2018 Update Memorandum For

FEDERAL INCOME TAXATION OF PARTNERSHIPS AND S CORPORATIONS

FIFTH EDITION

by

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PREFACE

This 2018 Update to Federal Income Taxation of Partnerships and S Corporations provides users of the text with materials reflecting developments in federal income taxation of partnerships and S Corporations since May 31, 2012, (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 May 31, 2012 and before April 15, 2018.

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Federal Income Taxation of Partnerships and S Corporations

PART I

TAXATION OF PARTNERS AND PARTNERSHIPS

CHAPTER 1

INTRODUCTION TO PARTNERSHIP TAXATION

SECTION 1. INTRODUCTION TO SUBCHAPTER K

Pages 4-5:

Delete the material from the fourth sentence of the paragraph that begins on page 4 and ends with footnote 4 through the end of the paragraph on page 5; 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. 14–17, 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 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 26:

After the last paragraph of section 1.2, 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 30:

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 37:

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. CONTRIBUTION 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 first full paragraph of section 4.1, 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. 9–11.

Page 50:

Replace Section 8 of the *Detailed Analysis* with the following:

8. NONCOMPENSATORY PARTNERSHIP OPTIONS

Treas.Reg. § 1.721–2, promulgated in 2013, addresses the issuance of noncompensatory partnership options, including convertible debt and convertible equity interests. Under the regulations, the issuance of an option is not governed by § 721, but rather by general tax principles under which it is an open transaction for the issuer and an investment by the holder. Neither the grant nor the exercise of a noncompensatory option generally results in the recognition of gain or loss to the partnership or the option holder. If, however, the holder uses appreciated or depreciated property to acquire the option, the holder will recognize gain or loss.

Upon exercise, the option holder is treated as contributing property to the partnership in exchange for the partnership interest; the contributed property is equal to the sum of the original premium, the exercise price, and the option privilege.[1] Section 721 applies even if the exercise results in a shift of capital from the old partners to the option holder. Section 721 does not apply to the lapse of an option; the lapse of an option results in recognition of income by the partnership and the recognition of loss by the former option holder. To deal with the fact that the option holder generally receives a partnership interest with a value that is greater or less than the sum of the option premium and exercise price, i.e., there is a capital shift, the regulations under § 704 allocate a disproportionate share of gross income, without a corresponding allocation of book income, to any partner or partners who have benefited from such a capital shift. This aspect of the treatment of partnership options is discussed starting at page 11 of this Update.

SECTION 3. CONTRIBUTION OF PROPERTY VERSUS CONTRIBUTION OF SERVICES

A. TREATMENT OF THE PARTNER RECEIVING A PARTNERSHIP INTEREST IN EXCHANGE FOR SERVICES

Page 60:

After the carryover paragraph of *Detailed Analysis* 2.2, insert the following:

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[1] The conversion right in convertible debt or convertible equity is taken into account for tax purposes as part of the underlying instrument. (The regulations do not deal with the consequences of a right to convert partnership debt into an interest in the issuing partnership to the extent of any accrued but unpaid interest on the debt.) Treas.Reg. § 1.1272–1(e) treats partnership interests as stock for purposes of the special OID rules for convertible debt instruments. Treas.Reg. § 1.1272–1(e).

In Crescent Holdings, LLC v. Commissioner, 141 T.C. 477 (2013), an individual (Fields) received a two percent capital interest in a partnership (Crescent Holdings) as compensation for entering into a contract to provide services to an LLC owned by the partnership. Field's membership interest would be forfeited if he terminated his employment within three years. He was entitled to the same distributions as other members of the LLC, and any distributions he received were not subject to forfeiture. Fields did not make a § 83(b) election. Fields did not receive any distributions, but the partnership allocated nearly $4 million to Fields as his distributive share of partnership income. The court held that although neither § 83 or Treas.Reg. § 1.83-1(a)(1) specifically addressed the issue, the transferee of a nonvested partnership capital interest does not recognize in income the undistributed partnership profit or loss allocations attributable to that interest. Fields' right to receive the undistributed income allocations attributable to his interest was subject to the same substantial risk of forfeiture as his right to the partnership interest itself; if he forfeited his right to the partnership interest, then he would also forfeit his right to receive any benefit from the undistributed income allocations. The court held that under Treas.Reg. § 1.83-1(a)(1), undistributed partnership allocations attributable to a nonvested partnership capital interest are included in the gross income of the transferor. Based on the contractual provisions regarding the formation of the two LLCs, Crescent Holdings was the transferor. Accordingly, the profits attributable to Field's forfeitable two percent interest were allocated to the other LLC members (partners) in accordance with their distributive shares. The court noted that if Fields continued his employment until the interest vested, the fair market value of the interest includable in gross income at that time would include the undistributed income.

CHAPTER 3

TAXATION OF PARTNERSHIP TAXABLE INCOME TO THE PARTNERS

SECTION 1. PASS-THRU OF PARTNERSHIP INCOME AND LOSS

Page 95:

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 97:

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

Page 98:

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 98:

After the carryover paragraph from page 97, 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 98:

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

Pages 101-105:

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 that 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. 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 110:

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 110:

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. 43 for additional details).

CHAPTER 4

DETERMINING PARTNERS' DISTRIBUTIVE SHARES

Page 112:

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. 14–17, 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 2. THE SECTION 704(b) REGULATIONS

A. ALLOCATIONS OF ITEMS UNRELATED TO NONRECOURSE DEBT

(1) ECONOMIC EFFECT

Page 141:

Replace the sixth sentence of *Detailed Analysis* 6.2 with the following:

The third layer is then allocated to the class B units to the extent of the current and cumulative yield promised to the class B units.

SECTION 3. ALLOCATIONS WITH RESPECT TO CONTRIBUTED PROPERTY

Page 188:

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 190:

Replace Section 4. With the following:

SECTION 4. ALLOCATIONS RELATING TO NONCOMPENSATORY PARTNERSHIP OPTIONS

Treas.Reg. § 1.721–2, promulgated in 2013, provides that upon the exercise of a noncompensatory partnership option, the option holder is treated as contributing property to the partnership in exchange for the partnership interest; the contributed property is the sum of the original premium paid by the option holder to the partnership, the exercise price, and the option privilege. Section 721 applies even if the option holder receives a partnership interest with a value greater or less than the sum of the option premium and exercise price, i.e., a capital shift resulting from the exercise. To deal with the fact that the option holder generally receives a partnership interest with a value that is greater or less than the sum of the option premium and exercise price, i.e., there is a capital shift, the regulations under § 704 allocate a disproportionate share of gross income, without a corresponding allocation of book income, to any partner who has benefited from such a capital shift.

Under Treas.Reg. § 1.704–1(b)(2)(iv)(*d*)(4), the option holder's initial capital account equals the consideration paid to the partnership for the option plus the fair market value of any property (other than the option itself) contributed to the partnership upon exercise. To meet the substantial economic effect test of Treas.Reg. § 1.704–1(b), Treas.Regs. §§ 1.704–1(b)(2)(iv)(*h*)(2) and 1.704–1(b)(2)(iv)(*s*) require the partnership to revalue its property following the exercise of the option, and to allocate the unrealized income, gain, loss, and deductions from the revaluation, first, to the option holder to reflect the holder's right to partnership capital, and then, to the historic partners. To the extent that unrealized appreciation or depreciation in the partnership's assets has been allocated to the option holder's capital account, under § 704(c) principles the holder will recognize correlative allocations of any income or loss attributable to that appreciation or depreciation as the underlying assets are sold, depreciated, or amortized.

Suppose the AB Partnership, in which A is a one–third partner and B is a two-thirds partner, had the following assets and partners' capital accounts:

	Assets			Partners' Capital Accounts	
	Book	Tax Basis		Book	Tax Basis
Blackacre	$300	$300	A	$400	$400
Whiteacre	$900	$900	B	$800	$800

In consideration of $100, C is granted an option to acquire a one-quarter partnership interest within two years in exchange for a contribution of $400 at the time C exercises the option. (Upon exercise of the option, A's interest is reduced to one-quarter and B's interest is reduced to one-half.) When C exercises the option, the fair market value of Blackacre is $500 and the fair market value of Whiteacre is $1,500. After revaluation of the partnerships assets and partners' capital accounts as required by Treas.Regs. §§ 1.704–1(b)(2)(iv)(*h*)(2) and 1.704–1(b)(2)(iv)(*s*), and taking into account C's contributions, the ABC Partnership's balance sheet is as follows:

	Assets			Partners' Capital Accounts	
	Book	Tax Basis		Book	Tax Basis
Cash	$500	$500	A	$ 625	$400
Blackacre	$300	$300	B	$1,250	$800
Whiteacre	$900	$900	C	$ 625	$500
	$2,500	$1,700		$2,500	$1,700

There has been a reallocation of $125 of capital from A and B to C, as required by Treas.Reg. § 1.704–2(b)(2)(iv)(*s*)(3). Pursuant to Treas.Reg. § 1.704–2(b)(2)(iv)(*s*)*(2)*), the first $125 of gross income thereafter realized by the ABC Partnership, whether upon the sale of Blackacre, Whiteacre, from rental receipts or from any other source, must be allocated to C. For example, if Blackacre were sold for $500, reflecting no book gain, the tax gain of $200 would be allocated $125 to C, $25 to A and $50 to B. If the partnership had inadequate gross income to eliminate C's book/tax disparity, the partnership would be required to allocate tax deductions differently than book deductions by allocating to A and B tax deductions the correlative book deductions for which were allocated to C. For example, if Blackacre were to be sold for $180 and the $320 book loss allocated $80 to each of A and C and $160 to B, none of the $120 tax loss—being less than the prior $125 capital shift from A and B to C—would be allocated to C; the tax loss would be allocated $40 to A and $80 to B.

If after all of the unrealized appreciation or depreciation in the partnership's assets has been allocated to the option holder and the option holder's capital account still does not equal the amount of partnership capital to which the option holder is entitled, then the partnership must adjust the capital accounts of the historic partners by the amounts necessary to provide the option holder with a capital account equal to the holder's rights to partnership capital under the agreement. Starting with the year the option is exercised, the partnership must make corrective allocations of tax items—that differ from the partnership's allocations of book items—of gross income or loss to the partners to reflect any shift in the partners' capital accounts occurring as a result of the exercise of an option.

DETAILED ANALYSIS

1. REVALUATIONS OF PARTNERS' CAPITAL ACCOUNTS

Treas.Reg. § 1.704–1(b)(2)(iv)(h)(2) provides rules for revaluing the partners' capital accounts while an option is outstanding. In revaluing partnership property under Treas.Reg. § 1.704–1(b)(2)(iv)(f), the aggregate value of partnership property must be reduced by the amount by which the value of the option exceeds its price or is increased by the amount by which the price of the option exceeds its value.

2. RECHARACTERIZATION OF OPTION HOLDER AS A PARTNER

An option holder will be recharacterized as a partner if (1) under a facts and circumstances test, the option holder's rights are substantially similar to the rights afforded to a partner and (2) as of the date that the noncompensatory option is issued, transferred, or modified, there is a strong likelihood that the failure to treat the option holder as a partner would result in a substantial reduction in the present value of the partners' and the option holder's aggregate tax liabilities. Treas.Reg. § 1.761–3. If an option is reasonably certain to be exercised, the first half of this test is generally met. If the option holder is treated as a partner under the regulations, then the holder's distributive share of the partnership's income, gain, loss, deduction, or credit must be determined in accordance with such partner's interest in the partnership under Treas.Reg. § 1.704–1(b)(3). For this purpose, the option holder's share of partnership items should reflect the lesser amount of capital investment if appropriate; the option holder's distributive share of partnership losses and deductions may be limited by §§ 704(b) and (d) to the amount paid for the option.

SECTION 5. ALLOCATIONS WHERE INTERESTS VARY DURING THE YEAR.

Page 193:

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

Page 194:

After the first full paragraph of the *DETAILED ANALYSIS*, 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 196:

After the second 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 197:

Delete the second 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. 27). 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 201:

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

Pages 202 through 203:

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 209:

After the first full paragraph, insert:

Prop.Reg. § 1.752-2(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 217:

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 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 220:

After the carryover 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. 39–40, 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 227:

After the last 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 230:

Add to the citations:

PROPOSED REGULATIONS: Section 1.707-2.

Page 237:

At the end of the first 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. 14–17, 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 241

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 248:

After the first full 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 250:

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 would 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 partner 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 there is a cap on allocations of partnership income that is reasonably expected to apply in most years, the allocation of the service provider's share of income is reasonably certain for one or more years, the allocation is an allocation of gross income, 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 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, which 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. § 1.707-2(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 255:

In in the carryover paragraph replace the citations to Treas.Reg. § 1.267(b) **with citations to** Treas.Reg. § 1.267(b)-1(b)**.**

Page 262:

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).

Pages 262-263:

Replace the paragraph beginning at the bottom of page 262 with:

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 264, 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 265:

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 289:

After the first 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 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 296:

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 297:

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. 9–11) 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. 14–17). (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 302:

Delete the beginning four sentences of section 2.1 before the parenthetical sentence that carries over to page 303 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 321:

After the carryover paragraph of *Detailed Analysis* 3, insert the following:

In Mingo v. Commissioner, T.C. Memo. 2013-149, the taxpayer sold an interest in a partnership holding cash-method accounts receivable, receiving in exchange a promissory note. The value of the taxpayer's partnership interest was $832,090, of which $126,240 was attributable to the partner's interest in partnership unrealized receivables that were uncollected accounts receivable for services. The taxpayer reported the partner's entire gain on the sale under the § 453 installment method, but the IRS asserted a deficiency on the ground that the gain on the § 751(c) unrealized receivables was not eligible for installment reporting. The Tax Court upheld the IRS's position that § 453 installment reporting is not available for gains attributable to § 751(c) unrealized receivables that represent uncollected cash-method accounts receivable for services. 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.

Replace the first full sentence of *Detailed Analysis* 4 with the following:

Upon the sale of depreciable real property, under § 1(h)(1)(D) "unrecaptured section 1250 gain," is taxed at a maximum rate of 25 percent, not the more favorable lower rates otherwise available for gains on § 1231 assets held for more than one year.

Replace the first full sentence of the second paragraph of *Detailed Analysis* 4 with the following:

Section 1(h)(5)(B) provides that any gain from the sale of an interest in a partnership that has been held for more than one year and which is attributable to unrealized appreciation in the value of collectibles held by the partnership is treated as gain from the sale or exchange of a collectible, taxable at rates up to 28 percent rather than taxable at a maximum rate of 20 percent.

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

Page 324:

Before the final sentence of the carryover 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 339:

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. 9–11) 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. 14–17). (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 368:

At the end of Section 1, insert:

6. 2014 PROPOSED REGULATIONS

The IRS and Treasury Department have proposed amendments to the regulationsnder § 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 (as 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 357) 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 376:

Before the detailed analysis, 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 385:

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 424–27:

Delete Section 7: Sales of Partnership Interests Causing Constructive Terminations

This deletion results from the repeal of the constructive termination rule by the 2017 Tax Act. See this Update, Chapter 8, pg. 45, for additional discussion.

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PART II

ELECTIVE PASSTHROUGH TAX TREATMENT

CHAPTER 10

S CORPORATIONS

SECTION 1. INTRODUCTION

Page 449:

Add the following paragraphs at the end of the page:

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. 12–14. 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. 14–17, 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

A. SHAREHOLDER RULES

Page 457:

In the second full paragraph, third from the last line, change the citation to Temp. Reg. § 1.409(p)-1T, and Prop.Reg. § 1.409(p)-1 (2003) **to** Treas.Reg. § 1.409(p)-1.

E. COORDINATION WITH SUBCHAPTER C

Page 468:

Before the first full paragraph beginning on the page, insert:

Section 1371(a) provides that, except when specifically displaced, the normal Subchapter C rules, including the rules governing corporate distributions, are applicable to Subchapter S corporations. This is in contrast to § 1361(b), which provides that subject to certain exceptions, the taxable income of an S corporation is computed in the same manner as an individual's taxable income. Trugman v. Commissioner, 138 T.C. 390 (2012), held that the first time homebuyer's credit under now-expired § 36, which was available to an "individual" who had no present ownership interest in a principal residence during the three year period ending on the date of the purchase, was not allowable to an S corporation that purchased a home for its shareholders, notwithstanding that the § 36 credit was not one of the listed exceptions in § 1363(b). The court held that a corporation could not be an "individual" for purposes of § 36, and election of subchapter S status did not change that characterization. The court reasoned that only individuals can have a principal residence—a corporation has a principal place of business. Thus, before concluding that a provisions that applies to individuals also applies to S corporations, the statutory provision in question must be carefully examined.

Page 468:

Add after the second full paragraph:

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 10, pgs. 60–61.

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 474:

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 476:

After the second 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." Treas.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. Treas.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 485:

After the carryover 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. 43.

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

Pages 486-500 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 476.

B. DISTRIBUTIONS

Page 504:

After the first full 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 10, pg. 57.

SECTION 4. QUALIFIED SUBCHAPTER S SUBSIDIARIES

Page 506:

At the end of the third full paragraph, insert:

In Ball v. Commissioner, T.C. Memo. 2013-39, the court rejected the taxpayer's assertion that unrecognized gain on the deemed § 332 liquidation on a QSub election for an existing subsidiary is "exempt" income that permits a basis increase under § 1367(a)(1)(A). The court held that nonrecognition under § 332 does not create an item of tax-exempt income under § 1366(a)(1)(A), but defers recognition through substituted basis rules. 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. Passive Investment Income of an S Corporation with Accumulated Earnings and Profits

Page 512:

In the first full paragraph, change the computation to:

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

C. Built-in Gain Tax

Page 516:

At the end of the carryover paragraph, insert:

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

Page 517:

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