

SUMMER 2023

STUDENT UPDATE MEMORANDUM

to

**FUNDAMENTALS OF BUSINESS
ENTERPRISE TAXATION**

Cases and Materials

Seventh Edition

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PREFACE

This Summer 2023 Student Update Memorandum brings *Fundamentals of Business Enterprise Taxation* up to date by summarizing major developments since publication of the Seventh Edition in December of 2019. It is organized to parallel the text, with cross references to chapter and topic headings and page numbers. The Memorandum covers developments through July 1, 2023, including selected provisions of the Inflation Reduction Act of 2022, Pub. L. No. 117-168, 136 Stat. 1818, and provides our annual bipartisan overview of pending legislative proposals with potential impact on business enterprise taxation and their prospects for enactment.

Instructors who have adopted the text for classroom use may provide electronic or paper copies of all or part of the Update Memorandum to their students.

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PART ONE: INTRODUCTION

CHAPTER 1. AN OVERVIEW OF BUSINESS ENTERPRISE TAXATION

B. BUSINESS ENTERPRISE TAXATION MODELS

3. INFLUENTIAL POLICIES

Page 9:

As noted in the text, the policies influencing the business enterprise taxation landscape have been in a periodic (some might say “constant”) state of flux as part of a highly politicized tax legislative process. Changes usually follow a shift in the balance of power, which occurred with the 2020 elections albeit with the narrowest of margins in Congress, but enactment of major tax legislation has become virtually impossible during periods of divided government.

During his first 100 days in office, President Biden opened the bidding on a sweeping list of tax proposals that were a major piece of a broader legislative package. <https://home.treasury.gov/policy-issues/tax-policy/revenue-proposals>. Key components of the initial Biden tax plan were: (1) an increase in the corporate income tax rate from 21 to 28 percent; (2) an increase in the top marginal individual income tax rate from 37 to 39.6 percent; (3) a 15 percent minimum tax on the book income of certain large corporations; (4) taxation of long-term capital gains and qualified dividends at ordinary income tax rates for taxpayers with adjusted gross income of more than \$1 million; (5) taxation of most carried (profits) interests in investment partnerships as ordinary income if the service partner’s taxable income from all sources exceeded \$400,000 and subjecting such income to self-employment tax; and (6) treatment of gifts and bequests of appreciated property as taxable events (with a \$1 million lifetime exclusion and an exemption for transfers to spouses). The plan also would have made major changes to the U.S. taxation of multinational businesses and increase the budget for IRS enforcement and tax administration.

A more targeted measure was designed to ensure that all income passing through to high-income taxpayers from partnerships, LLCs, and S corporations is subject to either the 3.8 percent tax on net investment income or the 3.8 percent Medicare component of self-employment tax. Among other things, this proposal would have closed gaps under current law that allow S corporation shareholders, limited partners, and members of LLCs who are active in the corporation’s business to avoid self-employment tax on their allocable share of the company’s business income (see casebook, pp. 1036-1042). The administration also proposed to tax income allocated to managers of certain types of investment partnerships from what are known as “carried interests” as ordinary income rather than long-term

capital gain and subject such income to self-employment tax if the service partner's taxable income from all sources exceeds \$400,000.

In the Summer 2021 update we said:

If the Democratic members of Congress remain united (not a sure thing), many of these proposals could be enacted and take effect for taxable years beginning in 2022. Depending on the ultimate outcome, this legislative package potentially will influence future decisions on choice of entity for a business enterprise and change the tax stakes for many transactions involving business entities and their owners.

As the process played out, Senate Democrats were not united, with Senator Kirsten Sinema of Arizona (who later changed her party affiliation to "Independent") opposing the tax rate increases and Senator Joe Manchin of West Virginia objecting to the overall cost of the broader legislative package. In November 2021, a diluted version of the Biden administration's proposals narrowly passed the House as part of the Build Back Better Act (H.R. 5376). This wide-ranging legislation abandoned the corporate and individual tax rate increases and pivoted to alternative measures, such as a surcharge on high-income individuals and a corporate-level excise tax on stock buybacks. Amidst continuing political gridlock, however, the Build Back Better Act stalled and then died in the Senate.

Undaunted, President Biden in his fiscal year 2023 revenue proposals resurrected the corporate and individual tax rate increases, floated a minimum income tax on taxpayers with a net worth of more than \$100 million, refined the international tax reforms, and included a list of loophole closers many of which dated back to the Obama administration. See General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals, Dept. of the Treasury, March 2022, available at <https://home.treasury.gov/system/files/131/General-Explanations-FY2023.pdf>. After prolonged negotiations to round up sufficient support in the Senate, a reworked version of the Build Back Better Act – known as the Inflation Reduction Act of 2022 – passed by the narrowest of margins and became law in August 2022. The major substantive business tax provisions were: (1) a selective 15 percent corporate minimum tax, (2) a new one percent excise tax on stock repurchases by certain publicly traded companies, and (3) a two-year extension of the Section 461(l) limitation on excess business losses. The Inflation Reduction Act also included provisions to increase funding for IRS enforcement, extend and expand various clean energy tax credits, and boost subsidies under the Affordable Care Act (a/k/a Obamacare).

As this Update Memorandum is being completed in early July 2023, the prospects for enactment of any significant tax legislation during the months leading up to the 2024 Presidential election are slim to none. This forecast has not halted the issuance of competing wish lists from the Biden administration and House Republicans. In his fiscal year 2024 budget message, President Biden continued to advocate for corporate and individual tax increases, a new minimum tax on certain wealthy taxpayers, closing of familiar loopholes, and expansion of credits for lower income workers and families. See General Explanations of the Administration's Fiscal Year 2024 Revenue Proposals, Dept. of

the Treasury, March 9, 2023, available at <https://home.treasury.gov/system/files/131/General-Explanations-FY2024.pdf>. In June 2023, the House Ways and Means Committee sharpened the debate by approving a set of mostly pro-business measures consolidated into a bill branded as the American Families and Jobs Act. Among other things, the Republican tax package would halt the phase-out of 100 percent expensing under Section 168(k), suspend a controversial provision requiring amortization of research and experimentation expenses, relax the limitation on deduction of business interest, expand the exclusion from gain for sales of Section 1202 qualified business stock, pare back clean energy tax incentives, and temporarily increase the individual standard deduction (to be renamed the “guaranteed deduction”) with a phase-out for higher-income taxpayers. The proposal to restore full expensing of R & E expenditures has substantial bipartisan support but only a slight chance of enactment unless the two sides agree to attach it to another bill, which would require including an item high up on the Democrats’ wish list, such as expansion of the child tax credit.

As usual, the results of the 2024 Presidential and congressional elections will have an enormous influence on the direction of future tax legislation. Significantly, the individual tax rate reductions and many pro-business provisions from the 2017 Tax Cuts and Jobs Act (except for the “permanent” reduction of the corporate income tax rate) were only temporary and are set to expire at the end of 2025 unless they are extended or made permanent. Some of the controversial revenue raisers in the 2017 legislation, such as the limit on deducting state and local taxes and the flat ban on deducting miscellaneous itemized deductions, also will expire, restoring the law as it was prior to 2018. So something will happen in 2025 even if Congress does nothing while watching the late December sunset. Its inaction (unlikely) will have economic consequences and implications for individual and business tax planning. Our only predictions are that the debate will be contentious and, unless one political party has a landslide victory in 2024, the outcome will go down to the wire.

Page 12:

The International Dimension: A Global Minimum Tax. Erosion of the corporate income tax base is a concern not only for the U.S. but also for countries around the world. In response, more than 130 countries, including the United States, recently agreed to implement major international tax changes, including a global minimum tax. OECD, Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy (Oct. 2021). These international agreements have the potential to fundamentally alter the tax rules applicable to multinational companies. Additional details are (far) beyond the scope of a text focused on the domestic tax rules applicable to corporations and their shareholders. Nevertheless, these international tax developments may provide useful background because they could ultimately affect the behavior of corporations that operate in the U.S. and lead to changes to U.S. tax laws applicable to corporations.

C. INTRODUCTION TO CHOICE OF BUSINESS ENTITY

Page 23:

Employment Tax Considerations. The wage basis for Social Security and self-employment tax was raised to \$160,200 for 2023.

Recent comments from practitioners and IRS officials confirm an increased level of scrutiny of limited partners and LLC members claiming the exemption from self-employment tax. The Service appears to be focusing on the extent of the services provided by the limited partner or LLC member on behalf of the entity, consistent with the standards articulated in the 1997 proposed regulations.

PART TWO: PARTNERSHIPS

CHAPTER 2. FORMATION OF A PARTNERSHIP

A. CONTRIBUTIONS OF PROPERTY

2. INTRODUCTION TO PARTNERSHIP ACCOUNTING

Page 63:

In the balance sheet in the text, Partner B's basis and book capital account should each be \$48,000, not \$96,000.

CHAPTER 3. OPERATIONS OF A PARTNERSHIP: GENERAL RULES

B. TAX CONSEQUENCES TO THE PARTNERS

2. DEDUCTION FOR QUALIFIED BUSINESS INCOME

Page 104:

In the first full paragraph, seventh line from the bottom, the reference to the inflation adjustment for married taxpayers filing jointly should be to the year 2019, not 2010. The threshold amounts for 2023 are \$182,100 for single taxpayers and \$364,200 for married taxpayers filing jointly.

C. LIMITATIONS ON PARTNERSHIP LOSSES

4. LIMITATION ON EXCESS BUSINESS LOSSES

Page 124:

The Coronavirus Aid, Relief, and Economic Security ("CARES") Act delayed application of the Section 461(l) limitation on excess business losses of noncorporate taxpayers until years after 2020. The American Rescue Plan Act of 2021 extended the provision through 2026, and the Inflation Reduction Act of 2022 further extended it through 2028. For 2023, the indexed thresholds in Section 461(l)(3) are \$289,000 for single taxpayers and \$578,000 for a married couple filing a joint return.

CHAPTER 4. PARTNERSHIP ALLOCATIONS: SECTION 704(b)

B. SPECIAL ALLOCATIONS UNDER SECTION 704(b)

2. THE SECTION 704(b) REGULATIONS: BASIC RULES

c. ECONOMIC EFFECT

Page 144:

Deficit Restoration Obligations. The text describes instances in which a deficit restoration obligation will not be respected for purposes of the alternate test for economic effect pursuant to proposed regulations issued in 2016. Final regulations issued in 2019 largely adopt the approach of the proposed regulations. See T.D. 9874 (Sept. 13, 2019) (promulgating Reg. § 1.704-1(b)(2)(ii)(c)(4)).

d. SUBSTANTIALITY

Page 153:

Transitory Allocations. In the second full paragraph, the illustration of a transitory allocation assumes that Partner A has an expiring net operating loss from activities unrelated to the partnership. Since NOL carryforwards no longer expire (until an individual partner dies), the illustration should be changed to assume that at the beginning of year one Partner A knows he will incur a significant deductible expense in a business activity unrelated to the partnership. To help A enjoy the tax benefit from the deduction as soon as possible, the partners agree to allocate partnership income as described in the illustration.

e. DEFAULT REALLOCATIONS: THE PARTNERS' INTEREST IN THE PARTNERSHIP

Page 155, footnote 98:

For a case illustrating the difficulty in determining the partners' interests in the partnership in the context of a failed attempt to comply with the alternate test for economic effect, see *Clark Raymond & Co. v. Commissioner*, T.C. Memo. 2022-105, 124 T.C.M. (CCH) 246.

CHAPTER 5. PARTNERSHIP ALLOCATIONS: INCOME-SHIFTING SAFEGUARDS

A. ALLOCATIONS WITH RESPECT TO CONTRIBUTED PROPERTY

3. DEPRECIATION OF CONTRIBUTED PROPERTY

Page 191:

Allocation of Depreciation under the Remedial Method: Effect of Section 168(k). In the discussion of the allocation of depreciation deductions under the remedial method, the text notes that the excess book basis may be depreciated using any applicable recovery period available to the partnership for newly acquired property. That is correct. However, the text goes on to suggest that the excess book basis therefore may be subject to 100 percent bonus depreciation under Section 168(k). That interpretation proved too ambitious and is incorrect.

Final regulations issued under Section 168(k) issued in 2019 adopt the position of proposed regulations issued in 2018 that remedial allocations under Section 704(c) do not qualify for the additional first year depreciation deduction. See Reg. § 1.168(k)-2(b)(3)(iv)(A); Reg. § 1.704-3(d)(2). The preamble to the final regulations explains that, because the property was contributed to the partnership in a nonrecognition transaction under Section 721 and has a basis determined by reference to the transferor's basis in property, the requirement of Section 168(k)(2)(E)(ii)(II) is not satisfied (due to a failure to satisfy Section 179(d)(2)(C)). Furthermore, because the use of the property did not originate with the partnership, the property fails the "original use" requirement of Section 168(k)(2)(A)(ii). See T.D. 9874, at p. 28 (Sept. 13, 2019).

Note that the 100 percent "applicable percentage" of the additional depreciation allowance provided by Section 168(k) ended with property placed in service prior to 2023. Pursuant to Section 168(k)(3)(A), the applicable percentage is reduced to 80 percent for property placed into service before 2024, with 20 percent reductions following in each year thereafter until the provision phases out completely for property placed in service after 2027.

CHAPTER 6. PARTNERSHIP LIABILITIES

B. RECOURSE LIABILITIES

Page 210:

Final Regulations. Final regulations issued in 2019 further restrict the general presumption that recourse liabilities will be satisfied by the partners regardless of their net worth. In addition to an exception for instances in which the facts and circumstances relating to a liability indicate a plan to circumvent or avoid the obligation, the final regulations provide an exception based on the reasonableness of the prospect of repayment. Specifically, the presumption that the liability will be satisfied by the partners does not apply if there is not a reasonable expectation that the obligor will have the ability to make the required payments if the obligation were to become due and payable. Reg. § 1.752-2(b)(6)(ii). In making this determination, the facts and circumstances to be considered are those that a third-party creditor would take into account in determining whether to extend a loan. Reg. § 1.752-2(k)(1). This effective creditworthiness inquiry substantially alters the baseline presumption that partners will satisfy their obligations regardless of net worth – rendering planning for liability allocations under Section 752 less certain but, perhaps, more accurate.

Page 215:

Bottom Dollar Payment Obligations. As described in the text, the Service issued temporary regulations in 2016 defining the scope of “bottom dollar payment obligations” that will not be respected as recourse obligations for purposes of Section 752. The Service largely adopted the temporary regulations through the issuance of final regulations in 2019. See T.D. 9877 (Oct. 9, 2019). In the process, the Service clarified the approach of this regime to obligations to make a capital contribution or to restore a deficit balance in a partner’s capital account. Any such obligation other than one in which the partner is or would be required to (a) make the full amount of the partner’s capital contribution or (b) restore the full amount of the partner’s deficit capital account balance falls within the scope of a bottom dollar payment obligation for this purpose. Reg. § 1.752-2(b)(3)(ii)(C)(1)(iii).

Page 217:

Anti-Abuse Rule. The text describes how proposed regulations issued in 2016 articulated a non-exhaustive list of seven factors that may indicate a plan to circumvent or avoid a payment obligation, a standard which permits the Service to disregard the payment obligation under the anti-abuse rule. The Service formalized this approach through the issuance of final regulations under Section 752 in 2019. See T.D. 9877 (Oct. 9, 2019) (promulgating Reg. § 1.752-2(j)(3)(ii)(A)-(G)).

CHAPTER 7. COMPENSATING THE SERVICE PARTNER

B. PARTNERSHIP EQUITY ISSUED IN EXCHANGE FOR SERVICES

5. TAXATION OF “CARRIED INTERESTS”

b. RECHARACTERIZATION OF GAIN: § 1061

Page 280:

In 2021, the Service promulgated final regulations under Section 1061 providing additional clarity to the operation of this recently enacted statute. T.D. 9945 (Jan. 7, 2021), 2021-5 I.R.B. 627. These regulations, summarized below, address many of the lingering questions highlighted in the text.

Scope of the Statute. In its most straightforward application, Section 1061(a) operates to recharacterize distributive shares of long-term capital gain to the holder of an applicable partnership interest (API) as short-term capital gain if the asset giving rise to the gain had been held by the partnership for more than one year but not more than three years. But that is not the exclusive scope of Section 1061(a). In defining the “Recharacterization Amount” subject to Section 1061(a), the regulations also include: (1) long-term capital gain realized on an actual sale of an API held for more than one year but not more than three years; (2) long-term capital gain realized under Section 731(a) on the deemed sale or exchange of an API held for more than one year but not more than three years as a result of a partnership distribution; and (3) long-term capital gains realized on the sale of property distributed with respect to API, provided the property has a holding period of more than one year but not more than three years in the hands of the partner on the date of disposition (considering tacked holding periods under Section 735(a)).¹ The regulations therefore reach all manners in which a partner may realize long-term capital gain with respect to an API in which the holding period of the underlying property or the API itself is less than three years.

The regulations clarified a few other distinct items relating to the scope of the statute. Amounts subject to recharacterization under Section 1061(a) include only those long-term capital gains that possess that characterization due to the holding period provisions of Section 1222. Importantly, the statute does not apply to Section 1231 gains that may give rise to long-term capital gain under Section 1231(a)(1).² Accordingly, long-term capital gains on depreciable property used in a trade or business or real property used in a trade or business are not subject to being recharacterized as short-term capital gain.

¹ Each category is first reduced by long-term losses realized within that category. The mechanics of determining the “Recharacterization Amount” – replete with defined terms – are set forth in Reg. § 1.1061-4.

² Reg. § 1.1061-4(b)(7)(i).

Furthermore, the regulations clarify that the exception to the definition of an API for interests held by a corporation does not apply to interests held by S corporations (closing what would have been gaping loophole in the statute).³

Exclusion for Capital Interests. Pursuant to an exclusion from the definition of an applicable partnership interest, Section 1061 does not apply to a partnership capital interest.⁴ The regulations provide additional guidance on the scope of this statutory exclusion, one that is critically important to the private equity industry. The regulations explain that an allocation of gains and losses will be considered to have been made with respect to a capital interest provided the allocation is determined and calculated in a manner *similar to* allocations made to unrelated non-service partners who have made significant aggregate capital contributions to the partnership (that is, more than five percent or more of the aggregate contributed capital).⁵ The “similar to” standard leaves room for modest deviations, so long as the allocations to the service provider are “reasonably consistent” with those made to the unrelated non-service partners.⁶ Specifically, the allocation to the service provider may be subordinated to the allocations to non-service partners, the allocation to the service provider need not be charged management fees or carried interest, and the service provider may be entitled to receive tax distributions (i.e., distributions to help partners pay income taxes on their distributive share of partnership income) even if the non-service partners are not.⁷

Private equity managers frequently acquire their capital interests through loans from the partnership or other partners. The regulations clarify that a capital interest acquired in such a manner – that is, through the use of proceeds of a loan made or guaranteed by the partnership, a partner, or any related party – will not benefit from the capital interest exclusion unless the partner is personally liable for repayment of the loan.⁸

Furthermore, private equity managers often receive an allocation of gain based on the book value of their partnership interest, which may include gains that have not yet been realized for tax purposes (e.g., gain arising from a revaluation of partnership assets). The regulations clarify that the capital interest exclusion from Section 1061 does not extend to capital attributable to unrealized gains. For the exclusion to apply, such gain must be realized for tax purposes and effectively reinvested in the partnership.⁹

Gains from Non-Portfolio Investments. Section 1061(b) authorizes “[t]o the extent provided by the Secretary,” an exclusion for income or gain attributable to any asset not held for portfolio investment on behalf of third party investors. Presumably, this exclusion is intended to remove from the scope of Section 1061 gain attributable to the enterprise

³ Reg. § 1.1061-3(b)(2). This aspect of the regulations confirms guidance previously provided by the Service in Notice 2018-18.

⁴ I.R.C. § 1061(c)(4)(B).

⁵ Reg. § 1.1061-3(c)(i), (iv).

⁶ Reg. § 1.1061-3(c)(ii).

⁷ Reg. § 1.1061-3(c)(ii)(A).

⁸ Reg. § 1.1061-3(c)(v).

⁹ Reg. §§ 1.1061-2(a)(1)(ii); 1.1061-3(c)(iii).

value (goodwill) of a business. The regulations under Section 1061 decline to give shape to this exclusion, instead reserving the matter for further study.¹⁰

Transfer of API to Related Party. One of the more cryptic aspects of Section 1061 is the provision contained in subsection (d) that applies in the context of a transfer of an API to a person related to the taxpayer (that is, a member of the taxpayer's family under Section 318(a)(1) or a person who performed a service within the calendar year or three preceding calendar years in the applicable trade or business in which or for which the taxpayer provided a service). Importantly, the regulations interpret this provision as applying only to transfers that constitute sales or exchanges on which gain is recognized for tax purposes – reversing the approach taken under proposed regulations, which extended to nonrecognition transactions.¹¹ Accordingly, Section 1061(d) does not apply in the context of gifts (rendering the example in the text inapposite).

With respect to a sale or exchange to which Section 1061(d) applies, the regulations determine the amount of long-term capital gain recharacterized as short-term by adopting a look-through approach with respect to the partnership's assets. The recharacterization amount is determined by reference to the net long-term capital gain on assets held for three years or less that would be recognized by the transferee partner if the partnership were to sell all of its assets for fair market value in a fully taxable transaction.¹² The recharacterization amount, however, is capped at the amount of long-term capital gain that the transferee partner recognizes on the sale or exchange.¹³ Given that Section 1061(a) can apply to long-term capital gain realized on the sale of an API held for less than three years, Section 1061(d) therefore appears to target the potential avoidance of the statute through the sale of an API that has been held for more than three years to a related party.

As previewed earlier in this Update Memorandum, the Biden administration's tax proposals would take a different approach to carried interests by generally taxing as ordinary income (not short-term capital gain and without regard to holding period) a service partner's share of income from certain investment partnerships if the partner's taxable income from all sources exceeds \$400,000. This same income also would be subject to self-employment tax. The proposal would take precedence over Section 1061 for taxpayers with taxable income over the \$400,000 threshold for taxable years beginning after December 31, 2023. The administration's plan reflects continuing policy concerns (summarized at pages 283 of the text) that, even with Section 1061, the current system creates an inequitable and inefficient tax preference for highly compensated managers of investment partnerships.

¹⁰ Reg. § 1.1061-3(e); see also Preamble, Part IV, Section A.

¹¹ Reg. § 1.1061-5(b).

¹² Reg. § 1.1061-5(c).

¹³ Reg. § 1.1061-5(a)(2).

CHAPTER 8. PROPERTY TRANSACTIONS BETWEEN PARTNERS AND PARTNERSHIPS

B. SALES AND EXCHANGES OF PROPERTY BETWEEN PARTNERS AND PARTNERSHIPS

2. DISGUISED SALES

Page 302:

Further Case Developments. In describing the disguised sale technique prior to the discussion of the *Canal Corp.* case, the casebook notes (p. 294) that the planning technique gained broader recognition when it was employed in the 2009 disposition of the Chicago Cubs baseball franchise by its then-parent corporation, Tribune Media. The Service challenged the transaction, and the Tax Court issued its opinion in the case in the fall of 2021. See *Tribune Media Co. v. Commissioner*, T.C. Memo. 2021-122. The *Tribune Media* case provides another helpful example of the disguised sale technique. Although the opinion represents something of a split decision for the taxpayer on the merits, the Tax Court respected the selling partner's guaranty of the primary liability used to finance the distribution for purposes of the Section 707(a)(2)(B).

Before delving into the specifics of the transaction at issue, the Tax Court provided a concise summary of the intended tax advantages of the disguised sale transaction:

Suppose instead of selling property for cash, a person contributes the property to a partnership in exchange for a partnership interest. The contribution is not a taxable event, and the contributing partner's basis in the partnership interest is generally equal to the basis in the property at the time of the contribution. Under normative rules, if that partner receives a distribution of cash from the partnership in excess of the basis of the property at the time of the contribution, that excess distribution would be income. But economically, the transaction looks a lot like a sale: Property is transferred and cash is received. This is a disguised sale, and the Code and the regulations set forth rules on how to calculate the gain, if any.

We can apply these same basis principles to a situation in which a person borrows against property before contributing it. We've already established that a person can borrow against property and the loan proceeds are generally not taxable. And we've already established that contributing property to a partnership is not a taxable event. If we combine these two transactions, a person could borrow against the property and then contribute the property to the partnership while retaining the loan proceeds and

remaining liable on the loan. There would be no tax on that series of transactions. The contributing partner would have the loan proceeds in hand, be liable for repayment of the loan, and own a partnership interest with a basis equal to the basis of the property at the time of the contribution.

Suppose instead of borrowing before contributing the property to the partnership, the person contributes the property and the partnership takes out the loan. The tax results follow the same basic rules we've already outlined. The person contributes the property, taking a basis in the partnership interest equal to the basis in the property at the time of contribution. As discussed above, this is a disguised sale, and the contributing partner will be taxed on the distribution under the disguised sale rules.

But what if the contributing partner is personally liable on the loan? Assuming responsibility for that liability would result in an increase to the contributing partner's basis. As a result, that partner could receive a greater tax-free distribution because the partner's basis includes the combination of the basis in the property at the time of contribution plus the amount of liability assumed by the contributing partner. This relatively straightforward example is the debt-financed distribution exception to the disguised sale rule [Reg. § 1.707-5(b)(1).]

T.C. Memo. 2021-122, at 45-47 (footnotes omitted).

The core structure of the transaction at issue in *Tribune Media* was fairly straightforward. In soliciting bidders for the Cubs franchise, Tribune Media specified that the disposition would occur through a partnership holding the Cubs assets in which the purchaser would hold a 95 percent interest. Tribune Media would retain a 5 percent interest in the partnership, an interest the purchaser could acquire after 12 years.

Consistent with this structure and having identified the Ricketts family as the successful suitor for the franchise, Tribune Media transferred the assets associated with the Cubs franchise (including Wrigley Field) to Chicago Baseball Holdings, LLC ("CBH") having a fair market value net of associated liabilities of \$735 million. Tribune Media's basis in the assets at the time was \$146 million. The purchasing partner, Ricketts Acquisition LLC ("RAC"), an entity controlled by the Ricketts family, contributed \$150 million to CBH.

In addition to these equity investments, CBH issued two categories of debt to finance the transaction. CBH borrowed \$425 million from third party commercial lenders, with this borrowing being referred to as the Senior Debt. After maximizing its borrowing on the traditional market, CBH borrowed an additional \$249 million from RAC Finance, an entity separately owned by the Ricketts family. This borrowing was subordinate to the Senior Debt, and as such was referred to as the Sub Debt.

Tribune Media provided a guaranty of collection for both the Senior Debt and the Sub Debt, which required the lenders to pursue all legal remedies against CBH before Tribune Media could be called on its guaranty. At the time the Cubs transaction closed, Tribune Media was in Chapter 11 bankruptcy with a cash position of approximately \$300 million.

Considering the capital contributions and the borrowed proceeds, CBH held \$824 million in cash in addition to the \$735 million in Cubs assets. At closing, CBH made a special distribution of \$705 million to Tribune Media. Tribune Media continued to own a 5 percent interest in CBH, with a 95 percent interest being held by RAC. (The net capital contributions by the parties would have suggested a 12 percent interest for Tribune and an 88 percent interest for RAC. However, taking the investment represented by the Sub Debt into account as a capital contribution on behalf of RAC corresponded precisely with the 5%/95% division of ownership.)

Tribune Media contended that its guaranty of both the Senior Debt and the Sub Debt provided sufficient basis to shield the \$705 million distribution from generating gain under the debt-financed distribution rule of Reg. § 1.707-5(b)(1). The Service countered that the Sub Debt did not represent debt for tax purposes; rather, in substance it represented equity contributed on behalf of RAC (rendering Tribune Media's guaranty of that obligation irrelevant for tax purposes). The Service conceded that the Senior Debt represented debt for tax purposes but contended that Tribune Media's guaranty of the debt should be disregarded.

Regarding the portion of the transaction relating to the Sub Debt, the Tax Court comfortably determined that the arrangement represented equity instead of debt for tax purposes. Although the court engaged in an exhaustive review of 13 factors relevant to the debt/equity determination, a handful of factors proved most influential in its analysis. First, the Sub Debt did not have a fixed maturity date. Although the nominal term of the debt was 15 years, the subordination agreement provided that principal could not be paid prior to payment of the Senior Debt, and the holders of the Senior Debt could unilaterally extend the term of its financing. Second, the holder of the Sub Debt was closely aligned with RAC (owned by members of the same family), and CBH had maximized the debt financing available from third party lenders. Third, the proceeds of the Sub Debt were used to fund an acquisition of capital assets, more typical of an equity investment. Fourth, the marketing materials for the Sub Debt noted that "[i]nvestors should have the financial ability to sustain a complete loss of their investment," a warning more typical of the risk associated with an equity investment as opposed to debt. Lastly, the parties themselves treated the Sub Debt as an equity investment in determining the percentage ownership interests of CBH following closing. Tribune Media's guaranty of the Sub Debt therefore failed to generate additional basis for purposes of the debt-financed distribution rule.

With respect to the more traditional Senior Debt (which the Service conceded represented true debt), the Service challenged Tribune Media's guaranty on several grounds. First, the Service contended that Tribune Media's guaranty of collection did not sufficiently obligate it to pay under the constructive liquidation test, both literally and as a

matter of economic substance. The Tax Court disagreed. As a literal matter, it determined that Tribune Media in fact could be called to pay the CBH's obligations under the Senior Debt in a worst-case scenario (as contemplated by the Section 752 regulations applicable to the transaction). The court was not persuaded that the obligation of Senior Debt holders to first exhaust their remedies against CBH rendered Tribune Media's guaranty contingent; rather, the court was satisfied that Tribune Media stood as the payor of last resort.

Next, the Tax Court dismissed the Service's invocation of the anti-abuse rule under Reg. § 1.752-2(j)(1) on grounds that numerous practical buffers existed to Tribune Media ever being called to pay on its guaranty. The Service viewed the Ricketts family as being the true guarantor of the debt in substance. The court disagreed, citing the absence of any formal obligation on the part of the Ricketts to satisfy the liabilities of CBH. In the process, the Tax Court distinguished the *Canal Corp.* case on grounds that the purchaser in that case used a thinly capitalized corporation as an intermediary to issue the guaranty. Additionally, the guaranty at issue in *Canal Corp.* related to principal only, and any payment on the guaranty provided the payor with an increased equity interest in the partnership. The court noted that these more egregious factors were lacking in Tribune Media's guaranty of the Senior Debt.

The Tax Court next dismissed the Service's invocation of the broader partnership anti-abuse regulation, Reg. § 1.701-2(a), noting that the regulation does not require each and every component of a partnership transaction (in this case, the guaranty of the Senior Deb) to have a business purpose. Conceding that Tribune Media viewed the likelihood of being called on the guaranty as remote, the Tax Court nonetheless explained that "We honor a guaranty if the guarantor has ultimate economic responsibility for the loan." On these terms, the Tax Court was satisfied.

Lastly, the Tax Court flatly rejected the Service's attempt to disregard the guaranty on substance-over-form grounds. Instead, the court found that the substance of the transaction aligned precisely with the form; that is, as a disguised sale intending to fall within the debt-financed distribution exception in the regulations. Hence, although the substance of the transaction may be a sale of the assets contributed to the partnership, the statute and regulations specifically contemplate when a transaction structured in this manner will successfully defer gain recognition.

On the whole, the Tax Court's opinion in *Tribune Media* should be welcome news for the tax-planning community. The general theme from the court's opinion in the case is that the use of a leveraged partnership to dispose of appreciated property is not necessarily abusive, even when the stated goal of the transaction is deferral of income recognition.

Allocation of Liability Regulations. In 2016, the Service signaled its intention to significantly curtail the use of liability allocations to circumvent the disguised sale rules by issuing temporary regulations treating *all* liabilities for this purpose as nonrecourse obligations to be allocated in accordance with the partners' interests in partnership profits. In June of 2018, the Service reversed course, issuing proposed regulations that would

negate the 2016 temporary regulations. In 2019, the Service completed this reversal by promulgating final regulations returning to the landscape prior to the issuance of the 2016 temporary regulations. See T.D. 9876 (Oct. 9, 2019) (promulgating Reg. § 1.707-5(a)(2)). The debt-financed distribution technique nonetheless remains subject to challenge based on the relevant liability being treated as a bottom dollar payment obligation (and therefore disregarded as a recourse liability). Alternatively, the relevant liability could be disregarded under the anti-abuse rule, as was the case in *Canal Corp.*

CHAPTER 9. SALES AND EXCHANGES OF PARTNERSHIP INTERESTS

B. CONSEQUENCES TO THE BUYING PARTNER

Page 335:

Final regulations issued under Section 168(k) adopt a favorable approach with respect to the additional basis created in respect of the purchasing partner under Section 743(b). The regulations provide that, in determining whether the Section 743(b) basis adjustment meets the used property acquisition requirements of Section 168(k)(2)(E)(ii), each partner is treated as having owned and used the partner's proportionate share of the partnership property. The relevant inquiry is whether the transferee partner has used the portion of the partnership property to which the Section 743(b) adjustment relates, not whether the property has been previously used by the partnership. See Reg. § 1.168(k)-2(b)(3)(iv)(D). Hence, whether the purchasing partner is new to the partnership or an existing partner acquiring an additional interest, the additional basis created in respect of the purchased interest under Section 743(b) will be subject to the additional first year depreciation deduction, provided the other requirements of Section 168(k) are satisfied.

CHAPTER 10. OPERATING DISTRIBUTIONS

B. CONSEQUENCES TO THE DISTRIBUTE PARTNER

1. NONRECOGNITION RULES ON THE DISTRIBUTION

Page 344:

When a distributee partner receives property with a basis determined under Section 732, that distributee partner is not eligible for the additional first-year depreciation deduction under Section 168(k). Reg. § 1.168(k)-2(b)(3)(iv)(B). The property fails the original

use requirement of Section 168(k)(2)(A)(ii) because it was used by the partnership, and the acquisition requirements of Section 168(k)(2)(E)(ii)(II) are not satisfied because the basis of the property is determined by reference to the partnership's basis in the distributed property.

C. CONSEQUENCES TO THE DISTRIBUTING PARTNERSHIPS

Page 359:

Notwithstanding the general rule that any increase in basis under Section 734 is treated as newly purchased recovery property that is placed in service on the date of the distribution giving rise to the basis increase, the additional basis is not treated as satisfying the original use requirement of Section 168(k)(2)(A)(ii) or the used property requirement of Section 168(k)(2)(E)(ii)(I). See Reg. § 1.168(k)-2(b)(3)(iv)(C). Hence, the additional basis does not give rise to additional first-year depreciation.

Page 360, footnote 88:

See *Clark Raymond & Co. v. Commissioner*, T.C. Memo. 2022-105, 124 T.C.M. (CCH) 246 (finding that partnership failed to maintain capital accounts in accordance with Section 704(b) regulations because it did not allocate gain inherent in customer-based intangibles among the partners' book capital accounts prior to reducing capital account balances by the fair market value of those intangibles upon distribution to existing partners).

PART THREE: C CORPORATIONS

CHAPTER 14. THE C CORPORATION AS A TAXABLE ENTITY

A. THE CORPORATE INCOME TAX

Page 466:

The Corporate Alternative Minimum Tax. For taxable years beginning after 2022, Section 55, as amended by the Inflation Reduction Act of 2022, imposes an alternative minimum tax on “applicable” corporations, which generally are corporations (other than Subchapter S corporations, regulated investment companies, and real estate investment trusts) with average annual adjusted financial statement income for the prior three-year period of over \$1 billion. I.R.C. §§ 55(a), (b)(2); 59(k). Greatly simplified, an applicable corporation is likely to owe alternative minimum tax when 15 percent of its financial statement income is greater than its regular tax liability.

Technically and very generally, the corporate alternative minimum tax is equal to the excess of (1) the corporation’s tentative minimum tax for the taxable year, over (2) its regular tax for the year plus an anti-abuse tax levied on certain multinational corporation transactions. I.R.C. § 55(a). Tentative minimum tax is 15 percent of a corporation’s “adjusted financial statement income” for the taxable year under Section 56A, reduced by the corporation’s alternative minimum tax foreign tax credit under Section 59(l). I.R.C. § 55(b)(2)(A). Adjusted financial statement income of the corporation is the net income or loss set forth in the corporation’s “applicable financial statement” (as defined in Section 451(b)(3)), with certain adjustments. See generally I.R.C. § 56A(c). In determining the corporate AMT base, the statutory scheme provides many highly specialized rules for commonly controlled corporate enterprises, other complex structures, corporations whose financial statements include income from partnerships and disregarded entities, net operating losses, tax credits, and more. Finally, an applicable corporation is also allowed a limited tax credit for alternative minimum tax paid in prior years. I.R.C. § 53(e).

It is too soon to know for sure, but it appears likely that the new corporate alternative minimum tax will have a limited reach. The Joint Committee on Taxation staff estimates that for the 2023 taxable year approximately 150 corporations will be subject to the tax, generating approximately \$35 billion in revenue. See Staff of the Joint Committee on Taxation, Overview of the Federal Tax System as in Effect for 2023, JCX-9K-23, May 11, 2023.

CHAPTER 15. FORMATION OF A CORPORATION

F. CAPITAL STRUCTURE

2. LIMITATION ON DEDUCTION OF BUSINESS INTEREST

Page 566:

The Service has issued final regulations interpreting the Section 163(j) limitation on the deduction of business interest. T.D. 9905 (Sept. 14, 2020), 2020-40 I.R.B. 614. The regulations follow the broad structure of the proposed regulations as described in the text and are substantively similar to those regulations in many respects. For example, the final regulations retain the provision that makes it clear that the business interest limitation rules have no effect on a corporation's earnings and profits. Reg. § 1.163(j)-4(c)(1). The final regulations take up approximately 160 pages of the Federal Register, so additional details about these regulatory changes are beyond the scope of a "fundamentals" book.

4. DEBT VS. EQUITY

b. SECTION 385

Page 577:

Section 385 Regulatory Developments. In October 2019, the Service issued final regulations removing the strict documentation regulations while noting that it might propose a modified version that is simpler and more streamlined. T.D. 9880 (Oct. 31, 2019), 2019-47 I.R.B. 1085. Simultaneously, the Service issued an advance notice of proposed rulemaking indicating its intent to propose regulations that streamline and better target the distribution regulations, which treat as stock certain related-party debt issued in connection with distributions. REG-123112-19 (Oct. 31, 2019), 2019-47 I.R.B. 1104.

The saga continued in May 2020, when the Service finalized regulations under Section 385 in a form that was substantively the same as the temporary and proposed regulations issued in October 2016. T.D. 9897 (May 14, 2020), 2020-23 I.R.B. 882. Demonstrating once again that nothing involving Section 385 is ever "final," the Service indicated that it would continue to consider modifications to streamline and better target the distribution regulations.

G. COLLATERAL ISSUES

1. CONTRIBUTIONS TO CAPITAL

Page 586, footnote 208:

The text following the citation to Section 118(a) should be deleted.

Page 586:

As discussed in the text, in 2017 Congress limited the Section 118 exclusion from gross income with an amendment providing that any contribution to capital by a nonshareholder, including those made in aid of construction and any other contribution made by a customer, potential customer, governmental entity, or civic group would not qualify for the exclusion. In the Infrastructure Investment and Jobs Act (P.L. 117-58), Congress partially reversed this enhanced limitation by amending Section 118 to provide that contributions of money or other property from any person, whether or not a shareholder, to a regulated utility which provides water or sewerage disposal services will qualify as a nontaxable contribution to capital, subject to several additional requirements. This change was made to stimulate new infrastructure investments in the targeted businesses.

CHAPTER 16. NONLIQUIDATING DISTRIBUTIONS

A. INTRODUCTION

1. DIVIDENDS: IN GENERAL

Page 591:

In the Regulations assignment, replace § 1.301-1(c) with § 1.301-1(d).

B. EARNINGS AND PROFITS

Page 600:

Footnote 41. The citation to I.R.C. § 312(k)(3)(B) should be changed to I.R.C. § 312(k)(3)(B)(i).

Page 601:

In the list of income and expense items in the Problem, it should be assumed that the depreciable property purchased by X has a 7-year class life. For computational

convenience, also assume that the property was fully expensed under Section 168(k) despite the phase-out of 100 percent expensing that began in 2023 and continues through 2028.

C. DISTRIBUTIONS OF CASH

Page 601:

In the Regulations assignment, replace § 1.301-1(a), (b) with § 1.301-1(a), (c)

Page 602:

The rule in the regulations regarding proration of current earnings and profits among distributions in order to determine dividend status previously only applied when both (1) the distributions during the taxable year consist only of money, and (2) those distributions exceed the current earnings and profits for the year. The regulations have been amended to eliminate the first of those requirements. See Reg. § 1.316-2(b). So now proration of current earnings and profits will result when distributions during the year exceed current earnings and profits, regardless of the nature of the property distributed. The change was made to clarify the allocation of current earnings and profits in situations where a corporation distributes both money and other property. T.D. 9914, 85 F.R. 66476 (Oct. 20, 2020).

D. DISTRIBUTIONS OF PROPERTY

1. CONSEQUENCES TO THE DISTRIBUTING CORPORATION
- d. DISTRIBUTIONS OF A CORPORATION'S OWN OBLIGATIONS

Page 610:

In the Regulations assignment, replace § 1.301-1(d)(1)(ii) with § 1.301-1(b).

Page 611:

Change the citations in footnote 73 to Reg. § 1.301-1(b), -1(g).

E. CONSTRUCTIVE DISTRIBUTIONS

Page 612:

In the Regulations assignment, replace § 1.301-1(j) with § 1.301-1(h).

CHAPTER 21. REDEMPTIONS AND PARTIAL LIQUIDATIONS

A. INTRODUCTION

Page 640:

At the end of the second full paragraph, add: The introduction of Section 4501, which imposes a one percent excise tax on repurchases of stock made by publicly traded corporations, slightly alters the stakes for public companies by creating a small disincentive to making redemptions that are treated as exchanges.

Page 641:

At the end of the first full paragraph, add: If the distributing corporation is publicly traded, it might also be subject to a one percent excise tax on the fair market value of any of its stock it repurchases. I.R.C. § 4501. See Chapter 17E4, *infra*.

E. CONSEQUENCES TO THE DISTRIBUTING CORPORATION

Page 690:

4. THE EXCISE TAX ON CORPORATE STOCK BUYBACKS

Code: § 4501.

In the Inflation Reduction Act of 2022, Congress added Section 4501, which imposes an excise tax on any “covered” corporation in an amount equal to one percent of the fair market value of the corporation’s stock that the corporation repurchases after December 31, 2022. I.R.C. § 4501(a). A corporation is a “covered” corporation if it is a U.S. corporation whose stock is traded on an established securities market. I.R.C. § 4501(b). The covered corporation is also subject to the excise tax to the extent that the covered corporation’s stock is purchased by a partnership or corporation that is more than 50 percent owned by the covered corporation. I.R.C. § 4501(c)(2). The excise tax is imposed on the covered corporation itself, not on the shareholders from whom the stock is repurchased. The amount subject to the tax is the fair market value of the repurchased stock, not the gain from the repurchase (i.e., there is no reduction for shareholders’ stock basis).

Section 4501 contains a “netting” rule that provides that the amount subject to the excise tax is reduced by the fair market value of any stock issued by the covered corporation during the taxable year. I.R.C. § 4501(c)(3). Thus, the excise tax only applies to the extent that the value of the corporation’s stock repurchased during the taxable year exceeds the value of the corporation’s stock issued during the taxable year.

Several exceptions further narrow Section 4501's application. The stock buyback tax does not apply (1) to the extent the stock repurchase is treated as a dividend (I.R.C. § 4501(e)(6)), (2) when it is a de minimis repurchase because the total value of the stock repurchased in the taxable year does not exceed \$1,000,000 (I.R.C. § 4501(e)(3)), (3) if it is a repurchase of stock by a regulated investment company (i.e., a mutual fund) or real estate investment trust (I.R.C. § 4501(e)(5)), (4) when the stock repurchased (or an amount of stock equal to the value of the stock repurchased) is contributed to certain employee retirement funds (I.R.C. § 4501(e)(2)), (5) to the extent the repurchase is tax-free to the shareholder because it is part of a qualified reorganization plan under Section 368 (I.R.C. § 4501(e)(1)), and (6) under regulations issued by the IRS, repurchase by securities dealers in the ordinary course of business (I.R.C. § 4501(e)(4)).

The corporation may not take a deduction for the payment of any tax imposed by Section 4501. I.R.C. § 275(a)(6).

CHAPTER 18. STOCK DIVIDENDS AND SECTION 306 STOCK

B. TAXATION OF STOCK DIVIDENDS UNDER SECTION 305

Page 737:

Replace footnote 16 with: Reg. §§ 1.301-1(b); 1.305-1(b)(1). In the case of a noncorporate shareholder, taxable stock dividends may be qualified and eligible for preferential rates under Section 11(h).

Change the citation in footnote 17 to: Reg. § 1.301-1(g).

CHAPTER 21. TAX-FREE CORPORATE REORGANIZATIONS

C. NONACQUISITIVE, NONDIVISIVE REORGANIZATIONS

1. TYPE E: RECAPITALIZATION

a. INTRODUCTION

Page 873:

In the Regulations assignment, replace § 1.301-1(*l*) with § 1.301-1(j).

b. TYPES OF RECAPITALIZATIONS

Page 876:

In footnote 203, replace the citation to Reg. § 1.301-1(*l*) with Reg. § 1.301-1(j).

Page 877:

In footnote 208, Prop. Reg. § 1.301-1(j) has been finalized and replaced Reg. § 1.301-1(*l*).

CHAPTER 23. CARRYOVERS OF CORPORATE TAX ATTRIBUTES

C. LIMITATIONS ON NET OPERATING LOSS CARRYFORWARDS: SECTION 382

3. RESULTS OF AN OWNERSHIP CHANGE

Page 972:

In September 2019, the Service proposed regulations that are intended to provide guidance about the method for determining a corporation's net unrealized built-in loss, net unrealized built-in gain, realized built-in gain, and realized built-in loss. REG-125710-18 (Sept. 10, 2019), 2019-40 I.R.B. 785. A discussion of the details of the proposed regulations is more complex than is merited in a "fundamentals" book.

PART FOUR: S CORPORATIONS

CHAPTER 24. S CORPORATIONS AND THEIR SHAREHOLDERS

D. TREATMENT OF THE SHAREHOLDERS

3. LOSS LIMITATIONS

a. IN GENERAL

Page 1007:

The CARES Act delayed application of the Section 461(*l*) limitation on excess business losses of noncorporate taxpayers until years after 2020. The American Rescue Plan Act of 2021 extended the provision through 2026, and the Inflation Reduction Act of 2022 further extended it through 2028. The Biden administration continues to propose making Section 461(*l*) permanent.

For 2023, the indexed thresholds in Section 461(*l*)(3) are \$289,000 for single taxpayers and \$578,000 for a married couple filing a joint return.