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2022 Update Memorandum For

**FEDERAL  
INCOME TAXATION OF  
BUSINESS  
ORGANIZATIONS**

SIXTH EDITION

*by*  
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# PREFACE

This 2022 Update to Federal Income Taxation of Business Organizations provides users of the text with materials reflecting developments in federal income taxation of corporations since April 30, 2019, and of partnerships as of March 31, 2020 (the dates as of which the materials in the text are current). This update is current as of July 1, 2022.

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July 2022

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2022 Update Memorandum

**FEDERAL  
INCOME TAXATION OF  
CORPORATIONS**

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PART 1

# TAXATION OF CORPORATIONS AND SHAREHOLDERS

CHAPTER 3

## THE CAPITAL STRUCTURE OF THE CORPORATION

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### **SECTION 1. DEBT VERSUS EQUITY**

A. CLASSIFICATION OF DEBT OR EQUITY

#### **DETAILED ANALYSIS 1: THE NATURE OF THE INQUIRY**

1.1. *Generally*

**Page 156:**

**Replace the last three sentences of the second to last paragraph with the following:**

In general, the 2016 § 385 regulations focused on implementing documentation requirements and on characterizing arrangements between certain related entities. They were,

however, subject to significant criticism, and the documentation requirements of Treas.Reg. § 1.385-2 were removed without ever having taken effect. T.D. 9880, 84 Fed. Reg. 59,297 (Nov. 4, 2019). Nevertheless, in 2020, other portions of the regulations were finalized without any material change. Even with the issuance of final regulations under § 385, however, judicial authority will continue to govern in areas not controlled by the regulations (such as closely held businesses), and in many instances the regulations require taxpayers to look at existing judicial authority. See Treas.Reg. § 1.385-1(b).

## **DETAILED ANALYSIS 7: CONVERTIBLE OBLIGATIONS, HYBRID SECURITIES, AND OTHER FINANCIAL INSTRUMENTS**

### ***7.1. Convertible Obligations***

**Page 168:**

**After second paragraph, add the following paragraph:**

In Notice 94-47, 1994-1 C.B. 357, the IRS further clarified the scope of Rev.Rul. 85-119. In this Notice, the IRS said that Rev. Rul. 85-119 would not apply in situations where the instrument “has terms substantially identical to the [Rev.Rul. 85-119] notes except for a provision that requires the holder to accept payment of principal solely in stock of the issuer (or, in certain circumstances, a related party).” Likewise, the IRS stated that “an instrument does not qualify as debt if it has terms substantially identical to the [Rev.Rul. 85-119] notes except that (a) the right to elect cash is structured to ensure that the holder would choose the stock, or (b) the instrument is nominally payable in cash but does not, in substance, give the holder the right to receive cash because, for example, the instrument is secured by the stock and is nonrecourse to the issuer.”

## **DETAILED ANALYSIS 8: SECTION 385 REGULATIONS**

**Page 170:**

**In the first full paragraph after the second sentence, add the following:**

These regulations were finalized without significant change in 2020. See T.D. 9897, Treatment of Certain Interests in Corporations as Stock or Indebtedness, 85 Fed. Reg. 28,867 (May 14, 2020).

**Page 170:**

**Delete the last full paragraph.** [Note: the documentation requirements of Treas. Reg. § 1.385-2 were deleted in T.D. 9880, 84 Fed. Reg. 59,297 (Nov. 4, 2019).]

**Page 171–72:**

**Replace the final paragraph of page 171 (and block quotation over to page 172) with the following:**

In May 2020, the Treasury Department and the IRS issued final regulations (TD 9897, 85 Fed. Reg. 28,867 (May 14, 2020)) that adopt without substantive change the 2016 proposed regulations under § 385. The final regulations address the treatment of qualified short-term debt instruments, controlled partnerships, and consolidated groups under the so-called Distribution Regulations; these regulations recharacterize a debt instrument issued by a domestic corporation as stock if the instrument is issued to a member of the domestic corporation's expanded group in a distribution, in exchange for related-party stock, or in exchange for property in certain asset reorganizations. Although the 2016 proposed regulations cross-referenced temporary regulations that expired on October 13, 2019, taxpayers were permitted to rely on the 2016 proposed rules if they applied the rules consistently and in their entirety.

**DETAILED ANALYSIS 9: LIMITATION ON BUSINESS INTEREST DEDUCTION****Page 172:**

**Replace the second full paragraph of Detailed Analysis 9. Limitation on Business Interest, with the following two paragraphs:**

During 2020 and 2021, Treasury adopted final Regulations relating to implementation of § 163(j), and it has indicated it will continue to study the need for further regulatory guidance. See T.D. 9943, 86 Fed. Reg. 5496 (Jan. 19, 2021); T.D. 9905, 85 Fed. Reg. 56,686 (Sept. 14, 2020).

Business interest means any interest paid or accrued on indebtedness properly allocable to a trade or business. Business interest income means the amount of interest includible in the gross income of the taxpayer for the taxable year that is properly allocable to a trade or business. Reg. § 1.163(j)–6(j). Floor plan financing interest is defined as interest paid to finance motor vehicles that are held for sale or lease.

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**B. DEDUCTIONS FOR LOSS OF INVESTMENT IN A CORPORATION****DETAILED ANALYSIS 2. BUSINESS VERSUS NONBUSINESS BAD DEBT**

**Page 177:**

**In the second full paragraph, delete the first two sentences and substitute the following:**

Loss incurred by a noncorporate creditor-investor on an advance that qualifies as a debt, and hence is not a contribution to capital, that is not evidenced by a security, is deductible as an ordinary loss only if the advance qualifies as a business bad debt. A bad debt is a business bad debt only if the creditor-investor is engaged in a trade or business and has established the necessary degree of connection between the debt and the business to qualify the debt as a business bad debt.

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## CHAPTER 4

# DIVIDEND DISTRIBUTIONS

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### SECTION 4. DISGUISED DIVIDENDS

#### DETAILED ANALYSIS 2. COMPENSATION TO SHAREHOLDERS

##### 2.1. Salary and Bonuses

**Page 246:**

**After the first full paragraph, add the following case summary.**

To a similar effect is the Tax Court decision in *Aspro, Inc. v. Commissioner*, T.C. Memo. 2021-8 (2021). Among the factors relied upon by the Tax Court in reaching its conclusion that purported management fees were in fact disguised dividends were the following: (1) the corporation lacked a dividend-paying history; (2) the amounts paid out as management fees roughly corresponded to shareholders' respective interests in the corporation; (3) some of the shareholders were holding companies that did not actually perform the claimed services; (4) the payments were made at the end of the year rather than throughout the year; (5) the corporation had relatively little taxable income after deducting the fees; and (6) the process for setting the fees was unstructured and was not set in advance of services being performed. The case is currently on appeal to the Eighth Circuit.

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## CHAPTER 7

# CORPORATE LIQUIDATIONS

### SECTION 4. LIQUIDATION OF SUBSIDIARY CORPORATIONS-SECTION 332

#### DETAILED ANALYSIS 1. EIGHTY PERCENT CONTROL REQUIREMENT AND TAX PLANNING

Page 419

**Add new: paragraph 1.3 *Possible Overlap with Section 368(a)(1)(C) Reorganization.***

As will be further addressed in Chapter 10, Treas.Reg. § 1.368-2(d)(4) currently allows reorganizations to qualify for nonrecognition treatment under § 368(a)(1)(C) even if stock of the target corporation were previously owned and not acquired as part of the reorganization. As a result of this regulatory change, it is now possible for an upstream liquidation of a subsidiary into its parent corporation to qualify as a reorganization under § 368(a)(1)(C) whereas that possibility did not exist under the Treasury regulations at the time of the *Granite Trust* decision. However, in order for the subsidiary's liquidation to qualify as a tax-free reorganization under § 368(a)(1)(C), another requirement is that the parent corporation must acquire "substantially all" of the properties of the liquidating subsidiary as part of the transaction. If the parent corporation acquires only 70% of the pro rata assets of the liquidating subsidiary, this substantially all requirement is unlikely to be met under the case law. Thus, the outcome under the precise facts in *Granite Trust* would likely remain unchanged even under this Regulation. If, however, a parent corporation were to receive more than 70% of the liquidating subsidiary's operating assets but less than 80% of the liquidating subsidiary's operating assets, it is more possible the receipt of operating assets of the liquidating subsidiary would satisfy the "substantially all" standard. If it does, then the *Granite Trust* outcome would be supplanted for that fact pattern, and nonrecognition treatment would be afforded in the reorganization provisions.

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PART 2

# CORPORATE ACQUISITION TECHNIQUES

## CHAPTER 8

### TAXABLE ACQUISITIONS: THE PURCHASE AND SALE OF A CORPORATE BUSINESS

#### SECTION 1. ASSET SALES AND ACQUISITIONS

#### DETAILED ANALYSIS 2. LIABILITIES

Page 443

**At the end of the paragraph carried over from pg. 442:**

In *Hoops L.P. v. Commissioner*, T.C. Memo 2022-9, an NBA owner sold its NBA franchise along with \$12.6 million of contingent deferred compensation liabilities to a buyer. The contingent deferred compensation liabilities were contractually required to be made in future years and related to prior years of service, but no deduction had been allowed to the seller because the employee had not yet included these amounts into income as required by § 404(a)(5). The Tax Court held that the seller was required to include the net present value of these contingent deferred compensation liabilities as sales proceeds in the year of the sale. However, the Tax Court then held that the seller was not allowed an offsetting deduction in

the year of sale. According to the Tax Court, the contingent liability relating to deferred compensation could only be deducted when the particular basketball player included those amounts into income. The Tax Court distinguished *Commercial Security Bank* by saying that case did not involve deferred compensation subject to § 404(a)(5). The Tax Court did not address whether the seller would be allowed a deduction in a later year when the deferred compensation is included into the basketball players income. That outcome arguably is a correct inference given the Tax Court's reasoning in the case, but the Tax Court did not explicitly reach that issue as those later years were not at issue before the court.

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## CHAPTER 9

# DISTRIBUTIONS MADE IN CONNECTION WITH THE SALE OF A CORPORATE BUSINESS: “BOOTSTRAP” ACQUISITIONS

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### SECTION 2. BOOTSTRAP TRANSACTIONS INVOLVING CORPORATIONS

**Page 491:**

**Delete the first full paragraph and substitute the following:**

The IRS will closely scrutinize such a dividend payment and, depending on the particular facts, may assert that a dividend is in fact additional purchase price and therefore yields capital gain that is not eligible for the § 243 deduction. As the materials that follow will highlight, the results in the courts have been mixed.

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### SECTION 3. BOOTSTRAP SALE TO CHARITABLE ORGANIZATION

#### DETAILED ANALYSIS 1. STEP TRANSACTION DOCTRINE

**Page 506:**

**After the carryover paragraph from page 505, add the following new paragraph:**

The application of the *Palmer* and *Grover* line of authority that restricts the application of the step transaction doctrine to only the binding commitment test in the context of a bootstrap donation of appreciated property to a charity was upheld in the context of a donation of appreciated nonpublic stock to a donor advised fund in *Dickinson v. Commissioner*, T.C. Memo 2020-128. In *Dickinson*, the taxpayer irrevocably transferred appreciated stock in a private corporation to a donor advised

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fund that was a charitable organization described in § 501(c)(3). The donor advised fund had standing directives to immediately liquidate any nonpublic stock. In this context, the IRS argued that neither *Palmer*, *Grover*, nor its concession in Rev.Rul. 78–197 should be applied to supplant the application of the step transaction doctrine in the context of a donation of appreciated stock to donor advised funds where the donor advised fund has standing instructions to immediately liquidate donated nonpublic stock. The Tax Court disagreed, stating that Rev.Rul. 78–197 did not articulate the test for resolving anticipatory assignment of income issues and that *Palmer* and *Grove* should apply without reservation to a donation of appreciated stock to a donor advised fund as long as the donor had made an absolute gift of the appreciated stock at a time when the corporation was not legally obligated to make a redemption even when the corporation in fact did redeem the appreciated stock immediately after its donation. The Tax Court’s refusal to apply step transaction principles, except where the binding commitment test is implicated, circumscribes that doctrine’s application in the context of a bootstrap donation to charity even when the charitable organization is a donor advised fund.

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## CHAPTER 10

# TAX-FREE ACQUISITION REORGANIZATIONS

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### **SECTION 2. REORGANIZATION FUNDAMENTALS & TYPE (A) REORGANIZATIONS**

#### A. OVERVIEW

#### **DETAILED ANALYSIS: 1. THE DEFINITION OF “STATUTORY MERGER”**

##### **1.1 Mergers Involving a Disregarded Entity**

##### **Page 519:**

**Replace the second sentence of the first paragraph, but keep the footnote 3 at the end of that sentence, with the following:**

Subject to very limited exceptions, each combining entity (a term that does not include disregarded entities) of the acquired combining unit must simultaneously cease its separate legal existence for all purposes.

#### D. TAX RESULTS TO THE PARTIES TO A TYPE (A) REORGANIZATION

##### (1) TARGET SHAREHOLDERS AND SECURITY HOLDERS

#### **DETAILED ANALYSIS: 6. PREFERRED STOCK**

##### **6.1 Nonqualified Preferred Stock**

##### **Page 573–74:**

**Replace last paragraph on page 573 that carries over to page 574 with the following:**

Because nonqualified preferred stock received in an exchange will not be treated as stock or securities but, instead, will be treated as boot, the receipt of nonqualified preferred stock will result in recognition of gain under § 356 unless a specified exception applies. Whereas in a § 351 exchange nonqualified stock is treated as boot in all events, § 354(a)(2)(C)(i) and § 356(e)(2) provide that nonqualified preferred stock is treated as stock rather than as other property in cases where the nonqualified preferred stock is received in exchange for other nonqualified preferred stock. In these cases, the receipt of nonqualified preferred stock will not result in recognition of gain under § 356. Treas.Reg. §§ 1.354-1(f) and 1.356-7(b) provide additional rules to deal with various aspects of exchanges where nonqualified preferred stock is received in a reorganization and the preferred stock that was surrendered was not itself nonqualified preferred stock. These additional rules apply only when the reason that the preferred stock surrendered was not nonqualified preferred stock on issuance was that it was subject to repurchase rights or obligations exercisable only after more than 20 years had passed from the date of issuance or the likelihood of redemption or purchase at any time was low enough. Further, under the general rule in the Regulations, the nonrecognition rules apply only if nonqualified preferred stock that is received in the exchange is “substantially identical” to the original preferred stock surrendered in the exchange. Stock is considered to be substantially identical if two conditions are met: First, the stock received does not contain any terms which, in relation to the terms of the stock previously held, decrease the period in which a redemption or purchase right will be exercised, increase the likelihood that such a right will be exercised, or accelerate the timing of the returns from the stock instrument (including the receipt of dividends or other distributions). Second, as a result of the receipt of the stock, the exercise of the right or obligation does not become more likely than not to occur within a 20-year period beginning on the issue date of the stock previously held.

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## SECTION 9. JUDICIAL DOCTRINES AND LIMITATIONS

### B. STEP TRANSACTION DOCTRINE

Page 682

**At the end of the seventh line, add the following:**

The regulations under Treas.Reg. § 1.368-1(c) require the existence of a “plan of reorganization,” but the regulations are otherwise silent on the underlying facts that must exist for such a plan to exist. In PLR 202128001, a taxpayer represented that it would take five years to complete its own plan of reorganization due to the expected time it would take to obtain the necessary regulatory approvals in foreign jurisdictions. The IRS favorably ruled that a plan of reorganization existed notwithstanding that the plan of reorganization would take five years to complete and notwithstanding that there was no binding commitment for the taxpayer to complete those steps. The IRS’s

willingness to favorably rule that a taxpayer's plan of reorganization could extend to a five-year period without the existence of a binding commitment demonstrates that the determination of whether a plan of reorganization exists is ultimately a facts and circumstances analysis.

### C. STEP TRANSACTION DOCTRINE AND THE INTERACTION OF SECTIONS 338 AND 368

#### DETAILED ANALYSIS 1. REVENUE RULING 2001-46 AND REVENUE RULING 2008-25:

**Page 692:**

**Replace the third full paragraph with the following:**

Finally, compare the results in Rev.Rul. 2001-46 with Treas.Reg. § 1.338(h)(10)-1(e) Examples 11 and 12. In those examples, the transaction would have represented a tax-free § 368(a)(1)(A) reorganization by reason of the step transaction doctrine. However, Treas.Reg. § 1.338(h)(10)-1(c)(2) provides that if the taxpayer makes an affirmative election to apply § 338, then the step transaction doctrine is supplanted, and the transaction is treated as a taxable asset acquisition under § 338. Thus, once a taxpayer has made a § 338 election, the transaction is then treated as a taxable acquisition subject to § 338, and the separate steps are given independent significance in accordance with the prescriptive rules set forth under § 338. Thus, the step transaction doctrine is supplanted once the taxpayer elects to apply § 338. This approach is in accord with Rev.Rul. 90-95, which was discussed in Chapter 8, as well as in the excerpt provided in this Chapter 10 of Rev.Rul. 2001-46.

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PART 3.

# NONACQUISITIVE REORGANIZATIONS

## CHAPTER 12

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

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#### SECTION 2. “ACTIVE CONDUCT OF A TRADE OR BUSINESS,” “DEVICE,” AND OTHER LIMITATIONS

##### B. ACTIVE TRADE OR BUSINESS

##### DETAILED ANALYSIS 1. ACTIVE TRADE OR BUSINESS

##### 1.1 WHAT IS A TRADE OR BUSINESS?

Page 754

At the end of 1.1 *What Is a Trade or Business?*, add the following additional paragraph:

Although the determination of an active trade or business has always been a facts and circumstances analysis, the IRS made this even clearer in recent pronouncements. Historically, the IRS had maintained a bright line standard indicating that a business could not be an active trade or business unless it collected income from its activities. See Rev. Rul. 57-464, 1957-2 C.B. 244; Rev. Rul. 57-492, 1957-2 C.B. 247. However, in Rev. Rul. 2019-9, 2019-14 I.R.B. 925, the IRS indicated that it was suspending these two rulings and would study whether a substantial business could be an active trade or business even though it had yet to generate income. One could imagine a pharmaceutical business or some other technology business where substantial assets and employees are engaged in ongoing business activity but have not yet produced a profit. Since its issuance of Rev. Rul. 2019-9, the IRS has issued several favorable private rulings where it found that a corporation met the active trade or business requirement of § 355(b) even though the corporation's activities had yet to generate any actual income. See, e.g., PLR 202150004 (Dec. 21, 2021); PLR 202009002 (Sept. 4, 2019).

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## SECTION 5. DIVISIVE DISTRIBUTIONS IN CONNECTION WITH ACQUISITIONS

### DETAILED ANALYSIS 1. ASPECTS OF SECTION 355(e):

#### 1.3 Corporate Level Issues

**Page 832:**

**After first full paragraph, add the following paragraph:**

The application of § 355(e) and § 355(f) becomes more complicated if there are internal restructurings prior to the divisive transaction that is the subject of a later § 355 distribution. In T.D. 9888, 84 Fed. Reg. 69,308 (Dec. 18, 2019), the Treasury issued final Regulations on how to apply § 355(e) and § 355(f) in the context of predecessor and successor entities to the distributing corporation and to the controlled subsidiary that are parties to the § 355 distribution. Treas.Reg. § 1.355-8(b)(2) defines a *potential* predecessor as a corporation other than the distributing corporation or the controlled corporation *if either* (1) as part of a plan, the corporation transfers property to a potential predecessor, the distributing corporation, or a member of the same expanded affiliated group in a transaction described by § 381 or (2) immediately after completion of the plan, the corporation is a member of the same expanded affiliate group as the distributing corporation. (Section 381 is covered in detail in Chapter 13, Section 1.) Only a *potential* predecessor can become an *actual* predecessor. For that to occur, Treas.Reg. § 1.355-8(a)(3) provides that the potential predecessor (1) must transfer property

to the controlled corporation in a tax-deferred transaction as part of a plan for a future § 355 distribution, or (2) must transfer property to the distributing corporation in a tax-deferred transaction as part of a plan for a further § 355 distribution.

**Page 833:**

**After the second full paragraph, add the following:**

1.3.2 *Synthetic § 355 Distributions*

Section 355(e)(4)(D) provides that references in § 355(e) to the distributing or controlled corporation apply also to any predecessor or successor of each. In order to fulfill the goals of § 355(e), the Treasury believes that it should apply § 355(e) whenever a § 355 distribution accomplishes a “synthetic spin-off” of the assets that are transferred by a “divided corporation” to the distributing corporation or to the controlled corporation and a § 355 distribution occurs thereafter. See T.D. 9888, 84 Fed. Reg. 69,308 (Dec. 18, 2019). The Treasury’s concern is perhaps best understood by considering a base example, which appears in the preamble to the Regulations. A synthetic spin-off could be achieved through the following series of transactions occurring pursuant to a plan: (1) a corporation (P) merges into a distributing corporation in a § 368(a)(1)(A) reorganization, (2) the distributing corporation contributes some (but not all) of P’s assets to a controlled subsidiary in a § 368(a)(1)(D) reorganization, and (3) the distributing corporation thereafter distributes all of the stock of the controlled corporation in a § 355 distribution. In this base case example, the divided corporation (that is, P) could have separated its assets in a nonrecognition transaction without gain or loss. But, if the divided corporation had been in the position of being itself a distributing corporation and had attempted to separate its assets between itself and a controlled subsidiary and then distributed its controlled subsidiary in a § 355 distribution, the result would have been that § 355(e) clearly would have applied.

In light of this economically equivalent alternative path, Treasury was concerned that § 355(e) and its strictures could be side-stepped by having a predecessor corporation separate its assets in nonrecognition transactions with the distributing corporation and the controlled subsidiary prior to a § 355 distribution. Thus, Treas.Reg. § 1.355–8 seeks to apply § 355(e) to a § 355 distribution if a predecessor of the distributing corporation divided its assets between the distributing corporation and the controlled corporation as part of a plan to accomplish a 50% acquisition of the predecessor’s relevant assets. The Regulations achieve this goal by treating the divided corporation in the base case example as a predecessor of the distributing corporation and applies § 355(e) in that context.

Treas.Reg. § 1.355–8(a)(3) asserts that § 355(e) applies to a § 355 distribution if, as part of a plan, some of the assets of a predecessor of a distributing corporation are transferred directly or indirectly to controlled corporation without full recognition of gain and the § 355 distribution accomplishes a division of the assets of the *actual* predecessor of the distributing

corporation. Only a *potential* predecessor can become an *actual* predecessor. A corporation is a *potential* predecessor corporation if it transfers property to the distributing corporation in a § 381-covered transaction. Treas.Reg. § 1.355-8(b)(2)(ii)(A)(1). (Section 381 is covered in detail in Chapter 13, Section 1.) Two pre-distribution requirements and one post-distribution requirement must be satisfied for a potential predecessor to be a predecessor of distributing corporation. Treas.Reg. § 1.355-8(b)(1)(i).

The two pre-distribution requirements consist of a “relevant property” requirement and a “reflection of basis” requirement. The term “relevant property” generally refers to any property held by the potential predecessor at any point during the plan period (that is, the period that ends immediately after the § 355 distribution and begins on the earliest date on which any part of the plan is agreed to or understood, arranged, or substantially negotiated). See Treas.Reg. § 1.355-8(b)(2)(iv). The relevant property requirement is satisfied if, before the § 355 distribution and as part of a plan, any distributed stock in controlled had been acquired by distributing corporation in an exchange for interests in relevant property held by controlled immediately before the distribution and built-in gain in the relevant property was not recognized in full at any point during the period of the plan. The first pre-distribution test is also met if, as part of a plan, the controlled stock is relevant property and is distributed; controlled stock would be relevant property if the potential predecessor owned stock in the controlled. Accordingly, in the absence of a plan, a predecessor of the distributing corporation cannot exist for purposes of § 355(e). If the basis in the stock of the controlled corporation is determined in whole or in part by the basis in relevant property (or if the controlled corporation stock is itself relevant property), then the reflection of basis, pre-distribution requirement is met. Treas.Reg. § 1.355-8(b)(1)(ii). If, however, during the plan period the controlled stock had already been distributed in a § 355(e)-governed distribution or transferred in a transaction in which the gain built into it had been recognized in full, the reflection of basis test is not satisfied.

The post-distribution requirement is satisfied if there is a division of relevant property between the controlled subsidiary that is the subject of the § 355 distribution and the distributing corporation so that there is a segregation of the relevant property before the controlled corporation stock is distributed in a § 355 transaction. Treas.Reg. § 1.355-8(b)(1)(iii).

Under the general requirements of § 355(e), the distributing corporation recognizes all the gain in its controlled stock, but in the situation of a synthetic structure, that could lead to more gain being recognized than should be, depending on where the relevant assets end up in the overall structure. As a result, Treas.Reg. § 1.355-8 has a limitation on the amount of gain that must be recognized, with the calculation dependent on whether, as part of a plan, the predecessor corporation of the distributing corporation or the distributing corporation is the subject of a 50% or greater acquisition. Treas.Reg. § 1.355-8(e). The amount of gain is never greater than the gain recognition required under § 355(e) more generally, which the regulation refers to as the “statutory recognition amount.” To determine the percentage of acquisition,

each owner's interest is compared between the owner's direct or indirect interest immediately before the § 381 transaction with the interest immediately after the § 381 transaction. If there is a 50% or greater acquisition of the predecessor corporation of the distributing corporation, the amount of gain required to be recognized under § 355(e) is limited to the gain in the relevant property that was separated from the predecessor corporation—i.e., moved to the controlled corporation. Treas.Reg. § 1.355-8(e)(2). On the other hand, if the § 355 distribution creates a 50% or greater acquisition of the distributing corporation, then the amount of gain recognized is instead limited to the excess of the statutory recognition amount over the amount of gain built into the property moved from the predecessor to the controlled. These rules apply whether or not the distributing corporation ever directly held the separated, relevant property.

Additional situations may also trigger these rules. For example, a synthetic § 355 distribution can exist with respect to a predecessor of a *controlled* corporation if the predecessor corporation transfers assets to the controlled corporation in a § 381 transaction and the predecessor corporation remains in existence after the transfer so that a separation of relevant assets occurs in that context. Treas.Reg. § 1.355-8(c)(1). The regulations also contain rules for how to handle multiple predecessors or a series of predecessors.

**Page 835:**

**Problem Set 7**

**Add the following new problem:**

4. (a) Xavier owns 100% of the stock of Peach Corp., which holds multiple assets. Yuri owns 100% of the Durian Corp. The following steps occur as part of a plan: Peach Corp. merges into the Durian Corp. in a valid Type A reorganization under § 368. Immediately after the merger, Xavier and Yuri own 10% and 90%, respectively, of the stock of Durian Corp. Durian Corp. then contributes to Chayote Corp., a corporation controlled by Durian, one of its assets (Asset 1) acquired from Peach Corp. in the Type A merger. At the time of the contribution, Asset 1 has a basis of \$60,000 and a fair market value of \$165,000. Prior to the exchange of Asset 1 by Durian for cash and Chayote stock, Durian Corp.'s basis in Chayote was \$90,000 and the value of the Chayote stock was \$150,000. In exchange for Asset 1, Durian Corp. receives additional stock in Chayote Corp. and cash of \$15,000. Duran Corp. distributes all the Chayote Corp. stock (but not the cash) to Xavier and Yuri, pro rata. Assume that Durian's exchange with Chayote followed by the distribution of Chayote stock constitute a valid divisive Type D reorganization.

(b) The facts are the same as in 4(a) above except that the merger of Peach Corp. into Durian Corp. occurred before the existence of a plan.

(c) The facts are the same as in Problem 4(a) except for two changes. First, Durian Corp. does not contribute Asset 1 to Chayote; instead, Durian Corp. continues to own Asset 1 throughout the relevant period. Second, prior to the merger of Peach Corp. into Durian Corp., Peach Corp. owned 65% of Chayote Corp. (Block 1 stock), and Durian Corp. owned the remaining 35% of Chayote Corp. (Block 2 stock). As part of a plan, after Type A merger of Peach Corp. into Durian Corp., the stock of Chayote Corp. became 100% owned Durian Corp. In a qualifying § 355 distribution, Durian Corp. distributed the Chayote stock, with Xavier receiving 90% and Yuri receiving 10% percent. Prior to the § 355 distribution of the Chayote stock, Durian's ownership was as follows: (i) Block 1 shares had an aggregate basis of \$30,000 and fair market value of \$35,000 and (ii) Block 2 shares had an aggregate basis of \$10,000 and a fair market value of \$65,000.

(d) Xavier owns 100% of Peach Corp. and Yuri owns 100% of Durian Corp. Peach Corp. held multiple assets, including Asset 1, Asset 2, and Asset 3. Instead of a merger occurring between Peach Corp. and Durian Corp., the following instead occurs all as part of a prearranged plan. First, in an exchange qualifying under § 351 and as joint transferors, Peach Corp. transfers Asset 1 and Asset 2 to Durian Corp. and Yuri transfers other property Durian Corp. Immediately after the § 351 exchange, Peach Corp. owns 10% of Durian Corp., and Yuri owns 90% of Durian. Second, Durian Corp. contributes Asset 1 to Chayote Corp., a corporation controlled by Durian, in exchange for additional Chayote stock. And third, Durian distributes all of the Chayote stock to Peach Corp. and to Yuri, pro rata. Durian Corp. continues to hold Asset 2 directly, and Peach Corp. continues to hold Asset 3 directly. Assume that Durian's exchange with Chayote followed by the distribution of Chayote stock constitute a valid divisive Type D reorganization. Immediately before the § 355 distribution, Asset 1 has a basis of \$60,000 and a fair market value of \$165,000, and the stock of the Controlled Corporation held by the Distributing Corporation has a basis of \$150,000 and a fair market value of \$300,000. Following the § 355 distribution, and as part of the same plan, Zeus acquires 51% of the stock of Peach Corp.

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PART 4.

# CORPORATE ATTRIBUTES IN REORGANIZATIONS AND OTHER TRANSACTIONS

## CHAPTER 13

### CARRYOVER AND LIMITATION OF CORPORATE TAX ATTRIBUTES

#### **SECTION 2. LIMITATION ON NET OPERATING LOSS CARRYOVERS FOLLOWING A CHANGE IN CORPORATE OWNERSHIP**

#### **DETAILED ANALYSIS 3. COMPUTING THE SECTION 382 LIMITATION**

##### *2.3.1. Identifying Five Percent Stockholders*

Page 876

At the end of the paragraph carried over from page 876, add the following:

In PLR 202146003 (Nov. 19, 2021), a public corporation proposed to acquire another public corporation. In the ruling, the parties stipulated that certain acquiring shareholders also owned less stock of the target corporation, creating an overlapping public group. The acquiring corporation had no actual knowledge regarding members of the overlapping public group other than knowledge obtained through (a) corporate records of acquiring and target; (b) a survey of relevant SEC filings, and (c) additional information obtained through “Written Questionnaires” to potential overlapping public group shareholders. After determining that this information indicated that there was an overlapping ownership, the IRS accepted that shares issued to the overlapping group would not be counted as a part of an ownership change.

### **3.3 Built-In Gains and Losses**

**Page 888:**

**After the first full paragraph, insert the following:**

As previously mentioned, the approach taken in Notice 2003–65, 2004–40 I.R.B. 747, particularly the so-called § 338 wasting asset methodology, generally was favorable to taxpayers with a NUBIG as that § 338 wasting asset methodology allowed an adjustment to the realized built-in gain (RBIG) based on a hypothetical sale and subsequent hypothetical cost recovery regardless of whether any actual realized gains occurred. Under the § 338 wasting asset methodology, items of RBIG (and RBIL) generally are computed by comparing the loss corporation’s actual items of income, gain, etc. during the recognition period with those that would have been recognized if a § 338 election had been made with respect to a hypothetical purchase. The § 338 approach thus allows loss corporations to “create” RBIG even without a realization event. This treatment under the § 338 wasting asset methodology follows from the logic that such built-in gain assets could have generated increased limitation if the assets had been subject to a § 338 election as the seller could have utilized the loss corporation’s net operating losses without limitation prior to the ownership change and the buyer would have received a stepped-up basis, and so from a policy perspective it seemed inappropriate to have a different § 382 limitation for the buyer based solely on whether or not an actual § 338 election had been made.

Shortly after passage of the Tax Cuts and Jobs Act of 2017, the government issued Notice 2018–30, 2018–21 I.R.B. 610 to make it clear that the calculation under the § 338 wasting asset methodology should utilize a hypothetical cost recovery without regard to § 168(k) bonus depreciation. The effect of this Notice was to ensure that the bonus depreciation deduction allowed by reason of § 168(k) was ignored for purposes of calculating the hypothetical deductions that would have been allowed had an asset been the subject of a § 338 election and then had been depreciated in accordance with § 168 (while ignoring § 168(k)) over the five-year recognition period.

On September 10, 2019, the IRS issued Proposed Regulations 1.382-7 that signaled a more expansive reformulation of the government's efforts to circumscribe the § 338 wasting asset methodology as evidenced by the following statement:

After study, and based on taxpayer input, the Treasury Department and the IRS have decided not to incorporate the 338 approach into these proposed regulations. . . . [T]he Treasury Department and the IRS have concluded that the 338 approach lacks sufficient grounding in the statutory text of section 382(h). Further, the Treasury Department and the IRS have determined that the mechanics underlying the 338 approach (i) are inherently more complex than the accrual-based 1374 approach, (ii) can result in overstatements of RBIG and RBIL, and (iii) as a result of the TCJA, would require substantial modifications to eliminate increased uncertainty and ensure appropriate results. By eliminating the 338 approach, the Treasury Department and the IRS have determined that these proposed regulations would significantly reduce current and future complexity of section 382(h) computations for taxpayers and the IRS alike. The Treasury Department and the IRS welcome public comment on this proposed elimination of the 338 approach for determining RBIG and RBIL.

REG-125710-18, 84 Fed. Reg. 47,455, 47,457 (Sept. 20, 2019). One of the reasons given in the Proposed Regulations for withdrawing the § 338 wasting asset methodology is that the statutory basis for promulgating Notice 2003-65 was lacking. Another factor that may have played into the retrenchment is the revelation that some of the changes that were made in the 2017 Act, namely the full-expensing approach of § 168(k) and the expanded earnings-stripping limits under § 163(j), exposed some of the difficulties of making the required computation under the § 338 wasting asset methodology. Also, the modification of § 172(a) so that a net operating loss can only offset 80% of the current year taxable income made the hypothetical § 338 wasting asset methodology more favorable than would arise if there had been an actual § 338 election in many instances. Nevertheless, these Proposed Regulations are only to be applied prospectively, and so taxpayers can continue to rely on Notice 2003-65 until the Proposed Regulations are finalized. Given the significant business disruption that has continued into 2021 caused by the COVID-19 pandemic, the ability to rely on Notice 2003-65 remains a critically important tax planning tool in this period of uncertainty.

### 3.3.1 *Post-ownership Change Cancellation of Debt Income*

Another fundamental question raised from the very beginning of the adoption of § 382(h) involves how to handle post-ownership change cancellation of indebtedness income. For loss corporations, net operating losses and cancellation of indebtedness income are often opposite sides of the same tax coin; in many cases, corporate losses are funded with borrowed money, and the fact that the loss corporation cannot generate positive income also correlates with its inability to service the borrowing which, debt when discharged, generates cancellation of

indebtedness income that has the effect of reversing the net operating losses. For this reason, among others, there was a certain symmetry in Notice 2003–65’s treatment of post-ownership change cancellation of indebtedness income arising from pre-ownership change debt as creating items of RBIG.

Proposed Regulations 1.382-7(c)(3)(ii) (2019), however, take a much different approach with respect to the treatment of cancellation of indebtedness income than the one taken in Notice 2003–65, with the consequence that the amount of cancellation of indebtedness income arising in a post-change period that will be considered RBIG will be significantly less for many taxpayers for several reasons. First, the elimination of the § 338 wasting asset methodology is likely to substantially decrease the ability to categorically treat post-ownership change cancellation of indebtedness income as RBIG. In this regard, under the § 338 wasting asset methodology set forth in Notice 2003–65, cancellation of indebtedness income attributable to indebtedness that existed as of the ownership change date was automatically treated as an item of income under the RBIG rules as long as the cancellation of indebtedness income arising in the post-change period did not exceed the difference between the adjusted issue price of the debt obligation and its fair market value as of the ownership change date. The import of this approach was that the § 338 wasting asset methodology represented a favorable means to outright classify cancellation of indebtedness income arising in the post-change period as RBIG. With the elimination of the § 338 wasting asset methodology, this opportunity is eliminated.

Second, the Proposed Regulations modify the treatment of cancellation of indebtedness income in the context of the § 1374 approach in significant ways as well. Under the § 1374 “safe harbor” in Notice 2003–65, the amount of cancellation indebtedness income recognized in the first 12 months of the recognition period was included an RBIG, and this treatment extended to cancellation of indebtedness income that was excluded from income by reason of an exception under § 108 where the taxpayer reduced tax basis in assets under § 1017(a). In contrast, under the Proposed Regulations, the cancellation of indebtedness income recognized during the post-change period generally would not be treated as RBIG except in certain limited situations where cancellation of indebtedness income arises within the first 12 months of the five-year recognition period and either of the following is true: (i) the debt is recourse debt that creates taxable cancellation of indebtedness income or creates excluded cancellation of indebtedness income but in the latter situation only to the extent that the excluded cancellation of indebtedness income resulted in a reduction of attributes that are not attributable to pre-change losses, including reduction of basis of the loss corporation’s assets only of assets that were not held at the time of the ownership change or (ii) the debt is nonrecourse debt that gives rise to taxable cancellation of indebtedness income or results in excluded cancellation of indebtedness income but in the latter situation only to the extent that the excluded cancellation of indebtedness income resulted in a reduction of attributes that are not attributable to pre-change losses, including reduction in the basis of assets only when the loss corporation did not own those assets immediately before the ownership change. See Prop.Reg. § 1.382–7(d)(2)(iii) and (iv).

Even in these limited situations, the amount of RBIG that can arise from these provisions is capped. In the context of recourse liabilities, the RBIG related to the recourse debt cannot exceed the amount of the excess recourse liabilities that existed at the time of the ownership change. Prop.Reg. § 1.382-7(c)(3)(iii)(C) (2019). Excess liabilities mean the amount discharged in a bankruptcy proceeding or the amount of the loss corporation's insolvency at the time of the ownership change. See Prop.Reg. § 1.382-7(b)(8) (2019). In the context of nonrecourse debt, the RBIG related to the nonrecourse debt cannot exceed the amount by which the adjusted issue price of the nonrecourse debt exceeds the fair market value of the property securing the debt immediately before the ownership change. Prop.Reg. § 1.382-7(d)(2)(iv)(C).

Although cancellation of indebtedness income is included as an RBIG only if it arises within the first 12 months of the recognition period, the Proposed Regulations treat bad debt deductions, to the extent attributed bad debts existing on the ownership change date create RBILs if recognized at any time during the five-year recognition period. See Prop.Reg. § 1.382-7(d)(3)(iv). It is unclear to the authors why the government does not provide a symmetrical five-year time period for determining whether cancellation of indebtedness income creates RBIG as it provides for purposes of determining whether, in the reverse situation, a bad debt deduction creates an RBIL.

Another issue in terms of applying the § 382 limitation involves the treatment of contingent liabilities. Under Notice 2003-65, the estimated value of contingent liabilities as of the ownership change date were included in the calculation of NUBIG and NUBIL but the payment of such liabilities did not give rise to an RBIL regardless of when the contingent liability accrued in the post-ownership change period. This was a decidedly pro-taxpayer approach. In contrast to the approach taken in Notice 2003-65, the Proposed Regulations treat the payment of a contingent liability during the five-year recognition period as an RBIL if the contingent liability existed as of the ownership change date, but then only to the extent of the estimated value of that contingent liability as of the ownership change date. See Prop.Reg. § 1.382-7(d)(3)(v). If the loss corporation is subject to an acquisition where purchase accounting is utilized for financial statement purposes and contingent liabilities are valued in those records, then the approach taken in the Proposed Regulations is readily administrable. However, if the loss corporation experiences an ownership change and financial statement records are not prepared as of the ownership change date to determine the contingent liabilities known at that date, then the approach taken in the Proposed Regulations with respect to the treatment of contingent liabilities creates significant administrative burdens as it will be difficult to retroactively identify and value contingent liabilities as of the date of the ownership change date.

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**Page 889:**

**After the carryover first paragraph, add the following new section:**

*3.5 Disallowed Interest Expense*

In 2017, Congress added § 382(d)(3) to make clear that a taxpayer's pre-ownership change loss includes any carryover of disallowed interest expense described in § 163(j)(2). Thus, this carryover is subject to the § 382(b) limitations along with any net operating loss that arises in the pre-ownership change period. I.R.C. § 382(d)(1) and (3). The preamble to the Proposed Regulations, 84, Fed. Reg. at 47,465, notes that disallowed interest under § 163(j) could fall within the definition of an RBIL under § 382(h)(6), thereby causing such items to be counted twice for the purpose of § 382. To prevent this result, Prop.Reg. § 1.382-7(d)(3)(vi) provides that the use of § 163(j) carryovers during the recognition period does not give rise to an RBIL.

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PART V

SPECIAL RULES TO PREVENT  
AVOIDANCE OF SHAREHOLDER  
LEVEL TAX

CHAPTER 14

PENALTY TAXES

**SECTION 1. THE ACCUMULATED EARNINGS TAX**

**DETAILED ANALYSIS 2.4 PROVISION FOR CONTINGENCIES**

**Page 906**

**After the first full paragraph, add the following new paragraph:**

The docketed Tax Court case of *Alta Peruvian Lodge Ltd. v. Commissioner*, Docket No. 022821-21 (Tax Court, filed Sept. 15, 2021; trial date set for Oct. 11, 2022) further highlights the subjective nature of the interaction of perceived business contingencies and liability for the penalty tax. In this case, the IRS assessed an accumulated earnings tax on \$2.5 million of a ski lodge's retained earnings as of the tax period ending April 30, 2019. The tax, as described in § 531, is a 20% penalty imposed by the IRS when a corporation retains profits

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beyond what it reasonably needs for its business operations. In its petition, Alta Peruvian Lodge Ltd. claims that it needs a large retained earnings reserve to manage fluctuations in revenue caused by such things as erratic weather, pandemics, and competition from other hotels. The taxpayer further asserted that its retention of a significant amount of retained earnings was justified because reservation numbers for its rooms fluctuate and are subject to factors beyond its control. According to the taxpayer, the cyclical nature of its business is further evidenced by the fact that substantially all of the ski lodge's revenue is earned between the months of November and April from customers who reserve rooms at the lodge for skiing.

PART 7

# ELECTIVE PASSTHROUGH TAX TREATMENT

## CHAPTER 16

## S CORPORATIONS

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

#### A. PASSTHROUGH OF INCOME AND LOSS

#### DETAILED ANALYSIS 5. LIMITATION ON BUSINESS INTEREST

**Page 1002:**

**Replace the last sentence immediately following the block quotation in the first full paragraph with the following insert:**

Final Regulations incorporate this approach, and those Regulations, along with further Proposed Regulations issued in that same year, expand on the manner of application of § 163(j) to S corporations. Treas.Reg. § 1.163-6; Prop.Reg. § 1.163(j)-6, REG-107911-18, 85 Fed. Reg. 56,846 (Sept. 14, 2020); see also T.D. 9943, 86 Fed. Reg. 5496 (Jan. 19, 2021).

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**Replace the last sentence of Detailed Analysis 5 at the bottom of page 1002 and carrying over to page 1003 with the following:**

The Regulations apply to S corporations the same carryover rules applicable to a C corporation that is not a member of a consolidated group. Treas.Reg. § 1.163(j)-6(d)(5).

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PART VIII

TAXATION OF PARTNERS AND  
PARTNERSHIPS

CHAPTER 17

INTRODUCTION TO PARTNERSHIP  
TAXATION

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**SECTION 3. ANTI-ABUSE REGULATIONS**

**Page 1086:**

**Add to the end of the third sentence of the first complete paragraph:**

In *Tribune Media Company v. Commissioner*, T.C. Memo. 2021-122, the court interpreted the “business purpose” language of Treas.Reg. § 1.701-2(a) as a “broad provision applying to the function of the partnership as a whole. It is not intended to apply to every agreement into which the partnership or its partners enter. That level of minutiae was not contemplated by the general anti-abuse rule.” In that case, the IRS argued that a guaranty of a nonrecourse debt lacked a substantial business purpose and was instead motivated by tax considerations.

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## CHAPTER 18

# TAXATION OF PARTNERSHIP TAXABLE INCOME TO THE PARTNERS

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### SECTION 1. PASS-THROUGH OF PARTNERSHIP INCOME AND LOSS

#### Page 1101:

#### Delete the final sentence of Detailed Analysis 2.3 and insert:

This new rule and recently finalized Regulations are discussed primarily in Chapters 4 and 8.

#### Pages 1105–1107:

#### Substitute the below for the material contained in Detailed Analysis 4.2.2:

Section 163(j) contains specific rules for partnerships, and Regulations finalized in 2020 and 2021 provide additional guidance. Application of the § 163(j) limitation to a partnership’s business interest expense is determined at the partnership level. In some situations, this will be simpler than applying the limitation at the partner level. For example, the final Regulations clarified that if a partnership qualifies for the “small business” exemption of § 163(j)(3), then the partnership’s business interest expense is not limited and is not re-tested under § 163(j) at the partner level. Treas.Reg. § 1.163(j)–6(m)(1) & (o)(11), Ex. 11.

If the partnership does not qualify as a small business (or for any other exception), the partnership applies the limitation provided in § 163(j)(1) to determine the amount of the deductible business interest expense, which will be treated as a nonseparately stated item. Treas.Reg. § 1.163(j)–6(a). It will, of course, be rare that the partnership’s business interest expense precisely matches the sum of 30% of the partnership’s adjusted taxable income plus its business interest income. As the preamble to the final regulations emphasized, the partnership may have either, but not both in the same taxable year, (1) excess business interest expense or (2) excess taxable income and/or excess business interest income. T.D. 9905, 2020–40 I.R.B. 614. For example, if a partnership has \$0 business interest income, \$150x of adjusted taxable income, and

\$30x of business interest expense, there will be \$50x of “excess taxable income,” because 30% of \$100x adjusted taxable income will allow deduction of the \$30x of business interest expense, leaving \$50x adjusted taxable income as “excess taxable income,” up to 30% of which could be used to permit deduction of a partner’s business interest expenses from another business (e.g., a sole proprietorship). There is, however, no carryforward of excess taxable income or excess business interest income.

If a partnership lacks sufficient adjusted taxable income and business interest income, then there will be “excess business interest expense.” Instead of being carried forward at the partnership level, excess business interest expense is allocated among the partners, and the allocation will reduce a partner’s basis in the partnership interest, but not below zero. I.R.C. § 163(j)(4)(B)(iii). Even though an allocation of excess business interest expense reduces basis, it is not treated as paid or accrued until the partner is allocated a share of excess adjusted taxable income. At that point, the *partner* is treated as paying a portion of the carried over excess business interest expense equal to the amount of excess taxable income allocated to that partner. I.R.C. § 163(j)(4)(B)(ii). This does not necessarily mean the carried forward excess business interest expense is deductible; instead, the carryforward is treated as paid and thereby becomes subject to the § 163(j) limitation, determined at the partner level for that year. For example, if a partner has a \$30x excess business interest expense from a prior year and is allocated \$50x of excess taxable income in the current year, all \$30x excess business interest expense is treated as *paid*, but if the partner’s only source of adjusted taxable income is the \$50x of excess taxable income and the partner has no business interest income, then only \$15x of the \$30x excess business interest expense will be deductible (30% of \$50x); the remaining portion would be carried forward again. Treas.Reg. § 1.163(j)–6(o)(2), (7) & (8), Exs. 2, 7–8.

If a partner is allocated excess business interest expense but has insufficient basis, the final Regulations clarify that the allocation is treated as a § 704(d) suspended loss (discussed in Section 2 of this Chapter) and is labelled as a “negative § 163(j) expense.” Treas.Reg. § 1.163–6(h). Once the negative § 163(j) amount is no longer suspended (by operation of the general rules applicable to § 704(d) suspended losses), it becomes excess business interest expense, reduces basis (again not below zero), and is treated as paid only to the extent the partner is allocated excess taxable income. Treas.Reg. § 1.163(j)–6(h)(2) & (o)(7)–(8), Exs. 7–8.

If the partner has been allocated excess business interest expense that reduced basis and then sells all or part of the partner’s partnership interest before that excess business interest expense is treated as paid, the final Regulations provide that a proportionate share (by relative fair market value) of the excess business interest expense is added to the basis of the sold interest (and removed from the remaining

excess business interest expense associated with the retained partnership interest). If a partner's interest is completely terminated through liquidation, this is also treated as a disposition of the interest for purposes of this rule. The basis increase is in lieu of deducting the implicated portion of excess business interest expense. Treas.Reg. § 1.163(j)–6(h)(3) & (o)(9)–(10), Exs. 9–10. Note that this basis increase at disposition is not available with respect to suspended, negative § 163(j) expense because that portion would not yet have reduced basis in the partnership interest.

If there is excess business interest income or excess taxable income, these items are allocated to the partners and are used to compute a partner's § 163(j) limitation with respect to business interest expense at the partner level (which, as previously noted, may include excess business interest expense from a prior year treated as paid by the partner because of the allocation of excess taxable income).

These rules require an allocation of the (1) excess business interest expense or (2) excess taxable income and/or excess business interest income. The final Regulations adopted a complex, 11-step process for assigning these items. This lengthy process is not required if a partnership makes use of pro rata allocations. The preamble explains such a process is necessary because “the 11-step calculation preserves the entity-level calculation required in section 163(j)(4) while also preserving the economics of the partnership, including respecting any special allocations made in accordance with section 704 and the regulations . . . . Stated otherwise, the allocations of section 163(j) excess items prescribed by the 11-step calculation attempt to reflect the aggregate nature of partnerships under subchapter K of the Code while remaining consistent with the application of section 163(j) at the partnership level.” T.D. 9905. See Treas.Reg. § 1.163(j)–6(o)(17) through (o)(22), Ex. 17–22.

Because a partner may have a business separate from the partnership (e.g., a sole proprietorship), rules are also required to prevent a partner from using a partnership's taxable income twice—once when the partnership determines the limitation for its business and once when the partner determines the § 163(j) limitation as to any other businesses the partner may have. In applying § 163(j) at the individual partner level, the statute provides that a partner must initially disregard all of the partner's partnership tax items and then add back in the partner's share, if any of the partnership's excess taxable income. I.R.C. § 163(j)(4)(A). The final Regulations make clear that this is the same “excess taxable income” allocated in the 11-step process. See Treas.Reg. § 1.163(j)–6(o)(1) through (o)(8) & (o)(17) through (o)(22), Exs. 1–8 & 17–22.

The Regulations contain many additional rules. For example, a special rule applies if a partner lends to the partnership; that rule deems excess business interest income to the lending partner determined with reference to the lesser of the lending partner's

interest from the loan or the partner's excess business interest expense. Treas.Reg. § 1.163(j)–6(n). The final Regulations also contain rules for how to handle interest that would be treated as investment interest by certain partners (e.g., non-materially participating partners in certain trading partnerships) and how to handle interest allocated to a “C” corporation partner, as such interest is deemed to be business interest. Treas.Reg. §§ 1.163(j)–4(b)(3), –6(c). Regulations proposed in September 2020 contain additional rules for determining how to assign interest paid by a partnership among its businesses and investments. Prop.Reg. § 1.163–14, 85 Fed. Reg. 56,846 (Sept. 14, 2020). Suffice it to say, the complexity added by the § 163(j) limitation on deductibility of business interest is high.

**Page 1107:**

**Delete Detailed Analysis 4.2.3** [CARES Act Modifications to § 163(j) have not been extended past 2020.]

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## CHAPTER 19

# FORMATION OF THE PARTNERSHIP

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### SECTION 3. CONTRIBUTION OF PROPERTY VERSUS CONTRIBUTION OF SERVICES

**Page 1154:**

**Substitute the following for the last sentence of the carryover paragraph from page 1153:**

Section 1061 is discussed in greater detail in Chapter 4 (for its application to distributive share allocations) and in Chapter 8 (for its application to partnership interest dispositions).

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## CHAPTER 20

# DETERMINING PARTNERS' DISTRIBUTIVE SHARES

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### SECTION 2. THE SECTION 704(b) REGULATIONS

#### A. ALLOCATIONS OF ITEMS UNRELATED TO NONRECOURSE DEBT

##### (2) SUBSTANTIALITY

**Page 1221–1222:**

**Replace the material in Detailed Analysis 4 with the following:**

Section 1061, added in 2017, applicable to the exchange of services for a profits interest in certain investment-focused partnerships such as private equity partnerships, requires that the service partner treat as short-term capital gain the excess (if any) of the partner's net long-term capital "with respect to the interest" calculated using the general § 1222 rules over the partner's net long-term capital gain computed as though § 1222 said "3 years" instead of "1 year."

Regulations finalized in January 2021 clarify that § 1061 may affect not only the character of gain on the disposition of a partnership interest but also the character of distributive share allocations of capital gain. The Regulations apply only to long-term capital gain triggered through application of § 1222 and not, for example, to gain treated as long-term capital gain through § 1231 or any other provision. Treas.Reg. § 1.1061-4(b)(7). The relevant holding period is determined by looking at the direct owner of the asset, except that a special rule applies to prevent using distributions by a partnership to circumvent this rule. Treas.Reg. §§ 1.1061-1(a), -4(b)(8), (c)(1)(ii). Thus, for example, if a partnership is subject to § 1061, holds a capital asset for 2 years, and sells the asset at a gain, the distributive share allocation of that capital gain to a partner subject to § 1061 would be subject to the recharacterization rule of § 1061, even if the partner had held the partner's partnership interest for more than 3 years. The same result would apply if the partnership distributed the capital asset and the partner sold it at a gain shortly after the distribution. Treas.Reg. § 1.1061-4(c)(1)(i) through (ii), Exs. 1–2.

The Regulations contain rules providing that allocations made with respect to contributed capital are not subject to recharacterization if the allocation “is determined and calculated in a similar manner as the allocations with respect to capital interests held by similarly situated “Unrelated Non-Service Partners” who have made significant aggregate capital contributions.” Treas.Reg. § 1.1061–3(c)(3). “Significant” contributions by such unrelated non-service partners require that they own at least 5% or more of the aggregate capital contributed to the partnership when the allocations are made. *Id.* “Related Person” means a person or entity treated as related through § 707(b) or § 267(b), and an “Unrelated Non-Service Partner” means partners who do not provide services to the partnership and who are not related to *any* person who provides services to the partnership or to any holder of an applicable partnership interest. Treas.Reg. § 1.1061–1(a)(ii).

The Regulations specify that the analysis includes not simply looking to allocations but also to distribution rights, and they contain a list of factors that are relevant in determining whether the “allocation and distribution rights with respect to capital contributed . . . are reasonably consistent with allocation and distribution rights” of the unrelated non-service partners. Treas.Reg. § 1.1061–3(c)(3). The Regulations allow capital contributions through reinvestment but limit the extent to which a partner will be treated as making a capital contribution when using borrowed funds. *Id.*

Special allocations intended to reduce the impact of § 1061 will require careful evaluation under the substantiality requirement.

## B. ALLOCATIONS ATTRIBUTABLE TO NONRECOURSE DEBT

**Page 1230:**

**Substitute the following for the text of the first sentence of the second full paragraph (keep footnote 8):**

If a partnership’s depreciation is funded solely through nonrecourse debt (e.g., the partnership owns one depreciable asset purchased solely with nonrecourse debt and no equity), then a special allocation of depreciation alone, with all other items of the partnership being allocated according to a different consistent fraction, will not meet the regulatory safe harbor.

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## CHAPTER 21

# ALLOCATION OF PARTNERSHIP LIABILITIES

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**Page 1275:**

**Add to the end of the second full paragraph:**

It is important to remember that general principles may be invoked to recharacterize debt as equity, thereby taking a transaction outside of § 752's purview. See *Tribune Media Company v. Commissioner*, T.C. Memo. 2021-122 (using 13-factor test to determine that subordinated financing was equity, not debt, and thus did not increase a partner's allocable share of recourse debt).

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## SECTION 2. ALLOCATION OF NONRECOURSE DEBT

**Pages 1299–1300:**

**Delete the second full paragraph on page 1299 through the first table on page 1300 and insert:**

First, pursuant to § 704(c) and Treas.Reg. § 1.704-3, D would be allocated \$1,500 of the \$4,500 of taxable gain (the excess of tax gain over book gain). Second, because under Treas.Reg. § 1.704-2(d)(3) partnership minimum gain is computed with reference to the excess of the nonrecourse debt over book value, the amount of the partnership's minimum gain is \$3,000. That gain would be allocated between the partners in the ratio they claimed the nonrecourse depreciation deductions, which are also determined with reference to the excess of nonrecourse debt over book value—\$1,000 to each of D, E, and F. (That is, each partner's allocation of \$1,500 of book depreciation included \$1,000 of nonrecourse deductions; the *tax* allocation required by § 704(c) of \$1,500 to E and F are not relevant to the first component.) Thus, under the first component of the formula in Treas.Reg. § 1.752-3, \$1,000 of the nonrecourse debt is allocated to each of D, E, and F. Under the second component of the formula, \$1,500 is allocated to D (notice that this component is tied to "taxable gain" allocated under § 704(c) on a disposition of the property). And under the third component of the formula, the remaining \$3,000 of

the debt is allocated equally among the partners, \$1,000 to each. D's total share of the indebtedness is \$3,500, and the total share of each of E and F is \$2,000. As a result, even though the individual components of each partner's share of the debt shifted, none of the partners experienced an overall change in debt share (that is, D's debt share remained \$3,500, while E and F's share each remained \$2,000). At the end of the year, the partnership balance sheet would be as follows:

	Assets		Indebtedness and Partners' Capital Accounts		
	Book	Tax Basis		Book	Tax Basis
Cash	\$3,000	\$3,000	Debt	\$7,500	
Property	\$4,500	\$3,000	D	\$ 0	\$2,000
			E	\$ 0	\$2,000
			F	<u>\$ 0</u>	<u>\$2,000</u>
	<u>\$7,500</u>	<u>\$6,000</u>		<u>\$7,500</u>	<u>\$6,000</u>

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## CHAPTER 22

# TRANSACTIONS BETWEEN PARTNERS AND THE PARTNERSHIP

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### SECTION 2. SALES OF PROPERTY

**Page 1343:**

**After the end of the first full paragraph on page 1343 before *Detailed Analysis 3.3.3*, add:**

Treas.Reg. § 1.707–5 may trigger a disguised sale not only when a partnership assumes the debt of a contributing partner but also when the partnership incurs new debt following a contribution. Treas.Reg. § 1.707–5(b) provides, however, that if the new debt is used to fund a transfer to the contributing partner within 90 days of the partnership incurring the debt, then the transfer is treated as part of a disguised sale only to the extent the amount of the transfer exceeds the contributing partner’s allocable share of the new partnership debt.

In *Tribune Media Company v. Commissioner*, T.C. Memo. 2021-122, the Chicago Tribune and its affiliates (Tribune) attempted, with partial success, to use this “debt-financed distribution exception” to reduce tax gain on the sale of the Chicago Cubs. Tribune contributed the Cubs to a newly formed LLC in a § 721 transaction; cash contributions to the new LLC were made at the same time by the buyer, a trust controlled by the Ricketts family. On the same date, the LLC borrowed money through two different arrangements and distributed the proceeds to Tribune. One financing arrangement was through commercial banks—the “Senior Debt.” Tribune guaranteed the Senior Debt and argued this guaranty made the debt recourse with respect to Tribune, thereby increasing its basis and reducing the portion of the cash transfer that would be characterized as a disguised sale. The IRS argued that the guaranty was invalid under the Regulations, including both the § 752 Regulations and the general anti-abuse partnership Regulations, as well as under general substance-over-form principles. The Tax Court held for the Tribune as to this issue. (The LLC formation took place in 2009, so recent amendments strengthening the anti-abuse rules of the § 752 Regulations were not addressed by the Tax Court, but given the Tax Court’s view that Tribune had the financial wherewithal to make good on the guaranty (notwithstanding that

Tribune was in bankruptcy proceedings) and its finding that there were no other guarantees or indemnification agreements, it seems likely the outcome would have been the same under the current § 752 Regulations.)

The second “loan” arrangement was financed by entities affiliated with the Ricketts family and was subordinated to the Senior Debt. The IRS argued that this arrangement constituted equity, instead of a loan, and thus could not give rise to additional recourse debt share for the Tribune and would increase the amount of gain on the disguised sale. The IRS prevailed on this argument with the Tax Court applying a 13-factor test to determine that the arrangement constituted equity. The Tax Court emphasized that the enforcement rights were meaningless and that only through treating the arrangement as equity would the equity ownership percentages match the operating agreement percentages. The Tax Court also noted the relatedness of the Ricketts family entities as well as the failed attempts to market the subordinated debt to other parties, including through offering owner-type privileges such as box seats and priority parking.

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## CHAPTER 24

# SALES OF PARTNERSHIP INTERESTS BY PARTNERS

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### SECTION 1. THE SELLER'S SIDE OF THE TRANSACTION

#### B. CAPITAL GAIN VERSUS ORDINARY INCOME: SECTION 751

##### **Page 1407:**

**Substitute the following for the last two sentences of the carryover paragraph from page 1406 and the first sentence of the first full paragraph on page 1407:**

Final Regulations provide that the term “corporation” for purposes of § 1061(c)(4)(A) does not include “S” corporations or any pass-through entity. Treas.Reg. § 1.1061–3(b).

The statutory language of § 1061 seems to require recognition of short-term capital gain on the direct or indirect transfer of a covered interest to certain related parties. I.R.C. § 1061(d)(1). Regulations finalized in January 2021 define “transfer” to mean “a sale or exchange in which gain is recognized by the Owner Taxpayer,” thereby taking a narrow approach to the statute and not, for example, requiring acceleration of gain recognition on gratuitous transfers. Treas.Reg. § 1.1061–5(b).