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SUPPLEMENTAL MATERIALS

FOR

CORPORATE TAXATION THROUGH THE LENS OF MERGERS & ACQUISITIONS INCLUDING CROSS-BORDER TRANSACTIONS

(Carolina Academic Press Second Edition 2016)

Samuel C. Thompson, Jr
Professor and Director Center for the Study of Mergers and Acquisitions
Penn State Law

Developments from May 2015 through July 2018:
Including Changes Made by the Tax Cuts and Jobs Act of 2018
[New Sections of the Book Are Underlined, e.g., Sec. 1.3.A]

[To Be Updated Periodically]

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Carolina Academic Press
700 Kent Street
Durham, North Carolina 27701
Telephone (919) 489-7486
Fax (919) 493-5668
E-mail: cap@cap-press.com
www.cap-press.com

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I. CHAPTER 1, INTRODUCTION AND REVIEW OF BASIC CONCEPTS

A. Page 1, New Sec. 1.1.A. Introduction to the 2017 Tax Cuts and Jobs Act (TCAJA)

Page 1, New Sec. 1.1.A. Add the following immediately after the heading to Section 1.1:
New Sec. 1.1.A. **Introduction to the 2017 Tax Cuts and Jobs Act (TCAJA)**

The 2017 Tax Cuts and Jobs Act (TCAJA) amended many of the provisions of the Internal Revenue Code, including many provisions that impact domestic and international operations of the four principal ways of conducting a business: (1) sole proprietorship, including single member LLC; (2) partnership, including multimember LLCs; (3) S corporation; and (4) C corporation. Many of the changes have an impact on mergers and acquisitions.

In addition to materials not directly related to the TCAJA, this Supplement contains excerpts from the Conference Report to the TCAJA that relate to the particular provisions of the Code covered in the applicable chapter. *See* Joint Explanatory Text of the Committee of Conference (H. Rept. 115-466, Dec. 15, 2017) [the "TCAJA Conference Report"]. The Conference Report and other related materials are contained in Wolters Kluwer, *The Tax Cuts and Jobs Act, Law, Explanation and Analysis* (Dec. 2017) [the "Wolters Kluwer, *Explanation of the TCAJA*"].

It must be emphasized that the TCAJA made numerous amendments to the Code that are not discussed in this Supplement; this Supplement focuses on those provisions of the TCAJA that are most likely to impact the tax treatment of (1) a general business (*e.g*., a business that is not subject to special regulations or special provisions of the Code, such as utilities and Real Estate Investment Companies) and (2) the owners of such a business.

B. Page 6, New Sec. 1.3.A. Introduction to the Individual Rate Structure Adopted by the TCAJA

Page 6, New Sec. 1.3.A. Add immediately after Sec. 1.3. the following:
New Sec. 1.3.A. **Introduction to the Individual Rate Structures Adopted by the TCAJA**

1. In General

In connection with the study of section 1.3, read also the following provisions of the Conference Report to the TCAJA and related Code sections. This section focuses only on (1) the new section 1 rate structures for individuals, (2) the retention of the tax treatment of capital gains and dividends, (3) the increase in the standard deduction, (4) the repeal of the deduction for the personal exemption, and (5) the amendment to the Alternative Minimum Tax. These provisions are likely to impact in a significant way most individuals. Another provision with a broad impact is the modification in the deduction for state and local taxes, but this provision is not discussed further here.

2. Individual Rate Structure

TCAJA CONFERENCE REPORT

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Reduction and Simplification of Individual Income Tax Rates (sec. 1001 of the House bill, sec. 11001 of the Senate amendment, and sec. 1 of the Code)

PRESENT LAW

In general

To determine regular tax liability, an individual taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her regular taxable income. [*See* § 1] The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's income increases.

Tax rate schedules

Separate rate schedules apply based on an individual's filing status. For 2017, the regular individual income tax rate schedule [for married filing jointly was] as follows: * * *

TABLE 1.—FEDERAL INDIVIDUAL INCOME TAX RATES FOR 2017

Married Individuals Filing Joint Returns and Surviving Spouses

If taxable income is:	*Then income tax equals:*
Not over $18,650	10% of the taxable income
Over $18,650 but not over $75,900	$1,865 plus 15% of the excess over $18,650
Over $75,900 but not over $153,100	$10,452.50 plus 25% of the excess over $75,900
Over $153,100 but not over $233,350	$29,752.50 plus 28% of the excess over $153,100
Over $233,350 but not over $416,700	$52,222.50 plus 33% of the excess over $233,350
Over $416,700 but not over $470,700	$112,728 plus 35% of the excess over $416,700
Over $470,700	$131,628 plus 39.6% of the excess over $470,700 * * *

Capital gains rates

In general

In the case of an individual, estate, or trust, any adjusted net capital gain which otherwise would be taxed at the 10- or 15-percent rate is not taxed. Any adjusted net capital gain which otherwise would be taxed at rates over 15-percent and below 39.6 percent is taxed at a 15-percent rate. Any adjusted net capital gain which otherwise would be taxed at a 39.6-percent rate is taxed at a 20-percent rate. [*See* § 1(h)] * * *

In addition, a tax is imposed on net investment income in the case of an individual, estate, or trust. In the case of an individual, the tax is 3.8 percent of the lesser of net investment income, which includes gains and dividends, or the excess of modified adjusted gross income over the threshold amount. [*See* § 1411] The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in the case of any other individual.

Definitions

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Net capital gain [See § 1222]
In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Net capital gain is the excess of the net long term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

A capital asset [see § 1221] generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, (5) certain U.S. publications, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. [*See* § 1245] Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances available under the straight-line method of depreciation. [*See* § 1250]

Adjusted net capital gain [*See* § 1(h)(3)]
The ''adjusted net capital gain'' of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain. The net capital gain is reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation under section 163(d).

Qualified dividend income [*See* § 1(h)(11)]
Adjusted net capital gain is increased by the amount of qualified dividend income.
A dividend is the distribution of property made by a corporation to its shareholders out of its after-tax earnings and profits. [*See* § 301] Qualified dividends generally includes dividends received from domestic corporations and qualified foreign corporations. The term ''qualified foreign corporation'' includes a foreign corporation that is eligible for the benefits of a comprehensive income tax treaty with the United States which the Treasury Department determines to be satisfactory and which includes an exchange of information program.
In addition, a foreign corporation is treated as a qualified foreign corporation for any dividend paid by the corporation with respect to stock that is readily tradable on an established securities market in the United States. * * *

HOUSE BILL

Modification of rates
The House bill replaces the individual income tax rate structure with a new rate structure.
TABLE 2.—FEDERAL INDIVIDUAL INCOME TAX RATES FOR 2018 UNDER THE HOUSE BILL
[For married individuals filing jointly] If taxable income is: Then income tax equals: * * *
Married Individuals Filing Joint Returns and Surviving Spouses

If taxable income is:	*Then income tax equals:*
Not over $90,000	12% of the taxable income

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Over $90,000 but not over $260,000 .... $10,800 plus 25% of the excess over $90,000
Over $260,000 but not over $1,000,000 .... $53,300 plus 35% of the excess over $260,000

The dollar amounts for bracket thresholds are all adjusted for inflation[.] * * * Unlike present law, which uses a measure of the Consumer Price Index for All Urban Consumers (''CPI–U''), the new inflation adjustment uses the Chained Consumer Price Index for All Urban Consumers (''C–CPI–U''). * * *

Maximum rates on capital gains and qualified dividends
The provision generally retains the present-law maximum rates on net capital gain and qualified dividends. The breakpoints between the zero- and 15-percent rates (''15-percent breakpoint'') and the 15- and 20-percent rates (''20-percent breakpoint'') are based on the same amounts as the breakpoints under present law, except the breakpoints are indexed using the C–CPI–U in taxable years beginning after 2017. Thus, for 2018, the 15-percent breakpoint is $77,200 for joint returns[.] * * * The 20-percent breakpoint is $479,000 for joint returns[.] * * *

Therefore, in the case of an individual (including an estate or trust) with adjusted net capital gain, to the extent the gain would not result in taxable income exceeding the 15-percent breakpoint, such gain is not taxed. Any adjusted net capital gain which would result in taxable income exceeding the 15-percent breakpoint but not exceeding the 20-percent breakpoint is taxed at 15 percent. The remaining adjusted net capital gain is taxed at 20 percent. * * *

Effective date.—The provision applies to taxable years beginning after December 31, 2017.

SENATE AMENDMENT

Temporary modification of rates
The Senate amendment temporarily replaces the individual income tax rate structure with a new rate structure.
TABLE 3.—FEDERAL INDIVIDUAL INCOME TAX RATES FOR 2018 UNDER THE SENATE AMENDMENT
If taxable income is: Then income tax equals:
Married Individuals Filing Joint Returns and Surviving Spouses
If taxable income is: *Then income tax equals:*
Not over $19,050 .... 10% of the taxable income
Over $19,050 but not over $77,400 .... $1,905 plus 12% of the excess over $19,050
Over $77,400 but not over $140,000 .... $8,907 plus 22% of the excess over $77,400
Over $140,000 but not over $320,000 .... $22,679 plus 24% of the excess over $140,000
Over $320,000 but not over $400,000 .... $65,879 plus 32% of the excess over $320,000
Over $400,000 but not over $1,000,000 .... $91,479 plus 35% of the excess over $400,000
Over $1,000,000 .... $301,479 plus 38.5% of the excess over $1,000,000 * * *

CONFERENCE AGREEMENT

The conference agreement temporarily replaces the existing rate structure with a new rate structure.

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TABLE 4.—FEDERAL INDIVIDUAL INCOME TAX RATES FOR 2018 UNDER THE CONFERENCE AGREEMENT * * *

Married Individuals Filing Joint Returns and Surviving Spouses

If taxable income is:	*Then income tax equals:*
Not over $19,050	10% of the taxable income
Over $19,050 but not over $77,400	$1,905 plus 12% of the excess over $19,050
Over $77,400 but not over $165,000	$8,907 plus 22% of the excess over $77,400
Over $165,000 but not over $315,000	$28,179 plus 24% of the excess over $165,000
Over $315,000 but not over $400,000	$64,179 plus 32% of the excess over $315,000
Over $400,000 but not over $600,000	$91,379 plus 35% of the excess over $400,000
Over $600,000	$161,379 plus 37% of the excess over $600,000 * * *

The provision's rate structure does not apply to taxable years beginning after December 31, 2025. * * * The conference agreement follows the House bill and generally retains present-law maximum rates on net capital gains and qualified dividends. * * *

Effective date.—The provision applies to taxable years beginning after December 31, 2017. * * *

13 For 2017, the additional amount is $1,250 for married taxpayers (for each spouse meeting the applicable criterion) and surviving spouses. The additional amount for single individuals and heads of households is $1,550. An individual who qualifies as both blind and elderly is entitled to two additional standard deductions, for a total additional amount (for 2017) of $2,500 or $3,100, as applicable.

14 Thus, the standard deduction is the same for 2018 and 2019.

3. Increase in the Standard Deduction

TCAJA CONFERENCE REPORT

Increase in standard deduction (sec. 1002 of the House bill, sec. 11021 of the Senate amendment, and sec. 63 of the Code)

PRESENT LAW

Under present law, an individual who does not elect to itemize deductions may reduce his or her adjusted gross income (''AGI'') by the amount of the applicable standard deduction in arriving at his or her taxable income. The standard deduction is the sum of the basic standard deduction and, if applicable, the additional standard deduction. The basic standard deduction varies depending upon a taxpayer's filing status. For 2017, the amount of the basic standard deduction is * * * $12,700 for married individuals filing a joint return and surviving spouses. An additional standard deduction is allowed with respect to any individual who is elderly or blind. The amount of the standard deduction is indexed annually for inflation. * * *

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HOUSE BILL

The House bill increases the standard deduction for individuals across all filing statuses. Under the provision, the amount of the standard deduction is $24,400 for married individuals filing a joint return[.] * * * The amount of the standard deduction is indexed for inflation using the C–CPI–U for taxable years beginning after December 31, 2019. The provision eliminates the additional standard deduction for the aged and the blind.

Effective date.—The provision is effective for taxable years beginning after December 31, 2017.

SENATE AMENDMENT

The Senate amendment temporarily increases the basic standard deduction for individuals across all filing statuses. Under the provision, the amount of the standard deduction is temporarily increased to $24,000 for married individuals filing a joint return[.] * * * The amount of the standard deduction is indexed for inflation using the C–CPI–U for taxable years beginning after December 31, 2018. The additional standard deduction for the elderly and the blind is not changed by the provision.

Effective date.—The provision is effective for taxable years beginning after December 31, 2017.

CONFERENCE AGREEMENT

The conference agreement follows the Senate amendment.

4. Repeal of the Deduction for the Personal Exemption

TCAJA CONFERENCE REPORT

Repeal of the deduction for personal exemptions (sec. 1003 of the House bill, sec. 11041 of the Senate amendment, and sec. 151 of the Code)

PRESENT LAW

Under present law, in determining taxable income, an individual reduces AGI by any personal exemption deductions and either the applicable standard deduction or his or her itemized deductions. Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2017, the amount deductible for each personal exemption is $4,050. This amount is indexed annually for inflation. The personal exemption amount is phased out in the case of an individual with AGI in excess of $313,800 for married taxpayers filing jointly[.] * * *

HOUSE BILL

The House bill repeals the deduction for personal exemptions. * * *

SENATE AMENDMENT

The Senate amendment suspends the deduction for personal exemptions. * * *
Effective date.—The provision is effective for taxable years beginning after December 31, 2017.

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CONFERENCE AGREEMENT

The conference agreement follows the Senate amendment and suspends the deduction for personal exemptions. The suspension does not apply to taxable years beginning after December 31, 2025. * * *
Effective date.—The provision is effective for taxable years beginning after December 31, 2017. * * *

5. The Amendments to the Individual and Corporate AMTs

Alternative Minimum Tax (sec. 2001 of the House bill, sec. 12001 of the Senate amendment, and secs. 53 and 55–59 of the Code)

PRESENT LAW

Individual alternative minimum tax

In general

An alternative minimum tax (''AMT'') is imposed on an individual, estate, or trust in an amount by which the tentative minimum tax exceeds the regular income tax for the taxable year. For taxable years beginning in 2017, the tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed $187,800 ($93,900 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The breakpoints are indexed for inflation. The taxable excess is so much of the alternative minimum taxable income (''AMTI'') as exceeds the exemption amount. The maximum tax rates on net capital gain and dividends used in computing the regular tax are used in computing the tentative minimum tax. AMTI is the taxable income adjusted to take account of specified tax preferences and adjustments.

The exemption amounts for taxable years beginning in 2017 [is]: (1) $84,500 in the case of married individuals filing a joint return and surviving spouses[.] * * *

HOUSE BILL

The House bill repeals the individual and corporate alternative minimum tax. * * *

Effective date.—The provision is effective for taxable years beginning after December 31, 2017. * * *

SENATE AMENDMENT

The Senate amendment temporarily increases both the exemption amount and the exemption amount phaseout thresholds for the individual AMT. * * *

The provision does not change the corporate alternative minimum tax.

Effective date.—The provision is effective for taxable years beginning after December 31, 2017.

CONFERENCE AGREEMENT

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The conference agreement temporarily increases both the exemption amount and the exemption amount phaseout thresholds for the individual AMT. * * *

The conference agreement follows the House bill in repealing the corporate alternative minimum tax.

C. Page 6, New Sec. 1.3.B. Introduction to the TCAJA's C Corporate Rate Structure Generally and for Intercorporate Dividends

Page 6, New Sec. 1.3.B. Add immediately after the new Sec. 1.3.A. the following:

New Sec. 1.3.B. **Introduction to the TCAJA's C Corporation Rate Structure Generally and for Intercorporate Dividends**

1. In General

In connection with the study of section 1.3, read also the following provisions of the Conference Report to the TCAJA and related Code section addressing the C corporation rate structure and rules for taxing intercorporate dividends.

2. The TCAJA's C Corporation Rate Structure Generally and for Intercorporate Dividends

TCAJA CONFERENCE REPORT

Reduction in corporate tax rate (sec. 3001 of the House bill, secs. 13001 and 13002 of the Senate amendment, and secs. 11 and 243 of the Code)

PRESENT LAW

In general [See § 11]

Corporate taxable income is subject to tax under a four-step graduated rate structure. The top corporate tax rate is 35 percent on taxable income in excess of $10 million. The corporate taxable income brackets and tax rates are as set forth in the table below.

Taxable Income	Tax rate (percent)
Not over $50,000	15
Over $50,000 but not over $75,000	25
Over $75,000 but not over $10,000,000	34
Over $10,000,000	35

Dividends received deduction [See § 243]

Corporations are allowed a deduction with respect to dividends received from other taxable domestic corporations. The amount of the deduction is generally equal to 70 percent of the dividend received. In the case of any dividend received from a 20-percent owned corporation, the amount of the deduction is equal to 80 percent of the dividend received. The term ''20-percent owned corporation'' means any corporation if 20 percent or more of the stock of such corporation (by vote and value) is owned by the taxpayer. For this purpose, certain preferred stock is not taken into account. In the case of a dividend received from a corporation that is

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a member of the same affiliated group, a corporation is generally allowed a deduction equal to 100 percent of the dividend received.

HOUSE BILL

The provision eliminates the graduated corporate rate structure and instead taxes corporate taxable income at 20 percent. Personal service corporations are taxed at 25 percent. * * * The provision reduces the 70 percent dividends received deduction to 50 percent and the 80 percent dividends received deduction to 65 percent. * * *

Effective date.—The provision applies to taxable years beginning after December 31, 2017.

SENATE AMENDMENT

The Senate amendment follows the House bill, but does not provide a special rate for personal service corporations.

Effective date.—The provision applies to taxable years beginning after December 31, 2018.

CONFERENCE AGREEMENT

The conference agreement follows the Senate amendment, but provides for a 21-percent corporate rate effective for taxable years beginning after December 31, 2017. * * *

D. Page 6, New Sec. 1.3.C. The TCAJA's Deduction for Passthrough Income, Section 199A

Page 6, New Sec. 1.3.C. Add immediately after the new Sec. 1.3.B. the following:

New Sec. 1.3.C. **The TCAJA's Deduction for Passthrough Income, Section 199A**

Deduction for qualified business income (sec. 1004 of the House bill, sec. 11011 of the Senate amendment, and sec. 199A of the Code)

PRESENT LAW

Individual income tax rates

To determine regular tax liability, an individual taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's income increases. * * *

Partnerships

Partnerships generally are treated for Federal income tax purposes as pass-through entities not subject to tax at the entity level. Items of income (including tax-exempt income), gain, loss, deduction, and credit of the partnership are taken into account by the partners in computing their income tax liability (based on the partnership's method of accounting and regardless of whether the income is distributed to the partners). A partner's deduction for partnership losses is limited to the partner's adjusted basis in its partnership interest. Losses not allowed as a result of that limitation generally are carried forward to the next year. * * *

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Partnerships may allocate items of income, gain, loss, deduction, and credit among the partners, provided the allocations have substantial economic effect. * * *

S corporations
For Federal income tax purposes, an S corporation generally is not subject to tax at the corporate level. Items of income (including tax-exempt income), gain, loss, deduction, and credit of the S corporation are taken into account by the S corporation shareholders in computing their income tax liabilities (based on the S corporation's method of accounting and regardless of whether the income is distributed to the shareholders). * * *

Sole proprietorships
Unlike a C corporation, partnership, or S corporation, a business conducted as a sole proprietorship is not treated as an entity distinct from its owner for Federal income tax purposes. Rather, the business owner is taxed directly on business income, and files Schedule C (sole proprietorships generally), Schedule E (rental real estate and royalties), or Schedule F (farms) with his or her individual tax return. Furthermore, transfer of a sole proprietorship is treated as a transfer of each individual asset of the business. Nonetheless, a sole proprietorship is treated as an entity separate from its owner for employment tax purposes, for certain excise taxes, and certain information reporting requirements.

HOUSE BILL

Qualified business income of an individual from a partnership, S corporation, or sole proprietorship is subject to Federal income tax at a rate no higher than 25 percent. Qualified business income means, generally, all net business income from a passive business activity plus the capital percentage of net business income from an active business activity, reduced by carryover business losses and by certain net business losses from the current year, as determined under the provision. * * *

SENATE AMENDMENT

In general
For taxable years beginning after December 31, 2017 and before January 1, 2026, an individual taxpayer generally may deduct 23 percent of qualified business income from a partnership, S corporation, or sole proprietorship, as well as 23 percent of aggregate qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income. Special rules apply to specified agricultural or horticultural cooperatives. A limitation based on W–2 wages paid is phased in above a threshold amount of taxable income. A disallowance of the deduction with respect to specified service trades or businesses is also phased in above the threshold amount of taxable income.

Qualified business income
Qualified business income is determined for each qualified trade or business of the taxpayer. For any taxable year, qualified business income means the net amount of qualified items of income, gain, deduction, and loss with respect to the qualified trade or business of the taxpayer. The determination of qualified items of income, gain, deduction, and loss takes into account these items only to the extent included or allowed in the determination of taxable income for the year.

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For example, if in a taxable year, a qualified business has $100,000 of ordinary income from inventory sales, and makes an expenditure of $25,000 that is required to be capitalized and amortized over 5 years under applicable tax rules, the qualified business income is $100,000 minus $5,000 (current-year ordinary amortization deduction), or $95,000. The qualified business income is not reduced by the entire amount of the capital expenditure, only by the amount deductible in determining taxable income for the year.

If the net amount of qualified business income from all qualified trades or businesses during the taxable year is a loss, it is carried forward as a loss from a qualified trade or business in the next taxable year. Similar to a qualified trade or business that has a qualified business loss for the current taxable year, any deduction allowed in a subsequent year is reduced (but not below zero) by 23 percent of any carryover qualified business loss. * * *

Domestic business
Items are treated as qualified items of income, gain, deduction, and loss only to the extent they are effectively connected with the conduct of a trade or business within the United States. * * *

Treatment of investment income
Qualified items do not include specified investment-related income, deductions, or loss. Specifically, qualified items of income, gain, deduction and loss do not include [*inter alia*] (1) any item taken into account in determining net long-term capital gain or net long-term capital loss, (2) dividends, income equivalent to a dividend, or payments in lieu of dividends, [and] (3) interest income other than that which is properly allocable to a trade or business[.]

Reasonable compensation and guaranteed payments
Qualified business income does not include any amount paid by an S corporation that is treated as reasonable compensation of the taxpayer. Similarly, [in the case of a partnership] qualified business income does not include any guaranteed payment [*see* § 707(c)] for services rendered with respect to the trade or business, and to the extent provided in regulations, does not include any amount paid or incurred by a partnership to a partner who is acting other than in his or her capacity as a partner for services [*see* § 707(a)(1)].

Qualified trade or business
A qualified trade or business means any trade or business other than a specified service trade or business and other than the trade or business of being an employee. * * *

Specified service business
A specified service trade or business means any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, including investing and investment management, trading, or dealing in securities, partnership interests, or commodities, and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees. * * *

Phase-in of specified service business limitation

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The exclusion from the definition of a qualified business for specified service trades or businesses phases in for a taxpayer with taxable income in excess of a threshold amount. The threshold amount is $250,000 (200 percent of that amount, or $500,000, in the case of a joint return) (the ‘‘threshold amount’’). The threshold amount is indexed for inflation. The exclusion from the definition of a qualified business for specified service trades or businesses is fully phased in for a taxpayer with taxable income in excess of the threshold amount plus $50,000 ($100,000 in the case of a joint return). For a taxpayer with taxable income within the phase-in range, the exclusion applies as follows. In computing the qualified business income with respect to a specified service trade or business, the taxpayer takes into account only the applicable percentage of qualified items of income, gain, deduction, or loss, and of allocable W–2 wages. The applicable percentage with respect to any taxable year is 100 percent reduced by the percentage equal to the ratio of the excess of the taxable income of the taxpayer over the threshold amount bears to $50,000 ($100,000 in the case of a joint return).

For example, Taxpayer has taxable income of $280,000, of which $200,000 is attributable to an accounting sole proprietorship after paying wages of $100,000 to employees. Taxpayer has an applicable percentage of 40 percent. In determining includible qualified business income, Taxpayer takes into account 40 percent of $200,000, or $80,000. In determining the includible W–2 wages, Taxpayer takes into account 40 percent of $100,000, or $40,000. Taxpayer calculates the deduction by taking the lesser of 23 percent of $80,000 ($18,400) or 50 percent of $40,000 ($20,000). Taxpayer takes a deduction for $18,400.

Tentative deductible amount for a qualified trade or business
In general
For each qualified trade or business, the taxpayer is allowed a deductible amount equal to the lesser of 23 percent of the qualified business income with respect to such trade or business or 50 percent of the W–2 wages with respect to such business (the ‘‘wage limit’’). However, if the taxpayer's taxable income is below the threshold amount, the deductible amount for each qualified trade or business is equal to 23 percent of the qualified business income with respect to each respective trade or business.

W–2 wages
W–2 wages are the total wages subject [*inter alia*] to wage withholding[.] * * * ,

Phase-in of wage limit
The application of the wage limit phases in for a taxpayer with taxable income in excess of the threshold amount. The wage limit applies fully for a taxpayer with taxable income in excess of the threshold amount plus $50,000 ($100,000 in the case of a joint return). For a taxpayer with taxable income within the phase-in range, the wage limit applies as follows. With respect to any qualified trade or business, the taxpayer compares (1) 23 percent of the taxpayer's qualified business income with respect to the qualified trade or business with (2) 50 percent of the W–2 wages with respect to the qualified trade or business. If the amount determined under (2) is less than the amount determined (1), (that is, if the wage limit is binding), the taxpayer's deductible amount is the amount determined under (1) reduced by the same proportion of the difference between the two amounts as the excess of the taxable income of the taxpayer over the threshold amount bears to $50,000 ($100,000 in the case of a joint return). * * *

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Special rules and definitions
For purposes of the provision, taxable income is determined without regard to the deduction allowable under the provision. * * *

CONFERENCE AGREEMENT

The conference agreement follows the Senate amendment with modifications.

Deduction percentage
Under the conference agreement, the percentage of the deduction allowable under the provision is 20 percent (not 23 percent).

Threshold amount
The conference agreement reduces the threshold amount above which both the limitation on specified service businesses and the wage limit are phased in. Under the conference agreement, the threshold amount is $157,500 (twice that amount or $315,000 in the case of a joint return), indexed. The conferees expect that the reduced threshold amount will serve to deter high-income taxpayers from attempting to convert wages or other compensation for personal services to income eligible for the 20-percent deduction under the provision. The conference agreement provides that the range over which the phase-in of these limitations applies is $50,000 ($100,000 in the case of a joint return).

Limitation based on W–2 wages and capital
The conference agreement modifies the wage limit applicable to taxpayers with taxable income above the threshold amount to provide a limit based either on wages paid or on wages paid plus a capital element. Under the conference agreement, the limitation is the greater of (a) 50 percent of the W–2 wages paid with respect to the qualified trade or business, or (b) the sum of 25 of percent of the W–2 wages with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property.

For purposes of the provision, qualified property means tangible property of a character subject to depreciation that is held by, and available for use in, the qualified trade or business at the close of the taxable year, and which is used in the production of qualified business income, and for which the depreciable period has not ended before the close of the taxable year. The depreciable period with respect to qualified property of a taxpayer means the period beginning on the date the property is first placed in service by the taxpayer and ending on the later of (a) the date 10 years after that date, or (b) the last day of the last full year in the applicable recovery period that would apply to the property * * * (without regard to section 168(g)).

For example, a taxpayer (who is subject to the limit) does business as a sole proprietorship conducting a widget-making business. The business buys a widget-making machine for $100,000 and places it in service in 2020. The business has no employees in 2020. The limitation in 2020 is the greater of (a) 50 percent of W–2 wages, or $0, or (b) the sum of 25 percent of W–2 wages ($0) plus 2.5 percent of the unadjusted basis of the machine immediately after its acquisition: $100,000 × .025 = $2,500. The amount of the limitation on the taxpayer's deduction is $2,500.

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In the case of property that is sold, for example, the property is no longer available for use in the trade or business and is not taken into account in determining the limitation. The Secretary is required to provide rules for applying the limitation in cases of a short taxable year of where the taxpayer acquires, or disposes of, the major portion of a trade or business or the major portion of a separate unit of a trade or business during the year. The Secretary is required to provide guidance applying rules similar to the rules of section 179(d)(2) to address acquisitions of property from a related party, as well as in a sale-leaseback or other transaction as needed to carry out the purposes of the provision and to provide anti-abuse rules, including under the limitation based on W–2 wages and capital. Similarly, the Secretary shall provide guidance prescribing rules for determining the unadjusted basis immediately after acquisition of qualified property acquired in like-kind exchanges or involuntary conversions as needed to carry out the purposes of the provision and to provide anti-abuse rules, including under the limitation based on W–2 wages and capital.

Specified service trade or business

The conference agreement modifies the definition of a specified service trade or business in several respects. The definition is modified to exclude engineering and architecture services, and to take into account the reputation or skill of owners. A specified service trade or business means any trade or business involving the performance of services in the fields of health, law, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management trading, or dealing in securities, partnership interests, or commodities. For this purpose a security and a commodity have the meanings provided in the rules for the mark-to-market accounting method for dealers in securities (sections 475(c)(2) and 475(e)(2), respectively).

Determination of the taxpayer's deduction

The taxpayer's deduction for qualified business income for the taxable year is equal to the sum of (a) the lesser of the combined qualified business income amount for the taxable year or an amount equal to 20 percent of the excess of taxpayer's taxable income over any net capital gain and qualified cooperative dividends, plus (b) the lesser of 20 percent of qualified cooperative dividends and taxable income (reduced by net capital gain). This sum may not exceed the taxpayer's taxable income for the taxable year (reduced by net capital gain). * * * The combined qualified business income amount for the taxable year is the sum of the deductible amounts determined for each qualified trade or business carried on by the taxpayer and 20 percent of the taxpayer's qualified REIT dividends and qualified publicly traded partnership income. The deductible amount for each qualified trade or business is the lesser of (a) 20 percent of the taxpayer's qualified business income with respect to the trade or business, or (b) the greater of 50 percent of the W–2 wages with respect to the trade or business or the sum of 25 percent of the W–2 wages with respect to the trade or business and 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property.

Deduction against taxable income

The conference agreement clarifies that the 20-percent deduction is not allowed in computing adjusted gross income, and instead is allowed as a deduction reducing taxable income. Thus, for

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example, the provision does not affect limitations based on adjusted gross income. Similarly the conference agreement clarifies that the deduction is available to both non-itemizers and itemizers. * * *

Effective date.—The provision is effective for taxable years beginning after December 31, 2017.

E. Page 10, New Sec. 1.3.D. The TCAJA's Treatment of Carried Interests, Section 1061

Page 10, New Sec. 1.3.D. Add immediately after the new Sec. 1.3.C. the following:

New Sec. 1.3. D. **The TCAJA's Treatment of Carried Interests, Section 1060**

Recharacterization of certain gains in the case of partnership profits interests held in connection with performance of investment services (sec. 3314 of the House bill, sec. 13310 of the Senate amendment, and secs. 1061 and 83 of the Code)

PRESENT LAW

Partnership profits interest for services

A profits interest in a partnership is the right to receive future profits in the partnership but does not generally include any right to receive money or other property upon the immediate liquidation of the partnership. The treatment of the receipt of a profits interest in a partnership (sometimes referred to as a carried interest) in exchange for the performance of services has been the subject of controversy. Though courts have differed, in some instances, a taxpayer receiving a profits interest for performing services has not been taxed upon the receipt of the partnership interest. In 1993, the Internal Revenue Service, referring to the litigation of the tax treatment of receiving a partnership profits interest and the results in the cases, issued administrative guidance that the IRS generally would treat the receipt of a partnership profits interest for services as not a taxable event for the partnership or the partner. Under this guidance, this treatment does not apply however, if: (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (2) within two years of receipt, the partner disposes of the profits interest; or (3) the profits interest is a limited partnership interest in a publicly traded partnership. More recent administrative guidance clarifies that this treatment applies with respect to substantially unvested profits interests provided the service partner takes into income his distributive share of partnership income, and the partnership does not deduct any amount either on grant or on vesting of the profits interest.

By contrast, a partnership capital interest received for services is includable in the partner's income under generally applicable rules relating to the receipt of property for the performance of services. A partnership capital interest for this purpose is an interest that would entitle the receiving partner to a share of the proceeds if the partnership's assets were sold at fair market value and the proceeds were distributed in liquidation.

Property received for services under section 83

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In general
Section 83 governs the amount and timing of income and deductions attributable to transfers of property in connection with the performance of services. If property is transferred in connection with the performance of services, the person performing the services (the ‘‘service provider’’) generally must recognize income for the taxable year in which the property is first substantially vested (i.e., transferable or not subject to a substantial risk of forfeiture). The amount includible in the service provider’s income is the excess of the fair market value of the property over the amount (if any) paid for the property. A deduction is allowed to the person for whom such services are performed (the ‘‘service recipient’’) equal to the amount included in gross income by the service provider. * * *

Section 83(b) election
Under section 83(b), even if the property is substantially nonvested at the time of transfer, the service provider may nevertheless elect within 30 days of the transfer to recognize income for the taxable year of the transfer. * * *

Passthrough tax treatment of partnerships
The character of partnership items passes through to the partners as if the items were realized directly by the partners. * * *

Net long-term capital gain
In the case of an individual * * * [a]ny adjusted net capital gain which otherwise would be taxed at a 39.6-percent rate is taxed at a 20-percent rate. * * *

HOUSE BILL

General rule
The provision provides for a three-year holding period in the case of certain net long-term capital gain with respect to any applicable partnership interest held by the taxpayer. Section 83 (relating to property transferred in connection with performance of services) does not apply to the transfer of a partnership interest to which the provision applies.

Short-term capital gain
The provision treats as short-term capital gain taxed at ordinary income rates 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 of such gain calculated as if a three-year (not one-year) holding period applies. * * *

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. * * *

Applicable trade or business
An applicable trade or business means any activity (regardless of whether the activity [is] conducted in one or more entities) that consists in whole or in part of the following: (1) raising or

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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. * * *

Effective date.—The provision applies to taxable years beginning after December 31, 2017.

SENATE AMENDMENT

The Senate amendment is generally the same as the House bill, except with respect to the nonapplicability of section 83. Under the Senate amendment, the provision provides a three-year holding period in the case of certain net long-term capital gain with respect to any applicable partnership interest held by the taxpayer, notwithstanding the rules of section 83 or any election in effect under section 83(b).

CONFERENCE AGREEMENT

The conference agreement follows the Senate amendment. The conferees wish to clarify the interaction of section 83 with the provision's three-year holding requirement, which applies notwithstanding the rules of section 83 or any election in effect under section 83(b). Under the provision, the fact that an individual may have included an amount in income upon acquisition of the applicable partnership interest, or that an individual may have made a section 83(b) election with respect to an applicable partnership interest, does not change the three-year holding period requirement for long-term capital gain treatment with respect to the applicable partnership interest. Thus, the provision treats as short-term capital gain taxed at ordinary income rates 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 of such gain calculated as if a three-year (not one-year) holding period applies. In making this calculation, the provision takes account of long-term capital losses calculated as if a three-year holding period applies.

§ 1.2 CHAPTER 2, AN OVERVIEW OF BASIC CORPORATE TAX PRINCIPLES

A. Page 41, New Sec. 2.3.C. The TCAJA's Replacement of the Prior Section 163(j) Interest Stripping Provision with the Current Section 163(j) Interest Limitation Provision

Page 41, New Sec. 2.3.C. Insert immediately before Sec. 2.4 the following new Sec. 2.3.C:

New Sec. 2.3.C. **The TCAJA's Replacement of the Prior Section 163(j) Interest Stripping Provision with the Current Section 163(j) Interest Limitation Provision**

Interest (secs. 3203 and 3301 of the House bill, secs. 13301 and 13311 of the Senate amendment, and sec. 163(j) of the Code)

PRESENT LAW

Interest deduction

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Interest paid or accrued by a business generally is deductible in the computation of taxable income subject to a number of limitations. Interest is generally deducted by a taxpayer as it is paid or accrued, depending on the taxpayer's method of accounting. For all taxpayers, if an obligation is issued with original issue discount (''OID''), a deduction for interest is allowable over the life of the obligation on a yield to maturity basis. Generally, OID arises where interest on a debt instrument is not calculated based on a qualified rate and required to be paid at least annually.

Investment interest expense
In the case of a taxpayer other than a corporation, the deduction for interest on indebtedness that is allocable to property held for investment (''investment interest'') is limited to the taxpayer's net investment income for the taxable year. * * *

Earnings stripping
Section 163(j) may disallow a deduction for disqualified interest paid or accrued by a corporation in a taxable year if two threshold tests are satisfied: the payor's debt-to-equity ratio exceeds 1.5 to 1.0 (the safe harbor ratio) and the payor's net interest expense exceeds 50 percent of its adjusted taxable income (generally, taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under section 199, depreciation, amortization, and depletion). Disqualified interest includes interest paid or accrued to: (1) related parties when no Federal income tax is imposed with respect to such interest; (2) unrelated parties in certain instances in which a related party guarantees the debt; or (3) to a real estate investment trust (''REIT'') by a taxable REIT subsidiary of that trust. Interest amounts disallowed under these rules can be carried forward indefinitely. In addition, any excess limitation (i.e., the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.

HOUSE BILL

In general
In the case of any taxpayer for any taxable year, the deduction for business interest is limited to the sum of (1) business interest income; (2) 30 percent of the adjusted taxable income of the taxpayer for the taxable year; and (3) the floor plan financing interest of the taxpayer for the taxable year. [Floor plan financing (e.g., certain indebtedness used to finance the acquisition of motor vehicles) is not addressed further here.] The amount of any business interest not allowed as a deduction for any taxable year may be carried forward for up to five years beyond the year in which the business interest was paid or accrued, treating business interest as allowed as a deduction on a first-in, first-out basis. The limitation applies at the taxpayer level. In the case of a group of affiliated corporations that file a consolidated return, the limitation applies at the consolidated tax return filing level.

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

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Adjusted taxable income means the taxable income of the taxpayer computed without regard to (1) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business; (2) any business interest or business interest income; (3) the amount of any net operating loss deduction; and (4) any deduction allowable for depreciation, amortization, or depletion. The Secretary may provide other adjustments to the computation of adjusted taxable income. * * *
It is generally intended that, similar to present law, section 163(j) apply after the application of provisions that subject interest to deferral, capitalization, or other limitation. Thus, section 163(j) applies to interest deductions that are deferred, for example under section 163(e) or section 267(a)(3)(B), in the taxable year to which such deductions are deferred. Section 163(j) applies after section 263A is applied to capitalize interest and after, for example, section 265 or section 279 is applied to disallow interest.

Application to passthrough entities
In general
In the case of any partnership, the limitation is applied at the partnership level. * * * Similar rules apply with respect to any S corporation and its shareholders.

Double counting rule
The adjusted taxable income of each partner (or shareholder, as the case may be) is determined without regard to such partner's distributive share of the nonseparately stated income or loss of such partnership. In the absence of such a rule, the same dollars of adjusted taxable income of a partnership could generate additional interest deductions as the income is passed through to the partners. * * *

Carryforward of disallowed business interest
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. Business interest may be carried forward for up to five years. * * *

Exceptions
The limitation does not apply to any taxpayer that meets the $25 million gross receipts test of section 448(c), that is, if the average annual gross receipts for the three-taxable-year period ending with the prior taxable year does not exceed $25 million. * * *

SENATE AMENDMENT

The Senate amendment is the same as the House bill, with the following modifications.
In general
The Senate amendment makes several changes to the definition of adjusted taxable income. Specifically, the Senate amendment does not add back deductions allowable for depreciation, amortization, or depletion, but does add back any deduction under section 199, and any deduction under section 199A with respect to qualified business income of a passthrough entity. * * * The Senate amendment permits interest deductions to be carried forward indefinitely, subject to certain restrictions applicable to partnerships, described below.

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Application to passthrough entities
The Senate amendment requires a partner in a partnership to ignore the partner's distributive share of all items of income, gain, deduction, or loss of the partnership when calculating adjusted taxable income (rather than merely ignoring the nonseparately stated income or loss, as in the House bill). The Senate amendment takes a different mathematical approach from the House bill to calculating a partner's interest limitation, though both provisions have the same practical effect. In the Senate amendment, 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 taxable income. The excess taxable income with respect to any partnership is the amount which bears the same ratio to the partnership's adjusted taxable income as the excess (if any) of 30 percent of the adjusted taxable income of the partnership over the amount (if any) by which the business interest of the partnership, reduced by floor plan financing interest, exceeds the business interest income of the partnership bears to 30 percent of the adjusted taxable income of the partnership. This allows a partner of a partnership to deduct additional interest expense the partner may have paid or incurred to the extent the partnership could have deducted more business interest. The Senate amendment requires that excess taxable income be allocated in the same manner as nonseparately stated income and loss. As in the House bill, rules similar to these rules also apply to S corporations.

The Senate amendment provides a special rule for carryforward of disallowed partnership interest. In the case of a partnership, the general carryforward rule described in the discussion of the House bill does not apply. Instead, any business interest that is not allowed as a deduction to the partnership for the taxable year is allocated to each partner in the same manner as nonseparately stated taxable income or loss of the partnership. The partner may deduct its share of the partnership's excess business interest in any future year, but only against excess taxable income attributed to the partner by the partnership the activities of which gave rise to the excess business interest carryforward. Any such deduction requires a corresponding reduction in excess taxable income. Additionally, when excess business interest is allocated to a partner, the partner's basis in its partnership interest is reduced (but not below zero) by the amount of such allocation, even though the carryforward does not give rise to a partner deduction in the year of the basis reduction. However, the partner's deduction in a future year for interest carried forward does not reduce the partner's basis in the partnership interest. In the event the partner disposes of a partnership interest the basis of which has been so reduced, the partner's basis in such interest shall be increased, immediately before such disposition, by the amount that any such basis reductions exceed any amount of excess interest expense that has been treated as paid by the partner (i.e., excess interest expense that has been deducted by the partner against excess taxable income of the same partnership). This special rule does not apply to S corporations and their shareholders.

Exceptions
The Senate amendment exempts certain categories of taxpayers or trades or businesses from the interest limitation. First, any taxpayer that meets the $15 million gross receipts test of section 448(c) is exempt from the interest limitation. * * *

CONFERENCE AGREEMENT

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The conference agreement generally follows the Senate amendment, with the following modifications. Under the conference agreement, for taxable years beginning after December 31, 2017 and before January 1, 2022, adjusted taxable income is computed without regard to deductions allowable for depreciation, amortization, or depletion. Additionally, because the conference agreement repeals section 199 effective December 31, 2017, adjusted taxable income is computed without regard to such deduction. The conference agreement follows the House in exempting from the limitation taxpayers with average annual gross receipts for the three-taxable year period ending with the prior taxable year that do not exceed $25 million.* * *

Effective date.—The provision applies to taxable years beginning after December 31, 2017.

§ 1.3 CHAPTER 9, SPIN-OFFs UNDER SECTION 355 AND THEIR USE IN ACQUISITIONS

A. Page 585, New Sec. 9.4.E.3. When is a Trade or Business Too Small? Proposed Regulations

Page 585, New Sec. 9.4.E.3. Add immediately before section E the following new section 9.4.E.3:

New Sec. 9.4.E.3 **When is a Trade or Business Too Small? Proposed Regulations**

In 2016, the Treasury issued proposed regulations[1] under Section 355 that would provide (1) guidance with regard to the device clause in section 355(a)(1)(B), and (2) a minimum threshold for the assets of one or more active trades or businesses, within the meaning of section 355(a)(1)(C) and (b), which relate to the active business requirement. In general, these proposed regulations give guidance regarding the required size of the trade or business that must be held by the parent (Distributing) and the sub (Controlled) in a section 355 distribution. The preamble to the proposed regulations states that to satisfy the active business requirement the business must be "economically insignificant in relation to other assets of Distributing or Controlled."

B. Page 587, New Sec. 9.4.I. Ruling Policy on Leveraged Spin-Offs

Page 587, New Sec. 9.4.I. Add immediately before sec 9.5 the following new section:

New Sec. 9.4.I. **Ruling Policy on Leveraged Spin-Offs**

Rev. Proc. 2017-38
2017-22 I.R.B. 1258

Rev. Proc. 2017-3, 2017-1 I.R.B 130, is modified by deleting section 5.01 (4) (providing that whether § 355 or § 361 applies to a distributing corporation's distribution of stock or securities of a controlled corporation in exchange for, and in retirement of, any putative debt of the distributing corporation if such distributing corporation debt is issued in anticipation of the distribution, is an area under study in which a ruling letter will not be issued) and section 5.01 (6) (cross-referencing section 5.01 (4)).

[1] REG–134016–15, Proposed Regulations under Section 355 (Aug. 1, 2016).

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The Service continues to study matters concerning issues in this area (i.e., transactions in which debt is issued prior to and as part of a spin-off). However, it has been determined that issuing private letter rulings or determination letters in this area would be in the interest of sound tax administration.

C. Page 587, New Sec. 9.4.J. The "North-South" Spin-Off Ruling

Page 587, New Sec. 9.4.J. Add immediately after the new sec 9.4.I the following new section:
New Sec. 9.4.J. **The "North-South" Spin-Off Ruling**

Rev. Rul. 2017–09
IRB 2017-21 (May 22, 2017)

ISSUES

(1) If a parent corporation (*P*) transfers property (including property constituting an active trade or business that is transferred for the purpose of meeting the requirements of § 355(b)(1)(A) of the Internal Revenue Code (Code)), to its subsidiary (*D*), and if, pursuant to the same overall plan, this transfer is followed by a distribution by *D* of the stock of its controlled subsidiary (*C*) to *P*, are the transactions treated for federal income tax purposes as an exchange under § 351, followed by a distribution under § 355?

(2) Is a transfer of money or other property by *C* to *D*, made in pursuance of a plan of reorganization under §§ 368(a)(1)(D) and 355, governed by § 301 or § 361?

FACTS

Situation 1:

P owns all the stock of *D*, which owns all the stock of *C*. The fair market value of the *C* stock is $100X. *P* has been engaged in Business A for more than 5 years, and *C* has been engaged in Business B for more than 5 years. Business A and Business B each constitutes the active conduct of a trade or business within the meaning of § 355(b). *D* is not engaged in the active conduct of a trade or business, directly or through any member of its separate affiliated group (within the meaning of § 355(b)(3)) other than *C*.

On Date 1, *P* transfers the property and activities constituting Business A, having a fair market value of $25X, to *D* in exchange for additional shares of *D* stock. On Date 2, pursuant to a dividend declaration, *D* transfers all the *C* stock to *P* for a valid corporate business purpose. *D* retains the Business A property and continues the active conduct of Business A after the distribution. The purpose of *P*'s transfer of the property and activities of Business A to *D* is to allow *D* to satisfy the active trade or business requirement of § 355(b)(1)(A).

Situation 2:

P owns all the stock of *D*, which owns all the stock of *C*. *D* has been engaged in Business A for more than 5 years. *C* has been engaged in Business B for more than 5 years. Business A and

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Business B each constitutes the active conduct of a trade or business within the meaning of § 355(b).

On Date 1, *C* transfers $15X of money and property having a fair market value of $10X to *D*, pursuant to a dividend declaration, and *D* retains the money and property. On Date 2, *D* transfers to *C* property having a basis of $20X and a fair market value of $100X, and *D* distributes all the *C* stock to *P* in a transaction qualifying as a reorganization under §§ 368(a)(1)(D) and 355. *C* and *D* planned and executed the Date 1 transfer in pursuance of the plan of reorganization.

LAW

Section 301(c)(1) provides that a distribution that is a dividend (as defined in § 316), made by a corporation to a shareholder with respect to its stock, will be includible in the gross income of the shareholder. Section 301(c)(2) provides that the portion of the distribution which is not a dividend will be applied against and reduce the adjusted basis of the stock. Section 301(c)(3) provides that the portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, will be treated as gain from the sale or exchange of property.

Section 311(b) provides in part that, if a corporation distributes appreciated property to a shareholder in a distribution to which § 301 applies, gain (but no loss) will be recognized to the distributing corporation as if it had sold the property to the shareholder at its fair market value.

Section 316 generally defines a dividend as any distribution of property made by a corporation to its shareholders out of its earnings and profits accumulated after February 28, 1913, or out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any other distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Section 351(a) provides that no gain or loss will be recognized when property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in § 368(c)) of the corporation.

Section 355(a)(1) provides that, if certain requirements are met, a corporation may distribute stock and securities of a controlled corporation to its shareholders and security holders without recognition of gain or loss (nonrecognition treatment) or income to the recipient shareholders or security holders.

Section 355(a)(1)(A) provides that, for a distribution to qualify for nonrecognition treatment, the distributing corporation must distribute stock or securities of a corporation it controls (as defined in § 368(c)) immediately before the distribution.

Section 355(a)(1)(D) provides in part that a distribution may qualify for nonrecognition treatment if the distributing corporation distributes an amount of stock in the controlled corporation constituting control within the meaning of § 368(c).

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Section 355(b)(1)(A) provides that the distributing corporation and the controlled corporation each must be engaged in the active conduct of a trade or business immediately after the distribution.

Section 361(a) provides that no gain or loss will be recognized to a corporation a party to a reorganization upon exchange of property in pursuance of a plan of reorganization solely for stock or securities in another corporation a party to the reorganization.

Section 361(b) provides that, if § 361(a) would apply to an exchange of assets by a reorganizing corporation but for the fact that the property received in exchange consists not only of stock or securities of the acquiring corporation permitted by § 361(a) to be received without the recognition of gain, but also of other property or money, then (A) if the corporation receiving that other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation will be recognized from the exchange, but (B) if the corporation receiving that other property or money does not distribute it in pursuance of the plan of reorganization, any gain that the corporation realizes on the exchange of its property will be recognized up to the sum of the money and the fair market value of the other property received that is not distributed.

Section 361(c)(2)(A) provides that, if the acquiring corporation distributes property other than qualified property (defined in § 361(c)(2)(B)), and the fair market value of such property exceeds its adjusted basis, then gain will be recognized as if such property were sold to the distributee at its fair market value.

Section 368(a)(1)(D) includes within the definition of "reorganization" a transfer by a corporation of part of its assets to another corporation if immediately after the transfer the transferor is in control of the corporation to which the assets are transferred and the transferor distributes the stock in a transaction that qualifies under § 354, § 355, or § 356.

Section 368(c) defines "control" as ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

Section 1001(a) provides that the gain from the sale or other disposition of property will be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss will be the excess of the adjusted basis provided in such section for determining loss over the amount realized. Section 1001(c) provides that except as otherwise provided in subtitle A of the Code, the entire amount of the gain or loss, determined under § 1001, on the sale or exchange of property will be recognized.

Section 1032(a) provides that no gain or loss will be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.

Section 1.1002–1(c) provides, in part, with respect to §§ 351 and 361, that the underlying assumption of these exceptions to the recognition of gain or loss under § 1001 is that the new property is substantially a continuation of the old investment still unliquidated; and in the case of

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reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.

In Rev. Rul. 74–79, 1974–1 C.B. 81, the Internal Revenue Service (Service) ruled that § 355(b)(1)(A)'s requirement that the distributing corporation be engaged in an active trade or business was satisfied where the distributing corporation was an inactive holding company, and a subsidiary of the distributing corporation engaged in a § 332 liquidation for the purpose of transferring its active trade or business to the distributing corporation.

In Rev. Rul. 2003–51, 2003–1 C.B. 938, a person (transferor) transferred assets to a corporation (first corporation) in exchange for an amount of stock in the first corporation constituting control (first transfer). Pursuant to a binding agreement entered into by the transferor with a third party prior to the first transfer, (i) the transferor transferred the stock of the first corporation (second transfer) to another corporation (second corporation); (ii) the third party transferred money to the second corporation (third transfer); and (iii) the second corporation transferred the money transferred to it by the third party to its wholly-owned subsidiary, the first corporation. Immediately after these transactions, the transferor and the third party were in control of the second corporation, and the second corporation was in control of the first corporation. The Service ruled that the first transfer satisfied the control requirement of § 351(a) notwithstanding the second transfer. The Service concluded that the second transfer, a nontaxable disposition of the stock received in the first transfer, was not inconsistent with the purposes of § 351 because the transaction lacked the characteristics of a sale and the transferor retained beneficial ownership in the assets transferred to the first corporation.

In *Estates of Bell v. Comm'r*, T.C.M. 1971–285, the Tax Court explained that sales of assets between a taxpayer's wholly-owned corporations followed by liquidating distributions "literally comply with the provisions of the Code dealing with complete liquidations, sections 331, 332, and 337, but *in substance* accomplish a reorganization coupled with the distribution of a dividend." (Emphasis added.) The court went on to state that, because § 356 is "the exclusive measure of dividend income provided by Congress where money is distributed to shareholders as an incident of a reorganization," § 301 and § 1.301–1(l) were not applicable to the acquisitive reorganization under § 368(a)(1)(D).

ANALYSIS

Situation 1: The federal income tax consequences to *P* and *D* in Situation 1 will depend on whether the Date 1 and Date 2 transfers are treated as separate transactions. Because they are undertaken pursuant to the same overall plan, a question arises as to whether the two transactions are part of a single reciprocal transfer of property—an exchange.

If the Date 1 and Date 2 transfers are respected as separate transactions for federal income tax purposes, *P* would be treated as transferring property to *D* on Date 1 for *D* stock in an exchange to which § 351 applies, and *D* would be treated as distributing all the stock of *C* to *P* on Date 2 in a distribution to which § 355 applies (assuming the requirements under those Code sections are otherwise satisfied).

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If the Date 1 and Date 2 transfers are integrated into a single exchange for federal income tax purposes, *P* would be treated as transferring its Business A property to *D* in exchange for a portion of the *C* stock in an exchange to which § 1001 applies. In such an exchange, gain or loss would be recognized to *P* on the transfer of its property to *D*; gain or loss would be recognized to *D*, under § 1001(a), upon its transfer of 25 percent of the *C* stock to *P* in exchange for the property transferred to it. In addition, § 355 would not apply to any part of the distribution of *C* stock because *D* would not have distributed stock constituting § 368(c) control of *C*. Gain would be recognized to *D*, under § 311(b), upon the distribution of the remaining 75 percent of the *C* stock with respect to *P*'s stock in *D* to which § 301 would apply.

The determination of whether steps of a transaction should be integrated requires review of the scope and intent underlying each of the implicated provisions of the Code. The tax treatment of a transaction generally follows the taxpayer's chosen form unless: (1) there is a compelling alternative policy; (2) the effect of all or part of the steps of the transaction is to avoid a particular result intended by otherwise-applicable Code provisions; or (3) the effect of all or part of the steps of the transaction is inconsistent with the underlying intent of the applicable Code provisions. *See H.B. Zachry Co. v. Comm'r*, 49 T.C. 73 (1967); *Makover v. Comm'r*, T.C. Memo 1967–53; Rev. Rul. 78–330, 1978–2 C.B. 147. Sections 351, 355, and 368 generally allow continued ownership of property in modified corporate form without recognition of gain. *See American Compress & Warehouse Co. v. Bender*, 70 F.2d 655 (5th Cir. 1934), *cert. denied*, 293 U.S. 607 (1934); § 1.1002–1(c); Rev. Rul. 2003–51.

Section 355(b)(2)(C) and (D) permit the direct and indirect acquisition of an active trade or business by a corporation within the 5-year period ending on the date of a distribution in transactions in which no gain or loss was recognized. The intent of § 355(b)(2)(C) and (D) is to prevent the acquisition of a trade or business by the distributing corporation or the controlled corporation from an outside party in a taxable transaction within the 5-year pre-distribution period. *See* Rev. Rul. 78–442, 1978–2 C.B. 143 (holding that § 357(c) gain arising from a § 351 transfer of an active trade or business does not violate § 355(b)(2)(C)). These provisions ensure that transfers of assets in transactions eligible for nonrecognition treatment (nonrecognition transactions) throughout the 5-year period will not adversely impact an otherwise qualifying § 355 distribution. This principle is illustrated in Rev. Rul. 74–79, in which an active trade or business was transferred to a distributing corporation in a § 332 liquidation to satisfy the requirements of § 355(b).

The transfer of property permitted to be received by *D* in a nonrecognition transaction has independent significance when undertaken in contemplation of a distribution by *D* of stock and securities described in § 355(a)(1)(A). The transfer thus is respected as a separate transaction, regardless of whether the purpose of the transfer is to qualify the distribution under § 355(b). *See*, *e.g.*, Rev. Rul. 78–330; § 1.355–6(d)(3)(v)(B), Example 1; and *Athanasios v. Comm'r*, T.C. Memo 1995–72. Back-to-back nonrecognition transfers are generally respected when consistent with the underlying intent of the applicable Code provisions and there is no compelling alternative policy. *See*, *e.g.*, Rev. Rul. 2015–9, 2015–21 I.R.B. 972, and Rev. Rul. 2015–10, 2015–21 I.R.B. 973.

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P's transfer on Date 1 is the type of transaction to which § 351 is intended to apply. Analysis of the transaction as a whole does not indicate that *P's* transfer should be properly treated other than in accordance with its form. Each step provides for continued ownership in modified corporate form. Additionally, the steps do not resemble a sale, and none of the interests are liquidated or otherwise redeemed. On these facts, nonrecognition treatment under §§ 351 and 355 is not inconsistent with the congressional intent of these Code provisions. The effect of the steps in Situation 1 is consistent with the policies underlying §§ 351 and 355. Accordingly, the Date 1 and Date 2 transfers described in Situation 1 will be respected as separate transactions for federal income tax purposes. Therefore, § 351 applies to *P's* transfer on Date 1 and § 355 applies to *D*'s transfer on Date 2.

The federal income tax consequences would be the same (qualification under § 355) if, instead of acquiring an active trade or business in a § 351 transfer from *P* to *D*, *D* acquired an active trade or business from a subsidiary of *P* in a cross-chain reorganization under § 368(a)(1). *See* Rev. Rul. 74–79.

Situation 2: If the distribution by *C* of money and other property on Date 1 is treated as separate from the distribution of *C* stock, § 301 would apply to *D*'s receipt of the money and other property from *C*, and no gain would be recognized to *D* upon the transfer of property to *C*.

If the Date 1 distribution is treated as made in pursuance of the plan of reorganization under §§ 368(a)(1)(D) and 355 that includes the Date 2 distribution of *C* stock, the money and other property distributed by *C* to *D* would constitute boot to *D*, and, under § 361(b)(1)(B), gain would be recognized to *D* on its transfer of property to *C* to the extent of the amount of the money and the fair market value of the property. Section 361(b) requires gain recognition to *D* if boot is distributed to *D* and not further distributed by *D* to its shareholders or creditors in pursuance of the plan of reorganization unless the facts establish that the distribution is in substance a separate transaction. *Cf.*, Rev. Rul. 71–364, 1971–2 C.B. 182 (finding that a distribution of money declared and paid following a reorganization exchange is treated as boot in the reorganization).

As noted above, in *Estates of Bell v. Comm'r*, the Tax Court explained that the boot rules are "the exclusive measure of dividend income provided by Congress where cash is distributed to shareholders as an incident of a reorganization." *See also American Manufacturing. Co. v. Comm'r*, 55 T.C. 204 (1970). Section 361 broadly looks to whether transfers of money or other property occur "in pursuance of the plan of reorganization" or "in connection with the reorganization."

In Situation 2, the distribution is made in pursuance of the plan of reorganization. A distribution of money and other property in pursuance of the plan of reorganization will be treated as boot subject to recognition of gain, consistent with the congressional intent underlying § 361.

Therefore, the federal income tax treatment of the transaction will follow its substance, and the distribution of money and property by *C* to *D* will constitute a distribution of boot under § 361(b).

HOLDINGS

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(1) In Situation 1, the transfer by *P* to its subsidiary, *D*, of property (including a transfer of property constituting an active trade or business for the purpose of meeting the requirements of § 355(b)(1)(A)), immediately followed by the distribution by *D* to *P* of the stock of its controlled subsidiary, *C*, is treated as an exchange to which § 351 applies, followed by a distribution of *C* stock to which § 355 applies.

(2) In Situation 2, § 361, and not § 301, applies to the transfer of money or other property by *C* to *D* made in pursuance of the plan of reorganization under §§ 368(a)(1)(D) and 355.

EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2017–3, 2017–1 I.R.B. 130, is modified by deleting section 5.02 (with respect to steps in North-South transactions). However, the Service may decline to issue a letter ruling addressing the integration of steps when appropriate in the interest of sound tax administration or on other grounds when warranted by the facts or circumstances of a particular case. There are also areas in which the Service will not issue letter rulings or determination letters because the issues are inherently factual, in the interest of sound tax administration, and other reasons. *See* Rev. Proc. 2017–1, 2017–1 I.R.B. 1, section 6.02; Rev. Proc. 2017–3, sections 2.01 and 3.01(51).

D. Page 587, New Sec. 9.4.K. The Successor-Predecessor Temp Regs

Page 587, New Sec. 9.4.K. Add immediately after the new sec 9.4.J the following new section:
New Sec. 9.4.K. **The Successor-Predecessor Temp Regs**

Temporary Regulation, T.D. 9805
Guidance under Section 355(e) Regarding Predecessors, Successors, and Limitation on Gain Recognition; Guidance under Section 355(f)
December 9, 2016

SUMMARY: This document contains temporary regulations that provide guidance regarding the distribution by a distributing corporation of stock or securities of a controlled corporation without the recognition of income, gain, or loss. The temporary regulations provide guidance in determining whether a corporation is a predecessor or successor of a distributing or controlled corporation for purposes of the exception under section 355(e) of the Internal Revenue Code (Code) to the nonrecognition treatment afforded qualifying distributions, and they provide certain limitations on the recognition of gain in certain cases involving a predecessor of a distributing corporation. The temporary regulations also provide rules regarding the extent to which section 355(f) of the Code causes a distributing corporation (and in certain cases its shareholders) to recognize income or gain on the distribution of stock or securities of a controlled corporation. These temporary regulations affect corporations that distribute the stock or securities of controlled corporations and the shareholders or security holders of those distributing corporations. The text of these temporary regulations also serves as the text of the proposed regulations in the related notice of proposed rulemaking (REG-140328-15) set forth in the Proposed Rules section in this issue of the Federal Register. * * * .

[**Preamble**] Section 355(e) does not provide a definition of a predecessor or successor of Distributing or Controlled. The proposed regulations generally defined the terms predecessor and

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successor for purposes of section 355(e) and provided guidance regarding the acquisition or deemed acquisition of the stock of predecessors of Distributing and certain other acquisitions. As more fully described in part 2.E. of this preamble, the proposed regulations also limited Distributing's recognition of gain in two cases and provided an overall gain limitation. Parts 2.A. through 2.F. of this preamble describe the proposed regulations, which the temporary regulations largely adopt with the modifications described in part 3. of this preamble. * * *

[B]y operation of section 355(e)(2)(C), section 355(e) does not apply to an Internal Distribution if immediately after the Plan Distributing and each Controlled remain members of the same Expanded Affiliated Group. Also * * * section 355(f) prevents section 355 from applying to an Internal Distribution if section 355(e) would otherwise apply to such distribution[.] * * *.

[T]hese temporary regulations provide that section 355(f) does not apply [in certain circumstances] * * * As a result, section 355(e) . . . applies to the Internal Distribution. However, the temporary regulations provide that [under certain circumstances] a Lower-Tier Distributing may choose to apply section 355(f) to an Internal Distribution it makes[.]