness Income," Daily Tax Rep. (BNA) No. 221, at G-10 (Nov. 16, 2011) (reporting that Curt Wilson, Associate Chief Counsel (Passthroughs and Special Industries), stated that because the withdrawal of the *De Minimis* Exception is contained in proposed regulations, "people still have the opportunity to use the current regs for the time being").

[35] The current version of section 7805(b)(1)(C), which prescribes the circumstances under which Treasury and the IRS are permitted to promulgate retroactive regulations, applies only to regulations that relate to statutory provisions enacted on or after July 30, 1996. Taxpayer Bill of Rights 2, Pub. L. No. 104-168, § 1101(a), 110 Stat. 1452, 1468-69 (1996). The current version of section 7805(b)(1)(C) does not apply to regulations under section 704(b), because section 704(b) was not enacted after July 30, 1996. Nevertheless, we believe that, if Treasury and the IRS decide to make the final regulations retroactive, it would be sound tax policy for Treasury and the IRS to issue a notice so that taxpayers will be notified of this change.

for partnerships to obtain the necessary information about their ultimate partners.[36] Perhaps for this reason, Treasury and the IRS (in the preamble to the Proposed Regulations) requested comments on how to reduce the burden of complying with the substantial economic effect rules with respect to Indirect Partners without diminishing the safeguards the rules provide.

We believe that an appropriate balance can be struck between the burdens of compliance and the need to prevent abusive partnership allocations by permitting partnerships to make reasonable assumptions about certain classes of partners. Specifically, we recommend that Treasury and the IRS promulgate regulations that permit partnerships to apply the substantiality tests of Treas. Reg. § 1.704-1(b)(2)(iii) based on "reasonable assumptions," discussed below, about (i) the tax attributes of any partner that owns (directly, indirectly, and through attribution)[37] not more than a 5 percent interest in the capital or profits of the partnership (each, a "*De Minimis* Partner") [38] and (ii) the identity and tax attributes of any person that owns an interest in the partnership indirectly through one or more "look-through entities" within the meaning of Treas. Reg. § 1.704-1(b)(2)(iii)(*d*)(*2*) other than disregarded entities[39] (each, an "Indirect Partner").

We recommend that future regulations provide that, to be able to rely on the reasonable assumptions rule, a partnership must make reasonable inquiries regarding the tax attributes of all *De Minimis* Partners and Indirect Partners. If, after making reasonable inquiries,

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36 There are certain situations in which partners are obligated to provide information to their partnerships or in which partnerships are obligated to seek information from their partners. *See*, *e.g*., Treas. Reg. § 1.743-1(k)(2)(i) (a transferee of an interest in a partnership that has a section 754 election in effect for the year of the transfer, resulting in a section 743(b) basis adjustment, must notify the partnership of the transfer); Treas. Reg. § 1.752-2(k)(5) (requiring the owner of a disregarded entity to provide information to the partnership as to the entity's tax classification if the partner may be treated as bearing the economic risk of loss for a liability of the partnership); Treas. Reg. § 1.6050K-1(d)(1) (requiring a partner that transfers an interest in a partnership that owns section 751 property to notify the partnership of the transfer); Temp. Treas. Reg. § 1.108(i)-2T(b)(3)(iv) (requiring that partners furnish information at the request of a partnership electing to defer cancellation of indebtedness income under section 108(i)); Notice 2005-32; 2005-1 C.B. 895 (requiring transferees of partnership interests to comply with Treas. Reg. § 1.743-1(k)(2) if the partnership has a substantial built-in loss at the time of the transfer). *Cf.* Treas. Reg. § 1.1446-1(c)(2) (requiring a partnership to obtain withholding certificates and providing that, if a partnership has actual knowledge or reason to know that any information on a withholding certificate or statement is incorrect or unreliable, or if its knowledge of relevant facts or if statements contained on the form or other documentation is such that a reasonably prudent person in the position of the withholding agent would question the claims made, the partnership may not rely upon such documentation); and Treas. Reg. § 1.1446-1(c)(3) (providing that if a valid withholding certificate is otherwise not available to a partnership, then the partnership "must presume that the partner is a foreign person").

37 For this purpose, indirect ownership should be determined in the same manner as in Treas. Reg. § 1.704-1(b)(2)(iii)(*d*)(*6*), which incorporates the principles of section 318 by reference, substituting the phrase "10 percent" for the phrase "50 percent" each time it appears.

38 To be a *De Minimis* Partner, one must be a direct partner, *i.e.*, one must actually own an interest in the partnership for U.S. federal income tax purposes. Thus, if one owns an interest in a partnership only indirectly or through attribution, one cannot be a *De Minimis* Partner, although one might be an Indirect Partner.

39 When a partnership interest is owned by a disregarded entity, the partnership generally must know who the owner of that disregarded entity is because the owner of the disregarded entity is treated as the owner of the partnership interest for tax purposes. *See* Treas. Reg. § 1.752-2(k)(5) (requiring the owner of a disregarded entity to provide information to the partnership as to the entity's tax classification if the partner may be treated as bearing the economic risk of loss for a liability of the partnership).

the partnership is unable to obtain the necessary information with respect to certain *De Minimis* Partners and Indirect Partners, the partnership then should be permitted to make reasonable assumptions about the tax attributes of those partners, but only if, in the aggregate, those *De Minimis* Partners and Indirect Partners do not own more a 30 percent interest in the profits and capital of the partnership.

If a partnership relies on this rule, then, provided the partnership's assumptions are reasonable,[40] allocations that would be substantial on the basis of those reasonable assumptions would be respected even if those assumptions later are determined to have been incorrect. The standards for determining reasonableness are discussed below.

2. Standard for Determining Reasonableness

Whether a partnership's assumptions about the tax attributes of *De Minimis* Partners and the identity and tax attributes of Indirect Partners are reasonable should be determined based on all of the facts and circumstances. To be reasonable, an assumption must be consistent with information the partnership actually has about the tax attributes of its *De Minimis* Partners, the ownership of partners that are look-through entities, and the tax attributes of its Indirect Partners, as well as information that the partnership should be treated as having, such as publicly available information. We recommend that future regulations provide examples illustrating the application of this standard. For example,

- If a partner has provided a partnership with a mailing address in another country for purposes of receiving her Schedule K-1 or provides withholding certificates indicating that she is a foreign national, it would be reasonable for the partnership to assume that the partner is a non-U.S. person who in general is not subject to U.S. tax on her worldwide income.[41]

- If a partner is identifiable (by its name or otherwise) as a charitable organization or educational institution, it would not be reasonable for a partnership to assume that the partner is a fully taxable individual or corporation. Similarly, if an investment fund knows that one of its partners is an upper-tier partnership the partners of which are, principally,

[40] A reasonableness requirement underlies the section 704(c) regulations. *See* Treas. Reg. § 1.704-3(a)(1) (requiring that the allocations with respect to section 704(c) property must be made using a reasonable method that is consistent with the purpose of section 704(c)).

[41] If, however, a partnership has reason to know that information on a withholding certificate is incorrect, it would not be reasonable for the partnership to make assumptions based on the information. *See* Treas. Reg. § 1.1446-1(c)(2) (providing that if a partnership has actual knowledge or reason to know that any information on a withholding certificate or statement is incorrect or unreliable, or if its knowledge of relevant facts or if statements contained on the form or other documentation is such that a reasonably prudent person in the position of the withholding agent would question the claims made, the partnership may not rely upon such documentation).

tax-exempt institutional investors, it would not be reasonable to assume that any of those partners is a fully taxable individual or corporation.[42]

- If a corporate partner has disclosed in filings with the Securities and Exchange Commission that the partner has net operating loss carryforwards that are expected to expire, it would not be reasonable for a partnership to disregard those carryforwards, or the expected expiration of those carryforwards.

- If (i) five of the partners in a partnership are look-through entities, and (ii) one of the other partners is an individual that owns a 2 percent interest in partnership capital and profits and is entitled to allocations of 2 percent of all partnership items, it would be reasonable for the partnership to assume that the individual is not a direct or indirect owner of one or more of the look-through entities.

3. Limitations on the Reasonable Assumptions Rule

The reasonable assumptions rule should be subject to certain additional limitations and conditions. A partnership should not be permitted to rely on the reasonable assumptions rule for *De Minimis* Partners and Indirect Partners that own more than 30 percent of the interests in the capital or profits in a partnership.[43]

4. Examples of the Application of the Reasonable Assumptions Rule

The application of these recommendations is illustrated by the following examples. In both examples, we have assumed that a partnership cannot rely on the reasonable assumptions rule for *De Minimis* Partners and Indirect Partners that own more than 30 percent of the interests in the capital or profits in a partnership.

> **Example 2**. Partnership has eleven partners. Each of partners 1 through 10 is an individual that owns a 4 percent interest in Partnership's capital and profits. Partner 11, which is a stand-alone C corporation, owns the remaining 60 percent interest in Partnership's capital and profits and manages Partnership operations (and is responsible for the preparation of Partnership's tax returns). Collectively, *De Minimis* Partners own 40 percent of Partnership's capital and profits.

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[42] Depending on the facts and circumstances, however, it might be reasonable for the partnership to assume that as much as 20 percent of the income of the investment fund is allocable to fully taxable individuals in respect of the profits interest typically granted to managers of investment funds.

[43] We considered, as an alternative proposal, denying a partnership the benefit of making reasonable assumptions with respect to the tax attributes of any partner whenever the aggregate interests of its *De Minimis* Partners and Indirect Partners exceed 30 percent of partnership profits or capital. We believe such an "all-or-nothing" rule would be unduly restrictive and fail to address the administrative challenges facing partnerships seeking to comply with the substantial economic effect requirements.

Partnership solicits information about the tax attributes of each of its *De Minimis* Partners through an email questionnaire. Partners 1 through 8 respond. Partners 9 and 10 do not respond.

Partnership may not make reasonable assumptions about partner 11 because it is neither a *De Minimis* Partner nor an Indirect Partner. In addition, Partnership may not make reasonable assumptions about the tax attributes of partners 1-8 because it has information about the tax attributes of those partners. Partnership may make reasonable assumptions about the tax attributes of partners 9 and 10 because they did not respond to the questionnaire. Based on all of the facts and circumstances known (or that should have been known) by Partnership at the time the allocation becomes part of the partnership agreement, Partnership reasonably assumes that each of partners 9 and 10 is subject to federal tax at the highest marginal rate.

Later, Partnership learns that partner 9 incurred substantial losses and has not had any federal tax liability for many years (and is not expected to have any federal tax liability for many years in the future). Because Partnership satisfied its inquiry obligations and made reasonable assumptions regarding partner 9's tax attributes to test the substantiality of its allocations at the time the allocation provisions became part of the partnership agreement, Partnership's allocations would be respected.

Example 3. The facts are the same as in Example 2, except that, when Partnership solicits information about the tax attributes of each of its *De Minimis* Partners, partner 1 responds and partners 2-10 do not respond to the email questionnaire. Accordingly, after this initial inquiry, Partnership does not have information about the tax attributes of *De Minimis* Partners that own 36 percent of the partnership's capital and profits. Partnership cannot make reasonable assumptions about the tax attributes of partners 2-10 and, for this reason, whether an allocation is substantial within the meaning of Treas. Reg. § 1.704-1(b)(2)(iii) would be determined under the usual rules for testing the substantiality of a partnership allocation, taking into account the partners' actual tax attributes.