PARTNERSHIP TAXATION

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to
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RICHARD M. LIPTON, ESQ.

Partner, Baker & McKenzie LLP

PAUL CARMAN, ESQ.

Partner, Chapman and Cutler LLP

ROSS D. COHEN, ESQ.

Partner, Bingham Greenebaum Doll LLP

WALTER D. SCHWIDETZKY

Professor of Law

University of Baltimore School of Law

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Includes relevant changes made by the Tax Cuts and Jobs Act of 2017 and relevant Proposed and Final Regulations released in 2018 and Winter of 2019.

PARTNERSHIP TAXATION

ADDITIONS, SUBSTITUTIONS 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 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

1 Treas. Reg. § 1.7704-1(c)(1).
2 Treas. Reg. § 1.7704-1(c)(2).
3 Treas. Reg. § 301.7701(i)-1(c)(5)(ii)(C).

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 an investment trust described in Treas. Reg. § 301.7701-4(c).

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]

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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).
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).

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 unless certain conditions are met.[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 Rev. Rul. 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 Rev. Rul. 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 Rev. Rul. 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 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]

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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).

18 Treas. Reg. § 301.7701-4(c)(1).

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

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

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

§ 2.02 TRANSFERS OF PROPERTY TO PARTNERSHIP

E. Stock of Corporate Partners

If a corporation transfers its own stock to a partnership in exchange for a partnership interest, it is clear that the stock is treated as property for purposes of I.R.C.§ 721. On the basis of the rules of Subchapter K, alone, one would expect the corporation to have nonrecognition on the transaction.

However, if a partnership engages in an I.R.C. § 337(d) transaction, the corporate partner must recognize gain.[20] Under the Regulations, an I.R.C. § 337(d) transaction may occur if (i) a corporate partner contributes appreciated property to a partnership that owns stock of the corporate partner; (ii) a partnership acquires stock of the corporate partner, (iii) a partnership that owns stock of a corporate partner distributes appreciated property to a partner other than the corporate partner, (iv) a partnership distributes stock of a corporate partner to the corporate partner, or (v) a partnership agreement is amended in a manner that increases a corporate partner's interest in the stock of the corporate partner.[21] So, although a corporation's transfer of its own stock to a partnership may qualify for I.R.C. § 721 treatment, it is still required to recognize gain under I.R.C. § 337(d).

20 Treas. Reg. § 1.337(d)-3(d)(1).
21 Treas. Reg. § 1.337(d)-3(c)(3).

The amount of gain the corporate partner recognizes equals the product of the corporate partner's gain percentage[22] and the gain from the appreciated property that is the subject of the exchange that the corporate partner would recognize if, immediately before the I.R.C. § 337(d) Transaction, all assets of the partnership and any assets contributed to the partnership in the I.R.C. § 337(d) Transaction were sold in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account I.R.C. § 7701(g)), reduced, but not below zero, by any gain the corporate partner is required to recognize with respect to the appreciated property in the I.R.C. § 337(d) Transaction under any other provision of the Code.[23] This gain is computed taking into account allocations of tax items applying the principles of I.R.C. § 704(c), including any remedial allocations under Treas. Reg. § 1.704-3(d), and also taking into account any basis adjustments including adjustments made pursuant to I.R.C. § 743(b).

The basis of the corporate partner's interest in the partnership is increased by the amount of gain recognized.[24] Similarly, the partnership's basis in the stock contributed is increased by the amount of gain that the corporate partner recognized.[25]

§ 2.03 Transfers to Investment Companies

B. Table

I.R.C. § 721(b) Transfers to Investment Companies	
Background	To qualify as tax-free under I.R.C. § 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.

22 The gain percentage is the fraction, (i) the numerator of which is the corporate partner's interest in appreciated property effectively exchanged, and (ii) the denominator is the corporate partner's interest in appreciated property before the exchange. Treas. Reg. § 1.337(d)-3(c)(4).

23 Treas. Reg. § 1.337(d)-3(d)(3)(i).

24 Treas. Reg. § 1.337(d)-3(d)(4)(i).

25 Treas. Reg. § 1.337(d)-3(d)(4)(ii).

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.[26]

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."[27] 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.[28] 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

26 Rev. Rul. 88-77, 1988-2 C.B. 128.
27 Treas. Reg. § 1.451-1(a).
28 I.R.C. § 451(b)(1)(C); Treas. Reg.§ 1.451-1(a).

obligations, the provision requires the taxpayer to allocate the transaction price in accordance with the allocation made in the taxpayer's applicable financial statement.[29]

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.[30]

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.[31] 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.[32] The provision requires the inclusion in gross income of a deferred advance payment if the taxpayer ceases to exist.[33]

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 (A) or (B).[34] 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.[35]

§ 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.[36] Such losses are carried forward and treated as part of the taxpayer's net operating loss ("NOL") carryforward in subsequent taxable years.[37] NOL carryovers generally are allowed for a taxable year up to the lesser of the carryover amount or 80% of taxable income determined without regard to the deduction for NOLs.[38]

29 I.R.C. § 451(b)(4).
30 I.R.C. § 451(b)(2).
31 2004-22 I.R.B. 991.
32 I.R.C. § 451(c).
33 I.R.C. § 451(c)(3).
34 I.R.C. § 451(b)(3).
35 I.R.C. § 451(b)(5).
36 I.R.C. § 461(l).
37 I.R.C. § 461(l)(2).
38 I.R.C. § 172(a).

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.[39] 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.[40] 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.[41] 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.[42]

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.[43] For taxable years beginning after 2017, a new limitation may apply for net business interest expense.

The deduction for business interest is limited to the sum of (1) business interest income; (2) 30% of the adjusted taxable income ("ATI") of the taxpayer for the taxable year; and (3) the floor plan financing interest of the taxpayer for the taxable year.[44] 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.[45] The limitation applies at the taxpayer level.

Business interest means any interest paid or accrued on indebtedness properly allocable to a trade or business.[46] In general, any amount treated as interest for purposes of the Code is interest for purposes of the provision. Under this definition, interest would include not only stated interest on traditional debt instruments, but would also include any amount treated as interest, such as original issue discount, accrued market discount, and amounts with respect to an integrated transaction.[47]

In addition, Proposed Regulations treat as interest certain amounts that are closely related to interest and that affect the economic yield or cost of funds of a transaction involving interest, but that may not be compensation for the use or forbearance of money on a stand-alone basis. Bond premium, income, deduction, gain, or loss from a transaction used to hedge an interest bearing asset or liability, a substitute interest payment made under a securities lending or a sale-repurchase transaction, certain commitment fees,

39 I.R.C. § 461(l)(3).
40 I.R.C. § 461(l)(3)(B).
41 I.R.C. § 461(l)(4).
42 I.R.C. § 461(l)(6).
43 I.R.C. § 163.
44 I.R.C. § 163(j)(1).
45 I.R.C. § 163(j)(2).
46 I.R.C. § 163(j)(5).
47 Prop. Reg. § 1.163(j)-1(b)(2)(i).

certain debt issuance costs, guaranteed payments from partnerships, and factoring income would be included as interest.[48]

The Proposed Regulations treat a swap (other than a cleared swap) with significant nonperiodic payments as two separate transactions consisting of an on-market, level payment swap and a loan.[49] The loan would be accounted for by the parties to the contract independently of the swap. The time value component associated with the loan would be recognized as interest expense to the payor and interest income to the recipient.

A "cleared swap" is a swap that is cleared by a derivatives clearing organization or a clearing agency, if the derivatives clearing organization or clearing agency requires the parties to post and collect margin or collateral.[50] The treatment of cleared swaps is reserved under the Proposed Regulations. Business interest expense does not include interest expense that is permanently disallowed by another provision of the Code.[51] Also, business interest expense that is deferred or suspended by another provision of the Code is treated as business interest expense in the year in which the expense is no longer deferred or suspended.[52]

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).[53]

ATI 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.[54]

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% of adjusted taxable income.[55]

In the case of any partnership, the limitation is first 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.[56] A partner cannot include the partner's share of the partnership's business interest income for a taxable year except to the extent of the partner's share of the excess of (i) the partnership's business interest income over (ii) the partnership's business interest expense (not including floor plan financing).[57]

48 Prop. Reg. § 1.163(j)-1(b)(20)(iii)
49 Prop. Reg. § 1.163(j)-1(b)(20)(ii).
50 Prop. Reg. § 1.163(j)-1(b)(5).
51 Prop. Reg. § 1.163(j)-3(b)(2).
52 Prop. Reg. § 1.163(j)-3(b)(3).
53 I.R.C. § 163(j)(6).
54 I.R.C. § 163(j)(8).
55 I.R.C. § 163(j)(1).
56 I.R.C. § 163(j)(4)(A)(i).
57 Notice 2018-28, 2018-16 IRB 492 (April 2, 2018).

The ATI of each partner is determined without regard to such partner's distributive share of the nonseparately stated income or loss of such partnership.[58] In the absence of such a rule, the same dollars of ATI 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% of adjusted taxable income, that is, 30% * $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 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% * $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% * $0 = $0, resulting in a deduction disallowance of the entire $25 interest expense.[59]

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 ATI limitation.[60] However, a partner cannot include such partner's share of the partnership's floor plan financing interest in determining the partner's annual business interest expense deduction limitation.[61]

Proposed Regulations provide that the manner for allocating excess taxable income, excess business interest income and excess business interest expense must be consistent with the resolution of the following issues: (1) I.R.C. § 163(j) is applied at the partnership level; (2) a partnership cannot have both excess taxable income (or excess business interest income) and excess business interest expense in the same taxable year; (3) parity must be preserved between a partnership's deductible business interest expense and I.R.C. § 163(j) excess items and the aggregate of each partner's share of deductible business interest expense and I.R.C. § 163(j) items from such partnership; (4) if in a given year a partnership has both deductible business interest expense and excess business interest expense, a partnership should not allocate excess business interest expense to a partner to the extent such partner was allocated the items comprising ATI (or business interest income) that supported the partnership's deductible business interest expense; and (5) if in a given year a partnership has excess taxable income (or excess business or interest income), only partners allocated more items comprising ATI (or business interest income) than necessary to support their allocation of business interest expense should be allocated a share of excess taxable income (or excess business interest income).[62]

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.[63]

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58 I.R.C. § 163(j)(4)(A)(ii)(I).
59 Conference Report to Accompany H.R. 1, 115 Cong. 1st Sess., Rep. 115-466, p. 388 (Dec. 15, 2017).
60 I.R.C. § 163(j)(4)(A)(ii)(II).
61 Notice 2018-28.
62 REG-106089-18, 83 CFR 67490 (December 28, 2018).
63 I.R.C. § 163(j)(2).

The ATI 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.[64]

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.[65] 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?

Proposed Regulations would establish an 11-step method of determining a partner's share of a business interest deduction from a partnership.

(i) First, a partnership must determine its I.R.C. § 163(j) limitation.

(ii) Second, a partnership must determine each partner's allocable share of each I.R.C. § 163(j) item under I.R.C. § 704(b) and I.R.C. § 704(c), other than remedial items. Only items that were actually taken into account in the partnership's I.R.C. § 163(j) calculation are taken into account in determining each partner's allocable share.

(iii) Third, a partnership must compare each partner's allocable business interest income to such partner's allocable business interest expense. To the extent a partner's allocable business interest income exceeds its allocable business interest expense, the partner has an allocable business interest income excess. To the extent a partner's allocable business interest expense exceeds its allocable business interest income, the partner has an allocable business interest income deficit.

(iv) Fourth, a partnership must determine each partner's final allocable business interest income excess. A partner's final allocable business interest income excess is determined by reducing, but not below zero, such partner's allocable business interest income excess, if any, by the product of the total allocable business interest income deficit of the partners in the partnership and the ratio of such partner's allocable business interest income excess to the total allocable business interest income excess.

(v) Fifth, a partnership must determine each partner's remaining business interest expense.

(vi) Sixth, a partnership must determine each partner's final allocable ATI.

(vii) Seventh, a partnership must compare each partner's ATI capacity to such partner's remaining business interest expense. A partner's ATI capacity is 30% of such partner's final allocable ATI.

(viii) Eighth, a partnership must determine if it is required to make any adjustments to a partner's ATI.

(ix) Ninth, a partnership must determine each partner's final ATI capacity excess. A partner's final ATI capacity excess amount is determined by reducing, but not below zero, such partner's ATI capacity excess, if any, by the product of the total ATI capacity deficit and the ratio of such partner's ATI capacity excess to the total ATI capacity excess.

(x) Tenth, a partnership must determine each partner's final ATI capacity deficit.

(xi) Eleventh, a partnership must allocate I.R.C. § 163(j) excess items and deductible business interest expense to its partners.[66]

The ATI of a partner is determined first without regard to such partner's distributive share of any items from the partnership and is increased by the partner's distributive share of the partnership's excess

64 I.R.C. § 163(j)(4).

65 I.R.C. § 163(j)(7)(B).

66 Prop. Reg. § 1.163(j)-6(f)(2).

taxable income determined under the 11-step program described above.[67] If a partner is allocated remedial or basis items, such partner's ATI is increased or decreased by the amount of such items.[68]

If a partner recognizes gain or loss upon the disposition of interests in a partnership, and the partnership which is sold only only trade or business business assets the income in respect of which would be included in ATI, the gain or loss on the disposition of the partnership interest is included in the partner's ATI.[69]

§ 4.09 PARTNERSHIP LEVEL LIABILITY ON AUDITS

Replace the second and third to last sentences with:

Partnerships that have another partnership, a disregarded entity or a trust as a partnership may not opt out.[70] It is not uncommon for family paratnerships, including relatively small ones, to have partnerships, disregarded entities or trusts as partners.

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

I.R.C. § 199A, created by the 2017 Tax Cuts and Jobs Act (TCJA), allows many individuals, trusts and estates owning sole proprietorships, partnerships, or S corporations to deduct up to 20 percent of their qualified business income. The IRS has issued final I.R.C. § 199A Regulations and a corrected version implementing the new qualified business income (QBI) deduction (the I.R.C. § 199A deduction).[71] Concurrently the IRS released three related guidance items: (i) proposed I.R.C. § 199A Regulations, (addressing the treatment of previously suspended losses and the treatment of real estate investment trust (REIT) dividends flowing through a Registered Investment Company (RIC)),[72] (ii) Notice 2019-07 (new safe harbor to define rental real estate trade or business) and (iii) Rev. Proc. 2019-11 (providing three methods for calculating W-2 wages).

The I.R.C. § 199A deduction is available in tax years beginning after Dec. 31, 2017, meaning eligible taxpayers will be able to claim it for the first time on their 2018 Form 1040. The I.R.C. § 199A deduction expires in 2026.[73] The I.R.C. § 199A deduction applies to individuals and certain trusts with qualified business income earned directly or through pass-through entities. Eligible taxpayers can also deduct 20% of their qualified real estate investment trust (REIT) dividends and publicly traded partnership income. The QBI deduction has additional restrictions for high-earning taxpayers with taxable income above $315,000 for joint returns and $157,500 for other filers. For high-earning taxpayers, the QBI deduction is capped at the greater of 50% of W-2 wages paid; or 25% of W-2 wages plus 2.5% of the unadjusted basis, immediately after acquisition ("UBIA"), of all depreciable qualified property used in the eligible trade or business.

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67 Prop. Reg. § 1.163(j)-6(e)(1).
68 Prop. Reg. § 1.163(j)-6(e)(2).
69 Prop. Reg. § 1.163(j)-6(e)(3).
70 Treas. Reg. § 301.6221(b)-1(b)(3)(ii).
71 TD 9847, 84 Fed. Reg. 2952 (Feb. 8, 2019).
72 REG-134652-18 (January 18, 2019).
73 I.R.C. § 199A(i).

Thus, 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 QBI amount or (b) 20% 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% of the aggregate amount of qualified cooperative dividends or (b) taxable income reduced by net capital gain.[74]

The combined QBI amount is further defined by another formula. The combined QBI 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% of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income for the taxable year.[75] The income/wage amount with respect to each qualified trade or business is the *lesser* of (1) 20% of the taxpayer's QBI with respect to such qualified trade or business or (2)[76] the *greater* of (a) 50% of the W-2 wages with respect to the qualified trade or business or (b) the sum of (i) 25% of the W-2 wages with respect to the qualified trade or business plus (ii) 2.5% of the unadjusted basis immediately after the acquisition of all qualified property (mainly, tangible, depreciable, personal and real property).[77] The objective of the 50% 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% W-2 wage plus 2.5% of adjusted basis) was added by the Conference Committee late in the process as part of reconciliation, which extends the benefits of I.R.C. § 199A to owners of businesses with large holdings of "qualified property" (e.g., real estate) having few or even no employees.

QBI is the net amount of qualified items of income, gain, deduction and loss from any qualified trade or business.[78] Only items included in taxable income are counted. Items such as capital gains and losses, C corporation dividends, and interest income are excluded from QBI.[79] In addition, the items must be effectively connected with a U.S. trade or business.[80] A qualified trade or business is any trade or business, except for any specified service trade or business (SSTB),[81] which includes a trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, investing and investment management, trading, dealing in certain assets or any trade or business where the principal asset is the reputation or skill of one or more of its employees.[82] The SSTB limitation does not apply if a taxpayer's taxable income is below $315,000 for a married couple filing a joint return, or $157,500 for all other taxpayers.[83] If a taxpayer's taxable income is above the $315,000/$157,500 thresholds, the deduction may be limited based on whether the taxpayer's business is an SSTB, the W-2 wages paid by the business, and the unadjusted basis of certain property used by the business. These limitations are phased in for joint filers with taxable income between $315,000 and $415,000, and all other taxpayers with taxable income between $157,500 and $207,500. These threshold amounts and phase-in ranges are for tax year 2018 and will be adjusted for inflation in subsequent years.[84] For taxpayers with taxable income in excess of the phase-in range, a trade or business' characterization as an SSTB excludes the trade or business from being treated as a qualified trade or business.

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74 I.R.C. § 199A(a).
75 I.R.C. § 199A(b)(1).
76 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), subject to a cost of living adjustment. 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).
77 I.R.C. § 199A(b)(6).
78 I.R.C. § 199A(c)(1).
79 I.R.C. § 199A(c)(3)(B).
80 I.R.C. § 199A(c)(3)(A)(i).
81 I.R.C. § 199A(d)(1)(A).
82 I.R.C. § 199A(d)(2).
83 I.R.C. § 199A(d)(3).
84 I.R.C. § 199A(e)(2)(B).

The Proposed Regulations allowed taxpayers to aggregate trades or businesses.[85] Aggregation is allowed (but not required) if certain criteria are met, providing some flexibility to taxpayers. Aggregation allows taxpayers to treat multiple trades or businesses as a single trade or business for purposes of applying the wage and qualified property limitations. To aggregate multiple trades or businesses each trade or business must independently qualify as a trade or business, and there must be 50% or more ownership (directly or indirectly) of each trade or business to be aggregated by the same person or group of persons. Further, no trade or business may be a SSTB, and trades or businesses must be integrated.[86] Trades or businesses are integrated if at least two of the following factors exist (1) the trades or businesses provide products and services that are the same or customarily offered together; (2) the trades or businesses share facilities or share significant centralized business elements; and (3) the trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group.[87]

The Proposed Regulations provided a de minimis rule pursuant to which a trade or business (determined before the application of the aggregation rules) is not an SSTB if its gross receipts in a taxable year are $25 million or less and less than 10% of its gross receipts is attributable to the performance of services in an SSTB (including activities incident to the performance of those services), or its gross receipts in a taxable year are more than $25 million and less than 5% of its gross receipts is attributable to the performance of services in an SSTB (including activities incident to the performance of those services). These rules provided essentially a “cliff effect”: if a taxpayer’s receipts from banned services for a business that has less than $25 million of gross receipts is 11%, then none of the income from that business is allowed to use the I.R.C. § 199A deduction.

The final Regulations continue to use the I.R.C. § 162 standard for defining a trade or business, specifically declining to use the more liberal concepts under I.R.C. § 469. The Preamble observes that this fact-specific inquiry is guided by case law requiring (i) profit motive, and (ii) scope of the activities that is "considerable, regular, and continuous."[88] The Preamble also observes that if a taxpayer is reporting a business as an I.R.C. § 162 business under I.R.C. § 199A, the taxpayer should be consistent with other tax reporting such as reporting for Treas. Reg. § 301.7701-1(a)(2) (making it difficult for a tenancy in common interest to claim trade or business status) and I.R.C. § 6041 (ensuring consistent compliance with reportable payment rules for trades or businesses).[89]

The new guidance provide for a safe harbor to determine when rental real estate activities rise to the level of a trade or business. Notice 2019-7 provides a limited safe harbor for real estate rentals (other than triple-net leases) involving over 250 annual rental service hours (starting in 2023 the 250 hours can be satisfied for 3 out of the past 5 years). Rental services may be performed by owners or by employees, agents, and/or independent contractors of the owners. The safe harbor requires that the taxpayer maintain separate books and records for the rental business and contemporaneous hours logs including (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services. Also, qualifying rental service hours do not include financial or investment management activities, such as arranging financing; procuring property; studying and reviewing financial statements or reports on operations; planning, managing, or constructing long-term capital improvements; or hours spent traveling to and from the real estate.

85 Prop. Reg. § 1.199A-4.
86 Prop. Reg. § 1.199A-4(b).
87 Prop. Reg. § 1.199A-4(b)(1)(v).
88 TD 9847, 84 Fed. Reg. at 2954.
89 *Id.* at 2956.

In determining whether a rental real estate activity is an I.R.C. § 162 trade or business, relevant factors might include, but are not limited to (i) the type of rented property (commercial real property versus residential property), (ii) the number of properties rented, (iii) the owner's or the owner's agents day-to-day involvement, (iv) the types and significance of any ancillary services provided under the lease, and (v) the terms of the lease (for example, a net lease versus a traditional lease and a short-term lease versus a long-term lease).

The final Regulations clarify that to have businesses be considered separate, they must have a complete and separate set of books and records for each separate business. However, the Regulations also observe that a trade or business can generally not be conducted through multiple entities (although looking through disregard entities), and therefore suggest that the optional aggregation rules is the method taxpayers must use to combine multiple trades or businesses across multiple entities.

The final Regulations continued the same aggregation framework that was in the Proposed Regulations, although now expands the scope to aggregation to allow partnerships and S corporations to report multiple trades or businesses on a combined basis. Aggregation requires a 50% or more related ownership (now clarified to be tested under traditional I.R.C. § 267(b) and 707(b) principles) and requires the satisfaction of 2 out of 3 of the following prongs:

> (A) Offered/sold together. The trades or businesses provide products, property, or services that are the same or customarily offered together.
> (B) Shared business infrastructure. The trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources.
> (C) Coordinated/interdependent operations. The trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group (for example, supply chain interdependencies).[90]

The final Regulations helpfully added "property" to the first prong to more clearly allow application to real estate, and two new real estate examples demonstrate that the IRS views commercial and residential real estate to be different enough as to not satisfy the first prong. The net result of retaining the 50% common ownership requirement and the strict 3 prong test is that aggregation will be mostly limited to more traditional controlled subsidiary relationships. Partnerships with different capital partners, even if controlled by the same general partner, will not typically be aggregated.

The final Regulations reversed course and do not reduce UBIA in a tax-free transaction such as an I.R.C. § 1031 like-kind exchange or an I.R.C. § 721 transfer of property to a partnership. The Regulations provide UBIA adjustments for items like receipt of boot, although the specific mechanics may need some further refinement. Similarly, the final Regulations conclude that basis in depreciable property under I.R.C. § 743(b) upon the acquisition of a partnership interest creates UBIA to the extent the adjustment is not duplicative of UBIA inside the partnership (providing that the qualified portion of the I.R.C. § 743(b) adjustment is the adjustment that would result if the inside basis of the partnership assets is equal to the UBIA basis the partnership is using for I.R.C. § 199A purposes). Although helpful, this formula fails to recognize that the amortization period for the new I.R.C. § 743(b) UBIA has a longer life than the UBIA inside the partnership, thus still causing a detriment to the purchasing partner for the period after the inside UBIA depreciable life ends. Further, an example shows how a negative I.R.C. § 743(b) adjustment can lower net UBIA.

90 Treas. Reg. § 1.199A-4(b)(1)

The I.R.C. § 199A deduction is calculated based on the lower of 20% of QBI or the "W-2 wages/qualified property limitation." The proposed Regulations expanded upon these items and clarified a number of questions that emerged from the initial I.R.C. § 199A language. The final Regulations confirmed that W-2 wages are not reduced by elective deferrals (such as retirement plan deferrals). New Rev. Proc. 2019-11 provides three alternative methods for computing W-2 wages, including a simplified method. In conjunction with the final rules, Rev. Proc. 2019-11 clarifies that W-2 wages include elective deferrals to Simplified Employee Pensions, simple retirement accounts, and other qualified plans. It also specifies that amounts reported on W-2s for statutory employees (as checked in Box 13) should not be included in the calculation of W-2 wages. The summary also states that W-2 wages include amounts paid to S Corporation shareholders and common-law employees. The final Regulations confirm that partnership guaranteed payments neither create favorable W-2 wages nor are they considered allocations to carry out the I.R.C. § 199A deduction.

New Proposed Regulations favorably allow a look through approach to allow RICs, which do not otherwise generate an I.R.C. § 199A benefit, to pass through the I.R.C. § 199A benefit from REIT stock that is owned by the RIC. The IRS continues to study whether similar treatment should apply to PTPs owned by a RIC, noting certain complications with this approach. The Proposed Regulations also address (i) the treatment of previously suspended losses that constitute qualified business income; and (ii) the determination of the I.R.C. § 199A deduction for taxpayers who hold interests in charitable remainder trusts and split-interest trusts.

CHAPTER 6: DISPOSITIONS OF PARTNERSHIP INTERESTS

§ 6.03 CHARACTER OF GAIN OR LOSS

C. Unrecaptured I.R.C. § 1250 Gain and Collectibles Gain

Similar to the treatment of unrealized receivables and inventory, when a partner sells an interest that the partner has held for more than one year in a partnership with unrecaptured I.R.C. § 1250 gain or collectibles gain, a limited aggregate approach is applied.[91]

I.R.C. § 1(h)(1)(E) provides that the maximum capital gains rate for individuals for unrecaptured I.R.C. § 1250 gain is 25%, rather than the 20% that applies to the general basket for long-term capital gains. For these purposes, the unrecaptured I.R.C. § 1250 gain is the additional gain that would ordinary income if I.R.C. § 1250 required the recapture of all depreciation of real estate as ordinary income rather than just requiring the excess of actual depreciation over straight line depreciation to be recaptured as ordinary income.[92]

Similarly, I.R.C. § 1(h)(4) provides that the maximum capital gains rate for individuals for collectibles gain is 28%, rather than the 20% that applies to the general basket for long-term capital gains. Collectibles gain means gain from the sale of any work of art, any rug or antique, any metal or gem, any stamp or coin, any alcoholic beverage or any other specified tangible personal property that is held as a capital asset for more than one year.[93]

In each case, if a partner sells an interest in a partnership that the partnership has held for more than one year, the partner recognizes as unrecaptured I.R.C. § 1250 gain or collectibles gain the amount of

91 Treas. Reg. § 1.1(h)-1(a).
92 I.R.C. § 1(h)(6)(A).
93 I.R.C. § 1(h)(5)(A).

unrecaptured I.R.C. § 1250 gain or collectibles gain that would be allocated to the partner if the partnership sold its I.R.C. § 1250 property and collectibles for cash equal to the fair market value of the property.[94]

The aggregate approach does not apply for unrecaptured I.R.C. § 1250 gain or collectibles gain on the redemption of a partnership interest.[95]

§ 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.[96]

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).[97]

F. Additional Aspects of Adjustment

Add at the end of subsection 6:

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94 Treas. Reg. § 1.1(h)-1(a)(2)(ii) and (a)(3)(ii).
95 Treas. Reg. § 1.1(h)-1(a)(2)(ii) and (a)(3)(ii).
96 Conference Report to Accompany H.R. 1, 115 Cong. 1st Sess., Rep. 115-466, p. 512-13 (Dec. 15, 2017).
97 Prop. Reg. § 1.754-1(b)(1).

Proposed Regulations would also allow bonus depreciation under I.R.C. § 168(k) to be taken in respect of an I.R.C. § 743 basis adjustment if certain conditions are met.[98]

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 partnership form.[99] 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.[100] 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. 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.[101] 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.[102]

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].[103]

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

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98 Prop. Reg. § 1.168(k)-2(b)(3)(iv)(D).

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

100 Treas. Reg. § 1.708-1(b)(1).

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

102 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).

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

interest of the deceased partner continues to share in the profits or losses of the partnership business.[104]

Note that if a partnership converts to a corporation, the business will not be continued by any partner in partnership form.[105]

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.[106]

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.[107] 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).[108] Likewise, a contribution of property to a partnership was not treated as a sale or exchange.[109]

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.[110]

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 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).[111]

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104 Treas. Reg. § 1.708(b)(1)(i).
105 Rev. Rul. 84-11, 1984-2 1970-1 C.B. 88.
106 *See* PLR 8517022 (Jan. 25, 1985); PLR 7952057 (Sept. 25, 1979).
107 Treas. Reg. § 1.708-1(b)(2).
108 *Id.*
109 *Id.*
110 *Id.*
111 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.

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).[112] 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.[113]

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.[114] 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.[115] 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.[116] 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.[117] 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.[118]

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.[119]

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 an I.R.C. § 754 election in effect, if this is desired by the new partnership, prudence dictates that the new partnership make a new I.R.C. § 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.[120]

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

113 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).

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

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

116 Treas. Reg. § 1.708-1(b)(5).

117 Treas. Reg. § 1.743-1(h)(1).

118 Prop. Reg. § 1.755-1(c)(2)(vi).

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

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 7: PARTNERSHIP DISTRIBUTIONS

§ 7.03 NONLIQUIDATING DISTRIBUTIONS OF PROPERTY

D. Distributions When Stock is Held of a Corporate Partner

It may seem like ancient history now, but in Chapter 2 we discussed transactions which may cause gain recognition on a contribution of property because a partnership holds stock of a corporate partner.[121] Because the IRS was concerned that some transactions had already completed the first step (the acquisition of the stock of a corporate partner) before the original guidance was released, the Regulations also treat as gain recognition events (i) the distribution by a partnership that owns stock of a corporate partner of appreciated property to a partner other than the corporate partner and (ii) the distribution of stock of the corporate partner to the corporate partner.[122]

The calculation of the amount of gain is the same as discussed in Chapter 2.[123]

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

§ 8.06 DISGUISED SALES

A. The Disguised Sale of Assets

3. Liabilities

Big picture: As discussed up to this point, an easy way to end-run I.R.C. § 707(a)(2)(B) would be for a partner to encumber a property with a liability shortly before contributing it to the partnership. The partner has cash in his pocket from the liability and can correctly claim that he has received no money from the partnership. The Regulations contain a complex set of rules to address this problem. One of the reasons the Regulations are so complex is that not all liabilities are created equal. Some liabilities, for example a liability to acquire a property that puts no cash in the partner's pocket, are unobjectionable. As a consequence, the Regulation divides the world into "qualified liabilities" and "nonqualified liabilities." Many, but not all, qualified liabilities will not trigger I.R.C. § 707(a)(2)(B). As we will discuss, some qualified liabilities can be tainted. You might think that in the case of nonqualified liabilities, the partnership

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120 Treas. Reg. §§ 1.704-4(c)(3), 1.737-2(a).
121 *See* § 2.02E. The background of these provisions are discussed in § 13.04A.
122 Treas. Reg. § 1.337(d)-3(c)(3)(iii) & (iv).
123 Treas. Reg. § 1.337(d)-3(d)(3).

will be deemed to transfer consideration to the partner to the extent the partner is deemed relieved of the liability under I.R.C. § 752 Regulations (discussed in Chapter 3), and that is mostly true.

Partner's Share of Liability for Disguised Sale Purposes: As discussed in Chapter 3, a partner's share of a recourse liability is the amount for which the partnership has the economic risk of loss.[124] A partnership liability is a recourse liabilitiy to the extent that the obligtions is a recourse liability under Treas. Reg. § 1.752-1(a)(1) or would be treated as a recourse liability under that section if it were treated as a partnership liability for the purposes of that section.[125]

> **Example 1:** (i) C transfers property Y to a partnership. At the time of its transfer to the partnership, property Y has a fair market value of $10,000,000 and is subject to an $8,000,000 liability that C incurred, immediately before transferring property Y to the partnership, in order to finance other expenditures. Upon the transfer of property Y to the partnership, the partnership assumed the liability encumbering that property. The partnership assumed this liability solely to acquire property Y. Under I.R.C. § 752 and the regulations thereunder, immediately after the partnership's assumption of the liability encumbering property Y, the liability is a recourse liability of the partnership and C's share of that liability is $7,000,000.
>
> (ii) Under the facts of this example, the liability encumbering property Y is not a qualified liability (discussed below). Accordingly, the partnership's assumption of the liability results in a transfer of consideration to C in connection with C's transfer of property Y to the partnership in the amount of $1,000,000 (the excess of the liability assumed by the partnership ($8,000,000) over C's share of the liability immediately after the assumption ($7,000,000)).[126]

Recall that nonrecourse liabilities are, in general, shared under a three-part stacking rule.[127] For the purposes of the disguised sale rule, a partner's share of nonrecourse liabilities is determined by applying the same percentage that was used in the third tier. "Tier 3" of that rule addresses "excess nonrecourse liabilities," i.e., liabilities not covered by the first two parts. Excess nonrecourse liabilities (liabilities subject to Tier 3) are generally shared based on partnership profits, though there are also other options. (See § 3.04D.)

> **Example 2:** (i) A and B form partnership AB, which will engage in renting office space. A transfers $500,000 in cash to the partnership, and B transfers an office building to the partnership. At the time it is transferred to the partnership, the office building has a fair market value of $1,000,000, has an adjusted basis of $400,000, and is encumbered by a $500,000 nonrecourse liability, which B incurred 12 months earlier to finance the acquisition of other property and which the partnership assumed. No facts rebut the presumption that the liability was incurred in anticipation of the transfer of the property to the partnership. Assume that this liability is a nonrecourse liability of the partnership within the meaning of I.R.C. § 752 and the regulations thereunder. The partnership agreement provides that partnership items will be allocated equally between A and B, including excess nonrecourse

124 Prop. Reg. § 1.707-5(a)(2)(i).
125 *Id.*
126 Prop. Reg. § 1.707-5(f) ex. 2.
127 "Tier 1" is a partner's share of minimum gain. Treas. Reg. § 1.752-3(a)(1). Tier 2 is a partner's share of I.R.C. § 704(c) gain from properties subject to nonrecourse debt. Treas. Reg. § 1.752-3(a)(2).

liabilities under Treas. Reg. § 1.752-3(a)(3). The partnership agreement complies with the requirements of Treas. Reg. § 1.704-1(b)(2)(ii)(b).

(ii) The nonrecourse liability secured by the office building is not a qualified liability. B would be allocated 50% of the excess nonrecourse liability under the partnership agreement. Accordingly, immediately after the partnership's assumption of that liability, B's share of the liability is $250,000 (B's 50% share of the partnership's excess nonrecourse liability as determined in accordance with B's share of partnership profits under Treas. Reg. § 1.752-3(a)(3)).

(iii) The partnership's assumption of the liability encumbering the office building is treated as a transfer of $250,000 of consideration to B (the amount by which the liability ($500,000) exceeds B's share of that liability immediately after the partnership's assumption of the liability ($250,000)). B is treated as having sold $250,000 of the fair market value of the office building to the partnership in exchange for the partnership's assumption of a $250,000 liability. This results in a gain of $150,000 ($250,000 minus ($250,000/$1,000,000 multiplied by $400,000)).[128]

Qualified Liabilities: A liability assumed or taken subject to by a partnership in connection with a transfer of property to the partnership by a partner is a "qualified liability" of the partner only to the extent the liability is:

(1) A liability that was incurred by the partner more than two years prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property throughout that two-year period;

(2) A liability that was not incurred in anticipation of the transfer of the property to a partnership, but that was incurred by the partner within the two-year period prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property since it was incurred (but see presumption below);

(3) A liability that is allocable under the rules of Temp. Reg. § 1.163-8T to capital expenditures with respect to the property (meaning that the liability proceeds were invested in the property);

(4) A liability that was incurred in the ordinary course of the trade or business in which property transferred to the partnership was used or held but only if all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business (an example would be an account payable); or

(5) A liability that was not incurred in anticipation of the transfer of the property to a partnership, but that was incurred in connection with a trade or business in which property transferred to the partnership was used or held but only if all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business.[129] (Note that unlike in 4, the liability need not be incurred in the ordinary course of a trade or business. An example would be a "one-off" liability, the proceeds of which were necessary for the operation of the business.).

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128 Treas. Reg. § 1.707-5(f).

129 Treas. Reg. § 1.707-5(a)(6). Liabilities covered by paragraphs 2 or 5 must be disclosed to the IRS. Treas. Reg. § 1.707-5(a)(7)(ii).

Further, in any of the above cases, if the liability is a recourse liability, the amount of the liability may not exceed the fair market value of the transferred property (less the amount of any other liabilities that are senior in priority and that either encumber such property or are liabilities described in paragraphs 3 and 4 above) at the time of the transfer.[130]

Presumption: A liability incurred within two years of transfer is generally presumed to be in anticipation of the transfer (making it a nonqualified liability), unless the liability falls within paragraphs 3 and 4 above or unless the facts and circumstances clearly establish that the liability was not incurred in anticipation of the transfer.[131]

> **Example 3:** F purchases property Z in 2012. In 2017, F transfers property Z to a partnership. At the time of its transfer to the partnership, property Z has a fair market value of $165,000 and an adjusted tax basis of $75,000. Also, at the time of the transfer, property Z is subject to a $75,000 nonrecourse liability that F incurred more than two years before transferring property Z to the partnership. The liability has been secured by property Z since it was incurred by F. Upon the transfer of property Z to the partnership, the partnership assumed the liability encumbering that property. The partnership made no other transfers to F in consideration for the transfer of property Z to the partnership. Assume that immediately after the partnership's assumption of the liability encumbering property Z, F's share of that liability for disguised sale purposes is $25,000. The $75,000 liability secured by property Z is a qualified liability. Therefore, since no other transfer to F was made as consideration for the transfer of property Z, the partnership's assumption of the qualified liability of F encumbering property Z is not treated as part of a sale. Thus, F is deemed to have contributed property Z to the partnership in F's capacity as a partner.

If a partner transfers property subject to a nonqualified liability to the partnership, but also transfers money to the partnership, it is only the liabilities in excess of the money transferred that normally will be part of a disguised sale. Consequently, the Regulations provide that if pursuant to a plan a partner pays or contributes money to the partnership and the partnership assumes or takes subject to one or more liabilities (other than qualified liabilities) of the partner, the amount of those liabilities that the partnership is treated as assuming or taking subject to is reduced by the money transferred.[132]

"Tainted" Qualified Liabilities: A special rule applies if a partner transfers property to the partnership subject to a qualified liability, but the partner also transfers property subect to a nonqualified liability and/or receives a distribution from the partnership that triggers the disguised sale rules. The (now somewhat tainted) qualified liability is treated as a transfer of consideration made pursuant to a a sale or the property to the partnership only to the extent of the lesser of (1) the amount of consideration that the partnership would treated as transferring to the partner if the liability were not a qualified liability; or (2) the amount obtained by multiplying the amount of the qualified liability by th epartner's net equity perntage with respect to that property.[133] A partner's net equity percentage with respect to an item of property equals the perntage determined by dividing (1) the aggregate transfers of money or other consideration to the partner by the partnership (other than any transfer at issue) that are treated as proceed realized from the sale of the

130 Treas. Reg. § 1.707-5(a)(6)(ii).
131 Treas. Reg. § 1.707-5(a)(7)(i).
132 The amount of the liabilities so treated cannot be reduced below zero. Treas. Reg. §1.707-5(d).
133 Treas. Reg. § 1.707-5(a)(5)(i).

transferred property; by (2) the excess of the fair market value of the property at the time it is transferred to the partnership over any qualified liability encumbering or properly allocable to the property.[134]

There is a complex *de minimis* exception to the tainted qualified liability rule: If in connection with a transfer of property by a partner to a partnership that is treated as a sale due solely to the partnership's assumption of or taking property subject to a nonqualified liability, the partnership's assumption of or taking property subject to a qualified liability is not treated as a transfer of consideration made pursuant to the sale if the total amount of all nonqualified liabilities that the partnership assumes or takes subject to is the lesser of 10% of the total amount of all qualified liabilities the partnership assumes or takes subject to, or $1,000,000.[135]

> **Example 4:** The facts are the same as in Example 3, except that the partnership makes a transfer to F of $30,000 in money that is consideration for F's transfer of property Z to the partnership. As in Example 3, the $75,000 liability secured by property Z is a qualified liability of F. Since the partnership transferred $30,000 to F in addition to assuming the qualified liability, assuming no other exception to disguised sale treatment applies to the transfer of the $30,000, the partnership's assumption of this qualified liability is treated as a transfer of additional consideration to F to the extent of the lesser of (1) the amount that the partnership would be treated as transferring to F if the liability were not a qualified liability ($50,000 — that is, the excess of the $75,000 qualified liability over F's $25,000 share of that liability); or
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> (2) the amount obtained by multiplying the qualified liability ($75,000) by F's net equity percentage with respect to property Z (which is one-third, or $25,000). F's net equity percentage with respect to property Z equals the fraction determined by dividing the aggregate amount of money or other consideration (other than the qualified liability) transferred to F and treated as part of a sale of property Z under Treas. Reg. § 1.707-3(a) ($30,000 transfer of money); by (2) F's net equity in property Z ($90,000 (that is, the excess of the $165,000 fair market value over the $75,000 qualified liability)). Accordingly, the partnership's assumption of the qualified liability of F encumbering property Z is treated as a transfer of $25,000 (one-third of $75,000) of consideration to F pursuant to a sale. Therefore, F is treated as having sold $55,000 of the fair market value of property Z to the partnership in exchange for $30,000 in money and the partnership's assumption of $25,000 of the qualified liability. $55,000 is one-third of the fair market value of property Z. As discussed in § 8.06A1, F is thus deemed to have sold one-third of the property to the partnership. One-third of F's basis in property Z is $25,000. Accordingly, F must recognize $30,000 of gain on the sale (the excess of the $55,000 amount realized over $25,000).

Liability Incurred by Partnership: Of course, instead of the partner borrowing the money, the partnership could borrow the money and give it to the partner. The disguised sale rules should still be able to apply. Consequently, the Regulations provide that if a partner transfers property to a partnership and the partnership incurs a liability that is allocable in whole or in part to a transfer of money or other consideration to the partner within 90 days of the partnership incurring the liability, the transfer of money or other consideration to the partner is taken into consideration under the disguised sale rules, but

134 Treas. Reg. § 1.707-5(a)(5)(ii).
135 Treas. Reg. § 1.707-5(a)(5)(iii).

only to the extent that the money or other consideration exceeds the partner's allocable share of the partnership liability.[136] This is sometimes called the "debt-financed distribution exception," since a partner can avoid disguised sale treatment to the extent he is allocated a share of the parnership liability.

> **Example 5:** K transfers property Z to partnership KL in exchange for a 50% interest in the partnership on April 9, 2017. On September 13, 2017, the partnership incurs a nonrecourse liability of $20,000. (Note that there is no limit, as such, on the time between when the partner contributed the property to the partnership and when the partnership incurred the liability.) On November 17, 2017, the partnership transfers $20,000 to K, and $10,000 of this transfer is determined to be allocable to proceeds of the partnership liability. The remaining $10,000 is paid from other partnership funds. Assume that on November 17, 2017, for disguised sale purposes, K's share of the $20,000 liability is $10,000. Because a portion of the transfer made to K is allocable to proceeds of a partnership liability that was incurred by the partnership within 90 days of that transfer, K is required to take the transfer into account in applying the disguised sale rules, but only to the extent that the amount of the transfer exceeds K's allocable share of the liability used to fund the transfer. K's allocable share of the $20,000 liability used to fund $10,000 of the transfer to K is $5,000 (K's share of the liability ($10,000) multiplied by the fraction obtained by dividing (1) the amount of the liability that is allocable to the distribution to K ($10,000) by (2) the total amount of such liability ($20,000)). Therefore, K is required to take into account $15,000 of the $20,000 partnership transfer to K for disguised sale purposes ($5,000 attributable to the partnership liability plus $10,000 that came from other partnership funds). Under these facts, assuming no other exception applies and the within-two-year presumption is not rebutted, this $15,000 transfer will be treated as part of a sale by K of property Z to the partnership.[137]

Ordering Rules: The debt-financed distribution exception applies before the exceptions for preferred returns, guaranteed payments, operating cash flow distributions, and preformation expenditures.[138]

Anti-Abuse Rules: Treas. Reg. § 1.707-5 contains a number of anti-abuse provisions. We will not burden you with them, but know that it is not easy to end-run these Regulations.[139]

§ 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.[140] For the purposes of

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136 Treas. Reg. § 1.707-5(b)(1) and (2). Rules similar to those set forth in Treas. Reg. § 1.707-3 apply in determining whether a transfer of property by a partnership to a partner and one or more transfers of money or other consideration by that partner to the partnership are treated as a sale of property, in whole or part, to the partner. Treas. Reg. § 1.707-6. The allocation of the liability to the transfer to the partner occurs under the rules of Temp. Reg. § 1.163-8T. Treas. Reg. § 1.707-5(b)(1).

137 *See* Treas. Reg. § 1.707-5(f) Ex. 10.

138 Treas. Reg. § 1.707-5(b)(3).

139 *See, e.g.*, Treas. Reg. § 1.707-5(a)(3); Prop. Reg. § 1.707-5(f) Ex. 3.

140 I.R.C. § 1061(a).

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).[141]

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 for the purposes of determining long term gain or loss.[142] 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).[143] 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.[144] 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.[145]

An applicable partnership interest does not include an interest in a partnership directly or indirectly held by a "corporation."[146] Unfortunately, this only includes "C corporations" not "S corporations."[147] 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.

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.[148]

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.[149]

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141 *Id.*
142 *Id.*
143 I.R.C. § 1061(c)(1).
144 Conference Report to Accompany H.R. 1, 115 Cong. 1st Sess., Rep. 115-466, p. 420 (Dec. 15, 2017).
145 I.R.C. § 1061(c)(1).
146 I.R.C. § 1061(c)(4)(A).
147 Notice 2018-8, 2018-2 I.R.B. 443.

148 I.R.C. § 1061(c)(4)(B).
149 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.[150]

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.[151]

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.[152]

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.[153] 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.[154]

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

B. Foreign Tax Credit Rules in Regard to Foreign Partnerships

Substitute the following for the first three paragraphs of § 12.02 B:

1. *Generally*

The United States employs a worldwide tax system under which U.S. individuals and domestic corporations generally are taxed on all income, whether derived in the United States or abroad; the foreign tax credit provided under I.R.C. § 901 allows some relief from double taxation. Subject to certain limitations, a U.S. taxpayer is allowed to claim a credit against its U.S. income tax liability for the foreign income taxes that it pays or accrues. A "foreign income tax" is any income, war profits, or

150 I.R.C. § 1061(c)(2).
151 Conference Report to Accompany H.R. 1, 115 Cong. 1st Sess., Rep. 115-466, p. 421 (Dec. 15, 2017).
152 I.R.C. § 1061(c)(3).
153 Conference Report to Accompany H.R. 1, 115 Cong. 1st Sess., Rep. 115-466, p. 421 (Dec. 15, 2017).
154 Conference Report to Accompany H.R. 1, 115 Cong. 1st Sess., Rep. 115-466, p. 421-22 (Dec. 15, 2017).

excess profits tax paid or accrued to any foreign country or to any U.S. possession. A "foreign income tax" includes any tax paid in lieu of such a tax within the mean- ing of I.R.C. § 903. A domestic corporation that owns at least 10% of the vote or value of the stock of a foreign corporation (a "*U.S. Shareholder*") is allowed a deemed-paid credit for foreign income taxes paid by the foreign corporation that the U.S. Shareholder is deemed to have paid when the foreign corporation's earnings are included in the U.S. Shareholder's income under the provisions of subpart F.[155]

Although partnerships cannot benefit directly from the foreign tax credit, the Regulations provide that a U.S. citizen, a resident alien, or a domestic corporation may claim a share of a partnership's taxes that are attributable to such person.[156] In addition, under I.R.C. § 703(b)(3), the election under I.R.C. § 901 (whether to take a credit in respect of the foreign taxes) is made by each partner separately. In Rev. Rul. 71-141,[157] the IRS held that two domestic corporations are entitled to a foreign tax credit on foreign taxes withheld on payments to a partnership with they jointly owned.

Regulations contain separate rules for allocating foreign tax credits and the expenses related to the income associated with the taxes.[158] If a domestic corporation owns an interest in a CFC through a domestic partnership, to the extent the domestic corporation is a United States shareholder with respect to the CFC, the proposed regulations provide that the domestic corporation is deemed to have paid foreign income taxes as if the domestic corporation had included the income from the CFC directly rather than as a distributive share of the partnership's income. A domestic corporation that has a distributive share of a domestic partnership's subpart F inclusion and is also a United States shareholder with respect to the CFC that gives rise to a subpart F inclusion is treated as a subpart F inclusion of the domestic corporation for purposes of I.R.C. § 960(a).[159] Similarly, the domestic corporation's distributive share of a domestic partnership's receipt of previously taxed income is treated as a receipt by the domestic corporation directly for purposes of the tax credit rules.[160]

2. *Foreign Tax Credit Splitter Transactions*

The second and third sentences of the second paragraph are deleted.

C. Controlled Foreign Corporations as Partners in Foreign Partnerships

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

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

155 I.R.C. § 960. Subpart F is the portion of the Code dealing with the conditions under which U.S. shareholders are required to currently include income recognized by a controlled foreign cor- poration. A controlled foreign corporation is a foreign corporation if more than 50% of (i) the total combined voting power of all classes of stock of such corporation entitled to vote, or (ii) the total value of the stock of such corporation, is owned or is considered as owned by United States share- holders on any day during the taxable year of such foreign corporation. I.R.C. § 957. Controlled foreign corporations are sometimes referred to as "*CFCs*."

156 Treas. Reg. § 1.901-1(a).

157 1971-1 C.B. 211.

158 Reg. § 1.861-8; Prop. Reg. § 1.861-9(e)(4).

159 Prop. Reg. § 1.960-2(b)(4).

160 *See* Prop. Reg. § 1.960-3(b)(5).

Insert before the text accompanying footnote 35:

The global intangible low-taxed income (GILTI) tax adds another layer of world-wide taxation to the U.S. system to provide a minimum tax for types of income that may have escaped Subpart F.

Under I.R.C. § 951A, a U.S. shareholder of any CFC must include in gross income for a taxable year its GILTI in a manner generally similar to inclusions of Subpart F income. GILTI means the excess (if any) of the shareholder's net CFC tested income over the shareholder's net deemed tangible income return.[161]

Net CFC tested income means, with respect to any U.S. shareholder, the excess of the aggregate of the shareholder's pro rata share of the tested income of each CFC with respect to which it is a U.S. shareholder over the aggregate of its pro rata share of the tested loss of each CFC with respect to which it is a U.S. shareholder.[162] Pro rata shares are determined under the rules of I.R.C. § 951(a)(2).[163]

The tested income of a CFC means the excess (if any) of the gross income of a corporation—determined subject to certain exclusions—over deductions (including taxes) properly allocable to such gross income.[164] The exclusions to tested income are: (1) the corporation's ECI under I.R.C. § 952(b); (2) any gross income taken into account in determining the corporation's subpart F income; (3) any gross income excluded from foreign base company income or insurance income by reason of the high-tax exception under I.R.C. § 954(b)(4); (4) any dividend received from a related person (as defined in I.R.C. § 954(d)(3)); and (5) any foreign oil and gas extraction income (as defined in I.R.C. § 907(c)(1)).[165]

The shareholder's net deemed tangible income return is an amount equal to 10% of the aggregate of the shareholder's pro rata share of the qualified business asset investment ("QBAI") of each CFC with respect to which it is a U.S. shareholder. QBAI means, with respect to any CFC for a taxable year, the average of the aggregate of its adjusted bases, determined as of the close of each quarter of the taxable year, in specified tangible property used in its trade or business and of a type with respect to which a deduction is generally allowable under I.R.C. § 167.[166] Specified tangible property means any property used in the production of tested income.[167] If such property was used in the production of both tested income and income that is not tested income (i.e., dual-use property), the property is treated as specified tangible property in the same proportion that the amount of tested gross income produced with respect to the property bears to the total amount of gross income produced with respect to the property.[168]

I.R.C. § 951A(d)(3)1 (the "partnership QBAI paragraph") states that if a CFC holds an interest in a partnership at the close of the CFC's taxable year, the CFC takes into account under I.R.C. § 951A(d)(1) its "distributive share of the aggregate of the partnership's adjusted bases (determined as of such date in the hands of the partnership)" in specified tangible property in computing its QBAI. The partnership QBAI paragraph further provides that a CFC's "distributive share of the adjusted basis of any property shall be the controlled foreign corporation's distributive share of income with respect to such property."

Add to footnote 35:

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161 I.R.C. § 951A(b)(1).
162 I.R.C. § 951A(c).
163 I.R.C. § 951A(e)(1).
164 I.R.C. § 951A(c)(2)(A).
165 I.R.C. § 951A(c)(2)(A)(i).
166 I.R.C. § 951A(d)(1).
167 I.R.C. § 951A(d)(2)(A).
168 I.R.C. § 951A(d)(2)(B).

Proposed Regulations would allow a reduction of the I.R.C. § 956 inclusion to the extent that a recipient would have been allow a dividends received deduction from foreign income had the earnings actually been distributed. REG-114540-18, 83 Fed. Reg. 55324 (Nov. 5, 2018). Proposed Regulations would also deny a foreign tax credit for an I.R.C. § 956 inclusion. REG-105600-18, 83 Fed. Reg. 63200 (Dec. 7, 2018).

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. Temp. 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.[169] 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% 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".[170]

Except as allowed under the gain deferral method, described below, Temp. 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% or more of the interests in partnership capital, profits, deductions, or losses.[171] 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).

Temp. 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 an I.R.C. § 721(c) partnership during the partnership's taxable year does not exceed $1 million.

Temp. Reg. § 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 an 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 uppertier partnership will recognize the entire built-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. § 721(c) property.

169 Temp. Reg. § 1.721(c)-1T(a)(15).
170 Temp. Reg. § 1.721(c)-1T(a)(6).
171 Temp. Reg. § 1.721(c)-1T(a)(14).

2. *Gain Deferral Method*

Temp. 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 Temp. Reg. § 1.721(c)–3T(b) for applying the gain deferral method to an item of I.R.C. § 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.

Temp. 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*

Temp. 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.[172] 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,[173] 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, 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

172 Treas. Reg. § 1.721(c)-4T(b).
173 Grecian Magnesite Mining v. Commissioner, 149 T.C. No. 3 (2017).

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.[174]

I.R.C. § 1446(f) also requires the transferee of a partnership interest to withhold 10% 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.[175]

As to non-publicly traded partnerships, the IRS has provided guidance repeating the statutory exception for U.S. persons and providing four non-statutory exceptions. First, if the transferee receives a certification that the transferor is a U.S. person, no withholding is required (unless the transferee has actual knowledge that the certification is false).[176] Second, if the transferee receives a certification that no gain will be realized, no withholding is required (unless the transferee has actual knowledge that the certification is false).[177] Third, if the transferee receives a certificate that the transferor's share of income from the partnership for the three preceeding taxable years was comprised of less than 25% income effectively connected to a U.S. trade or business, no withholding is required.[178] Fourth, if the transferee receives a certificate that if partnership sold all of its assets less than 25% of the gain would be was income effectively connected to a U.S. trade or business, no withholding is required.[179] Finally, no withholding is required if the transferor realizes gain but is not required to recognize gain because the transfer is a non-recognition transaction.[180]

In some circumstances, a transferee may ignore the liabilities of the partnership in determining the amount to withhold, but this is not the general rule.[181]

F. Base Erosion and Anti-Abuse Tax

I.R.C. § 59A imposes a tax on certain corporate taxpayers in addition to any other regular tax liability the taxpayer may have. Liability for this additional tax is generally limited to those taxpayers with substantial gross receipts and is determined, in part, by the extent to which the taxpayer has made deductible payments to foreign related parties. Taxpayers potentially liable for this additional tax have three-year average gross receipts in excess of $500 million and a "base erosion percentage" exceeding a specified threshold. The base erosion percentage is generally determined by dividing "base erosion tax benefits" by the amount of deductions allowable to the taxpayer for the taxable year. The taxpayer's additional tax is computed by comparing the taxpayer's "modified taxable income" to the taxpayer's regular tax liability (as defined in I.R.C. § 26(b)) after the regular tax liability has been reduced by certain credits against tax. Modified taxable

174 Treas. Reg. § 1.6012-1, -2.
175 Notice 2018-8, 2018-4 IRB (Jan. 2, 2018).
176 Notice 2018-29, 2018-16 IRB 495 ¶ 6.01.
177 Notice 2018-29, ¶ 6.02.
178 Notice 2018-29, ¶ 6.03.
179 Notice 2018-29, ¶ 6.04.
180 Notice 2018-29, ¶ 6.05.
181 Notice 2018-29, ¶ 8.

income is the taxpayer's regular taxable income increased by any base erosion tax benefit with respect to any ''base erosion payment'' and an adjustment for the taxpayer's NOL deduction, if any. The taxpayer has an additional tax liability equal to the difference between 10% of the taxpayer's modified taxable income and the taxpayer's regular tax liability after adjustment has been made to account for certain credits against the taxpayer's regular tax liability. The term 'base erosion payment' means any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer and with respect to which a deduction is allowable under the Code.[182]

Special rules apply in the case of banks and securities dealers. Special rules also apply in the case of the taxpayer's taxable year beginning in 2018 and for taxable years beginning after December 31, 2025.

A partnership is not an "applicable taxpayer" as defined in I.R.C. § 59A; only corporations can be applicable taxpayers. In general, a partnership also is not subject to the income tax. Instead, partners are liable for income tax only in their separate capacities. Each taxpayer that is a partner in a partnership takes into account separately the partner's distributive share of the partner's income or loss in determining its taxable income. Accordingly, an item of income is subject to federal income taxation based on the status of the partners, and not the partnership as an entity. Similarly, a partnership does not itself benefit from a deduction. Instead, the tax benefit from a deduction is taken by the taxpayer that is allocated the deduction under I.R.C. § 704. I.R.C. § 702(b) provides that the character of any item be taken into account as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership. I.R.C. § 702(b) acknowledges that differences in partner tax characteristics (for example, whether the partner is a corporation or an individual, or domestic or foreign) may result in differences in the tax consequences of items the partnership allocates to its partners.

The Proposed Regulations generally provide that partnerships are treated as an aggregate of the partners in determining whether payments to or payments from a partnership are base erosion payments.[183] Thus, when determining whether a corporate partner that is an applicable taxpayer has made a base erosion payment, amounts paid or accrued by a partnership are treated as paid by each partner to the extent an item of expense is allocated to the partner under I.R.C. § 704. Similarly, any amounts received by or accrued to a partnership are treated as received by each partner to the extent the item of income or gain is allocated to each partner under I.R.C. § 704. The rules and exceptions for base erosion payments and base erosion tax benefits then apply accordingly on an aggregate basis.

§ 12.08 FATCA

Add to footnote 158:

Proposed Regulations would eliminate the requirement to withhold on gross proceeds. REG-132881-17, 83 Fed. Reg. 64757 (Dec. 18, 2018).

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

182 I.R.C. § 59A(d)(1).
183 Prop. Reg. § 1.59A-7(b).

is subject to tax,[184] or (2) such related party is allowed a deduction with respect to such amount under the tax law of such country.[185] 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).[186] 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.

A disqualified related party does not include a partnership because a partnership generally is not liable to tax and therefore is not the person allowed a deduction. However, a partner of a partnership may be a disqualified related party. For example, in the case of a payment made by a partnership a partner of which is a domestic corporation, the domestic corporation is a disqualified party and its allocable share of the deduction for the payment is subject to disallowance under I.R.C. § 267A

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.[187] 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.[188] 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.[189]

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.[190]

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%, (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.[191]

184 I.R.C. § 267A(b)(1)(A).
185 I.R.C. § 267A(b)(1)(B).
186 *See* discussion of controlled foreign corporations in § 12.02 C.
187 I.R.C. § 267A(c).
188 *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).
189 *See* Treas. Reg. § 1.446-3(f)(2)(iii)(B).
190 I.R.C. § 267A(d).
191 I.R.C. § 267A(e).

CHAPTER 13: ANTI-ABUSE PROVISIONS

§ 13..04 Mixing Bowl Transactions

A. Introduction

Substitute the following for the next-to-last paragraph:

Upon hearing of the May Company transaction, the I.R.S. promptly issued a notice under its corporate taxation regulatory authority, stating that in the future such transactions would be treated for tax purposes in the same manner they were treated for financial accounting purposes.[192] That was followed with proposed, final and temporary Regulations to the same effect.[193] Finally, in 2018 the Treasury and the I.R.S. released final Regulations that addressed the May Company transaction.[194] Under the Regulations, an "I.R.C. § 337(d) transaction" may occur if (i) a corporate partner contributes appreciated property to a partnership that owns stock of the corporate partner; (ii) a partnership acquires stock of the corporate partner, (iii) a partnership that owns stock of a corporate partner distributes appreciated property to a partner other than the corporate partner, (iv) a partnership distributes stock of a corporate partner to the corporate partner, or (v) a partnership agreement is amended in a manner that increases a corporate partner's interest in the stock of the corporate partner.[195] If a partnership engages in an I.R.C. § 337(d) transaction, the corporate partner must recognize gain.[196]

CHAPTER 14: FAMILY PARTNERSHIPS

Renumber current §14.06 as §14.07 and insert the following as new §14.06.

§ 14.06 FAMILIES AND I.R.C. § 162 AND 212

The term "trade or business" is not defined in the Code. The Supreme Court made it clear many years ago in *Higgins*[197] that managing one's own investments is not a trade or business, irrespective of how substantial and justified the management activities are. In response, Congress enacted I.R.C. § 212 which generally allowed taxpayers to deduct ordinary and necessary expenses incurred by a taxpayer in conducting investment activities. The expenses of this type were, however, "below the line" and thus only available to taxpayers who itemized. Further, under I.R.C. § 67 they were usually "miscellaneous itemized deductions," and, as such, could only be deducted to the extent they exceeded 2% of adjusted gross income.[198] I.R.C. § 162 expenses, on the other hand, are deductible under I.R.C. § 62 (i.e. above the line). The 2017 Tax Cuts and Jobs Act dramatically changed the rules in this regard, prohibiting the deduction of miscellaneous itemized deductions altogether. Going forward, therefore, taxpayers commonly will want to bring expenses within I.R.C. § 162 and avoid I.R.C. § 212 to the extent possible.

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192 1989-1 C.B. 679, Notice 89-37.

193 *See* Prop. Reg. § 1.337(d)-3 and TD 9722, 80 Fed Reg. 33402 (June 2, 2015).

194 TD 9833, 83 Fed. Reg. 26580 (June 8, 2018).

195 Treas. Reg. § 1.337(d)-3(c)(3). These transactions are discussed in greater detail at § 2.02E.

196 Treas. Reg. § 1.337(d)-3(d)(1).

197 Higgins v. Commissioner, 312 US 212 (1941).

198 Most I.R.C. § 212 expenses are miscellaneous itemized deductions, but deductions for interest and taxes are not (though taxpayers may still have to itemize to take these latter deductions). Further, losses from the sale or exchange of investment properties and deductions "attributable to rents and royalties" from investment properties (e.g. interest, taxes, and depreciation) are deductible under I.R.C. § 62(a)(3) and (4), respectively.

What if family members jointly manage their investments? Generally, that will not bring any expenses within I.R.C. §162, as the Supreme Court has held that to be engaged in a trade or business the taxpayer must seek compensation beyond a normal investor's return.[199]

What if some family members manage the family's investments on behalf of other family members and are compensated for their efforts? That issue was addressed by the Tax Court in 2017 in *Lender Management, LLC*.[200] There, a subset of family members formed an LLC ("Lender Management") which was tasked with managing investments held by other LLCs owned by family members. All the LLCs were classified as partnerships for tax purposes. Lender Management did not receive any fixed fees for its services (though it is common for professional investment managers to charge such fees). To the extent that the net assets of the investment LLCs increased in value, however, the operating agreements provided that Lender Management could receive compensation separate from and in addition to the amounts that it received for its membership interests. Thus, Lender Management was seeking a return beyond simply that of an investor. Further, Lender Management's efforts primarily benefited family members other than the members of Lender Management. In a nonfamily setting, the Tax Court had rules that activities such as those of Lender Management could constitute a trade or business.[201] The Tax Court acknowledged that transactions within a family group are subjected to heightened scrutiny, but are not barred from trade or business status. The court concluded that even after applying heightened scrutiny, Lender Management was engaged in a trade or business, emphasizing the following facts: Lender Management's employees worked full time, no more than two members of the family owned Lender Management, and the investment LLCs were not required to use Lender Management if they became dissatisfied with its efforts. The court also noted that the family was widely dispersed and many family members did not know each other, though the court's reasoning suggests that it is unlikely that the court would have reached a different decision if the family had been less dispersed and more closely knit.

Lender Management is an important case in light of the prohibition against deducting miscellaneous itemized deductions. Practitioners often structure family investments with Lender Management in mind.

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199 Whipple v. Commissioner, 373 US 193 (1963).
200 Lender Management, LLC v. Commissioner, T.C. Memo. 2017-246.
201 Dagres v. Commissioner, 136 T.C. 263 (2011).

ERRATA

PAGE 277

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