PARTNERSHIP TAXATION

January 2018 Supplement to FOURTH EDITION

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Includes relevant changes made by the Tax Cuts and Jobs Act of 2017.

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ADDITIONS AND INSERTIONS

CHAPTER 1: DEFINING PARTNERSHIPS AND PARTNERS FOR TAX PURPOSES

§ 1.03 CLASSIFYING PARTNERSHIPS FOR TAX PURPOSES

D. RECLASSIFYING PARTNERSHIPS AS CORPORATIONS

2. Publicly Traded Partnerships

For purposes of determining whether a partnership is a publicly traded partnership, the interests in the partnership are readily tradable on a secondary market or the substantial equivalent thereof, if, taking into account all of the facts and circumstances, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market.[1] Interests in a partnership will be deemed to be readily tradable on a secondary market or the substantial equivalent thereof if:

(i) interests in the partnership are regularly quoted by any person, such as a broker or dealer, making a market in the interests;

(ii) any person regularly makes available to the public (including customers or subscribers) bid or offer quotes with respect to interests in the partnership and stands ready to effect buy or sell transactions at the quoted prices for itself or on behalf of others;

(iii) the holder of an interest in the partnership has a readily available, regular, and ongoing opportunity to sell or exchange the interest through a public means of obtaining or providing information of offers to buy, sell, or exchange interests in the partnership; or

(iv) prospective buyers and sellers otherwise have the opportunity to buy, sell, or exchange interests in the partnership in a time frame and with the regularity and continuity that is comparable to that described in the other tests listed above.[2]

3. Taxable Mortgage Pools

For purposes of the definition of a TMP, real estate mortgages (or interests therein) include: (i) obligations (including participations or certificates of beneficial ownership therein) that are principally secured by an interest in real property; (ii) regular and residual interests in a real estate mortgage

1 Treas. Reg. § 1.7704-1(c)(1).

2 Treas. Reg. § 1.7704-1(c)(2).

investment conduit; and (iii) stripped bonds and stripped coupons which are stripped from bonds or coupons that would have qualified as real estate mortgages or interests therein.[3] An obligation is principally secured by an interest in real property if the fair market value of the interest in real property securing the obligation was at least equal to 80% of the adjusted issue price of the obligation on the issue date.[4] An obligation is also principally secured by an interest in real property if substantially all of the proceeds of the obligation were used to acquire, improve, or protect an interest in real property that, on the issue date, is the only security for the obligation.[5]

Debt obligations have two or more maturities if they have different stated maturities or if the holders of the obligations possess different rights concerning the acceleration of or delay in the maturities of the obligations.[6] Debt obligations are not treated as having two or more maturities merely because they allocate credit risk unequally.[7]

§ 1.04 DISTINGUISHING PARTNERSHIPS FROM OTHER CONTRACTUAL ARRANGEMENTS

E. Distinguishing Partnerships from Trusts

1. Grantor Trusts

For income tax purposes, there are complex trusts, simple trusts, split-interest trusts and grantor trusts. Because grantor trusts are closest to partnerships, we will focus on grantor trusts. But first, it is necessary to have a basic understanding of what a "trust" is.

For income tax purposes, a "trust" is an arrangement by which title to property is held by a person or persons, with a fiduciary responsibility to conserve or protect the property for the benefit of another person or persons.[8] Trusts may be formed under common law or under statutory provisions. A trust formed under common law may have the necessary fiduciary duty imposed by the applicable trusts and trustees act. A trust formed under statutory provisions may or may not have fiduciary duties. If an entity is formed as a state law trust without fiduciary duties, the arrangement may be recharacterized as something other than a trust.

Assuming that you have a trust, I.R.C. § 671 provides that where the grantor or another person is treated as the owner of any portion of a trust, there will be included in computing taxable income and credits of the grantor or other person, those items of income, deduction and credits against tax of the trust attributable to that portion of the trust to the extent that such items would be taken into account in computing the taxable income or credit against the tax of an individual. Treas. Reg. § 1.671-2(e)(3) provides that a "grantor" includes a purchaser of an interest in a trust described in Treas. Reg. § 301.7701-4(c).

3 Treas. Reg. § 301.7701(i)-1(c)(5)(ii)(C).
4 Treas. Reg. § 301.7701(i)-1(d)(3)(i)(A).
5 Treas. Reg. § 301.7701(i)-1(d)(3)(i)(B).
6 Treas. Reg. § 301.7701(i)-1(e)(1).
7 Treas. Reg. § 301.7701(i)-1(e)(2).
8 Treas. Reg. § 301.7701-4(a).

2. *Business Trusts*

Forming an entity as a trust may not prevent the entity from being classified as a business entity. In general, if the organizational documents of a trust explicitly authorize the trust to conduct business[9] or the trust does, in fact, conduct business,[10] an entity formed as a trust may be viewed as a business entity.[11] However, business transactions which are necessary to an orderly liquidation or the preservation of the trust property will not cause the trust to be taxed as an association.[12]

3. *Investment Trusts*

Certain trusts formed to make investments may also be classified as business entities. Although both *Tower* and *Andantech*, discussed above, could be read to hold that conducting business is an essential characteristic of a business entity, there is a long tradition of authority that will classify an investment trust as a business entity even if the only activity of the trust is investing.[13]

Treas. Reg. § 301.7701-4(c)(1) provides that an investment trust will be treated as a business entity if the trustees have a power to vary the investment of the trust certificate holders. For example, in Revenue Ruling 78-371,[14] the IRS ruled that a real estate trust, which was formed to collect and distribute income from the trust property, was a business entity where the trustees had the power to change the property into which the trust assets were invested.[15] In contrast, in Revenue Ruling 79-77,[16] the IRS ruled that a real estate trust, which was similarly formed to act as a signatory to leases and collect and distribute the income from the property, was organized to conserve property (and, thus, treated as a trust) because the trustees lacked the powers given to the trustees in Revenue Ruling 78-371.[17]

Separately, an investment trust with multiple classes of ownership interest will ordinarily be classified as a business entity unless (i) there is no power to vary the investment of the certificate holders

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9 *Morrissey v. Commissioner*, 296 U.S. 344 (1935); *Elm Street Reality Trust v. Commissioner*, 76 TC 803 (1981).

10 *Abraham v. United States*, 406 F.2d 1259 (6th Cir. 1969).

11 Treas. Reg. § 301.7701-4(b).

12 *See Nee v. Main Street Bank*, 174 F.2d 425 (8th Cir. 1949).

13 *See Commissioner v. North American Bond Trust*, 122 F.2d 545 (2d Cir. 1941), *cert. denied*, 314 U.S. 701 (1942). Under current law, investing for one's own account is not a trade or business. *Commissioner v. Groetzinger*, 480 U.S. 23 (1987).

14 1978-2 C.B. 344.

15 The trustees had the power to:

(a) purchase and sell contiguous or adjacent real estate;

(b) accept and retain contributions of contiguous or adjacent real estate from the beneficiaries or members of their families;

(c) raze or erect any building or other structure and make any improvements they deem proper on the land originally donated to the trust or on any adjacent or contiguous land subsequently acquired by the trust; and

(d) borrow money and mortgage and lease the property.

16 1979-1 C.B. 448.

17 *See also* Rev. Rul. 77-349, 1977-2 C.B. 20 and Rev. Rul. 84-10, 1984-1 C.B. 155 (mortgage-back security pool classified as a trust where trustee did not have the power to vary the investments).

and (ii) the trust is formed to facilitate direct investment in the assets of the trust and the existence of multiple classes of ownership interests is incidental to that purpose.[18]

If a trustee has additional powers under the trust agreement such as the power to do one or more of the following: (i) dispose of the trust's property and acquire new property; (ii) renegotiate the lease leases of the trust's property with the original lessee or enter into leases with tenants other than the original lessee; (iii) renegotiate or refinance the obligation used to purchase the trust's property; (iv) invest cash received to profit from market fluctuations; or (v) make more than minor non-structural modifications to the trust's property not required by law, the trust will be a business entity.[19]

F. Comparison Charts

Entity	State Law Issues	Tax Issues
C corporation	Limited liability	Double taxation
S corporation	Limited liability	Single level of taxation Single class of stock
General partnership	Joint and several liability (unless LLP)	Single level of taxation Multiple classes possible Special allocations possible
Limited partnership	General partner has unlimited liability (unless LLLP)	Single level of taxation Multiple classes possible Special allocations possible
Limited liability company	Limited liability	Single level of taxation Multiple classes possible Special allocations possible
Investment Trust	Limited liability	Single level of taxation No power to vary Limited ability to have multiple classes No special allocations possible

18 Treas. Reg. sec. 301.7701-4(c)(1).

19 Rev. Rul. 2004-86, 2004-2 C.B. 191.

Partnerships and LLCs	
Formation	A contribution of property in exchange for a partnership interest is generally not taxable.
Operations:	The net income of a partnership is taxable to the partners.
Distributions:	A distribution is taxable to the extent that the amount of cash distributed is in excess of the recipient's basis in the recipient's partnership interest.
Liquidations:	A distribution is taxable to the extent that (i) the amount of cash distributed is in excess of the recipient's basis in the recipient's partnership interest and (ii) the income allocated.
Sales and Reorganizations:	Partnerships are quite limited in the types of reorganizations in which they may participate.

C Corporations	
Formation	A contribution of property for stock is generally not taxable if the contributors hold at least 80% of the stock immediately after the exchange.
Operations:	The net income of a C corporation is taxable to the corporation.
Distributions:	A distribution from a C corporation is taxable to the recipient to the extent that (i) the distribution is out of earnings and profits or (ii) the distribution is in excess of the recipient's stock basis.
Liquidations:	A distribution in liquidation is generally taxable to the recipient to the extent that the value of the distribution exceeds the recipient's tax basis.
Sales and Reorganizations:	Corporations may participate in a variety of tax-free reorganizations.

S Corporations	
Formation	A contribution of property for stock is generally not taxable if the contributors hold at least 80% of the stock immediately after the exchange.

Operations:	The net income of an S corporation is taxable to the shareholders of the corporation.
Distributions:	A distribution from an S corporation is taxable to the recipient to the extent that the distribution is in excess of the recipient's stock basis.
Liquidations:	A distribution in liquidation is generally taxable to the recipient to the extent that the distribution exceeds the recipient's tax basis.
Sales and Reorganizations:	Corporations may participate in a variety of tax-free reorganizations.

§ 1.08 Series LLCs

D. Side Pockets and Alternative Investment Vehicles

Although when the proposed regulations for series LLCs first came out there was a strong push from several quarters to get the series of series LLCs recognized as separate entities for tax purposes, no uniform market practice has developed at this point. Part of the reason for this lack of uniformity is the treatment of side pockets and alternative investment vehicles.

A practice called "side pockets" is common for investment partnerships that have partners that have regulatory or other legal restrictions on the partners' investments. If an investment is made by the partnership that will run into one of these regulatory restrictions, the investment is put into what is commonly called a side pocket. The income and cash flow from the investment is allocated and distributed only to the partners without the regulatory restriction. It is common practice for investment partnerships to treat such arrangements as "special allocations" rather than a distribution of certain assets to a portion of the partners (or to a new partnership for the benefit of certain partners).

A separate, but similar, issue is raised by alternative investment vehicles. Sometimes investment partnerships allow investors that prefer not to have certain types of income to have their investment routed through a separate legal entity with the goal of changing the type of income to one which these partners prefer. From a business perspective, it is common for the economics of the main fund and the alternative investment vehicle to be calculated together for many purposes with the two entities sharing income and expenses on a proportionate basis. It is also common industry practice to treat as the main fund and alternative investment vehicle as separate entities for federal and state tax purposes -- without creating a deemed partnership between the two entities.

So, on the one hand, the treatment of side pockets does not recognize the existence of a separate entity for tax purposes where segregated assets are not put into a separate state-law entity. This creates tension with the fact the series LLCs are usually not separate legal entities. On the other hand, alternative investment vehicles are treated as separate entities if they are recognized as separate entities for state law purposes. This, again, puts the emphasis on the recognition of the state law series LLC rather than the economic units created by the series under the series LLC.

CHAPTER 2: FORMATION OF THE PARTNERSHIP

§ 2.03 TRANSFERS TO INVESTMENT COMPANIES

B. Table

I.R.C. § 721(b) Transfers to Investment Companies	
Background	To qualify as tax-free under 351, contributions to a partnership that would be treated as an investment company under I.R.C. § 351 must either be diversified portfolio(s) or identical assets.
What is tested?	To be a "diversified portfolio," each transferor's contribution must pass both a 25% diversification test and a 50% diversification test.
25% test	Not more than 25% of the value of its total assets may be invested in the stock and securities of any one issuer.
50% test	Not more than 50% of the value of its total assets investments may be in the stock and securities of 5 or fewer issuers.
Government Securities	Government securities are included in total assets (the denominator), but are not treated as securities of an issuer (the numerator) for both the 25% and 50% test. However, government securities acquired for purposes of meeting the tests are not included in the total assets (denominator), but are still included in the numerator.
Securities of RICs or REITs	Look through the RICs or REITs to underlying assets.
Cash items	Cash and cash items (including receivables) are excluded from the numerator and denominator for both the 25% and 50% tests.
De minimis rule	Insignificant transfers are ignored (one or more transfers of nonidentical assets which, taken in the aggregate, constitute an insignificant portion of the total value of assets transferred).
Controlled groups	All members of a controlled group are treated as one issuer. Controlled group means chains of corporations connected through 80% control of voting power or value.

CHAPTER 3: OUTSIDE BASIS AND ALLOCATION OF LIABILITIES

§ 3.04 EFFECT OF PARTNERSHIP LIABILITIES

B. Definition of a Recourse and Nonrecourse Liabilities

1. Definition of the Liability

Add at the end of the section:

However, some obligations are not "liabilities" for the purposes of I.R.C. § 752. In Rev. Rul. 88-77, the I.R.S. concluded that accrued but unpaid expenses and accounts payable are not "liabilities of a partnership" or "partnership liabilities" within the meaning of I.RC. § 752. Thus, such obligations were not taken into account for the purpose of determining the outside basis of a partner in the partnership interest.[20]

CHAPTER 4: OPERATION OF THE PARTNERSHIP: CALCULATION OF PARTNERSHIP TAXABLE INCOME

§ 4.05 ACCOUNTING METHOD

C. Accrual Method Taxpayers that Issue Financial Statements

I.R.C. § 451(b) revises the timing rules for the recognition of income for accrual method taxpayers. Accrual method taxpayers are generally subject to the "all events test."[21] Under the "all events test", income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.[22] I.R.C. § 451(b) requires an accrual method taxpayer to recognize such income no later than the taxable year in which such income is taken into account as revenue in an applicable financial, but provides an exception for taxpayers without an applicable or other specified financial statement. In the case of a contract which contains multiple performance obligations, the provision requires the taxpayer to allocate the transaction price in accordance with the allocation made in the taxpayer's applicable financial statement.[23]

In addition, accrual method taxpayers with an applicable financial statement must apply the income recognition rules under I.R.C. § 451 before applying the special rules for OID, market discount, discounts on short-term obligations, OID on tax-exempt bonds, and stripped bonds and stripped coupons.[24]

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20 Rev. Rul. 88-77, 1988-2 C.B. 128.

21 Treas. Reg. § 1.451-1(a).

22 I.R.C. § 451(b)(1)(C); Treas. Reg.§ 1.451-1(a).

23 I.R.C. § 451(b)(4).

24 I.R.C. § 451(b)(2).

The provision also codifies the current deferral method of accounting for advance payments for goods, services, and other specified items provided by the IRS under Revenue Procedure 2004–34.[25] That is, the provision allows accrual method taxpayers to elect to defer the inclusion of income associated with certain advance payments to the end of the tax year following the tax year of receipt if such income also is deferred for financial statement purposes.[26] The provision requires the inclusion in gross income of a deferred advance payment if the taxpayer ceases to exist.[27]

For purposes of the provision, the term ''applicable financial statement'' means: (A) a financial statement which is certified as being prepared in accordance with generally accepted accounting principles and which is (i) a 10–K (or successor form), or annual statement to shareholders, required to be filed by the taxpayer with the United States Securities and Exchange Commission ("SEC"), (ii) an audited financial statement of the taxpayer which is used for (I) credit purposes, (II) reporting to shareholders, partners, or other proprietors, or to beneficiaries, or (III) any other substantial nontax purpose, but only if there is no statement of the taxpayer described in clause (i), or (iii) filed by the taxpayer with any other federal agency for purposes other than federal tax purposes, but only if there is no statement of the taxpayer described in clause (i) or (ii); (B) a financial statement which is made on the basis of international financial reporting standards and is filed by the taxpayer with an agency of a foreign government which is equivalent to the SEC and which has reporting standards not less stringent than the standards required by the SEC, but only if there is no statement of the taxpayer described in subparagraph (A); or (C) a financial statement filed by the taxpayer with any other regulatory or governmental body specified by the Treasury, but only if there is no statement of the taxpayer described in subparagraph (A) or (B).[28] If the financial results of a taxpayer are reported on the applicable financial statement for a group of entities, such statement is treated as the applicable financial statement of the taxpayer.[29]

§ 4.07 LOSS LIMITATION RULES

D. Excess Business Losses

For taxable years beginning after December 31, 2017 and before January 1, 2026, excess business losses of a taxpayer other than a corporation are not allowed for the taxable year.[30] Such losses are carried forward and treated as part of the taxpayer's net operating loss ("NOL") carryforward in subsequent taxable years.[31] Under the bill, NOL carryovers generally are allowed for a taxable year up

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25 2004-22 I.R.B. 991.

26 I.R.C. § 451(c).

27 I.R.C. § 451(c)(3).

28 I.R.C. § 451(b)(3).

29 I.R.C. § 451(b)(5).

30 I.R.C. § 461(l).

31 I.R.C. § 461(l)(2).

to the lesser of the carryover amount or 80 percent of taxable income determined without regard to the deduction for NOLs.[32]

An excess business loss for the taxable year is the excess of aggregate deductions of the taxpayer attributable to trades or businesses of the taxpayer (determined without regard to the limitation of the provision), over the sum of aggregate gross income or gain of the taxpayer plus a threshold amount.[33] The threshold amount for a taxable year is $250,000 (or twice the otherwise applicable threshold amount in the case of a joint return). The threshold amount is indexed for inflation.[34] Note that treating the disallowed amount as part of the NOL means the threshold amount can only be used once against a given loss.

In the case of a partnership, the provision applies at the partner level.[35] Each partner's distributive share of items of income, gain, deduction, or loss of the partnership are taken into account in applying the limitation under the provision for the taxable year of the partner. As a practical matter, this loss limitation will prevent an individual from using excess business losses in the year in which generated against non-business income, but the loss will be carried forward as an NOL that can be used against all income (business and non-business) in subsequent taxable years subject to the limitations on utilization of NOLs.

The provision applies after the application of the passive loss rules.[36]

E. Limitation on the Deductibility of Business Interest

Interest paid or accrued by a business generally is deductible in the computation of taxable income subject to a number of limitations.[37]

The deduction for business interest is limited to the sum of (1) business interest income; (2) 30 percent of the adjusted taxable income of the taxpayer for the taxable year; and (3) the floor plan financing interest of the taxpayer for the taxable year.[38] The amount of any business interest not allowed as a deduction for any taxable year may be carried forward beyond the year in which the business interest was paid or accrued, treating business interest as allowed as a deduction.[39] The limitation applies at the taxpayer level.

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32 I.R.C. § 172(a).

33 I.R.C. § 461(l)(3).

34 I.R.C. § 461(l)(3)(B).

35 I.R.C. § 461(l)(4).

36 I.R.C. § 461(l)(6).

37 I.R.C. § 163.

38 I.R.C. § 163(j)(1).

39 I.R.C. § 163(j)(2).

Business interest means any interest paid or accrued on indebtedness properly allocable to a trade or business.[40] Any amount treated as interest for purposes of the Code is interest for purposes of the provision. Business interest income means the amount of interest includible in the gross income of the taxpayer for the taxable year which is properly allocable to a trade or business. Business interest does not include investment interest, and business interest income does not include investment income within the meaning of I.R.C. § 163(d).[41]

Adjusted taxable income means the taxable income of the taxpayer computed without regard to (1) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business; (2) any business interest or business interest income; (3) the amount of any net operating loss deduction; (4) the amount of any deduction allowable under I.R.C. § 199A, and (5) (for taxable years beginning before January 1, 2022) any deduction allowable for depreciation, amortization, or depletion.[42]

By including business interest income in the limitation, the rule operates to allow a deduction for business interest to the full extent of business interest income. This means a partnership which is in the business of lending would be able to deduct all of its interest expense up to its interest income. To the extent that business interest exceeds business interest income and floor plan financing interest, the deduction for the net interest expense is limited to 30 percent of adjusted taxable income.[43]

In the case of any partnership, the limitation is applied at the partnership level. Any deduction for business interest is taken into account in determining the nonseparately stated taxable income or loss of the partnership.[44] It is not clear whether the trade or business of a partnership will be attributed to its partners for purposes of applying the limitation in I.R.C. § 163(g) with respect to debt incurred by the partner to acquire its interest in the partnership.

The adjusted taxable income of each partner is determined without regard to such partner's distributive share of the nonseparately stated income or loss of such partnership.[45] In the absence of such a rule, the same dollars of adjusted taxable income of a partnership could generate additional interest deductions as the income is passed through to the partners.

> Example 1.−ABC is a partnership owned 50-50 by XYZ Corporation and an individual. ABC generates $200 of noninterest income. Its only expense is $60 of business interest. Under the provision the deduction for business interest is limited to 30 percent of adjusted taxable income, that is, 30 percent * $200 = $60. ABC deducts $60 of business interest and reports ordinary business income of $140. XYZ's distributive share of the ordinary business income of ABC is $70. XYZ has net taxable income of zero from its other operations, none of which is attributable to interest income and without regard to its

40 I.R.C. § 163(j)(5).

41 I.R.C. § 163(j)(6).

42 I.R.C. § 163(j)(8).

43 I.R.C. § 163(j)(1).

44 I.R.C. § 163(j)(4)(A)(i).

45 I.R.C. § 163(j)(4)(A)(ii)(I).

> business interest expense. XYZ has a business interest expense of its own of $25. In the absence of any special rule, the $70 of taxable income from its interest in ABC would permit the deduction of up to an additional $21 of interest (30 percent * $70 = $21), resulting in a deduction disallowance of only $4. XYZ's $100 share of ABC's adjusted taxable income would generate $51 of interest deductions in the aggregate. If XYZ were instead a passthrough entity, additional deductions could be available at each tier. The double counting rule provides that XYZ has adjusted taxable income computed without regard to the $70 distributive share of the nonseparately stated income of ABC. As a result, XYZ has adjusted taxable income of $0. XYZ's deduction for business interest is limited to 30 percent * $0 = $0, resulting in a deduction disallowance of the entire $25 interest expense.[46]

The limit on the amount allowed as a deduction for business interest is increased by a partner's distributive share of the partnership's excess amount of unused adjusted taxable income limitation.[47]

The amount of any business interest not allowed as a deduction for any taxable year is treated as business interest paid or accrued in the succeeding taxable year.[48]

The adjusted taxable income limitation does not apply to any taxpayer if the average annual gross receipts for the three-taxable-year period ending with the prior taxable year does not exceed $25 million.[49]

The limitation also does not apply to any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.[50] As noted previously, it is unclear whether a real property trade or business conducted by a taxpayer through a partnership will be attributed to the taxpayer for purposes of applying this limitation. For example, if a real estate investment trust (a REIT) owns its assets through a partnership, will debt incurred by the REIT be subject to this exception if the REIT owns no other assets?

CHAPTER 5: OPERATION OF A PARTNERSHIP; ALLOCATION OF PARTNERSHIP INCOME AND LOSSES

Section 5.10 is renumbered 5.11 and new section 5.10 is inserted before it:

§ 5.10 DEDUCTION FOR QUALIFIED BUSINESS INCOME/I.R.C. § 199A

Under new section 199A, for taxable years beginning after December 31, 2017, an individual taxpayer generally may be entitled to deduct an amount based, in part, upon the taxpayer's qualified

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46 Conference Report to Accompany H.R. 1, 115 Cong. 1st Sess., Rep. 115-466, p. 388 (Dec. 15, 2017).

47 I.R.C. § 163(j)(4)(A)(ii)(II).

48 I.R.C. § 163(j)(2).

49 I.R.C. § 163(j)(4).

50 I.R.C. § 163(j)(7)(B).

business income.[51] The actual formula for the allowable deduction is quite complex. Commonly, individuals will be able to deduct 20% of net business income earned in the U.S. (irrespective of whether the taxpayer is active in the business) and 20% of certain other kinds of income (e.g., from a REIT). Note that this is an owner-level deduction for individuals, not a partnership deduction. But the partnership "qualified business income" allocated to a partner who is an individual can qualify for the deduction. It is a "nonitemized, below the line" deduction.[52] Thus, the deduction could not, for example, reduce income subject to Social Security and Medicare taxes. You need to master several terms in order to understand section 199A, two of which have similar names, but different meanings: "Combined qualified business income" and "qualified business income."

In the case of a taxpayer other than a corporation, a deduction is allowed equal to the *sum* of (1) the *lesser* of (a) the combined qualified business income amount or (b) 20 percent of the excess of (i) the taxable income over (ii) the sum of net capital gain and any qualified cooperative dividends, *plus* (2) the *lesser* of (a) 20 percent of the aggregate amount of qualified cooperative dividends or (b) taxable income reduced by net capital gain.[53]

The combined qualified business income amount is further defined by another formula. The combined qualified business income amount is the sum of (what we will call)an income/wage amount with respect to all of the taxpayer's qualified trades or businesses plus 20 percent of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income for the taxable year.[54] The income/wage amount with respect to each qualified trade or business is the *lesser* of (1) 20 percent of the taxpayer's qualified business income with respect to such qualified trade or business or (2)[55] the *greater* of (a) 50 percent of the W-2 wages with respect to the qualified trade or business or (b) the sum of (i) 25 percent of the W-2 wages with respect to the qualified trade or business plus (ii) 2.5 percent of the unadjusted basis immediately after the acquisition of all qualified property (mainly, tangible, depreciable, personal and real property).[56] The objective of the 50 percent W-2 wage limitation is to encourage the employment of US citizens and residents by the business. Note that if a taxpayer's business paid no wages, under the 50% test, he would get no deduction, as 50% of 0 is 0. However, an alternative to this limitation (the 25 percent W-2 wage plus 2.5 percent of adjusted basis) was added by the Conference Committee late in the process as part of reconciliation, which extends the benefits section 199A to owners of businesses with large holdings of "qualified property" (e.g., real estate) having few or even no employees. In addition, neither the W-2 wage-limitation nor the W-2 wage/capital-limitation provisions apply to taxpayers with *taxable* income below \$157,500 (single) or \$315,000 (married filing jointly), subject to a phase-in of these limitations at taxable income levels between \$157,500 and \$207,500

51 I.R.C. § 199A(a).

52 I.R.C. § 63(b)(3).

53 I.R.C. § 199A(a).

54 I.R.C. § 199A(b)(1).

55 The limitations in (2) does not apply if the taxpayer's income is less than \$157,500 (200% of such amount in the case of a joint return). I.R.C. § 199A(b)(3)(A). Additional special rules apply to phase-in the application of these limitations if a taxpayer's taxable income exceeds the above thresholds by less than \$50,000 for single filers or \$100,000 in the case of a joint return. I.R.C. § 199A(b)(3)(B).

56 I.R.C. § 199A(b)(6).

(single) and between $315,000 and $415,000 (married filing jointly).[57] This means that taxpayers can generally deduct 20 percent of their qualified business income regardless of the amount of wages paid by their qualified businesses as long as their taxable income is at or below the stated thresholds. We define qualified business income next.

"Qualified business income" is defined as the net amount of qualified items of income, gain, deduction, and loss with respect to qualified trades or business of the taxpayer.[58] In general, "qualified items of income" with respect to a qualified trade or business includes items of income, gain, deduction or loss to the extent such items are effectively connected with the conduct of a trade or business within the United States.[59] "Qualified items of income" does not include long or short-term capital gain or loss, dividends, income equivalent to dividends, interest income other interest income properly allocable to a trade business, commodities and foreign currency gains, or income from notional principal contracts (other than in qualified hedging contracts).[60] A "qualified trade or business" includes any trade or business other than certain specified service businesses or the trade or business of performing services as an employee.[61] The specified service businesses that are excluded are health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, any trade or business where the principal asset is the reputation or skill of one or more employees, or investing and investment management, trading or dealing in securities, partnership interests or commodities.[62] But there is yet another exception. Taxpayers with income from a specified service business may nonetheless qualify for the section 199A deduction with respect to such service income if the taxpayer's total *taxable* income is less than $157,500 (single) or $315,000 (married filing jointly).[63] A phase out applies if the taxpayers taxable income exceeds those thresholds. Thus an unmarried lawyer working as an associate at a law firm making $100,000 per year gets no deduction, while a self-employed lawyer earning the same amount of income would.

A partner will apply the section 199A provisions at the partner level to her allocable share of partnership items.[64]

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57 I.R.C. § 199A(b)(3) and (e)(2).

58 I.R.C. § 199A(c)(1). However, such amount does not include any qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income. Id.

59 I.R.C. § 199A(c)(3)(A).

60 I.R.C. § 199A(c)(3)(B).

61 I.R.C. § 199A(d)(1).

62 I.R.C. § 199A(d)(2).

63 I.R.C. § 199A(d)(3).

64 I.R.C. § 199A(f)(1).

CHAPTER 6: DISPOSITIONS OF PARTNERSHIP INTERESTS

§ 6.07 OPTIONAL ADJUSTMENT TO BASIS OF PARTNERSHIP PROPERTY

Add after the final paragraph

Under new I.R.C. § 743(d)(1)(B), in addition to the definition under I.R.C. § 743(d)(1)(A), 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, immediately after the transfer of the partnership interest.

> For example, a partnership of three taxable partners (partners A, B, and C) has not made an election pursuant to I.R.C. § 754. The partnership has two assets, one of which, Asset X, has a built-in gain of $1 million, while the other asset, Asset Y, has a built-in loss of $900,000. Pursuant to the partnership agreement, any gain on sale or exchange of Asset X is specially allocated to partner A. The three partners share equally in all other partnership items, including in the built-in loss in Asset Y. In this case, each of partner B and partner C has a net built-in loss of $300,000 (one third of the loss attributable to asset Y) allocable to his partnership interest. Nevertheless, the partnership does not have an overall built-in loss, but a net built-in gain of $100,000 ($1 million minus $900,000). Partner C sells his partnership interest to another person, D, for $33,333. With the amendment to I.R.C. § 743(d), the test for a substantial built-in loss applies *both* at the partnership level and at the transferee partner level. If the partnership were to sell all its assets for cash at their fair market value immediately after the transfer to D, D would be allocated a loss of $300,000 (one third of the built-in loss of $900,000 in Asset Y). Consequently, a substantial built-in loss exists under I.R.C. § 743(d)(1)B), and the partnership must give D a negative $100,000 I.R.C. § 743(b) adjustment with regard to asset Y, notwithstanding the fact that no actual I.R.C. § 754 election is in effect.[65]

B. Making the I.R.C. §754 Election

Add at the end of the section:

Proposed Regulations would remove the signature requirement for the I.R.C. § 754 election, requiring only the name and address of the partnership making the election and contain a declaration that the partnership elects under I.R.C. § 754 to apply the provisions of I.R.C. § 734(b) and I.R.C. § 743(b).[66]

Section 6.08 of the text is restated as follows:

§ 6.08 TERMINATION OF PARTNERSHIPS

I.R.C. § 708(a) provides that a partnership is considered to continue until it is terminated (it is rare, but sometimes the Code states the obvious). Under I.R.C. § 708(b)(1), for tax years beginning after December 31, 2017, a partnership is only deemed to be terminated if: (i) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in the

65 Conference Report to Accompany H.R. 1, 115 Cong. 1st Sess., Rep. 115-466, p. 512-13 (Dec. 15, 2017).

66 Prop. Reg. § 1.754-1(b)(1).

partnership form.[67] Under I.R.C. § 708(b)(1), for tax years beginning before December 31, 2017, a partnership is terminated if: (i) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in the partnership form, *or* (ii) within a 12-month period there is a sale or exchange of 50% or more of the total interest in partnership capital and profits.

A. General Rule

Under the general rules of I.R.C. § 708(b)(1)(A), the partnership is terminated if no part of any business of the partnership is carried on by any of its partners in partnership form.[68] There are two possible ways a termination might be triggered. First, it might be triggered if no part of the partnership business is carried on by any of the partners. Second, it might be triggered if the business is no longer being carried on in partnership form, even though it might be continued outside the partnership.

The Regulations interpreting I.R.C. § 708(b)(1)(A) establish a liberal approach to a finding of a business nexus sufficient to maintain a partnership. In accordance with those regulations, a partnership continues to exist even when its operations are substantially changed or reduced in a period of winding up, and even when its sole asset during that period is cash.[69] The Ninth Circuit, in affirming the Tax Court, held that no termination occurs until all the assets of a partnership are distributed to the partners and all partnership activity ends.[70]

The Regulations provide an example of a business not being continued in partnership form.

> For example, on [DATE]. A and B, each of whom is a 20-percent partner in partnership ABC, sell their interests to C, who is a 60-percent partner. Since the business is no longer carried on by any of its partners in a partnership, the ABC partnership is terminated as of [DATE].[71]

Thus, since ABC only had one partner, it could no longer be a partnership and had terminated. The Regulations caution about taking this principal too far, however. Upon the death of one partner in a 2-member partnership, the partnership will not be considered as terminated if the estate or other successor in interest of the deceased partner continues to share in the profits or losses of the partnership business.[72]

Note that if a partnership converts to a corporation, the business will not be continued by any

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67 For special rules with respect to the termination of a partnership in the case of mergers or divisions, see § 9.02.

68 Treas. Reg. § 1.708-1(b)(1).

69 Treas. Reg. § 1.708-1(b)(1). Harbor Cove Marina Partners Partnership v. Comm'r, 123 T.C. 64, 81 (2004).

70 Baker Commodities, Inc. v. Comm'r, 415 F.2d 519 [24 AFTR 2d 69-5516] (9th Cir. 1969), aff'g 48 T.C. 374 (1967) (cert. denied).

71 Treas. Reg. § 1.708(b)(1). (original dates removed).

72 Treas. Reg. § 1.708(b)(1)(i).

partner in partnership form.[73]

B. The Old Twelve-Month Rule

Under I.R.C. § 708(b)(1)(B), for tax years beginning before December 31, 2017, a partnership is terminated if within a 12-month period there is a sale or exchange of 50% or more of the total interest in partnership capital and profits.

Since there must be a sale or exchange of a 50% interest in both capital and profits during a 12-month period, a natural question is presented as to whether a sale can be structured so that less than 50% is sold within the 12-month period, and the balance is sold following the expiration of the 12-month period. In Private Rulings, the IRS has approved transactions of this type.[74]

1. What Transactions Are Taken in Account

Not all transfers of partnership interests were necessarily taken into account in determining whether the required 50% change has occurred. A sale from one partner to an existing partner is taken into account.[75] A transfer of a partnership interest by gift, bequest, or inheritance, and a liquidation of a partnership interest was not treated as a sale or exchange for purposes of I.R.C. § 708(b)(1)(B).[76] Likewise, a contribution of property to a partnership was not treated as a sale or exchange.[77]

If a sale or exchange of an interest in an upper-tier partnership results in a termination of the upper-tier partnership, the upper-tier partnership is treated as exchanging its interest in the capital and profits of the lower-tier partnership. If, however, the sale or exchange of an interest in the upper-tier partnership does not result in a termination of the upper-tier partnership, then the sale or exchange is *not* treated as a sale or exchange of a proportionate part of the upper-tier partnership's interest in the capital and profits of the lower-tier partnership.[78]

Is there a sale or exchange for purposes of I.R.C. § 708(b)(1)(B) where a partnership interest is transferred in a nontaxable transaction? The IRS has generally taken the position that as long as there is an exchange, the fact that the exchange qualifies for tax-free treatment does not prevent the transaction from being treated as an exchange for purposes of I.R.C. § 708(d)(1)(B). It has been held that a transfer of

73 Rev. Rul. 84-11, 1984-2 1970-1 C.B. 88.

74 *See* PLR 8517022 (Jan. 25, 1985); PLR 7952057 (Sept. 25, 1979).

75 Treas. Reg. § 1.708-1(b)(2).

76 *Id.*

77 *Id.*

78 *Id.*

a 50% interest in capital and profits by a partner to a corporation in a transaction which was tax-free pursuant to I.R.C. § 351 qualified as an exchange for purposes of I.R.C. § 708(b)(1)(B).[79]

In Private Rulings, the IRS has held that the transfer of a partnership interest to another partnership is an exchange for purposes of I.R.C. § 708(b)(1)(B).[80] Where a partnership interest is owned by a corporation which participates in a tax-free reorganization within the meaning of I.R.C. § 368(a) in which the assets of the corporate partner are transferred to another party to the reorganization, the IRS has held that the transfer of the partnership interest is an exchange to which I.R.C. § 708(d)(1)(B) applies.[81]

2. Transactions Deemed to Occur

Treas. Reg. § 1.708-1(b)(4) provides that if a partnership is terminated pursuant to I.R.C. § 708(b)(1)(B) as a result of a sale or exchange, the partnership is deemed to have contributed all of its assets and liabilities to a new partnership in exchange for the interests in the new partnership and to immediately thereafter distribute those interests in the new partnership to the purchasing partner and the other remaining partners, in proportion to their respective interests in the terminated partnership, in liquidation of the terminated partnership. As a result of these deemed transactions, the new partnership's basis for its assets is unchanged, as are the capital accounts of the partners.[82] Even though the assets of the old partnership may have been appreciated, no new I.R.C. § 704(c) gain is created as a result of the deemed transfer by the old partnership of its assets to the new partnership.[83] If a partnership is terminated by a sale or exchange of an interest in the partnership, an I.R.C. § 754 election (including an I.R.C. § 754 election made by the terminated partnership on its final return) that is in effect for the taxable year of the terminated partnership in which the sale occurs, applies with respect to the incoming partner.[84] Therefore, the bases of partnership assets are adjusted pursuant to I.R.C. §§ 743 and 755 prior to their deemed contribution to the new partnership. A partner with a basis adjustment in property held by a partnership that terminates under I.R.C. § 708 (b)(1)(B) will continue to have the same basis adjustment with respect to property deemed contributed by the terminated partnership to the new partnership under Treas. Reg. § 1.708-1(b)(1)(iv), regardless of whether the new partnership makes an I.R.C. § 754 election.[85] Proposed Regulations suggest that the deemed liquidation in an I.R.C. § 708(b)(1)(B) termination could also result in an adjustment if the resulting partnership makes an I.R.C. § 754 election for its first year.[86]

79 Evans v. Commissioner, 54 T.C. 40 (1970), *aff'd*, 447 F.2d 547 (7th Cir. 1971); *see also* Rev. Rul. 81-38, 1981-1 C.B. 386.

80 PLR 8116041 (Jan. 21, 1981); PLR 8229034 (Apr. 20, 1982).

81 Rev. Rul. 87-110, 1987-2 C.B. 159. The Revenue Ruling carved out an exception for those reorganizations which are described in I.R.C. § 368(a)(1)(F).

82 Treas. Reg. § 1.708-1(b)(4), example (ii); Treas. Reg. § 1.704-1(b)(2)(iv)(l).

83 Treas. Reg. § 1.708-1(b)(4), example (iii); Treas. Reg. § 1.704-3(a)(3)(i).

84 Treas. Reg. § 1.708-1(b)(5).

85 Treas. Reg. § 1.743-1(h)(1).

86 Prop. Reg. § 1.755-1(c)(2)(vi).

3. Effect of Partnership Termination

Under the I.R.C. § 708(b)(1)(B) termination rules, the new partnership retained the taxpayer identification number of the old partnership.[87]

Since the Regulations treated the old partnership as having transferred its assets to a new partnership, the new partnership should have been able to make all new tax elections, although this is not specifically stated. If the old partnership had a section 754 election in effect, if this is desired by the new partnership, prudence dictates that the new partnership make a new section 754 election.

A termination of a partnership under I.R.C. § 708(b)(1)(B) did not trigger gain recognition under either I.R.C. § 704(c)(1)(B) or 737.[88]

The principal issue which occurs with respect to a termination of a partnership under I.R.C. § 708(b)(1)(B) related to depreciation. Under I.R.C. § 168(i)(7)(A), if depreciable property is transferred to a partnership in a transaction to which I.R.C. § 721 applies, the transferee partnership steps in the shoes of the transferor with respect to depreciation. The provisions of I.R.C. § 168(i)(7)(A), however, did not apply in the case of a termination of a partnership under I.R.C. § 708(b)(1)(B). Thus, the new partnership is treated as having newly acquired the assets of the old partnership and must depreciate the basis of those assets using the appropriate life under the modified accelerated cost recovery system.

CHAPTER 8: TRANSACTIONS BETWEEN PARTNER AND PARTNERSHIP; ISSUANCE OF A PARTNERSHIP INTEREST FOR SERVICES

§ 8.08D HOLDING PERIOD FOR PARTNERSHIP INTERESTS ISSUED FOR SERVICES

A. General Rule

In general, new I.R.C. § 1061 requires a three-year holding period to qualify for long-term capital gain with respect to any applicable partnership interest held by the taxpayer.[89] For the purposes of determining the taxpayer's holding period, the rules of I.R.C. § 83 do not apply, including the election under I.R.C. § 83(b).[90]

B. Short-Term Capital Gain

I.R.C. § 1061(a) treats as short-term capital gain the amount of the taxpayer's net long-term capital gain with respect to an applicable partnership interest for the taxable year that exceeds the amount (if any) that would be long-term capital gain if a three-year (instead of a one-year) holding period applied

87 Treas. Reg. § 1.708-1(b)(4), example (ii); Treas. Reg. § 301.6109-1(d)(2)(iii)

88 Treas. Reg. §§ 1.704-4(c)(3), 1.737-2(a).

89 I.R.C. § 1061(a).

90 *Id.*

for the purposes of determining long term gain or loss.[91] Recall that short-term capital gains are commonly taxed at ordinary income rates.

C. Applicable Partnership Interest

An applicable partnership interest is any interest in a partnership that, directly or indirectly, is transferred to (or held by) the taxpayer in connection with performance of services in any applicable trade or business (defined below).[92] The services may be performed by the taxpayer or by any other related person or persons in any applicable trade or business. The legislative history indicates that is intended that partnership interests shall not fail to be treated as transferred or held in connection with the performance of services merely because the taxpayer also made contributions to the partnership.[93] An applicable partnership interest does not include an interest held by a person who is employed by another entity that is conducting a trade or business (which is not an applicable trade or business) and who provides services only to the other entity.[94]

An applicable partnership interest does not include an interest in a partnership directly or indirectly held by a "corporation," presumably including both C corporations and S corporations.95 For example, if two C corporations form a partnership to conduct a joint venture for developing and marketing a pharmaceutical product, the partnership interests held by the two corporations are not applicable partnership interests. It also appears that an individual partner in a partnership could avoid the application of I.R.C. § 1061 to his partnership interest merely by transferring the interest to an S corporation wholly owned by the individual. Many think this taxpayer-friendly outcome is unintended, as it would make it easy to avoid I.R.C. § 1061, and that by "corporation" Congress meant C corporations. If true, a near-term technical correction in this regard can be expected.

An applicable partnership interest does not include any capital interest in a partnership giving the taxpayer a right to share in partnership capital commensurate with either (i) the amount of capital contributed by the taxpayer (as of the time the partnership interest was received), or (ii) the value of the partnership interest that is taxed to the taxpayer under I.R.C. § 83 on receipt or vesting of the partnership interest.[96]

For example, if Elinore holds a capital interest in the partnership with respect to capital she contributed to the partnership, if the partnership agreement provides her with a share of partnership capital that is commensurate with the amount of capital she contributed (as of the time the partnership interest was received), Elinore's partnership interest is not an applicable partnership interest to that extent.[97]

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91 *Id.*

92 I.R.C. § 1061(c)(1).

93 Conference Report to Accompany H.R. 1, 115 Cong. 1st Sess., Rep. 115-466, p. 420 (Dec. 15, 2017).

94 I.R.C. § 1061(c)(1).

95 I.R.C. § 1061(c)(4)(A).

96 I.R.C. § 1061(c)(4)(B).

97 Conference Report to Accompany H.R. 1, 115 Cong. 1st Sess., Rep. 115-466, p. 420 (Dec. 15, 2017).

D. Applicable trade or business

An applicable trade or business means any activity conducted on a regular, continuous, and substantial basis that consists, in whole or in part, of: (1) raising or returning capital, *and either* (2) investing in (or disposing of) specified assets (or identifying specified assets for investing or disposition), or (3) developing specified assets.[98]

The legislative history indicates that developing specified assets takes place, for example, if it is represented to investors, lenders, regulators, or others that the value, price, or yield of a portfolio business may be enhanced or increased in connection with choices or actions of a service provider or of others acting in concert with or at the direction of a service provider.[99]

E. Specified Assets

"Specified assets" means securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing, as well as an interest in another partnership to the extent of the partnership's proportionate interest in the foregoing.[100]

A partnership interest in another partnership is treated as a specified asset even if the partnership interest is not otherwise treated as a security for purposes of I.R.C. § 1061.[101] For example, assume that a hedge fund acquires an interest in an operating business conducted in the form of a non-publicly traded partnership that is not widely held; the partnership interest is a specified asset for purposes of the provision.[102]

I.R.C. § 1061 can yield results that some would find surprising. For example, if Wolfgang receives an interest in a partnership solely in exchange for raising funds for and supervising the construction of an apartment building for the partnership, Wolfgang holds an applicable partnership interest.

CHAPTER 12: FOREIGN PARTNERSHIPS, FOREIGN PARTNERS, AND PARTNERSHIPS WITH TAX-EXEMPT ENTITIES

§ 12.02 FOREIGN PARTNERSHIPS

C. Controlled Foreign Corporations as Partners in Foreign Partnerships

The first full sentence at the top of page 393 is replaced with the following:

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98 I.R.C. § 1061(c)(2).

99 Conference Report to Accompany H.R. 1, 115 Cong. 1st Sess., Rep. 115-466, p. 421 (Dec. 15, 2017).

100 I.R.C. § 1061(c)(3).

101 Conference Report to Accompany H.R. 1, 115 Cong. 1st Sess., Rep. 115-466, p. 421 (Dec. 15, 2017).

102 Conference Report to Accompany H.R. 1, 115 Cong. 1st Sess., Rep. 115-466, p. 421-22 (Dec. 15, 2017).

A "U.S. shareholder" for these purposes is a shareholder that owns or is considered as owning 10 percent or more of the total combined voting power of all classes of stock of the relevant foreign corporation or 10 percent or more of the total value of shares of all classes of stock of such foreign corporation.

F. Transfers to Partnerships with Related Foreign Partners

1. General Rules

In Chapter 2 we discussed the general rule under I.R.C. § 721(a) that a transfer to partnership in exchange for a partnership interest does not result in gain or loss to the partnership or the contributing partner. Treas. Reg. § 1.721(c)–2T provides a rule that overrides I.R.C. § 721(a) nonrecognition of gain upon a contribution of I.R.C. § 721(c) property to a partnership. In general, I.R.C. § 721(c) property is property with built-in gain that is contributed to a partnership by a U.S. transferor.[103] Cash equivalents, securities, tangible property with a book value that exceeds the adjusted tax basis by no more than $20,000, and an interest in a partnership in which 90 percent or more of the property (measured by value) held by the partnership (directly or indirectly) is excluded from the meaning of "I.R.C. § 721(c) property".[104]

Except as allowed under the gain deferral method, described below, Treas. Reg. § 1.721(c)–2T(b) provides that nonrecognition under I.R.C. § 721(a) will not apply to gain realized upon a contribution of I.R.C. § 721(c) property to an I.R.C. § 721(c) partnership. An I.R.C. § 721(c) partnership is any U.S. or non-U.S. partnership if there is a contribution of I.R.C. § 721(c) property to the partnership and after the contribution and all transactions related to the contribution, (a) a non-U.S. person related to the U.S. transferor is a direct or indirect partner in the partnership and (b) the U.S. transferor and related persons own 80 percent or more of the interests in partnership capital, profits, deductions, or losses.[105] Nonrecognition under I.R.C. § 721(a) continues to apply—to a direct contribution of I.R.C. § 721(c) property by an ''unrelated'' U.S. transferor (in other words, a U.S. transferor that does not, together with related persons with respect to it, satisfy the ownership requirement).

Treas. Reg. § 1.721-1(c)–2T(c) provides a de minimis exception to the general rule. Under the de minimis exception in the temporary Regulations, contributions of I.R.C. § 721(c) property will not be subject to immediate gain recognition if the sum of all built-in gain for all I.R.C. § 721(c) property contributed to a I.R.C. § 721(c) partnership during the partnership's taxable year does not exceed $1 million.

I.R.C. § 1.721(c)–2T(d)(1) provides a look-through rule for identifying an I.R.C. § 721(c) partnership when an upper-tier partnership in which a U.S. transferor is a direct or indirect partner contributes property to a lower-tier partnership. For purposes of determining if the lower-tier partnership is a I.R.C. § 721(c) partnership, the U.S. transferor will be treated as contributing to the lower-tier partnership its share of the property actually contributed by the upper-tier partnership to the lower-tier partnership. If the lower-tier partnership is an I.R.C. § 721(c) partnership, absent application of the gain deferral method by the lower-tier partnership to the entire property and by the upper-tier partnership to the partnership interest in the lower-tier partnership, the upper- tier partnership will recognize the entire built-

103 Treas. Reg. § 1.721(c)-1T(a)(15).

104 Treas. Reg. § 1.721(c)-1T(a)(6).

105 Treas. Reg. § 1.721(c)-1T(a)(14).

in gain in the I.R.C. § 721(c) property under the general gain recognition rule, because the entire property will be I.R.C. § 1.721(c) property.

2. Gain Deferral Method

Treas. Reg. § 1.721(c)–3T describes the gain deferral method, which generally must be applied in order to avoid the immediate recognition of gain upon a contribution of I.R.C. § 721(c) property to an I.R.C. § 721(c) partnership. There are five general requirements under Treas. Reg. § 1.721(c)–3T(b) for applying the gain deferral method to an item of section 721(c) property. First, the I.R.C. § 721(c) partnership must adopt the remedial allocation method for the purposes of I.R.C. § 704(c) and allocate I.R.C. § 704(b) items of income, gain, loss, and deduction with respect to the I.R.C. § 721(c) property in a manner that satisfies the consistent allocation method, described below. Second, the U.S. transferor must recognize gain equal to the remaining built-in gain with respect to the I.R.C. § 721(c) property upon an acceleration event, or an amount of gain equal to a portion of the remaining built-in gain upon a partial acceleration event or certain transfers to foreign corporations described in I.R.C. § 367. Third, certain procedural and reporting requirements are satisfied. Fourth, the U.S. transferor extends the period of limitations on assessment of tax. Fifth, the rules for tiered partnerships are also applied.

Treas. Reg. § 1.721(c)–3T(c)(1) describes the consistent allocation method, which, like the gain deferral method, applies on a property-by-property basis. The consistent allocation method requires an I.R.C. § 721(c) partnership to allocate the same percentage of each book item of income, gain, deduction, and loss with respect to the I.R.C. § 721(c) property to the U.S. transferor.

3. Acceleration Events

Treas. Reg. § 1.721(c)–4T provides rules regarding acceleration events, which, like the gain deferral method, apply on a property-by-property basis. When an acceleration event occurs with respect to I.R.C. § 721(c) property, remaining built-in gain in the property must be recognized and the gain deferral method no longer applies. An acceleration event with respect to I.R.C. § 721(c) property is any event that either would reduce the amount of remaining built-in gain that a U.S. transferor would recognize under the gain deferral method if the event had not occurred or could defer the recognition of the remaining built-in gain.[106] An acceleration event includes a contribution of I.R.C. § 721(c) property to another partnership by an I.R.C. § 721(c) partnership and a contribution of an interest in an I.R.C. § 721(c) partnership to another partnership.

§ 12.03 U.S. PARTNERSHIPS WITH FOREIGN PARTNERS

E. Disposition of Interests in U.S. Partnership by Non-U.S. Persons.

Add at the end of the section:

The Tax Court concluded in 2017 that Rev. Rul. 91-32 is invalid,[107] allowing a non-U.S. person to dispose of a partnership interest in a partnership that was engaged in a U.S. trade or business without the income on the disposition being treated as income effectively connected with a U.S. trade or business through an office in the United States. However, for dispositions of partnership interests after November 27, 2017, I.R.C. § 864(c)(8) would effectively frustrate the conclusion of *Grecian Magnesite*. In addition,

106 Treas. Reg. § 1.721(c)-4T(b).

107 Grecian Magnesite Mining v. Commissioner, 149 T.C. No. 3 (2017),

the new provision requires withholding on the payments for the partnership interest for dispositions after December 31, 2017.

Under I.R.C. § 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. The provision requires that any gain or loss from the hypothetical asset sale by the partnership be allocated to interests in the partnership in the same manner as nonseparately stated income and loss. This portion of the provision applies to dispositions of partnership interests after November 27, 2017.

As a result of I.R.C. § 864(c)(8), non-U.S. partners would be subject to a return filing requirement in the United States from the disposition of the partnership interest, and, potentially be subject to tax in the United States.[108]

I.R.C. § 1446(f) also requires the transferee of a partnership interest to withhold 10 percent of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that the transferor is not a nonresident alien individual or foreign corporation. 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. The statutory language indicates that the provision is effective for dispositions of partnership interests after December 31, 2017. However, the IRS has indicated that it will defer application of I.R.C. § 1446(f) in respect of a disposition of an interest in a publicly traded partnership until Regulations or other guidance is issued.[109]

Section 12.09 is renumbered as 12.10 and new 12.09 inserted as follows:

§ 12.09 HYBRID TRANSACTIONS AND HYBRID ENTITIES

I.R.C. § 267A denies a deduction for any disqualified related party amount paid or accrued pursuant to a hybrid transaction or by, or to, a hybrid entity. A disqualified related party amount is any interest or royalty paid or accrued to a related party to the extent that: (1) such amount is not included in the income of the related party under the tax law of the country of which such related party is a resident for tax purposes or is subject to tax,[110] or (2) such related party is allowed a deduction with respect to such amount under the tax law of such country.[111] A disqualified related party amount does not include any payment to the extent such payment is included in the gross income of a U.S. shareholder under I.R.C. § 951(a).[112] A related party for these purposes is determined under the rules of I.R.C. § 954(d)(3), except that such section applies with respect to the payor of the payment that is being tested as a potential hybrid transaction as opposed to the CFC otherwise referred to in such section.

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108 Treas. Reg. § 1.6012-1, -2.

109 Notice 2018-8, 2018-4 IRB (Jan. 2, 2018).

110 I.R.C. § 267A(b)(1)(A).

111 I.R.C. § 267A(b)(1)(B).

112 See discussion of controlled foreign corporations in § 12.02 C.

A hybrid transaction is any transaction, series of transactions, agreement, or instruments, one or more payments with respect to which are treated as interest or royalties for U.S. federal income tax purposes and which are not so treated for purposes of the tax law of the non-U.S. country of which the recipient of such payment is resident for tax purposes or is subject to tax.[113] This could occur when the instrument itself is treated as debt for U.S. tax purposes but treated as equity for purposes of the jurisdiction in which the related party is tax resident.[114] It could also occur when the U.S. tax system deems payments to include interest, such as occurs with a notional principal contract with substantial non-periodic payments, but the jurisdiction in which the related party is tax resident treats the instrument according to its terms.[115]

A hybrid entity is any entity which is either: (1) treated as fiscally transparent for U.S. federal income tax purposes but not so treated for purposes of the tax law of the non-U.S. country of which the entity is resident for tax purposes or is subject to tax, or (2) treated as fiscally transparent for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or is subject to tax but not so treated for U.S. federal income tax purposes.[116]

I.R.C. § § 267A further provides that the Treasury will issue guidance as may be necessary to carry out the purposes of the provision, including Regulations or other guidance providing rules for: (1) denying deductions for conduit arrangements that involve a hybrid transaction or a hybrid entity, (2) the application of this provision to branches or domestic entities, (3) applying I.R.C. § 267A to certain structured transactions, (4) denying a deduction claimed for interest or a royalty that is included in the recipient's income under a preferential tax regime of the country of residence of the recipient and has the effect of reducing the country's generally applicable statutory tax rate by at least 25 percent, (5) denying all of a deduction claimed for an interest or a royalty payment if such amount is subject to a participation exemption system or other system which provides for the exclusion or deduction of a substantial portion of such amount, (6) rules for determining the tax residence of a foreign entity if the foreign entity is otherwise considered a resident of more than one country or of no country, (7) exceptions to the general rule, and (8) requirements for record keeping and reporting.[117]

113 I.R.C. § 267A(c).

114 See, e.g., Hewlett-Packard Co. & Consolidated Subsidiaries v. Commissioner, T.C. 2012-135, aff'd, 120 AFTR 2d 2017-6542 (investment in the form of preferred stock recharacterized as debt).

115 See Treas. Reg. § 1.446-3(f)(2)(iii)(B).

116 I.R.C. § 267A(d).

117 I.R.C. § 267A(e).

ERRATA

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The reference to "1.1245(f)" should be deleted.