Terence Cuff Interviewed By Jerald David August

In this special feature of Corporate Taxation, Jerald David August interviews Terence Cuff, a leading expert in partnership taxation with decades of experience in practice and commentary. Mr. Cuff comments on the complexity of partnership taxation, gives advice to practitioners, and offers some suggestions for tax reform. Mr. August previously interviewed Mr. Cuff for the March/April 2022 issue of this journal.

Question: In your earlier interview published in Corporate Taxation March/April 2022, you were asked "What is wrong with Subchapter K today? How can Subchapter K be improved?" At that time, you mentioned it was "too complicated," "too extensive," and "produced too much uncertainty." Have your thoughts and observations about partnership tax law during the interim period remained the same or are we sliding further into the "bog"?

Response: As a basic principle of tax policy, Internal Revenue Service auditors and normal tax practitioners need to understand the tax law. We do not have a real tax law if no one can understand it – or if the tax law can be understood only by a small group of experts.

Ideally, the tax law should be understandable by lay taxpayers. We are far from that point. I question whether anyone fully understands the rules of partnership taxation.

There are substantial grey areas in partnership tax, even for national class tax specialists. Even where the law may be clear, partnership tax principles are often difficult to apply in practice.

As a general rule, most tax practitioners in private practice and most Internal Revenue Service auditors do not have an adequate understanding of the partnership tax rules. We need a partnership tax law that we can understand and apply without heroic effort. The Internal Revenue Service needs a partnership tax law that auditing agents can apply understandably, consistently, and rigorously in taxpayer audits.

Instead, we have an enormous body of code, regulations, and cases that often are complex, difficult to understand, and filled with areas of uncertainty.

Many practitioners and partnerships exploit uncertainties and confusion in the partnership tax law for creative tax planning. Many partnerships are involved in abusive or improper tax practices. Abuse of the partnership tax rules is much more widespread than generally acknowledged.

We need comprehensive partnership tax reform and simplification – true simplification. All issues and all provisions of partnership tax law should be on the table for reform. We need a system of partnership tax laws that is understandable and reasonably easily administrable. This will require reevaluating everything about partnership tax. Any doubt should be resolved in favor of simplicity and administrability.

Reforming the partnership tax rules for simplicity and administrability will result in changes many advisors and taxpayers may find difficult to accept. For example, tax reform might:

- Realign the partnership tax rules more with the rules of subchapter S.
- Make some common partnership nonrecognition transactions taxable.
- Eliminate flexibility in partnership allocations.
- Eliminate electivity of methods under Section 704(c)(1)(A).
- Eliminate Section 704(c)(1)(A).
- Eliminate Section 734 and Section 754 adjustments.
- Eliminate partnership liabilities from a partner's basis in his partnership interest.
- Result in a one class of partnership interest rule.
- Eliminate the nontaxable receipt of profits interests for services.
- Eliminate tiered partnerships.
- Limit the rules of partnership tax to small business partnerships and exclude partnerships with many partners and massive amounts of assets.

Question: We have frequently discussed the partnership audit rules that were enacted by Congress in 2015. What can you say that is good about these rules and what is not so good? Why are these rules better than the TEFRA audit rules or simply each partner, one audit approach?

Response: The TEFRA partnership audit rules did not work well. Deficiencies could be difficult to collect, particularly

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when partnerships had tiered structures. Partnership examinations could be administratively cumbersome. Partnership disputes could be litigated simultaneously in a variety of forums.

The BBA partnership audit rules are a draconian solution to the problems of TEFRA. Much about the BBA partnership audit rules could be questioned as unfair or inappropriate.

The idea of a unified partnership audit makes sense. That is the good aspect of the BBA partnership audit rules.

However, the provisions of the BBA partnership audit rules concerning powers of the partnership representative are overbroad. The partnership representative is given imperial powers in a BBA partnership audit rules audit. Centralized, imperial powers invite abuse. The BBA partnership audit rules are overbroad in defining the powers of the partnership representative. Partners can be left out in the cold during a partnership tax controversy. The BBA partnership audit rules take away from partners due process of law. The BBA partnership audit rules provide the minority partner who disagrees with the partnership audit positions or audit strategy with practically no recourse. This is inappropriate.

There are many technical rules in computing the imputed underpayment under the BBA partnership audit rules that are unfair to taxpayers. While the theory of these rules is understandable, I cannot support the imposition of liability for the imputed underpayment on the partnership as opposed to the partners. This can result in unfairness to the partners. This distorts basic principles of the partnership tax laws.

I cannot support the decision of the BBA partnership audit rules to make adjustments taxable in the year of adjustment rather than in the year under audit. This violates the basic tax theory that a taxpayer should compute tax liability for a year based on his income and loss for that year.

Question: Section 704(b) and the various methods for allocation of tax items seem overly complex and to some extent not really complied with. Do you agree? What should we require taxpayers and their advisors to spend time and effort on to ensure compliance or arrive at allocations that are at least supportable? What about requiring all related parties to receive a "straight up" pro rata allocation of income, deduction, loss, or credit? What can be done in this area to simplify allocations and their impact on capital accounts?

Response: As developed in regulations under Section 704, substantial economic effect is a complicated concept and a challenge for partnership agreement drafters. There are many situations in which the substantiality rules cannot be applied reliably by return preparers.

Only a small minority of partnership agreements currently comply with the substantial economic effect regulations. Other partnership agreements rely on partners' interests in the partnership. Unfortunately, the partners' interests in the partnership rules in the Section 704 regulations generally cannot be applied reliably. This creates frequent issues concerning partnership allocations.

It is difficult indeed to propose simple, comprehensive rules for either substantial economic effect or partners' interests in the partnership. The current regulations miss the mark of simplicity and administrability. The current regulations often are ambiguous. For practical purposes, the Internal Revenue Service seems to make no attempt to audit most partnership allocation schemes.

The best solution may be to eliminate flexibility in partnership allocations and to impose what in effect would be a one class of partnership interest rule that does not permit special allocations. This would eliminate reliance on substantial economic effect and partners' interests in the partnership.

Question: This may seem a bit too technical, but please explain for our readers the difference between "book capital accounts" and "tax capital accounts" and why tax advisers, lawyers, and accountants should understand the difference? When you become involved in representing a partner in a mid-stream partnership, how important is it to have contractual protection and assurances on "book capital accounts" on date of entry or other items? Any comments on "reverse" book up Section 704(c) allocations or other esoteric stuff like remedial or curative allocations?

Response: Capital accounts track investment in a partnership or a limited liability company. It is the record of investment – distributions + income – losses.

Capital accounts differ from tax basis in a partnership or limited liability company. Tax basis is also increased by a partner's net share of partnership liabilities. Capital accounts are not affected by partnership liabilities.

Tax capital accounts, as the term is commonly used, are based purely on federal income tax principles for adjusted tax basis, income, gain, deduction, loss, depletion, and depreciation.

Book capital accounts are based on federal income tax principles, but applied with the fair market value of contributed assets as the starting point. Certain adjustments are permitted to adjust book capital accounts to fair market value of partnership assets on events listed in regulations.

If partnership allocations are designed to have substantial economic effect, then the partnership will liquidate in accordance with positive book capital account balances. The capital accounts will fundamentally affect partnership economics.

If partnership allocations do not have substantial economic effect, book capital accounts still should be important in determining partnership allocations of income and loss. Knowledge of book capital account balances will be fundamental to understanding partnership income and loss allocations.

A partnership is permitted to redetermine ("rebook") all capital accounts to fair market value on events listed in Section 704(b) regulations. These are events like a contribution of money or other property to the partnership or a distribution of money or other property to a partner. After the revaluation, unrealized appreciation in partnership assets will be credited to partner capital accounts. Future partnership allocations will be made based on redetermined

capital accounts. The disparity between redetermined book value and adjusted tax basis will be handled under Section 704(c) principles after the regulations. The allocations are referred to as "reverse Section 704(c) allocations."

What most practitioners miss is the requirement that the adjustment to capital account be "made principally for a substantial non-tax business purpose." This requirement usually is easily satisfied if the partnership expressly liquidates in accordance with book capital account balances. This requirement may be impossible to satisfy if the partnership does not expressly liquidate in accordance with book capital account balances.

Question: When investors in joint ventures treated as partnerships seek to have a "hurdle" or "preferred" rate of return, what are the drafting issues and challenges that lawyers must address for the preferred investor as well as the non-preferred or common investors? Do you like working with targeted cash allocations? Why or why not?

Response: Distribution provisions that use hurdles or preferred returns can work well if drafted properly. However, drafters too often fail to recognize the nuances of these provisions. Few drafters draft hurdles and preferred returns with sufficient care. Many distribution provisions in partnership agreements are defective.

One of the flaws of many tiered, hurdle-based distribution provisions is failure clearly to indicate precisely what distributions are counted in satisfying the distribution hurdle.

For example, the first tier distribution provision ((a) tier) may return to partners an x% preferred return on unrecovered invested capital. The distribution provision then has (b), (c), (d) and (e) tiers. Assume that in year 1 the partnership makes distributions first under tier (a) (the x% preferred return), tier (b), and tier (c).

The distribution provision is applied again in year 2. A badly drafted distribution provision may count the year 1 distributions under tiers (b) and (c) in determining whether the hurdle in tier (a) has been satisfied in year 2. This can result in the tier (a) provision distributing nothing in year 2 because the distribution hurdle already has been satisfied by distributions that were made in year 1 under tiers (b) and (c). That is rarely how the partners want the distributions to work.

Some distribution provisions are based on satisfying a percentage internal rate of return.

A well-drafted agreement will clarify precisely what distributions are counted in satisfying the internal rate of return hurdle. Many badly-drafted agreements fail to provide this clarification; they may count lower-tier distributions made in earlier years in determining whether the internal rate of return hurdle has been satisfied.

These badly-drafted agreements may first have a tier (a) with an internal rate of return hurdle and a tier (b) that returns capital. That scheme rarely works well.

Few partnership agreements are precise in specifying how hurdles should be computed. If a distribution tier provides a percentage return, the agreement should clarify whether the percentage rate is compounded, what is the compounding period, what are the compounding dates, what is the computational year, and when the computational year begins.

A well-drafted provision also should clarify when contributions are deemed received in computing the return and when distributions are deemed paid for purposes of satisfying the hurdle.

Use particular care when dealing with hurdles defined by satisfying a specified internal rate of return. Remember that it is highly unlikely that distributions will give a partner precisely a 7% internal rate of return. The partner's return generally will increase from slightly below a 7% internal rate of return to slightly above a 7% internal rate of return. A hurdle base that switches off tier (a) when distributions under tier (a) give a partner a 7% internal rate of return will not work well. The hurdle never will be satisfied. The partner never will have exactly a 7% internal rate of return.

Distribution tiers based on internal rate of return should also address how to handle multiple solutions to the internal rate of return in a particular year.

Internal rate of return should be defined carefully. I very much dislike definitions of internal rate of return based on the Microsoft Excel IRR function. The use of Microsoft Excel XIRR function is better, but it can create occasional problems. It is much better to define internal rate of return by formula and not by reference to the result of computer software.

When drafting distribution hurdles, be careful about terms like "Unrecovered Contribution."

A distribution tier might read, "First, all Distributions will be made to Partner A under this tier (a) until Partner A has received Distributions under this tier (a) equal to his Unrecovered Contribution."

If Partner A started with an Unrecovered Contribution of $100,000, the hurdle condition will be satisfied when Partner A has received $50,000 (not $100,000) in distributions, as each $1 in distribution reduces Unrecovered Contributions by $1. When the partner has received $50,000 in distributions under tier (a), Unrecovered Contribution will have been reduced to $50,000. The hurdle condition will have been satisfied. Distribution provisions like this can lead to misadventure.

Few distribution hurdles are drafted with the proper level of care.

I enjoy working with targeted allocation provisions. Targeted allocations are difficult to draft well. Everyone has his own style of drafting targeted allocations. The targeted allocation provisions often produce different results.

I consider targeted allocations like a child's toy. They are fun to play with. I also realize that, like the child's toy, the targeted allocations in the partnership agreement are unlikely to control allocations for federal income tax purposes. Nevertheless, targeted allocations can be fun to draft, even though they likely do not control for tax purposes.

Question: What if partnership contributions were all taxable, at least to the extent of gain realization? Similarly, what if distributions of appreciated property were taxable to the

partnership as if Section 311(b) applied to partnerships, i.e., new Section 711?[1] What would be the "pros" and the "cons" of that idea? If that were the law, could the mixing bowl rules and disguised sale provisions be eliminated or at least modified?

Response: Contributions of appreciated or depreciated property potentially shift built-in income or loss among partners. Section 704(c)(1)(A) is a complex provision that often is applied in an abusive manner. I would like to eliminate Section 704(c)(1)(A). I would accept the inconvenience of gain recognition on contribution as the price of eliminating Section 704(c)(1)(A). Eliminating Section 704(c)(1)(A) also would increase the fungibility of partnership interests and contribute significantly to simplifying partnership tax.

Avoiding partnership gain recognition on distribution of property to a partner has resulted in complex basis adjustment rules. These basis adjustment rules have led to some unfortunate tax shelter transactions. I would prefer to eliminate these basis adjustment rules. I would accept recognition on distribution of property as the price of eliminating the complex basis adjustment rules.

Of course, one could argue that taxing the appreciation in capital contributions and partnership distributions will impede the formation of partnerships. I believe that the gain in simplicity is worth the economic sacrifice.

Question: There are several sets of anti-abuse regulations in the partnership regulations and of course there is the general anti-abuse regulation in Reg. 1.701-2(b). Please comment on why the Service continues to promulgate regulations in the partnership area that guard against abuses that comply with the statutory and regulatory requirements but still should be stricken by application of a regulation? Has the Supreme Court's repeal of the Chevron Doctrine of judicial deference in issuance of tax regulations in *Loper Bright Enterprises v. Raimondo*, 144 S.Ct. 2244 (2024) signal that anti-abuse regulations may themselves be invalid under the Administrative Procedure Act and the Skidmore (v. Swift Co., 323 U.S. 134, 140 (1944)) doctrine?

Response: *Loper Bright Enterprises* and other authorities under the Administrative Procedure Act make tax planning much more interesting. Not only does the planner need to seek to understand what the regulations say. The planner also needs to evaluate the authority and validity of the regulation in the light of *Loper Bright Enterprises*.

It is premature to gauge the ultimate effect of *Loper Bright Enterprises*. For many years, the Internal Revenue Service claimed exemption from many requirements of the Administrative Procedure Act. Many regulations exploited the presumption of validity under Chevron. Many regulations contain interpretations of the tax law that are creative and far from a simple, straight-forward reading of the underlying statute. These regulations at least invite reconsideration under *Loper Bright Enterprises* and other authorities. Planners also need to consider the possibility that some taxpayer-favorable regulations might be challenged under *Loper Bright*.

I do not know how the controversy over the validity of regulations will be resolved. I suspect that this resolution may require years of tax litigation and perhaps further clarification by the Supreme Court.

Question: Section 752 makes it important to determine when and the extent to which a partner is treated as relieved from part or all of an indebtedness and then at times when a partner is allowed to increase his tax basis for increasing his share of partnership debt. Recourse liability is where a partner(s) is (are) personally obligated to repay the indebtedness under a deemed liquidation construct. Where no partner or related person bears economic risk of loss for repayment of the partnership liability, the obligation is treated as nonrecourse. Some have questioned whether "recourse" debt should be treated differently for federal income tax purposes. What is your take on this issue and how would this work out if all partnership debt were to be treated as "nonrecourse"?

Response: I do not find it productive to have different definitions of "nonrecourse" and "recourse" debt under Section 465, Section 707, Section 752, and Section 1001. Having different definitions of "nonrecourse" and "recourse" unnecessarily complicates the partnership tax law.

As a matter of simplification, I would be inclined not to include liabilities in a partner's tax basis in his partnership interest.

Having said that, I do not see a considerable benefit in treating all liabilities as nonrecourse liabilities under Section 752.

Question: Do you see Congress repealing the carried interest rules for gain characterization and/or the application of Section 83 principles to the receipt of a profits interest for services? How confident should tax advisors be that deals going "live" now with carried interests may not be grandfathered in were Congress to redesign "The Playing Field" as you accurately described in Cuff, "Drafting and Understanding Partnership and LLC Allocation and Distribution Provisions", Chapter 30. Carried Interests and Section 1061 Regulations" (WESTLAW).

Response: The tax treatment of the grant of a profits interest as consideration for services has been a difficult issue for many years. Section 83 would seem to say that the transaction is taxable upon grant. The courts have agreed, but generally have been persuaded on the facts of each case that the profits interest involved had a zero value. The issue should be engaged by Congress, which should determine whether the grant of a profits interest should be taxable. In this regard, many profits interests are structured with preferential allocations so that they are practically capital interests.

Section 1061 is an imperfect solution. Section 1061 is a complicated solution. Section 1061 is a very political solution.

I cannot confidently predict how Section 1061 or Section 83 might be amended by Congress in the future. I do believe that profits interests will continue to be controversial.

I do believe that partnership profits interests issued for services require a more careful, consistent, and comprehensive solution. I do not know whether and when Congress will provide this solution.

Question: In drafting partnership agreements, what are common mistakes or issues that are overlooked by lawyers and tax advisors? Would this include electing to have a limited partnership or limited liability company with multiple members electing Subchapter S? Your thoughts?

Response: I am concerned that so many partnership agreements are drafted by drafters who do not understand partnership agreements and partnership tax well.

I am particularly concerned how often partnership agreements get the economics wrong. Partnership distribution provisions too often are careless, ambiguous, or incorrect. It is important to model (with numbers) partnership economic provisions whenever the partnership economic model is complicated. Many economic errors or ambiguities could be discovered and corrected with careful modelling.

Tax distribution provisions too often are drafted with inadequate care. Among other things, tax distribution provisions usually should be drafted as advances that are recoverable from future distributions to the partner.

Target allocation provisions should be drafted to account for the operation of nonrecourse deduction allocations, minimum gain chargebacks, partner minimum gain chargebacks, qualified income offsets, and special allocations.

BBA partnership audit provisions rarely are drafted with adequate care. These provisions should provide adequate management controls over the partnership representative. These provisions also should clarify that the accountants are engaged by the partnership (and not the partnership representative) and report to partnership management. BBA partnership audit provisions should be drafted in consideration of whether the partnership plans to push out adjustments. BBA partnership audit provisions should clarify who will bear partnership audit expenses. BBA partnership audit provisions should also provide rules governing a BBA partnership audit after the partnership has wound up and dissolved. These should include provisions for financing the audit.

I prefer to form S corporations as corporations and not LLCs. It is easy to violate rules of subchapter S when working with an LLC that has elected corporate status. Too many S corporations violate S corporation rules.

Question: What if Congress were to call you and ask if it should return to the TEFRA audit rules instead of the BBA partnership audit rules Centralized Audit Regime?

Response: I do not see a return to TEFRA audit rules as a practical possibility. I nevertheless believe that the BBA partnership audit rules require substantial reform. I do not expect that material improvements in the BBA partnership audit rules will be at all imminent.

I believe that reform should limit the authority of the partnership representative, provide adequate rights for the partners in an audit, and provide for adjustments to be made in partner returns in the year under audit.

I believe that the partnership should not have liability for the imputed underpayment. Failing to eliminate the imputed underpayment, Congress should amend the rules to improve the computation of the imputed underpayment.

Appropriate changes in statutes of limitations to facilitate partnership audits also would be appropriate.

End Notes

[1] See August, "The No-Look, Just Pass It" Legislation to Prevent Abuse of Partnerships by Wealthy Investors and Mega-Corporations to Avoid Paying Tax", fn. 11, Corporate Taxation (WG&L) Sep/Oct 2021. See also Testimony of Blake D. Rubin Before the Subcommittee on Select Revenue Measures, Committee on Ways And Means, United States House of Representatives," May 15, 2013, reprinted in American Law Institute-CLE, SY004 ALI-CLE 89 (2016); American Law Institute, "Federal Income Tax Project, Subchapter K" (1984).