Morgan Lewis

NAVIGATING US TAX REFORM:

WHAT BUSINESSES NEED TO KNOW

Pass-Through Entities

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AGENDA

- Partnership-Specific Provisions
- Interaction with Other Parts of the Code
- BBA Regulations

PARTNERSHIP-SPECIFIC PROVISIONS

Repeal of Technical Terminations

- Under prior law, the sale or exchange of 50% or more of outstanding interests in partnership capital and profits within a 12 month period would result in a termination of a partnership under section 708(b)(1)(B).
- This rule was repealed. Now, a partnership terminates only if:
  - “no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership,” or
  - The partnership terminates pursuant to the merger or division rules of section 708(b)(2).

Carried Interest: Three Year Holding Period

- For holders of "applicable partnership interests," new section 1061 converts the holder's share of long-term capital gain attributable to property held by a partnership for less than three years into short-term capital gain.
- "Applicable partnership interest"
  - Held in connection with the performance of services in any applicable trade or business
  - Services can be performed by the taxpayer or related persons
  - Does not include interests held by corporations
  - Does not include capital interests

Carried Interest

- "Applicable trade or business"
  - Raising and returning capital, and either:
    - Investing in/identifying specified assets, or
    - Developing specified assets
- "Specified Assets"
  - Securities, commodities,
  - Rental or investment real estate,
  - Cash or cash equivalents,
  - Options or derivatives with respect to the above
  - Interests in a partnership to the extent of the partnership's proportionate interest in the above

Carried Interest

- Unclear how the rule applies to sale of interests in "applicable partnerships"
  - Consider a case where a partner has held his or her interest for two years, but all of the partnership's assets have been held for 10 years
  - Unless regulations under section 1061(b) say otherwise, it appears that gain from the sale of an interest in an "applicable partnership" must be held for three or more years to qualify for long-term capital gains rates

Grecian Magnesite Repeal

- *Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (July 13, 2017) held, contrary to Rev. Rul. 91-32, that gain or loss on sale or exchange by a foreign person of an interest in a partnership that is engaged in a U.S. trade or business is foreign-source.
- Under the new provision, 864(c)(8), gain or loss from the sale or exchange of a partnership interest is effectively connected with a U.S. trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange.
  - How does this rule apply to nonrecognition transactions?

Grecian Magnesite Repeal

- New section 1446(f)(1) provides that if any portion of the gain on any disposition of an interest in a partnership would be treated under new section 864(c)(8) as effectively connected US gain, then the transferee/buyer must withhold a tax equal to 10 percent of the amount realized on the disposition.
  - There is an exception if the transferor/seller certifies that it is not a foreign person.
    - The certificate must contain the transferor's/seller's tax ID and a statement that the person is not a foreign person, under penalties of perjury
  - Under Notice 2018-8, there is also an exception for sales or exchanges of publicly traded partnership interests until regulations or other guidance is published.
- If the transferee fails to withhold the correct amount, the partnership is required to deduct and withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold.

Grecian Magnesite Repeal

- Well-advised taxpayers will ask for a certificates in every case where they purchase a partnership interest
- What liability if no withholding and no certificate, but no underlying liability?

Built-In Loss for 743(b): $250k for Buyer

- Mandatory basis adjustments to partnership property if the partnership has a section 754 election in effect, or if there is a "substantial built-in loss."
- "Substantial built-in loss" exists if the partnership's adjusted basis in its property is $250,000 greater than the fair market value of partnership property.
- Under the bill, a "substantial built-in loss" also exists if the transferee would be allocated a net loss in excess of $250,000 upon a hypothetical disposition by the partnership of all partnership's assets in a fully taxable transaction for cash equal to the assets' fair market value.

Section 704(d)

- Under previous law, a zero-basis partner could get the benefit of a partnership charitable contribution without an offsetting decrease in the basis of his interest.
- The statute modifies the basis limitation on partner losses to provide that the limitation takes into account a partner's distributive share of partnership charitable contributions and foreign taxes (described in section 901) paid or accrued.
  - Thus, the amount of the basis limitation on partner losses is decreased to reflect these items. In the case of a charitable contribution by the partnership, the amount of the basis limitation on partner losses is decreased by the partner's distributive share of the adjusted basis of the contributed property.
- The zero basis partner is thus prevented from taking the charitable deduction associated with the basis of the gifted asset. Instead, the deduction is allowed when the section 704(d) limit increases.

GENERAL PROVISIONS AFFECTING PARTNERSHIPS

Choice of Entity

- Operations that are currently in partnership form may consider incorporation
  - Compare the new reduced rate provided by 199A with the reduced corporate rate
- Two ways to incorporate:
  - Incorporate the entire partnership
  - Select partner incorporate only their interests

Section 199A

- Deduction equal to 20% of (1) an individual's "qualified business income" plus (2) aggregate qualified REIT dividends, cooperative dividends, and publicly traded partnership income
  - Excludes investment income, capital gains and losses, etc.
  - Special limitations for most service businesses
  - Limited based on the taxpayer's W-2 wages with respect to the business, plus 2.5% of the taxpayer's unadjusted basis in certain tangible property (in some cases).
- Expires after 2025.

Section 199A

- Applied at the partner level
- Allocable share of W-2 wages is based on partner's allocable share of wage expense
- Allocable share of unadjusted basis in tangible property is based on share of depreciation
  - Not clear whether this limitation is with respect to the tangible property in question

Section 199A: Qualified Business Income

- "Qualified business income" is reduced by:
  - "reasonable compensation" paid to the taxpayer,
  - section 707(c) guaranteed payments made for services, and
  - Under regulations, any 707(a) payments for services
- "Reasonable compensation" apparently only applies to S-corporations
- Tremendous pressure on the proposed "service" regs under 1.707-2
  - Would recharacterize distributive share as either 707(a) compensation or 707(c) guaranteed payment

Section 199A

- Qualified publicly traded partnership income is eligible for the deduction
  - Statute limited to income "with respect to any qualified trade or business of the taxpayer." § 199A(e)(5). Unclear whether unitholders are engaged in the business of the PTP.
  - § 199A(f)(1)(A)(i) (dictating that the provision is to be applied at the partner level) could be read to treat the unit holder as engaged in the trade or business of the partnership.
    - This reading would limit the benefit to the unitholder's distributive share of active business income.
- Gain from the disposition of a PTP interest that is ordinary in character under § 751(a) also qualifies for the deduction.

Limitation on Deduction for Interest: Section 163(j)

- Section 163(j) now limits the deduction for business interest to the sum of business interest income plus 30 percent of the taxpayer's adjusted taxable income. 163(j)(1)(C).
  - "Business interest" is interest paid or accrued on indebtedness "properly allocable" to a trade or business.
  - Business interest income is limited to interest properly allocable to a trade or business, and does not include investment income.
  - "Adjusted taxable income" means the taxable income of the taxpayer exclusive of:
    - items not properly allocable to a trade or business,
    - business interest or business interest income,
    - any NOL,
    - any § 199A deduction, and
    - for taxable years beginning before January 1, 2022, any deduction for depreciation, amortization, or depletion.

Limitation on Deduction for Interest: Section 163(j)

- Activities/entities that are not subject to 163(j):
  - Public utilities,
  - Electing real estate businesses,
  - Electing farming businesses,
  - The business of being an employee.

Limitation on Deduction for Interest: Section 163(j)

- Application to partnerships:
  - Provision applies at the partnership level
  - Deduction for business interest must be taken into account in determining partnership § 702(a)(8) “bottom line” income or loss
- The adjusted taxable income of each partner is determined without regard to its distributive share of any item of partnership income or loss, and then is increased by the partner’s distributive share of the partnership’s “excess taxable income.”
- Excess taxable income: the amount by which 30 percent of the partnership’s adjusted taxable income exceeds its business interest
  - Thus, any “unused” partnership capacity to deduct interest is passed up to its partners.
  - A partner’s distributive share of excess taxable income is the same as its share of § 702(a)(8) bottom line income or loss.

Limitation on Deduction for Interest: Section 163(j)

- If business interest is not deductible at the partnership level, it becomes "excess business interest":
  - carried forward at the partner level (based on the partner's share of bottom line income or loss)
  - becomes deductible by the partner to the extent it is allocated excess taxable income from that partnership in a subsequent taxable year.
- Any excess taxable income used to permit the deduction of carried forward excess business interest does not also increase the taxpayer's adjusted taxable income in the carry forward year – no double counting allowed.
- The partner's basis in its interest is reduced (but not below zero) by the excess business interest in the allocation year (even though it produces no deduction).
- If the partner disposes of the interest before all of the carried forward excess business interest has been deducted, its basis in the transferred interest is increased by any remaining carry forward amount, and the carry forward disappears.

Limitation on Deduction for Interest: Section 163(j)

- Unexpected results:
  - The first is the product of completely segregating partnership activities from the taxpayer’s other activity.
  - Normally, if a taxpayer engages in an activity that generates a loss, that loss must be subtracted from income from other business activities in measuring adjusted taxable income, such that the loss reduces the otherwise allowable business interest deduction by 30 percent.
  - If the loss-generating activity is conducted through a partnership, however, <u>the loss is ignored in computing adjusted taxable income, thereby increasing the partner’s allowable interest deduction by 30 percent of the loss</u>.
  - The segregation approach may facilitate the allocation of interest expense to investment activity by placing the interest expense in a partnership carrying on an investment activity, thus avoiding the uncertainty inherent in the “properly allocable” rule generally applicable to characterizing interest as business interest versus investment interest.

Limitation on Deduction for Interest: Section 163(j)

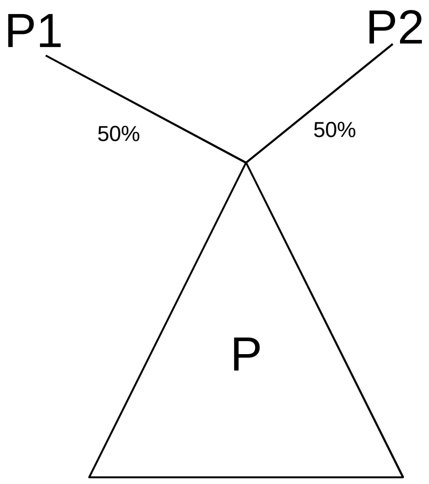
- Further unexpected results:
  - The second anomaly is the result of the partnership level application of the rule.
  - To the extent the partnership does not use its full capacity to deduct interest, that excess capacity needs to be allocated among the partners.
  - This excess capacity is a tax attribute that has no impact on capital accounts, and therefore is not subject to the § 704(b) allocation scheme.
  - The drafters chose to allocate this attribute according to the partners' share of bottom-line income or loss
    - as experienced draftspersons well understand, these shares do not always coincide with the overall economics of the venture.

Limitation on Deduction for Interest: Section 163(j)

- Consider the use of preferred partnerships as alternative financing structures
- 163(j)(5): interest is "paid or accrued on indebtedness"
- But consider *Pritired* and similar cases

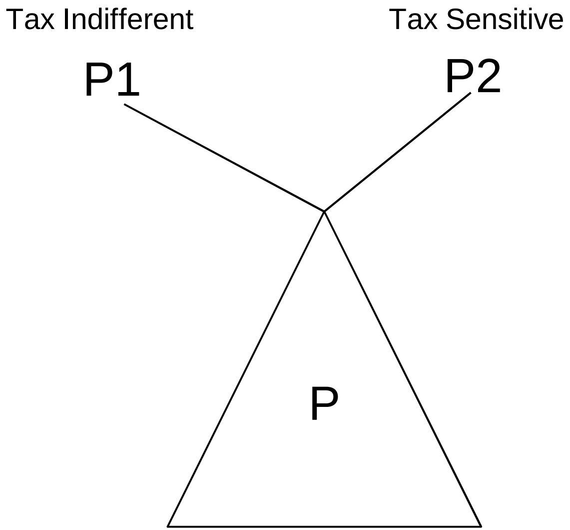
Limitation on Deduction for Interest: Section 163(j)

- P has:
  - $200 Gross Income
  - $100 Non-interest expense
  - $30 Excess taxable income
  - (30% x $100 taxable income)
- P2 is hampered by the § 163(j) limit, and is tax sensitive.
- P1 is tax indifferent.



Limitation on Deduction for Interest: Section 163(j)

- The partners amend their agreement for Year X to specially allocate partnership gross income 90% to P1 and 10% to P2, and to allocate partnership bottom line income or loss 10% to P1 and 90% to P2.
- In addition, the partners agree to a special allocation of gain to first equalize capital accounts.

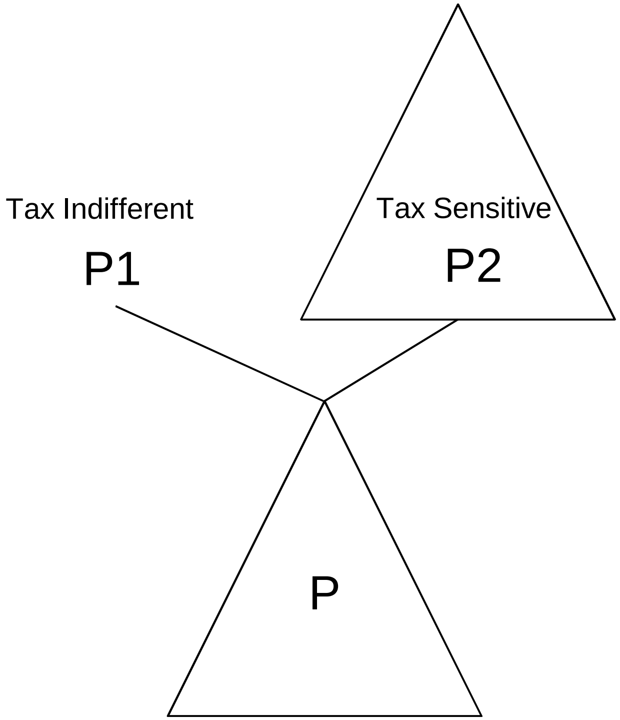


Limitation on Deduction for Interest: Section 163(j)

- In Year X, P's gross income of $200 is allocable $180 to P1 and $20 to P2.
- P's bottom line loss of $100 (the special allocation of gross income removes it from the computation) is allocated $10 to P1 and $90 to P2, and carries with it the $30 of excess taxable income ($3 to P1 and $27 to P2).
- Although P's capital accounts are skewed sharply in P1's favor (up by $170 while P2's capital account is down by $70), P2 is counting on the special gain allocation to equalize capital accounts.
- In Year X, P2 simultaneously enjoys a net $70 tax loss and a $27 <u>increase</u> in its interest deduction (since its § 163(j) limit is increased by P2's share of P's "excess taxable income.)"

Limitation on Deduction for Interest: Section 163(j)

- The bottom line allocation rule apparently extends through tiers of partnerships.
  - For example, if P2 in the Example is itself a partnership generating income from other business activities, the allocation of P2's bottom line income or loss should effectively carry with it P2's $27 of excess taxable income.
  - P2's Allocations:
    - $20 special gross income allocation
    - $(90) bottom line
    - $27 excess taxable income



Limitation on Deduction for Interest: Section 163(j)

- If P2 has $80 of income in Year X from other activities, the allocation of P2’s bottom line income of $10 controls the allocation of P2’s excess taxable income.
- P2’s excess taxable income equals 30 percent of its income computed without regard to its distributive share of P’s income (30% x $80 = $24) plus the $27 of excess taxable income from P, for a total of $51.
- The ability of taxpayers to amend their allocation agreements for a particular year until March 15 of the following year may lead to significant discussions among partners during that first two-and-one-half month period.

GILTI

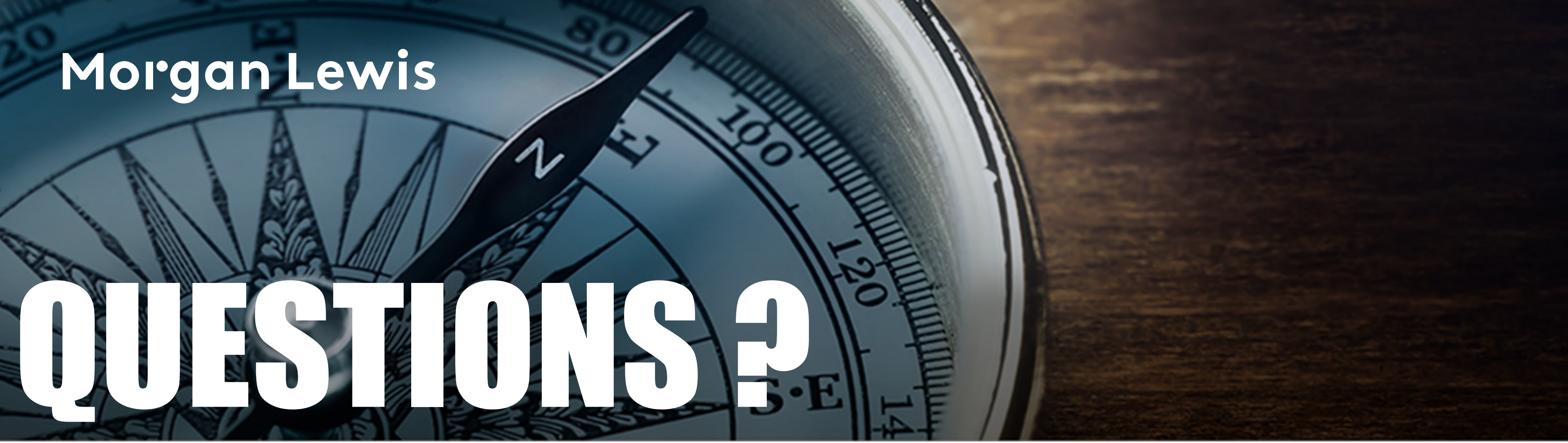
- The US shareholder of any CFC must include in gross income its “global intangible low-taxed income” (“GILTI”). The computation allows the shareholder to earn a return on its tangible assets free of the GILTI tax.
- If a CFC holds an interest in a partnership at the close of the CFC’s taxable year, the CFC takes into account its distributive share of the aggregate of the partnership’s adjusted bases (determined as of such date in the hands of the partnership) in tangible property held by the partnership to the extent:
  - that the property is used in the trade or business of the partnership,
  - is of a type with respect to which a deduction is allowable under section 167, and
  - is used in the production of tested income (determined with respect to the CFC’s distributive share of income with respect to the property).
- The CFC’s distributive share of the adjusted basis of any property is the CFC’s distributive share of income with respect to the property.

Changes to Partnership Audit Rules

- Enacted Legislation:
  - Bipartisan Budget Act of 2015 (the "BBA")
  - Protecting Americans from Tax Hikes Act (the "Path Act")
  - Final Regulations
    - Implementation of the election out, effective January 2, 2018
  - Proposed Regulations
    - Implementation Rules, June 2017
    - International Tax Rules, November 2017
    - Rules for Push-out Election, Tiered Partnerships and Administrative Provisions, January 2018
- Potential rules currently in limbo:
  - Tax Technical Corrections Act of 2016
    - Introduced but not enacted; status uncertain
  - No Regulations yet that address BBA impact on basis and capital account

Key Provisions of the BBA

- Any adjustment to items of partnership income, gain, loss or credit is determined at the partnership level.
- All tax, penalties, and interest attributable to any adjustment is assessed and collected at the partnership level.
- Limited mechanisms to shift liability from the partnership to the partners exist.
- Applies to all partnerships as a default
- Partners with less than 100 partners and who do not have a direct partner that is a partnership, trust, or disregarded entity may elect out.
- Participation in the partnership examination is limited to the "Partnership Representative"



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QUESTIONS ?

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THANK YOU

Biography

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Bill McKee’s practice encompasses all areas of federal taxation, with special emphasis on partnership taxation. Bill served as tax legislative counsel at the US Treasury Department from 1981 to 1983. He is a member of the American Law Institute, the American College of Tax Counsel, and the National Institute for Tax Professionals.

In addition to authoring numerous articles, Bill co-authored the treatise Federal Taxation of Partnerships and Partners (Warren, Gorham & Lamont, 4th edition, 2007) as well as Structuring and Drafting Partnership Agreements: Including LLC Agreements (Warren, Gorham & Lamont, 3rd edition, 2003). He also frequently speaks on partnership taxation at seminars across the United States. Ranked in Band 1 by Chambers USA, Bill is described as “a pre-eminent expert in the tax field” and “simply unparalleled in partnership taxation.” Clients praise Bill as a “clear thinker and an excellent communicator” who is client-focused and has “extraordinary technical tax expertise.” He has been repeatedly named a leading lawyer in both Chambers USA and Chambers Global.

Biography

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Will Nelson’s practice encompasses all areas of federal taxation, with special emphasis on partnership taxation and tax controversy and litigation matters. Previously chief counsel for the Internal Revenue Service, Will co-authored the treatise Federal Taxation of Partnerships and Partners (Warren, Gorham & Lamont, 4th edition, 2007) as well as Structuring and Drafting Partnership Agreements: Including LLC Agreements (Warren, Gorham & Lamont, 3rd edition, 2003). Will writes on tax law for numerous journals, and he frequently lectures at tax institutes.

Noted as “technically expert, creative, and a terrific tax litigator” as well as a “tremendous thinker who always provides great guidance," Will is named one of the leading practitioners in taxation by Chambers Global and Chambers USA, among others.

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Sarah Brodie concentrates her practice on tax planning, with special focus on partnership tax. She advises financial institutions, energy companies, and other multinational corporations in various contexts. Sarah has worked in mergers and acquisitions, internal restructurings, and various proceedings before the Internal Revenue Service (IRS). She drafts partnership agreements and recently became a co-editor of Structuring and Drafting Partnership Agreements: Including LLC Agreements (Warren, Gorham & Lamont).

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

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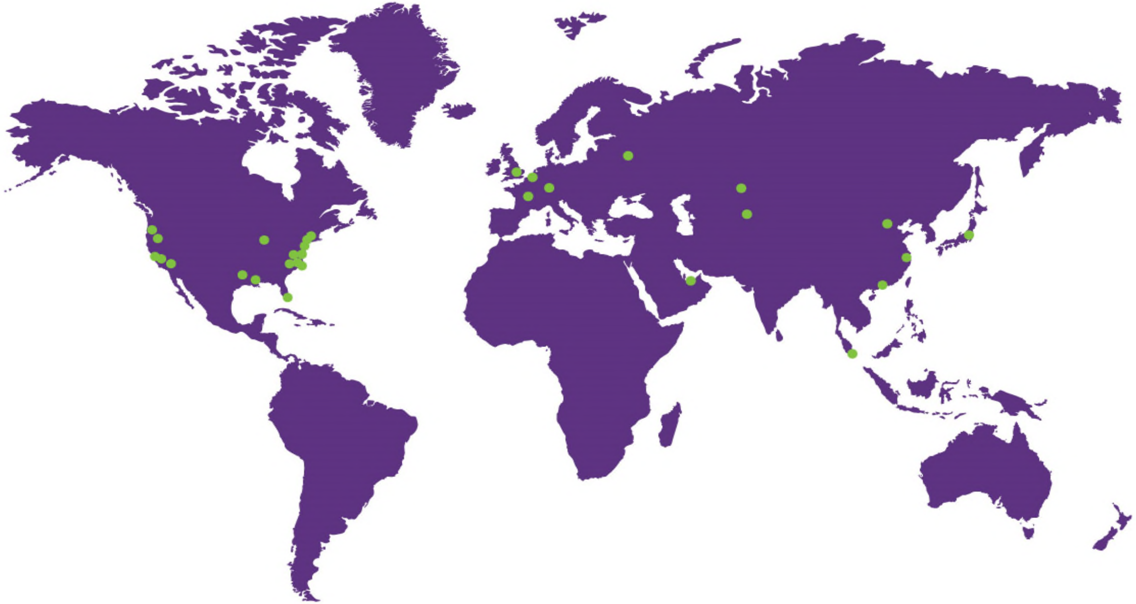
Boston	Frankfurt	Miami	Pittsburgh	Tokyo
Brussels	Hartford	Moscow	Princeton	Washington, DC
Century City	Hong Kong*	New York	San Francisco	Wilmington



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