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The Biden Administration Proposes Changes to the Taxation of Partnerships

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On March 28, 2022, the Biden Administration proposed certain limited changes to the taxation of partnerships. In short, the Administration's proposals would (i) prevent related partners in a partnership that has made a section 754 election from basis shifting to reduce taxable income;[1] and (ii) make two helpful changes to the partnership audit rules.

I. Prevent Basis Shifting by Related Partners

Under current law, if a partnership with appreciated non-depreciable assets and depreciable or amortizable assets makes a "section 754 election" and distributes the appreciated non-depreciable assets on a tax-free basis to one partner, the other partners are entitled to "step-up", or increase, their basis in the depreciable or amortizable assets. This allows them to claim increased depreciation or amortization deductions or generate losses from assets to be sold. These transactions are known as "basis bumps".

A section 754 election is an election that allows a partner that purchases an interest in a partnership to adjust its share of the partnership's "inside" tax basis in its assets to fair market value and permits the partners in a partnership to adjust their inside basis in partnership assets upon the distribution of an asset to another partner. The increase in basis upon the distribution of an appreciated asset is generally equal to the (i) distributee-partner's gain; or if a distributee-partner takes a lower basis in the distributed asset than that partner's inside basis before the distribution, (ii) the amount by which the partnership's basis exceeds the distributee-partner's basis in the distributed asset immediately before distribution.

Two related partners in a partnership can use this rule to generate increased amortization or depreciation deductions for one of the partners by distributing an appreciated non-depreciable asset to the other. Additionally, these transactions can be used to reduce gain or generate a loss on assets that are anticipated to be sold, while continuing to hold the low basis assets.

The Biden Administration has proposed to prevent related parties in a partnership from using this rule to generate deductions by prohibiting any partner related to the distributee-partner from benefitting from the partnership's basis step-up until the distributee-partner disposes of the distributed asset in a fully taxable transaction. In addition, the proposal would authorize Treasury to issue regulations to implement this matching rule with respect to related-party partners. The proposal does not define "related" for these purposes.

The proposal has no effect on unrelated partners that use the same strategy to generate increased depreciation or amortization deductions by causing the partnership to distribute appreciated assets to one of the partners.

The proposal would be effective for taxable years beginning after December 31, 2022.

II. Amend the Bipartisan Budget Act of 2015's Centralized Partnership Audit Regime

a. Permit the Carryover of a Reduction in Tax that Exceeds a Partner's Tax Liability

Section 6225 generally requires a partnership to pay tax attributable to adjustments as the result of an audit in the prior allocation of income, gain, loss or deductions to the partners, unless the partnership has made a "push-out" election under section 6226, in which case, the partners that were partners in the taxable year under audit bear the taxes, interest, and penalties attributable to the adjustment. For partners subject to audit for multiple years or whose adjustments in a single audited year affect their tax liability in subsequent years, section 6226 allows the partners to net the amounts for each year and report either an additional tax or tax reduction in the year in which they take into account their share of adjustments (the "reporting year"). However, if the calculation results in a net decrease, the partners can use the decrease to reduce their reporting year tax liabilities to zero and cannot benefit from a refund or carry forward.

The Biden Administration helpfully proposes to permit partners that receive a favorable adjustment under section 6226 (i.e., partners who paid too much tax) to treat the excess as an overpayment under section 6401 that may be refunded.

The proposal would be effective on the date of enactment.

a. Incorporate Chapters 2/2A in Centralized Partnership Audit Regime

As mentioned above, under the general rule of section 6225, partnership adjustments made as a result of an audit are assessed against the partnership. However, section 6225 applies only to income taxes and not to self-employment, or the 3.8% Medicare tax on "net investment income" Self-employment and net investment income taxes are subject to the old audit rules (i.e., before the Bipartisan Budget Act of 2015 (the "BBA") amended the audit rules).

Thus, the IRS conducts one audit proceeding under the BBA rules for income taxes and a separate audit proceeding under the pre-BBA rules for net investment income and self-employment taxes. Taxpayers may have to amend multiple returns as a result.

The Biden Administration would helpfully include net investment income and self-employment taxes in the BBA audit rules that apply to income taxes.

The proposal would be effective after the date of enactment for all open taxable years.

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[1] All references to sections are to the Internal Revenue Code.

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