PARTNERSHIPS & PASSTHROUGHS: RECENT DEVELOPMENTS

DID YOU GET YOUR BADGE SCANNED?
# Table of Contents

1. BBA Audit Rules  
2. Section 163(j)  
3. Section 1061  
4. Section 168(k)  
5. Sections 864(c)(8) & 1446(f)  
6. Section 199A
BBA
(Partnership Audit and Adjustment Rules)
**BBA Audit Rules**

For returns filed for partnership taxable years beginning after December 31, 2017:

- **Section 6221**: Election out for partnerships with 100 or fewer partners
- **Section 6222**: Consistency requirement for partners’ returns
- **Section 6223**: Partnership must designate one representative to deal with IRS examinations
- **Section 6225 (Default Rule)**: Tax on imputed underpayments is assessed and collected at the partnership level in the adjustment year and adjustment-year partners bear economic burden
- **Section 6226 (Push-out Election)**: Election available to pass adjustment through to its partners by the partnership
**BBA -- Default Rule vs. Push-Out**

**Default Rule**
- Tax on “imputed underpayments” is assessed and collected at the partnership level in the adjustment year
- Shift the economic burden to the current year partners (adjustment year)

**Push-out**
- Prevent adjustment-year partners from bearing tax liability for reviewed years (unless they also were reviewed-year partners)
- Mitigates potential distortions caused by the default rule (requires the reviewed-year partners to bear the tax liability for the reviewed year)
- Higher interest than under default rule (+ 2%)
- Partnership furnishes statement
BBA -- Updated Guidance

- REG-120232-17 and REG-120233-17 specifies that partnership can pass the tax along to the ultimate partner in a tiered structure (December 19, 2017)
- REG-118067-17 aims to re-align partnership owners’ capital accounts after an audit if the partnership pays the tax liability (February 2, 2018)
- All passthrough partners making a push-out election must furnish push-out statements no later than the extended due date for the return for the adjustment year of the partnership that made the election (the audited partnership)
BBA -- Updated Guidance

• Q: Does the partnership need to amend the partnership agreement?
• A: No. Designation of PR and/or election out are made on partnership returns; there is no requirement to amend the partnership agreement

• Q: Is it a good idea to amend the partnership agreement to clarify who will serve as PR and to address conflicts that may arise among the partners with regard to the application of the BBA rules?
• A: Yes

• Q: What should the amendment say?
• A: It depends

• Q: The statute goes into effect at the end of the year, do the amendments to the partnership agreement need to be completed by January 1, 2018?
• A: No
Key Practical Considerations -- The Partnership Representative

- Choice of partnership representative
- Approval of partnership representative’s decisions—any limits need to be included in the partnership agreement
- Level of engagement/diligence expected from partnership representative—does state law impose any duty of care? Does it matter whether the partnership representative is itself a partner?
- Indemnification of the partnership representative—any limits?
Key Practical Considerations -- Pay or Push-out

- Consider inter-generational conflicts
- Consider whether the total adjustment amount plus interest is higher under section 6225 or 6226
- If tax is paid at the partnership level, how is the allocation of the tax burden among the partners determined?
- If tax is paid at the partnership level, how is the tax payment funded?
Key Practical Considerations -- Actions of Partners to Reduce Imputed Underpayment

• Can the partnership representative require partners to file amended returns?
• Can the partnership representative require a partner to provide information that would reduce the partnership’s tax? What if the partner is itself a partnership? Can an upper-tier partnership be required to provide information about its partners?
• If a partner’s attribute (e.g., status as tax exempt) results in a reduction in the partnership’s tax, should the benefit be allocated solely to the partner with the attribute or shared?
Retaining Flexibility: One Approach

• **A. General designation of the partnership representative and scope of authority**
  - General partner is designated as the partnership representative (PR)
  - PR has the right to take all actions/make all elections provided in BBA
  - Partners agree to cooperate with such actions/election (e.g., file amended returns and pay tax and provide any requested information required to reduce tax under section 6225)

• **B. Provisions to address payment of tax by the partnership**
  - If partnership pays the tax, GP may cause the partners (including former partners) to pay their share of the tax, as determined by the GP in its "sole [good faith] discretion"
  - If the partner does not pay promptly, interest accrues on the amount due to the partnership
  - A payment of the tax is not treated as a capital contribution/does not reduce capital commitment
  - Partnership may reduce distributions by unpaid amount

• **C. Some indemnification/hold harmless language that applies to the PR for actions taken in its capacity as PR**
Section 163(j)
Section 163(j)

Background and policy considerations

• Encourage de-leveraging
• Should interest deductions be limited in a world with increased expensing?

Additional revenue for offsets?
Section 163(j)

Summary of the provision

• Limits net interest expense deduction to 30% of adjusted taxable income (ATI);

• Calculation of ATI:
  ➢ Through 2021 is EBITDA; after 2021 is EBIT
  ➢ Computed without regard to items not properly allocable to the trade or business

• Limitation is applicable at partnership level
Section 163(j)

Summary of the provision

- “Excess” partnership income (portion of ATI not used in 30% calculation) is passed through to partners in determining their ATI
- Excess partnership interest expense passes through to partners for use only against that partnership’s income
- Special basis rules apply for excess partnership interest expense (reduce basis in interest by excess; increase basis on sale)
Section 163(j)

Discussion

• Application where excess capacity or excess interest expense
• Transfers of partnership interests in non-taxable transactions
• Application to:
  — Tiered partnerships
  — Debt-funded contributions or distributions
  — Corporate partners
Example 1: Third-Party Debt Owed by Partnership (No Disallowance)

Facts:

— X and Y are equal partners and agree to allocate items of XY pro rata.

Analysis:

— XY Interest Expense Deduction = $10 (Limit of $18 = $60 x 30%)

— Allowed interest expense becomes part of XY’s non-separately stated income or loss.

— XY’s business interest should not be retested by X and Y under 163(j).

— Further, each of X and Y is allocated $13.33 of the Excess Taxable Income from XY, where partnership Excess Taxable Income = $60 x [($18 - $10)/$18], or $26.66.

— Because X and Y do not incur interest expense and have no Excess Business Interest from prior years, the Excess Taxable Income cannot be used. ETI does not carryforward.

For simplicity, it is assumed that the debtor does not meet the small business exception as applied under section 448(c).
Example 2: Third-Party Debt Owed by Partnership (Disallowance)

Facts:

Same facts as in Example 1, except XY ATI = $20 in Year 1.

Analysis:

• XY Disallowed Interest Expense = $4 (Interest Expense of $10 – Limit of $6 [$20 x 30%]).
• XY Interest Expense allowed = $6 (Interest Expense of $10 – Disallowed Interest Expense of $4).
• The allowed interest expense of $6 becomes part of XY’s non-separately stated income or loss, which is allocated to X and Y.
• Each of X and Y is also allocated $2 of Excess Business Interest ($4 XY Disallowed Interest Expense/2), which may be carried forward indefinitely. Each of X and Y should reduce its adjusted basis in XY by $2.
• Note that despite X having $100 of ATI, its excess business interest of $2 continues to be carried forward.

For simplicity, it is assumed that the debtor does not meet the small business exception as applied under section 448(c).
Example 3: Use of Excess Business Interest

Facts:
Same facts as in Example 2, except that XY’s ATI in Year 2 = $80.

Analysis:

- Year 2 XY Disallowed Interest Expense = $0 (Limit of $24 [$80 x 30%]) exceeds Interest Expense of $10).
- Each of X and Y is allocated $23.33 of Excess Taxable Income from XY (Excess Taxable Income = $46.66 [$80 x ($24 - $10)/$24]).
- Although not entirely clear, it appears that each of X and Y would first use $6.67 of Excess Taxable Income to offset the $2 of Excess Business Interest that had been limited in Year 1 (Excess Business Interest of $2 / 30%). Thus, each of X and Y can treat the $2 of Excess Business Interest as paid or accrued, and also deductible, in Year 2.
- Because each of X and Y is able to deduct the full amount of Excess Business Interest, the remaining Excess Taxable Income of $16.66 allocated from XY could be used to increase each of X and Y’s ATI. To the extent X and Y do not incur interest expense, the limit does not carry forward.

For simplicity, it is assumed that the debtor does not meet the small business exception as applied under section 448(c).
Corporations: Business vs. Non-Business Interest

— Can a corporation have non-business interest for purposes of section 163(j)?

— New section 163(j) only applies to business interest.

— For section 163(j) purposes, business interest is defined as follows:
  ▪ “... means any interest paid or accrued on indebtedness properly allocable to a trade or business. Such term shall not include investment interest (within the meaning of subsection (d)).”
  ▪ Section 163(d) provides for a limitation on investment interest applicable to non-corporate taxpayers, with section 163(d)(1) specifically excluding corporations and section 163(d)(3) defining the term “investment interest” as interest paid or accrued on debt properly allocable to property held for investment.

— The House Report (and as described in the Conference Report) provides that “section 163(d) applies in the case of a taxpayer other than a corporation” and, “[t]hus, a corporation has neither investment interest nor investment income within the meaning of section 163(d)” and “[t]hus, interest income and interest expense of a corporation is properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of the provision...
As noted earlier, section 163(j) applies only to "business interest," it does not apply to "investment interest."

In each scenario above, partnership XY owns only stock which it holds for investment. How should section 163(j) apply to the interest expense of XY where XY has one corporate partner and one individual partner? Should the answer change if XY has only corporate partners?

For simplicity, it is assumed that the debtor does not meet the small business exception as applied under section 448(c).
Example 5: Cost Recovery Deductions Attributable to a Section 743(b) Adjustment Pre- and Post-1/1/2022

Facts: X and Y are equal partner in the XY Partnership; all items are allocated pro rata. XY has $130 of ATI and incurs $10 of interest expense. X has a section 743(b) adjustment resulting in $100 of depreciation/amortization per year (attributable to X’s purchase of its partnership interest from Z when XY had a valid section 754 election in effect). Each of XY, X, and Y is a calendar taxpayer.

Analysis:
• For taxable years beginning before January 1, 2022, X’s depreciation and amortization deductions attributable to its section 743(b) adjustment should have no effect on the computation of XY’s ATI.
• The potential treatment of depreciation and amortization deductions attributable to X’s section 743(b) adjustment for taxable years beginning on 1/1/2022 or later is unclear.
• Continued on next slide

For simplicity, it is assumed that the debtor does not meet the small business exception as applied under section 448(c).
Example 5: Cost Recovery Deductions Attributable to a Section 743(b) Adjustment Pre- and Post-1/1/2022

Analysis:

- One possibility is that a partner’s section 743(b) adjustments are entirely ignored at the partnership level and instead applied solely in the partner’s own section 163(j) calculation.

- Alternatively, section 743(b) adjustments could be integrated into the partnership-level interest expense limitation calculation. This approach could require separate partnership level calculations for the section 743(b) and non-section 743(b) partners to avoid distortions of ATI.

- Others approaches?

- Should ATI be calculated with reference to section 704(c) items?

For simplicity, it is assumed that the debtor does not meet the small business exception as applied under section 448(c).
**Example 6: Multiple Trades or Businesses**

- XY has two trades or businesses: an electing real property trade or business and a trucking business.

- How should XY determine how much of its interest expense is properly allocable to its electing real property trade or business versus its trucking business?

- How should XY delineate the assets and liabilities associated with those businesses? Different answer if the two businesses are held in separate DREs?

For simplicity, it is assumed that the debtor does not meet the small business exception as applied under section 448(c).
Example 7: Debt-Financed Partnership

**Facts:** A and B are equal partners in AB. AB borrows $100 from Bank and distributes the proceeds equally to A and B.

**Analysis:**

- For purposes of section 163(j), it is necessary to determine whether any interest paid or accrued on indebtedness is properly allocable to a trade or business.
- Section 163(j) does not provide explicit rules to determine whether interest with respect to a debt-financed partnership distribution is properly allocable to a trade or business.
- Notice 89-35
- Because a partner is under no obligation to inform the partnership of its use of the debt proceeds, a partnership might not know how a partner used the debt proceeds.

For simplicity, it is assumed that the debtor does not meet the small business exception as applied under section 448(c).
**Example 8: ConsolidatedGroup**

**Facts:** Parent borrows $100 from Bank and incurs $10 of interest expense. XY ATI = $40, and each of Parent, X, and Y have ATI = $0

**Analysis:**

- The statute is unclear whether members of the same consolidated group can take into account another member’s share of a partnership’s Excess Taxable Income. Legislative history indicates that section 163(j) should be taken into account on a consolidated group basis.

- If Parent can take into account X and Y’s shares of XY’s Excess Taxable Income, Parent would have $0 disallowed interest expense (Limit of $12 [$40 Adjusted Taxable Income x 30%], which exceeds interest expense of $10).

For simplicity, it is assumed that the debtor does not meet the small business exception as applied under section 448(c).
Section 1061
(Carried Interest Issues)
**Carried Interest Issues (Section 1061) -- What’s the New Law?**

**The Act:**

- Long-term capital gains (LTCGs) with respect to certain ‘applicable partnership interests’ (APIs) get benefit of preferential 20% rate only if the capital asset was held for at least three years.

- **Applicable partnership interest**: a partnership interest that is transferred to a partner in connection with the performance of substantial services in connection with an ‘applicable trade or business’

- **An applicable trade or business**: raising and returning of capital in connection with either (i) investing in ‘specified assets’ or (ii) developing specified assets

- **Specified assets**: securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing, and an interest in a partnership to the extent of the partnership’s proportionate interest in any of the foregoing
Carried Interest Issues (Section 1061) -- What’s the New Law? (continued)

- APIs do not include interests held by a corporation and certain capital interests.
  - Does corporation mean just C corporations? What about S corporations?
  - What about mixed profits and capital interests?
  - Purchased interests?

- Specified assets: regulations may exclude ‘any asset not held for portfolio investment on behalf of third party investors’ (not self effecting).

- Does the provision apply to partnership interests, partnership assets, or both?

- Who’s holding period -- partner’s or partnership’s -- is relevant?

- What is the effect of special long-term capital gain provisions (e.g., Section 1231 or Section 1256)?
Other Passthrough Considerations -- What’s the New Law?

The Act:
- Repeals the technical termination rules for partnership for tax years beginning after December 31, 2017 (Section 708)

- Modifies the definition of ‘substantial built-in loss’ under Section 743(d) to provide that a substantial built-in loss also exists if the transferee partner would be allocated a net loss in excess of $250,000 upon a hypothetical sale and liquidation of the partnership (not an issue for partnerships making a Section 754 election)

- Modifies Section 704(d) to apply the outside basis limitation to a partner’s distributive share of charitable contributions and foreign tax credits

- Section 168(k) allows businesses to expense immediately the cost of qualified property

- Section 743(b) possible direct expensing
Section 168(k)
Section 168(k)

Background and policy considerations

• Encourage purchases of depreciable tangible property
**Section 168(k)**

**Summary of the provision**

- Full expensing for certain tangible asset purchases
- Elimination of original use requirement
  - Prior use by the taxpayer prohibited
  - Satisfaction of Section 179(d)(2)(A), (2)(B), (2)(C), and (3) required; requirements include the following limitations:
    - Not purchased from Sections 267 or 707(b) related party
    - Not acquired in a carryover basis or Section 1014 transaction
- Effective for property placed in service after 9/27/17 and before 1/1/23 (then lower percentages)
- Numerous unanswered questions for partnerships
Section 168(k)

Discussion

- Scope of provision related to partnerships (illustrated on following page)
  - Application to purchaser of partnership interest (Section 743)?
  - Application to certain distributions (Sections 734 and 732)?
  - Application to disguised sales (Section 707(a)(2)(B))? 
  - Application to contributions of property with built-in gain (Section 704(c))? 
  - Application to Rev. Rul. 99-5 transactions (deemed asset purchase/contribution)?
**Section 168(k)**

**Illustration**

Scenarios:
- C sells ABC interest to D
- ABC redeems A
- B contributes property to ABC for cash and ABC interests
- ABC was formed with contributions of built-in gain property by each
- C sells an interest in CLLC to D
Sections 864(c)(8) & 1446(f)
Codifies Rev. Rul. 91-32
Foreign transferor recognizes g/l on transfer of ECI-owning partnership
Why do you care?
Section 1446(f)
Transferee must withhold 10%
Does section 1446(f) require withholding?

Any partnership

Any foreign person

Any transfer

Any person anywhere

Any ECI at all
Amount withheld = 10% of amount realized
Amount realized =
Proceeds + debt relief
Foreign Sells interest

US LLC

Cost=$1m
FMV=$1.01m

$1 ECI gain
$100m debt.

$100m debt.
Foreign Sells interest

US LLC

$1 ECI gain $200m debt.

Cost=$1m FMV=$1.01m

5% x 10%

Amt realized = $1.01m proceeds $5.0 m debt relief $0.6 m withheld
Like section 1445 withholding?
Section 1445 withholding: Guardrails (50/90 test)
Withhold, withhold, withhold....
Require nonforeign affidavits from all transferors
Consider blocking any ECI-producing assets
(for tiered partnerships)
Sells interest

Buyer

US assets

Rev. Rul. 99-6 transactions
Technical questions:
Technical questions:
g/l: net or gross
Technical questions:
nonrecognition transactions
Technical questions:
calculating “share” of ECI assets
Technical questions:
Look to non-separatedly stated items
Technical questions:
Look to non-separately stated items
704(b) or tax?
Technical questions:
Look to non-separately stated items
section 743(b) adjustments?
Section 199A
Questions?