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Partnership Tax Provisions of the TCJA as Illustrations of Planning Simplification Versus Compliance Simplification Trade-Offs

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Partnership Tax Provisions of the TCJA as Illustrations of Planning Simplification Versus Compliance Simplification Trade-Offs

Emily Cauble*

Abstract

Oftentimes, efforts to simplify the process of reporting the tax consequences of events that have already occurred exacerbate complexity faced by taxpayers at the stage in time when they are deciding how to act. Efforts to simplify reporting include, for instance, provisions that obviate the need to value assets prior to their sale or methods for determining tax consequences that reduce the number of computational steps used when determining tax liability. While such efforts may, to a degree, simplify tax compliance, they can also set traps for unwary taxpayers at the planning stage. Avoiding asset valuation or taking short-cuts when determining tax liability can cause a transaction's tax consequences to depart from its economic consequences or make it so that small non-tax changes to a transaction can drastically affect its tax outcome. When tax consequences diverge from economic consequences or when small non-tax changes produce radical differences in tax outcome, taxpayers who act without considering the resulting tax consequences are more likely to act in a way that differs from how an informed taxpayer would act.

With respect to decisions that taxpayers would alter if they considered the resulting tax consequences, simplifying tax planning may be more important than simplifying tax reporting. Taxpayers who are most in need of

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simplification—unsophisticated taxpayers—may more acutely feel the pain of planning complexity than reporting complexity. At the planning stage, such taxpayers are likely left to their own devices while they may be more likely to seek expert assistance at the reporting stage.

The 2017 Tax Cuts and Jobs Act tinkered with two partnership tax provisions that illustrate the trade-off between compliance simplification and planning simplification. These particular changes made by the Act were a small step in the right direction. However, the measures were modest and should have gone further.

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I. INTRODUCTION

Avoiding undue complexity is often cited by lawmakers and scholars as a justification for some of the design features of current tax law.[1] Lawmakers motivated by the desire to simplify tax law face trade-offs. Tax simplification measures directed at easing the burdens faced by taxpayers at the stage in time when they must report the consequences of events that have already occurred (the "reporting stage") can make the law more complicated at the stage in time when taxpayers contemplate the likely tax consequences of potential transactions (the "planning stage").

In some instances, lawmakers have exhibited a preference for easing complexity at the reporting stage at the expense of exacerbating complexity at the planning stage.[2] For example, many existing tax rules are designed to obviate the need to value assets prior to their sale.[3] Other rules are adopted in lieu of plausible alternatives because they offer more computational simplicity—they require fewer mathematical steps to determine the tax outcome of a given transaction.[4] Rules that remove the need to value assets

1. *See, e.g.*, Emily Cauble, *Superficial Proxies for Simplicity in Tax Law*, 53 U. RICH. L. REV. 329 (2019). Some invocations of the goal of simplification may be merely window dressing—an explanation with popular appeal that is offered for proposed measures that have truer aims that are less popular. *See, e.g.*, *id.*; Steven A. Dean, *Attractive Complexity: Tax Deregulation, the Check-the-Box Election, and the Future of Tax Simplification*, 34 HOFSTRA L. REV. 405 (2005); Samuel A. Donaldson, *The Easy Case Against Tax Simplification*, 22 VA. TAX REV. 645, 647 (2003) ("In some cases, proposals for simplifying the Code appear to be mere rhetorical diversions that conceal other, more controversial objectives."). The rhetoric surrounding the Tax Cuts and Jobs Act provides examples of this phenomenon, such as the discussion of the act allowing for a "postcard" tax return. Carlos Barria, *Don't Expect a Postcard-Sized Tax Return from the Republican Plan*, CNBC (Dec. 14, 2017, 6:54 AM), https://www.cnbc.com/2017/12/14/dont-expect-a-postcard-sized-tax-return-from-the-republican-plan-experts-say.html. Some invocations of the goal of simplification may be more sincere. *See* Donaldson, *supra*, at 648 ("Lately, however, Congress has shown signs that tax simplification may be more than an empty political pick-up line."); Edward J. McCaffery, *The Holy Grail of Tax Simplification*, 1990 WIS. L. REV. 1267, 1319 (1990) ("Yet we cannot forget that simplification offers numerous attractive benefits—in terms of equity and efficiency gains, taxpayer and citizen morale, and democratic knowledge of and participation in the laws and their development."). This Article focuses on measures that fall into the latter category in that they provide simplification in some genuine way. However, this Article notes that, in many cases, even these measures may miss the mark. *See, e.g.*, *infra* Part III. They simplify the law in some respects for some taxpayers and make it more complex in other respects for other taxpayers, and on balance, may do more harm than good. *See, e.g.*, *infra* Part III.

2. *See infra* Part III.

3. *See infra* Section III.A.

4. *See infra* Section III.B.

or that streamline computation of tax liability may simplify tax reporting.[5] However, they often drive a wedge between a transaction's economic consequences and its tax consequences, or they result in a system in which small non-tax changes to a transaction can drastically affect its tax outcome.[6] When tax consequences diverge from economic consequences or when small non-tax changes produce extreme differences in tax outcome, tax law is less intuitive. When tax law is less intuitive, an uninformed taxpayer is more likely to engage in transactions different from those undertaken by informed taxpayers. Thus, efforts to streamline tax reporting often burden taxpayers at the planning stage, particularly those who act without evaluating the resulting tax consequences.

In areas of life in which decisions are immune to a consideration of tax consequences, the choice to prioritize reporting simplicity over planning simplicity is logical—if taxpayers universally tend to not engage in tax planning with respect to a particular decision, there is no sense in making tax planning with respect to that decision easier if doing so would make tax reporting more difficult.[7] Thus, in these areas, championing simplification of tax reporting in ways that sacrifice tax planning simplicity may be a sensible decision. However, with respect to decisions that taxpayers would alter if they considered the resulting tax consequences, lawmakers should often prioritize simplification of tax planning over simplification of tax reporting. Taxpayers who are most in need of simplification—unsophisticated taxpayers—may more acutely feel the pain of planning complexity than reporting complexity. At the planning stage, such taxpayers are likely left to their own devices while they may be more likely to seek expert assistance at the reporting stage.[8]

This Article will proceed as follows: Part II will provide an overview of various factors that contribute to complexity at the planning stage and at the reporting stage, as experienced both by taxpayers who assess tax consequences prior to acting and taxpayers who do not do so. Part III will highlight ways in which tax law prioritizes tax reporting simplification over tax planning simplification. Part IV will discuss two alterations to partnership tax law made by the Tax Cuts and Jobs Act and explain why the changes did not go far enough.

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5. *See infra* Sections III.A. and III.B.
6. *See infra* Sections III.A. and III.B.
7. *See infra* note 35.
8. *See infra* note 38 and accompanying text.

II. TAX PLANNING AND TAX REPORTING COMPLEXITY

Much has been written about complexity[9] in tax law—and in law, generally.[10] This Part will place existing observations within a framework that aims to provide an overview of factors that are relevant to complexity from the point of view of different types of taxpayers at the tax planning stage and the tax reporting stage, and, at the same time, demonstrate that trade-offs exist.[11] Measures that make the law simpler at one stage or for some taxpayers

9. There is a growing literature that imports concepts from complexity science into studies of legal complexity. *See, e.g.*, J.B. Ruhl & Daniel Martin Katz, *Measuring, Monitoring, and Managing Legal Complexity*, 101 IOWA L. REV. 191 (2015). As Professors Ruhl and Katz explain, "there is a difference between complexity in the sense of 'complicatedness' and complexity in the sense of system structure and behavior." *Id.* at 201. The term "complexity" might be better understood, in a formal sense, in the way in which it is defined by this body of literature, and some of the factors that I identify as contributing to complexity might be more accurately described as contributing to "complicatedness." *Id.* at 201–02 (discussing the difference between complexity and complicatedness). However, when policymakers aim to reduce complexity, or claim to be taking steps to do so, they are likely referring to some features of law better described as contributing to complicatedness and some that contribute to complexity, and therefore, the discussion in this Article is not limited to complexity in the formal sense. For instance, steps taken to obviate the need to value assets, described below in Section III.A, might be better described as aimed at reducing complicatedness. However, I nevertheless use the term "complexity" for ease of exposition.

10. *See, e.g.*, DAVID F. BRADFORD, UNTANGLING THE INCOME TAX (1986); Boris I. Bittker, *Tax Reform and Tax Simplification*, 29 U. MIAMI L. REV. 1 (1974); Dean, *supra* note 1; Donaldson, *supra* note 1; William G. Gale, *Tax Simplification: Issues and Options*, 92 TAX NOTES 1463 (2001); Louis Kaplow, *How Tax Complexity and Enforcement Affect the Equity and Efficiency of the Income Tax*, 49 NAT'L TAX J. 135 (1996); Stanley A. Koppelman, *At-Risk and Passive Activity Limitations: Can Complexity Be Reduced?*, 45 TAX L. REV. 97 (1989); McCaffery, *supra* note 1; Charles E. McLure, Jr., *The Budget Process and Tax Simplification/Complication*, 45 TAX L. REV. 25 (1989); John A. Miller, *Indeterminacy, Complexity, and Fairness: Justifying Rule Simplification in the Law of Taxation*, 68 WASH. L. REV. 1 (1993); Jeffrey Partlow, *The Necessity of Complexity in the Tax System*, 13 WYO. L. REV. 303 (2013); Deborah L. Paul, *The Sources of Tax Complexity: How Much Simplicity Can Fundamental Tax Reform Achieve?*, 76 N.C. L. REV. 151 (1997); Randolph E. Paul, *Simplification of Federal Tax Laws*, 29 CORNELL L. Q. 285 (1944); Sheldon D. Pollack, *Tax Complexity, Reform, and the Illusions of Tax Simplification*, 2 GEO. MASON INDEP. L. REV. 319 (1994); Sidney I. Roberts et al., *A Report on Complexity and the Income Tax*, 27 TAX L. REV. 325 (1972); Deborah H. Schenk, *Simplification for Individual Taxpayers: Problems and Proposals*, 45 TAX L. REV. 121 (1989); Peter H. Schuck, *Legal Complexity: Some Causes, Consequences, and Cures*, 42 DUKE L.J. 1 (1992); Karla W. Simon, *Tax Simplification and Justice*, 36 TAX NOTES 93 (1987); Mila Sohoni, *The Idea of "Too Much Law,"* 80 FORDHAM L. REV. 1585 (2012); Stanley S. Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 LAW & CONTEMP. PROBS. 673 (1969); R. George Wright, *The Illusion of Simplicity: An Explanation of Why the Law Can't Just Be Less Complex*, 27 FLA. ST. U. L. REV. 715 (2000); Lawrence Zelenak, *Complex Tax Legislation in the TurboTax Era*, 1 COLUM. J. TAX L. 91 (2010).

11. *See infra* Section II.C. For further discussion of trade-offs, see, for example, Sohoni, *supra* note 10, at 1608 ("Complexity is easy to redistribute but hard to reduce."); Wright, *supra* note 10, at

can make it more complex at another stage or for other taxpayers.[12] Of particular relevance to this Article, in some cases, methods that alleviate complexity that faces taxpayers when they must report the tax consequences of events that have already occurred can exacerbate complexity faced by taxpayers at the point in time when they are deciding how to act.[13]

Taxpayers encounter complexity at the tax planning stage when they evaluate the likely tax consequences of an anticipated transaction and at the tax reporting stage when they report the tax consequences of a transaction that has already occurred.[14] This Part will discuss factors that contribute to complexity at each stage in time, examining the relevant factors from the perspective of two different types of taxpayers—sophisticated taxpayers who attempt to ascertain the content of tax law and unsophisticated taxpayers who act without knowledge of applicable tax law. A taxpayer may fall into different categories at different stages in time. For instance, a taxpayer might carry out a transaction without evaluating its tax consequences but seek expert advice when reporting its tax consequences.

A. Planning Stage

Complexity in tax law affects taxpayers at the planning stage by making more onerous the process of predicting the tax consequences of an anticipated transaction.[15] In addition, complexity causes some taxpayers to not learn about applicable tax law and, as a consequence, act differently than they would have had they known the law.[16] Furthermore, at the planning stage,

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716 ("We can reduce legal complexity in one respect without also reducing the law's complexity in other respects, and usually only at the cost of greater complexity in other respects.").

12. *See infra* Section II.C.

13. *See infra* Section II.C.

14. *See, e.g.*, BRADFORD, *supra* note 10, at 266–67; Gale, *supra* note 10, at 1464–65; McCaffery, *supra* note 1, at 1288–91; Andrea Monroe, *Integrity in Taxation: Rethinking Partnership Tax*, 64 ALA. L. REV. 289, 299–300 (2012). For related discussion regarding legal complexity generally, see Schuck, *supra* note 10, at 18. Complexity can also affect taxpayers at the enforcement stage, when the IRS audits and potentially challenges the tax consequences claimed by the taxpayer. *See, e.g.*, Leslie Book, *The IRS's EITC Compliance Regime: Taxpayers Caught in the Net*, 81 OR. L. REV. 351, 351 (2002).

15. *See, e.g.*, BRADFORD, *supra* note 10, at 266–67 ("We may distinguish three kinds of complexity: . . . 'transactional complexity' (referring to the problems faced by taxpayers in organizing their affairs so as to minimize their taxes within the framework of the rules)."); McCaffery, *supra* note 1, at 1271 (discussing "structural complexity").

16. *See, e.g.*, Gale, *supra* note 10, at 1465 ("Provisions aimed at encouraging certain activities—such as saving for college—will be less likely to be used and hence less effective if people cannot

complexity can cause taxpayers who do inform themselves of applicable law to make costly changes to their behavior.[17]

1. Taxpayers Who Attempt to Ascertain Content of Law

For a taxpayer who attempts to ascertain the content of tax law prior to acting or who utilizes an advisor who attempts to do so on the taxpayer's behalf, complexity at the planning stage consists of anything that increases the amount of time required to determine the likely tax outcome of a contemplated transaction. The volume of applicable law as well as the technical nature of relevant rules can be aggravating factors.[18] When a wide array of sources must be consulted to determine tax law's content, the task of the taxpayer (or the taxpayer's advisor) becomes more arduous.[19] Uncertainty

understand how they work."); McCaffery, *supra* note 1, at 1271 (discussing "structural complexity"); Deborah H. Schenk & Andrew L. Grossman, *The Failure of Tax Incentives for Education*, 61 TAX L. REV. 295, 355 (2008) ("It is also not possible to affect college participation if taxpayers do not know about the tax incentives. Studies show that taxpayers are woefully unaware of the tax benefits.").

17. *See, e.g.*, BRADFORD, *supra* note 10, at 266–67 (defining "'transactional complexity' (referring to the problems faced by taxpayers in organizing their affairs so as to minimize their taxes within the framework of the rules)"); McCaffery, *supra* note 1, at 1271 (discussing "structural complexity").

18. *See, e.g.*, Donaldson, *supra* note 1, at 733–34 ("The federal tax laws are 'complex' because: (1) they contain a large number of rules; (2) those several rules are highly detailed; . . . [and] they require technical expertise to comprehend fully . . . ." (footnote omitted)); McCaffery, *supra* note 1, at 1270–71 ("The first basic understanding of simplification may be termed 'technical complexity.' Such complexity refers to the pure intellectual difficulty of ascertaining the meaning of tax law."); Monroe, *supra* note 14, at 300 ("Complex provisions typically involve opaque terminology, elaborate definitional schemes, computations, or multifactored tests."); Schuck, *supra* note 10, at 3–4 (describing technicality as a feature of a complex legal system and observing, "Technical rules require special sophistication or expertise on the part of those who wish to understand and apply them. Technicality is a function of the fineness of the distinctions a rule makes, the specialized terminology it employs, and the refined substantive judgments it requires. The Internal Revenue Code is probably the leading example of technical rules." (emphasis omitted) (footnote omitted)). The technical nature of rules may matter more or less depending on the type of taxpayer at which the provision is targeted. *See, e.g.*, Bittker, *supra* note 10, at 2, 5 (observing that technical language is less of a concern when it is addressed to tax experts and applies to transactions that rarely occur, while simplification of "mass" provisions that affect millions of taxpayers may be more important); Donaldson, *supra* note 1, at 672 ("There is no question that the Code makes for slow reading (and in many cases, re-reading). Yet the calls to make the Code more reader-friendly forget that the Code's intended audience is not the lay taxpayer." (footnotes omitted)); Surrey, *supra* note 10, at 697 ("In general, the pattern here is that of experts speaking to experts, with the knowledgeable practitioners talking to the draftsmen in the stilted, artificial language that each understands well. But it is their language alone and not that of the less expert and uninitiated.").

19. *See, e.g.*, Partlow, *supra* note 10, at 320 ("With broad statutes and imprecise language, the task of filling in the detail is left to the courts and the Treasury. As courts interpret the law, the 'simple'

will also increase the cost of predicting the tax consequences of a proposed transaction.[20]

A closer match between applicable law and the taxpayer's—or his or her advisor's—intuitive expectations can streamline the process of ascertaining applicable law's content. Law is more amenable to quick understanding when it conforms to our expectations. In addition, when law is more consistent with expectations, a taxpayer or his or her advisor can more readily reach a conclusion, with some confidence, about the tax treatment of a transaction that is not explicitly covered by existing law—when applicable law forms a more coherent, intuitive framework it is easier to predict the tax consequences of facts that are not squarely covered by existing rules.[21]

Consistency in the law can also facilitate easier determinations of law's content.[22] Thus, others have suggested that the adoption of uniform definitions of various terms across different Internal Revenue Code provisions

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and easily understood words in the Code become complex because their meanings stem from judicial interpretation and can be understood only by reference to case law." (footnote omitted)); Schuck, *supra* note 10, at 3–4 (listing differentiation as a feature of a complex legal system and stating that "[a] legal system is institutionally differentiated insofar as it contains a number of decision structures" (emphasis omitted)).

20. *See, e.g.*, Roberts et al., *supra* note 10, at 327–28 (describing how the difficulty of reaching a sufficiently certain conclusion can prevent some transactions from going forward); Schuck, *supra* note 10, at 3 (listing indeterminacy or uncertainty as a feature of a complex legal system).

21. *See, e.g.*, Surrey, *supra* note 10, at 699 (observing that, when tax law is not intuitive, "it becomes impossible to fly by the seat of one's tax pants . . . . While this is not a serious calamity, there is a need to provide working room for the use of tax instinct. An intelligent statutory structure makes it possible to rely on a well-trained tax instinct to provide the probable answers to the problems unforeseen by the draftsman.").

22. *See, e.g.*, Surrey, *supra* note 10, at 696 ("The sections and provisions carrying the rules for the treatment of a given area must possess an internal consistency, so that the framework and inner logic of the statutory solution can be grasped."). Consistency across rules and with statutory purpose also eases the process of determining the likely tax consequences of a transaction not explicitly covered by existing rules and makes it more likely that taxpayers who act without verifying the content of law might make correct guesses. *See, e.g.*, Donaldson, *supra* note 1, at 737–38 ("Tax expenditures routinely violate basic principles of the federal income tax. This breeds confusion among taxpayers. An individual, for instance, might know of the home mortgage interest deduction and reasonably extrapolate from this rule that all home-related expenses are deductible. Of course, this extrapolation is wrong, but the mortgage interest deduction reasonably leads taxpayers into thinking other, related expenditures may be deductible. Some taxpayers will likely claim such deductions without checking for authority."); Deborah L. Paul, *supra* note 10, at 161–62 ("[C]oherence eases application of a tax regime. Under a coherent regime, people may interpret the law in the absence of a specific authority on point by considering the regime's purposes. Under an incoherent regime, interpretation of the law is more difficult because the competing purposes embodied in the regime favor inconsistent interpretations.").

could simplify tax law in some respects.[23] On an even more ambitious scale, consistency would be well served by taxing all similar transactions in the same manner to the greatest extent possible.[24]

2. Taxpayers Who Do Not Attempt to Ascertain Content of Law

If a taxpayer engages in a transaction without attempting to determine its tax consequences, the only cost caused by complexity that burdens the taxpayer at the planning stage is the potential cost of engaging in a transaction that differs from the transaction in which the taxpayer would have engaged had he or she assessed the relevant tax consequences prior to acting.[25] For a

23. *See, e.g.*, Donaldson, *supra* note 1, at 727–28 ("Consistent definitions would do a lot to reduce the tax complexity of phaseouts."); Michelle Lyon Drumbl, *Those Who Know, Those Who Don't, and Those Who Know Better: Balancing Complexity, Sophistication, and Accuracy on Tax Returns*, 11 PITT. TAX REV. 113, 127 (2013) ("Olson recommends that Congress consolidate the family status provisions as a measure to simplify the Code."); Richard M. Lipton, *Statement of Richard M. Lipton on Behalf of the American Bar Association Section of Taxation Before the Committee on Finance of the United States Senate on the Subject of Tax Simplification April 26, 2001*, 54 TAX LAW. 617, 631–32 (2001) (proposing standardization of attribution rules); McLure, *supra* note 10, at 53; Partlow, *supra* note 10, at 328 ("Congress could eliminate one area of unnecessary complexity by adopting a uniform definition of qualified education expenses for purposes of the various education tax incentives, qualified state tuition programs, and education IRAs." (footnotes omitted)); Schenk, *supra* note 10, at 129 ("Definitions and qualifying thresholds should be as simple and uniform as possible.").

24. *See, e.g.*, BRADFORD, *supra* note 10, at 267 ("Transactional complexity arises basically because of the possibility that economically equivalent activities may have very different tax consequences, depending on the precise way the transactions are structured . . . . Rules with a high degree of economic consistency serve transactional simplicity, although they may impose costs in the form of compliance and rule complexity."). Taxing similar transactions similarly eases the learning process. Taxing similar transactions similarly might also reduce planning costs that take the form of taxpayers modifying their contemplated transactions. It is also possible that taxing some transactions similarly could induce taxpayers to make even more costly modifications to their transactions to obtain more favorable tax treatment. *See* David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1320 (2001) ("[E]ven if some planning is stopped, total planning waste could still increase if those who continue to plan face higher costs."); David A. Weisbach, *Disrupting the Market for Tax Planning*, 26 VA. TAX REV. 971, 972–74 (2007); David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in Tax Law*, 84 CORNELL L. REV. 1627, 1628–30, 1664–71 (1999); David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 239 (2002). *See generally* Philip A. Curry et al., *Creating Failures in the Market for Tax Planning*, 26 VA. TAX REV. 943 (2007) (discussing how policymakers face a trade-off when considering taking steps to attack current tax planning strategies, namely, the trade-off between (i) costs arising from taxpayers' use of those current tax planning strategies and (ii) costs arising from taxpayers' search for new tax planning strategies once the existing methods are attacked).

25. For discussion of this cost, see *supra* note 16 and accompanying text. This group of taxpayers does not face the cost of determining what tax law provides as they do not attempt to do so, and this group of taxpayers does not face the cost of redesigning their transactions to obtain more favorable

taxpayer who acts without considering tax consequences, the factor that most significantly contributes to complexity at the planning stage is the extent to which tax law diverges from the taxpayer's intuitive expectations.

B. Reporting Stage

At the reporting stage, taxpayers must report the tax consequences of events that have already occurred, and complexity can magnify the costs of doing so.[26]

1. Taxpayers Who Attempt to Ascertain Content of Law

Just as they can exacerbate costs faced at the planning stage, various factors such as the length and technical nature of rules and the presence of rules in diffuse sources can also compound complexity-induced costs at the reporting stage.[27] In addition, at the reporting stage, taxpayers may have to engage in recordkeeping and reporting that can be time-consuming even when the tasks required are clear.[28] Any costs attributable to computational complexity, at the compliance stage, can be largely eliminated by pervasively used tax software.[29]

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tax consequences because these taxpayers do not contemplate tax consequences prior to acting.

26. *See, e.g.*, BRADFORD, *supra* note 10, at 266–67; McCaffery, *supra* note 1, at 1272.

27. *See supra* notes 18–19 and accompanying text.

28. *See, e.g.*, BRADFORD, *supra* note 10, at 266–67 ("We may distinguish three kinds of complexity: 'compliance complexity' (referring to the problems faced by the taxpayer in keeping records, choosing forms, making necessary calculations, and so on)."); McCaffery, *supra* note 1, at 1272.

29. *See, e.g.*, Zelenak, *supra* note 10, at 93 ("In the TurboTax era, mere computational complexity does not rule out any legislative innovation."). Computational complexity may impose costs at the planning stage. *See id.* ("On the curse side, however, it may be that computationally complex tax rules are usually bad rules for reasons other than mere computational complexity . . . . [P]rovisions of major computational complexity and widespread applicability usually constitute bad tax policy even when computers are available to do all the number crunching. Such provisions render the [tax] system opaque to the average taxpayer, making it impossible for taxpayers to evaluate whether their tax liabilities are generated by a fair set of rules, and making it impossible for taxpayers to engage in informed tax planning."). However, this is not always true—there are circumstances in which precisely formulating an intuitive concept could require more technical specificity than enacting rules that produce counter-intuitive results. One example of this phenomenon is making basis adjustments as discussed below in Section III.B.

2. Taxpayers Who Do Not Attempt to Ascertain Content of Law

Most U.S. taxpayers must file an annual income tax return—something they would not do but for the tax requirement to do so. Therefore, at the reporting stage, taxpayers who do not attempt to ascertain the content of tax law are unlikely to do what tax law requires. Such a taxpayer will incur the resulting costs (which could include owing interest and penalties if the taxpayer underpays his or her tax liability or forgoing a refund if the taxpayer overpays through withholding).[30] As long as self-reporting is required, the only feasible mechanism for mitigating costs incurred by individuals who do not ascertain the content of law at the reporting stage is to reduce the number of taxpayers that inhabit this group. In particular, reducing the costs faced by taxpayers who do obtain information about tax law at the reporting stage could encourage more taxpayers to shift from the category of taxpayers who do not obtain information to the category of taxpayers who do.[31] This goal can be served by making tax software more available as well as measures that would ease compliance further such as the institution of a "Ready Return" system.[32] Under a Ready Return system, the IRS would prepare a draft return on behalf of the taxpayer based on information available to the IRS, and the taxpayer would verify and modify the return as needed.[33]

C. Trade-Offs

Because different features of tax law are more likely to impose costs on different taxpayers at different times, measures that might make law simpler for one group of taxpayers can often increase costs borne by another group of taxpayers, and steps that might simplify tax law at one stage in time might levy offsetting costs at another time.[34] Of particular relevance to this Article,

30. Reducing compliance costs for taxpayers who are unaware of tax law would entail the institution of a return-free filing system in which all taxes are withheld at source. *See, e.g.*, Joseph Bankman, *Simple Filing for Average Citizens: The California Ready Return*, 107 TAX NOTES 1431, 1434 (June 13, 2005) (discussing return-free systems). This would shift compliance costs from individual taxpayers to employers and other payors, and it would involve substantive changes to tax law. *Id.*

31. *See, e.g.*, Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L. J. 557, 596–97 (1992) (discussing how more individuals will learn about the content of the law when it is easier to do so).

32. For discussion of the "Ready Return" system, see Bankman, *supra* note 30.

33. For discussion of the "Ready Return" system, see Bankman, *supra* note 30.

34. *See, e.g.*, Sohoni, *supra* note 10, at 1608 ("Complexity is easy to redistribute but hard to

in some cases, methods that alleviate compliance complexity that faces taxpayers when they must report the tax consequences of events that have already occurred can exacerbate complexity faced by taxpayers at the point in time when they are deciding how to act.

As discussed in greater detail in Part III below, lawmakers sometimes exhibit a preference for reporting simplification at the expense of making tax planning more complicated. The focus on reporting simplification is unfortunate because taxpayers who are most in need of simplification—unsophisticated taxpayers—may more acutely feel the pain of planning complexity than reporting complexity, at least with respect to decisions that would be altered based on the resulting tax consequences.[35] Individuals are generally aware of the requirement to file tax returns, and if they cannot comply independently, they will seek assistance.[36] By contrast, many taxpayers may be unaware of the myriad ways in which altering their behavior or transactions can affect tax consequences. Thus, at the planning stage, unsophisticated taxpayers are likely left to their own devices while they may be more likely to seek expert assistance at the reporting stage.[37] Ultimately, whether or not this is true is an empirical question. However, it is quite plausibly the case, and existing data provide at least some support.[38]

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reduce."); Wright, *supra* note 10, at 716 ("We can reduce legal complexity in one respect without also reducing the law's complexity in other respects, and usually only at the cost of greater complexity in other respects.").

35. For decisions that universally tend to be unaffected by a consideration of tax consequences, the focus on reporting simplification may be sensible. *See, e.g.*, Schenk, *supra* note 10, at 127–28 (observing that low income taxpayers are unaffected by complexity at the planning stage but are affected by complexity at the compliance stage with respect to certain decisions: "Transactional complexity is an unknown concept. Taxpayers do not either give birth to or support children to obtain a dependency exemption or an earned income credit. They do not marry or divorce to change filing status.").

36. In addition, computational complexity can be ameliorated by pervasively used tax software. *See, e.g.*, Zelenak, *supra* note 10, at 93 ("In the TurboTax era, mere computational complexity does not rule out any legislative innovation.").

37. *See, e.g.*, Leslie Book, *Preventing the Hybrid from Backfiring: Delivery of Benefits to the Working Poor Through the Tax System*, 2006 WIS. L. REV. 1103, 1115 (2006) (noting the extent to which lower-income taxpayers obtain expert assistance at the reporting stage when claiming the EITC).

38. *See id.* In particular, although data about the extent to which taxpayers seek assistance at the planning stage is lacking, existing data does show that a significant number of taxpayers seek assistance at the tax reporting stage. *Id.* (revealing that in 2001, 67% of lower-income taxpayers claiming the EITC used paid preparers).

III. THE UNFORTUNATE PRIORITIZATION OF REPORTING SIMPLIFICATION OVER PLANNING SIMPLIFICATION

Frequently, measures that ease complexity at the tax reporting stage can exacerbate complexity at the tax planning stage, and, in some cases, lawmakers have exhibited a preference for tax reporting simplification at the expense of making planning more difficult.[39] Examples of this preference can be sorted into three general categories. First, some tax provisions aimed at limiting the necessity for asset valuation (in the name of simplifying reporting) drive a wedge between tax consequences and economic consequences or make it so that different transactional forms receive different tax treatment, and both of these effects exacerbate planning complexity.[40] Second, some tax provisions aimed at reducing the number of computational steps required to determine tax outcome sacrifice accuracy by making it so that tax consequences more loosely track economic consequences, making tax consequences less intuitive and, therefore, making planning more difficult.[41] Third, and relatedly, tax provisions aimed at alleviating computational complexity faced by taxpayers at the reporting stage sometimes entail enacting rules that are discontinuous—so that small non-tax changes can drastically affect tax outcomes.[42] While such rules may be easier to apply after the fact, they impose greater costs at the planning stage.[43] Part III will proceed by discussing examples of each of these three phenomena.

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39. *See, e.g.*, Walter J. Blum, *Simplification of the Federal Income Tax Law*, 10 TAX L. REV. 239, 250 (1955) ("In theory it would be possible to create a system which would bring virtually all items of economic enhancement into the tax equation without any distinctions among them . . . . This theoretical model would embody a minimum of distinctions and hence a minimum of rules, and in this respect it would be the ultimate in simplicity. However, a tax law that approached perfect neutrality in this sense would carry with it great administrative burdens."); BRADFORD, *supra* note 10, at 267 ("Of particular importance is the tension between rule and transactional complexity. Transactional complexity arises basically because of the possibility that economically equivalent activities may have very different tax consequences, depending on the precise way the transactions are structured. . . . Rules with a high degree of economic consistency serve transactional simplicity, although they may impose costs in the form of compliance and rule complexity."); McLure, *supra* note 10, at 42 ("There are cases in which provisions that complicate rules or compliance lead to transactional simplicity.").

40. *See infra* Section III.A.

41. *See infra* Section III.B.

42. *See infra* Section III.C.

43. *See infra* Section III.C.

A. Avoiding the Need for Valuation Sets Traps for Unwary Taxpayers at the Planning Stage

Many features of our current tax system are designed to obviate the need to value assets prior to their sale. While they can reduce tax reporting complexity, these tax law features tend to exacerbate complexity at the tax planning stage. Part III.A will discuss one example of this occurrence that involves the tax treatment of a partner selling his or her interest in a partnership.[44]

A partner who wishes to dispose of his or her interest in a partnership can structure the transaction in one of two ways—the partner could sell his or her interest in the partnership or the partnership could sell its underlying assets and distribute the proceeds to the partner in liquidation.[45] Either form of the transaction will achieve the partner's non-tax objective of exiting the

44. Other examples could be found throughout tax law. First, and most fundamentally, the "realization requirement"—the requirement that a taxpayer generally must sell or exchange an asset before gain or loss is realized—provides an example. Jeffrey L. Kwall, *When Should Asset Appreciation Be Taxed?: The Case for a Disposition Standard of Realization*, 86 IND. L.J. 77, 78 (2011) ("The realization requirement is one of the most basic elements of the United States income tax."). The realization requirement complicates tax planning because non-tax changes (such as changing the time at which assets are sold, selling depreciated rather than appreciated property when a taxpayer requires liquidity, or disposing of assets by gift rather than sale) can produce large tax changes. At the same time, abandoning the realization requirement would increase compliance costs by requiring regular valuation of assets, which could be difficult for assets that are not publicly traded. Thus, incorporating the realization requirement into tax law prioritizes reporting simplification over planning simplification. *See, e.g.*, Bittker, *supra* note 10, at 3; David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111, 1115–18, 1183–84 (1986). Second, rules governing the income tax treatment of gifts offer another example. Under current law, the owner of an asset that has appreciated (or depreciated) in value does not realize the gain (or loss) at the time of the gift. *See*, *e.g*., Kwall, *supra* note 44, at 80 ("Quite clearly, a mere transfer of property is not sufficient for realization under current law because gratuitous transfers of appreciated property are not realization events."). To some degree, this may simplify tax reporting by avoiding the need to value the asset at the time of the gift (although the necessity of valuing the asset may exist anyway for other reasons). *Id.* at 97–98. However, the current regime complicates tax planning because tax outcome can turn on non-tax differences such as whether a donor sells an asset and gives the proceeds to the donee or, instead, the donor gives the asset to the donee and the donee sells the asset. *See, e.g.*, Emily Cauble, *Tax Law's Loss Obsession*, 2018 UTAH L. REV. 979, 1011–16 (2018); Robert I. Keller, *At a Loss: A Half Century of Confusion in the Tax Treatment of Transfers of Depreciated Property Between Related Taxpayers*, 44 TAX LAW. 445, 454–60 (1991); Kwall, *supra* note 44.

45. In a situation in which not all partners are exiting the business, sale by the partnership of its underlying assets may not be a feasible route of exit. In that situation, a selling partner who aimed to obtain the tax consequences of an asset sale might, instead of selling his or her partnership interest, have the partnership distribute to him or her a pro rata interest in each of the partnership's underlying assets and then sell those assets.

partnership, but in some cases, the tax consequences of the two potential routes of exit differ.[46] Congress has enacted provisions that, in some cases, equate the tax treatment of the two versions of the transaction, but Congress has not insisted on identical tax treatment in all cases in order to avoid the need to value each of a partnership's assets when a partner sells his or her interest in the partnership.[47] Thus, concern about reporting complexity (in particular, the need to value assets) prompted Congress to settle for rules that allow for small changes in transactional form to create differences in tax outcome, which exacerbates complexity at the planning stage.[48]

In order to demonstrate, consider the following example.

> **Example 1:** Anne and David form a partnership on January 1, 2017 in which they are equal partners. They each contribute $100 to the partnership. The partnership acquires a capital asset (Capital Asset 1) for $100, and the partnership acquires inventory (Inventory) for $100. On January 1, 2020, the partnership sells Capital Asset 1 for $300, producing $200 of long-term capital gain that is allocated $100 to each partner. The partnership uses the resulting $300 of proceeds to acquire another capital asset (Capital Asset 2). On March 31, 2020, Capital Asset 2 is worth $450 and the Inventory is worth $150.

In Example 1, if Anne were to sell her interest in the partnership on March 31, 2020 for $300, Anne would recognize $25 of ordinary income and $75 of *long-term capital gain*.[49] By contrast, if the partnership were to sell its

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46. *See* Example 1 *infra* Section III.A (demonstrating how the tax consequences of the two transactions can diverge).

47. *See infra* notes 67–69 and accompanying text.

48. *See also*, BRADFORD, *supra* note 10, at 267 ("Transactional complexity arises basically because of the possibility that economically equivalent activities may have very different tax consequences, depending on the precise way the transactions are structured."). The rules applicable to S Corporations provide a more extreme example of the rules discussed here. In the case of an S Corporation, the tax treatment of the sale of an interest in the entity can diverge even more greatly from the tax treatment of the sale of underlying assets because look-through to underlying assets is not required even in the case of inventory or unrealized receivables. Thus, the tax rules applicable to S Corporations involve even more emphasis on simplification at the reporting stage that undermines, even more significantly, simplification at the planning stage.

49. When Anne sells her partnership interest, she will recognize $25 of ordinary income because § 751(a) provides that a selling partner will recognize ordinary income or loss equal to the net amount of income or loss that would have been allocated to the selling partner with respect to the transferred interest upon disposition by the partnership of all inventory or unrealized receivables for fair market value, immediately prior to the disposition of the selling partner's interest. I.R.C. § 751(a) (2018). If

underlying assets and liquidate, Anne would recognize $25 of ordinary income and $75 of *short-term capital gain*.[50] Thus, sale of the partnership interest can produce tax consequences that differ from (and, in some cases, are more favorable than)[51] the tax consequences that follow from a sale of underlying assets.[52]

The divergence in tax treatment stems from the fact that tax law does not require a selling partner to treat the sale of a partnership interest the same as the partner treats a sale of the partner's share of underlying assets in all cases.[53]

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the inventory were sold for $150 (its fair market value), the partnership would recognize $50 of gain (the difference between $150 and the partnership's $100 cost basis in the inventory) and the partnership would allocate $25 of this gain to Anne because Anne and David have agreed to share all gains and losses equally. Thus, Anne recognizes $25 of ordinary income on sale of her partnership interest. The total gain recognized by Anne on sale of her partnership interest is $100 which is the difference between the $300 selling price and her $200 basis in her partnership interest (her basis is $200 because, when she contributed $100 cash to the partnership, her initial basis became $100 per § 722, and when she was allocated $100 of gain from sale of Capital Asset 1, her basis increased by $100 to become $200 per § 705(a)(1)(A)). I.R.C. §§ 705(a)(1)(A), 722 (2018). Because her total gain recognized is $100 and she recognizes $25 of ordinary income per § 751(a), she will recognize $75 of capital gain from sale of her interest in the partnership per § 741. Moreover, the entire $75 of gain will be long term because her holding period in her interest in the partnership is three years and three months. When a partner contributes cash to the partnership, the partner's holding period of the partnership interest received in exchange starts anew upon receipt of the partnership interest. *See* Treas. Reg. § 1.1223-1(a). Because Anne contributes cash on January 1, 2017 and makes no further cash contributions, she would have a holding period in her partnership interest of three years and three months by March 31, 2020. Thus, the gain from sale of her partnership interest would be long-term capital gain. *See* I.R.C. § 1222(3) (2018) (defining long-term capital gain as gain from the sale of a capital asset held for more than one year).

50. *See id.* § 1222(1) (defining short-term capital gain as gain from the sale or exchange of a capital asset held for not more than one year). Given that the partnership holds the inventory as inventory and has held the capital asset for not more than one year, when the partnership sells the assets, the gain allocated to Anne from sale of the inventory is treated as ordinary income and the gain from sale of the capital asset is treated as short-term capital gain. *See id.* § 702(b).

51. Classifying capital gain as long term is more favorable than classifying it as short term because, unless the taxpayer has recognized short-term capital losses and long-term capital gains from other sources, short-term capital gain will be taxed at regular ordinary income rates while long-term capital gain will be taxed at lower rates applicable to net capital gain. *See id.* § 1(h) (providing for a lower tax rate on "net capital gain"); *id.* § 1222 (defining "net capital gain").

52. *See generally* Emily Cauble, *Taxing Selling Partners*, 94 WASH. L. REV. 1 (2019) (providing additional examples of ways in which the tax treatment of the sale of a partnership interest can diverge from the tax treatment of the sale of underlying assets).

53. *See, e.g.*, WILLIAM S. MCKEE, WILLIAM F. NELSON & ROBERT L. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 1.02 (2018) ("Subchapter K represents a blending of two views as to the nature of partnerships. The first view is that a partnership is simply an aggregation of individuals, each of whom should be treated as the owner of a direct undivided interest in partnership assets and operations. This is sometimes referred to as the 'aggregate' or 'conduit' view

Instead, the partner only needs to look through to underlying assets to the extent that the partnership holds certain assets the sale of which would produce ordinary income or loss.[54]

More specifically, if selling partners were taxed based on a pure entity approach, a partner's total tax gain or loss would equal the difference between the consideration received by the partner and his or her basis in the partnership interest, and the gain or loss would be characterized, in its entirety, as capital gain or loss from the sale of an interest in the partnership.[55] Alternatively, under a pure aggregate approach, a selling partner would be treated as if he or she had sold his or her share of each underlying asset held by the partnership.[56] The Internal Revenue Code uses an approach that is a compromise between these two approaches—tax law factors in underlying assets only to the extent that the partnership holds "unrealized receivables" or "inventory items" (assets whose sale would produce at least some ordinary income or loss) and any residual gain or loss recognized by the partner is treated, consistently with the entity view, as capital gain or loss resulting from a sale of the partnership interest.[57]

Legislative history[58] suggests that Congress spurned the pure entity

of partnerships. The second view is that a partnership is a separate entity, with a tax existence apart from the partners. Under this view, a partner has no direct interest in partnership assets or operations, but only an interest in the partnership entity separate and apart from its assets and operations . . . . The entity approach . . . predominates in the treatment of transfers of partnership interests as transfers of interests in a separate entity rather than in the assets of the partnership. (Aggregate notions come into play in this area as well, however, particularly in connection with § 751(a), which examines the character of partnership assets in determining the tax consequences to the transferor of a partnership interest, and § 743(b), under which adjustments may be made to the bases of partnership assets with respect to the transferee of a partnership interest.)").

54. *See* I.R.C. § 751(a) (2018).

55. *See supra* note 53.

56. *See supra* note 53.

57. *See supra* note 53.

58. *See* H.R. REP. NO. 83-1337, at 70 (1954) ("Under existing law, a tax at ordinary income rates can be avoided by the members of a partnership through the devices of liquidating the partnership or selling an interest in the partnership."); *see also* S. REP. NO. 83-1622, at 4731–32 (1954) ("In order to prevent the conversion of potential ordinary income into capital gain by virtue of transfers of partnership interests or by distributions of property, certain rules have been adopted by the House and your committee which will apply to all dispositions of partnership interests . . . . In effect, [under § 751,] the partner is treated as though he disposed of [unrealized receivables or inventory] independently of the rest of his partnership interest . . . . The statutory treatment proposed, in general, regards [unrealized receivables and inventory items] as severable from the partnership interest and as subject to the same tax consequences which would be accorded an individual entrepreneur."); George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141, 235 (1999) ("[The rules

approach in order to prevent taxpayers from converting what would be ordinary income into capital gain (currently taxed at lower rates than ordinary income for non-corporate taxpayers).[59] In order to demonstrate, consider Example 1 again. If the pure entity approach dictated the tax treatment of Anne's sale of her partnership interest on March 31, 2020 for $300, Anne would recognize $100 of long-term capital gain from a sale of her interest in the partnership.[60] All of the gain would be characterized as capital despite the fact that, if the partnership sold the underlying Inventory and Capital Asset 2 for fair market value and liquidated, Anne would recognize $25 of ordinary income and $75 of short-term capital gain.[61] Thus, under a pure entity approach, selling a partnership interest could convert ordinary income into capital gain.[62]

Under the approach actually used by current law, Anne will recognize $25 of ordinary income and $75 of long-term capital gain (rather than $100 of long-term capital gain) upon sale of her interest in the partnership.[63] As a result, at least with respect to the Inventory in this example, current law harmonizes the tax treatment of the sale of a partnership interest with the tax treatment of the sale of the partnership's underlying assets, foreclosing the possibility of converting ordinary income into capital gain through sale of a partnership interest.[64]

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related to 'hot assets'] essentially insure that the transfer of a partnership interest be viewed as a transfer of the underlying assets in order to preserve the character of gain or loss inherent in the transfer.").

59. *See* I.R.C. § 1(h) (2018).

60. The total gain recognized by Anne on sale of her partnership interest is $100 which is the difference between the $300 selling price and her $200 basis in her partnership interest (her basis is $200 because, when she contributed $100 cash to the partnership, her initial basis became $100 per § 722, and when she was allocated $100 of gain from sale of Capital Asset 1, her basis increased by $100 to become $200 per § 705(a)(1)(A)). I.R.C. §§ 705(a)(1)(A), 772 (2018). Under the entity view, the entire gain is treated as gain from sale of her partnership interest and thus is all long-term capital gain because she holds her partnership interest as a capital asset and her holding period in the partnership interest is more than one year.

61. Given that the partnership holds the Inventory as inventory and has held the capital asset for not more than one year, if the partnership sold the assets, the gain allocated to Anne from sale of the inventory would be treated as ordinary income and the gain from sale of the capital asset would be treated as short-term capital gain. *See* I.R.C § 702(b) (2018).

62. *See supra* note 58 and accompanying text (discussing how concern about the ability to convert ordinary income into capital gain prompted lawmakers to move away from the pure entity approach). *See also* Cauble, *supra* note 52, at 14.

63. *See supra* note 49.

64. The current approach can also be more favorable to taxpayers than a pure entity approach if

As just discussed, Congress spurned the pure entity approach in order to prevent taxpayers from converting ordinary income into capital gain.[65] This same objective could have been achieved by using a pure aggregate approach in lieu of the hybrid approach actually used. Under a pure aggregate approach, the selling partner would receive the same treatment that would follow from a sale of each underlying asset held by the partnership.[66] In Example 1 above, under a pure aggregate approach, Anne would recognize $25 of ordinary income and $75 of short-term capital gain from selling her interest in the partnership, results identical to what would occur if the partnership, instead, sold her share of the underlying assets. Congress's failure to adopt the pure aggregate approach was evidently motivated by concerns about complexity.[67] Specifically, Congress apparently intended to obviate the need to value each of the partnership's underlying assets as would be compelled by a pure aggregate approach.[68] Under the hybrid approach actually adopted, valuation of individual assets is only required for any "inventory items" or "unrealized receivables" held by the partnership.[69]

Thus, in Example 1 above, when Anne sells her interest in the partnership, the only asset that needs to be valued at the time of the sale of her partnership interest is the Inventory.[70] The value of Capital Asset 2 does not need to be determined. Once she determines the value of the Inventory is $150, she can determine that $25 of ordinary income would be allocated to her upon sale of the Inventory.[71] She then determines her total gain recognized as the difference between the selling price ($300) and her $200 basis in her partnership interest, resulting in $100 of total gain.[72] Of this $100, $25 was treated as ordinary income (as a result of the Inventory) and all of the remainder ($75) is treated as gain from sale of her partnership interest (and,

the taxpayer sells an interest in a partnership that holds inventory or unrealized receivables that have depreciated in value.

65. *See supra* note 58 and accompanying text.

66. *See supra* note 53.

67. *See infra* note 68.

68. *See Fragmentation of Gain and Loss on Disposition of a Partnership Interest*, *in* SUBCHAPTER K: PROPOSALS OF ALI ON THE TAXATION OF PARTNERS, FEDERAL INCOME TAX PROJECT 22, 23–24 (1984) [hereinafter SUBCHAPTER K] (discussing how the hybrid approach does not necessitate valuation of underlying assets to the same degree as the pure aggregate approach).

69. I.R.C. § 751(a) (2018).

70. *See id.*

71. *See id.*

72. *See supra* note 49.

thus, long-term capital gain).[73]

Not requiring that she look through to the other assets (here, Capital Asset 2), however, allows for the tax treatment of the sale of her partnership interest to diverge from the tax treatment of the sale of underlying assets.[74] If she were required to look through to all assets, she would determine that the sale of her partnership interest produced $25 of ordinary income and $75 of short-term capital gain (rather than long-term capital gain).[75] Thus, requiring full look-through to underlying assets would fully harmonize the tax treatment of the sale of a partnership interest with the tax treatment of the sale of underlying assets.[76] Requiring full look-though could complicate tax reporting by requiring additional asset valuation.[77] At the same time, requiring full look-though would make it so that either the sale of a partnership interest or the sale of underlying assets would produce the same tax consequences.[78] As a result, taxpayers seeking to exit from a partnership would not inadvertently select a form of exit that produced suboptimal tax consequences given that either form of exit would receive the same tax treatment.[79] Thus, Congress's reluctance to require full look-through represents an example of an attempt to avoid asset valuation (and, thereby, reduce reporting complexity)[80] at the expense of exacerbating planning complexity.

73. *See supra* note 49.

74. *See* discussion of Example 1, *supra* Section III.A.

75. *See* discussion of Example 1, *supra* Section III.A.

76. *See* discussion of Example 1, *supra* Section III.A.

77. The extent to which this is true, however, is not entirely clear. *See infra* note 80.

78. *See* discussion of Example 1, *supra* Section III.A.

79. *See* Cauble, *supra* note 52, at 3–4 ("Thus, according different tax treatment to the two possible routes of exit produces tax revenue loss (as a result of tax planning by sophisticated parties), unfairness (as a result of unsophisticated taxpayers overlooking the same tax planning opportunities), and may increase tax planning costs incurred by taxpayers who assess relevant tax consequences when structuring their exit from a partnership." (footnotes omitted)).

80. In addition to exacerbating planning complexity, Congress's approach also might not, in fact, offer much of a reporting simplification benefit because the need to value assets may still exist for several reasons. First, tax law already requires valuation of any inventory or unrealized receivable. *See, e.g.*, Philip F. Postlewaite, Thomas E. Dutton & Kurt R. Magette, *A Critique of the ALI's Federal Income Tax Project—Subchapter K: Proposals on the Taxation of Partners*, 75 GEO. L. J. 423, 575 (1986). Second, valuation of other assets may already be required for other tax reasons (for instance, in order to determine whether a substantial built-in loss exists) or for non-tax reasons. *See*, *e.g*., Cauble, *supra* note 52, at 37 nn.201–02; Postlewaite, *supra*, at 575 ("[W]hen a prospective purchaser seeks to purchase a partnership interest, or when the partnership decides to 'buy' (redeem) one of its partner's interests, a detailed evaluation of each asset's fair market value is required to determine a fair purchase (redemption) price. Behaving in any other manner would be economically imprudent.").

B. Making the Math Simpler While Sacrificing Accuracy

As discussed above, tax law features designed to eliminate the need to value assets prior to their sale may produce simplification at the tax reporting stage, but they often sacrifice planning simplicity in the process.[81] Likewise, tax law contains a number of examples of rules that were adopted in the name of computational simplicity that make planning more difficult.[82] Such rules streamline the process of computing tax liability compared to alternative rules, thus serving the goal of reporting simplification. However, oftentimes they sacrifice accuracy—they result in tax consequences that do not precisely track economic consequences. As a result, they make tax consequences less intuitive, which makes tax law more complicated at the planning stage particularly for taxpayers who act without considering the resulting tax consequences. This phenomenon can be illustrated by the rules governing the determination of a partnership's basis in its assets following the sale of a partnership interest.[83]

Section 754 is a provision that allows a partnership to make an election that will generally dictate whether or not the partnership will adjust its basis in its assets following a transfer of an interest in the partnership or following certain distributions made by the partnership.[84] This section discusses the mechanics of § 754 in detail.[85]

When one partner sells his or her interest in a partnership to another person, unless a § 754 election is in effect, generally the sale will have no effect on the partnership's basis in its assets.[86] As a result, if a § 754 election is not in effect, gain attributable to an increase in the value of a partnership's assets potentially will be recognized twice for tax purposes—first on sale of an interest in the partnership and second on sale by the partnership of its

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81. *See supra* Section III.A.

82. *See infra* Section III.B.

83. *See* I.R.C. § 754 (2018); I.R.C. § 743(a) (2018). Other examples of the choice to limit computational complexity that sacrifice planning simplicity include the decision to not mandate use of the remedial method for allocation of gain recognized by a partnership on sale of contributed property. For further discussion, see, for example, Emily Cauble, *Making Partnerships Work for Mom and Pop and Everyone Else*, 2 COLUM. J. TAX L. 247 (2011) [hereinafter Cauble, *Making Partnerships Work*].

84. I.R.C. § 754 (2018).

85. For additional discussion of the mechanics of § 754, see Cauble, *Making Partnerships Work*, *supra* note 83, at 274–81.

86. I.R.C. § 743(a) (2018).

assets.[87] By making a § 754 election, the partnership effectively eliminates the second, duplicative tax gain.[88] Special rules apply in the case of partnerships that hold assets that have declined in value.[89]

The mechanics of a § 754 election in the context of a partnership that holds assets that have appreciated in value can be more fully demonstrated by an example.

> **Example 2:** Two individuals, Catherine and Robert, each contribute $100 in exchange for a 50% interest in a newly formed entity treated as a partnership for tax purposes. As a result, each partner will have a basis in his or her interest in the partnership equal to $100.[90] The partnership uses the cash contributed by the partners to acquire a parcel of land for $200, so the partnership's initial tax basis in the land is $200. Over time, the value of the land increases. Two years after the formation of the partnership, when the value of the land is $300 and the partnership holds no other assets and owes no liabilities, Catherine sells her interest in the partnership to Anabel for $150. As a result of the sale, Catherine will recognize $50 of gain for tax purposes, which equals the excess of the amount received from Anabel over Catherine's basis in her interest in the partnership.[91] Anabel's initial basis in her interest in the partnership will be $150.[92]

If the partnership does not have a § 754 election in effect, the transfer will not affect the partnership's basis in the land, and thus, under the facts of Example 2, the partnership's basis in the land will remain $200.[93] Assume, one year after the sale of Catherine's interest in the partnership to Anabel, the partnership sells the land for $300. Because the partnership's basis in the land remained $200, the partnership recognizes $100 of tax gain on sale of the land

87. *See also* Cauble, *Making Partnerships Work*, *supra* note 83 at 275–76 (discussing how gain duplication follows from failing to make a § 754 election).

88. *See* I.R.C. § 743(b). Once a partnership files a § 754 election, the election generally will apply to all transfers that occur in the year with respect to which the election was filed and any subsequent year. *Id.* § 754.

89. *See infra* notes 106–117 and accompanying text.

90. *See* I.R.C. § 722.

91. *See id.* § 1001. This gain will be capital gain assuming the partnership does not hold the land as inventory and holds no unrealized receivables. *See id.* §§ 741, 751(a).

92. *See id.* § 742.

93. *See id.* § 743(a).

which is allocated $50 to Anabel and $50 to Robert. The $50 of tax gain that is allocated to Anabel is effectively a duplication of the tax gain recognized by Catherine on sale of her interest in the partnership to Anabel because both items of $50 tax gain are attributable to Catherine's share of the increase in value of the land that occurred prior to sale of the partnership interest by Catherine to Anabel.

This duplication of tax gain may be temporary. In particular, as a result of the allocation of $50 of tax gain to each partner, each partner's basis in his or her interest in the partnership will increase by $50 so that Anabel's basis in her interest in the partnership becomes $200 and Robert's becomes $150.[94] As a result, if the partnership distributes $150 cash to Robert and Anabel in liquidation, Anabel will recognize a $50 tax loss at the time of the liquidation (the excess of Anabel's basis in her interest in the partnership over the amount of cash received) and Robert will recognize no tax gain or loss.[95] The tax loss recognized by Anabel on liquidation is equal in amount to the earlier, duplicative tax gain recognized by Anabel on sale of the land.[96] However, the tax loss recognized by Anabel may not fully offset the effects of the $50 of tax gain recognized by Anabel on sale of the land for two reasons. First, if the $50 of tax loss does reduce Anabel's tax liability, it does so in the year of liquidation (or in a later year if she does not have income against which it can be deducted that year), and the year of liquidation may be later than the year in which Anabel incurred tax liability as a result of the sale of the land.[97] Therefore, taking into account the time value of money and the fact that applicable tax rates may have changed since the time when the land was sold, the tax loss may not fully offset the consequences of the tax gain. Second, the tax loss is likely a capital loss[98] and may result in only a limited reduction of tax liability if Anabel does not recognize capital gains in the year in which the partnership is liquidated or in a subsequent year. This is so because capital losses of non-corporate taxpayers can only be used against capital gains and

94. *See* I.R.C. § 705(a) (2018).

95. *See id.* § 731(a).

96. As noted, the tax loss recognized is $50. *See supra* note 95 and accompanying text. This is the same amount as the $50 duplicative tax gain allocated to Anabel upon sale of the land.

97. This is true because the loss is not recognized until the partnership liquidates, while the gain was recognized when the partnership sold the land.

98. *See* I.R.C. § 731(a) (stating that the tax loss recognized on liquidation will be treated as tax loss recognized by Anabel from a sale of the partnership interest); *id.* § 741 (stating that, except as provided in § 751, tax loss recognized from the sale of a partnership interest will be treated as capital loss).

up to $3,000 of ordinary income,[99] and excess capital losses of non-corporate taxpayers can be carried forward to succeeding taxable years to be used in those years subject to the restrictions just described.[100]

By contrast, if the partnership has made a § 754 election, the transfer of the partnership interest from Catherine to Anabel will affect the partnership's basis in the land.[101] In particular, under the facts of Example 2, the partnership will increase its basis in the land by $50, which is calculated based on the excess of Anabel's basis in her interest in the partnership (the $150 paid by Anabel for the interest) over Anabel's share of the partnership's basis in its assets ($100 or 50% of the $200 basis in the land).[102] However, this increase in basis will be taken into account solely for purposes of determining Anabel's tax consequences and will not affect tax gain or loss allocated to Robert.[103] Assume, one year after the sale of Catherine's interest in the partnership to Anabel, the partnership sells the land for $300. Absent the $50 increase in basis of the land, the partnership's basis in the land would have been $200, so that the partnership would have recognized $100 of tax gain. Fifty percent of this amount (or $50) would be allocated to Robert, and even taking into account the basis adjustment, $50 is in fact allocated to Robert because the basis adjustment affects Anabel and not Robert. By contrast, the $50 of tax gain that would have been allocated to Anabel absent an upward basis adjustment of $50 is entirely eliminated by the $50 upward basis adjustment, so that no tax gain or loss is allocated to Anabel. Thus, unlike what occurs in the absence of a § 754 election, the $50 of tax gain attributable to Catherine's share of the increase in the value of the land that occurred prior to Catherine's sale of her partnership interest to Anabel (and that was recognized by Catherine on sale of her interest in the partnership to Anabel) is not recognized a second time by Anabel when the land is sold by the partnership. After the partnership recognizes $50 of tax gain and allocates it to Robert, Robert's basis in his interest in the partnership becomes $150 and Anabel's remains $150. Thus, if the partnership distributes $150 of cash to each partner on liquidation, neither partner recognizes gain or loss as a result of the liquidation.[104]

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99. *See id.* § 1211 (2018).
100. *See id.* § 1212.
101. *Id.* § 743(b).
102. *See id.*
103. *See id.*
104. *See* I.R.C. § 731 (2018). A similar issue of potential duplication of built-in gain arises when

Making the basis adjustments that follow from a § 754 election is more computationally complex than not making them (particularly when a partnership holds many assets).[105] However, it results in tax consequences that more accurately track economic consequences. In Example 2 above, for instance, without basis adjustments, tax gain is recognized by Anabel at the time the land is sold even though the land does not increase in value after Anabel joins the partnership so that she does not benefit economically from any increase in value. When basis adjustments are made, by contrast, she does not recognize a tax gain upon sale of the land—consistent with her lack of economic gain.

If a partnership's assets have a "substantial built-in loss" immediately after the transfer of an interest in the partnership, then the results that would follow from making a § 754 election are mandatory regardless of whether the partnership has made such an election.[106] In other words, in such a case, the partnership is required to take steps to avoid the recognition of the same tax loss a second time. A "substantial built-in loss" exists if a partnership's total basis in its assets, in aggregate, exceeds the total value of the partnership's assets by more than $250,000.[107] The following example demonstrates the results of a mandatory downward basis adjustment. For purposes of the example, assume the following facts:

> **Example 3:** Two individuals, Michael and Madeline, each contribute $500,000 in exchange for a 50% interest in a newly formed entity treated as a partnership for tax purposes. The partnership uses the cash contributed by the partners to acquire a parcel of land for $1,000,000. Over time the value of the land decreases. Two years after the formation of the partnership, when the value of the land is $700,000 and the partnership holds no other assets and owes no liabilities, Michael sells his interest in the partnership to Reynolds for $350,000. One year later, the partnership sells the land for $700,000. Two years after that, the partnership distributes $350,000 cash to each

property is distributed by a partnership to a partner, and whether the gain is duplicated will depend on whether the partnership has a § 754 election in effect. *Id.* § 734(a)–(b).

105. *See infra* notes 121–125 and accompanying text.

106. *See* I.R.C. § 743(b).

107. *See id.* § 743(d)(1)(A). A similar rule applies in the case of downward basis adjustments in connection with the distribution of property. *See id.* §§ 734(b), (d). The Tax Cuts and Jobs Act provides for an additional circumstance in which a substantial built-in loss exists, as discussed below in Section IV.B.

of Madeline and Reynolds in liquidation.

Because the partnership's basis in its assets exceeds the value of the partnership's assets by $300,000 immediately after the transfer under the facts of Example 3, a substantial built-in loss exists, and the partnership must reduce the basis in the land by $150,000 for purposes of determining Reynold's tax consequences.[108] As a result, Michael will recognize a $150,000 loss on sale of the partnership interest to Reynolds,[109] but, when the land is sold by the partnership in year three, Reynolds will recognize no tax gain or loss[110] and Madeline will recognize a tax loss of $150,000.[111] Neither Madeline nor Reynolds will recognize any gain or loss on liquidation in year five.[112]

108. *See* I.R.C. § 743(d)(1)(A) (2018) (providing that a substantial built-in loss exists when the partnership's basis in partnership property exceeds the fair market value of partnership property by more than $250,000); *id.* § 743(a) (providing that "[t]he basis of partnership property [will] . . . be adjusted as [a] result of a transfer of a [partnership] interest . . . [if] the partnership has a substantial built-in loss"). In addition to the rules that apply in cases in which a partnership's assets have a substantial built-in loss, the partnership anti-abuse regulations contain examples regarding potentially abusive transactions that involve the failure to make a § 754 election. *See* Treas. Reg. § 1.701-2(d) (suggesting, through Example 8 and Example 9 in the Treasury Regulations, that if a partnership is formed largely for the purpose of duplicating a tax loss that results from the failure to make a § 754 election, the transaction can be successfully challenged). However, the mere failure to make a § 754 election, in and of itself, will not be considered abusive simply because it results in the duplication of tax loss in a particular situation. *See* Treas. Reg. § 1.701-2(d), Example 9. As the Treasury Regulations state: "The electivity of section 754 is intended to provide administrative convenience for bona fide partnerships that are engaged in transactions for a substantial business purpose . . . . Congress clearly recognized that if the section 754 election were not made, basis distortions may result." *Id.*

109. As a result of contributing $500,000 cash to the partnership, Michael will have a basis in his partnership interest equal to $500,000. *See* I.R.C. § 722 (2018). Thus, when Michael sells the partnership interest to Reynolds for $350,000, Michael will realize and recognize a tax loss of $150,000. *Id.* § 1001.

110. Upon sale of the land, the partnership will recognize a tax loss of $300,000, but the half of that loss that would otherwise be allocated to Reynolds ($150,000) will be eliminated by the $150,000 downward basis adjustment that is required as a result of the fact that the partnership had a substantial built-in loss when Michael's partnership interest was transferred to Reynolds. *See id.* §§ 743(a)–(b).

111. Upon sale of the land, the partnership will recognize a tax loss of $300,000, and the half of that loss that is allocated to Madeline ($150,000) will not be affected by the mandatory downward basis adjustment which only affects Reynolds's tax consequences. *See id.* § 743(b).

112. *See id.* §§ 705(a), 722, 731(a), 742. As a result of the allocation of $150,000 of tax loss to Madeline, her basis is reduced from the original basis ($500,000) to $350,000. *See id* §§ 705(a), 722. Thus, she recognizes no gain or loss when she receives a liquidating distribution of $350,000 cash. *See id.* § 731(a). Reynolds's initial basis in his partnership interest is $350,000, the amount he paid to acquire it. *See id.* §§ 742, 1012(a). No tax gains or losses have been allocated to Reynolds that would

Example 3 can be contrasted with an example in which a built-in loss exists, but it is not a substantial built-in loss so loss duplication is allowed. In order to demonstrate, consider the example that follows.

> **Example 4:** Two individuals, Mike and Dianne, each contribute $500,000 in exchange for a 50% interest in a newly formed entity treated as a partnership for tax purposes. The partnership uses the cash contributed by the partners to acquire a parcel of land for $1,000,000. Over time the value of the land decreases. Two years after the formation of the partnership, when the value of the land is $800,000 and the partnership holds no other assets and owes no liabilities, Mike sells his interest in the partnership to Ellen for $400,000. One year later, the partnership sells the land for $800,000. Two years after that, the partnership distributes $400,000 cash to each of Dianne and Ellen in liquidation. The partnership does not have a § 754 election in effect.

Because the partnership's basis in its assets exceeds the value of the partnership's assets by only $200,000 immediately after the transfer under the facts of Example 4, a substantial built-in loss does not exist.[113] Because there is no substantial built-in loss, and because no § 754 election is in effect, the partnership need not reduce the basis in the land for purposes of determining Ellen's tax consequences.[114] As a result, not only will Mike recognize a $100,000 tax loss on sale of the partnership interest to Ellen,[115] but when the partnership sells the land in year three, Ellen will recognize that tax loss of $100,000 a second time,[116] and Dianne will recognize a tax loss of $100,000.[117] The duplicative tax loss will be, in a sense, temporary because

change his basis. *See id.* § 705(a). Thus, he recognizes no gain or loss when he receives a liquidating distribution of $350,000 cash. *See id.* § 731(a).

113. *See* I.R.C. § 743(d)(1)(A) (providing that a substantial built-in loss exists when "the partnership's adjusted basis in the partnership property exceeds . . . the fair market value of [partnership] property" by more than $250,000).

114. *See id.* § 743(a) (establishing that there is no basis adjustment absent a § 754 election or a substantial built-in loss).

115. As a result of contributing $500,000 cash to the partnership, Mike will have a basis in his partnership interest equal to $500,000. *See id.* § 722. Thus, when Mike sells the partnership interest to Ellen for $400,000, Mike will realize and recognize a tax loss of $100,000. *See id.* § 1001.

116. Upon sale of the land, the partnership will recognize a tax loss of $200,000. Half of the loss is allocated to Ellen.

117. Upon sale of the land, the partnership will recognize a tax loss of $200,000. Half of the loss

Ellen will recognize a $100,000 tax gain on liquidation in year five.[118] This later tax gain, however, may not fully offset the effects of the earlier duplicative tax loss because it occurs in a later year and also because it may be of a different character than the tax loss.

As originally enacted, the results that follow from a § 754 election were not mandatory even in cases involving potential duplication of substantial built-in losses.[119] In 2004, Congress enacted the rules mandating downward basis adjustments in cases in which a partnership's assets have a substantial built-in loss, in order to address concerns about tax-shelter transactions involving intentional duplication of losses.[120] Concerns about computational complexity have influenced the hesitation to require basis adjustments in all cases.[121] For example, in a 1980 report recommending making basis adjustments mandatory in all cases, the A.L.I. acknowledged objections that could be made to such a change in the law.[122] One objection was that "unsophisticated partnerships might have to make complex basis adjustments."[123] The A.L.I. also expressed concern for partnerships at the other end of the spectrum, stating that large partnerships would face complexity if they had to make basis adjustments for "innumerable

is allocated to Dianne.

118. *See* I.R.C. §§ 705(a), 731(a), 742, 1012(a) (2018). Ellen's initial basis in her partnership interest is $400,000—the amount she paid to acquire it. *Id.* §§ 742, 1012(a). Her basis is reduced by $100,000 as a result of the allocation to her of $100,000 loss from sale of the land. *Id.* § 705(a). Thus, she recognizes gain of $100,000 when she receives a liquidating distribution of $400,000 cash because the distribution exceeds her basis in the partnership interest by $100,000. *Id.* § 731(a).

119. *See* S. REP. NO. 108-192, at 189 (2003) (explaining why Congress moved to make the elections mandatory).

120. *See, e.g.*, *id.* at 151 ("The Committee believes that the present-law electivity of partnership basis adjustments upon transfers and distributions leads to anomalous tax results, causes inaccurate income measurement, and gives rise to opportunities for tax sheltering. In particular, the failure to make partnership basis adjustments permits partners to duplicate losses and to transfer losses among partners, creating an inappropriate incentive to use partnerships as tax shelter vehicles.").

121. For an alternative explanation for the § 754 election, see Heather M. Field, *Choosing Tax: Explicit Elections as an Element of Design in the Federal Income Tax System*, 47 HARV. J. ON LEGIS. 21, 35–36 (2010) (arguing that the purpose of allowing taxpayers to make the § 754 election is to reconcile the differences between tax consequences that result from a sale of an interest in a partnership and tax consequences that result from an economically similar sale by a partnership of an interest in its assets). Yet, as Professor Field observes, this purpose could be served equally well if the results following from a § 754 election were mandatory. *Id.* at 42. Professor Field also notes that mandatory adjustments may be undesirable because of complexity. *Id.* at 43.

122. Am. Law Inst., Federal Income Tax Project 81 (Tentative Draft No. 4, 1980).

123. *Id.* at 81–82.

partners."[124]

Similarly, in 2004, the House Committee Report described the limitation of mandatory basis adjustments to cases involving substantial built-in losses as a feature that would preserve "the simplification aspects of the current partnership rules for transactions involving smaller amounts."[125] Interestingly, while the changes ultimately enacted principally resembled the House version of the bill, the Senate's original version of the bill would have required basis adjustments in all cases.[126] When discussing its proposed bill, the Senate Report stated:

> The electivity of these adjustments has become anachronistic and should be eliminated, the Committee believes. Therefore, this provision makes these partnership basis adjustments mandatory, addressing both loss and gain situations. The bill provides that the partnership basis adjustments remain elective in the limited case of transfers of a partnership interest by reason of the death of a partner because that situation may involve unsophisticated taxpayers and constitutes only a narrow, limited set of transfers.[127]

Likely, the fact that any computations can now be automated is a fact that the Senate had in mind when it stated that the elective nature of basis adjustments is "anachronistic." Thus, the computational complexity created by basis adjustments can be mitigated.

Moreover, even if making basis adjustments is more computationally onerous than not making them, basis adjustments result in each economic gain or loss generating only one matching tax gain or loss, which can simplify tax planning by making tax consequences more consistent with intuitive expectations. For instance, in Example 2, an economic gain (Catherine's share of the increase in the value of the land) produces two tax gains (one recognized by Catherine and one recognized by Anabel) when a § 754 election is not in effect so that basis adjustments are not made. The duplicative tax gain is eliminated when basis adjustments are made. The result of recognizing a duplicative tax gain that does not correspond with an economic gain is likely inconsistent with the intuitive expectations of taxpayers. Thus,

124. *Id.* at 82.
125. H.R. REP. No. 108-548, at 283 (2004).
126. *See* S. REP. NO. 108-192, at 189–90 (2004).
127. *Id.*

unsophisticated taxpayers who do not consider the resulting tax consequences and neglect to make a § 754 election may be caught unaware.[128] In addition, not mandating basis adjustments in all situations involving built-in losses leaves open the possibility that sophisticated taxpayers will continue to benefit from loss duplication in some cases.[129]

C. Discontinuous Numerical Rules

As discussed above, some features of tax law designed with tax reporting simplification in mind exacerbate tax planning complexity.[130] For example, rules designed to obviate the need to value assets prior to sale and rules designed to reduce the number of steps necessary for computing tax liability may serve the goal of easing the burden of tax reporting.[131] Yet such rules often make tax planning more complicated by making tax results less intuitive (because tax consequences diverge from economic consequences or because drastic changes in tax outcome are permitted to turn on small non-tax differences).[132] One particular type of rule that reduces the number of computational steps required to determine tax liability and that allows for extreme differences in tax outcome to turn on small non-tax dissimilarities is a rule that produces what is often described as a "cliff effect."[133]

While cliff effects are not limited to rules that are based on a taxpayer's income (or some subset of a taxpayer's income), many examples do involve

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128. For discussion of this problem in the context of tax elections generally, see, e.g., Field, *supra* note 121, at 31 ("[A]n election, while technically available to all eligible taxpayers, may be functionally available only to the wealthiest, most sophisticated group of taxpayers, who can best navigate the complexity of the election process.")

129. Consider, for instance, Example 4. *See supra* Section III.B. *See also* S. REP. NO. 108-192, at 189 (2004) ("In particular, the failure to make partnership basis adjustments permits partners to duplicate losses and to transfer losses among partners, creating an inappropriate incentive to use partnerships as tax shelter vehicles.").

130. *See supra* Sections II.A–II.B.

131. *See supra* Sections II.A–II.B.

132. *See supra* Sections II.A and II.B.

133. For discussion of cliff effects in tax generally, see Lily L. Batchelder, *What Should Society Expect from Heirs? The Case for a Comprehensive Inheritance Tax*, 63 TAX L. REV. 1, 91 n.303 (2009); Karen C. Burke & Grayson M.P. McCouch, *Death Without Taxes?*, 20 VA. TAX REV. 499, 531 (2001); Glenn E. Coven, *Taxing Corporate Acquisitions: A Proposal for Mandatory Uniform Rules*, 44 TAX L. REV. 145, 174–75 (1989); Manoj Viswanathan, *The Hidden Costs of Cliff Effects in the Internal Revenue Code*, 164 U. PA. L. REV. 931 (2016); Lawrence Zelenak, *Doing Something About Marriage Penalties: A Guide for the Perplexed*, 54 TAX L. REV. 1, 59 (2000); Lawrence Zelenak, *Taxing Gains at Death*, 46 VAND. L. REV. 361, 416–17 (1993).

income.[134] Lawmakers make available a given tax benefit (such as a credit or deduction) but limit its availability to taxpayers with incomes (or some other income-related measurement) below a certain threshold.[135] In some cases, a taxpayer whose income exceeds the relevant threshold will lose the benefit gradually over a range of income, in which case the benefit is subject to an income-based "phase-out."[136] In other cases, a taxpayer whose income exceeds the threshold level by any amount will lose the benefit entirely, in which case the rules produce what is referred to as a cliff effect.[137] Rules containing phase-outs and rules that produce cliff effects are not entirely distinct phenomena but rather lie on a spectrum. A rule that contains a phase-out begins to approach a rule that produces a cliff effect as the range of income over which the phase-out occurs becomes narrower.

Rules that produce cliff effects are computationally simpler than rules containing phase-outs.[138] A taxpayer either is entitled to the benefit in its entirety or is not entitled to the benefit at all depending on whether the taxpayer is on one side of the cliff or the other.[139] By contrast, when a rule

134. *See*, *e.g*, Viswanathan, *supra* note 133, at 935 ("Qualitatively, a cliff effect exists when a differential change to some characteristic of an individual has significant economic consequences to that individual. In practice, the reference metric to which the cliff effect is attached is often, but not always, an income or asset level.").

135. *See*, *e.g*., David M. Schizer, *Limiting Tax Expenditures*, 68 TAX L. REV. 275, 333 (2015) ("Phase-outs and cliffs deny tax benefits to those who earn more than a minimum amount. The disallowance occurs all at once with a cliff, and over a range with a phase-out.").

136. For discussion of phase-outs generally, see, for example, Charles S. Hartmann, *Missed It by That Much—Phase-Out Provisions in the Internal Revenue Code*, 22 U. DAYTON L. REV. 187 (1996); Robert J. Peroni, *Reform in the Use of Phase-Outs and Floors in the Individual Income Tax System*, 91 TAX NOTES 1415 (2001); Ellin Rosenthal, *Phaseouts: Too Much of a Good Thing?*, 40 TAX NOTES 1228 (1988).

137. *See, e.g.*, Schizer, *supra* note 135, at 333 ("Phase-outs and cliffs deny tax benefits to those who earn more than a minimum amount. The disallowance occurs all at once with a cliff, and over a range with a phase-out.")

138. For discussion of the complexity produced by phase-outs, see, for example, Peroni, *supra* note 136, at 1431 ("These provisions complicate filing by adding additional decision trees and calculations to the tax determination process."). For discussion of the computational simplicity afforded by rules that produce cliff effects, see, for example, Viswanathan, *supra* note 133, at 940 ("The use of a cliff effect with respect to the income of a qualifying relative establishes a bright-line rule which provides definitional clarity because classification as a dependent is binary and does not exist as a continuous function: a nonchild relative either is or is not a qualifying relative.").

139. This is not to say that computational simplicity is the only reason for selecting a rule that produces a cliff effect instead of a phase-out. The choice between a cliff and a phase-out (and the width of the phase-out range) also have implications for tax revenue and for who receives a given tax benefit. *See, e.g.*, Schizer, *supra* note 135, at 334; Viswanathan, *supra* note 133, at 943.

contains a phase-out, if a taxpayer falls within the phase-out range, additional computations are required to determine how much of the benefit is phased out.

As an example, consider the Earned Income Tax Credit (the EITC).[140] The EITC is a tax provision designed to provide economic relief to the working poor.[141] A taxpayer's eligibility for the EITC and the amount of any available EITC depend on a number of variables, with some of the applicable rules containing phase-outs (or phase-ins) and some producing cliff effects.[142] One variable is the taxpayer's investment income, and with respect to investment income, the rules produce a cliff effect.[143] If a taxpayer's investment income exceeds a specified dollar threshold by any amount whatsoever, the taxpayer loses the EITC entirely.[144]

One could imagine an alternative rule under which the EITC was subject to a phase-out over some range of investment income. If the taxpayer's investment income fell within the phase-out range, the taxpayer would lose a given percentage of the EITC to which he or she would otherwise be entitled based on the extent to which the taxpayer's investment income exceeded the start of the phase-out range. For example, the EITC could be phased out for any investment income, up to $6,000. If the taxpayer earned $3,000 of investment income, the taxpayer would be entitled to half of the EITC to which the taxpayer would be entitled absent the phase-out for investment income. If the taxpayer earned $4,500 of investment income, the taxpayer would be entitled to one-quarter of the EITC to which he or she would be entitled without the investment income phase-out. If the taxpayer earned

140. I.R.C. § 32 (2018).

141. Ann L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 HARV. L. REV. 533 (1995) (indicating that the EITC "uses the federal income tax system to provide an earnings subsidy to low-income workers").

142. A full discussion of the EITC is beyond the scope of this Article. For further discussion of the EITC, see, for example, Alstott, *supra* note 141, at 533; Book, *supra* note 14, at 351; Book, *supra* note 37; Drumbl, *supra* note 23; Francine J. Lipman, *The Working Poor Are Paying for Government Benefits: Fixing the Hole in the Anti-Poverty Purse*, 2003 WIS. L. REV. 461; Jonathan P. Schneller, *The Earned Income Tax Credit and the Administration of Tax Expenditures*, 90 N.C. L. REV. 719 (2012); Jonathan P. Schneller, Adam S. Chilton & Joshua L. Boehm, *The Earned Income Tax Credit, Low-Income Workers, and the Legal Aid Community*, 3 COLUM. J. TAX L. 176 (2012); Susannah C. Tahk, *The Tax War on Poverty*, 56 ARIZ. L. REV. 791, 797–803 (2014); David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 997–1012 (2004); Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Tax Credit*, 52 UCLA L. REV. 1867 (2005).

143. *See* Viswanathan, *supra* note 133, at 938.

144. *See id.*

$6,000 or more of investment income, the taxpayer would lose the EITC entirely.

The choice to instead adopt a rule that produces a cliff effect streamlines the process for computing the amount of the EITC. One only needs to determine whether or not investment income is above the threshold. With a phase-out, additional computations are required if a taxpayer is within the phase-out range.[145] Yet a rule that produces a cliff effect makes tax consequences less intuitive—for a taxpayer who earns investment income close to the threshold amount, earning a small amount of additional investment income could result in the taxpayer losing the EITC entirely.[146]

Taxpayers who do not plan prior to acting face potentially more dire consequences when faced with rules that produce cliff effects than when faced with more gradual rules.[147] When faced with a rule that produces a cliff effect, a small misstep can result in losing a benefit entirely in a circumstance in which the same misstep would result in only a partial reduction in the benefit if the rule, instead, contained a phase-out.[148] For example, a taxpayer who is

145. A phase-out also requires knowing the amount of the variable that subjects the taxpayer to the phase-out with more precision than what is required in the case of a cliff in some cases. For a related observation, see James M. Puckett, *Improving Tax Rules by Means-Testing: Bridging Wealth Inequality and "Ability to Pay,"* 70 OKLA. L. REV. 405, 447 (2018) ("A $2 million cliff could mitigate complexity because the valuation question would be limited to identifying onto which side of the threshold the taxpayer falls rather than identifying a precise value.").

146. *See infra* note 147 and accompanying text.

147. *See* Viswanathan, *supra* note 133, at 953 ("[T]he consequences of improper planning become increasingly severe—$1 of additional income could actually reduce post-tax earnings. For example, if the taxpayer is not acutely aware of payments potentially out of her direct control, such as dividend or interest payments, the result can be the loss of a $5572 Earned Income Tax Credit benefit."). Adopting a phase-out rather than a rule that produces a cliff effect, however, can potentially exacerbate planning complexity by increasing the number of taxpayers who are subject to the phase-out and who, therefore, might face surprising tax consequences if they do not plan adequately. For discussion of how increasing the width of a phase-out range can produce this effect, see Peroni, *supra* note 136, at 1434 ("The income range selected must carefully balance the equity and efficiency gains resulting from making the phase-out range wider so as to minimize the increase in effective marginal rates resulting from the phase-out provision against the simplification losses resulting from making more taxpayers subject to the phase-out provision.").

148. The choice between a phase-out and a rule producing a cliff effect also has implications for efficiency—however, it is not clear which selection is more or less likely to distort taxpayers' decisions. For further discussion, see, for example, David A. Weisbach, *Formalism in the Tax Law*, 66 U. CHI. L. REV. 860, 873 (1999) ("A discontinuous law, a cliff, may have very different behavioral effects than a continuous law, although one cannot say which will be more efficient without more information. For example, if the tax law required assets to remain in the partnership for two years prior to distribution to avoid disguised sale treatment, taxpayers who gain more from avoiding sale treatment than they lose by waiting two years will shift their behavior to use partnerships rather than

otherwise eligible for the EITC but who earns investment income close to the threshold amount and who acts without considering the resulting tax consequences might sell an investment asset that produced a small amount of gain, but enough gain to push the taxpayer's investment income over the threshold amount.[149] If the taxpayer had considered the resulting tax consequences, the taxpayer would have deferred sale of the asset to a later year in which the taxpayer's investment income, with the gain, would not exceed the threshold. When the rules are designed in a way that produces a cliff effect (which is the case under current law in the case of investment income and the EITC), this oversight results in the taxpayer losing the EITC entirely, while, if the EITC was instead subject to a phase-out based on investment income, this oversight would only result in a partial reduction in the amount of the EITC.

In summary, in various contexts, lawmakers have adopted rules that produce cliff effects in that small changes in a non-tax variable (such as the amount of income earned by a taxpayer) produce dramatic differences in tax outcome. The design of rules producing cliff effects may be explained based on simplification considerations (reducing computational complexity or other compliance costs).[150] Although the rules may ameliorate complexity in this respect, they produce counter-intuitive results, which increases the costs faced by taxpayers who do not plan prior to acting.

IV. TINKERING BY THE TAX CUTS AND JOBS ACT

The Tax Cuts and Jobs Act modified the tax treatment of a non-U.S. partner who sells an interest in a partnership that conducts a U.S. trade or business and also slightly expanded upon the circumstances in which a partnership will be required to adjust its basis in partnership assets following the sale of a partnership interest. Both changes achieved some simplification at the planning stage. However, the measures were modest and should have gone further. Each of the measures is discussed, in turn, below.

sales. Those who would have waited two years anyway have no costs imposed on them.").

149. *See* Viswanathan, *supra* note 133, at 952–53.

150. *See, e.g.*, Viswanathan, *supra* note 133, at 940 ("The use of a cliff effect with respect to the income of a qualifying relative establishes a bright-line rule which provides definitional clarity because classification as a dependent is binary and does not exist as a continuous function: a nonchild relative either is or is not a qualifying relative.").

A. Tax Treatment of Selling Partners

As discussed above in Section III.A, in some circumstances, the sale of a partnership interest can produce tax consequences that differ from the sale of a partnership's underlying assets. Congress could have fully harmonized the tax treatment of the two transactions by subjecting a partner who sells his or her interest in a partnership to the same tax treatment that follows from a sale of underlying assets in all cases. Congress stopped short of doing so in all cases in order to obviate the need for taxpayers to value each of the partnership's assets upon sale of a partnership interest. Thus, failing to fully equate the tax treatment of the two transactions may preserve some degree of simplification at the tax reporting stage. However, by allowing differences in tax outcome to persist, Congress has exacerbated complexity at the planning stage. Two equivalent routes of exiting a partnership receive potentially different tax treatment. This state of affairs can trap unwary taxpayers who might select a route of exit without considering the possibility that a transaction structured in a slightly different manner could produce more favorable tax consequences.

One scenario in which sale of a partnership interest can produce tax consequences that differ from the results following from sale of the partnership's underlying assets entails the sale by a non-U.S. person of an interest in a partnership that conducts a trade or business in the United States.[151] In this scenario, the sale of the partnership interest can lead to tax results that are more favorable than what would follow if the partnership sold its underlying assets.[152] The Tax Cuts and Jobs Act includes a provision that partially eliminates the potential tax savings resulting from sale of a partnership interest in this particular context.[153] However, the Tax Cuts and Jobs Act's solution fails to fully eliminate the possibility that the sale of a partnership interest could produce more beneficial tax treatment than the sale of underlying assets even in the specific context that it addressed as well as more generally.[154]

Understanding this example requires a brief primer on the taxation of non-U.S. persons holding interests in a partnership. A non-U.S. person is generally

151. For additional discussion of this example and § 751(a) generally, see Cauble, *supra* note 52, at 20.

152. *See id.* at 19 (discussing the "unduly favorable results" created by this scenario).

153. *See* I.R.C. § 864(c)(8) (2018).

154. *See infra* notes 177–184 and accompanying text.

subject to U.S. tax only on U.S. source income of certain types and income effectively connected with a U.S. trade or business (ECI).[155] If a non-U.S. person holds an interest in a partnership that conducts a trade or business in the United States and the partnership sells assets that generate ECI, then the resulting income allocated to the non-U.S. partner will be treated as ECI and subject to U.S. tax.[156]

When deciding a 2017 case, *Grecian Magnesite Mining Industrial & Shipping Co. v. Commissioner*, the Tax Court addressed the question of what would occur when a non-U.S. person, instead, sold an interest in a partnership that conducted a trade or business in the United States.[157] In the case, a non-U.S. corporation owned an interest in a partnership that engaged in the business of extracting, producing, and distributing magnesite that it mined in the United States.[158] The non-U.S. corporation recognized gain from a sale of its interest in the partnership when the partnership redeemed the interest it held.[159] The Tax Court concluded that the gain from the sale[160] was not ECI.[161] The gain was not attributable to any inventory items or unrealized receivables held by the partnership.[162] Section 741 of the Code provides that, except for gain attributable to such assets, gain from sale of an interest in a partnership shall be treated as gain from sale of a *capital asset*.[163] The IRS argued that § 741 does not specify *which* capital asset—in other words, the statute could mean that the gain would be treated as gain from a sale of the assets that were underlying assets held by the partnership (so that the resulting gain would be ECI).[164] The Tax Court disagreed, concluding that the "capital asset" to which § 741 refers is the partnership interest itself, and capital gain resulting from

155. I.R.C. §§ 881–82 (2018).

156. *Id.* §§ 702(b), 875.

157. 149 T.C. 63 (2017).

158. *Id.* at 67.

159. *Id.* at 67–68.

160. This was true except for gain attributable to U.S. real estate held by the partnership, which was subject to tax under rules specifically applicable to U.S. real estate. *See* I.R.C. § 897(g) (2018) (for rules applicable to U.S. real estate); *Grecian Magnesite Mining*, 149 T.C. at 66 ("A portion of the gain . . . pertained to . . . U.S. real property interests, and GMM has now conceded that this portion is subject to U.S. income tax. Still in dispute, however, is the remainder of the gain, which is not attributable to real property . . . .").

161. *Grecian Magnesite Mining*, 149 T.C. at 92.

162. If it had been attributable to inventory or unrealized receivables, the court would not have been analyzing the gain under § 741, but it did analyze the gain under that provision. *Id.* at 72.

163. *Grecian Magnesite Mining*, 149 T.C. at 72.

164. *Id.*

sale of the partnership interest was not ECI.[165] In so holding, the Tax Court rejected the position taken by the IRS in a prior revenue ruling from 1991.[166]

The Tax Cuts and Jobs Act included a partial legislative fix that addresses this one way, in which sale of a partnership interest could produce more favorable results than the sale of underlying assets, but the fix only works in some cases.[167] In particular, new § 864(c)(8) provides that gain or loss recognized by a non-U.S. person on sale of an interest in a partnership that is engaged in a trade or business in the United States shall be treated as ECI to the extent that the gain does not exceed the amount of ECI that would have been allocated to the partner if the partnership had sold all of its assets for fair market value.[168]

In the context of some fact patterns, the newly adopted provision will ensure that the tax treatment of the sale of a partnership interest is aligned with the tax treatment of the sale of underlying assets,[169] but opportunities for mismatch remain.[170] In order to demonstrate, consider the following examples.

> **Example 5:** Two non-U.S. individuals own interests in a partnership that conducts a trade or business in the United States. Upon formation, each individual contributes $50 to the partnership, and they agree to share equally in all gains and losses. The partnership acquires one asset for $25 (the ECI Asset), the sale of which would produce ECI, and the partnership acquires another asset for $75 (the Non-ECI Asset), the sale of which would not produce ECI. The ECI Asset appreciates in value to $125, and the Non-ECI Asset appreciates in value to $105. The ECI Asset and the Non-ECI Asset do not constitute inventory or unrealized receivables.

In Example 5, if the partnership were to sell both assets for fair market value and liquidate, each partner would recognize ECI of $50 as a result of the sale of the ECI Asset and no ECI as a result of the sale of the Non-ECI

165. *Id.* at 78–79, 82.
166. *See* Rev. Rul. 91-32, 1991-1 C.B. 107.
167. *See* I.R.C. § 864(c)(8) (2018).
168. *Id.*
169. *See* Example 5 *infra* Section IV.A.
170. *See* Example 6 *infra* Section IV.A.

Asset.[171]

In Example 5, if instead a partner were to sell his or her interest in the partnership for $115, prior to the enactment of the Tax Cuts and Jobs Act the partner would have recognized $65 of gain that was not ECI based on the Tax Court's holding in *Grecian Magnesite Mining*.[172] Thus, the partner would have received more favorable treatment by selling his or her interest in the partnership than the treatment that would have arisen from a sale of the partnership's underlying assets.[173]

In the context of Example 5, newly enacted § 864(c)(8) addresses this discrepancy.[174] In particular, it provides that the $65 gain that would be recognized by the partner on sale of his or her interest in the partnership will be treated as ECI to the extent that it does not exceed the $50 of ECI that would have been allocated to the selling partner if the partnership had sold all of its assets for fair market value.[175] Thus, the selling partner will recognize $50 of ECI and $15 of gain that is not ECI—a result that corresponds to the outcome of a sale by the partnership of its underlying assets.[176]

In order to demonstrate discrepancies between the sale of underlying assets and the sale of a partnership interest that persist even after the adoption of new § 864(c)(8), consider the following example.

> **Example 6:** Two non-U.S. individuals own interests in a partnership that conducts a trade or business in the United States. Upon formation, each individual contributes $50 to the partnership, and they agree to share equally in all gains and losses. The partnership acquires one asset for $25 (the ECI Asset), the sale of which would generate ECI, and the partnership acquires another asset for $75 (the Non-ECI Asset), the sale of which would not generate ECI. The ECI Asset appreciates in value to $125, *but the Non-ECI Asset declines in value to $45*. The ECI Asset and the Non-ECI Asset do not constitute inventory or unrealized receivables.

171. *See* Example 5 *infra* Section IV.A. These examples assume the Non-ECI Asset is not United States real estate.
172. *See supra* notes 157–166 and accompanying text.
173. *See supra* notes 171–172 and accompanying text.
174. I.R.C. § 864(c)(8) (2018).
175. *Id.*
176. *See supra* note 171 and accompanying text.

In Example 6, if the partnership were to sell both assets for fair market value and liquidate, each partner would recognize ECI of $50 as a result of the sale of the ECI Asset.[177] Each partner would also recognize a loss of $15 as a result of the sale of the Non-ECI Asset; however, this loss would not be effectively connected to a U.S. trade or business, and thus, could not be deducted against the $50 of ECI recognized by each partner.[178]

In Example 6, if instead a partner were to sell his or her interest in the partnership for $85, prior to the enactment of the Tax Cuts and Jobs Act the partner would have recognized $35 of gain that was not ECI based on the Tax Court's holding in *Grecian Magnesite Mining*.[179] Thus, the partner would have received more favorable treatment by selling his or her interest in the partnership than the treatment that would have arisen from a sale of the partnership's underlying assets.[180]

In the context of Example 6, newly enacted § 864(c)(8) only partially addresses this discrepancy.[181] In particular, it provides that the $35 gain that would be recognized by the partner on sale of his or her interest in the partnership will be treated as ECI to the extent that it does not exceed the $50 of ECI that would have been allocated to the selling partner if the partnership had sold all of its assets for fair market value.[182] Thus, the selling partner will recognize $35 of ECI—$15 less than the ECI that would be recognized by the partner upon sale by the partnership of its underlying assets.[183] In effect, sale of the partnership interest allows the partner to deduct the partner's share of the loss that has accrued in the Non-ECI Asset against the partner's share of the gain that has accumulated in the ECI Asset; a result that could not be achieved by a sale of underlying assets.[184]

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177. I.R.C. §§ 702(b), 875 (2018).

178. *Id.* § 882(c)(1)(A).

179. *See supra* notes 157–166 and accompanying text.

180. *See supra* notes 178–179 and accompanying text.

181. I.R.C. § 864(c)(8) (2018).

182. *Id.*

183. *See supra* note 178 and accompanying text.

184. In this respect, the approach of the new statutory provision is less robust than § 751(a). Under § 751(a), if a partnership holds appreciated inventory and capital assets that have declined in value, the partner will recognize the full amount of the ordinary income that would have been allocated to the partner upon sale of the inventory and a capital loss, rather than capping the ordinary income recognized at the total amount of gain recognized from sale of the partnership interest. For additional discussion of this difference between § 751(a) and § 864(c)(8), see KPMG LLP, TAX REFORM—KPMG REPORT ON NEW TAX LAW 78 (2018), https://home.kpmg/content/dam/kpmg/us/pdf/2018/02/tnf-new-law-book-feb6-2018.pdf ("Accordingly, where the partnership holds both

The regulations under § 864(c)(8) contain an anti-stuffing rule to guard against the possibility that taxpayers will reap the benefits of a sale of a partnership interest by manufacturing facts similar to Example 6.[185] Assume a partnership holds an asset (that is not inventory or an unrealized receivable), the sale of which would generate ECI, and assume a partner holds an asset (that, likewise, is not inventory or an unrealized receivable) that has declined in value and the sale of which would generate a non-effectively connected loss (a Non-ECI Asset).[186] If a partner contributes the Non-ECI Asset to the partnership to create facts that mirror Example 6 (with the principal purpose of reducing the amount of ECI recognized on a sale of the partnership interest) and subsequently sells an interest in the partnership to a third party, the regulations provide that the contribution of the Non-ECI Asset will be disregarded or the transaction will otherwise be characterized based on its substance.[187] For instance, this transaction might be recast by the IRS as a direct sale of the Non-ECI Asset by the partner to the third party and a sale of an interest in the partnership that did not hold the Non-ECI Asset. Nevertheless, if a partnership holds assets similar to those shown in Example 6 and the partners did not create the facts by stuffing Non-ECI Assets into the partnership too close in time to the sale of the partnership interest, the sale of a partnership interest can produce more favorable tax consequences than the sale of underlying assets. Thus, the Tax Cuts and Jobs Act's incomplete fix to the tax treatment of the sale of a partnership interest by a non-U.S. person leaves unaddressed ways in which the sale of a partnership interest by a non-U.S. person can produce results that differ from the sale of underlying assets.

Moreover, outside of this context, there exist many other potential differences between the tax treatment of the sale of a partnership interest and the tax treatment of the sale of underlying assets, and these differences went entirely unaddressed by the Tax Cuts and Jobs Act. For instance, as shown above in Example 1, in some contexts the sale of a partnership interest could produce long-term capital gain that would have been short-term capital gain

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appreciated effectively connected assets, and depreciated non-effectively connected assets, it appears that not all of the foreign partner's effectively connected gain, as determined on a look-through basis, would be recognized under the provision.").

185. *See* 26 Treas. Reg. 1.864(c)(8)–1(h) (2020).

186. For additional discussion of this possibility prior to the adoption of the anti-stuffing regulation, see Cauble, *supra* note 52, at 23–25. For the anti-stuffing regulation, see 26 Treas. Reg. 1.864(c)(8)–1(h) (2020).

187. *See* 26 Treas. Reg. 1.864(c)(8)–1(h) (2020).

as a result of the sale of underlying assets.[188]

B. Partnership's Basis in Assets

As discussed above in Section III.B, the sale of a partnership interest does not affect a partnership's basis in its assets unless the partnership has made an election under § 754 or the partnership's assets have a substantial built-in loss at the time of the transfer of the partnership interest.[189] Absent an adjustment to a partnership's basis in its assets, both gains and losses can, effectively, be duplicated for tax purposes, at least temporarily. In other words, if an asset held by a partnership has increased (or decreased) in value, not only will the transferor partner recognize a gain (or loss) attributable to that underlying asset at the time of the sale of his or her partnership interest, but also tax gain (or loss) attributable to the same increase (or decrease) in value can be recognized a second time by the transferee partner upon sale of the underlying asset.

Basis adjustments—which would eliminate the second duplicative tax gain (or loss)—only occur if the partnership has made a § 754 election or if a substantial built-in loss exists at the time of the partnership interest transfer.[190] A substantial built-in loss exists if the partnership's total basis in all of its assets exceeds the assets' total fair market value by more than $250,000.[191]

The Tax Cuts and Jobs Act slightly expanded the definition of substantial built-in loss.[192] It now also exists if "the transferee partner would be allocated a [net] loss" in excess of $250,000 upon a hypothetical disposition at fair market value by the partnership of all partnership assets immediately after the transfer.[193] In order to demonstrate, consider the following example.

> **Example 7:** Two individuals, Mindy and Danny, each contribute $1,000,000 in exchange for a 50% interest in a newly formed entity treated as a partnership for tax purposes. The partnership uses the

188. For discussion of other examples, see Cauble, *supra* note 52.

189. *See* I.R.C. § 743(a) (2018) ("The basis of partnership property shall not be adjusted as a result of the transfer of an interest in a partnership by sale or exchange . . . unless the election provided by section 754 . . . is in effect with respect to such partnership or unless the partnership has a substantial built-in loss immediately after such transfer.").

190. *See* I.R.C. § 743(a) (2018).

191. *Id.* § 743(d)(1)(A).

192. *Id.* § 743(d)(1)(B).

193. *Id.*

> cash contributed by the partners to acquire two parcels of land for $1,000,000 each. Mindy and Danny agree that any gain or loss from sale of the first parcel of land (Land #1) will be allocated entirely to Mindy and any gain or loss from sale of the second parcel of land (Land #2) will be allocated entirely to Danny. Over time the value of Land #1 decreases to $700,000. The value of Land #2 increases to $1,300,000. The partnership does not have a § 754 election in effect. At that time, Mindy sells her interest in the partnership to Morgan for $700,000. One year later, the partnership sells Land #1 for $700,000. Two years after that, the partnership sells Land #2 for $1,300,000 and distributes $700,000 cash to Morgan and $1,300,000 cash to Danny in liquidation.

Absent the changes made by the Tax Cuts and Job Act, in Example 7, the $300,000 loss built into Land #1 would, effectively, be recognized twice for tax purposes—once by Mindy on sale of her interest in the partnership and a second time by Morgan upon sale of Land #1 by the partnership.[194] As a result of the changes made by the Tax Cuts and Jobs Act, however, the second duplicative tax loss recognized by Morgan is eliminated.[195]

Even with the changes made by the Tax Cuts and Jobs Act, however, loss duplication is still possible. Because the existence of a substantial built-in loss is generally determined on an aggregate basis across all assets, a basis adjustment would not be required if, for example, a partnership held land with a built-in loss of $300,000 at the time of a transfer but also held another asset

194. Prior to the changes made by the Tax Cuts and Jobs Act, a substantial built-in loss only existed when the total basis in all partnership assets exceeded total value by more than $250,000. *See* I.R.C. § 743 (d)(1)(A). The total basis in both parcels of land is $2,000,000, and the total value is $2,000,000 ($700,000 plus $1,300,000). Thus, under this part of the definition, a substantial built-in loss does not exist. If a substantial built-in loss does not exist and a Section 754 election is not in effect, the partnership is not required to adjust the basis in its assets. *See id.* § 743. If the partnership does not adjust the basis in its assets, then, in addition to Mindy recognizing a loss of $300,000 (when she sells her partnership interest with a basis of $1,000,000 for $700,000), the sale by the partnership of Land #1 for $700,000 would produce a $300,000 tax loss allocated entirely to Morgan. Upon liquidation, Morgan would recognize gain, but, given that liquidation might occur later and given that the gain might be of a different character, it might not offset the effects of the earlier loss.

195. *See id.* § 743(d)(1)(B). As a result of the Tax Cuts and Jobs Act, a substantial built-in loss would be deemed to exist because, absent a basis adjustment, Morgan would be allocated a loss of more than $250,000 (in particular $300,000) if the partnership's assets were sold for cash equal to their fair market immediately after the transfer of the partnership interest to Morgan. The mandatory basis adjustment will, in effect, eliminate the $300,000 tax loss that otherwise would have been allocated to Morgan on sale of Land #1.

with a built-in gain of $50,000 at the time of the transfer, assuming that not more than $250,000 of the $300,000 loss is specially allocated to the transferee partner. Such a partnership could duplicate a $300,000 loss if it also duplicated a $50,000 gain. This could lead to tax savings not only because the amount of duplicated loss is more than the amount of duplicated gain, but also because, depending upon the character of the gain and the loss, it is possible that the loss could be of such a type that the tax savings produced by the loss exceeded the tax imposed upon gain of an equal amount. In the case of a partnership owned by individuals, this could be true if the built-in gain asset was a capital asset (so that the gain that is duplicated is a capital gain subject to preferential tax rates) and the built-in loss asset is inventory (so that the loss that is duplicated is an ordinary loss that can be used to offset ordinary income subject to higher tax rates). Loss duplication is also permitted in circumstances like Example 4, discussed above, in which a partnership holds one asset with a built-in loss but the built-in loss is not more than $250,000.

V. CONCLUSION

When simplification considerations guide the design of tax provisions, lawmakers often focus on simplification at the reporting stage.[196] For instance, the rules governing the tax treatment of the sale of a partnership interest do not fully equate the tax treatment of that transaction with the tax treatment of the sale of the partnership's underlying assets in order to avoid the need to value all of the partnership's assets at the time of the partnership interest sale.[197] While avoiding the need to value assets may simplify tax reporting, allowing the tax treatment of the two transactions to diverge makes tax planning more complicated. Unsophisticated taxpayers who select one form of the transaction without considering the resulting tax consequences may inadvertently miss an opportunity to select a slightly different form of the transaction that would have produced a more favorable tax outcome.[198]

The Tax Cuts and Jobs Act included a slight modification to the tax treatment of partnership interest sales that brings their treatment closer to the treatment of the sale of a partnership's underlying assets in some cases

196. *See supra* Part III.
197. *See supra* Section III.A.
198. *See supra* Sections II.A.2, III.A.

involving the sale by a non-U.S. partner of an interest in a partnership conducting a U.S. trade or business.[199] The change, however, does not go nearly far enough as it leaves unaddressed many instances in which the tax treatment of the sale of a partnership interest diverges from the tax treatment of the sale of underlying assets.[200] Lawmakers ought to go further and require looking through to underlying assets any time an asset's sale would produce gain or loss subject to different tax treatment than the gain or loss from sale of a partnership interest.[201]

In a similar vein, when a partnership interest is transferred, the partnership is not required to adjust its basis in its underlying assets in all cases. Basis adjustments entail computational complexity, thus, not requiring them provides some measure of tax reporting simplification.[202] However, without basis adjustments, economic gains that have accrued in a partnership's asset at the time of the sale of a partnership interest can produce duplicative tax gains—first, gain is recognized by the partner who sells his or her partnership interest and, second, the gain is recognized again by the transferee partner when the partnership sells the underlying asset.[203] Likewise, in some cases, economic losses can give rise to duplicative tax losses. The possibility for gain and loss duplication makes tax planning more complicated, which may particularly burden unsophisticated taxpayers who act without knowledge of the rules and thus might engage in transactions that differ from the transactions in which they would have engaged had they known the applicable rules.[204]

The Tax Cuts and Jobs Act slightly expanded upon the circumstances in which basis adjustments are required.[205] However, even with the changes made by the Tax Cuts and Jobs Act, basis adjustments are not required in many cases.[206] Lawmakers ought to go further and require basis adjustments in all cases.[207]

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199. *See supra* Part IV.
200. *See supra* Part IV.
201. *See supra* Part IV.
202. *See supra* Section III.B.
203. *See supra* Section III.B.
204. *See supra* Section II.A and Parts III–IV.
205. *See supra* Section IV.B.
206. *See supra* Section IV.B.
207. *See supra* Section IV.B.