2018 Update Memorandum For

FEDERAL INCOME TAXATION OF BUSINESS ORGANIZATIONS

FIFTH EDITION

by

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PREFACE

This 2018 Update to Federal Income Taxation of Business Organizations provides users of the text with materials reflecting developments in federal income taxation of partnerships and S Corporations since March 31, 2014, (the date as of which the materials in the text are current). This update is current as of April 15, 2018 and includes all significant federal income tax legislation, Treasury Regulations, judicial decisions, and Internal Revenue Service rulings promulgated after March 31, 2014 and before April 15, 2018.

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FEDERAL INCOME TAXATION OF BUSINESS ORGANIZATIONS

PART I

TAXATION OF PARTNERS AND PARTNERSHIPS

CHAPTER 1

INTRODUCTION TO PARTNERSHIP TAXATION

SECTION 1. INTRODUCTION TO SUBCHAPTER K

Page 6:

In the carryover paragraph from page 5, delete the material from the sentence beginning "Long-term" in line 11 through the end of the paragraph; replace with the following:

The preferential capital gain rates are zero, 15%, or 20%. § 1(h)(1)(A)–(D). For taxable years beginning after December 31, 2017, and before January 1, 2026, new legislation ("2017 Tax Act") specifies that the rate depends on the taxpayer's filing status and taxable income. § 1(j)(5); Pub. L. No. 115-97, § 11001 (2017). For example, in the case of a joint return, the zero rate applies if taxable income is below $77,200; the 15% rate applies if taxable income is below $479,000; and the 20% rate applies if taxable income is $479,000 or more. Under pre-2018 law (and post-2026 law if there is no new legislation), the capital gains rate was determined with reference to the taxable income rate brackets. The new breakpoints were, however, derived from the pre-2018 rate brackets, which means that the 2017 Tax Act largely preserves the pre-legislation capital gain rate structure. Cost-of-living adjustments will be made to the breakpoints after 2018, but the 2017 Tax Act tied the adjustments to a measure that is likely to be less favorable to taxpayers than was prior law. § 1(f), (j)(3). Also for taxable years beginning after December 31, 2017, and before January 1, 2026, the highest individual tax rate is reduced from 39.6% to 37%. § 1(a)–(e), (j)(1)–(2); Pub. L. No. 115-97, § 11001 (2017). Non-corporate taxpayers may be eligible for a deduction equal to 20% of qualified business income, which does not include capital gains and losses, under § 199A (see *infra* Update, Chapter 3, pgs. 13–16, for additional details). Pub. L. No. 115-97, § 11011 (2017). Although corporations do not enjoy a preferential rate on capital gains, for taxable years beginning after December 31, 2017, the corporate tax rate is a flat 21%, even for personal service corporations. § 11; Pub. L. No. 115-97, § 13001 (2017).

SECTION 2. DEFINITION OF A PARTNERSHIP

B. PARTNERSHIP ENTITY VERSUS OTHER BUSINESS ARRANGEMENT

Page 16:

In the INTERNAL REVENUE CODE citations, delete "704(e)(1)" and insert 761(b).

Pages 23-25:

Delete the material beginning with the carryover paragraph at the bottom of page 23 through the end of the section on page 25 and insert:

Legislation in 2015 ("2015 Act") deleted § 704(e)(1), moved the provision to § 761(b), and modified the language of former § 704(e)(1). As amended, § 761(b) adds the following sentence to the definition of a partner: "In the case of a capital interest in a partnership in which capital is a material income-producing factor, whether a person is a partner with respect to such interest shall be determined without regard to whether such interest was derived by gift from any other person." The amendment negates the holding of Evans v. Commissioner, 447 F.2d 547 (7th Cir. 1971), aff'g 54 T.C. 40 (1970), that the application of § 704(e)(1) was not limited to the context of family partnerships, where an interest in a partnership frequently is acquired by gift rather than by purchase, but is applicable whenever capital is a material income producing factor in a partnership. The revisions thus refocus the inquiry to whether a person is a partner and whether a partnership exists under the totality of the circumstances test of *Culbertson*. Under the revised § 761(b), a person's status as a partner with an interest in a family partnership in which capital is a material income producing factor acquired by gift should be tested under the same rules as a capital interest acquired by purchase or by a contribution to capital.

TIFD–III–E, Inc. v. United States, 666 F.3d 836 (2d Cir. 2012), rev'g 660 F. Supp. 2d 367 (D. Conn. 2009), held under the former version of § 704(e)(1) that holding an interest in a partnership in the form of debt (or an interest overwhelmingly in the nature of debt) did not create a capital interest in a partnership that could qualify as a partnership interest.

Page 25:

After the last paragraph, insert:

In DJB Holding Corp. v. Commissioner, 803 F.3d 1014 (9th Cir. 2015), the court applied the *Luna* factors to hold that a joint venture (NTC Project) between an operating corporation (WCI) and a partnership (WB Partners) owned by related parties who indirectly owned the stock of WCI was not a partnership for tax purposes. All of the work under a large environmental remediation project was performed by WCI under a contract between WCI and a third party. WB Partners was responsible for financial and guarantee services. Profits from the NTC Project environmental remediation work were allocated 30 percent to WCI and 70 percent to WB Partners. WB Partners share of the NTC Project's profits were passed through to tax-exempt retirement plans that benefited the ultimate owners of the entire structure. Relying on the second *Luna* factor, the court held that WB Partners provided nothing of value to the NTC Project venture adding that the two individual owners of the S corporation partners in the partnership would have been required to provide the financial guarantees claimed to represent contributions by the partnership to the joint venture. Additionally the court observed that the purported partners in the NTC Project joint venture did not in fact respect the terms of the joint venture agreement (the actual income allocation between the partners differed substantially from the terms of the agreement and no partnership tax returns were filed), and that the unilateral control exercised by the WCI belied the existence of a true partnership.

Page 29:

After the carryover indented quotation, insert:

Holdner v. Commissioner, T.C. Memo. 2010-175, aff'd, 483 Fed. Appx. 383 (9th Cir. 2012), found a partnership to exist with respect to a father-son farming venture. The taxpayer invested capital in a family farm for his son to operate and they agreed to divide the profits. As the farming operation expanded, father and son took title to the property as tenants in common, and the father began to perform services on behalf of the partnership. The taxpayer reported one-half of the income but claimed deductions for significantly more than one-half of the operating expenses. The court rejected the taxpayer's arguments that the father and son operated the farm as separate sole proprietors. It found that because both father and son contributed labor to the farm operation in the conduct of business activities, divided the net sales proceeds equally and paid the expenses out of farm income, and held themselves out to third-parties as partners, the enterprise was a partnership. The court further held that the taxpayer failed to rebut a presumption that the partners shared all items of income and expense equally and further that the unequal capital contributions to the venture did not justify an allocation of a disproportionate amount of the deductions for expenses to the father.

Page 36:

After the first full paragraph, insert:

The Third Circuit followed the approach of *Castle Harbour* in Historic Boardwalk Hall LLC v. Commissioner, 694 F.3d 425 (3d Cir. 2012), where a tax-exempt party attempted to transfer § 47 historic rehabilitation tax credits (HRTC) to a taxable corporation using a limited liability company taxed as a partnership. The New Jersey Sports and Exposition Authority had an ownership interest in the historic East Hall of the Atlantic City Boardwalk Hall under a 35-year lease, and it transferred that interest to Historic Boardwalk Hall, LLC, in which Pitney Bowes (through a subsidiary and an LLC) was the 99.9 percent member and the NJSEA was the 0.1 percent member. The transfer included the § 47 Federal tax credit of 20 percent of the qualified rehabilitation expenditures incurred in transforming the run-down East Hall from a flat-floor convention space to a "special events facility" that could host concerts, sporting events, and other civic events. Reversing the Tax Court, which upheld transfer of the HRTC in an opinion indicating that the purpose of § 47 was to encourage taxpayers to participate in what would otherwise be an unprofitable activity (136 T.C. 1 (2011), the Third Circuit held that Pitney Bowes was not a bona fide partner in Historic Boardwalk Hall LLC. Based on its analysis of the facts, the Third Circuit concluded that Pitney Bowes was not a partner because, as the transaction was structured, (1) Pitney Bowes "had no meaningful downside risk because it was, for all intents and purposes, certain to recoup the contributions it had made to HBH and to receive the primary benefit it sought —the HRTCs or their cash equivalent," and (2) Pitney Bowes's "avoidance of all meaningful downside risk in HBH was accompanied by a dearth of any meaningful upside potential." As for downside risk, the Court of Appeals reversed as clearly erroneous the Tax Court's finding that Pitney Bowes bore a risk because it might not receive an agreed upon 3% preferred return on its contributions to HBH. Referring to Virginia Historic Tax Credit Fund 2001 LLP v. Commissioner*,* 639 F.3d 129 (4th Cir. 2011), discussed at page 261 of the text, the Third Circuit treated Pitney Bowes 3% preferred return as a "return on investment" that was not a "share in partnership profits," which pointed to the conclusion that Pitney Bowes did not face any true entrepreneurial risk. As for upside potential, applying the substance over form doctrine, the court concluded that "although in form PB had the potential to receive the fair market value of its interest . . . in reality, PB could never expect to share in any upside." The court noted that it was "mindful of Congress's goal of encouraging rehabilitation of historic buildings," and that its holding might "jeopardize the viability of future historic rehabilitation projects," but the court observed that it was not the tax credit provision itself that was under attack, but rather the particular transaction transferring the benefits of the credit in the manner that it had.

CHAPTER 2

FORMATION OF THE PARTNERSHIP

SECTION 1. CONTRIBUTIONS OF MONEY OR PROPERTY

Page 45:

After the third sentence of paragraph 2.3, insert:

VisionMonitor Software, LLC v. Commissioner, T.C. Memo. 2014-182, reached the same result. The court upheld the IRS's long-standing position that the contribution of a partner's own note to the partnership is not the equivalent of a contribution of cash, Rev. Rul. 80-235, 1980-2 C.B. 229, and without more, it will not increase the partner's basis in the partnership interest.

Page 47:

At the end of the carryover paragraph from page 46, insert:

The 2017 Tax Act added § 1061, which requires a three-year holding period in order to obtain long-term capital gain "with respect to" certain partnership service interests. Section 1061 is discussed more fully in this Update, Chapter 3, pgs. 7–9.

CHAPTER 3

TAXATION OF PARTNERSHIP TAXABLE INCOME TO THE PARTNERS

SECTION 1. PASS-THRU OF PARTNERSHIP INCOME AND LOSS

Page 91:

Before section 3, insert the following:

2.3. Partnership Interests Held in Connection with Performance of Services

The 2017 Tax Act added a new § 1061, which applies to taxable years beginning after December 31, 2017. Pub. Law No. 115-97, §13309(a)(2) (2017). It requires that long-term capital gain "with respect to" covered partnership interests be treated as short-term capital gain unless the interest has been held for more than three years. As discussed in Chapter 2 § 3.A.3, the receipt of a partnership profits interest in exchange for services is generally not taxed to the recipient. After the service provider is a partner, the partnership can then allocate preferentially taxed long-term capital gains to that partner. The partner may then take distributions of cash tax-free in the same amount as the allocation (because the allocation will increase basis). § 705, § 731. On sale of an interest held for more than one year or on distributions in excess of basis, the parter will generally have long-term capital gain (or loss). § 741. (Note: § 751 may apply to alter these general rules. See Chapter 8 § 1.B (discussing the effect of § 751(a) on sales) and Chapter 9 §1.C (discussing the effect of § 751(b) on distributions.)) This ability of a partner to obtain long-term capital gain treatment for the provision of services has become known as the "carried interest" loophole. *See, e.g.*, Karen C. Burke, *The Sound and Fury of Carried Interest Reform*, 1 COLUM. J. TAX L. 1 (2009). Section 1061 was enacted in response; however politically helpful its enactment may turn out to be, it is unclear the extent to which it will in fact close this loophole.

If the provision applies, it requires that the taxpayer treat as short-term capital gain the excess (if any) of the taxpayer's net long-term capital gain with respect to the interest over the taxpayer's net long-term capital gain computed as though section 1222 said "3 years" instead of "1 year." This would require, for example, that if an individual sells a covered interest held for only two years, any net long term-capital gain on the transaction would be converted to short-term capital gain. (Section 1061 does not contain rules for coordinating with section 751(a).) Some commentators have argued that distributive share allocations of net long-term capital gain to the taxpayer would not be affected, so long as the partnership had held the underlying capital assets for more than three years. There is some statutory support for this position because § 1061(d)(1)(A) (applicable to certain transfers and discussed below) makes reference to gain attributable to the sale of "any asset held for not more than 3 years," which could suggest that the partnership's holding period in its assets can affect whether § 1061 applies. Such a reading would, however, weaken the effect of § 1061 because a partnership could maintain a pool of sufficiently aged assets and use those to allocate long-term capital gain to the service partners. The statutory language "with respect to" is broad and could support reading the language as requiring that net long-term capital gain allocations as to a partnership interest held for three years or less should also be re-characterized as short-term capital gains. (Incidentally, such a reading would not render the formula of § 1061(a) superfluous as a partner could have a bifurcated holding period in the interest—that is, the partner could have held 50% of the covered interest for more than three years and 50% for less.) To summarize, the three-year holding period applies to the partnership interest itself when determining gain on the transfer of the interest. The effect of the three-year holding period on distributive share allocations is ambiguous: does it depend on the partnership's capital asset holding period, the partner's holding period in his interest, or both? To the extent the holding period depends on the partnership's holding period in its underlying assets, the statute refers only to § 1222 and not to § 1231, which can also (eventually) yield net long-term capital gains (a partnership is supposed to report out separately net § 1231 gain or loss but does not determine whether it is capital gain or ordinary loss because the partner may have § 1231 gains or losses from other sources. Reg. § 1.702–1(a)(3)).

The statute provides that the conversion to short-term capital gain applies "notwithstanding section 83 or any election in effect under section 83(b)." The provision applies only to an "applicable partnership interest," which is any interest that is "directly or indirectly" transferred to or held by a taxpayer "in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business." § 1061(c). The definition of "applicable trade or business" will likely make the provision principally relevant to private equity funds, which, not coincidentally, have been the main source of concern regarding the carried interest loophole. Trade or business means "any activity conducted on a regular, continuous, and substantial basis" and that consists of (1) "raising or returning capital" and (2) either (a) investing in, disposing of, or identifying for purposes of investing in or disposing of "specified assets," or (b) developing "specified assets." § 1061(c)(2). The assets specified in the section are securities, commodities, rental or investment real estate, cash or cash equivalents, options or derivatives with respect to any of the above, and interests in a partnership to the extent of the partnership's proportionate interest in any of the above. § 1061(c)(3). The Treasury may provide that § 1061 does "*not* apply to income or gain attributable to any asset *not* held for portfolio investment on behalf of third party investors." § 1061(b) (emphasis added); *see also* § 1061(c)(5) (defining "third party investor").

The provision does not apply to a capital interest held by the service partner so long as the capital interest's "right to share in partnership capital" is "commensurate" with either (1) the amount of capital contributed at the time of receipt or (2) the amount included in income under § 83 on receipt or vesting of the capital interest. § 1061(c)(4)(B). The provision also does not apply to partnership interests "held by a corporation." § 1061(c)(4)(A). The IRS has issued a notice stating that the "Treasury Department and the IRS intend that those regulations will provide that the term 'corporation' for purposes of section 1061(c)(4)(A) does not include an S corporation." Notice 2018-18. The notice was released in response to reports that taxpayers intended to circumvent § 1061 by holding their partnership interests through shell S corporations.

The statute requires taxpayers to recognize short-term capital gain on the direct or indirect transfer of the covered interest to certain related parties. The amount required to be included is the taxpayer's share of long-term capital gains for the taxable year of the transfer "attributable to the sale or exchange of any asset held for not more than 3 years," minus the amount treated as short-term capital gain with respect to the transfer of such interest. A person is related to a taxpayer if either the person is within the taxpayer's family (as defined in § 318(a)(1)) or "the person performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service." § 1061(d)(2).

Page 93:

Add the subheading 4.1 *General* under the heading 4. Elections and Limitations

Page 94:
After the carryover paragraph from page 93, add:

The 2017 Tax Act modified various cost recovery rules. For example, it amended Section 168(k) to allow immediate expensing for property that has a cost recovery period of 20 years or less through the year 2023. In general the examples throughout the book assume straight-line recovery and ignore conventions and the availability of expensing.

Page 94:

Before section 5, insert the following:

4.2. Limitation on Business Interest

The 2017 Tax Act added a new limitation on the deductibility of interest properly allocable to a trade or business. § 163(j); Pub. L. No. 115-97, § 13301(a). "Small" businesses (average annual gross receipts of $25 million or less over a three-year period) are exempt. § 163(j)(3); § 448(c). "Trade or business" is defined to exclude the business of being an employee, as well as certain regulated utilities. § 163(j)(7). Certain businesses may elect out (i.e., a qualified "electing real property trade or business" or a qualified "electing farming business"). *Id.*; *see also* 168(g)(1)(G) (requiring alternative depreciation system for electing farming business).

If § 163(j) applies then, for taxable years beginning after December 31, 2017, the interest paid by a business is generally limited to the sum of (1) the business interest income of the taxpayer, plus (2) 30% of the positive adjusted taxable income of the taxpayer. § 163(j)(1). (There is an additional increase for "floor plan financing interest," which helps businesses engaged in selling "motor vehicles," which includes cars, boats, and farm equipment. § 163(j)(1)(C), (j)(9).) "Adjusted taxable income" means only income from a trade or business (but, remember, the business of being an employee does not count). Taxable income for this purpose is also computed without taking into account business interest paid, business interest income, the § 199A deduction, net operating losses, and, for taxable years beginning before January 1, 2022, cost recovery deductions. § 163(j)(8).

Section 163(j) applies "at the partnership level" and "any deduction for business interest shall be taken into account in determining the non-separately stated taxable income or loss of the partnership." § 163(j)(4)(A). Although taking an entity-level approach to partnership rules can lead to administrative simplification, in this case it does not. Instead, this approach brings with it an additional set of complex rules. First, a partner needs to be prevented from using the partner's share of partnership taxable income to increase the partner's adjusted taxable income for purposes of applying the 30% limitation rule to business interest paid by any other business the partner may have, such as a sole proprietorship. Otherwise, the partner will be able to use the partnership taxable income twice—once when the partnership determines the limitation for its business and once when the partner determines the limitation as to the partner's other businesses. Second, the partnership may have business interest that is less than the maximum amount the partnership is allowed (i.e., the business interest is less than 30% of the partnership's adjusted taxable income). In such a situation, a partner should be allowed to use the partner's share of the partnership's excess taxable income for purposes of applying the 30% limitation to the business interest paid through other businesses.

Section 163(j) resolves these two issues by requiring a partner to determine the partner's "adjusted taxable income" for purposes of applying the 30% limitation to any other businesses by disregarding *all* of the partner's partnership tax items and then adding back in the partner's share, if any, of the "partnership's excess taxable income." § 163(j)(4)(A)(ii). A partner's share of the excess taxable income is to be determined in the same manner as the partner's share of the nonseparately stated taxable income or loss of the partnership. *Id.* "Excess taxable income" is determined through a formula. The partnership must create a fraction, the numerator of which is 30% of the partnership's adjusted taxable income minus the amount of business interest it paid that exceeds its business interest income. The denominator is 30% of the partnership's adjusted taxable income. The fraction is then applied to the partnership's adjusted taxable income to obtain the "excess taxable income." For example, if a partnership had $100,000 of adjusted taxable income, $20,000 of business interest paid, and $10,000 of business interest income, the excess taxable income would be $66,667, computed as follows: $100,000 x [(30% of $100,000 – $20,000 + $10,000)/30% of $100,000]. A partner with a one-third interest in this partnership's nonseparately stated income would increase the partner's taxable income for purposes of applying the 30% rule to the partner's other businesses by $22,222 (and change). Note, this assumes the partner does not have "excess business interest" carryforward, which is discussed below.

The statute is silent with respect to another potential problem: the partner's use of the partner's share of partnership business interest income to offset business interest paid through other businesses or the partner's use of the partner's share of partnership's "floor plan financing" to increase the partner's deduction. The statutory rules described in the preceding paragraphs regarding taxable income are insufficient to address these issues. Notice 2018-28 provides:

> The Treasury Department and the IRS intend to issue regulations providing that, for purposes of calculating a partner's annual deduction for business interest under section 163(j)(1), a partner cannot include the partner's share of the partnership's business interest income for the 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). Additionally, the Treasury Department and the IRS intend to issue regulations providing that 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 under section 163(j). Such regulations are intended to prevent the double counting of business interest income and floor plan financing interest for purposes of the deduction afforded by section 163(j) and are consistent with general principles of Chapter 1 of the Code.

If the deduction of business interest is limited by § 163(j), the disallowed business interest is carried forward, and partnership specific rules apply. § 163(j)(2), (4). If a partnership has business interest that is limited by § 163(j), it is carried over to the next year. But, instead of the partnership applying the excess business interest payment to its computations for the succeeding year(s), the excess business interest is allocated to the partners, in proportion to their share of the partnership's nonseparately stated income or loss. This allocation reduces their outside bases (but not below zero). The allocated excess business interest is treated as *paid* (and thus deductible) only when and to the extent a partner is allocated "excess taxable income." § 163(j)(4)(B). Partners are required to apply "excess taxable income" first to any excess business interest they have been allocated before they may use it for purposes of applying the 30% limitation to business interest paid through other businesses. § 163(j)(4)(B)(ii)(flush language).

If a partner disposes of the partner's partnership interest before all of the excess business interest allocated to the partner has been treated as paid, the partner will increase the partner's basis in the interest immediately before the disposition. The adjustment equals the previous basis reduction(s) over the business interest treated as paid by the partner. § 163(j)(4)(B)(iii)(II). (This adjustment applies even if the basis increase is essentially meaningless—for example, if the disposition occurs by reason of death. *Id.*) No additional business interest deduction is allowed to either the transferor partner or the transferee. *Id.*

5. Section 199A

Section 199A, added by the 2017 Tax Act, applies for taxable years beginning after December 31, 2018, and before December 31, 2025. § 199A(i). The provision allows taxpayers other than corporations to deduct up to 20% of the "qualified business income" from pass-through businesses, including sole proprietorships, tax partnerships, and "S" corporations. § 199A(b)(2). The § 199A deduction is not an itemized deduction, but it reduces taxable income and does not reduce adjusted gross income. § 63(b)(3), (d)(3). (Adjusted gross income is frequently used in other Code sections for purposes of setting thresholds and phase-outs.) The provision is among the most complex of the new rules added by the 2017 Tax Act, and has generated a great deal of uncertainty. (It has already been amended to deal with a glitch relating to cooperatives. Pub. L. No. 115-141, Div. T, § 101(b).)

A "qualified trade or business" means any trade or business other than those specifically excepted. § 199A(d)(1). Without exception, the trade or business of being an employee is not a qualified business. Similarly, although located in a different subsection of § 199A, § 707(c) payments made to a partner for services rendered to the trade or business and, "to the extent provided in regulations," § 707(a) payments for services rendered to the trade or business are not included in qualified business income. § 199(c)(4). Certain "specified service" businesses are also not qualifying businesses, but for this category, a threshold tied to taxpayer income applies (described in greater detail below). A "specified service" business means any trade or business "involving the performance of services in the fields of health, law, . . . accounting, actuarial science, performing arts, 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 1 or more of its employees" and involving "the performance of services that consist of investing and investment management, trading, or dealing in securities. . ., partnership interest, or commodies." (The first ellipsis in the first quote indicates the deliberate removal of engineering and architecture from the list.)

Qualified business income means the "net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer." § 199A(c)(1). The amount is determined separately for each trade or business, and the reference to deductions and losses suggest that it may be a negative amount for a particular business (provision of a carryover provision also supports this conclusion). These tax items must be effectively connected with a U.S. trade or business and must be "included or allowed in determining taxable income for the taxable year." § 199A(c)(3)(A). The quoted language appears to mean that the § 199A amount is determined after application of various loss limitation rules applies, such as those discussed in Chapter 8, but the statute does not contain any guidance on this coordination issue. Certain items do not qualify; these include short- or long-term capital gains and losses; dividends, dividend equivalents and payments in lieu of dividends; interest income, other than business interest income; and gains and losses from certain commodities transactions, foreign currencies, and certain notional principal contracts; amounts received from a non-business annuity; and "[a]ny item of deduction or loss properly allocable" to the preceding list. § 199A(c)(3)(B). Finally, qualified REIT dividends and qualified publicly traded partnership income is not treated as "qualified business income," although such items are eligible for the § 199A deduction via another subsection. § 199A(b)(1)(B), (c)(1).

For each qualifying business, a percentage is applied to its net qualifying busines income. That percentage is the lesser of (1) 20% or (2) the greater of (a) 50% of the W-2 wages of the qualifying business or (b) 25% of the W-2 wages of the qualifying businss, plus 2.5% of the "unadjusted basis immediately after acquisition of all qualified property." § 199A(b)(2). (As discussed below, taxpayers below a certain income threshold use 20% as the percentage without the need to compare it W-2 wages or unadjusted basis.) W-2 wages are essentially the compensation paid to employees of the business and as to which the business is required to provide an information return. § 199A(b)(4). "Qualified property" is depreciable tangible property that is "held by, and available for use in" the qualified business, used "at any point during the taxable year in the production of qualified business income," and whose depreciable period has not ended before the close of the taxable year. § 199A(b)(6)(A). "Depreciable period" is defined as the later of 10 years after the property is placed in service or "the last day of the last full year of the applicable recovery period" that applies under § 168 (ignoring the alternative depreciation system).

Section 199A states that it "shall be applied at the partner" level, but the provision contemplates that the determination of whether there is a qualifying business is determined at the partnership level (the statute does not contain rules for how to determine whether a partnership, or any taxpayer, has a single qualifying business or multiple qualifying businesses). Section 199A(f)(1)(a)(ii) states that "each partner . . . shall take into account such person's share of each qualified item of income, gain, deduction, and loss." In addition, each partner must be assigned a share of the partnership's W-2 wages and unadjusted basis in order to complete the § 199A computation. The statute provides that partnership W-2 wages are to be allocated "in the same manner" as the partner's "allocable share of wage expenses," and unadjusted basis is to be allocated "in the same manner" as the partner's "allocable share of depreciation." § 199A(f)(1)(a)(iii)(flush language). As discussed in Chapter 4 and subject to the exceptions also discussed in that chapter, partners may generally determine by agreement their shares of wage expenses and depreciation, so this guidance is not particularly meaningful.

Once the maximum amount for each qualifying business is determined, the amounts from each business are then aggregated into the "combined qualified business income amount." § 199A. If the taxpayer has qualified REIT dividends or qualifying publicly traded partnership income, 20% of those items is included in the combined qualified business income amount. If there is an aggregate loss, the loss is carried over and treated as a qualified loss item for "**a** qualified trade or business" in the subsequent year. § 199A(c)(2)(emphasis added). The legislative history suggests this means that 20% of the carryover will reduce the combined qualified business income in the subsequent year. (The carryover provision is (confusingly) included in the section defining qualified business income rather than in the section on computing the combined amount, but it applies if the net amount "with respect to qualified trade**s** or businesse**s** of the taxpayer" is "less than zero." *Id.* (emphasis added).) If a qualifying business has net negative business income, no additional guidance is provided regarding the rule that determines whether the percentage to apply is 20% or some lower amount determined by W-2 wages and/or unadjusted basis.

Even after the taxpayer determines the taxpayer's "combined qualified business income," an overall limitation may limit the taxpayer's ability to deduct the entire amount. § 199A(a). The final deduction is the lesser of (1) the taxpayer's combined qualified business income or (2) 20% of the excess of the taxpayer's taxable income over the taxpayer's net capital gain. § 199A(a).

Taxpayers below certain income thresholds benefit through the relaxation of two of the rules discussed above. First, such taxpayers are able to treat "specified service" businesses as qualified businesses. Second, such taxpayers are able to take 20% of their net qualifying items from a qualifying business without being subject to the W-2 or unadjusted basis limitation. These benefits are lost gradually (and through complicated formulas) for taxpayers within a particular taxable income range. This range begins at $157,500 ($315,000 for joint filers), and the benefits are lost completely at $207,500 ($415,000 for joint filers). § 199A(b)(3), (d)(3), (e)(2). These ranges are indexed for inflation after 2018.

Page 94:

Change "5. Partnership Taxable Year" to "6. Partnership Taxable Year"

Pages 97-101:

Delete sections 6 and 7 and insert:

7. PARTNERSHIP TAX RETURNS AND AUDIT PROCEDURES

As previously noted, § 6031 requires that a partnership return be filed. Section 6698 imposes additional penalties, over and above the general failure to file penalty of § 7203, on any partnership that fails to file a *complete* partnership tax return. Individual partners are liable for the penalty to the extent of their liability for partnership debts generally. Section 6222 requires a partner to treat a partnership item on the partner's return in a manner that is consistent with the partnership return or to file a statement with the partner's return explaining any inconsistency.

The Bipartisan Budget Act of 2015 adopted significant revisions to the partnership audit rules that provide for an entity level audit process which allows the IRS to assess and collect taxes, and impose penalties, at the partnership level. I.R.C. §§ 6221-6223, 6225-6227, 6231-6235, and 6241. These rules are intended to simplify the prior complex procedures for determining who is authorized to settle on behalf of the partnership and to free the IRS from the obligation to send various notices to all of the partners. Deficiencies assessed against the partnership will be payable by the partnership. The tax rate applied to the underpayment will be the highest individual or corporate rate, subject to modifications to reflect tax exempt partners, potential favorable capital gains tax rates, and other considerations. A partnership with 100 or fewer partners with no other partnership as a partner is allowed to elect out of the partnership audit procedures. I.R.C. § 6221(b). For partnerships that elect out of the new rules, partnership audits will be much more complicated because the IRS will be required to deal separately with each partner. The new rules apply to partnership taxable years beginning after December 31, 2017.

Regulations for electing out of the centralized partnership audit regime under § 6221(b) were finalized in January 2018. Reg. § 301.6221(b)–1; *see* 83 F.R. 24 (Jan. 2, 2018). Multiple proposed regulations were issued during 2017. *See* Notice of Proposed Rulemaking, 82 F.R. 60,144, 60,144–167 (Dec. 19, 2017) (proposing regulations relating to (1) § 6226 (and similar rules); § 6226 is the election "by a partnership to have its partners take into account the partnership adjustments in lieu of paying the imputed underpayment determined under section 6225 (the push out election)"; and (2) "the assessment and collection, penalties and interest, periods of limitations, and judicial review under the new centralized partnership audit regime"; re-proposes and amends some rules proposed in earlier proposed regulations); Notice of Proposed Rulemaking, 82 F.R. 56,765, 56,765–76 (Nov. 30, 2017) (providing "rules addressing how certain international rules operate in the context of the centralized partnership audit regime"); Notice of Proposed Rulemaking, 82 F.R. 27,334, 27,334–402 (June 14, 2017) (proposing rules relating "filing administrative adjustment requests, and the determination of amounts owed by the partnership or its partners attributable to adjustments that arise out of an examination of a partnership" and rules regarding "the scope of the centralized partnership audit regime" (electing-out proposals contained in this notice were finalized in January 2018)).

SECTION 2. LIMITATION ON PARTNERS' DEDUCTIONS OF PARTNERSHIP LOSSES

Page 105:

Re-number section 3 as section 4 and insert as a new section 3 the following:

3. Relationship of Section 704(d) to Charitable Contributions and Foreign Taxes

The 2017 Tax Act amended § 704(d) so that it now contains three subsections. Pub. Law No. 115-97, § 13503(a) (2017). Section 704(d)(1) contains the general loss limitation rule, which remains unchanged; Section 704(d)(2) contains the carryover rule, which is also unchanged. Section 704(d)(3) provides a new rule specifying that a partner's distributive share of charitable contributions and foreign taxes paid are subject to the basis limitation rule of § 704(d)(1). This provision is aimed at correcting language in the Treasury regulations suggesting that charitable contributions and foreign taxes paid by the partnership are passed through to partners without limitation, even if those partners have insufficient outside basis. Reg. § 1.704–2(d); *see also* Priv. Ltr. Rul. 8405084 (Nov. 3, 1983) (providing that 704(d) was inapplicable to charitable contribution). Because taxpayers generally are permitted to take a charitable contribution in excess of basis for certain assets (e.g., corporate stock held more than one year), § 704(d)(3)(B) allows the same result for charitable giving by partnerships; it provides that, for "a charitable contribution of property whose fair market value exceeds its adjusted basis," the § 704(d) limitation does not apply "to the extent of the partner's distributive share of such excess." *See* I.R.C. § 170(e) (describing assets supporting charitable contribution deduction for unrealized asset appreciation).

Page 105:

Add to the end of the page:

The 2017 Tax Act added § 461(l), which (temporarily) imposes additional limitations on noncorporate taxpayers for their "excess business losses" (*see infra* Update, Chapter 7, pg. 38 for additional details).

CHAPTER 4

DETERMINING PARTNERS' DISTRIBUTIVE SHARES

Page 108:

Add to the end of the introductory material and before Section 1:

Section 199A, added by the 2017 Tax Act, alters the incentives and consequences of particular distributive share allocations. For example, long-term capital gains are not taken into account for purposes of computing the § 199A deduction. Further, as discussed in greater detail in this Update, Chapter 3, pgs. 13–16, because the § 199A deduction is computed with reference to a qualifying business's "W-2 wages" and "unadjusted basis," a qualifying business conducted through a partnership must allocate these items in order for eligible partners to complete their individual § 199A computations. The statute specifies that W-2 wages are required to be allocated "in the same manner" as the partner's "share of wage expenses," and the partnership's unadjusted basis is required to be allocated "in the same manner" as the partner's "allocable share of depreciation." § 199A(f)(1)(flush language).

SECTION 3. ALLOCATIONS WITH RESPECT TO CONTRIBUTED PROPERTY

Page 178:

After the first full paragraph of *Detailed Analysis* 5, insert:

Proposed amendments to Treas.Reg. § 1.704-3 and Prop.Reg. § 1.704-3(f) (2014) would implement § 704(c)(1)(C) by treating the partnership for all purposes as having an initial basis in contributed built-in loss property equal to its fair market value at the time of contribution and provide the so-called "section 704(c)(1)(C) partner" with a § 704(c)(1)(C) basis adjustment. The § 704(c)(1)(C) basis adjustment to the contributing partner initially is equal to the built-in loss associated with the

§ 704(c)(1)(C) property at the time of contribution and is subsequently adjusted to account for basis recovery by the contributing partner. Under this concept, the partnership's capital recovery and gain or loss with respect to § 704(c)(1)(C) property is determined using the partnership's fair market value basis from the date of contribution. The contributing partner first takes the contributing partner's distributive share of gain, loss, depreciation, or amortization with respect to the property first determined with respect to the partnership's common basis. The contributing partner's share of partnership items attributable to the § 704(c)(1)(C) property is then adjusted for tax purposes to account for the contributing partner's basis adjustment, as appropriate. The § 704(c)(1)(C) adjustment does not change the contributing partner's capital account. If § 704(c)(1)(C) property is subject to depreciation, § 197 amortization, or another cost recovery method, the § 704(c)(1)(C) basis adjustment associated with the property is recovered by the contributing partner in accordance with §§ 168(i)(7), 197(f)(2), or any other applicable provision, generally continuing the contributing partner's cost recovery with respect to the basis adjustment under the method used by the partner prior to the contribution. (See Prop.Reg. 1.704-3(f)(3)(ii)(D)(2), Ex.) Under the proposed regulations, a transferee of a contributing partner's partnership interest does not succeed to the § 704(c)(1)(C) basis adjustment; the share of the § 704(c)(1)(C) basis adjustment attributable to the interest transferred is eliminated. The adjusted partnership basis of § 704(c)(1)(C) property distributed to the contributing partner includes the § 704(c)(1)(C) basis adjustment for purposes of determining any § 734(b) basis adjustment; but § 704(c)(1)(C) basis adjustments are not taken into account in making allocations under Treas.Reg. § 1.755-1(c). If § 704(c)(1)(C) property is distributed to another partner, the contributing partner's § 704(c)(1)(C) basis adjustment for the distributed property is reallocated among the remaining items of partnership property under Treas.Reg. § 1.755-1(c). The proposed regulations *do not* extend any of these rules to reverse § 704(c) allocations.

SECTION 4. ALLOCATIONS RELATING TO NONCOMPENSATORY PARTNERSHIP OPTIONS

Page 182:

In the first line of *Detailed Analysis* 1, "Revaluations of Partners' Capital Accounts," **change the citation to** Treas.Reg. § 1.704–1(b)(2)(iv)(h)(2).

SECTION 5. ALLOCATIONS WHERE INTERESTS VARY DURING THE YEAR.

Page 182:

After the heading, insert REGULATIONS: 1.706-4, **and delete the reference to "**PROPOSED REGULATIONS: Section 1.706-4."

Page 184:

After the first full paragraph, insert:

The proposed regulations were finalized in 2015 as Treas.Reg. § 1.706-4, with some significant technical modifications to the proposed regulations and extensive changes in numbering of subsections.

Reg. § 1.706-4(a)(3) allows the partnership to allocate partnership items under its method of accounting to different segments of the taxable year using the closing of the books method for some segments and, when the partners agree, using the proration method for other segments.

Although the regulations apply to a change in a partner's interest attributable to a disposition of a partner's entire interest or a partial interest, the regulations do not apply to changes in allocations of partnership items among contemporaneous partners that satisfy the allocation rules of § 704(b), provided that a reallocation is not attributable to a capital contribution to the partnership or a distribution of money or property that is a return of capital. The regulations also do not apply to partnerships in which capital is not a material income producing factor; such partnerships may choose to determine a partner's distributive share of partnership items using any reasonable method to account for the varying interests of the partners in the partnership during the taxable year, provided that the allocations comply with § 704(b). Reg. § 1.706-4(b).

Page 185:

After the third full paragraph, insert:

Prop.Reg. § 1.706-2(a)(2) (2015) would provide that the term "allocable cash basis item" generally includes items of deduction, loss, income, or gain specifically listed in the statute: (i) interest, (ii) taxes, and (iii) payments for services or for the use of property. However, Prop.Reg. § 1.706-2(a)(2)(iii) provides an exception for deductions for the transfer of an interest in the partnership in connection with the performance of services; such deductions generally must be allocated under the rules for extraordinary items in Treas.Reg. § 1.706-4(d). Pursuant to the authority granted in § 706(d)(2)(B)(iv), the proposed regulations provide that the term "allocable cash basis item" includes (1) any allowable deduction that had been previously deferred under § 267(a)(2), Prop.Reg. § 1.706-2(a)(2)(iv), and (2) any item of income, gain, loss, or deduction that accrues over time and that would, if not allocated as an allocable cash basis item, result in the significant misstatement of a partner's income. Prop.Reg. § 1.706-2(a)(2)(v). Examples of such items include rebate payments, refund payments, insurance premiums, prepayments, and cash advances. Prop.Reg. § 1.706-2(c) provides a de minimis rule that would provide that an allocable cash basis item will not be subject to the rules in § 706(d)(2) if, for the partnership's taxable year (1) the total of the particular class of allocable cash method items (for example, all interest income) is less than five percent of the partnership's (a) gross income, including tax-exempt income described in § 705(a)(1)(B), in the case of income or gain items, or (b) gross expenses and losses, including § 705(a)(2)(B) expenditures, in the case of losses and expense items; and (2) the total amount of allocable cash basis items from all classes of allocable cash basis items amounting to less than five percent of the partnership's (a) gross income, including tax-exempt income described in § 705(a)(1)(B), in the case of income or gain items, or (b) gross expenses and losses, including § 705(a)(2)(B) expenditures, in the case of losses and expense items, does not exceed $10 million in the taxable year, determined by treating all such allocable cash basis items as positive amounts.

Whether these proposed regulations will be finalized is in significant doubt because this regulation project has been placed on inactive status by the Trump administration. Office of Information and Regulatory Affairs, Inactive List, Reginfo.gov, https://www.reginfo.gov/public/do/eAgendaInactive (last visited Mar. 31, 2018) (from the dropdown menu, select Fall 2017 list and select Treasury Department as the agency).

Page 186:

Delete the last full paragraph and insert:

1.3.1. *Extraordinary Items.*

Treas.Reg. § 1.706-4(e) prohibits allocation of "extraordinary items" under the proration method and requires the allocation of "extraordinary items" under both the closing of the books method and the proration method to the partners in proportion to their interests *at the time of day* on which the extraordinary item arose. Extraordinary items include, among others, gain or loss on the disposition or abandonment of capital assets, trade or business property, property excluded from capital gains treatment under § 1221(a)(1), (3), (4), or (5) if substantially all of the assets in a particular category are disposed of in one transaction, discharge of indebtedness (except items subject to § 108(e)(8) or 108(i)), certain credits, items from the settlement of tort or third-party liability, items that the partners agree are consistently extraordinary for the year (subject to an anti-abuse exception), certain items attributable to accounting method changes, any item identified in published guidance, and any item that in the opinion of the IRS would, if ratably allocated, result in a substantial distortion of income in any return in which the item is included.) .) Prop.Reg. § 1.706-4(e)(3) (2015) specifies that any deduction for the transfer of an interest for services is also an extraordinary item (but this regulation project has been moved to inactive status by the new administration; see this Update, Chapter 4, pg. 22). Treas.Reg. § 1.706-4(e)(3) provides an exception for small extraordinary items under which an extraordinary item may be treated as not being an extraordinary item if, for the partnership's taxable year, (1) the total of all items in the particular class of extraordinary items (for example, all tort or similar liabilities) is less than five percent of the partnership's gross income (including tax-exempt income described in § 705(a)(1)(B)) in the case of income or gain items, or gross expenses and losses (including § 705(a)(2)(B) expenditures) in the case of losses and expense items; and (2) the total amount of extraordinary items from all classes of extraordinary items amounting to less than five percent of the partnership's gross income (in the case of income or gain items) or gross expenses and losses (in the case of losses and expense items) does not exceed $10 million in the taxable year, determined by treating all such extraordinary items as positive amounts.

SECTION 6. FAMILY PARTNERSHIPS

Page 190:

In the Internal Revenue Code citations, add Section 761(b).

Pages 191 through 193:

In reading this material note the following statutory amendment.

The 2015 Act deleted § 704(e)(1), moved the provision to § 761(b), and modified the language of former § 704(e)(1). As amended, § 761(b) adds the following sentence to the definition of a partner: "In the case of a capital interest in a partnership in which capital is a material income-producing factor, whether a person is a partner with respect to such interest shall be determined without regard to whether such interest was derived by gift from any other person." The amendment negates the holding of Evans v. Commissioner, 447 F.2d 547 (7th Cir. 1971), aff'g 54 T.C. 40 (1970), that the application of § 704(e)(1) was not limited to the context of family partnerships, where an interest in a partnership frequently is acquired by gift rather than by purchase, but is applicable whenever capital is a material income producing factor in a partnership. The revisions thus refocus the inquiry to whether a person is a partner and whether a partnership exists under the totality of the circumstances test of *Culbertson*. Under the revised § 761(b), a person's status as a partner with an interest in a family partnership in which capital is a material income producing factor acquired by gift should be tested under the same rules as a capital interest acquired by purchase or by a contribution to capital.

TIFD–III–E, Inc. v. United States, 666 F.3d 836 (2d Cir. 2012), rev'g, 660 F. Supp. 2d 367 (D. Conn. 2009), held under the former version of § 704(e)(1) that holding an interest in a partnership in the form of debt (or an interest overwhelmingly in the nature of debt) did not create a capital interest in a partnership that could qualify as a partnership interest.

CHAPTER 5

ALLOCATION OF PARTNERSHIP LIABILITIES

SECTION 1. ALLOCATION OF RECOURSE LIABILITIES

Page 199:

After the carryover paragraph, insert:

Prop.Reg. § 1.752-2(a)(2) (a)(2), 72 F.R. 76,092, 76,095 (Dec. 16, 2013) would provide that where multiple partners bear the economic risk of loss with respect to the same liability, the amount of the liability would be taken into account only once, and if the total amount of liability borne by the partners exceeds the amount of the liability, the economic risk of loss to be borne by each partner would be determined by multiplying the amount of the liability by a fraction determined by dividing the amount of the economic risk of loss of a partner over the sum of the amount of loss borne by all partners. Thus, as illustrated by an example in the proposed regulations, where partner A guarantees the full $1,000 of a bank loan to the AB partnership and partner B guarantees $500 of the liability, the amount of the liability allocable to A is $667 ($1,000 × $1,000/$1,500), and the amount of the liability allocable to B is $333 ($1,000 × $500/$1,500).

Page 206:

After *Detailed Analysis* 4, insert:

5. PROPOSED REGULATIONS

Prop.Reg. § 1.752–2(j)(3) (2016) would provide an anti-abuse rule under which a payment obligation (other than an obligation to restore a deficit capital account upon liquidation) would not be respected in determining economic risk of loss. The reason for the proposed anti-abuse rule is that IRS and the Treasury Department consider the current approach inappropriate because in most cases a partnership will satisfy its liabilities with partnership profits, the partnership's assets do not become worthless, and the payment obligations of partners or related persons are not called upon. The IRS and the Treasury Department believe that some partners or related persons have entered into payment obligations that are not commercial solely to achieve an allocation of a partnership liability to such partner. Notice of Proposed Rulemaking, Section 707 Regarding Disguised Sales, Generally, 79 F.R. 4826 (Jan. 30, 2014); REG-122855-15, Liabilities Recognized as Recourse Partnership Liabilities Under Section 752, 81 F.R. 69301 (Oct. 5, 2016).

Under the anti-abuse rule, certain factors are considered to determine whether a payment obligation (other than an obligation to restore a deficit capital account upon liquidation) should be respected. These factors are intended to ensure that the terms of the payment obligation are not designed solely to obtain tax benefits. The listed factors include: (1) The partner or related person is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, including, for example, restrictions on transfers for inadequate consideration or distributions by the partner or related person to equity owners in the partner or related person; (2) The partner or related person is not required to provide (either at the time the payment obligation is made or periodically) commercially reasonable documentation regarding the partner's or related person's financial condition to the benefited party; (3) The term of the payment obligation terminates prior to the term of the partnership liability or the partner or related person has a right to terminate its payment obligation, if the purpose of limiting the duration of the payment obligation is to terminate such payment obligation prior to the occurrence of an event or events that increase the risk of economic loss to the guarantor or benefited party; (4) There exists a plan or arrangement in which the primary obligor or any other obligor (or a person related to the obligor) with respect to the partnership liability directly or indirectly holds money or other liquid assets in an amount that exceeds the reasonable foreseeable needs of such obligor; (5) The payment obligation does not permit the creditor to promptly pursue payment following a payment default on the partnership liability, or other arrangements with respect to the partnership liability or payment obligation otherwise indicate a plan to delay collection; (6) In the case of a guarantee or similar arrangement, the terms of the partnership liability would be substantially the same had the partner or related person not agreed to provide the guarantee; (7) The creditor or other party benefiting from the obligation did not receive executed documents with respect to the payment obligation from the partner or related person before, or within a commercially reasonable period of time after, the creation of the obligation. Prop.Reg. § 1.752–2(j)(3)(iii). The list of factors in the anti-abuse rule is nonexclusive, and the weight to be given to any particular factor depends on the particular case. The presence or absence of any particular factor, in itself, is not necessarily indicative of whether or not a payment obligation is recognized under Treas.Reg. § 1.752–2(b). The proposed regulations would remove Treas.Reg.

§ 1.752–2(k), which currently provides that a payment obligation of a disregarded entity is taken into account only to the extent of the net value of the disregarded entity as of the allocation date. In its place, the proposed regulations would create a presumption under the anti-abuse rule in Prop.Reg. § 1.752–2(j)(3)(iii) under which evidence of a plan to circumvent or avoid an obligation is deemed to exist if the facts and circumstances indicate that there is not a reasonable expectation that the payment obligor will have the ability to make the required payments if the payment obligation becomes due and payable. A payment obligor includes disregarded entities (including grantor trusts).

6. RELATED PARTY RULES

Under Treas.Reg. § 1.704-4(b)(1), an individual and a corporation are treated as related persons if the individual is an 80 percent or greater shareholder. Where the corporation is a lender to a partnership or has a payment obligation with respect to a partnership liability, Prop.Reg. § 1.752-4(b)(1)(iv), 72 F.R. 76,092, 76,095–96 (Dec. 16, 2013) would disregard the application of § 267(c)(1) that provides that stock owned by a partnership is treated as owned proportionately by its partners. As a result, a partner in a partnership that owns 80 percent of the stock of the corporate lender will not be treated as related to the corporation that bears the economic risk of loss. Prop.Reg. § 1.752-4(b)(2) (2013) would provide that if a person who is a lender or has a payment obligation for a partnership liability is related to more than one partner, the liability will be shared equally among the related partners. This rule revises the existing provision that allocates the liability to the partner with the highest percentage of related ownership. In addition, the rule of Treas.Reg. § 1.752-4(b)(2)(iii), which provides that persons owning interests in the same partnership are not treated as related persons for purposes of determining economic risk for partnership liabilities would be modified to apply only to persons who bear the economic risk for a liability as a lender or have a payment obligation for the partnership liability.

SECTION 2. ALLOCATION OF NONRECOURSE DEBT

Page 208:

After the second complete paragraph, insert:

Regulations proposed in 2014 would have changed Treas.Reg. § 1.752-3(a)(3) to require that the designated profits interest be in accordance with the partners' liquidation value percentages. In 2016, the Treasury withdrew this proposal, "[p]artially in response to commenters' concerns about both the liquidation value percentage and the relationship between the methods and certain rules under § 1.704–2." T.D. 9787, 81 F.R. 69,291, 69,294 (Oct. 5, 2016). Instead, "the final regulations under § 1.752–3 retain the significant item method and the alternative method, but do not adopt the liquidation value percentage approach for determining partners' interests in partnership profits." *Id.* As discussed in this Update, Chapter 6, pgs. 34–35, the Treasury did adopt temporary regulations that prohibit taxpayers from using the significant item method or alternative method for purposes of the disguised sale rules of § 707; the new administration, however, has indicated that rule will be revised.

Page 216:

After the carryover paragraph, insert:

Temp.Reg. § 1.752–2T(b)(3), promulgated in 2016, continues to provide that "[t]he determination of the extent to which a partner or related person has an obligation to make a payment under [Treas.Reg. § 1.752–2(b)(1)] is based on the facts and circumstances at the time of the determination," and that "[a]ll statutory and contractual obligations relating to the partnership liability are taken into account." However, the temporary regulation now carves out an exception under which "bottom dollar" guarantees and indemnities (or their equivalent, termed "bottom dollar payments") will not be recognized. Temp.Reg. § 1.752–2T(b)(3)(ii) and (iii). Temp.Reg. § 1.752–2T(b)(3)(ii)(C) provides:

> [t]he term "bottom dollar payment obligation" includes (subject to certain exceptions): (1) any payment obligation other than one in which the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that (A) any amount of the partnership liability is not otherwise satisfied in the case of an obligation that is a guarantee or other similar arrangement, or (B) any amount of the indemnitee's or benefited party's payment obligation is satisfied in the case of an obligation which is an indemnity or similar arrangement; and (2) an arrangement with respect to a partnership liability that uses tiered partnerships, intermediaries, senior and subordinate liabilities, or

> similar arrangements to convert what would otherwise be a single liability into multiple liabilities if, based on the facts and circumstances, the liabilities were incurred (A) pursuant to a common plan, as part of a single transaction or arrangement, or as part of a series of related transactions or arrangements, and (B) with a principal purpose of avoiding having at least one of such liabilities or payment obligations with respect to such liabilities being treated as a bottom dollar payment obligation. Any payment obligation under [Treas.Reg.] § 1.752–2, including an obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership as described in [Treas.Reg.] §1.704–1(b)(2)(ii)(b)(3), may be a bottom dollar payment obligation if it meets the requirements set forth above.

As long as a partner or related person is or would be liable for the full amount of a payment obligation, the obligation will be recognized under Temp.Reg. § 1.752–2T(b)(3) if, taking into account any indemnity, reimbursement agreement, or similar arrangement, that partner or related person is liable for at least 90 percent of the initial payment obligation. Temp.Reg. § 1.752–2T(b)(3)(ii)(B). Also, a payment obligation is not a bottom dollar obligation merely because a maximum amount is placed on the partner's or related person's payment obligation, a partner's or related person's payment obligation is stated as a fixed percentage of every dollar of the partnership liability to which such obligation relates, or there is a right of proportionate contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable. Temp.Reg. § 1.752–2T(b)(3)(ii)(C)(2). Guarantees of a vertical slice of a partnership liability will be recognized.

Temp.Reg. § 1.752–2T(j)(2) provides an anti-abuse rule that the IRS can apply to assure that if a partner actually bears the economic risk of loss for a partnership liability, partners may not agree among themselves to create a bottom dollar payment obligation so that the liability will be treated as nonrecourse.

The new administration initially suggested these temporary regulations would be modified. Notice 2017–38, Implementation of Executive Order 13789 (Identifying and Reducing Tax Regulatory Burdens). In October 2017, the Treasury Department apparently changed its position: "[A]lthough Treasury and the IRS will continue to study the technical issues and consider comments, they do not plan to propose substantial changes to the temporary regulations on bottom-dollar guarantees." Secretary of the Treasury, Second Report to the President on Identifying and Reducing Tax Regulatory Burdens, 82 F.R. 48,013, 48,016 (Oct. 16, 2017).

CHAPTER 6

TRANSACTIONS BETWEEN PARTNERS AND THE PARTNERSHIP

SECTION 1. TRANSACTIONS INVOLVING SERVICES, RENTS, AND LOANS

Page 219:

Add to the citations:

PROPOSED REGULATIONS: Section 1.707-2.

Page 225:

At the end of the second full paragraph, add the following:

Section 199A may introduce another difference between the effect of § 707(a) and § 707(c) payments. As discussed in greater detail in this Update, Chapter 3, pgs. 13–16, qualified business income does not include a § 707(c) payment for services, but with respect to § 707(a) payments for services, the statute specifies that qualified business income will not include such payments "to the extent provided in regulations."

Page 229

After the carryover paragraph, insert:

The preamble to amendments proposed in 2015 states, "Congress revisited the scope of section 707(a) in 1984 . . . . and [in legislative history] conclude[ed] that the payment in Rev. Rul. 81–300 should be recharacterized as a section 707(a) payment. Accordingly, the Treasury Department and the IRS are obsoleting Rev. Rul. 81–300 and request comments on whether it should be reissued with modified facts." Disguised Payments for Services, 80 F.R. 43652, 43653 (July 23, 2015) (citation omitted).

Page 236:

After the carryover paragraph, insert:

Amendments proposed in 2015 would modify Treas.Reg. § 1.707-1(c), Ex. (2) to provide that all of the minimum guaranteed amount would be treated as a guaranteed payment. Thus, in the example described in the text, all $100 of A's guaranteed minimum payment would be treated as guaranteed payment under 707(c) regardless of the amount and character of partnership income. Only amounts allocated to the partner in excess of the minimum amount would be treated as the partner's distributive share. The preamble to the regulations explains that the prior approach of example (2) is inconsistent with the principle adopted in the proposed regulations that an allocation must be subject to significant entrepreneurial risk to be treated as distributive share. 81 F.R. 43,652, 43,655 (July 23, 2015).

Page 237:

After the carryover paragraph, insert:

In 2015 the IRS and Treasury proposed regulations to address disguised payments for services under § 707(a)(2)(A). Parroting the statutory language, Prop.Reg. § 1.707-2(b)(1) (2015) would treat an arrangement as a disguised payment for services if (1) a person (service provider), either in a partner capacity or in anticipation of being a partner, performs services (directly or through its delegate) to or for the benefit of the partnership; (2) there is a related direct or indirect allocation and distribution to the service provider; and (3) the performance of the services and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a person acting other than in that person's capacity as a partner. An item that is treated as a disguised payment for services by the proposed regulations will be treated as a payment for services for all purposes of the Code. Prop.Reg. § 1.707-2(b)(2)(i) (2015). Such payments would be treated as a payment to a non-partner for purposes of determining the distributive shares of the other partners. Prop.Reg. § 1.707-2(b)(3)(i) (2015).would provide that the rules of the proposed regulations would apply even if it is determined the application of the rules would cause the service provider to be treated as not being a partyer or that no partnership exists.

The proposed regulations would apply a facts and circumstances analysis to identify a disguised payment for services at the time an arrangement is entered into. Prop.Reg. § 1.707-2(b)(2)(i) (2015). The proposed regulations generally adopt the factors specified in the Senate Committee Report, but stress significant entrepreneurial risk as the most significant factor. Prop.Reg. § 1.707-2(c) (2015) would provide that a payment that lacks significant entrepreneurial risk relative to the overall entrepreneurial risk of the partnership constitutes a payment for services. Prop.Reg. § 1.707-2(c)(1) (2015) would create a presumption that an arrangement lacks entrepreneurial risk if (i) there is a cap on allocations of partnership income that is reasonably expected to apply in most years, (ii) the allocation of the service provider's share of income is reasonably certain for one or more years, (iii) the allocation is an allocation of gross income, (iv) the allocation is an amount that is fixed or determinable or is designed to assure that significant net profits are available to make the allocation to the service provider, or (v) the arrangement allows the service provide to waive the service provider's right to receive payment for the future performance of services in a manner that is non-binding. The presumption is designed to prohibit fee waive arrangements that are popular for equity and hedge fund managers.

The secondary factors included in the proposed regulations that indicate that an arrangement is a disguised payment for services include whether the service provider's interest is transitory, that the allocation and distribution are in a time frame comparable to the time in which a non-partner service provider would receive payment, the service provider became a partner in order to obtain tax benefits not otherwise available, and the value of the service provider's interest in continuing partnership profits is small relative to the allocation and distribution. Prop.Reg. § 1.701-2(c)(2) – (5) (2015). The proposed regulations would add an additional factor, not contained in the Senate Finance Committee Report, that would apply if the arrangement provides for different allocations or distributions with respect to different services provided by one person or related persons and are subject to variable levels of entrepreneurial risk.

SECTION 2. SALES OF PROPERTY

Page 248:

At the end of the carryover paragraph, insert:

The Fourth Circuit reached the same result in Route 231, LLC v. Commissioner, 810 F.3d 247 (4th Cir. 2016).

Page 249:

Replace the second full paragraph with the following:

Temp.Reg. § 1.707–5T(a)(2), promulgated in 2016, provides, for purposes of the disguised sale rules, that the partners' shares of any partnership liabilities, regardless of whether they are recourse or nonrecourse under Treas.Reg. § 1.752–1 through 1.752–3, must be allocated in the manner that "excess nonrecourse liabilities" are allocated under Treas.Reg. § 1.752–3(a)(3), which was amended in 2016 to provide that, for purposes of determining a partner's share of partnership liabilities in applying the disguised sale rules of § 707(a)(2)(B) and Treas.Reg. § 1.707–5(a)(2), regardless of whether they are recourse or nonrecourse, only the default rule for allocating partnership "excess nonrecourse liabilities"—in accordance with the partners' interests in partnership profits—applies, "but such share shall not exceed the partner's share of the partnership liability under section 752 and applicable regulations (as limited in the application of [Treas.Reg. § 1.752–3(a)(3) to this paragraph (a)(2))." This means that for purposes of applying the disguised sale rules, the partner's liability share (1) may not be smaller than the partner's share determined using profits method for excess nonrecourse liability and (2) may not be larger than the partner's share of the liability under section 752. According to the preamble, the Treasury and IRS believed that for purposes of the disguised sale rules, this allocation method reflects the overall economic arrangement of the partners: "In most cases, a partnership will satisfy its liabilities with partnership profits, the partnership's assets do not become worthless, and the payment obligations of partners or related persons are not called upon." T.D. 9788, Liabilities Recognized as Recourse Partnership Liabilities Under Section 752, 81 F.R. 69282 (Oct. 5, 2016). These rules are designed to be the death knell of leveraged partnership disguised sale transactions as structured in *Canal Corp. v. Commissioner*, 135 T.C. 199 (2010), text page 250, to which reference is made in the preamble.

In October 2017, the Treasury Department signaled its intention to revise Temp. Reg. § 1.707–5T: "While Treasury and the IRS believe that the temporary regulations' novel approach to addressing disguised sale treatment merits further study, Treasury and the IRS agree that such a far-reaching change should be studied systematically. Treasury and the IRS, therefore, are considering whether the proposed and temporary regulations relating to disguised sales should be revoked and the prior regulations reinstated." Secretary of the Treasury, Second Report to the President on Identifying and Reducing Tax Regulatory Burdens, 82 F.R. 48,013, 48,016 (Oct. 16, 2017).

Page 251:

After the carryover paragraph, insert:

Amendments to the regulations under § 707 promulgated in 2016, provide a number of clarifications to the § 707 disguised sale rules: (1) An ordering rule has been added in Treas.Reg. § 1.707-5 to provide that the treatment of a transfer should first be determined under the debt-financed distribution exception, and any amount not excluded from Treas.Reg. § 1.707–3 under the debt financed distribution exception should be tested to see if such amount would be excluded from Treas.Reg. § 1.707–3 under a different exception in Treas.Reg. § 1.707–4. (2). The exception for preformation capital expenditures in Treas.Reg. § 1.707-4 has been clarified to expressly provide that the 20 percent of fair market value ceiling and the exception to the limitation where the fair market value of the property does not exceed 120 percent of basis apply property-by-property. However, aggregation is permitted to the extent: (i) the total fair market value of the aggregated property (of which no single property's fair market value exceeds 1 percent of the total fair market value of such aggregated property) is not greater than the lesser of 10 percent of the total fair market value of all property, excluding money and marketable securities (as defined under § 731(c)), transferred by the partner to the partnership, or $1,000,000; (ii) the partner uses a reasonable aggregation method that is consistently applied; and (iii) the aggregation of property is not part of a plan a principal purpose of which is to avoid Treas.Regs. §§ 1.707–3 through 1.707–5. (3) The amendments also provide a rule coordinating the exception for preformation capital expenditures and the rules regarding liabilities traceable to capital expenditures. For purposes of defining qualified liabilities under Treas.Reg. § 1.707–3, the term "capital expenditures" has the same meaning as the term "capital expenditures" generally does, except that it includes capital expenditures taxpayers elect to deduct, and does not include deductible expenses taxpayers elect to treat as capital expenditures. The final regulations add that to the extent any qualified liability under Treas.Reg. § 1.707–5(a)(6) is used by a partner to fund capital expenditures and economic responsibility for that borrowing shifts to another partner, the exception for preformation capital expenditures does not apply. Under the final regulations, capital expenditures are treated as funded by the proceeds of a qualified liability to the extent the proceeds are either traceable to the capital expenditures under Temp.Reg. § 1.163–8T or are actually used to fund the capital expenditures, irrespective of the tracing requirements under Temp.Reg. § 1.163–8T. (4) The final regulations provide a "step-in-the-shoes" rule for applying the exception for preformation capital expenditures and for determining whether a liability is a qualified liability under Treas.Reg. § 1.707–5(a)(6) when a partner acquires property, assumes a liability, or takes property subject to a liability from another person in connection with a nonrecognition transaction under §§ 351, 381(a), 721, or 731. (5) The amendments to the regulations add to the list of qualified liabilities that, pursuant to Treas.Reg. § 1.707–5, may be assumed without triggering the disguised sale rules liabilities that were not incurred in anticipation of the transfer of the property to a partnership, but that were 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). (6) The amendments to the regulations clarify the anticipated reduction rule in Treas.Reg. § 1.707–5(a)(3) by providing that a reduction that is subject to the entrepreneurial risks of partnership operations is not an anticipated reduction. (7) As amended, Treas.Reg. § 1.707–5(a)(5) does not take into account qualified liabilities as consideration in transfers of property treated as a sale when the total amount of all liabilities other than qualified liabilities that the partnership assumes or takes subject to is the lesser of 10 percent of the total amount of all qualified liabilities the partnership assumes or takes subject to, or $1,000,000.

CHAPTER 7

SPECIAL LIMITATIONS ON LOSS DEDUCTIONS AT THE PARTNER LEVEL

SECTION 3. THE PASSIVE ACTIVITY LOSS RULES OF SECTION 469

Page 273:

After the second full paragraph, insert:

The self-rental recharacterization rule of Treas.Reg. § 1.469-2(f)(6) is applicable to income from "an item of property" and thus does not apply to net income from an activity renting property to an active business of the taxpayer. This distinction was analyzed in Veriha v. Commissioner, 139 T.C. 45 (2013). The taxpayer was the sole owner of JVT, a C corporation that conducted a trucking business in which he actively participated. JVT leased the tractors and trailers used in its business from TRI, an S corporation in which the taxpayer owned 99 percent of the stock, and JRV, a single-member LLC wholly owned by the taxpayer and thus a disregarded entity. Each lease of a tractor or trailer was governed by a separate contract. During the year in issue, TRI realized net income and JRV realized a net loss. The taxpayer treated the net income from TRI as passive income and treated the net loss from JRV as a passive loss. The court agreed with the IRS that pursuant to Treas.Reg. § 1.469-2(f)(6) each tractor and each trailer should be considered a separate "item of property" and that the income the taxpayer received from TRI should be recharacterized as nonpassive income, while the net loss realized by JRV remained a passive activity loss. The Tax Court rejected the taxpayer's argument that all of the tractors and trailers collectively were one "item of property," and looking to *Webster's Third New International Dictionary* 1203 (2002) for the definition of the term "item", held that for purposes of applying Treas.Reg. § 1.469-2(f)(6), each individual tractor or trailer was an "item of property," and the income received from TRI was subject to recharacterization. However, because the IRS had not contested the taxpayer's netting of gains and losses within TRI, only TRI's net income was recharacterized as nonpassive income that could not be offset by losses from JRV.

Page 280:

Add a new section as follows:

SECTION 4. THE LIMITATION ON EXCESS BUSINESS LOSSES OF NONCORPORATE TAXPAYERS: SECTION 461(l)

For taxable years beginning after December 31, 2017, and before January 1, 2026, the 2017 Tax Act adds a new limitation on the deduction of business losses for noncorporate taxpayers, including individual partners and S corporation shareholders. Pub. L. No. 115-97, § 11012(a) (2017). Section 461(l) disallows the deduction of a taxpayer's "excess business loss." This is defined in § 461(l)(3) to mean the taxpayer's aggregate deductions for the year that are "attributable to trades or business of such taxpayer" over the sum of (1) the taxpayer's aggregate gross income or gain for the year attributable to the taxpayer's trades and (2) $250,000 (or $500,000 for joint filers), adjusted for inflation after 2018. Section 461(l) specifies that it applies after § 469.

Section 461(l) applies at the partner or shareholder level (for S corporations) and provides:

> [E]ach partner's or shareholder's allocable share of the items of income, gain, deduction, or loss of the partnership or S corporation for any taxable year from trades or businesses attributable to the partnership or S corporation shall be taken into account by the partner or shareholder in applying [§ 461(l)] to the taxable year of such partner or shareholder with or within which the taxable year of the partnerhsip os S corporation ends.

The statute explains that for S corporation shareholders, "allocable share" means their "pro rata share" of an item. § 461(l)(4).

If a taxpayer's deductions are disallowed, the disallowed amount is treated as a § 172 net operating loss in the subsequent year. § 462(l)(2). The 2017 Tax Act also changed the carryback and carryforward rules of § 172. For all taxpayers (other than certain insurance companies and farming businesses), the ability to carry back NOLs is eliminated and the carryover is limited to 80% of the taxpayer's taxable income. § 172(a)(2), (b)(1).

As is true of many (if not most) of the new rules contained in the 2017 Tax Act, guidance is needed regarding the definition of key terms and the coordination of § 461(l) with other statutory provisions.

CHAPTER 8

SALES OF PARTNERSHIP INTERESTS BY PARTNERS

SECTION 1. THE SELLER'S SIDE OF THE TRANSACTION

A. GENERAL PRINCIPLES

Page 281:

Add a new paragraph before the Revenue Ruling:

When a partnership interest is sold, new provisions added by the 2017 Tax Act may be applicable. Section 1061 (discussed *supra* Update, Chapter 3, pgs. 7–9) may affect whether a partner's capital gain on a sale is long-term or short-term. If § 751(a) requires that a partner recognize ordinary income or loss on the sale, that ordinary item appears to be eligible to be included in the § 199A qualified business income computation, assuming the other requirements of § 199A are met (discussed *supra* Update, Chapter 3, pgs. 13–16). (Capital gains or losses are not included in § 199A qualified business income.) These new provisions do not contain rules regarding how they interact with specific provisions of subchapter K, so we must await guidance.

Page 286:

Delete the beginning four sentences of section 2.1 before the parenthetical sentence and insert the following:

In what is arguably its only contribution to actual simplification in the partnership area, the 2017 Tax Act repealed the rule requiring termination of a partnership if 50% or more of the partnership interests were sold within a 12-month period. Pub. L. No. 115-97, § 13504(a)(1)–(2). Section 708(b)(1) now simply provides: "[A] partnership shall be considered as terminated only if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership."

B. CAPITAL GAIN VERSUS ORDINARY INCOME: SECTION 751

Page 303:

At the end of the first full paragraph, insert:

The Tax Court's decision was affirmed by Mingo v, Commissioner, 773 F.3d 629 (5th Cir. 2014). The Fifth Circuit relied on Sorensen v. Commissioner, 22 T.C. 321 (1954) and held that "the proceeds from the unrealized receivables, classified as ordinary income, do not qualify for installment method reporting because they do not arise from the sale of property" for purposes of § 453.

SECTION 2. THE PURCHASER'S SIDE OF THE TRANSACTION: BASIS ASPECTS

Page 306:

Before the final sentence of the first full paragraph, add the following:

The 2017 Tax Act added that a mandatory basis adjustment is also required if "the transferee partner would be allocated a loss of more than $250,000 if the partnership assets were sold for cash equal to their fair market value immediately after such transfer." § 743(d)(1)(B). Thus, a mandatory basis adjustment is required both when the partnership has an aggregate built-in loss of more than $250,000 in its assets and when the purchaser would be allocated a loss of more than $250,000 in a constructive sale of partnership assets at their fair market value after the purchase (for example, through a special loss allocation).

CHAPTER 9

PARTNERSHIP DISTRIBUTIONS

SECTION 1. CURRENT DISTRIBUTIONS

Page 321:

Add before the Revenue Ruling:

When a partner receives a current distribution, new provisions added by the 2017 Tax Act may be applicable. Section 1061 (discussed *supra* Update, Chapter 3, pgs. 7–9) may affect whether a partner's capital gain on a distribution is long-term or short-term. If § 751(b) requires that a partner (or partners) recognize ordinary items on the constructive taxable exchange, those items appear to be eligible to be included in the § 199A qualified business income computation, assuming the other requirements of § 199A are met (discussed *supra* Update, Chapter 3, pgs. 13–16). (Capital gains or losses are not included in § 199A qualified business income.) Guidance is required, however, regarding the interaction of provisions such as § 1061 and § 199A with the specific rules of subchapter K.

C. DISTRIBUTIONS BY PARTNERSHIPS HOLDING UNREALIZED RECEIVABLES OR SUBSTANTIALLY APPRECIATED INVENTORY

Page 348:

At the end of Section 1, insert:

6. 2014 PROPOSED REGULATIONS

The IRS and Treasury Department have proposed amendments to the regulations under § 751(b) that would completely change the mechanics of the application of § 751(b) in nonliquidating distributions. REG-151416-06, Certain Distributions Treated as Sales or Exchanges, 79 F.R. 65151 (Nov. 11 2014). As described in the text, the application of § 751(b) generally requires creation of a constructive taxable exchange whenever a partner receives a current distribution that alters the partners' respective interests in unrealized receivables or substantially appreciated inventory. As noted in Detailed Analysis 5 in the text, as implemented by the current regulations, § 751(b) is deeply flawed because it disproportionately measures by the value of substantially appreciated inventory and accounts receivable rather than by the built-in gain or loss attributable to these assets. Thus, it fails to fulfill completely its stated purpose. The proposed regulations would cure that flaw by amending the § 751(b) regulations to operate similarly to the § 751(a) regulations, which provide generally that a partner's interest in § 751 property is the amount of income or loss from § 751 property that would be allocated to the partner if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property. Prop.Reg. § 1.751-1(a)(2). The hypothetical sale approach in the proposed § 751(b) regulations shift the focus away from exchanges of gross value to tax gain and loss, and instead require the application of § 751(b) to the extent the distribution reduces a partner's share of income (or increases a partner's share of loss) related to § 751 assets.

If the distribution reduces the amount of ordinary income (or increases the amount of ordinary loss) from § 751 property that would be allocated to, or recognized by, a partner (thus reducing that partner's interest in the partnership's § 751 property), the distribution triggers § 751(b). To make this method work, Treas.Reg. § 1.704-1(b)(2)(iv)(f) would be amended to require revaluations of partnership property if the partnership distributes money or other property to a partner as consideration for an interest in the partnership and the partnership owns § 751 property immediately after the distribution. Prop.Reg. § 1.751-1(b)(2)(iv). (A partnership that does not own § 751 property immediately after the distribution may revalue its property, but is not required to do so.)

Determining whether any partner's share of § 751 gain or loss ("hot asset" gain or loss) is reduced in connection with a distribution can be complex because it takes into account (1) § 704(c) and reverse § 704(c) gain and loss with respect to § 751 assets (discussed in the text in Chapter 4, Section 3), (2) § 732 basis adjustments to distributed property (discussed at page 330 of the text), (3) § 734(b) basis adjustments (discussed in the text in Section 4 of this Chapter), and (4) shifts of § 743(b) basis adjustments among assets as a result of distributions (discussed in the text in Section 2 of this Chapter).

To determine each partner's net § 751 unrealized gain or loss immediately before and after a distribution, the proposed regulations use the hypothetical sale approach (a under § 751(a)) to determine a partner's net § 751 unrealized gain or loss. A partner's net § 751 unrealized gain or loss immediately before a distribution equals the amount of net income or loss from § 751 property that would be allocated to the partner if the partnership sold all of its assets for cash equal to their fair market value Prop.Reg. § 1.751-1(b)(2)(ii). This calculation takes into account (1) any § 743(b) basis adjustments with respect to the partners (as determined under Treas.Reg. § 1.743-1(j)(3)), (2) any remedial allocations under Treas.Reg. § 1.704-3(d), and (3) any carryover basis adjustments described in Treas.Reg. §§ 1.743-1(g)(2)(ii), 1.755-1(b)(5)(iii)(D), or 1.755-1(c)(4) (discussed in the text at page 337) as if those adjustments were applied to the basis of new partnership property with a fair market value of $0.

A partner's net § 751 unrealized gain or loss immediately after a distribution is calculated in the same manner, except that the partnership is deemed to have sold its retained assets and the distributee partner is deemed to have sold the assets received in the distribution. Prop.Reg. § 1.751-1(b)(2)(iii). The partnership's hypothetical sale determines the net § 751 unrealized gain or loss of the non-distributee partners (and the distributee partner if that partner was not completely redeemed) and the distributee partner's hypothetical sale determines the net § 751 unrealized gain or loss attributable to that partner outside the partnership. (However, any § 734(b) basis adjustments that occur as a result of the distribution are not taken into account in determining a partner's share of net § 751 unrealized gain or loss.)

Although the proposed regulations prescribe with specificity the method for determining whether § 751(b) will apply to a distribution, the proposed regulations do not require the use of any particular approach for determining the tax consequences of distribution that triggers § 751(b). Rather, the proposed regulations provide that if, under the hypothetical sale approach, a distribution reduces a partner's interest in the partnership's § 751 property, giving rise to a § 751(b) amount, then the partnership must use a reasonable approach that is consistent with the purpose of § 751(b) to determine the tax consequences of the reduction. According to the preamble to the proposed regulations, the reason behind this "reasonable approach" rule is that "a deemed gain approach produces an appropriate outcome in the greatest number of circumstances out of the approaches under consideration, and that the hot asset sale approach also produced an appropriate outcome in most circumstances. However, no one approach produced an appropriate outcome in all circumstances."

Generally, a partnership must use one approach consistently. Prop.Reg. § 1.751-1(b)(3)(i). Examples illustrate situations in which the approach adopted in § 1.752-1(b)(2) of the proposed regulations for purposes of determining partner's interest in the partnership's property is reasonable and in which it is not reasonable.

The preamble describes the general principle of the purpose of the § 751(b) recognition rules a follows:

> If § 751(b) applies to a distribution, each partner must generally recognize or take into account currently ordinary income equal to the partner's "§ 751(b) amount." If a partner has net § 751 unrealized gain both before and after the distribution, then the partner's § 751(b) amount equals the partner's net § 751 unrealized gain immediately before the distribution less the partner's net § 751 unrealized gain immediately after the distribution. If a partner has net § 751 unrealized loss both before and after the distribution, then the partner's § 751(b) amount equals the partner's net § 751 unrealized loss immediately after the distribution less the partner's net § 751 unrealized loss immediately before the distribution. If a partner has net § 751 unrealized gain before the distribution and net § 751 unrealized loss after the distribution, then the partner's § 751(b) amount equals the sum of the partner's net § 751 unrealized gain immediately before the distribution and the partner's net § 751 unrealized loss immediately after the distribution
>
> .

The examples in the proposed regulations illustrate two alternative reasonable approaches—the "deemed gain" approach and the "hot asset" sale approach—for determining the income inclusion for a partner whose net § 751 unrealized gain is reduced (or net § 751 unrealized loss is increased) in connection with a distribution. See Prop.Reg. § 1.751-1(g), Exs. 3-8. Examples also illustrate situations in which the approach adopted is not reasonable.

Under the "deemed gain" approach the partnership recognizes ordinary income in the aggregate amount of each partner's § 751(b) amount, and the partnership then allocates ordinary income to the partner or partners in proportion to their respective § 751(b) amounts. Thereafter, the partnership makes appropriate basis adjustments to its assets to reflect its ordinary income recognition, and the partners make appropriate adjustments to the bases of their partnership interests.

Under the "hot asset sale" approach, for any partner whose share of § 751 assets is reduced (selling partner), whether or not the selling partner is the distributee, the selling partner would be treated as receiving the relinquished hot assets in a deemed distribution and selling to the partnership the relinquished share of the hot assets immediately before the actual distribution. The hot asset sale approach is straightforward if the distributee partner's share of hot asset appreciation is reduced by the distribution: the partnership would be treated as distributing the relinquished share of § 751 assets to the distributee partner who in turn sells the § 751 assets back to the partnership, recognizing ordinary income, with appropriate adjustments to the distributee partner's basis in the partnership interest and capital account. The asset deemed to have been sold would take a cost basis, and the distribution would be governed by §§ 731 through 736.

Regardless of whether the deemed gain or hot asset sale method is adopted, The proposed regulations require a distributee partner to recognize capital gain to the extent necessary to prevent the distribution from triggering a basis adjustment under § 734(b) that would reduce other partners' shares of net unrealized § 751 gain or loss. Prop.Reg. § 1.751-1(b)(3)(ii)(A), -1(g, Exs. 5 & 6. This is required because the § 734(b) basis adjustment is not taken into account in determining the partners' net § 751 unrealized gain or loss immediately after the § 751 distribution. Thus, a nondistributee partner's interest in § 751 property may be reduced without triggering ordinary income under § 751(b). To avoid this result, Prop.Reg. § 1.751-1(b)(3)(ii)(A) requires the distributee partner to recognize capital gain immediately before the distribution in an amount that eliminates the § 734(b) basis adjustment. As a result, the basis of the distributed § 751 property is not reduced under § 732, thereby eliminating any § 734(b) basis adjustment.

In addition, either approach produces problems where the distributee partner has insufficient basis in its partnership interest to absorb the partnership's adjusted basis in the distributed hot assets. In this situation, the results can be inconsistent with the purpose of § 751(b). Thus, the proposed regulations allow distributee partners to elect to recognize capital gain in certain circumstances to avoid § 732 decreases to the basis of distributed § 751 property. Prop.Reg. § 1.751-1(b)(3)(ii)(B), -1(g), Ex. 7.

The proposed regulations also contain complex anti-abuse rules that apply when a partner engages in a transaction that relies on § 704(c) to eliminate or reduce ordinary income. Prop.Reg. § 1.751-1(b)(4).

The proposed regulations would apply to distributions occurring in any taxable period ending on or after the date of publication of final regulations. However, a partnership and its partners may rely on Prop.Reg. § 1.751-1(b)(2) for purposes of determining a partner's interest in the partnership's § 751 property on or after November 13, 2014, provided the partnership and its partners apply each of Prop.Regs. §§ 1.751-1(a)(2), 1.751-1(b)(2), and 1.751-1(b)(4) consistently for all partnership distributions and sales or exchanges. Generally speaking (with some exceptions) this means that if the partners' shares of ordinary income remain unchanged after a distribution, either due to reverse § 704(c) allocations or because the distribution carries out to the distributee partner a pro rata share of ordinary income (without regard to whether a pro rata share of the value of hot assets has been distributed) gain recognition under § 751(b) will not be triggered.

SECTION 3. DISTRIBUTIONS IN LIQUIDATION OF A PARTNERSHIP INTEREST

Page 355:

After the last paragraph, add the following:

When a partner receives a liquidating distribution, new provisions (e.g., § 199A, § 1061) added by the 2017 Tax Act may be relevant. Guidance is required, however, regarding the interaction of these new provisions with the specific rules of subchapter K. For example, § 199A(c)(4)(B) specifies that § 707(c) payments for services do not constitute qualified business income; it is not clear to what extent that may include payments made to a retiring service partner that are treated as § 707(c) payments through application of § 736(a)(2).

A. SECTION 736(b) PAYMENTS: DISTRIBUTIONS

Page 364:

After the first full paragraph, insert:

6. DISTINGUISHING A LIQUIDATING DISTRIBUTION FROM A CURRENT DISTRIBUTION

In Brennan v. Commissioner, T.C. Memo. 2012-209, the taxpayer withdrew from his membership in an LLC in 2002 but continued to retain an "economic interest" in payments due the LLC in 2003 and 2004 with respect to sales of institutional accounts for the management of portfolios of high-income individuals. The court rejected the taxpayer's claim that he ceased to be a member of the partnership when his interest was terminated, holding that a retiring partner remains a partner for tax purposes until the partners' interest has been completely liquidated. Thus, the retiring partner was responsible for reporting his share of partnership gain recognized in 2003 and 2004, partnership taxable years after the withdrawal.

SECTION 6. COMPLETE LIQUIDATION OF THE PARTNERSHIP

Page 400–02:

Delete Section 7: Sales of Partnership Interests Causing Constructive Terminations

This deletion is the result of the repeal of the constructive termination rule by the 2017 Tax Act. See this Update, Chapter 8, pg. 39, for additional discussion.

PART II

TAXATION OF CORPORATIONS AND SHAREHOLDERS

CHAPTER 10

TAXATION OF CORPORATE INCOME AND IDENTIFYING TAXABLE CORPORATE FORMATION OF THE CORPORATION

SECTION 1. THE CORPORATE INCOME TAX

Pages 422–23:

Delete from the fourth sentence in the second full paragraph on page 422 through the first full paragraph on page 423; replace with the following:

Legislation enacted in 2017 ("2017 Tax Act"), Pub. L. No. 115-97, § 11001 (2017), changed the corporate tax rate to a flat 21%, including for personal service corporations.

Page 424:

Delete the last two sentences of the carryover paragraph.

The 2017 Tax Act struck § 1201 for taxable years beginning after December 31, 2017.

Page 424:

Delete first full paragraph.

The 2017 Tax Act repealed § 199 for taxable years beginning after December 31, 2017.

Page 426:

After the last paragraph, insert the following:

The 2017 Tax Act complicates business planning. Prior to 2017, the double taxation of corporate earnings coupled with the near equivalency of the top corporate marginal tax rate of 35% and the top individual marginal income tax rate of 39.8% made it compelling under old law in most situations for business owners to conduct business activities in pass-through entity structures. However, current law provides a substantially lower corporate tax of 21% under § 11 versus a top individual marginal tax rate of 37% for individuals under § 1. This tax rate differential creates a complex set of trade-offs that should be considered before deciding whether to conduct business activities in a passthrough entity or in a C corporation. Section 199A (discussed in detail in this Update, Chapter 3, 13–16) provides a potential 20% deduction for net qualified business income from passthroughs, which further complicates the analysis.

If a C corporation earns income that is subject to corporate level taxation at a 21% corporate rate, then the after-tax corporate earnings would be equal to 79% of the corporation's taxable income. This 79% after-tax corporate earnings could then be distributed to the shareholder as a qualified dividend. Under currently law, individual shareholders are entitled to obtain concessionary capital gains rates under § 1(h) for qualified dividends, resulting in a maximum shareholder tax rate of 20%. The individual shareholder also would be subject to a 3.8% surtax under § 1411(a) upon receipt of that dividend. Thus, the all-in corporate tax cost would be 21%, and the all-in shareholder level tax cost of distributing a qualified dividend would be 18.8%.[1] Thus, the combination of the corporate level tax and shareholder level tax results in a combined tax cost of 39.8%. Thus, earning business income within a C corporation and then distributing the after-tax corporate earnings as a qualified dividend to an individual shareholder who is subject to the top individual marginal tax rate of 37% creates a double tax cost that is slightly higher than the top individual marginal income tax rate of 37%. However, this straightforward comparison is subject to several important caveats that can further complicate the choice of business entity analysis.

For example, assume that the C corporation will delay distributing its corporate earnings for five years and assume that the business owner has a 10% cost of capital. The deferral benefit of delaying the shareholder level tax cost of 18.8% for five years causes the present value of this shareholder level tax cost to be only of 11.67%.[2] Thus, in this scenario, the present value cost of earning income in the C corporation is only 32.67% (i.e., 21% corporate tax plus 11.67% which again represents the present value cost of the 18.8% shareholder level tax that is deferred for five years). If the deferral period were twice as long, then the present value cost of the 18.8% cost would be less than 7.25%.[3] Thus, in a situation where a business owner intends to reinvest earnings back into the business for a significant period of time and will defer her incurrence of the shareholder level tax cost, the deferral benefit time with respect to the shareholder level tax can substantially reduce the present value impact of that second level of taxation.

Moreover, if the individual shareholder does not distribute corporate earnings but instead disposes of the C corporate stock in a transaction that would allow the individual shareholder to claim an exemption for half of the capital gain for small business stock by reason of § 1202 , then the all-in tax cost would be limited to

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[1] The 18.8% is calculated by taking the after-corporate tax earnings of 79% (100%- 21% corporate tax) and multiplying that amount by the all-in 23.8% shareholder level tax arising from the 20% capital gains rate that applies on qualified dividends and the 3.8% surtax on net investment income under section 1411(a).

[2] The 11.67% represents the present value of the 18.8% shareholder level tax in the situation where it is deferred for five years with a 10% cost of capital tax deferred for 5 years = $\frac{18.8\%}{(1+10\%)^5}$).

[3] For example, if one were to assume a ten year deferral period of the 18.8% shareholder level tax, then the present value cost of that shareholder level tax that is deferred for ten years would be approximately 7.25%.

only the corporate level tax cost of 21% plus half of the preferential capital gains rate for the shareholder. Alternatively, if the C corporation withheld distributions of corporate earnings until the shareholder's death, then the shareholder's stock would have its basis increase to its fair market value at the time of shareholder's death under § 1014 with the consequence that the shareholder's estate or beneficiaries then could dispose of the stock without any shareholder level tax cost. In either of these two situations, the benefit of earning income in a C corporation that is subject to the relatively low 21% corporate tax rate and then avoiding the shareholder level tax (or deferring that shareholder level tax for a significant period of time) could result in a combined tax cost that is lower than simply earning that business income in a passthrough entity outside of the C corporation.

But the benefits of earning income in a passthrough entity structure that is eligible for a 20% deduction under § 199A provides a counter benefit. Of course, § 199A has various limitations on its availability, but consider if business income were earned by an individual who would otherwise be subject to the top individual marginal income tax rate but who is eligible to claim the maximum § 199A deduction. Then the individual taxpayer could achieve an effective tax rate on this pass-through income of 29.6%.[4] This 29.6% rate is higher than the 21% tax rate applicable to C corporations, but it is lower than the all-in tax rate for earning income in a C corporation and distributing dividends to owners after a 5 year deferral period (i.e., 32.67% all-in cost). However, if one's assumptions were to change, then a different result could arise. For example, if the shareholder level tax were deferred for ten years or could be minimized or avoided at the shareholder level by reason of § 1202 or § 1014, then the combined cost of earning income in a C corporation would be less than the tax cost of earning income in a passthrough entity structure.

The point of these examples is to illustrate that the choice of business entity decision matrix now has complex trade-offs under current law. Yes, corporate earnings generally are subject to taxation at both the shareholder level and the corporate level, but the 21% corporate level tax rate is substantially lower than the individual tax rate for earning business income in passthrough entities even with the

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[4] The 29.6% rate is computed by taking the top individual marginal income tax rate for individuals of 37% and multiplying this by 80% under the assumption that the individual shareholder was entitled to the maximum 20% deduction against taxable income under section 199A.

benefit of utilizing a § 199A deduction. The extra shareholder level tax cost of 18.8% could cause the C corporate alternative to be less desirable unless the shareholder level tax were deferred for a significant period of time or could be avoided or minimized through other strategies. Thus, a careful discussion of the client's planning assumptions is now likely to be needed.

Finally, the assumptions one makes about the sustainability of current law can also impact the business entity structure decision. In this regard, the 2017 Act was passed on a strictly party-line vote. So, one might question whether the corporate tax rate of 21% might increase in the future. If one were concerned that corporate tax rates might increase to 25% or higher, then the potential benefit of earning income in a C corporation would be substantially diminished versus earning income in a passthrough entity structure that entitles its owner to § 199A benefits. Thus, in this scenario, the added double taxation at the shareholder level may well cause C corporations to be less tax efficient than a passthrough entity structure.

Pages 427–30:

Delete all of Detailed Analysis 1 and all of Detailed Analysis 2

The 2017 Tax Act repealed § 199 for taxable years beginning after December 31, 2017.

The 2017 Tax Act repealed the corporate alternative minimum tax for taxable years beginning after December 31, 2017.

SECTION 2. IDENTIFYING TAXABLE CORPORATE ENTITIES

Page 436:

Delete the first sentence of Section 2 and replace with the following:

Under current law, corporate income is taxed at a flat rate of 21%, while the maximum individual marginal tax rate is 37% (in the absence of new legislation, the maximum individual tax rate will revert to 39.6% in 2026).

CHAPTER 11

FORMATION OF THE CORPORATION

SECTION 1. RECEIPT OF STOCK FOR PROPERTY

A. BASIC PRINCIPLES

Page 474:

Delete the last sentence of Detailed Analysis 5.2 and replace with the following:

If property is transferred as a contribution to capital by persons other than stockholders in aid of construction or any other contribution as a customer or potential customer or by a governmental entity or civic group (other than a contribution made by a shareholder as such), then § 118(b) excludes such payments from being treated as a capital contribution with the consequence that the corporation must treat these amounts as gross income.

C. "SOLELY FOR STOCK"—THE RECEIPT OF OTHER PROPERTY

Page 483:

Replace the first table in Revenue Ruling 68-55 with the following:

Character of asset.	*Asset I* Capital asset held more than 6 months.	*Asset II* Capital asset held not more than 6 months.	*Asset III* Section 1245 property.
Fair market value.	$22*x*	$33*x*	$55*x*
Adjusted basis.	40*x*	20*x*	25*x*
Gain (loss).	($18*x*)	$13*x*	$30*x*
Character of gain or loss.	Long-term capital loss.	Short-term capital gain.	Ordinary income.

Page 486:

After the citation to Guenther v. Commissioner, insert:

In Vest v. Commissioner, T.C. Memo. 2016-187, the Tax Court held that to avoid the application of § 453(g) a taxpayer can satisfy his burden of proof only by submitting evidence that clearly negates an income-tax-avoidance plan, with "more weight to objective facts than to the taxpayer's mere denial of tax motivation," and that the enhanced depreciation deductions available to the related buyer is relevant in deciding whether the seller had a principal purpose of avoiding tax.

SECTION 2. "SOLELY" FOR STOCK: ASSUMPTION OF LIABILITIES

A. BASIC PRINCIPLES

Page 494:

After the carryover paragraph from page 493, add the following:

The proposed net value regulations were withdrawn in July 2017. 82 F.R. 32,281, 32,282. The withdrawal notice provides: "The Treasury Department and the IRS are of the view that current law is sufficient to ensure that the reorganization provisions and section 351 are used to accomplish readjustments of continuing interests in property held in modified corporate form."

CHAPTER 12

THE CAPITAL STRUCTURE OF THE CORPORATION

SECTION 1. DEBT VERSUS EQUITY

A. GENERAL PRINCIPLES GOVERNING CLASSIFICATION AS DEBT OR EQUITY

Page 536:

After the heading, insert the citation:

INTERNAL REVENUE CODE: Section 385.
REGULATIONS: Sections 1.385-1 (a)–(c), -2 (a)–(d), (f), -3 (a), (b)(1)–(b)(4), (c)(4).

Page 563:

After the fourth paragraph, insert:

7A. 2017 SECTION 385 REGULATIONS

Attempts in Congress to define debt and equity when the 1954 Code was enacted were rejected by the Senate. The Senate Finance Committee Report stated that "any attempt to write into the statute precise definitions which will classify for tax purposes the many types of corporate stocks and securities will be frustrated by the numerous characteristics of an interchangeable nature which can be given to these instruments." S.Rep. No. 1622, 83d Cong., 2d Sess. 42 (1954). In the 1969 Act, however, Congress enacted § 385 in an attempt to transfer the problem of definition to the Treasury. Section 385(a) authorizes the IRS and Treasury to "prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness (or as in part stock and in part indebtedness)." Section 385(b) suggests a list of factors that might be taken into account in promulgating regulations.

Final § 385 regulations were issued in December 1980, applicable to instruments issued after April 30, 1981. T.D. 7747, 1981–1 C.B. 141. The effective date was extended several times and the regulations were withdrawn on August 5, 1983. T.D. 7920, 1983–2 C.B. 69. The regulations focused primarily on proportionality and valuation as the keys to debt/equity distinctions. An instrument in the form of debt that was not held in proportion to stock was generally treated as debt. Proportionately held obligations were treated as debt if the debt was not excessive (thin capitalization), the interest rate was commercially reasonable, or if interest was not reasonable, the obligation was issued for money repayable at a fixed time. Although elegant in structure and theoretical underpinning, the regulations were difficult to apply in the myriad of situations that they were required to cover. The § 385 regulations expired under the weight of their complexity, particularly in the small business context, and because enterprising taxpayers developed financial instruments that would have successfully taken advantage of the regulations' bright line classification of hybrid instruments. See Rev.Rul. 83–98, 1983–2 C.B. 40. No new regulations had been issued or proposed under § 385, until 2016 and the debt versus equity classification issue thus continued to turn on judicial authority.

Regulations promulgated in 2016 narrowly focus the regulatory debt versus equity characterization regime only on instruments issued between related corporations. T.D. 9790, Treatment of Certain Interests in Corporations as Stock or Indebtedness, 81 F.R. 72858 (October 21, 2016). For this purpose, the regulations adopt a definition of related party that includes an expanded group of corporations identified under § 1504(a), discussed in the text at page 854, to include corporations related through ownership of stock representing 80 percent of voting power and value, expanded to apply to corporations related by ownership of 80 percent of vote *or* value, and including exempt entities, foreign corporations and partnerships. Treas.Reg. § 1.385-1(c). However, none of the rules in the regulations apply to indebtedness between members of a consolidated group (discussed in Chapter 18, Section 2) during the period the corporations are members of the consolidated group, unless the debt instrument is transferred outside the consolidated group. Temp.Reg. § 1.385-4T; Treas.Reg. § 1.385-2(d)(2)(ii)(A). Thus, the rules are designed principally to deal with debt instruments between related domestic and foreign corporations where the borrower is a U.S. corporation.

Treas.Reg. § 1.385-2 provides detailed requirements for documentation and financial analysis of instruments issued as indebtedness between related parties, similar to what generally would be expected on issuance of debt instruments between unrelated parties. For an instrument to be treated as debt, documentation and information must be developed at the time an instrument is issued to demonstrate (1) an unconditional binding obligation to repay, (2) that the creditor has the typical legal rights of a creditor to enforce the terms of the instrument including rights to trigger a default and accelerate payments, (3) evidence of a reasonable expectation of repayment, including cash flow projections, financial statements, business forecasts, asset appraisals, determination of debt-to-equity and other relevant financial ratios of the issuer (compared to industry averages), and (4) timely evidence of an on-going debtor-creditor relationship. The documentation rules only apply if (1) the instrument is issued by a "covered member" (i.e., a U.S. corporation) or a disregarded entity owned by a covered member; and (2) threshold limitations are reached. The threshold limitations limit the rules to "large taxpayer groups," where the stock of any member of the expanded group is publicly traded, all or any portion of the expanded group's financial results are reported on financial statements with total assets exceeding $100 million, or the expanded group's financial results are reported on financial statements that reflect annual total revenue that exceeds $50 million.

As a general rule, Treas.Reg. § 1.385-3 treats an expanded group debt instrument as per se stock to the extent it is issued by a corporation to a member of the corporation's expanded group (1) in a distribution (including a redemption distribution), (2) in exchange for expanded group stock (subject to certain exceptions), or (3) as boot in an asset reorganization described in § 368(a)(1)(A), (C), (D), (F), or (G) (discussed in Chapter 21 of the text). All or a portion of an issuance of a debt instrument may be described in more than one prong of the general rule without changing the result that follows from being described in a single prong.

Treas.Reg. § 1.385-3(b)(3), the "funding rule," extends the per se stock rule to treat as stock an expanded group debt instrument to the extent that it is issued, for property, including cash, when the debt instrument is issued to an affiliate with a principal purpose of funding (1) a distribution of cash or other property to a related corporate shareholder, (2) an acquisition of affiliate stock from an affiliate, or (3) certain acquisitions of property from an affiliate pursuant to an internal asset reorganization. A per se rule automatically recharacterizes as equity any related party debt issued in the 36-month period before or after a distribution or acquisition described in the general rule. (However, certain short-term debt and loans in the ordinary course of business are excluded from this recharacterization rule. See Temp.Reg. § 1.385-3T(b)(3)(vii)). As a back-up, Treas.Reg. § 1.385-3(b)(4) provides an anti-abuse rule providing that a debt instrument is treated as stock if it is issued with a principal purpose of avoiding the application of the proposed regulations.

The per se stock rules of Treas.Reg. § 1.385-3 apply only when the debt that would be converted to equity exceeds $50 million. Exceeding the $50 million threshold would have a cliff effect; if the threshold is exceeded, all of the debt, and not merely the excess over $50 million would be treated as equity.

The new administration has signaled that it is likely to revisit the § 385 regulations and it has already delayed the documentation rules. The Treasury's Second Report to the President on Identifying and Reducing Tax Regulatory Burdens, 82 F.R. 48,013, 48,016–17 (Oct. 16, 2017), explains:

> Treasury and the IRS do not believe that taxpayers should have to expend time and resources designing and building systems to comply with rules that may be modified to alleviate undue burdens of compliance. Accordingly . . . Treasury and the IRS announced in Notice 2017–36 that application of the documentation rules would be delayed until 2019.
>
> After further study of the documentation regulations, Treasury and the IRS are considering a proposal to revoke the documentation regulations as issued. Treasury and the IRS are actively considering the development of revised documentation rules that would be substantially simplified and streamlined in a manner that will lessen their burden on U.S. corporations, while requiring sufficient legal documentation and other information for tax administration purposes. In place of any revoked regulations, Treasury and the IRS would develop and propose streamlined documentation rules, with a prospective effective date that would allow time for comments and compliance. Consideration is being given, in particular, to modifying significantly the requirement, contained in the documentation regulations, of a reasonable expectation of ability to pay indebtedness. This aspect of the documentation regulations proved particularly problematic. The treatment of ordinary trade payables under the documentation regulations is also being reexamined.

> . . . .
> [A]fter careful consideration, Treasury believes that proposing to revoke the existing distribution regulations before the enactment of fundamental tax reform, could make existing problems worse. If legislation does not entirely eliminate the need for the distribution regulations, Treasury will reassess the distribution rules and Treasury and the IRS may then propose more streamlined and targeted regulations.

Page 563:

Delete section 7.2.2.2 and replace with the following:

7.2.2.2 LIMITATION ON BUSINESS INTEREST

Section 163(j) imposes a new limitation on the deductibility of interest expense. Under this provision, an interest deduction for business interest shall not exceed the sum of the taxpayer's business interest income plus 30 percent of the taxpayer's adjusted taxable income plus the taxpayer's floor plan financing interest.

Business interest means any interest paid or accrued on indebtedness properly allocable to a trade or business. Business interest income means the amount of interest includible in the gross income of the taxpayer for the taxable year that is properly allocable to a trade or business. Notice 2018-28 states that for a C corporation, all interest paid or accrued by the corporation will be business interest, and all interest on indebtedness held by a C corporation that is includible in its gross income will constitute business interest income. Floor plan financing interest is defined as interest paid to finance motor vehicles that are held for sale or lease.

Adjusted taxable income is defined in § 163(j)(8) as the taxpayer's taxable income computed without regard to nonbusiness deductions, any business interest income, any net operating loss deduction, the deduction allowed under § 199A, and for the allowance of depreciation. However, for tax years beginning on or after January 1, 2022, the allowance for depreciation is not added back.

In scope, § 163(j)'s restriction on the deductibility of interest expense applies across-the-board regardless of the form of business entity utilized to conduct the business. However, § 163(j)(3) provides an exception for small businesses, which § 163(j)(3) defines by cross-reference to § 448(c) as a business with average annual gross receipts (computed over 3 years) of $25 million or less. For passthrough entities, the restriction on the interest expense deduction is computed at the passthrough entity level but the restriction is placed on the partner or shareholder (see this Update, Chapter 3, pgs. 10–13, for a more detailed discussion regarding § 163(j)'s application to partnerships). Furthermore, § 163(j)(7) provides further exceptions to § 163(j) because that section narrows § 163(j)'s applications trade or businesses other than the following: (i) a trade or business of performing services as an employee, (ii) any electing real property trade or business (cross-referenced to the definition in § 469(c)(7)(C)), (iii) any electing farming business (cross-referenced to § 263A(e)(4) or for cooperatives to § 199A(g)(2)), or (iv) the trade or business of the furnishing or sale of electrical energy, water, or sewage disposal services, gas or steam through a local distribution system, or transportation of gas or steam by pipeline if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative.

If a real estate business elects to be exempt from § 163(j), then § 168(i)(8) requires that real estate business to utilize the alternative depreciation system for its real property, thus causing it to have a longer recovery period. Because real estate businesses making the election allowed by § 163(j)(7)(B) must use the alternative depreciation system for so-called qualified improvement property (among other categories), electing out of the § 163(j)'s interest expense limitation makes these electing real estate businesses ineligible claiming bonus depreciation under § 168(k) with respect to any qualified improvement property.

Any disallowed interest expense is allowed to be carried forward indefinitely under § 163(j)(2) and utilized in a subsequent year to the extent that the taxpayer has excess limitation when the limitation calculation is made for that later year.

B. DEDUCTIONS FOR LOSS OF INVESTMENT IN A CORPORATION

Page 564:

Replace the citations to the REGULATIONS with the following:

REGULATIONS: Sections 1.165-5; 1.1244(a)-1(a)−(b); 1.1244(b)-1(a)−(b); 1.1244(c)-1(a), (c)−(d); 1.1244(c)-2(a)(1)−(3).

CHAPTER 13

DIVIDEND DISTRIBUTIONS

1. INTRODUCTION

Page 589:

Replace the second sentence of the third paragraph with the following:

Instead, § 243(a)(1) provides a corporation that is a shareholder in another corporation with a deduction equal to 70 percent of intercorporate dividends received; § 243(c) increases the deduction to 65 percent if the shareholder corporation owns at least twenty percent of the stock of the payor corporation; and § 243(a)(3) extends this deduction to 100 percent for affiliated corporations that so elect."

Page 593:

Replace the third sentence of the third paragraph with the following:

Absent any other transactions, at a 37 percent marginal tax rate this $200,000 gain would result in a tax of $74,000.

Page 593:

Third paragraph, in lines 18-19:

Replace "39.6" with "37" and '$79,200" with "$74,000".

Page 594:

Replace the carryover paragraph with the following:

benefit of "$34,000," even though it produced a break-even before-tax cash flow. Under § 1(h)(11)(B)(ii), however, because the minimum holding period has not been met, the dividend would have been taxed at 37 percent—resulting in a $74,0000 tax—instead of at 20 percent, and the $34,000 tax arbitrage benefit is eliminated.

Page 594:

Lines four and five of paragraph that carries over to page 595:

Replace "39.6" with "37" and replace "$277,200" with "$259,000"

SECTION 4. DISGUISED DIVIDENDS

Page 626:

Delete third paragraph and replace with the following:

The incentive to pay compensation to the point at which the corporation has no taxable income, which existed under prior law and undergirds many of the historic excessive compensation classes, no longer is a significant incentive under current law. It is true that a corporation which pays compensation to its shareholders in their capacity as an employee is generally entitled to claim a corporate level deduction for reasonable compensation whereas dividends paid to shareholders are not deductible at the corporate level. In addition, a qualified dividend is taxable at the shareholder level at the preferential tax rate set forth in § 1(h).[5] But, even though corporate earnings distributed to shareholders are technically subject to double taxation, current law has largely equated the tax consequences of dividends with compensation paid to shareholders. In this regard, if a corporation makes payments to shareholders as compensation, the corporation obtains a deduction, but the shareholder is taxable at regular individual tax rates of up to 37%, and this compensation may also be subject to additional FICA taxes and would be subject to Medicare taxes. Said differently, even if the shareholder's compensation exceeds the maximum FICA cap for the year, the shareholder would be subject to a 37% regular

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[5] See I.R.C.§ 1(h)(11).

shareholder level taxes plus the incremental Medicare taxes of up to 2.35%[6] for a total of 39.35%.

Now, contrast the above 39.35% tax result with a situation where the corporation is taxable on the business earnings and distributes those earnings as a qualified dividend to its shareholder. In this situation, because dividends are not deductible at the corporate level, the C corporation is subject to corporate level taxation at a 21% tax rate on the business income. The after-tax corporate earnings of 79% could then be distributed to the shareholder as a qualified dividend. Under current law, individual shareholders are entitled to obtain concessionary capital gains rates under section 1(h) for qualified dividends, resulting in a maximum shareholder tax rate of 20%. The individual shareholder would also be subject to a 3.8% surtax under section 1411(a) upon receipt of that dividend. Thus, the all-in corporate tax cost would be 21%, and the all-in shareholder level tax cost on the shareholder's receipt of the qualified dividend distribution of the 79% after-tax earnings amount would be 18.8%.[7] In combination, the corporate level tax and shareholder level tax results create a combined tax cost of 39.8%.

Thus, unlike for much of the US tax history, the combination of the substantially lower corporate tax rate versus the individual rate, plus the concessionary tax rate at the shareholder level for qualified dividends, has combined to largely eliminate the double tax disparity of earning business income in a corporation and distributing the after-tax income as a dividend versus the alternative of paying those amounts out to the shareholder as compensation payments.

Page 634:

After the second paragraph, insert:

In Key Carpets, Inc. v. Commissioner, T.C. Memo. 2016-30, a single shareholder owned all the stock of two corporations. One corporation, Key Carpets,

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[6] See I.R.C.§ 3101(b).

[7] The 18.8% is calculated by taking the after-corporate tax earnings of 79% (100%- 21% corporate tax) and multiplying that amount by the all-in 23.8% shareholder level tax arising from the 20% capital gains rate that applies on qualified dividends and the 3.8% surtax on net investment income under section 1411(a).

Inc., sold carpets to businesses. The other corporation, Clean Hands Co., Inc., which was attempting to develop a voice-activated hand washing monitoring system based on a patent owned by the shareholder. Clean Hands employed a computer technician who developed the voice-activated hand washing monitoring system. In addition to assisting with the development of the hand washing monitoring system, the Clean Hands computer technician provided information technology services to Key Carpets. Clean Hands paid the computer technician a salary of $100,000. The computer technician spent 85 percent to 95 percent of his time working on the Clean Hands hand washing monitoring system. Key Carpets paid Clean Hands $130,000 purportedly for "computer service and consulting." The IRS asserted deficiencies against both Key Carpets and the shareholder on the grounds that the payments by Key Carpets to Clean Hands were not ordinary and necessary business expenses, but were constructive dividends. The Tax Court upheld the deficiencies with respect to 85 percent of the amounts of the payments; only 15 percent of the amounts paid to Clean Hands by Key Carpets were actually paid for information technology services provided to Key Carpets by Clean Hands' computer technician. Because Key Carpets had no actual ownership interest in the hand washing monitoring system, Key Carpets' transfer of funds to Clean Hands provided significant economic benefit to the shareholder and Clean Hands. Thus, following Stinnett's Pontiac Serv., Inc. v. Commissioner, T.C. Memo. 1982-314, aff'd, 730 F.2d 634 (11th Cir. 1984), the payments were for the personal benefit of the common shareholder and thus a constructive dividend to that shareholder. Section 6662 accuracy related penalties were upheld.

SECTION 5. INTERCORPORATE DIVIDENDS

Page 636:

After the second sentence of the first full paragraph, add the following sentence:

In 2017, Congress reduced this rate to 65% for intercorporate dividends paid to corporate shareholders that own more than 20% but less than 80% of the distributing corporation.

Page 636:

Before the last sentence of the first full paragraph, add the following:

In 2017, Congress again modified §243(c) to reduce the intercorporate dividend deduction to 50% for corporate shareholders that do not own 20 percent or more (in value and voting power) of the distributing corporation's stock.

Page 636:

Delete second full paragraph and replace with the following sentence:

The maximum rate of tax on intercorporate dividends where the corporate shareholder owns less than 20% of the distributing corporation generally is 10.5 percent (21 percent times the 50 percent of the dividend included in income).

Page 636:

Delete the fourth and fifth sentences of the first paragraph of section 1 of the Detailed Analysis and replace with the following:

However, if the interest paid to finance the acquisition and 50 percent of the dividends received from the debt-financed portfolio stock are both deductible, then the corporation will have an after-tax profit, even if the stock does not increase in value, because it will recognize income of $100,000, but claim $150,000 of deductions. For example, if X Corporation were in the 21 percent marginal tax bracket, the excess deductions would yield tax savings of $10,500 (21 percent of $50,000).

Page 638:

In the fourth and fifth lines of the carryover paragraph from page 637, replace as follows:

Replace "35 percent (saving $70,000 of tax)" with "21 percent (saving $42,000 of tax)" and "an after-tax benefit of $49,000" with "an after-tax benefit of $21,000"

CHAPTER 14

STOCK REDEMPTIONS

SECTION 1. INTRODUCTION

Page 644:

Replace the third, fourth, and fifth sentences of the first full paragraph with the following:

Assume, for example, that X corporation owns less than 20 percent of the stock of Y Corporation (and thus is eligible for the 50 percent dividends received deduction under § 243) and 10 shares of Y Corporation owned by X Corporation, having a basis of $40, are redeemed for $100. If § 302(a) applies, X Corporation recognizes a $60 gain, taxed at normal corporate tax rates (currently, 21 percent). But if § 302(a) does not apply, and the $100 distribution is taxed as a dividend, after the resulting $50 dividend received deduction, only $50 is taxed at normal corporate tax rates.

Page 645:

In the first line of the second full paragraph, replace "312(f)" with "312(n)(7)".

Page 646:

In the second line of the third full paragraph, replace "302" with "301".

SECTION 6. REDEMPTIONS THROUGH THE USE OF RELATED CORPORATIONS

Page 693:

After the carryover sentence at the top of the page, insert.

See Prop.Reg. § 1.304-2(a)(4), (c), Ex.(2).

Page 695:

After the first sentence of the second paragraph, insert.

See Prop.Reg. § 1.304-2(a)(5).

CHAPTER 15

STOCK DIVIDENDS

SECTION 1. TAXABLE VERSUS NONTAXABLE STOCK DIVIDENDS

B. THE STATUTORY STRUCTURE

Page 714:

In the fifth line of the second paragraph, change "Treas.Reg. § 1.301-1(b)(1)" to "Treas.Reg. § 1.305-1(b)(1)".

Page 720:

After the last paragraph, insert:

2.10.3 *Proposed Regulations Regarding Adjustments to Conversion Rights*

Proposed amendments to Regs. §§ 1.305-1, 1.305-3, and 1.305-7 deal with distributions of warrants, subscription rights, options, convertible instruments that give the holder a right to convert the instruments into shares of stock in the issuing corporation, and similar instruments and adjustments to a convertible instrument that increase the number of shares of stock a holder would receive upon conversion that correspond to distributions of stock, cash, or other property made to actual shareholders, as well as rights to acquire stock that prevent actual shareholders' interests from being diluted as a result of distributions of stock, cash, or other property to deemed shareholders (i.e., holders of rights to acquire stock). REG–133673–15, Deemed Distributions Under Section 305(c) of Stock and Rights to Acquire Stock, 81 F.R. 21795 (April 4, 2016). The proposed regulations would provide that a deemed distribution of a right to acquire stock would be treated as a distribution of additional rights to acquire stock, the amount of which is the fair market value of the right. When an adjustment is or results in a deemed distribution under Prop.Reg. § 1.305-7(c)(1) or (2), the deemed distribution occurs at the time the adjustment occurs (pursuant to the terms of the relevant instruments), but in no event later than the date of the distribution of cash or property that results in the

deemed distribution. For rights with respect to publicly-traded stock, if the relevant instrument does not provide when the adjustment occurs, the deemed distribution would occur immediately prior to the opening of business on the ex-dividend date for the distribution of cash or property that results in the deemed distribution
.

CHAPTER 16

CORPORATE LIQUIDATION

SECTION 3. TREATMENT OF SHAREHOLDERS

Page 752:

After the carryover paragraph, insert:

In Bross Trucking, Inc. v. Commissioner, T.C. Memo. 2014-107, for many years Mr. Bross had owned and operated Bross Trucking, Inc., using leased vehicles. Bross Trucking's principal customers were three businesses owned by other Bross family members. Bross Trucking did not have any formal written service agreements with its customers, relying instead on Mr. Bross's close personal relationships with the owners of the customer businesses. Due to violations of state regulatory law, Bross Trucking was in danger of losing its hauling authority. As a result, Bross's sons—who were owners of Bross Trucking's customers—formed a new trucking company, LWK Trucking, 98.2 percent of which was owned by Bross's sons' and the remainder of which was owned by an unrelated third party. Mr. Bross was not involved in managing LWK Trucking. LWK Trucking hired several Bross Trucking employees and leased trucks that formerly had been leased to Bross Trucking. Until the vehicles were repainted (or magnetic signs installed) they bore the Bross Trucking logo. The IRS asserted that Bross Trucking had distributed "its operations," including "(1) goodwill; (2) established revenue stream; (3) developed customer base; (4) transparency of the continuing operations between the entities; (5) established workforce including independent contractors; and (6) continuing supplier relationships," all of which the court collectively described as "goodwill" to Mr. Bross, triggering gain to the corporation (which did not liquidate until several years later) under § 311(b) and that Mr. Bross in turn had made a taxable gift of that goodwill to his sons. The Tax Court, based on analogizing the facts in the instant case to the differences in the facts and results in Martin Ice Cream Co. v. Commissioner, 110 T.C. 189 (1998) and Solomon v. Commissioner, T.C. Memo. 2008-102, concluded that except for workforce in place Bross Trucking had no goodwill at the time of the "alleged transfer." Although it "might have had elements of corporate goodwill at some point ... through various regulatory infractions Bross Trucking lost any corporate goodwill because of an impending suspension and the negative attention brought by the Bross Trucking name." Judge Paris went on to find that "The remaining attributes assigned to Bross Trucking's goodwill all stem from Mr. Bross's personal relationships. Bross Trucking's established revenue stream, its developed customer base, and the transparency of the continuing operations were all spawned from Mr. Bross's work in the road construction industry."

> A company does not have any corporate goodwill when all of the goodwill is attributable solely to the personal ability of an employee. See MacDonald v. Commissioner, 3 T.C. 720, 727 (1944); Norwalk v. Commissioner, T.C. Memo. 1998-279. Unlike the taxpayer's products in Solomon v. Commissioner, T.C. Memo. 2008-102, Bross Trucking's products did not contribute to developing the goodwill.

Furthermore, "Mr. Bross did not transfer any goodwill to Bross Trucking through an employment contract or a noncompete agreement." No other Bross Trucking intangible assets were transferred because Bross Trucking's prior customers became LWK's customers and no longer wanted to deal with Bross Trucking due to its regulatory problems, and "LWK Trucking did not benefit from any of Bross Trucking's assets or relationships. LWK Trucking was independently licensed and developed a wholly new trucking company."

SECTION 4. LIQUIDATION OF SUBSIDIARY CORPORATIONS—SECTION 332

Page 760:

After the first full paragraph, add the following:

The proposed regulations were withdrawn in July 2017. 82 F.R. 32,281, 32,282. The withdrawal notice provides: "With respect to section 332, the holdings of H.K. Porter Co.. . . [and] . . . Spaulding Bakeries Inc. . . . continue to reflect the position of the Treasury Department and the IRS."

PART III

ELECTIVE PASSTHROUGH TAX TREATMENT

CHAPTER 17

S CORPORATIONS

SECTION 1. INTRODUCTION

Page 771:

Add the following paragraphs immediately before Section 2:

The 2017 Tax Act added new limitations on the deductibility of business interest paid or accrued. Section 163(j) is discussed in detail in this Update, Chapter 3, pgs. 10–13. The statute provides that "[r]ules similar to the rules" applicable to partners "shall apply with respect to any S corporation and its shareholders." § 163(j)(4)(D). Notice 2018-28 states that "similar rules will apply to any S corporation and its shareholders" as to regulations intended to prevent the double counting of partnership business interest income and floor plan financing. Notice 2018-28 also provides that the Treasury and the IRS have the intention to enact regulations that will specify that "all interest paid or accrued by" a C corporation will be business interest paid, and "all interest on indebtedness held by the C corporation that is includible in gross income" will be business interest income. The Notice states that the regulations will make clear that these presumptions will not apply to S corporations.

Section 199A, also added by the 2017 Tax Act and discussed in this Update, Chapter 3, pgs. 13–16, operates essentially the same for S corporation shareholders as it does for partners. Unlike Subchapter K, Subchapter S will require pro rata allocations of qualifying business items as well as of W-2 wages and unadjusted basis for the § 199A computations. § 199A(f)(1)(A). Section 199A(c)(4) provides that "reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business" is not qualified business income. The legislative history indicates that this provision, which is in the same section as the similar rules for § 707(a) and § 707(c) payments for services, is intended to apply to S corporations. The phrase "reasonable compensation" evokes the problem of S corporation shareholders deliberately limiting compensation in order to reduce Medicare taxes. *See* Joseph Radtke, S.C. v. United States, 712 F. Supp. 143 (E.D. Wis. 1989); Rev. Rul. 74–44.

SECTION 2. ELIGIBILITY, ELECTION AND TERMINATION

E. COORDINATION WITH SUBCHAPTER C

Page 788:

Add after the carryover paragraph from 787:

The 2017 Tax Act reduced the corporate tax rate from 35% to 21%. As a result, existing S corporations may find it advantageous to terminate S corporation status and become C corporations. The 2017 Tax Act provides two provisions that facilitate such a termination.

The 2017 Tax Act added § 481(d), which provides a rule allowing an "eligible terminated S corporation" to take into account over a 6-year period any § 481 adjustment required as a result of conversion. (Section 481 applies to accounting changes and requires that taxpayers take into account adjustments that are necessary "to prevent amounts from being duplicated or omitted.") An eligible terminated S corporation is a C corporation that was an S corporation on the day "before the date of the enactment of the Tax Cuts and Jobs Act," and terminates through revocation of its election under § 1362(a) during the following two year period. The 2017 Tax

Act was signed into law on December 22, 2017. (Owing to a decision by the Senate parliamentarian, the 2017 Tax Act was, however, not named the Tax Cuts and Jobs Act; instead it is technically "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018.") The owners of the stock when the revocation election is made must be "the same owners (and in identical proportions) as on the date" of the enactment of the legislation. § 481(d)(2)(B).

Section 1371(f) is the second provision, and it is discussed in this Update, Chapter 17, pg. 77.

SECTION 3. EFFECT OF THE SUBCHAPTER S ELECTION BY A CORPORATION WITH NO C CORPORATION HISTORY

A. PASSTHROUGH OF INCOME AND LOSS

(1) GENERAL PRINCIPLES

Page 794:

After the first full paragraph, insert:

In the case of a charitable contribution of property by an S corporation, under § 1367(a)(2), the shareholders' basis is decreased by the shareholder's proportionate share of the adjusted basis of the contributed property.

Page 796:

After the first full paragraph, insert:

4.1.1 Basis of Shareholder Indebtedness of Corporation

As amended in 2014, Treas.Reg. § 1.1366-2 provides that the basis of any indebtedness of the S corporation to the shareholder means the shareholder's adjusted basis (as defined in Reg. § 1.1011-1 and as provided in § 1367(b)(2)) in any "bona fide indebtedness of the S corporation that runs directly to the shareholder." Whether indebtedness is "bona fide indebtedness" to a shareholder is determined under general tax principles and depends on "all of the facts and circumstances." Reg. § 1.1366-2(a)(2)(i).

The regulations do not attempt to clarify the meaning of "bona fide indebtedness," or provide any examples of relevant facts and circumstances, but rely on "general Federal tax principles." This leaves somewhat ambiguous what might replace the "actual economic outlay" by the shareholder test for creating basis of indebtedness, applied in cases such as Maloof v. Commissioner, 456 F.3d 645 (6th Cir. 2006); Spencer v. Commissioner, 110 T.C. 62, 78-79 (1998), aff'd without published opinion, 194 F.3d 1324 (11th Cir. 1999); Hitchins v. Commissioner, 103 T.C. 711 (1994); and Perry v. Commissioner, 54 T.C. 1293 (1970). The preamble to the proposed regulations refers to Knetsch v. United States, 364 U.S. 361 (1960) (disallowing interest deductions for lack of actual indebtedness); Geftman v. Commissioner, 154 F.3d 61 (3d Cir. 1998); Estate of Mixon v. U.S., 464 F.2d 394 (5th Cir. 1972); and Litton Business Systems, Inc. v. Commissioner, 61 T.C. 367 (1973), as relevant authorities. In the preamble to the final regulations, the Treasury department expressly declined to accept a commentator's suggestion that the final "regulations provid[e] that actual economic outlay is no longer the standard used to determine whether a shareholder obtains basis of indebtedness," but "[w]ith respect to guarantees, however, the final regulations retain the economic outlay standard." In a recent Tax Court memorandum decision (Meruelo v. Commissioner, T.C. Memo. 2018-16), Judge Lauber weighed in:

> [T]he controlling test under prior case law, as under the new regulation, dictates that basis in an S corporation's debt requires proof of "bona fide indebtedness of the S corporation that runs directly to the shareholder." . . . Requiring that the shareholder have made an "actual economic outlay" is a general tax principle that may be employed under the new regulation, as it was applied under prior case law, to determine whether this test has been met.

Treas.Reg. § 1.1366-2(a)(2)(iii), Ex. (2), blesses a basis increase resulting from a back-to-back loan in which one S corporation lends money to the shareholder who in turn lends the loan proceeds to a second S corporation, if the loan to the second S corporation "constitutes bona fide indebtedness" from the borrower S corporation to the shareholder. Treas.Reg. § 1.1366-2(a)(2)(iii), Ex. (3), blesses a basis increase resulting from a distribution to a shareholder by one S corporation (S1) of a note evidencing the indebtedness of a second S corporation (S2) if after the distribution S2 is indebted to the shareholder and "the note constitutes bona fide indebtedness" from S2 to the shareholder where under local law the distribution relieved S2 of its obligation to S1 and S2 was liable only to the shareholder; however, whether S2 is indebted to the shareholder rather than S1 is determined under general federal tax principles and depends upon all of the facts and circumstances. Reg. § 1.1366-2(a)(2)(iii), Ex. (1), provides that a bona fide indebtedness from an S corporation to a disregarded entity (LLC) owned by the shareholder results in an increase in basis of indebtedness for the shareholder.

Finally, Treas.Reg. § 1.1366-2(a)(2)(ii) expressly provides that:

> A shareholder does not obtain basis of indebtedness in the S corporation merely by guaranteeing a loan or acting as a surety, accommodation party, or in any similar capacity relating to a loan. When a shareholder makes a payment on bona fide indebtedness of the S corporation for which the shareholder has acted as guarantor or in a similar capacity, then the shareholder may increase its basis of indebtedness to the extent of that payment.

Treas.Reg. § 1.1366-2(a)(2)(iii), Ex. (4), illustrates that the basis increase from satisfaction of a guarantee occurs pro tanto as serial payments on the guarantee are made.

Page 803:

After the last paragraph, add the following:

The 2017 Tax Act added § 461(l), which applies an additional limitation for "excess business loss." Section 461(l) is discussed in additional detail in this Update, Chapter 7, pg. 38.

(2) EFFECT OF INDIRECT CONTRIBUTIONS ON LIMITATION OF LOSS DEDUCTIONS TO SHAREHOLDER BASIS

Pages 805-816 of this subsection.

The cases and Rulings discussed in this section have been superseded by the 2014 amendments to Treas.Reg. § § 1.1366-2(a)(2), discussed in Detailed Analysis 4.1.1, in this Supplement at page reference 796.

B. DISTRIBUTIONS

Page 820:

After the last paragraph, add the following:

Section 1371(f) was added to the Code by the 2017 Tax Act and has an effective date of December 22, 2017. It provides:

> In the case of a distribution of money by an eligible terminated S corporation (as defined in section 481(d)) after the post-termination transition period, the accumulated adjustments account shall be allocated to such distribution, and the distribution shall be chargeable to accumulated earnings and profits, in the same ratio as the amount of such accumulated adjustments account bears to the amount of such accumulated earnings and profits.

This provision will have the effect of allowing shareholders to continue to treat at least a portion of any distributions as though they do not derive from C corporation earnings and profits and instead are in part from the terminated S corporation, thus allowing partial continuation of the privilege of tax-free distributions. The definition of "eligible terminated S corporation" is discussed in this Update, Chapter 17, pg. 73.

SECTION 4. QUALIFIED SUBCHAPTER S SUBSIDIARIES

Page 823:

At the end of the carryover paragraph, insert:

The Tax Court's decision in *Ball* was affirmed by the Third Circuit. Ball v. Commissioner, 742 F.3d 552 (3d Cir. 2014). The court reasoned that gains that are not recognized by virtue of a specific Code provision are not items of gross income, citing Treas.Reg. § 1.61-6(b)(1), and § 332 specifically provides nonrecognition on the liquidation of a controlled subsidiary. Thus, making the QSub election did not give rise to an item of gross income.

SECTION 5. S CORPORATIONS THAT HAVE A C CORPORATION HISTORY

B. BUILT-IN GAIN TAX

Page 828:

At the end of the first full paragraph, insert:

[Ed: The 2015 Act permanently shortens the recognition period of § 1374(d)(7) to five years.]

Page 829:

In the fourth full paragraph, at the end of the first line, substitute "five year**" for "**ten year".

C. PASSIVE INVESTMENT INCOME OF AN S CORPORATION WITH ACCUMULATED EARNINGS AND PROFITS

Page 834:

In the last paragraph, change the computation to:

$$(\$360{,}000 - \$60{,}000) \times \frac{\$360{,}000 - (\$960{,}000 \times .25)}{\$360{,}000} = \$100{,}000$$

PART IV.

AFFILIATED CORPORATIONS

CHAPTER 18

AFFILIATED CORPORATIONS

SECTION 1. TAX REDUCTION WITH MULTIPLE CORPORATE TAXPAYERS

Pages 844-48:

Delete the entirety of Section A and of Section B

The 2017 Tax Act replaced the prior multiple § 11 rate brackets with a single, flat 21% rate tax. As a result, corporations will no longer have an incentive to use multiple, controlled corporations to gain access to lower rate brackets. Section 1561 was substantially modified (with the details of its current form outside the scope of this casebook).

SECTION 2. CONSOLIDATED RETURNS

Page 859:

At the end of the last full paragraph, add:

See Treas.Reg. § 1.1502-32(c)(5), Ex. 1(a), (b), (d).

Page 861:

At the end of the carryover sentence at the top of the page, insert:

See Treas.Reg. § 1.1502-19(b)(2)(i).

PART V.

CORPORATE ACQUISITION TECHNIQUES

CHAPTER 19

TAXABLE ACQUISITIONS: THE PURCHASE AND SALE OF A CORPORATE BUSINESS

Page 879:

Replace the sixth and seventh sentences of the third paragraph with the following:

If this gain were taxed at the maximum tax rate of 21 percent, X Corporation would pay taxes of $84 and make a $616 liquidating distribution to A, who would recognize a capital gain of $416. A would pay a tax, at the preferential capital gains rate of 20 percent (assuming that A would be required to pay at this highest net capital gain rate), of $83.20 and would receive net after-tax proceeds of $532.80.

Page 880:

In the first full paragraph, eleventh line, replace “$560” with “$532.80.

SECTION 1. ASSETS SALES AND ACQUISITIONS

Page 888:

At the tenth line of the first full paragraph, delete the discussion of Peco Foods and insert:

In Peco Foods, Inc. v. Commissioner, T.C. Memo. 2012-18, aff'd, 522 Fed. Appx. 840 (11th Cir. 2013), the taxpayer entered into an agreement with the sellers of two poultry processing plants that allocated a large portion of the purchase price to processing plants on which the taxpayer claimed depreciation deductions as nonresidential real property with a MACRS life of 39 years. The agreements separately listed agreed-upon prices for land, buildings, and machinery and equipment. Subsequently, after a cost segregation study, the taxpayer attempted to change its method of accounting to separate out components of the buildings as equipment and machinery and claim accelerated depreciation on the basis of shorter MACRS recovery periods. The Tax Court held that under § 1060 and Commissioner v. Danielson, 378 F.2d 771 (3d Cir. 1967), the taxpayer was bound by the purchase price allocation agreement unless it could show fraud, undue influence, duress, etc. The court rejected the taxpayer's argument that nothing in § 1060 precluded the taxpayer from segregating components of assets broadly described as a production plant into components consisting of the real property and related equipment and machinery. The court also refused to accept the taxpayer's assertion that the agreements with the sellers should be disregarded because the use of the terms "Processing Plant Building" and "Real Property: Improvements" was ambiguous. Finally the court agreed with the IRS that the IRS did not abuse its discretion in prohibiting the taxpayer from adopting depreciation schedules that were inconsistent with the terms of the purchase agreements. The Court of Appeals affirmed the Tax Court's decision. The Court of Appeals noted that (1) "both agreements contain the statement that the original allocation shall be used 'for all purposes (including financial accounting and tax purposes),'" (2) in one agreement, "[t]he parties allocated the purchase price among three assets: 'Real Property: Land,' 'Real Property: Improvements,' and 'Machinery, Equipment, Furnitures [sic] and Fixtures,'" (3) "Peco intended 'Processing Plant Building' to be treated as a single asset when it entered the [other] agreement," and (4) the term "Processing Plant Building" in the agreements was unambiguous.

SECTION 2. STOCK SALES AND ACQUISITIONS

Page 897:

After the last sentence of the carryover paragraph from 896, add the following:

The 2017 Tax Act (temporarily) expanded bonus depreciation under § 168(k). One of the changes included allowing used property, such as equipment, to be eligible for bonus depreciation. In evaluating whether a § 338 election should be made, changes to § 168(k) should be considered; these changes are likely, however, to cause the circumstances in which a § 338 election makes economic sense to shift only from "very unusual" to "quite unusual."

Page 897:

Replace the second and third full paragraphs with the following revised example:

Suppose that individual C owns all of the stock of T Corporation. C's basis for the stock is $2,000. T Corporation's sole asset has a basis of $1,000 and a fair market value of $4,000. If T Corporation sold the asset to A Corporation for $4,000, it would owe taxes of $630 on its $3,000 gain (assuming that T Corporation was subject to a flat corporate tax of 21 percent) and would distribute $3,370 to C in a liquidating distribution. C would pay taxes of $274 (assuming a 20 percent rate) on the $1,370 gain, leaving C with $3,096 of net proceeds.

Alternatively, A Corporation could pay C $3,370 in cash for the stock, again leaving C with $3,096 after taxes. A Corporation could make a § 338 election, which would give rise to a $630 tax liability on the deemed sale of T Corporation's asset. The asset would acquire a $4,000 basis, which under 334(b) would carry over to A corporation if it liquidated T Corporation pursuant to § 332. Again, A Corporation has paid a total of $4,000 to acquire T Corporation's asset with a basis of $4,000.

CHAPTER 21

TAX-FREE ACQUISITIVE REORGANIZATIONS

SECTION 2. THE FUNDAMENTAL RULES GOVERNING REORGANIZATIONS

A. THE BASIC STATUTORY SCHEME

Page 951:

At the end of the carryover paragraph, add the following:

The proposed regulations, Prop.Reg. § 1.368–1(b)(1) and –1(f), were withdrawn in July 2017. 82 F.R. 32,281, 32,282. No explanation was provided regarding the withdrawal of the § 368 net value regulations.

B. THE CONTINUITY OF SHAREHOLDER INTEREST REQUIREMENT

(1) QUALITATIVE AND QUANTITATIVE ASPECTS

Page 962:

After the second full paragraph, add the following:

Rev. Proc. 2018-12 implements valuation methods and explains:

> The Treasury Department and the IRS received comments on the 2011 Proposed Regulations to the effect that parties to potential reorganizations frequently use average trading price methods to value Issuing Corporation stock in determining the amount and/or the mix of consideration to be exchanged for Target stock. The IRS agrees that such methods often produce a more reliable estimate of the fair market value of Issuing Corporation stock than its trading price on a single date. Accordingly, the IRS has concluded that, in certain circumstances, taxpayers should be able to rely on such methods for

> purposes of determining whether the COI requirement is satisfied. The IRS also agrees with commenters that taxpayers should be able to rely on such methods regardless of whether the Signing Date Rule or the Closing Date Rule applies to a particular transaction.

The Rev. Proc. then goes on to provide "certain Safe Harbor Valuation Methods and Measuring Periods."

(2) "REMOTE CONTINUITY OF INTEREST" AND "PARTY TO A REORGANIZATION"

Page 963:

Replace the citation to the REGULATIONS with:

REGULATIONS: Section 1.368-2(k)

D. JUDICIAL LIMITATIONS

(2) STEP TRANSACTION DOCTRINE

Page 1010:

After the carryover paragraph, insert:

In Rev. Rul. 2015-10, 2015-21 I.R.B. 973, the IRS illustrated its willingness to both disregard and apply the step transaction doctrine in the same multi-part integrated transaction. Pursuant to a plan the parent corporation transferred all of its interest in a wholly owned limited liability company, which was taxed as a corporation, to a subsidiary for stock, which in turn transferred the LLC to a second subsidiary for stock. The second subsidiary transferred the LLC to a third subsidiary. The LLC thereupon elected to be a disregarded entity, which is treated as a corporate liquidation of the LLC. The ruling concludes that notwithstanding the integrated nature of the transaction, the first two steps would be recognized as § 351 transfers, but that the third transfer, rather than be treated as a § 351 transfer followed by a corporate liquidation under § 332, would be treated as a single type D reorganization (discussed in the text at page 1063). The ruling states that "an analysis of the transaction as a whole does not dictate that . . . [it] be treated other than in accordance with its form in order to reflect the substance of the transaction."

SECTION 4. STOCK FOR ASSETS ACQUISITIONS: TYPE (C) REORGANIZATIONS

Page 1042:

After the first sentence of the paragraph that carries over to page 1043, add:

(The proposed net value regulations, Prop.Reg. § 1.368–1(b) and –1(f) were withdrawn in July 2017. 82 F.R. 32,281, 32,282.)

SECTION 6. ACQUISITIVE TYPE (D) REORGANIZATIONS

Page 1072:

After the first full paragraph, insert:

2.2.1 *Allocation of Basis in All Cash D Reorganizations*

Treas.Reg. § 1.358-2 deals with stock basis in all cash type D reorganizations. If an actual shareholder of the acquiring corporation is deemed to receive a nominal share of stock of the issuing corporation described in Treas.Reg. § 1.368-2(*l*), that shareholder must, after allocating and adjusting the basis of the nominal share in accordance with the rules of Treas.Reg. § 1.358-1, and after adjusting the basis in the nominal share for any transfers described in Treas.Reg. § 1.358-1, designate the share of stock of the acquiring corporation to which the basis, if any, of the nominal share will attach. Under these rules, the ability to designate the share of stock of the acquiring corporation to which the basis of the surrendered stock or securities of the target will attach applies only to a shareholder that actually owns shares in the issuing corporation. Thus, for example, if in an all cash type-D reorganization, Y Corporation, a first tier subsidiary of P Corporation, acquires the assets of T Corporation, a second tier subsidiary of P Corporation, owned by X Corporation, a first tier subsidiary of P Corporation, X Corporation cannot designate any share of Y Corporation stock to which the basis, if any, of the nominal share of Y Corporation stock will attach; and P Corporation cannot designate a share of Y Corporation stock to which basis will attach because P Corporation's basis in the nominal share of Y Corporation stock (deemed to have been distributed to it by X Corporation) is zero (its fair market value).

After the paragraph for Detailed Analysis 2.3, insert:

2.4 *Section 351 Transaction versus Reorganization.*

Rev. Rul. 2015-10, 2015-21 I.R.B. 973, dealt with the characterization of a transaction in which pursuant to a plan (1) a parent corporation transferred all of the interests in its wholly-owned limited liability company that was taxable as a corporation to its subsidiary (first subsidiary) in exchange for additional stock, (2) the first subsidiary transferred all of the interests in the limited liability company to its subsidiary (second subsidiary) in exchange for additional stock, (3) the second subsidiary transferred all of the interests in the limited liability company to its subsidiary (third subsidiary) in exchange for additional stock, and (4) the limited liability company elected to be disregarded as an entity separate from its owner for federal income tax purposes effective after it was owned by the third subsidiary. The ruling concluded that the series of events was properly treated as two transfers of stock in exchanges governed by § 351, followed by a § 368(a)(1)(D) reorganization. Even though the parent's transfer was part of a series of transactions undertaken as part of a prearranged, integrated plan involving successive transfers of the LLC interests, the transfer satisfied the formal requirements of § 351, including the requirement that the transferor control the subsidiary immediately after the exchange. Viewing the transaction as a whole did not dictate that the parent's transfer be treated other than in accordance with its form. Section 351 similarly, applied to the first subsidiary's transfer of the LLC interests to its subsidiary. But the transfer by the second subsidiary to the third subsidiary, coupled with the LLC's election to become a disregarded entity was characterized as a § 368(a)(1)(D) reorganization. If an acquiring corporation acquires all of the stock of a target corporation from a person controlling the acquiring corporation (within the meaning of § 304(c), via § 368(a)(2)(H)(i)) in an exchange otherwise qualifying as a § 351 exchange, and as part of a prearranged, integrated plan, the target corporation thereafter transfers its assets to the acquiring corporation in liquidation, the transaction is more properly characterized as a reorganization under § 368(a)(1)(D), to the extent it so qualifies. See Rev. Rul. 67-274, 1967-2 C.B.141.

Page 1073:

Delete the second paragraph of 3.2 *Control and Continuity of Interest.*

PART VI

NONACQUISITIVE REORGANIZATIONS

CHAPTER 22

SINGLE-CORPORATION REORGANIZATIONS

SECTION 3. CHANGES IN IDENTITY, FORM, OR PLACE OF ORGANIZATION: TYPE (F) REORGANIZATIONS

Page 1104:

Replace the citation to PROPOSED REGULATIONS: Section 1.368-2(m) with the following:

REGULATIONS: 1.368-2(m).

Page 1105-1108:

Replace PROPOSED RULES with the following:

Reorganizations Under Section 368(a)(1)(F); Section 367(a) and Certain Reorganizations Under Section 368(a)(1)

Treasury Decision 9739.
80 F.R. 56904 (Sept. 21, 2015).

SUMMARY: This document contains final regulations that provide guidance regarding the qualification of a transaction as a corporate reorganization under section 368(a)(1)(F) by virtue of being a mere change of identity, form, or place of organization of one corporation (F reorganization).

* * *

Background

1. Introduction

* * *

Section 368(a)(1) describes several types of transactions that constitute reorganizations. One of these, described in section 368(a)(1)(F), is "a mere change in identity, form, or place of organization of one corporation, however effected" (a Mere Change). One court has described the F reorganization as follows:

> [The F reorganization] encompass[es] only the simplest and least significant of corporate changes. The (F)-type reorganization presumes that the surviving corporation is the same corporation as the predecessor in every respect, except for minor or technical differences. For instance, the (F) reorganization typically has been understood to comprehend only such insignificant modifications as the reincorporation of the same corporate business with the same assets and the same stockholders surviving under a new charter either in the same or in a different State, the renewal of a corporate charter having a limited life, or the conversion of a U.S.-chartered savings and loan association to a State-chartered institution.

Berghash v. *Commissioner,* 43 T.C. 743, 752 (1965) (citation and footnotes omitted), *aff'd,* 361 F.2d 257 (2d Cir. 1966).

Although the statutory description of an F reorganization is short, and courts have described F reorganizations as simple, questions have arisen regarding the requirements of F reorganizations. In particular, when a corporation changes its identity, form, or place of incorporation, questions have arisen as to what other changes (if any) may occur, either before, during, or after the Mere Change, without affecting the status of the Mere Change (that is, what other changes are compatible with the Mere Change). These questions can become more pronounced if the transaction intended to qualify as an F reorganization is composed of a series of steps occurring over a period of days or weeks. Moreover, changes in identity, form, or place of organization are often undertaken to facilitate other changes that are difficult to effect in the corporation's current form or place of organization.

* * *

Explanation of Revisions

1. Overview

. . . The Final Regulations provide that a transaction that involves an actual or deemed transfer of property by a Transferor Corporation to a Resulting Corporation is a Mere Change that qualifies as an F reorganization if six requirements are satisfied (with certain exceptions). The Final Regulations provide that a transaction or a series of related transactions to be tested against the six requirements (a Potential F Reorganization) begins when the Transferor Corporation begins transferring (or is deemed to begin transferring) its assets to the Resulting Corporation, and ends when the Transferor Corporation has distributed (or is deemed to have distributed) the consideration it receives from the Resulting Corporation to its shareholders and has completely liquidated for federal income tax purposes. The concept of a Potential F Reorganization was added to the Final Regulations to aid in determining which steps in a multi-step transaction should be considered when applying the six requirements to a potential mere change (that is, which steps are "in the bubble").

In the context of determining whether a Potential F Reorganization qualifies as a Mere Change, deemed asset transfers include, but are not limited to, those transfers treated as occurring as a result of an entity classification election under paragraph § 301.7701-3(c)(1)(i), as well as transfers resulting from the application of step transaction principles. One example of such a transfer would be the deemed asset transfer by the Transferor Corporation to the Resulting Corporation resulting from a so-called "liquidation-reincorporation" transaction. *See, for example, Davant* v. *Commissioner,* 366 F.2d 874 [18 AFTR 2d 5523] (5th Cir. 1966); § 1.331-1(c) (liquidation-reincorporation may be a tax-free reorganization). Another example of such a deemed asset transfer would include the deemed transfer of the Transferor Corporation's assets to the Resulting Corporation in a so-called "drop-and-check" transaction in which a newly formed Resulting Corporation acquires the stock of a Transferor Corporation from its shareholders and, as part of the plan, the Transferor Corporation liquidates into the Resulting Corporation. *See, for example,* steps (d) and (c) of Rev. Rul. 2015-10, 2015-21 IRB 973; Rev. Rul. 2004-83, 2004-2 CB 157; Rev. Rul. 67-274, 1967- 2 CB 141.

. . . Viewed together, [the] six requirements ensure that an F reorganization involves only one continuing corporation and is neither an acquisitive transaction nor a divisive transaction. Thus, an F reorganization does not include a transaction that involves a shift in ownership of the enterprise, an introduction of assets in exchange for equity (other than that raised by the Transferor Corporation prior to the F reorganization), or a division of assets or tax attributes of a Transferor Corporation between or among the Resulting Corporation and other acquiring corporations. An F reorganization also does not include a transaction that leads to multiple potential acquiring corporations having competing claims to the Transferor Corporation's tax attributes under section 381.

Certain exceptions, … apply to these six requirements. Three of these exceptions allow de minimis departures from the six requirements for purposes unrelated to federal income taxation.

2. F Reorganization Requirements and Certain Exceptions

A. Resulting Corporation Stock Issuances and Identity of Stock Ownership

[T]he first and the second requirements of the Final Regulations reflect the Supreme Court's holding in *Helvering* v. *Southwest Consolidated Corp, supra,* that a transaction that shifts the ownership of the proprietary interests in a corporation cannot qualify as a Mere Change. Thus, the Final Regulations provide that a transaction that involves the introduction of a new shareholder or new equity capital into the corporation "in the bubble" does not qualify as an F reorganization.

[T]he first requirement in the Final Regulations is that immediately after the Potential F Reorganization, all the stock of the Resulting Corporation must have been distributed (or deemed distributed) in exchange for stock of the Transferor Corporation in the Potential F Reorganization. … The Treasury and the IRS believe … that a focus on the distribution of the stock of the Resulting Corporation better matches the transactions that occur (or are deemed to occur) in reorganizations.

[T]he second requirement is that, subject to certain exceptions, the same person or persons own all the stock of the Transferor Corporation at the beginning of the Potential F Reorganization and all of the stock of the Resulting Corporation at the end of the Potential F Reorganization, in identical proportions.

Notwithstanding these requirements … the Final Regulations allow the Resulting Corporation to issue a de minimis amount of stock not in respect of stock of the Transferor Corporation, to facilitate the organization or maintenance of the Resulting Corporation. This rule is designed to allow, for example, reincorporation in a jurisdiction that requires minimum capitalization, two or more shareholders, or ownership of shares by directors. It is also intended to allow a transfer of assets to certain pre-existing entities, for reasons explained further in section 2.B. of this Explanation of Revisions.

In addition, the Final Regulations allow changes of ownership that result from either (i) a holder of stock in the Transferor Corporation exchanging that stock for stock of equivalent value in the Resulting Corporation having terms different from those of the stock in the Transferor Corporation or (ii) receiving a distribution of money or other property from either the Transferor Corporation or the Resulting Corporation, whether or not in redemption of stock of the Transferor Corporation or the Resulting Corporation. In other words, the corporation involved in a Mere Change may also recapitalize, redeem its stock, or make distributions to its shareholders, without causing the Potential F Reorganization to fail to qualify as an F reorganization. These exceptions reflect the determination of the Treasury Department and the IRS that allowing certain transactions to occur contemporaneously with an F reorganization is appropriate so long as one corporation could effect the transaction without undergoing an F reorganization. These exceptions also reflect the case law … holding that certain transactions qualify as F reorganizations even if some shares are redeemed in the transaction, and rulings by the IRS that a recapitalization may happen at the same time as an F reorganization. See, for example, Rev. Rul. 2003-19, 2003-1 CB 468, and Rev. Rul. 2003-48, 2003-1 CB 863 (both providing that certain demutualization transactions may involve both E reorganizations and F reorganizations).

B. Resulting Corporation's Assets or Attributes and Liquidation of Transferor Corporation

[T]he third requirement (limiting the assets and attributes of the Resulting Corporation immediately before the transaction) and the fourth requirement (requiring the liquidation of the Transferor Corporation) under the Final Regulations reflect the statutory mandate that an F reorganization involve only one corporation. Although the Final Regulations generally require the Resulting Corporation not to hold any property or have any tax attributes immediately before the Potential F Reorganization, … the Resulting Corporation is allowed to hold a de minimis amount of assets to facilitate its organization or preserve its existence (and to have tax attributes related to these assets), and the Resulting Corporation is allowed to hold proceeds of borrowings undertaken in connection with the Potential F Reorganization.

A commenter… stated that the Final Regulations should allow the Resulting Corporation to hold, in addition to the proceeds of borrowings, cash proceeds of stock issuances before the Mere Change. The Treasury Department and the IRS do not believe that the Resulting Corporation should be allowed to issue more than a de minimis amount of stock before a transaction constituting a Mere Change because that would allow a substantial investment of new capital and/or new shareholders, or an acquisition of assets from more than one corporation. This rule does not, however, preclude the Transferor Corporation from issuing new stock before a Potential F Reorganization constituting an F reorganization. Nor does it preclude the Resulting Corporation from issuing new stock after the Potential F Reorganization.

Under the fourth requirement in the Final Regulations, the Transferor Corporation must completely liquidate in the Potential F Reorganization for federal income tax purposes. Nevertheless, … the Transferor Corporation is not required to legally dissolve and is allowed to retain a de minimis amount of assets for the sole purpose of preserving its legal existence.

C. One Section 381(a) Acquiring Corporation, One Section 381(a) Transferor Corporation

The fifth requirement under the Final Regulations is that immediately after the Potential F Reorganization, no corporation other than the Resulting Corporation may hold property that was held by the Transferor Corporation immediately before the Potential F Reorganization, if such other corporation would, as a result, succeed to and take into account the items of the transferor corporation described in section 381(c). Thus, a transaction that divides the property or tax attributes of a Transferor Corporation between or among acquiring corporations, or that leads to potential competing claims to such tax attributes, will not qualify as a Mere Change.

The sixth requirement under the Final Regulations is that immediately after the Potential F Reorganization, the Resulting Corporation may not hold property acquired from a corporation other than the Transferor Corporation if the Resulting Corporation would, as a result, succeed to and take into account the items of such other corporation described in section 381(c). Thus, a transaction that involves simultaneous acquisitions of property and tax attributes from multiple transferor corporations (such as the transaction described in Rev. Rul. 58-422, 1958-2 CB 145) will not qualify as a Mere Change.

* * *

[N]otwithstanding the overall flexibility provided with respect to transactions occurring contemporaneously with a Mere Change, the Final Regulations provide that a Mere Change cannot accommodate transactions that occur at the same time as the Potential F Reorganization if those other transactions could result in a corporation other than the Resulting Corporation acquiring the tax attributes of the Transferor Corporation.

… Consistent with the statutory language of section 368(a)(1)(F), the Treasury Department and the IRS believe that a Mere Change involves only one Transferor Corporation and one Resulting Corporation. Thus, the Final Regulations provide that only one Transferor Corporation can transfer property to the Resulting Corporation in the Potential F Reorganization. If more than one corporation transfers assets to the Resulting Corporation in a Potential F Reorganization, none of the transfers would constitute an F reorganization.

3. Series of Transactions

In some cases, business or legal considerations may require extra steps to complete a transaction that is intended to qualify as a Mere Change. … [T]he Treasury Department and the IRS concluded that the words "however effected" in the statutory definition of F reorganization reflect a Congressional intent to treat a series of transactions that together result in a Mere Change as an F reorganization, even if the transfer (or deemed transfer) of property from the Transferor Corporation to the Resulting Corporation occurs indirectly. The Final Regulations confirm this conclusion by providing that a Potential F Reorganization consisting of a series of related transactions that together result in a Mere Change may qualify as an F reorganization, whether or not certain steps in the series, viewed in isolation, might, for example, be treated as a redemption under section 304(a), as a complete liquidation under section 331 or section 332, or as a transfer of property under section 351. For example, the first step in an F reorganization of a corporation owned by individual shareholders could be a dissolution of the Transferor Corporation, so long as this step is followed by a transfer of all the assets of the Transferor Corporation to a Resulting Corporation. However, *see* § 1.368-2(k) for completed reorganizations that will not be recharacterized as a Mere Change as a result of one or more subsequent transfers of assets or stock, such as where a Transferor Corporation transfers all of its assets to its parent corporation in liquidation, followed by the parent corporation's retransfer of those assets to a new corporation. *See also* Rev. Rul. 69-617, 1969-2 CB 57 (an upstream merger followed by a contribution of all the target assets to a new subsidiary corporation is a reorganization under sections 368(a)(1)(A) and 368(a)(2)(C)).

4. Mere Change Within Larger Transaction

[T]he Treasury Department and the IRS recognized that an F reorganization may be a step, or a series of steps, before, within, or after other transactions that effect more than a Mere Change, even if the Resulting Corporation has only a transitory existence following the Mere Change. In some cases an F reorganization sets the stage for later transactions by alleviating non-tax impediments to a transfer of assets. In other cases, prior transactions may tailor the assets and shareholders of the Transferor Corporation before the commencement of the F reorganization. Although an F reorganization may facilitate another transaction that is part of the same plan, the Treasury Department and the IRS have concluded that step transaction principles generally should not recharacterize F reorganizations because F reorganizations involve only one corporation and do not resemble sales of assets. From a federal income tax perspective, F reorganizations are generally neutral, involving no change in ownership or assets, no end to the taxable year, and inheritance of the tax attributes described in section 381(c) without a limitation on the carryback of losses. *See, for example,* Rev. Rul. 96- 29…

The Final Regulations adopt the Related Events Rule …, which provided that related events preceding or following the Potential F Reorganization that constitutes a Mere Change generally would not cause that Potential F Reorganization to fail to qualify as an F reorganization. Notwithstanding the Related Events Rule, in the cross-border context, related events preceding or following an F reorganization may be relevant to the tax consequences under certain international provisions that apply to F reorganizations….

The Final Regulations also … [provide] that the qualification of a Potential F Reorganization as an F reorganization would not alter the treatment of other related transactions. For example, if an F reorganization is part of a plan that includes a subsequent merger involving the Resulting Corporation, the qualification of a Potential F Reorganization as an F reorganization will not alter the tax consequences of the subsequent merger.

5. Transactions Qualifying Under Other Provisions of Section 368(a)(1)

A comment … stated that, in some cases, an asset transfer that would constitute a step in an F reorganization is also a necessary step for characterizing a larger transaction as a nonrecognition transaction that would not constitute an F reorganization. For example, assume that corporation P acquires all of the stock of unrelated corporation T in exchange for consideration consisting of $50 cash and P voting stock with $50 value (without making an election under section 338), and, immediately thereafter and as part of the same plan, T is merged into corporation S, a newly-formed corporation wholly owned by P. Viewed in isolation, the merger of T into S appears to constitute a Mere Change. Provided the requirements for Asset Reorganization treatment are otherwise satisfied, however, the step transaction doctrine is applied to integrate the steps and treat the transaction as a statutory merger of T into S in which S acquires T's assets in exchange for $50 cash, $50 of P voting stock and assumption of T's liabilities, and T distributes the cash and P stock to its shareholders. This merger qualifies as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(D), and P's momentary ownership of T stock is disregarded. *See* Situation 2 of Rev. Rul. 2001-46, 2001- 2 CB 321 (same). The stock of S is not treated as issued for the assets of T; the historic shareholders of T are replaced by P as the shareholder of the resulting corporation (S); and the transaction is not a Mere Change.

To clarify this and similar situations, the Treasury Department and the IRS have determined that, if the Potential F Reorganization or a step thereof involving a transfer of property from the Transferor Corporation to the Resulting Corporation is also a reorganization or part of a reorganization in which a corporation in control (within the meaning of section 368(c)) of the Resulting Corporation is a party to the reorganization (within the meaning of section 368(b)), the Potential F Reorganization is not a Mere Change and does not qualify as an F reorganization. This rule will apply to transactions qualifying as reorganizations (i) under section 368(a)(1)(C) by reason of the parenthetical language therein, (ii) under section 368(a)(1)(A) by reason of ,and section 368(a)(2)(D), and (iii) under sections 368(a)(1)(A) or (C) by reason of section 368(a)(2)(C).

The IRS has long taken the position that, if a Transferor Corporation's transfer of property qualifies as a step in both an F reorganization and another type of reorganization in which the Resulting Corporation is the acquiring corporation, the transaction qualifies for the benefits accorded to an F reorganization. *See, for example,* Rev. Rul. 57-276, 1957-1 CB 126 (section 381(b) applies such that the parts of the Transferor Corporation's taxable year before and after an F reorganization constitute a single taxable year of the Acquiring Corporation, notwithstanding that the transaction also qualifies as another type of reorganization under section 368(a)(1)); Rev. Rul. 79-289, 1979-2 CB 145 (section 357(c) does not apply to an F reorganization even if the transaction also qualifies as another type of reorganization to which section 357(c) applies); § 1.381(b-1(a)(2) (providing for rules applicable to F reorganizations, regardless of whether such reorganizations also qualify as another type of reorganization).

To avoid confusion in the application of the reorganization provisions, the Treasury Department and the IRS have decided that, except as provided earlier in this section 5. of the Explanation of Revisions, if a Potential F Reorganization qualifies as a reorganization under section 368(a)(1)(F) and would also qualify as a reorganization under section 368(a)(1)(A), 368(a)(1)(C), or 368(a)(1)(D), then for all federal income tax purposes the Potential F Reorganization qualifies only as a reorganization under section 368(a)(1)(F). This rule does not apply to a reorganization within the meaning of sections 368(a)(1)(E) (*see* Rev. Rul. 2003-19, 2003-1 CB 468, and Rev. Rul. 2003-48, 2003-1 CB 863 (providing that certain demutualization transactions may involve both E Reorganizations and F reorganizations)) or 368(a)(1)(G) (*see* section 368(a)(3)(C)).

6. Distributions

* * *

Although the Treasury Department and the IRS considered whether a distribution occurring during a Potential F Reorganization should prevent it from qualifying as an F reorganization, the Treasury Department and the IRS determined to allow flexibility for such distributions. Nevertheless, unlike other types of reorganizations, which generally involve substantial changes in economic position, F reorganizations are mere changes in form. Accordingly, the Treasury Department and the IRS have concluded that any concurrent distribution should be treated as a transaction separate from the F reorganization. *See* § 1.301-1(l); *see also Bazley* v. *Commissioner,* 331 U.S. 737 (1947) (distribution in the context of a purported E reorganization treated as a dividend).

An F reorganization is a Mere Change involving only one continuing corporation and is neither an acquisitive transaction nor a divisive transaction. From a federal income tax perspective, F reorganizations generally are neutral, involving no change in ownership or assets, no end to the taxable year, and inheritance of the tax attributes described in section 381(c). A distribution that occurs at the same time as a Mere Change is, in substance, a distribution from one continuing corporation and is functionally separate from the Mere Change. The Treasury Department and the IRS believe that a distribution from one continuing corporation should not be treated the same as an exchange of money or other property for stock of a target corporation in an acquisitive reorganization. Instead, the distribution should be treated as a separate transaction occurring at the same time. . . .[T]he Treasury Department and the IRS believe it is sufficient to treat the distribution as a separate transaction that occurs at the same time as the F reorganization.

7. Entities Treated as Corporations for Federal Tax Purposes

As explained in this preamble, the first requirement of the Final Regulations is that all of the stock of the Resulting Corporation be distributed in exchange for stock of the Transferor Corporation. Certain entities may be treated as corporations for federal tax purposes even though they do not have owners that could be treated as shareholders for federal tax purposes to whom the profits of the corporation would inure (for example, some charitable organizations described in section 501(c)(3)). Nevertheless, these entities may be able to engage in corporate reorganizations. Thus, no inference should be drawn from the use of the terms "stock" or "shareholders" in these Final Regulations with respect to the ability of such entities to engage in reorganizations under section 368(a)(1)(F).

* * *

Pages 1108-1115:

All of the authorities discussed in these pages have been superseded by Treas.Reg. § 1.368-2(m), discussed above.

CHAPTER 23

CORPORATE DIVISIONS: SPIN-OFFS, SPLIT-OFFS, AND SPLIT-UPS

SECTION 2. "ACTIVE CONDUCT OF A TRADE OR BUSINESS," "DEVICE," AND OTHER LIMITATIONS.

B. ACTIVE CONDUCT OF A TRADE OR BUSINESS

Page 1141:

After the second full paragraph, insert:

As a related matter, the 2015 Act added § 355(h), which provides that § 355 does not apply if either the distributing corporation or the controlled corporation is a Real Estate Investment Trust (REIT). However, the distribution may still qualify under § 355 if both the distributing corporation and the controlled corporation are REITs immediately after the distribution or if during the three year period ending on the date of the distribution the controlled corporation was a REIT subsidiary of the distributing corporation at all times and the distributing corporation controlled the controlled corporation at all times.

Page 1144:

After the carryover paragraph, insert:

Rev. Rul. 2017-9, 2017-21 IRB 1244, dealt with whether the step transaction doctrine applied if a parent corporation (P) transferred property constituting an active trade or business to its controlled subsidiary (D) for the purpose of assuring that D met the requirements of § 355(b)(1)(A), and pursuant to the same overall plan, the transfer was followed by a distribution by D of the stock of its controlled subsidiary (C) to P. In the ruling, P had been engaged in an active business A for more than 5 years, and C had been engaged in an active business B for more than 5 years. Both businesses met the active conduct of a trade or business test of of § 355(b). However, 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. The ruling held that, the two transactions are not stepped together. Each is independently respected. The first transaction was treated as an exchange under § 351, and the second transaction qualified as a distribution governed by § 355. If the transactions had been stepped together into a single exchange, P would be treated as transferring the business property to D in exchange for a portion of the C stock in an exchange to which § 1001 applied. Gain or loss would have been recognized to P on the transfer of the property to D; gain or loss would have been recognized to D, under § 1001(a), upon its transfer of the C stock to P in exchange for the property transferred to it. In addition, because the value of the business transferred from P to D equaled 25 percent of the value of C, § 355 would not have applied to any part of the distribution of C stock because D would not have distributed stock constituting § 368(c) control of C. Gain would have been 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 have applied. The ruling reasoned as follows:

> 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.
>
> 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.

In contrast, the ruling held that, where a dividend was paid by C to D pursuant to a plan that included a transfer by D of appreciated assets to C and a distribution by D of the C stock that qualified under § 368(a)(1)(D) and 355, the step transaction applied to integrate all the three transactions. Because D retained the money and property distributed pursuant to the dividend declaration, that money and property was taxable boot received by D in the § 368(a)(1)(D) reorganization.

Page 1146:

After the first full paragraph, insert:

2.4 Proposed Minimum Size for Five Year Business

Prop. Reg. § 1.355–9 (2016) would provide a new minimum size requirement for an active business to qualify under § 355. The requirements of §§ 355(a)(1)(C) and 355(b) would be satisfied with respect to a distribution only if the five-year-active-business asset percentage (as defined in the regulations) of each of Distributing and Controlled is at least five percent.

C. THE "DEVICE" LIMITATION

Page 1159:

After the second full paragraph, insert:

A proposed amendment to the nature and use of assets device factor in Treas.Reg. § 1.355–2(d)(2)(iv) would focus on assets used in a business (as defined in Prop. Reg. § 1.355–2(d)(2)(iv)(B) (2016)) rather than only assets used in an active business meeting the five-year history requirement of § 355(b). The preamble to the proposed regulations states that the Treasury and IRS have concluded that the presence of business assets, whether or not held for five years, generally does not raise any more device concerns than the presence of assets used in a five-year active business. REG-134016-15, Guidance Under Section 355 Concerning Device and Active Trade or Business, 81 F.R. 46004 (July 15, 2016).

Conversely, the Treasury and IRS have concluded that device potential exists if either (1) Distributing or Controlled owns a large percentage of assets not used in business operations compared to total assets or (2) Distributing's and Controlled's percentages of these assets differs substantially. REG-134016-15, Guidance under Section 355 Concerning Device and Active Trade or Business, 81 F.R. 46004 (July 15, 2016). Accordingly, proposed regulations would provide thresholds for determining whether the ownership of nonbusiness assets and/or differences in the nonbusiness asset percentages (the percentage of a corporation's total assets that are nonbusiness assets) for Distributing and Controlled are evidence of device. If neither Distributing nor Controlled has nonbusiness assets that are 20 percent or more of its total assets, the ownership of nonbusiness assets ordinarily would not be evidence of device. Furthermore, a difference in the nonbusiness asset percentages for Distributing and Controlled ordinarily would not be evidence of device if such difference is less than 10 percentage points or, in the case of a non-pro rata distribution, if the difference is attributable to a need to equalize the value of the Controlled stock and securities distributed and the consideration exchanged therefor by the distributees.

Page 1161:

After the carryover paragraph, insert:

4. Proposed "Per Se" Device Rule

Prop. Reg. § 1.355–2(d)(5) (2016) would provide that a transaction is a per se device (notwithstanding the presence of any other nondevice factors, for example, a corporate business purpose or stock being publicly traded and widely held) if designated percentages of Distributing's or Controlled's total assets are nonbusiness assets. The test is multi-pronged. A per se device exists if both (1) the nonbusiness asset percentage of Distributing or Controlled is 66⅔ percent or more, and (2) the nonbusiness asset percentage of Distributing or Controlled is (a) 66⅔percent or more but less than 80 percent, and the nonbusiness asset percentage of the other corporation (Controlled or Distributing, as the case may be) is less than 30 percent, (b) 80 percent or more but less than 90 percent, and the nonbusiness asset percentage of the other corporation is less than 40 percent; or (c) 90 percent or more, and the nonbusiness asset percentage of the other corporation is less than 50 percent.

SECTION 4. CONSEQUENCES TO PARTIES TO A CORPORATE DIVISION

Page 1183:

After the first full paragraph of *Detailed Analysis* 4.1, insert:

Rev. Rul. 2017-9, 2017-21 IRB 1244, dealt with whether the step transaction doctrine applied to integrate a dividend from a controlled corporation to a distributing corporation with a § 368(a)(1)(D) reorganization related to a § 355 distribution. On Date 1, C transferred $15X of money and property having a fair market value of $10X to D, pursuant to a dividend declaration, and D retained the money and property. On Date 2, D transferred to C property having a basis of $20X and a fair market value of $100X, and D distributed 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. The ruling held that because the distribution was made pursuant to the plan of reorganization, the step transaction doctrine applied to integrate the Date 1 and Date 2 transactions. The "tax treatment of the transaction will follow its substance." Thus, the distribution of money and other property was treated as boot received by D in the § 368(a)(1)(D) reorganization that was subject to recognition of gain under § 361(b). The ruling reasoned as follows:

> [I]n Estates of Bell v. Comm'r [, T.C.M. 1971-285], 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).

In contrast, the ruling held that the step transaction doctrine did not apply where a parent corporation (P) transferred property constituting an active trade or business to its controlled subsidiary (D) for the purpose of assuring that D met the requirements of § 355(b)(1)(A), and pursuant to the same overall plan, the transfer was followed by a distribution by D of the stock of its controlled subsidiary (C) to P.

PART VII

CORPORATE ATTRIBUTES IN REORGANIZATIONS

CHAPTER 24

CARRY OVER AND LIMITATION OF CORPORATE TAX ATTRIBUTES

SECTION 1. CARRY OVER OF TAX ATTRIBUTES

Page 1209:

Replace the second full paragraph with the following:

As amended in 2014, Treas.Reg. § 1.381(a)-1(b)(2) provides that for purposes of determining the corporation that succeeds to the target corporation's tax attributes, including earnings and profits, in a tax-free reorganization, the acquiring corporation is the corporation that, pursuant to the plan of reorganization, directly acquires the assets transferred by the transferor corporation, even if that corporation ultimately retains none of the assets so transferred. According to the preamble to the proposed regulations (which were largely unchanged when finalized):

> The [prior] regulations under section 381 yield an identical result, except when a single controlled subsidiary of the direct transferee corporation acquires all of the assets transferred by the transferor corporation pursuant to a plan of reorganization. In that case, the

> [prior] regulations treat the subsidiary as the acquiring corporation, a result that effectively permits a taxpayer to choose the location of a transferor corporation's attributes by causing the direct transferee corporation either to retain or not to retain a single asset. The IRS and the Treasury Department believe the [amended provision] produces more appropriate results because it . . . eliminate[s] the electivity.

Acquiring Corporation for Purposes of Section 381, 79 F.R. 26190 (May 7, 2014).

Page 1209:

After the first sentence of the paragraph that carries over to page 1210, add the following:

Section 172(a) now provides that a net operating loss carryforward is allowed to create a deduction in the carryforward year in an amount equal to the lesser of the aggregate of the net operating loss carryovers or 80 percent of taxable income in the carryforward year. Thus, a limitation is imposed within § 172(a) on the amount of a net operating loss carryforward that can be used to only eighty percent of the corporation's taxable income before the allowance of the net operating loss carryforward. Section 382 also imposes a limitation on the use of tax attributes after an ownership change. Although an explicit ordering rule is not provided, it would seem that the taxpayer should subject its net operating losses to the limits afforded under Section 172(a) first and then should apply the further limitation on the usage of a net operating loss under § 382 thereafter.

In addition, § 172(b)(1) provides that the net operating loss can be carried forward indefinitely, but in a change from prior law the net operating can no longer be carried back. The inability to carryback a net operating loss curtails the ameliorative effects of the net operating loss provisions in a fact pattern where the corporation has income and then sustains losses during the trough of the business cycle.