Effect of proposed changes to partnership taxation and economic activity at partnerships

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EY

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Executive summary

This report examines the economic activity of businesses organized as partnerships in the 2019 US economy as well as their growing importance over time. Additionally, this analysis highlights how changes in partnership taxation could impact US partnership businesses. A partnership is an unincorporated legal form of organization for a business in which two or more persons or entities join together to conduct business and have a shared financial interest in the business.[1]

Key results

- **Partnerships are a significant share of US economic activity**
  - There were 744,000 partnerships in 2019 (12% of US businesses)
  - These businesses employed 16.3 million workers (12% of US employment)
  - These workers earned $809 billion (11% of US payroll)

- **Partnerships have grown in importance over time**
  - Between 2009 and 2019, employment at partnerships grew from 11.5 million workers to 16.3 million workers
  - Additionally, the share of US employment at partnerships grew from 10% in 2009 to 12% in 2019

- **Manufacturing partnerships are a significant share of US manufacturing**
  - There were 33,000 manufacturing partnerships in 2019 (14% of US manufacturing businesses)
  - These businesses employed 1.1 million workers (9% of US manufacturing employment)
  - These workers earned $57 billion (8% of US manufacturing payroll)

- **Manufacturing partnerships have grown in importance over time**
  - Between 2009 and 2019, employment at manufacturing partnerships grew from 863,000 workers to 1.1 million workers
  - Additionally, the share of US manufacturing employment at partnerships grew from 7% in 2009 to 9% in 2019

Proposed changes to partnership taxation

In September 2021, Senate Finance Committee Chair Ron Wyden, D-OR, unveiled a proposal to reform US federal income partnership taxation. The proposed changes would significantly modify or eliminate numerous long-standing rules. This report discusses four of the partnership tax changes proposed by Senator Wyden, summarizing current law, the proposed changes, and certain implications of those changes. The four proposals discussed in this report are:

1) changes to partnership "book" allocation methods;
2) changes to allocation methods accounting for built-in gain and loss in partnership property;

[1] Definitions throughout this report generally follow the US Census Bureau's Statistics of US Businesses. For detailed definitions see the report endnotes. Notably, statistics related to the economic footprint of partnerships include corporate-owned partnerships

3) changes to the taxation of distributions of partnership property with pre-contribution gains and losses (commonly referred to as the “anti-mixing bowl rules”); and,
4) changes to rules adjusting the basis of partnership property.

These new policies could discourage partnership formations and increase the cost of capital. Fewer partnership formations would reduce the amount of jobs and GDP that these businesses would support. An increased cost of capital discourages investment, which reduces the capital stock, reduces the productive capacity of the economy, and, ultimately, dampens economic growth and living standards.[2]

[2] This analysis does not consider the economic effects from the use of revenue raised. Depending on how the federal government uses the revenue, it could have varying impacts.

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I. Introduction

A partnership is an unincorporated legal form of organization for a business in which two or more persons or entities join together to conduct business and have a shared financial interest in the business.[1] Each person or entity in a partnership makes contributions such as money, skills, and labor, and in return receives a share in the business' profits and losses. Partnerships report their taxes by filing an annual information return with the Internal Revenue Service (IRS) (i.e., Form 1065), but are generally not responsible for paying federal income taxes. Instead, profits and losses are passed through to the partners and each partner pays taxes on their share of the profits.

There are business reasons to choose the partnership legal form of organization. For instance, compared to a sole proprietorship, which has a single owner, a partnership's legal structure often limits the partners' personal risk exposure. Additionally, compared to corporations, partnerships can have simpler operating structures and greater ease of acquiring capital.

This report examines the economic activity at partnerships in the 2019 US economy as well as their growing importance over the past decade. Specifically, this analysis examines the growth in the number of partnerships, the number of partnership establishments, partnership employment, and partnership payroll. Additionally, this analysis highlights how changes in partnership taxation could impact US partnership businesses. Definitions throughout this report generally follow the US Census Bureau's Statistics of US Businesses (SUSB). For detailed definitions see the report endnotes. More detailed data are presented in the appendix.

<u>Pass-through taxation</u>

Partnerships are considered pass-through businesses. Pass-through businesses are subject to a single level of tax on the income earned, whether or not it is distributed. The income and expenses of pass-through businesses are reported by an entity's owners. An individual owner's pass-through business income (or losses) is combined with an owner's other income and deductions and subject to individual income tax rates.

In contrast, the income of C corporations is subject to two levels of tax, first when earned at the corporate level, and again when paid out to shareholders in the form of dividends or retained and later realized by shareholders as capital gains. These two levels of tax are often referred to as the double tax on corporate profits.

The pass-through form provides business owners with different options for organizing their businesses. Sole proprietorships are unincorporated businesses owned by a single individual. Partnerships are unincorporated business entities owned by two or more entities or individuals, without any limit on size or type of partner. S corporations are domestic corporations that meet certain conditions that generally constrain their ability to raise capital through expansion of ownership and stock issuances.

Proposed changes to partnership taxation

In September of 2021, Senate Finance Committee Chair Ron Wyden, D-OR, unveiled a proposal to reform US federal income taxation with respect to partnerships. The proposed changes would significantly modify or eliminate numerous long-standing rules. This report discusses four of the partnership tax changes proposed by Senator Wyden, summarizing current law, the proposed changes, and certain implications of those changes. The four proposals discussed in this report are:

1) changes to partnership "book" allocation methods;
2) changes to allocation methods accounting for built-in gain and loss in partnership property;
3) changes to the taxation of distributions of partnership property with pre-contribution gains and losses (commonly referred to as the "anti-mixing bowl rules"); and,
4) changes to rules adjusting the basis of partnership property.

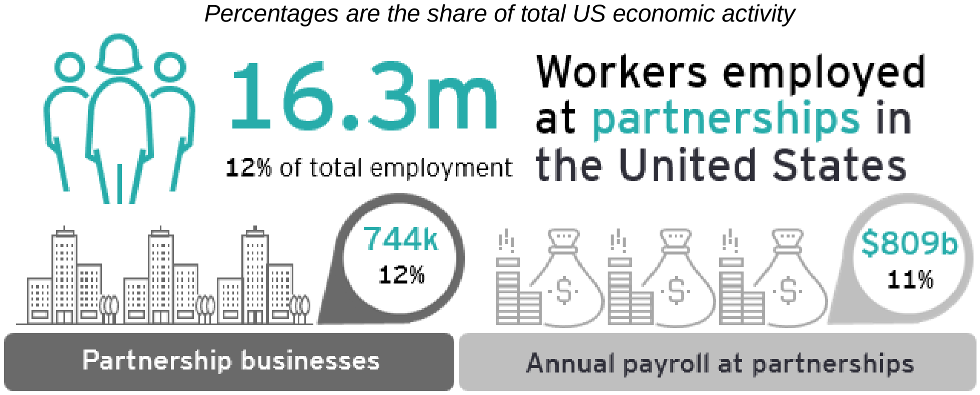
These new policies could discourage partnership formations and increase the cost of capital. Fewer partnership formations would reduce the amount of jobs and GDP that these businesses would support. An increased cost of capital discourages investment, which reduces the capital stock, reduces the productive capacity of the economy, and, ultimately, dampens economic growth and living standards.[2]

II. Economic activity at businesses organized in the partnership form

Economic activity at businesses organized in the partnership form comprises a significant portion of economic activity in the United States. As displayed in Figure 1, as of 2019, there were 16.3 million workers employed by partnerships in the United States. This represents approximately 12% of total US employment.[3] These workers were employed across 744,000 partnership businesses, which was approximately 12% of total businesses in the United States. In 2019 these workers earned $809 billion, which was 11% of total annual payroll in the United States.[4]

Figure 1. Economic activity at partnerships, 2019

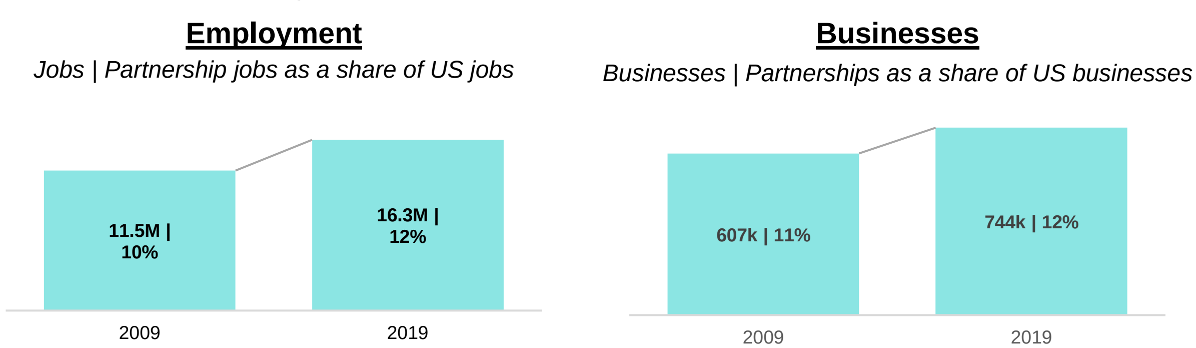
Percentages are the share of total US economic activity



Note: Definitions throughout this report generally follow the US Census Bureau's Statistics of US Businesses. For detailed definitions see the report endnotes. Figures are rounded.
Source: US Census Bureau and EY analysis.

The significance of partnerships to the US economy has grown over the past decade. As seen in Figure 2, between 2009 and 2019 the number of workers employed at partnerships grew from 11.5 million workers in 2009 (10% of US employment) to 16.3 million in 2019 (12% of US employment). The number of partnerships also increased from 607,000 in 2009 (11% of US businesses) to 744,000 businesses in 2019 (12% of US businesses). This reflects an increase in the number of workers by approximately 5 million and an increase in the number of partnerships by nearly 140,000 businesses between 2009 and 2019.

Figure 2. Growth in partnerships, 2009 to 2019



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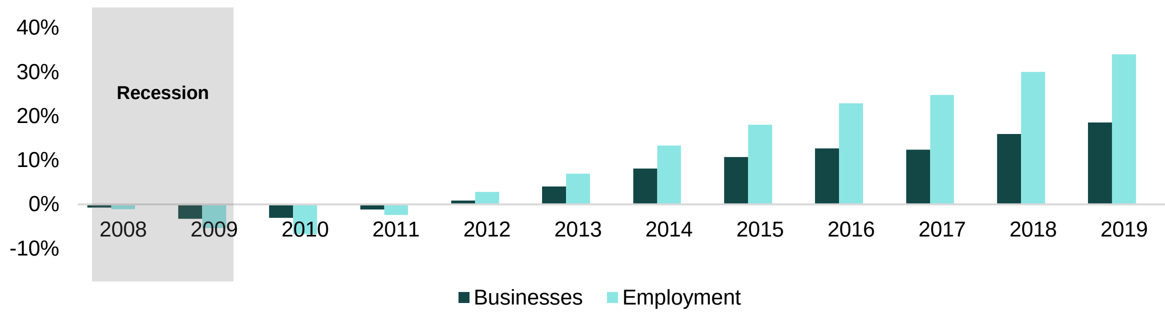
Source: US Census Bureau and EY analysis.

Figure 3 displays the cumulative change in the number of businesses organized as partnerships and the number of workers employed at partnerships between 2007 and 2019. Growth is displayed as cumulative growth relative to 2007. On net, between 2007 and 2019, the number of partnerships in the United States increased 19% and the number of workers employed at partnerships increased 34%. Notably, due to the Great Recession, the number of partnerships and related economic activity declined relative to 2007. However, in years after the recession the number of partnerships and employment at partnerships increased steadily on an annual basis.

Figure 3. Change in partnerships over time

Annual values benchmarked to 2007 values



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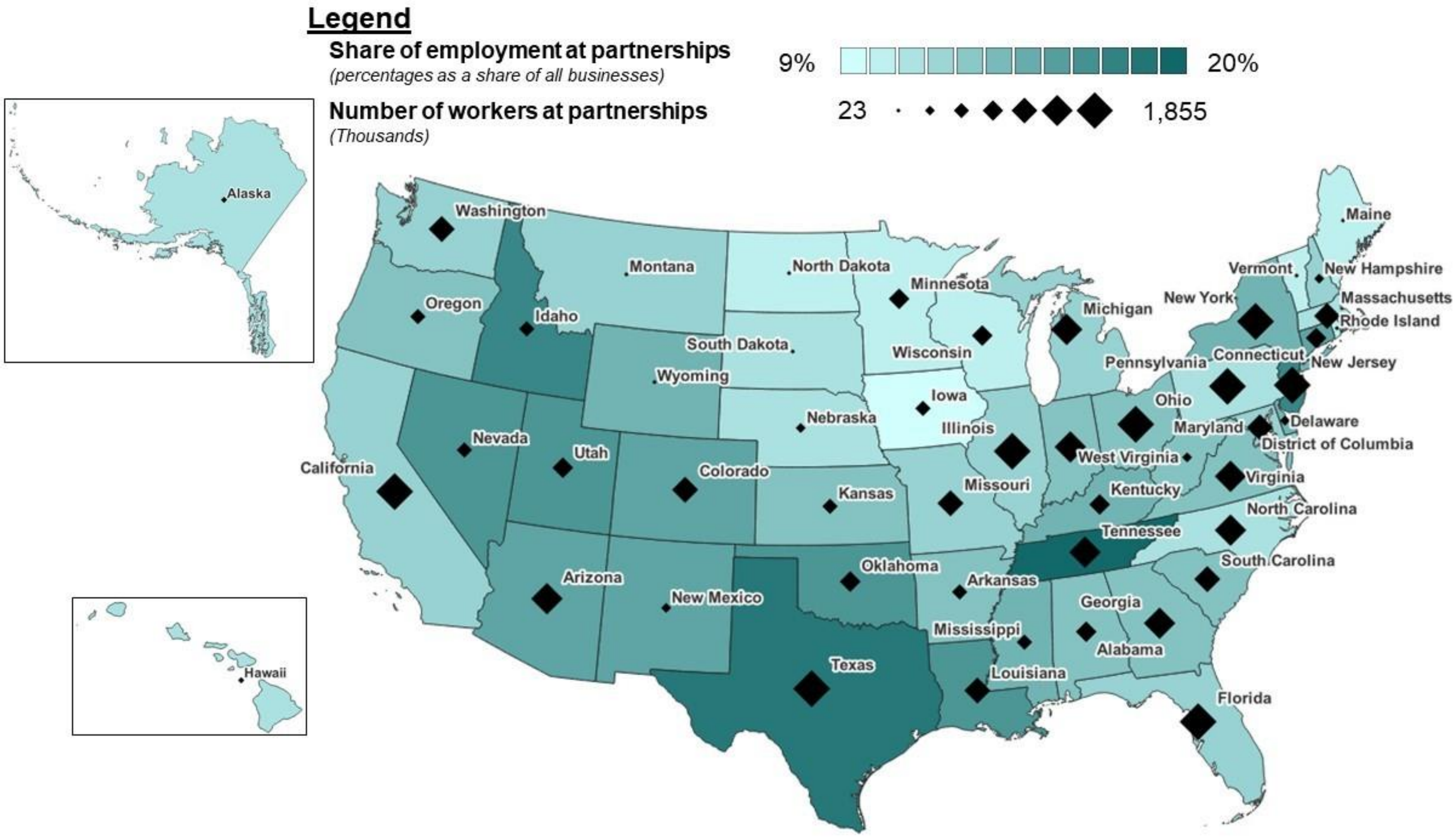
Source: US Census Bureau and EY analysis.

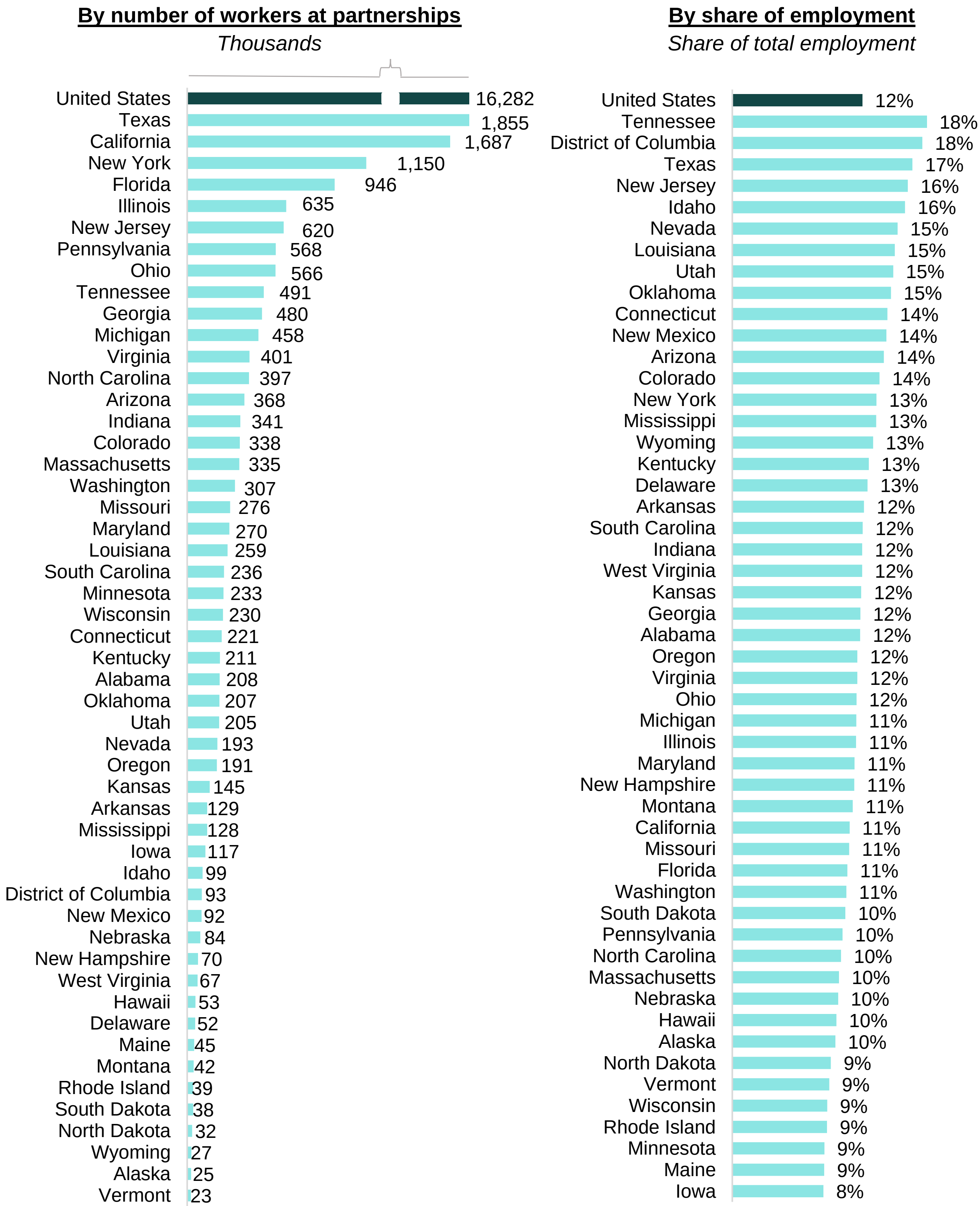
There is notable variation in economic activity at partnerships by state (plus the District of Columbia).[5] The amount of workers at partnerships and the share of employment at partnerships in 2019 by state are displayed in Figures 4 and 5. The states with the most workers at partnerships were: (1) Texas (1,855,000 workers), (2) California (1,687,000 workers), (3) New York (1,150,000 workers), (4) Florida (946,000 workers), and (5) Illinois (635,000 workers). The states with the largest share of employment at partnerships were: (1) Tennessee (18%), (2) District of Columbia (18%), (3) Texas (17%), (4) New Jersey (16%), and (5) Idaho (16%). Additional information can be found in the appendix.

Figure 4. Employment at partnerships by state, 2019



Note: Definitions throughout this report generally follow the US Census Bureau's Statistics of US Businesses. For detailed definitions see the report endnotes. Figures are rounded.
Source: US Census Bureau and EY analysis.

Figure 5. States with the most partnership employment



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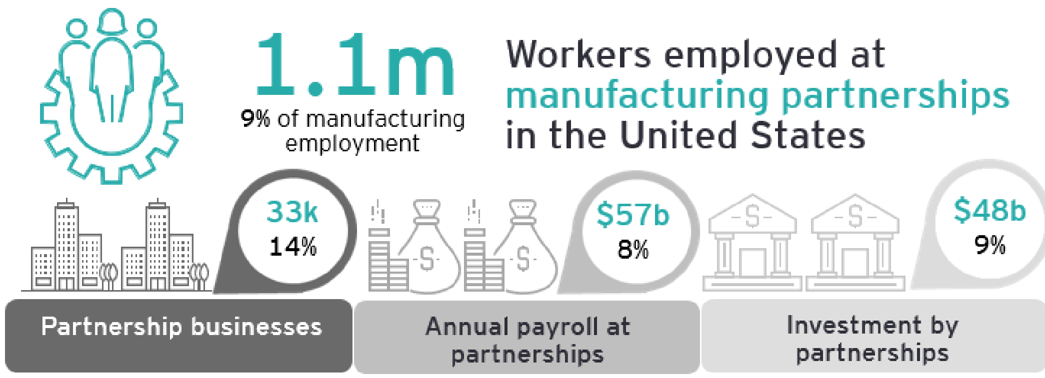
Source: US Census Bureau and EY analysis.

III. Economic activity at manufacturing businesses organized in the partnership form

As of 2019, there were 1.1 million workers employed at manufacturing partnerships in the United States earning $57 billion in payroll.[6] This comprised approximately 9% of total manufacturing employment and 8% of total manufacturing payroll in 2019. This economic activity was spread across 33,000 manufacturing partnerships. Total investment by manufacturing partnerships was $48 billion in 2019 (9% of manufacturing investment).[7]

Figure 6. Economic activity at manufacturing partnerships, 2019

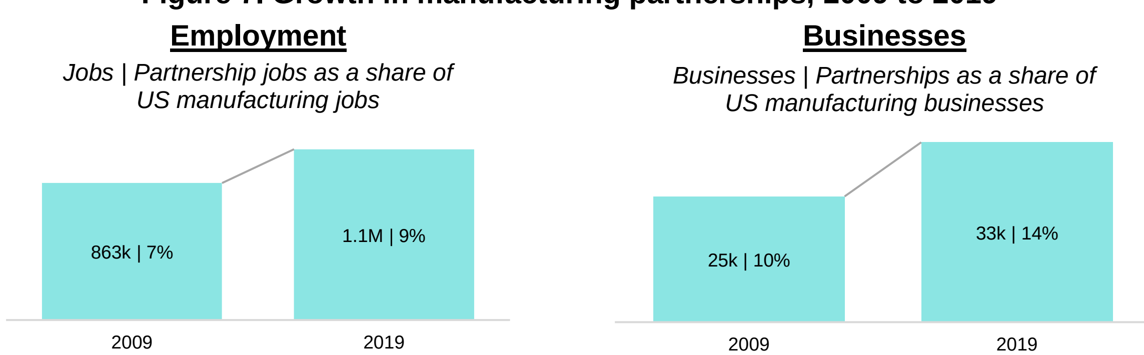
Percentages are the share of total economic activity at US manufacturing businesses



Note: Definitions throughout this report generally follow the US Census Bureau's Statistics of US Businesses. For detailed definitions see the report endnotes. Figures are rounded.
Source: US Census Bureau and EY analysis.

Similar to the overall growth in partnerships, the number of manufacturing partnerships and the employment at manufacturing partnerships have increased over the last decade. Figure 7 displays the growth in manufacturing partnerships and manufacturing partnership employment between 2009 and 2019. Specifically, between 2009 and 2019, manufacturing partnership grew by approximately 200,000 employees (from 863,000 to 1.1 million) and the number of manufacturing partnerships grew by approximately 8,000 businesses (from 25,000 to 33,000). In 2019, manufacturing partnerships were 14% of total manufacturing businesses and 9% of total manufacturing employment.

Figure 7. Growth in manufacturing partnerships, 2009 to 2019



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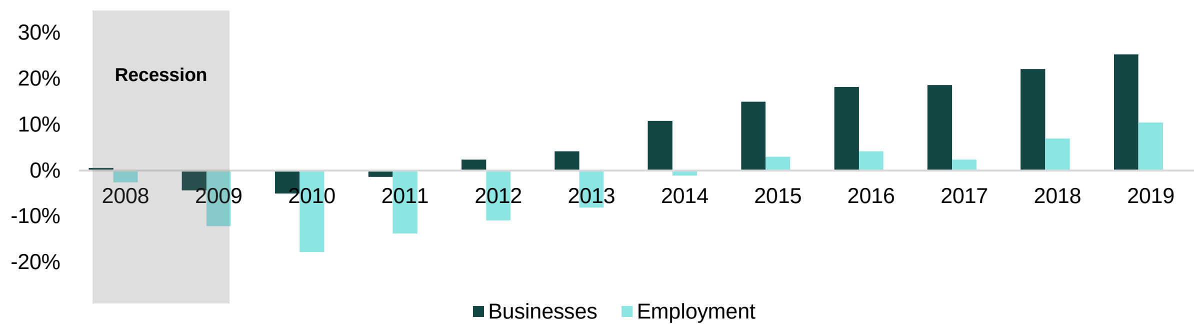
Source: US Census Bureau and EY analysis.

Figure 8 displays the cumulative change in the number of businesses organized as manufacturing partnerships and the number of workers employed at manufacturing partnerships between 2007 and 2019. Growth is displayed as cumulative relative to 2007. On net, between 2007 and 2019, the number of manufacturing partnerships in the United States increased 25% and the number of workers employed at manufacturing partnerships increased 10%. Notably, due to the Great Recession, the number of partnerships and related economic activity declined relative to 2007. However, after the recession the number of partnerships and employment at these partnerships increased steadily on an annual basis.

Figure 8. Change in manufacturing partnerships, 2007 through 2019

Annual values benchmarked to 2007 values



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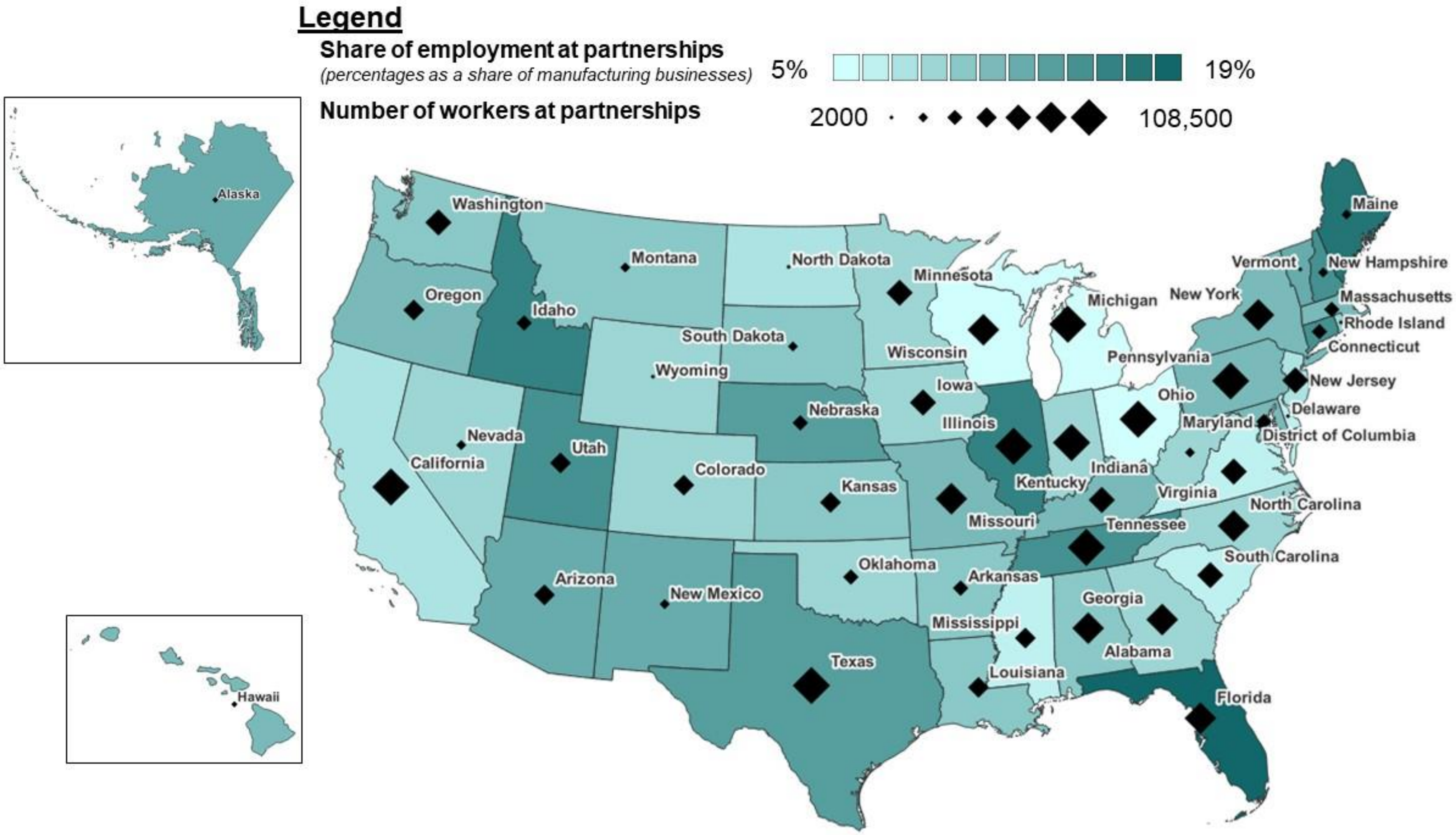
Source: US Census Bureau and EY analysis.

There is notable variation in economic activity at manufacturing partnerships by state (plus the District of Columbia). The amount of workers at manufacturing partnerships and the share of manufacturing employment at partnerships in 2019 by state are displayed in Figures 9 and 10. The states with the most workers at manufacturing partnerships were: (1) Texas (109,000 workers), (2) California (90,000 workers), (3) Ohio (57,000 workers), (4) Michigan (51,000 workers), and (5) Pennsylvania (44,000 workers). The states with the largest share of manufacturing employment at partnerships were: (1) District of Columbia (19%), (2) Louisiana (16%), (3) Hawaii (14%), (4) Idaho (14%), and (5) Wyoming (14%). Additional information can be found in the appendix.

Figure 9. Employment at manufacturing partnerships by state, 2019



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Source: US Census Bureau and EY analysis.

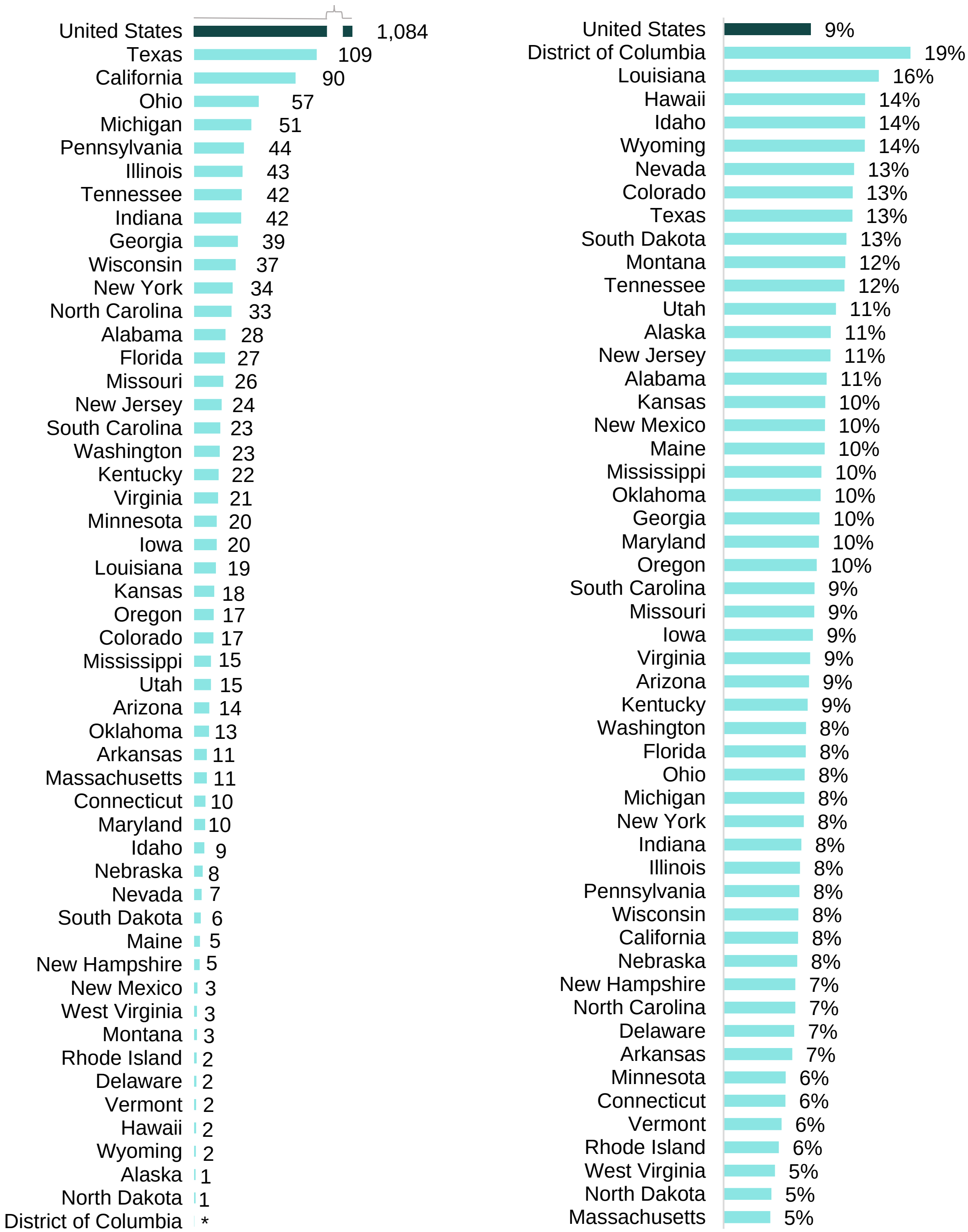
Figure 10. States with the most manufacturing partnership employment

By number of workers at partnerships

Thousands

By share of employment

Share of total employment



*Fewer than 500 employees.

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Source: US Census Bureau and EY analysis.

Smaller manufacturing partnerships

As of 2019, there were 658,000 workers employed across nearly 33,000 manufacturing partnerships with fewer than 500 employees. The annual payroll at these manufacturing partnerships with fewer than 500 employees was $31 billion. Manufacturing partnership businesses with fewer than 500 employees were 98% of total manufacturing partnerships in the United States.

Figure 11. Economic activity at manufacturing partnerships

Establishments with fewer than 500 employees, 2019

Percentages are the share of total economic activity at US manufacturing businesses

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Source: US Census Bureau and EY analysis.

As of 2019, there were 372,000 workers employed at approximately 31,000 manufacturing partnerships with fewer than 100 employees. The annual payroll at these manufacturing partnerships with fewer than 100 employees was $17 billion. Manufacturing partnership businesses with fewer than 100 employees make up 92% of total manufacturing partnerships in the United States.

Figure 12. Economic activity at manufacturing partnerships

Establishments with fewer than 100 employees, 2019

Percentages are the share of total economic activity at US manufacturing businesses

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Source: US Census Bureau and EY analysis.

IV. Proposed changes to partnership taxation

The current tax rules regarding partnerships have evolved over the decades from legislation, regulations, and case law. Although the current US income tax system began in 1913, partnership tax rules were not codified until Congress and President Eisenhower enacted the Internal Revenue Code of 1954. The Internal Revenue Code of 1954 contained Subchapter K which included Section 704(b) and Section 704(c) allocation rules.[8]

In September of 2021, Senate Finance Committee Chair Ron Wyden, D-OR, unveiled a proposal to reform US federal income partnership taxation.[9] The proposed changes would significantly modify or eliminate numerous long-standing rules. This report discusses four of the partnership tax changes proposed by Senator Wyden, summarizing current law, the proposed changes, and certain implications of those changes. The four proposals discussed in this report are:

1) changes to partnership "book" allocation methods;
2) changes to allocation methods accounting for built-in gain and loss in partnership property;
3) changes to the taxation of distributions of partnership property with pre-contribution gains and losses (commonly referred to as the "anti-mixing bowl rules"); and,
4) changes to rules adjusting the basis of partnership property.

Table 1. Selected proposed changes to the taxation of partnerships

Relevant code section	Current law	Proposed law	Implications
Partnership allocation methods *Proposal Section 2 – Code section 704(b)*	A partner's share of partnership income is generally determined in accordance with the partnership agreement if the allocations set forth in the partnership agreement have "substantial economic effect," which is a safe harbor laid out in extensive regulations. If the partnership agreement is silent or if the allocations set forth in the partnership agreement do not have "substantial economic effect," the partners' shares are determined in accordance with the "partners' interests in the partnership" ("**PIP**"), which is a "facts and circumstances" analysis of each partner's relative economic interest in the partnership.	Generally, all allocations would be required to be made in accordance with PIP. However, if members of a controlled group of corporations own 50% or more of partnership capital or profits, allocations must be made in accordance with the "consistent percentage method" ("**CPM**"), which generally requires allocations to be made proportionately based on each partner's net contributed capital. If the economic arrangement in the partnership agreement deviates from the CPM, partners would recognize additional income at least annually.	Requiring **PIP** creates uncertainty for taxpayers and the IRS as there are no clear rules regarding the **PIP** requirement. For certain partnerships with unrelated partners, **CPM** could potentially upend common commercial arrangements (e.g., preferred equity and profits interests). In addition, to avoid partners having to recognize annual income, existing partnership agreements would need to be amended to be consistent with the **CPM**. The potential for falling in and out of **CPM** treatment year over year could add complexity.
Allocation of built-in gain or loss *Proposal Section 3 – Code section 704(c)(1)(A)*	Built-in gain or loss associated with contributed property generally must be borne by the contributing partner for tax purposes. The regulations contain three methods to make allocations with respect to such property. Only one of those methods, the "remedial method**,**" ensures that the built-in gain will be borne solely by the contributing partner by creating notional items of income and deduction.	All partnerships would be required to use the remedial method with respect to contributed and revalued property.	The remedial method can be complex to administer and could result in the contributing partner of depreciable property realizing accelerated ordinary income without any corresponding cash. Similarly, existing partners could be subject to remedial allocations on a subsequent revaluation. In certain cases, the remedial method will also result in income being allocated to a partner even if the partnership is in a loss position, which could preclude tax distributions from being made under the partnership agreement. This would discourage partnership formations and contributions.
Taxing pre-contribution gains *Proposal Section 5 – Code section 704(c)(1)(B) and 737*	Partnership distributions of property are generally tax free. However, if a partner contributes built-in gain or loss property to a partnership, the contributing partner must recognize remaining built-in gain or loss if the contributed property is distributed to any other partner within seven years of the contribution. In addition, the contributing partner generally must recognize its remaining built-in gain if it receives a distribution of other property within seven years of the contribution.	Repeal the seven-year limitation on taxing built-in gain in contributed property.	The proposal would discourage partnership formation and contributions of productive assets, primarily by increasing the potential tax liability for exiting a joint venture. Moreover, the administrative burden associated with tracking pre-contribution gain and loss *ad infinitum* (as opposed to the current, time-limited requirement) could be significant.
Mandatory basis adjustments to partnership property *Proposal Sections 13 and 14 – Code section 734 and 743*	Generally, a partnership is required to adjust the basis of its assets in connection with a sale of a partnership interest or a partnership distribution only if those adjustments would reduce the basis of partnership assets. In other cases, the partnership can elect whether to increase the basis of its assets.	All basis adjustments would be mandatory, and the methodology for determining certain basis adjustments would be significantly modified.	Requiring basis adjustments to be made in all cases would impose a significant administrative burden each time there is a partnership distribution or transfer of a partnership interest (e.g., asset valuations). The modification of the methodology for certain basis adjustments would require guidance from the IRS which could take years to properly develop and administer, discouraging partnership formation.

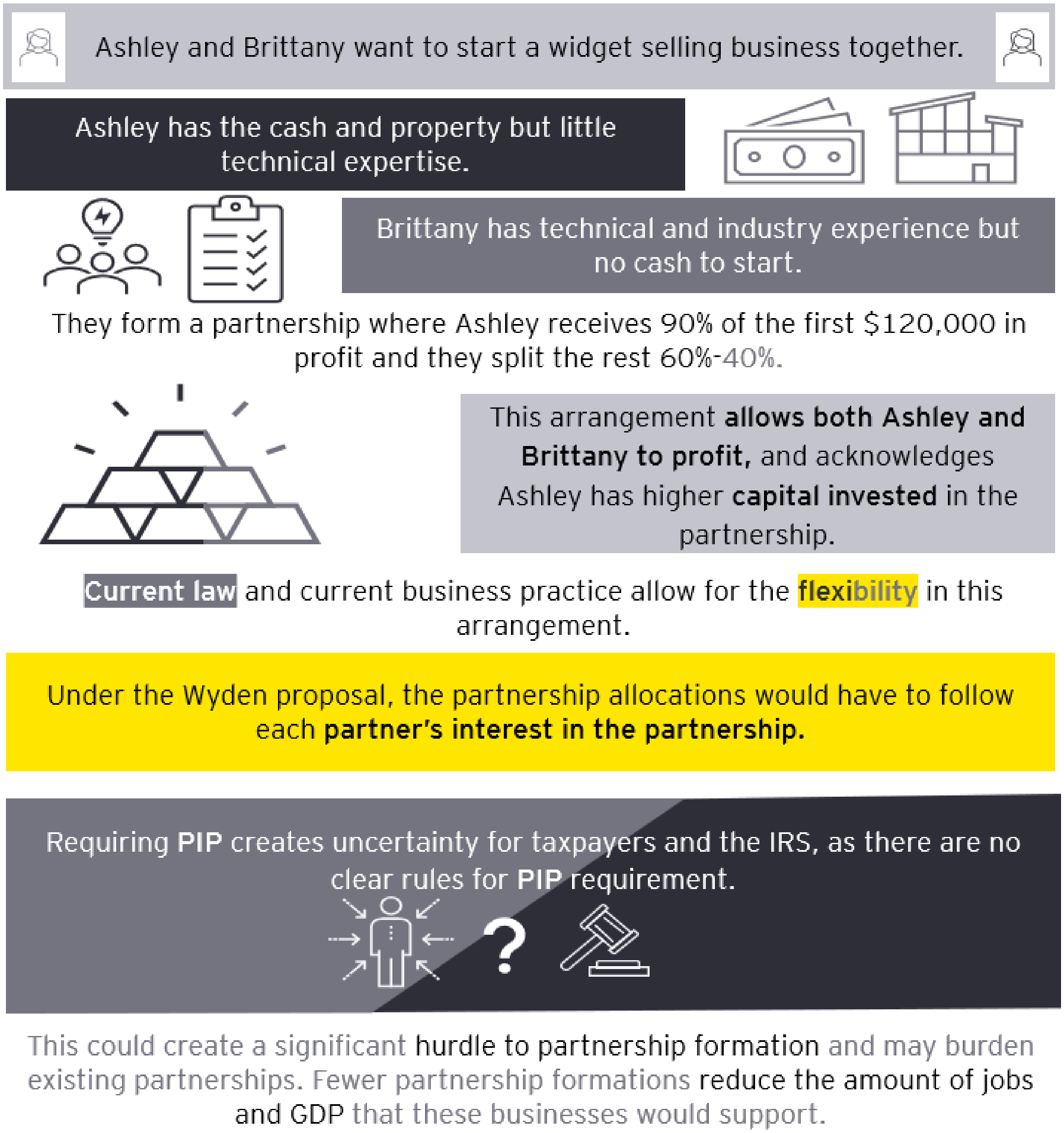
1. Partnership allocation methods: Proposal Section 2 – Code section 704(b)

As displayed in Figure 13, Ashley and Brittany want to start a widget selling business. Ashley has significant cash and property available to start the business. Brittany has extensive technical expertise and understands the widget industry. Ashley and Brittany enter a partnership agreement where Brittany will run the day-to-day business and operations while Ashley will provide $100,000 in cash and property to start the business.

Both understand Ashley is risking more capital if the business fails. They therefore create a partnership agreement where they split the first $120,000 in business profits on a 90%-10% split between Ashley and Brittany. After the first $120,000 in profits, they agree to a 60%-40% split on the remaining profits between Ashley and Brittany. This structure allows Ashley to recoup her investment with an 8% rate of return and still provides Brittany with a share of the profits. This arrangement allows both Ashley and Brittany to profit and acknowledges Ashley has higher capital invested in the partnership.

Current law and current business practice, including the allocation methods that have been used by taxpayers for decades, allow for the flexibility in this arrangement. Under the Wyden proposal, the partnership allocations would have to follow each partner's interest in the partnership (i.e., PIP). Accordingly, it is unclear whether allocations made by the partnership would be permitted to follow the sharing percentages under the business deal (90%-10% on the first $120,000 of business profits and 60%-40% spilt on business profits above $120,000) or if the PIP method would require an entirely different approach. Additionally, existing partnerships with a similar structure may have to rewrite their partnership agreements or dissolve altogether to comply with PIP. This could create a significant hurdle to partnership formation and may burden existing partnerships. Fewer partnership formations would reduce the amount of jobs and GDP that these businesses would support.

Figure 13. Partnership allocation under Wyden proposal



2. Allocation of built-in gain or loss: Proposal Section 3 – Code section 704(c)(1)(A)

As displayed in Figure 14, Andre and Charlotte own a manufacturing partnership that owns an existing factory that has been fully depreciated for tax purposes but has a market value of $1 million.[10] Due to an economic slowdown, the partnership is losing money and needs further capital to continue operations. Through his network, Andre hears that Brooke is interested in joining his partnership. To help the partnership through the slowdown, Brooke is willing to contribute $500,000 in cash to become a one-third partner (with Andre and Charlotte each owning a third) and split all tax income, deduction, gain, and loss equally among the three partners.

Were the partnership to purchase the factory immediately after Brooke's contribution, she would receive her one-third share of depreciation. However, the factory's zero tax basis means there is no tax depreciation to allocate to Brooke.

Treasury regulations allow partnerships to elect one of three methods to address this situation. One of the methods, the traditional method, would do nothing to address the lack of tax depreciation, meaning Brooke would not receive any depreciation deductions from the factory. Another, the remedial method, would create offsetting allocations that would provide Brooke tax depreciation but would cause the other partners to recognize taxable income to offset Brooke's deduction. The current elective regime allows the three partners to negotiate to determine which outcome is most efficient based on their particular circumstances.

The Wyden proposal would require the remedial method in all cases, meaning Andre and Charlotte will be allocated income under this example. This could require Andre and Charlotte to owe taxes even though the partnership is not making a profit and is struggling to remain in business. This could discourage Andre and Charlotte from entering an agreement with Brooke for necessary capital to continue operations and retain employees, thereby limiting alternatives for saving their business.

Figure 14. Allocation of built-in gain or loss

Andre and Charlotte own a manufacturing partnership with an existing factory that has been fully depreciated for tax purposes but still has a market value of $1 million. Due to an economic slowdown, the partnership is losing money.

Brooke is interested in joining the partnership. She is willing to contribute $500,000 of cash to become a one-third partner (with Andre and Charlotte each owning a third) and split all tax income, deduction, gain, and loss equally among the three partners.

Were the partnership to purchase the factory immediately after Brooke's contribution, she would receive her **one-third share of depreciation**. However, the factory's zero tax basis means there is no tax depreciation to allocate to Brooke. Treasury regulations **allow partnerships to elect** one of three methods to address this situation.

The current elective regime allows the three partners to negotiate to determine which outcome is most efficient based on their particular circumstances.

The Wyden proposal would **require the remedial method in all cases**, meaning Andre and Charlotte will be allocated income under this example. This could require Andre and Charlotte to **owe taxes even though the partnership is not making a profit and is struggling to remain in business.**

This could discourage Andre and Charlotte from entering an agreement with Brooke for the necessary capital to continue operations and retain employees, thereby limiting alternatives for saving their business.

3. Taxing pre-contribution gains: Proposal Section 5 –Code section 704(c)(1)(B) and 737

As displayed in Figure 15, Andrew and Sam run a successful and growing manufacturing partnership. Due to the demand for their products, the partnership needs to add another location. Brian owns a building in a developing industrial area. As the popularity of the industrial area in which Brian's building is located increased, so did its property value. Andrew and Sam approached Brian and suggested that Brian join the manufacturing partnership by contributing his building to enable the expansion of the partnership's business. After performing his due diligence, Brian believes that the partnership will thrive with the addition of his building, so Brian decides to enter the partnership. Eight years later, the partners decide to dissolve the business and distribute the partnership's remaining assets to the partners in liquidation. Brian's building remains an asset of the partnership. Andrew wants the building, and Brian prefers to receive other assets in liquidation of his interest.

Under current law, Brian does not have to recognize the gain in the building's property value when he contributes the building. Similarly, Brian will not have to recognize gain in the building when the building is distributed to Andrew in the liquidation. Non-recognition treatment with respect to contributions of property to partnerships allows partners contributing existing non-cash assets to receive the same tax treatment as partners contributing cash. If the property contribution was a recognition event, this would create significant burdens on the formation of many joint ventures.

Under the Wyden proposal, however, Brian would be required to recognize gain on the distribution of the property to Andrew equal to the remaining built-in gain in the building. In fact, Brian would be required to recognize the remaining built-in gain no matter how many years passed between his contribution of the building and its eventual distribution to Andrew. This cost reduces the ability of Brian, Andrew, and Sam to unwind their business without incurring tax and, as a result, could discourage Brian from joining Andrew's manufacturing partnership in the first place. Discouraging partnership formations could slow the velocity of investment, resulting in market illiquidity and increased cost of capital. An increased cost of capital discourages investment, which reduces the capital stock, reduces the productive capacity of the economy, and, ultimately, dampens economic growth and living standards.

Figure 15. Taxing pre-contribution gains

Andrew and Sam run a manufacturing partnership looking to add a new location.

Brian owns a building in a developing industrial area, which realizes an increase in property value.

Brian joins the partnership by contributing the building for its expansion. Eight years later, the partners decide to dissolve the business and distribute the partnership's remaining assets. Brian's building remains an asset of the partnership. Andrew wants the building, and Brian prefers to receive other assets in liquidation of his interest.

Under current law, **Brian will not have to recognize gain in the building** when the building is distributed to Andrew in the liquidation.

Under the **Wyden proposal**, Brian would be required to recognize gain on the distribution of the property to Andrew equal to the remaining built-in gain in the building. In fact, **Brian would be required to recognize the remaining built-in gain no matter how many years passed.**

This cost reduces the ability of Brian and Andrew to unwind their business without incurring tax and, as a result, **could discourage Brian from joining Andrew's manufacturing partnership in the first place.**

Discouraging partnership formations could **slow the velocity of investment**, resulting in **market illiquidity** and **increased cost** of capital.

An **increased cost of capital discourages investment**, which reduces the capital stock, reduces the productive capacity of the economy, and, ultimately, **dampens economic growth and living standards.**

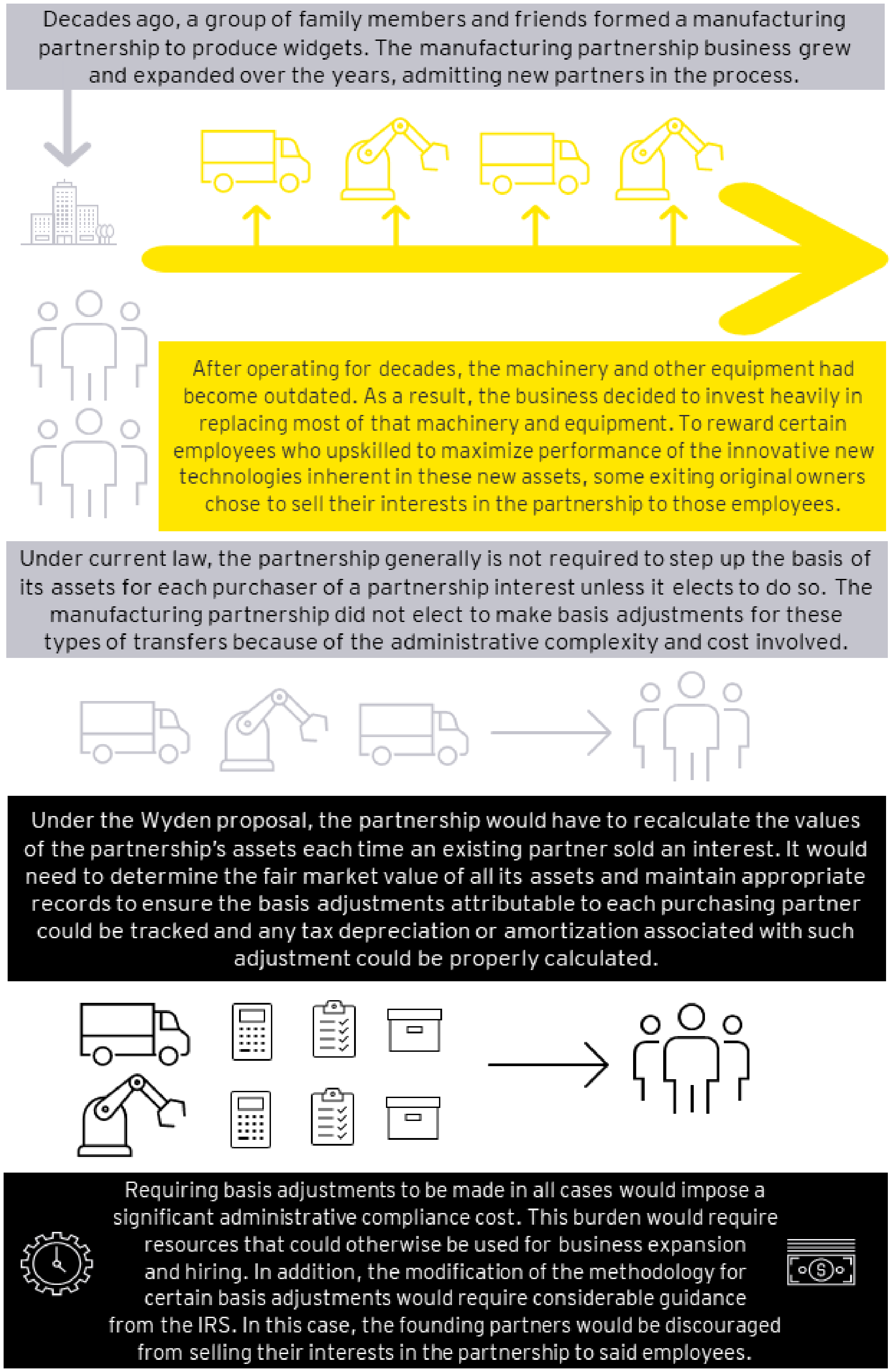
4. *Mandatory basis adjustments to partnership property: Proposal Sections 13 and 14 – Code section 734 and 743*

Figure 16 illustrates the impact of mandatory basis adjustments in the Wyden proposal. Decades ago, a group of family members and friends formed a manufacturing partnership to produce widgets. The manufacturing partnership business grew over the years, admitting new partners in the process. After operating for decades, the machinery and equipment used in the widget making process had become outdated. As a result, the business decided to invest heavily in replacing most of that machinery and equipment. Some original owners decided to exit the business during this period. To reward certain employees who upskilled to maximize performance of the innovative new technologies inherent in these new assets, exiting original owners chose to sell their interests in the partnership to those employees.

Under current law, the partnership generally is not required to step up basis of its assets for each purchaser of a partnership interest unless it elects to do so. The partnership in this example did not elect to make basis adjustments for these types of transfers because of the administrative complexity and cost involved. If the manufacturing partnership were to elect to make basis adjustments, it would need to determine the fair market value of all its assets and maintain appropriate records to ensure the basis adjustments attributable to each purchasing partner could be tracked and any tax depreciation or amortization associated with such adjustment could be properly calculated. This would be challenging for a family-owned partnership to do without considerable and costly assistance.

Under the Wyden proposal, the partnership would have to recalculate the values of the partnership's assets each time an existing partner sold an interest, as well as in connection with certain distributions. Requiring basis adjustments to be made in all cases would impose a significant administrative compliance cost. This burden would require resources that could otherwise be used for business expansion and hiring. In addition, the modification of the methodology for certain basis adjustments would require considerable guidance from the IRS. In this case, the founding partners would be discouraged from selling their interests in the partnership to said employees.

Figure 16. Basis readjustment under Wyden proposal



V. Caveats and limitations

Any modeling effort is only an approximate depiction of the economic forces it seeks to represent, and this analysis is no exception. Although various limitations and caveats might be listed, several are particularly noteworthy:

- **Statistics related to the economic footprint of partnerships include corporate-owned partnerships.** While providing an accurate indication of the use of the partnership organizational form, these statistics may overstate the footprint of individual ownership through the partnership form.
- **Partnership legal entities and entities classified as partnerships for US federal income tax purposes do not necessarily overlap.** Limited liability companies with more than one economic member are by default classified as partnerships, for instance, and partnerships can be taxed as corporations.
- **The results show a snapshot of current economic activity.** The statistics shown in this report show the historical number of partnerships and partnership establishments as well as their employment and annual payroll. The results do not reflect the impacts of an expansion or contraction of businesses organized as partnerships.
- **Estimates are limited by available public information.** The analysis relies on information reported by federal government agencies (primarily from the US Census Bureau and US Bureau of Economic Analysis). The analysis did not attempt to verify or validate this information using sources other than those described in the report.
- **Case studies are illustrative examples.** The case studies provided are stylized examples to illustrate the effects of the proposed legislative changes. The allocations, deductions, and taxes paid by partnerships will depend on the facts and circumstances involving those businesses and the transactions they choose to make.
- **Proposed legislation could be altered through the legislative process.** The analysis and selected policy changes are based on the proposed legislation as introduced by Senator Wyden. As the public comments on the proposed legislation and it moves through the legislative process, the underlying text and policies could change. Certain aspects of the analysis may not be relevant as the proposed legislation changes.
- **Proposed legislation relying on regulations have difficult-to-measure effects.** Certain policy changes within the proposed legislation introduced by Senator Wyden would require additional regulation from the IRS. Without the implementing regulations, it is difficult to measure the full effects of the proposed legislation. The analysis does not attempt to adjust the results to account for the implementing regulations.

Appendix A. Additional data/estimates

Table A.1. Partnership businesses, establishments, employees, and annual payroll (2019)
Economic activity by state

Geography	Businesses (thousands)	Establishments (thousands)	Employment (thousands)	Annual payroll ($billions)
United States	**744**	**941**	**16,282**	**$809**
Alabama	10	13	208	8
Alaska	2	3	25	1
Arizona	17	21	368	15
Arkansas	6	8	129	5
California	73	90	1,687	98
Colorado	17	20	338	17
Connecticut	15	17	221	13
Delaware	3	3	52	3
District of Columbia	3	3	93	8
Florida	44	54	946	42
Georgia	20	25	480	23
Hawaii	3	3	53	2
Idaho	7	8	99	4
Illinois	22	28	635	38
Indiana	12	16	341	14
Iowa	7	9	117	5
Kansas	8	9	145	6
Kentucky	8	12	211	7
Louisiana	13	16	259	11
Maine	3	4	45	2
Maryland	13	16	270	13
Massachusetts	15	18	335	23
Michigan	18	23	458	18
Minnesota	11	14	233	11
Mississippi	7	8	128	4
Missouri	15	18	276	11
Montana	4	4	42	1
Nebraska	5	6	84	3
Nevada	9	10	193	8
New Hampshire	5	6	70	3
New Jersey	40	44	620	29
New Mexico	5	6	92	4
New York	56	63	1,150	89
North Carolina	19	24	397	17
North Dakota	2	3	32	1
Ohio	24	31	566	23
Oklahoma	11	13	207	8
Oregon	13	15	191	8
Pennsylvania	27	32	568	27
Rhode Island	2	3	39	2
South Carolina	10	13	236	9
South Dakota	3	3	38	1
Tennessee	22	28	491	20
Texas	75	97	1,855	94
Utah	12	13	205	9
Vermont	2	2	23	1
Virginia	17	21	401	21
Washington	19	22	307	16
West Virginia	4	4	67	2
Wisconsin	13	15	230	9
Wyoming	3	3	27	1

Note: Figures are rounded.
Source: US Census Bureau and EY analysis.

Table A.2. Partnership businesses, establishments, employees, and annual payroll (2019)
Share of economic activity by state

Geography	Businesses	Establishments	Employment	Annual payroll
United States	**12%**	**12%**	**12%**	**11%**
Alabama	14%	13%	12%	10%
Alaska	14%	13%	10%	8%
Arizona	15%	14%	14%	11%
Arkansas	13%	12%	12%	10%
California	9%	9%	11%	9%
Colorado	12%	12%	14%	12%
Connecticut	22%	19%	14%	13%
Delaware	14%	13%	13%	11%
District of Columbia	16%	14%	18%	19%
Florida	9%	9%	11%	10%
Georgia	11%	10%	12%	11%
Hawaii	10%	10%	10%	8%
Idaho	16%	15%	16%	14%
Illinois	8%	9%	11%	12%
Indiana	11%	11%	12%	10%
Iowa	11%	10%	8%	7%
Kansas	14%	13%	12%	10%
Kentucky	13%	13%	13%	10%
Louisiana	16%	15%	15%	14%
Maine	9%	9%	9%	7%
Maryland	12%	11%	11%	10%
Massachusetts	10%	10%	10%	10%
Michigan	10%	10%	11%	9%
Minnesota	9%	9%	9%	7%
Mississippi	15%	14%	13%	10%
Missouri	13%	12%	11%	9%
Montana	11%	11%	11%	9%
Nebraska	11%	11%	10%	8%
Nevada	16%	15%	15%	13%
New Hampshire	17%	15%	11%	8%
New Jersey	20%	19%	16%	12%
New Mexico	14%	13%	14%	14%
New York	12%	11%	13%	15%
North Carolina	10%	10%	10%	8%
North Dakota	11%	11%	9%	8%
Ohio	13%	12%	12%	10%
Oklahoma	15%	14%	15%	13%
Oregon	13%	13%	12%	9%
Pennsylvania	12%	11%	10%	9%
Rhode Island	10%	9%	9%	8%
South Carolina	12%	11%	12%	11%
South Dakota	13%	12%	10%	9%
Tennessee	22%	20%	18%	15%
Texas	16%	16%	17%	15%
Utah	16%	16%	15%	13%
Vermont	10%	10%	9%	7%
Virginia	11%	10%	12%	11%
Washington	12%	11%	11%	8%
West Virginia	13%	13%	12%	10%
Wisconsin	12%	11%	9%	7%
Wyoming	15%	14%	13%	11%

Note: Figures are rounded.
Source: US Census Bureau and EY analysis.

Table A.3. Partnership businesses, establishments, employees, and annual payroll (2007-2019)
Economic activity by year

Year	Businesses	Establishments	Employment (thousands)	Annual payroll ($billions)
2007	627,549	774,033	12,146	478
2008	622,908	763,437	12,011	480
2009	606,909	748,178	11,496	457
2010	608,243	750,004	11,325	469
2011	620,361	764,827	11,854	506
2012	633,185	793,532	12,490	547
2013	653,178	812,418	12,988	567
2014	678,593	843,820	13,767	617
2015	694,770	863,623	14,340	656
2016	707,226	883,952	14,926	682
2017	705,152	894,584	15,161	711
2018	727,699	917,094	15,792	763
2019	744,170	940,668	16,282	809

Note: Figures are rounded.
Source: US Census Bureau and EY analysis.

Table A.4. Partnership businesses, establishments, employees, and annual payroll (2019)
Manufacturing economic activity by state

Geography	Businesses	Establishments	Employment (thousands)	Annual payroll ($millions)
United States	**33,236**	**36,111**	**1,084**	**$56,702**
Alabama	529	578	28	1,386
Alaska	110	119	1	103
Arizona	636	655	14	633
Arkansas	254	270	11	527
California	3,570	3,696	90	4,912
Colorado	810	825	17	866
Connecticut	639	644	10	513
Delaware	69	72	2	169
District of Columbia	23	23	*	7
Florida	1,294	1,351	27	1,390
Georgia	775	856	39	1,843
Hawaii	106	108	2	84
Idaho	312	326	9	427
Illinois	1,084	1,143	43	2,334
Indiana	863	914	42	2,126
Iowa	391	438	20	974
Kansas	355	371	18	833
Kentucky	467	497	22	1,188
Louisiana	490	519	19	1,507
Maine	192	198	5	259
Maryland	344	358	10	500
Massachusetts	538	546	11	637
Michigan	1,185	1,271	51	2,539
Minnesota	699	755	20	1,012
Mississippi	274	285	15	596
Missouri	747	787	26	1,191
Montana	215	216	3	110
Nebraska	194	203	8	348
Nevada	331	336	7	336
New Hampshire	248	253	5	275
New Jersey	1,169	1,189	24	1,265
New Mexico	223	227	3	115
New York	1,453	1,480	34	1,736
North Carolina	877	961	33	1,552
North Dakota	87	87	1	70
Ohio	1,572	1,663	57	2,894
Oklahoma	461	479	13	678
Oregon	880	904	17	819
Pennsylvania	1,567	1,620	44	2,297
Rhode Island	108	109	2	134
South Carolina	413	466	23	1,247
South Dakota	143	151	6	269
Tennessee	1,181	1,247	42	2,109
Texas	3,117	3,307	109	6,389
Utah	626	631	15	868
Vermont	144	145	2	79
Virginia	652	687	21	1,065
Washington	939	974	23	1,260
West Virginia	137	142	3	125
Wisconsin	878	930	37	2,018
Wyoming	98	99	2	84

*Indicates there are fewer than 500 employees.
Note: Figures are rounded.
Source: US Census Bureau and EY analysis.

Table A.5. Partnership businesses, establishments, employees, and annual payroll (2019)
Share of manufacturing economic activity by state

Geography	Businesses	Establishments	Employment	Annual payroll
United States	**14%**	**13%**	**9%**	**8%**
Alabama	14%	14%	11%	10%
Alaska	23%	21%	11%	14%
Arizona	16%	15%	9%	6%
Arkansas	11%	11%	7%	7%
California	10%	10%	8%	6%
Colorado	16%	16%	13%	11%
Connecticut	17%	16%	6%	4%
Delaware	13%	13%	7%	9%
District of Columbia	21%	20%	19%	13%
Florida	10%	10%	8%	8%
Georgia	12%	11%	10%	9%
Hawaii	14%	14%	14%	15%
Idaho	17%	17%	14%	11%
Illinois	9%	9%	8%	7%
Indiana	12%	12%	8%	7%
Iowa	14%	13%	9%	8%
Kansas	15%	14%	10%	8%
Kentucky	14%	13%	9%	8%
Louisiana	18%	17%	16%	17%
Maine	12%	12%	10%	9%
Maryland	12%	12%	10%	7%
Massachusetts	9%	9%	5%	4%
Michigan	11%	10%	8%	7%
Minnesota	11%	11%	6%	5%
Mississippi	15%	14%	10%	8%
Missouri	15%	14%	9%	7%
Montana	16%	16%	12%	11%
Nebraska	12%	12%	8%	7%
Nevada	18%	18%	13%	11%
New Hampshire	15%	14%	7%	6%
New Jersey	17%	17%	11%	9%
New Mexico	17%	17%	10%	8%
New York	10%	10%	8%	7%
North Carolina	11%	11%	7%	7%
North Dakota	14%	12%	5%	5%
Ohio	13%	12%	8%	7%
Oklahoma	15%	14%	10%	9%
Oregon	17%	17%	10%	7%
Pennsylvania	13%	12%	8%	7%
Rhode Island	9%	9%	6%	6%
South Carolina	12%	12%	9%	8%
South Dakota	15%	15%	13%	12%
Tennessee	23%	22%	12%	12%
Texas	18%	16%	13%	12%
Utah	19%	18%	11%	11%
Vermont	14%	14%	6%	4%
Virginia	14%	14%	9%	8%
Washington	15%	14%	8%	7%
West Virginia	14%	13%	5%	4%
Wisconsin	12%	11%	8%	7%
Wyoming	18%	17%	14%	11%

Note: Figures are rounded.
Source: US Census Bureau and EY analysis.

Table A.6. Partnership businesses, establishments, employees, and annual payroll (2019)

Manufacturing economic activity by state at partnerships with fewer than 100 employees

Geography	Businesses	Establishments	Employment (thousands)	Annual payroll ($millions)
United States	**30,715**	**31,184**	**372**	**$16,706**
Alabama	437	439	6	248
Alaska	104	105	1	41
Arizona	579	584	6	281
Arkansas	214	218	3	104
California	3,314	3,337	37	1,843
Colorado	765	768	7	325
Connecticut	604	608	6	267
Delaware	59	59	1	53
District of Columbia	23	23	*	7
Florida	1,198	1,206	12	511
Georgia	655	658	9	410
Hawaii	100	100	1	30
Idaho	288	291	3	106
Illinois	918	940	13	681
Indiana	725	731	11	491
Iowa	319	324	4	155
Kansas	304	308	4	166
Kentucky	394	398	5	220
Louisiana	432	438	5	251
Maine	175	177	2	83
Maryland	306	310	3	138
Massachusetts	493	497	6	329
Michigan	1,031	1,043	14	616
Minnesota	625	639	9	395
Mississippi	222	223	3	123
Missouri	660	680	8	325
Montana	203	204	2	51
Nebraska	172	173	2	98
Nevada	305	306	4	174
New Hampshire	230	230	2	97
New Jersey	1,093	1,095	12	561
New Mexico	212	216	2	62
New York	1,346	1,353	16	711
North Carolina	768	777	10	394
North Dakota	78	78	1	38
Ohio	1,378	1,391	19	815
Oklahoma	409	413	5	201
Oregon	814	824	8	338
Pennsylvania	1,403	1,419	17	726
Rhode Island	95	95	1	47
South Carolina	345	349	5	204
South Dakota	122	122	2	68
Tennessee	1,058	1,069	14	603
Texas	2,772	2,810	36	1,722
Utah	587	591	6	236
Vermont	139	140	1	48
Virginia	576	580	7	281
Washington	859	872	9	413
West Virginia	123	125	1	47
Wisconsin	756	764	12	538
Wyoming	83	84	1	31

*Indicates there are fewer than 500 employees.
Note: Figures are rounded.
Source: US Census Bureau and EY analysis.

Table A.7. Partnership businesses, establishments, employees, and annual payroll (2019)
Manufacturing economic activity by state at partnerships with fewer than 500 employees

Geography	Businesses	Establishments	Employment (thousands)	Annual payroll ($millions)
United States	**32,569**	**33,855**	**658**	**$31,020**
Alabama	496	500	14	582
Alaska	107	112	1	78
Arizona	617	634	11	493
Arkansas	237	243	5	207
California	3,472	3,523	58	2,950
Colorado	790	797	10	465
Connecticut	627	632	9	431
Delaware	66	69	2	123
District of Columbia	23	23	*	7
Florida	1,265	1,282	21	943
Georgia	723	749	19	829
Hawaii	103	104	1	47
Idaho	302	305	5	180
Illinois	1,022	1,058	25	1,332
Indiana	809	826	23	1,034
Iowa	359	375	8	346
Kansas	334	346	7	326
Kentucky	425	434	9	397
Louisiana	468	479	10	621
Maine	185	191	3	145
Maryland	329	343	6	310
Massachusetts	523	528	9	501
Michigan	1,126	1,155	26	1,265
Minnesota	675	705	15	721
Mississippi	253	255	8	308
Missouri	715	747	15	614
Montana	209	210	2	79
Nebraska	182	188	3	139
Nevada	322	325	5	242
New Hampshire	240	240	3	149
New Jersey	1,143	1,158	19	897
New Mexico	217	221	2	74
New York	1,420	1,434	28	1,296
North Carolina	825	847	16	699
North Dakota	82	82	1	49
Ohio	1,499	1,540	33	1,596
Oklahoma	445	458	9	437
Oregon	852	869	13	592
Pennsylvania	1,501	1,536	28	1,346
Rhode Island	102	103	2	84
South Carolina	380	386	9	385
South Dakota	133	135	3	147
Tennessee	1,131	1,154	24	989
Texas	3,009	3,136	72	3,552
Utah	612	617	9	410
Vermont	142	143	2	76
Virginia	614	635	12	485
Washington	906	932	16	786
West Virginia	130	132	2	88
Wisconsin	834	865	23	1,100
Wyoming	93	94	1	71

*Indicates there are fewer than 500 employees.
Note: Figures are rounded.
Source: US Census Bureau and EY analysis.

Endnotes

[1] Definitions throughout this report generally follow the US Census Bureau's Statistics of US Businesses (SUSB). Detailed definitions are included in the report endnotes.
[2] This analysis does not consider the economic effects from the use of revenue raised. Depending on how the federal government uses the revenue, it could have varying impacts.
[3] Total employment includes employment at C corporations, S corporations, partnerships, sole proprietorships, nonprofits, government (as included in the SUSB data), and other firm structures as included in the US Census Bureau's SUSB. The US Census Bureau defines the scope of the SUSB data as follows: the "Statistics of U.S. Businesses (SUSB) is an annual series that provides national and subnational data on the distribution of economic data by establishment industry & enterprise size. SUSB covers most of the country's economic activity. The series excludes data on nonemployer businesses, private households, railroads, agricultural production, and most government entities." The legal form of organization is defined at the establishment level. An establishment is defined as follows: "An establishment is a single physical location at which business is conducted or services or industrial operations are performed. It is not necessarily identical with a company or enterprise, which may consist of one or more establishments. When two or more activities are carried on at a single location under a single ownership, all activities generally are grouped together as a single establishment. The entire establishment is classified on the basis of its major activity and all data are included in that classification." A C corporation is defined as an "incorporated business that is granted a charter recognizing it as a separate legal entity having its own privileges, and liabilities distinct from those of its members." An S corporation is defined as a "form of corporation where the entity does not pay any federal income taxes. The corporation's income or losses are divided among and passed to its shareholders. The shareholders must then report the income or loss on their own individual income tax returns." A sole proprietorship is an "unincorporated business with a sole owner." A partnership is an "unincorporated business where two or more persons join to carry on a trade or business with each having a shared financial interest in the business." A nonprofit is an "organization that does not distribute surplus funds to its owners or shareholders, but instead uses surplus funds to help pursue its goals. Most non-profit organizations are exempt from income taxes." Government is a "business that taxpayers primarily fund. Most government businesses are out of scope to this data series."
[4] Employment is defined as "full- and part-time employees, including salaried officers and executives of corporations, who are on the payroll in the pay period including March 12. Included are employees on paid sick leave, holidays, and vacations; not included are sole proprietors and partners of unincorporated businesses." Businesses are defined as "a business organization consisting of one or more domestic establishments that were specified under common ownership or control. The enterprise and the establishment are the same for single-establishment firms. Each multi-establishment company forms one enterprise - the enterprise employment and annual payroll are summed from the associated establishments." Payroll is defined as "all forms of compensation, such as salaries, wages, commissions, dismissal pay, bonuses, vacation allowances, sick-leave pay, and employee contributions to qualified pension plans paid during the year to all employees. For corporations, payroll includes amounts paid to officers and executives; for unincorporated businesses, it does not include profit or other compensation of proprietors or partners. Payroll is reported before deductions for social security, income tax, insurance, union dues, etc. This definition of payroll is the same as that used by the IRS on Form 941 as taxable Medicare Wages and Tips (even if not subject to income or FICA tax). First-quarter payroll consists of payroll during the January-to-March quarter."
[5] Here and throughout this report, state refers to the 50 states and the District of Columbia. The District of Columbia is not a state.
[6] The definition of manufacturing follows the North American Industry Classification System (NAICS). This is a standard industry classification system used in government statistics.
[7] Investment is defined as investment in private fixed assets. Investment was estimated using US Bureau of Economic Analysis data on private fixed assets by industry assuming a constant amount of investment per employee across legal forms of organization.
[8] For more information on the history see, Borden, Bradley, "The Federal Definition of Tax Partnership," Houston Law Review, Volume 43, Issue 4, 2006, p. 941-957, https://brooklynworks.brooklaw.edu/cgi/viewcontent.cgi?referer=&httpsredir=1&article=1629&context=faculty
[9] See United States Senate Committee of Finance, "Wyden Unveils Proposal To Close Loopholes Allowing Wealthy Investors, Mega-Corporations To Use Partnerships To Avoid Paying Tax," September 10, 2021. https://www.finance.senate.gov/chairmans-news/wyden-unveils-proposal-to-close-loopholes-allowing-wealthy-investors-mega-corporations-to-use-partnerships-to-avoid-paying-tax
[10] This situation is relatively common. Property such as buildings that meet certain requirements have depreciation schedules built in that allow taxpayers to write off the depreciation over their useful life even if the property itself appreciates in value. For more details on property depreciation see, IRS Publication 946, https://www.irs.gov/publications/p946#