Partnership & Passthrough Updates (Part I)

Moderator:
Grace Kim, Grant Thornton

Agenda

- Partnership audit rules
- Section 199A
- Section 163(j) and partnerships

Panelists

- George Hani, Miller & Chevalier
- Laura Howell-Smith, Deloitte
- Kelley Miller, Reed Smith
- Frank Fisher, IRS
- Anthony McQuillen, IRS
- Robert Alinsky, IRS

Partnership Audit Rules

How We Got to Today

- Bipartisan Budget Act of 2015 (the "BBA") as modified by
  - The Protecting Americans from Tax Hikes Act (the "Path Act") (December 2015)
  - The Tax Technical Corrections Act of 2018 ("TTCA") (March 2018)
- Regulations
  - June 2017: proposed regulation with several bracketed items
  - Nov. 2017: proposed regulations on coordination for international issues
  - Dec. 2017: proposed regulations on "push out" through tiers and administrative issues
  - Jan. 2018: final regulations on electing out
  - Feb. 2018: proposed regulations on adjusting tax attributes
  - Aug. 2018: final regulations regarding partnership representative
  - Aug. 2018: re-proposed regulations to take into account changes from the TTCA
  - Dec. 2018: final regulation for many provisions

Agenda – Key Elements of TTCA

- Push Out Through Tiers
- Scope
- Netting of Partnership Adjustments
- Pull-In Modification
- Failure to Pay and Cease to Exist Rules
- The “ups and downs” after a push out
- Statutes of limitation

Agenda – Key Elements of Final Regulations

- Scope Clarified
- Clarified rules related to Consistency Requirement
- Imputed Underpayment computation clarified
- Revised rules for "negative adjustments" to penalties
- Note: Final regulations do not include:
  - Basis/capital account rules
  - Appeals procedures

Push Out Through Tiers

"Push or Pay"

- Pass-through partners can push out adjustments if meet two requirements:
  - File with Secretary a tracking report that includes information required by the Secretary
  - Furnish statements to its partners under rules similar to those under section 6226(a)(2)
- A pass-through partner that fails to furnish required statements must pay imputed underpayment under rules similar to section 6225
- Pass-through partner means a partnership, S corporation, certain trusts or a decedent's estate
  - Owner of DRE or wholly-owned trust is treated as reviewed-year partner (*i.e.*, DRE and wholly-owned trust are disregarded)
    - Owners that are pass-through entities can similarly elect to push or pay

Pushing Out Through Tiers

- If elect "pay"
  - Must pay an amount calculated like an imputed underpayment on the adjustments reflected in the statement (plus any interest and penalties)
- If elect "push"
  - Furnish statements to partners (the "affected partners")
    - Affected partners must take the adjustments into account as if reviewed-year partners
    - Pass-through affected partners can elect to push or pay

Due Date for Decision

- All statements must be furnished no later than the extended due date for the audited partnership's adjustment-year return
  - Calendar-year partnership – statements must be furnished by September 15
  - If a pass-through partner fails to furnish statements by September 15, pass-through partner is liable for tax
  - In multi-tiered structure, this could be a tight timeline to get all statements furnished in each tier
- Same due date in December 2017 proposed regulations and TTCA

Contents of Statements

- The name and taxpayer identification number (TIN) of the audited partnership;
- The adjustment year of the audited partnership;
- The extended due date for the return for the adjustment year of the audited partnership (as described in paragraph (e)(3)(ii) of this section);
- The date on which the audited partnership furnished its statements required under §301.6226-2(b);
- The name and TIN of the partnership that furnished the statement to the pass-through partner if different from the audited partnership;
- The name and TIN of the pass-through partner;
- The pass-through partner's taxable year to which the adjustments reflected on the statements described in paragraph (e)(3) of this section relates;
- The name and TIN (or alternative form of identification as prescribed by forms, instructions, or other guidance) of the affected partner to whom the statement is being furnished;
- The current or last address of the affected partner that is known to the pass-through partner;

Contents of Statements (continued)

- The affected partner's share of items as originally reported to such partner under section 6031(b) and, if applicable, section 6227, for the taxable year to which the adjustments reflected on the statement furnished to the pass-through partner relate;
- The affected partner's share of partnership adjustments determined under §301.6226-2(f)(1) as if the affected partner were the reviewed year partner and the pass-through partner were the partnership;
- Modifications approved by the IRS with respect to the affected partner that holds its interest in the audited partnership through the pass-through partner;
- The applicability of any penalties, additions to tax, or additional amounts determined at the audited partnership level that relate to any adjustments allocable to the affected partner and the adjustments allocated to the affected partner to which such penalties, additions to tax, or additional amounts relate, the section of the Internal Revenue Code under which each penalty, addition to tax, or additional amount is imposed, and the applicable rate of each penalty, addition to tax, or additional amount; and
- Any other information required by forms, instructions, and other guidance prescribed by the IRS.

Clarification on Scope of Partnership Audit Rules

TTCA Changes:

- Eliminated reference to adjustments to items of income, gain, loss, deduction, or credit.
- New definition refers to “any adjustment to a partnership-related item”
- Partnership-related item means:
  - “any item or amount . . . which is relevant (determined without regard to this subchapter) in determining the tax liability of any person under chapter 1”
  - Is determined “without regard to whether or not such item or amount appears on the partnership's return and including an imputed underpayment and any item or amount relating to any transaction with, basis in, or liability of, the partnership.”
  - Also includes any partner's distributive share of any item or amount described in above.”

Final Regs Further Clarify Scope

- Followed revised statute, but moved definition of partnership-related item to the general definition section, rather than including it in its own section
- Clarifies rules for items reported by third parties:
  - Excludes "items or amounts shown, or required to be shown, on a return of a person other than the partnership (or in that person's books and records) that result after application of the Code to a partnership-related item and that take into account the facts and circumstances specific to that person."
  - New examples show that the 170 limitation is not a partnership-related item
- Imputed underpayment is a partnership-related item

Examples of Partnership-Related Items

- Character, timing, source, and amount of partnership's income, gain, loss, deductions, or credits
- Contributions to and distributions from the partnership
- Transactions between a partnership and a partner (e.g., a disguised sale)
- Items relating to partnership terminations and partners' capital accounts
- Whether a person is a partner and whether a partnership exists
- Partnership's basis in its assets
- Amount and character of partnership liabilities
- Partnership allocations

Consistent Treatment

Changes to Consistency Rules

- Final regulations prohibit a notice of inconsistent position after NAP
- Unlike proposed regulations, final regulations permit notice of inconsistent position for an AAR item.

Computation of Imputed Underpayment

TTCA Change to Netting of Adjustments

- Requires "appropriate" netting of all partnership adjustments
- "Appropriate" netting based on categories
- Categories based on items that are required to be taken into account separately under section 702(a) or other provision
- In the case of partners' distributive shares, like items within categories are separately netted

Modification of Imputed Underpayment

Amended Return Modification and New Pull-In Procedure

- "Pull-In" Modification
  - Can achieve the same impact as an amended return modification if a reviewed year partner:
    - Pays that tax that would be due with an amended return
    - Makes binding changes to tax attributes for subsequent years
    - Provides (in a manner specified by the Secretary) information to substantiate that tax was appropriately calculated and paid.
  - No need to actually file amended returns
- Payment due when modification requests are due (270 days from NOPPA)
- TTCA clarified that amended return and pull-in modifications can be made notwithstanding statute of limitation for refund or assessment

Failure to Pay Imputed Underpayment

Failure of Partnership to Pay Imputed Underpayment

- TTCA added provision that allows IRS to assess and collect from adjustment-year partners if partnership fails to pay within 10 days of notice and demand
  - Applies only to adjustment-year partner's *proportionate share* of imputed underpayment, interest and penalties
  - Interest accrues at a rate that is AFR+5% rather than AFR+3%
- IRS has two years to assess adjustment-year partner
  - No need to follow deficiency procedures
- If partnership ceases to exist, assessment may be made against "former partners" as defined under section 6241(7)
  - Secretary has authority to define term

The Ups and the Downs

The Ups and the Downs

- Prior to TTCA:
  - Reviewed-year partner that receives a statement under 6226 computes its tax due based on all adjustments for reviewed year and all intervening years
    - Years when it would owe less taxes are disregarded
    - The additional taxes is due with tax return for year the statement is received
- After TTCA:
  - Reviewed-year partner takes into account tax increases and decreases for all years

Statutes of Limitation

Statutes of Limitation

- Under 6235(a), IRS may make adjustments the later of:
  - Three years after later of date return is due or filed, or AAR is filed
  - If there is a modification request – 270 days (plus any extension to modification period) after modification period ends (including any extension)
  - No modification request – 330 days (plus any extension to modification period) after NOPPA is issued
- The latter two periods are based on issuance of a NOPPA, but the statute did not contain a deadline for the issuance of a NOPPA
- TTCA requires that NOPPA must be mailed within three years of the later of the date the return is due or filed (plus extensions), or AAR is filed
  - Clarifies that a NOPPA cannot be used to revive an otherwise expired limitations period under section 6235
- Proposed Regulations had taken a similar approach

Penalties

TTCA Changes to Penalties

- Partnership adjustment tracking report (required to be filed pursuant to 6226 election) is treated as a return for penalties related to failure to file, frivolous position submissions, and preparation of tax returns
- Failure to comply with requirements to furnish statements in a push out is treated as a failure to pay the imputed underpayment and triggers penalty for failure to file a tax return or to pay tax
- An AAR under section 6227 is treated as a return for purposes of penalties related to frivolous position submissions and preparation of tax returns

Federal Bar Association

TAX LAW CONFERENCE

March 7-8, 2019

Ronald Reagan Building and International Trade Center
Washington, D.C.

SECTION 199A

Agenda

Overview of section 199A, final regulations, and other new guidance
Proposed safe harbor for rental real estate enterprise as a trade or business
Determination of W-2 wages
Determination of unadjusted basis immediately after acquisition of qualified property (UBIA)
Specified service trades or businesses (SSTBs)
Aggregation rules (including entity-level aggregation)
Definition of qualified business income (QBI)

Overview of section 199A, final regulations, and other new guidance

Overview of section 199A

Background

- Section 199A generally provides a deduction of up to 20 percent of qualified business income from a domestic business operated as a sole proprietorship or through a partnership, S corporation, trust, or estate, subject to certain significant limitations (the "section 199A deduction"). This provision applies to taxable years beginning after 2017 and before 2026.
- Congress enacted section 199A on December 22, 2017 as part of the 2017 Tax Act (Pub. L. 115-97), and later was amended by the Consolidated Appropriations Act (CAA), 2018 (H.R. 1625) enacted on March 23, 2018.
- On August 8, 2018, the Treasury Department ("Treasury") and the Internal Revenue Service (IRS) released proposed regulations under section 199A (the "2018 proposed regulations").
- On January 18, 2019, the Treasury and the IRS released final section 199A regulations, new proposed regulations under section 199A, and other guidance.
- On February 8, 2019, the Treasury and the IRS released a corrected version of the final section 199A regulations that were published in the Federal Register on February 8, 2019.

Overview of section 199A

New section 199A guidance released on January 18, 2019

- On January 18, 2019, the Treasury and the IRS released:
  - **Final section 199A regulations**, including a number of clarifying changes and new aggregation rules for relevant passthrough entities (RPEs);
    - Generally applicable to taxable years ending after the date the final regulations are published in the Federal Register.
    - However, **for taxable years ending in calendar year 2018**, final regulations provide that taxpayers may rely on either the final regulations, in their entirety, or the 2018 proposed regulations, in their entirety.
  - **New proposed regulations** covering:
    - The treatment of previously suspended losses that constitute qualified business income (QBI), and
    - The determination of the section 199A deduction for taxpayers that hold interests in regulated investment companies, charitable remainder trusts, and split-interest trusts;
  - **Notice 2019-07**, providing a proposed safe harbor to treat rental real estate as a trade or business; and
  - **Rev. Proc. 2019-11**, which provides methods for calculating W-2 wages for purposes of section 199A.

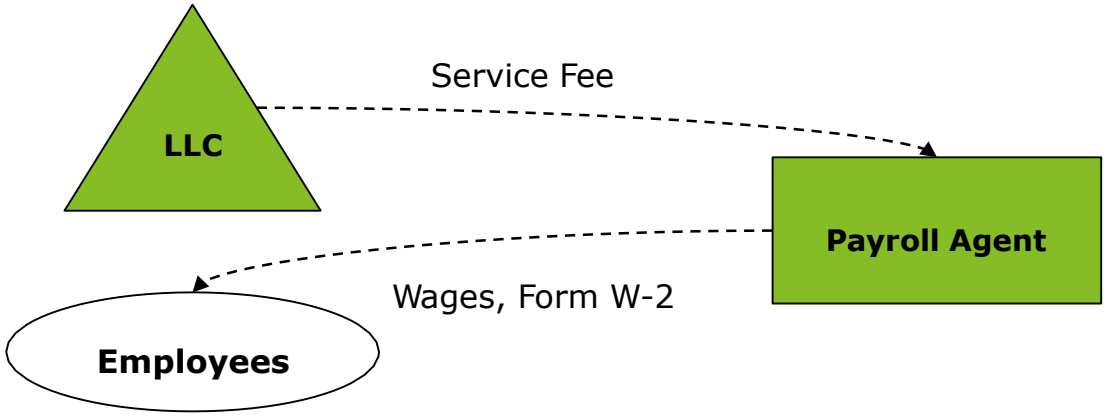
Overview of section 199A
Combined qualified business income (QBI)

- Under section 199A, an individual, estate or trust taxpayer generally may deduct the sum of -
  - An amount for each trade or business, equal to the lesser of –
    - 20 percent of the taxpayer's **QBI** with respect to the trade or business, or
    - The greater of the following limitations –
      - 50 percent of the **W–2 wages** with respect to the **trade or business**, or
      - the sum of 25 percent of the W–2 wages with respect to the **qualified trade or business**, plus 2.5 percent of the **UBIA of qualified property**.
  - 20 percent of aggregate **qualified REIT dividends** and **qualified publicly traded partnership income**.
- However, the section 199A deduction is limited to 20% of the amount by which taxable income exceeds net capital gain (the "overall limitation")
  - The final regulations clarify that the definition of "net capital gain" for this purpose means the excess of net long-term capital gain for the taxable year over the net short-term capital loss for such year plus any qualified dividend income.

Determination of W-2 wages

Determination of W-2 wages

- W-2 wages are a key component of the limitations used to determine the potential deduction for each trade or business.
- W-2 wages only include amounts reported on Form W-2 filed on or within 60 days after the due date (including extensions) for that form.
- Three methods for calculating the specific amount from Form W-2 that is considered W-2 wages for purposes of section 199A.
- Rev. Proc. 2019-11 replaces Notice 2018-64; provides additional guidance on three methods.
- The final regulations permit an individual or RPE to take into account wages paid by a different person (*e.g.*, appointed section 3504 agent), provided that the wages are paid to common law employees of the individual or RPE.



Employment Tax Considerations

- Review the current payroll reporting structure
- Identify who is the common law employer
- Identify other entities that are permitted to report payroll. Examples:
  - Appointed Agent (section 3504)
  - Professional Employer Organization (section 7705)
  - Statutory Employers (section 3401(d)(1))
- Must calculate wages paid based on form of payroll reporting structure that existed when wages were paid
- **Section 199A deduction may be impacted by improper reporting of W-2 wages**
- Identify issues with current form of payroll reporting structure and future remediation strategy
  - Example: Holdco reports payroll for all employers in its controlled group but may not satisfy the section 199A criteria to report payroll for another common law employer

Determination of unadjusted basis immediately after acquisition qualified property (UBIA)

UBIA
Generally

- Unadjusted basis immediately after acquisition (UBIA) generally is the basis on the placed in service date as determined under section 1012 without regard to certain adjustments
- Special rules for property acquired in nonrecognition transactions and for like-kind exchanges and involuntary conversions
- Special rules for partnership basis adjustments under section 743(b)
- Pass-through allocations of UBIA and other provisions

Nonrecognition transactions
UBIA

- Nonrecognition transactions
  - A transferee in a nonrecognition transaction generally steps into the shoes of the transferor's depreciable period and the transferor's UBIA (subject to certain adjustments for money exchanged as part of the transaction).
- Like-kind exchanges and involuntary conversions
  - The depreciable period and UBIA of replacement property generally carries over from the relinquished or involuntarily converted property in a transaction under section 1031 and section 1033, respectively.
  - The UBIA carried over is subject to certain adjustments for money or other property (*i.e.*, non-like-kind or property that is not similar or related in service or use to the involuntarily converted property) received or exchanged by the taxpayer in the transaction.

Basis adjustments
UBIA

- Basis adjustments
  - Certain portions of section 743(b) adjustments can be considered separate qualified property for purposes of determining UBIA
    - Section 743(b) and section 734(b) adjustments otherwise do not affect the determination of UBIA.
  - To avoid double counting the portion of section 743(b) adjustments that can be treated as separate qualified property (the "**excess section 743(b) basis adjustment**") is the excess of:
    - Section 743(b) adjustment with respect to an item of qualified property, over
    - Section 743(b) adjustment with respect to that property computed as if the property's adjusted basis was equal to its UBIA.
  - An excess section 743(b) basis adjustment amount can be positive or negative
    - Excess section 743(b) basis adjustments with respect to a transferee will generally increase or decrease (but not below zero) the transferee's share of UBIA from the partnership.

Additional changes in the final regulations
UBIA

- Allocation of partnership and S corporation UBIA
  - Each partner's share of the UBIA is determined in accordance with the section 704(b) depreciation allocation as of the last day of the taxable year.
  - In the case of qualified property held by an S corporation, each shareholder's share of UBIA is a share of the unadjusted basis proportionate to the ratio of shares in the S corporation held by the shareholder on the last day of the taxable year over the total issued and outstanding shares of the S corporation.
  - Because the final regulations allocate UBIA in proportion to end of year ownership, a taxpayer who disposes of its entire interest in an RPE prior to the close of the RPE's taxable year is not entitled to a share of UBIA from the RPE.
- Qualified property acquired from a decedent
  - UBIA acquired from a decedent and immediately placed in service will generally be the fair market value at the date of the decedent's death under section 1014 and have a new depreciable period that commences as of the date of the decedent's death.

Rental real estate as a trade or business

Rental real estate as a trade or business

- The final regulations acknowledge that rental activities may not rise to the level of a trade or business (being characterized more as investments). This explains the carve out for rentals to a commonly controlled trade or business.

- With two exceptions, a rental real estate enterprise may rise to the level of a trade or business, and therefore rental income can be QBI for purposes of computing the section 199A deduction.

Proposed safe harbor for rental real estate enterprise as a trade or business - Notice 2019-07

Notice 2019-07 proposes a safe harbor for certain rental real estate enterprises.

What is a "rental real estate enterprise"?

- An interest in real property held for the production of rents.
  - May include multiple properties
- A taxpayer must treat each property held for the production of rents as a separate enterprise or treat all similar properties held for the production of rents as a single enterprise.
- Commercial and residential real estate may not be part of the same enterprise.
- The individual or relevant pass-through entity (RPE) relying on the safe harbor must hold the interest directly or through a disregarded entity.

What real estate is *excluded* from the safe harbor?

- Real estate used as a personal residence by the taxpayer (including the owner or beneficiary of a RPE or trust relying on the safe harbor)
- Triple-net leased real estate

NOTE: Failure to satisfy the requirements of the safe harbor does not preclude a taxpayer from otherwise establishing that a rental real estate enterprise is a trade or business for section 199A.

Rental real estate enterprise safe harbor

Notice 2019-07 Requirements

During the taxable year:

- Maintain separate books and records for each rental real estate enterprise
- For taxable years beginning *prior to* 1/1/2023,
  - Perform 250 or more hours of "rental services" per year with respect to the rental enterprise
- For taxable years beginning *after* 12/31/2022,
  - Perform 250 or more hours of "rental services" with respect to the rental real estate enterprise during any three of the five consecutive taxable years that end with the taxable year
- Taxpayer must also maintain contemporaneous records showing safe harbor compliance for tax years after 12/31/2018

"Rental Services"

- May be conducted by owners or by employees, agents, and/or independent contractors of the owners
- Includes:
  - Advertising to rent or lease the real estate
  - Negotiating and executing leases
  - Verifying information contained in prospective tenant applications
  - Collection of rent
  - Daily operation, maintenance, and repair of the property
  - Management of the real estate
  - Purchase of materials
  - Supervision of employees and independent agents
- Does not include:
  - Financial and investment management activities (*e.g.*, procuring property, studying and reviewing financial statements, etc.)

Special rule for renting to a related person

Final regulations under section 199A

- Solely for purposes of section 199A, the rental or licensing of tangible or intangible property to a related trade or business is treated as a trade or business if the rental or licensing activity and the other trade or business are commonly controlled.

The final regulations clarify that this exception only applies to situations in which the related party, as determined under sections 267(b) or 707(b), is an individual or an RPE which is commonly controlled under Treas. Reg. § 1.199A-4(b)(1)(i).

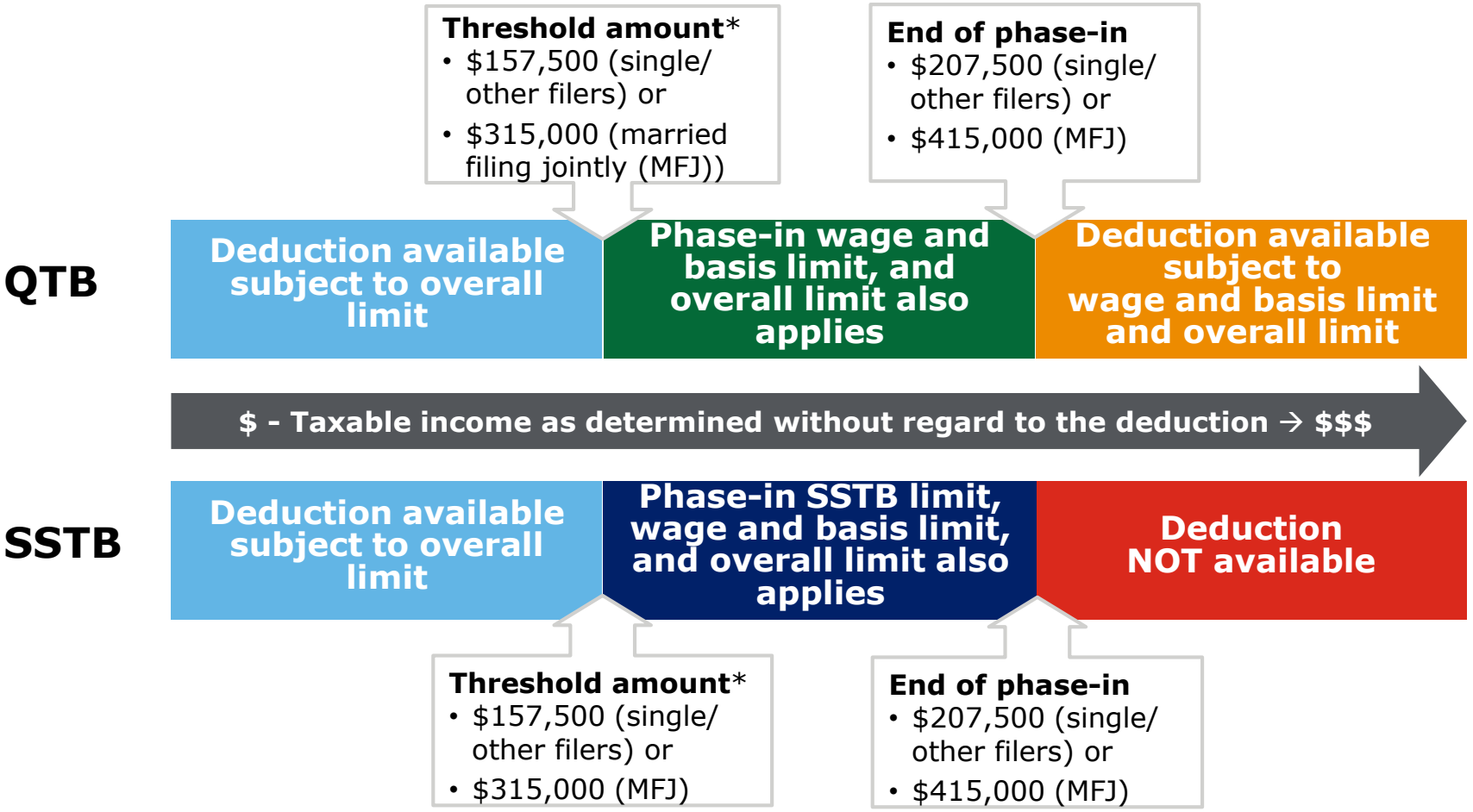
Specified service trades or businesses (SSTBs)

Multiple trades or businesses

While the Treasury and the IRS declined to provide specific guidance as to the definition of a trade or business under section 162, the Preamble acknowledges that an individual or an entity can conduct more than one trade or business. It further states that whether a single entity has multiple trades or businesses is a factual determination, but that the Treasury and the IRS believe that multiple trades or businesses generally will not exist within an entity unless different methods of accounting could be used for each trade or business under Treas. Reg. § 1.446-1(d).

- Treas. Reg. § 1.446-1(d)(2) provides that no trade or business will be considered separate and distinct unless a complete separate set of books and records is kept for such trade or business.
- The commentary in the Preamble is not addressed in the final regulations.

QTB and SSTB threshold application



* For taxable years beginning after 2018, the threshold amount will be adjusted for inflation (using a section 1(f)(3) cost-of-living adjustment).

Specified service trade or business

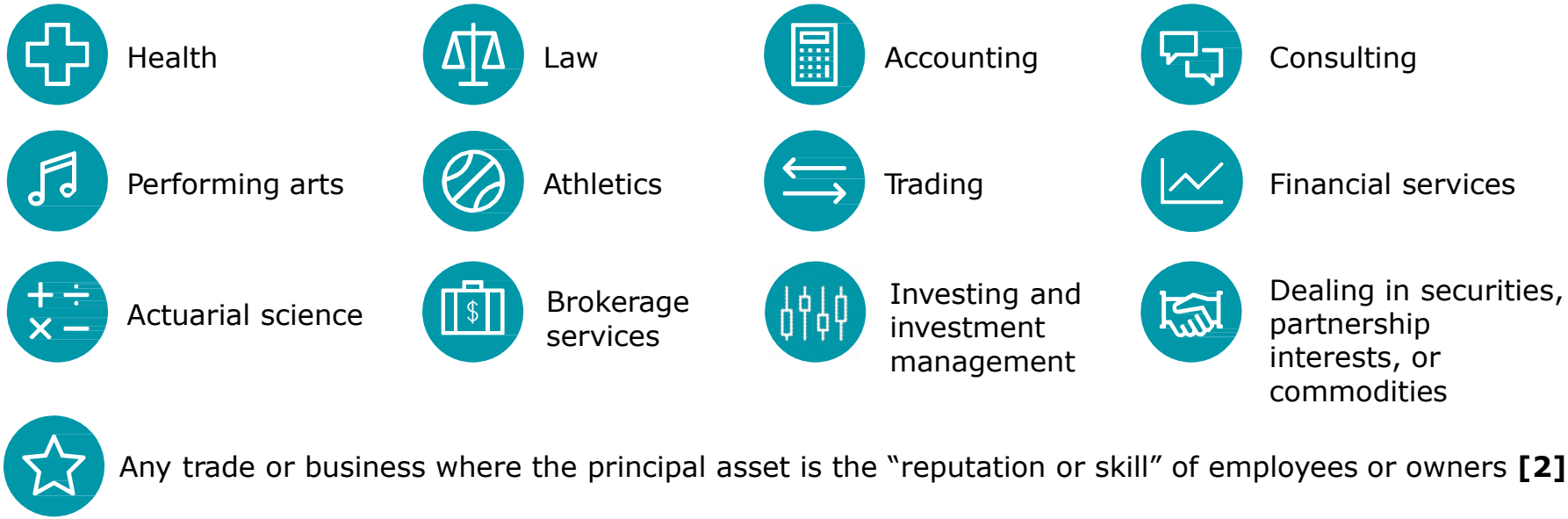
General definitions

- Unless a taxpayer's income is below the threshold amount, a qualified trade or business does not include a specified service trade or business (SSTB). The final regulations provide additional guidance on definitions for SSTBs.
- An **SSTB** means any trade or business involving the performance of services in one of more of the SSTB fields provided by the final regulations.
- If a trade or business conducted by a RPE is an SSTB, this limitation applies to any direct or indirect individual owners of the business, regardless of whether the owner is passive or participated in any specified service activity.
- **NOTE**: Performing services as an employee is not a qualified trade or business for purposes of section 199A.

Specified service trade or business

Definition of SSTB fields

In response to comments, the final regulations provide additional guidance for the definition of specific SSTB fields **[1]**, including businesses that could potentially be considered to involve the fields of health, consulting, athletics, financial services, and dealing.



[1] The rules for determining whether a business is an SSTB within the meaning of section 199A(d)(2) apply solely for purposes of section 199A and therefore, may not be taken into account for purposes of applying any other provision of law, except to the extent that another provision expressly refers to section 199A(d).

[2] The final regulations leave unchanged the 2018 proposed rule limiting the meaning of the "reputation or skill" clause to fact patterns in which an individual or RPE is engaged in the trade or business of receiving income from endorsements, the licensing of an individual's likeness or features, and appearance fees.

Specified service trade or business

Examples of specific guidance provided by the final regulations

Property or	QTB	SSTB
	architecture or engineering services	stock brokerage
	broadcasting or disseminating video or audio of professional sports or performing arts	medical services, **including those not directly provided to patients**
	retail banking, **including taking deposits or making loans**	**pharmacist providing medical services**
	insurance brokerage	consulting services
	payment processing & billing services	investment banking
	real property management	
	pharmaceuticals or medical devices	**veterinary services**
	operators of emergency care centers, urgent care, surgical centers	financial services, **including arranging lending transactions**
	lab services with no proximity to patients	dealing in securities, commodities, or partnership interests
	health clubs & spas	investment management
	consulting that is embedded or ancillary to the sale of goods	**sports teams**

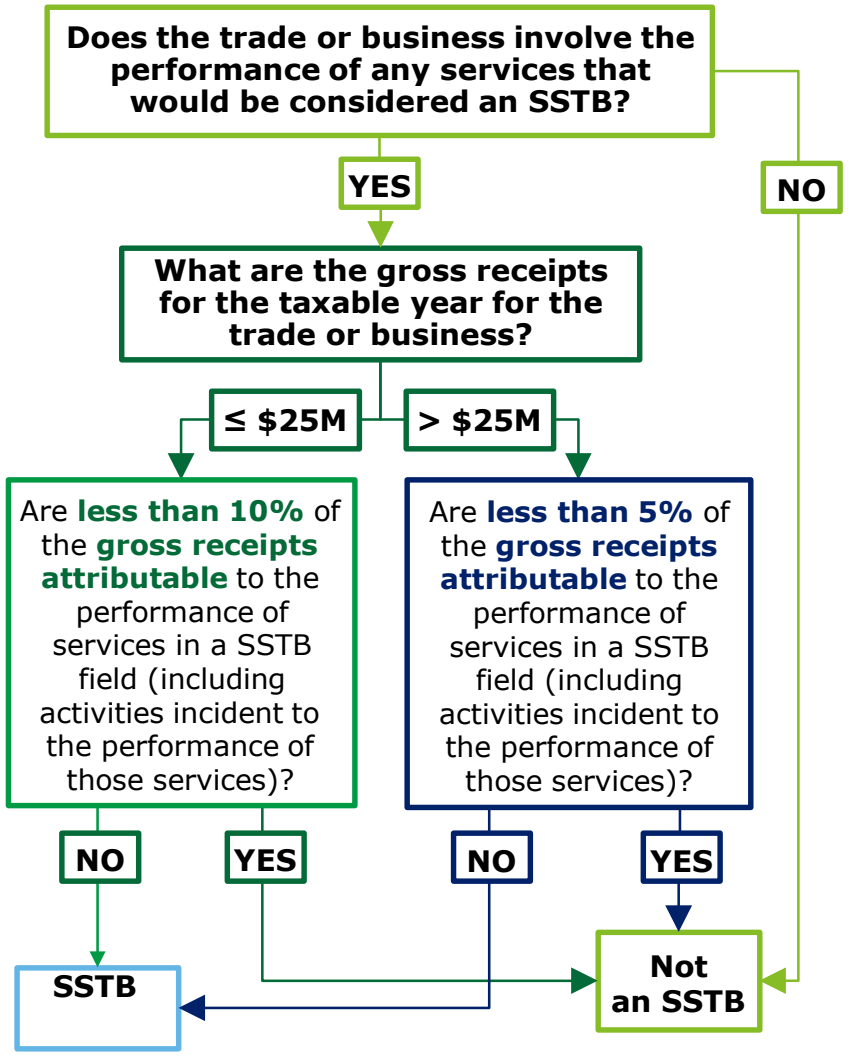
The "*de minimis* rule"

A trade or business (determined *before* the application of the aggregation rules) is NOT an SSTB if:

- Its gross receipts in a taxable year are **$25M or less** and **less than 10%** of its gross receipts is attributable to the performance of services in an SSTB, or
- Its gross receipts in a taxable year are **more than $25M** and **less than 5%** of its gross receipts is attributable to the performance of services in an SSTB.

Clarifications in the final regulations:

- There is a "cliff effect" when gross receipts from services in an SSTB field exceed the threshold.
- If an individual (or RPE) has more than one trade or business, the presence of specified service activity in one of those trades or business will not cause the individual's (or RPE's) other trades or businesses to be considered SSTBs (except to the extent that the rules in regarding services or property provided to an SSTB apply).

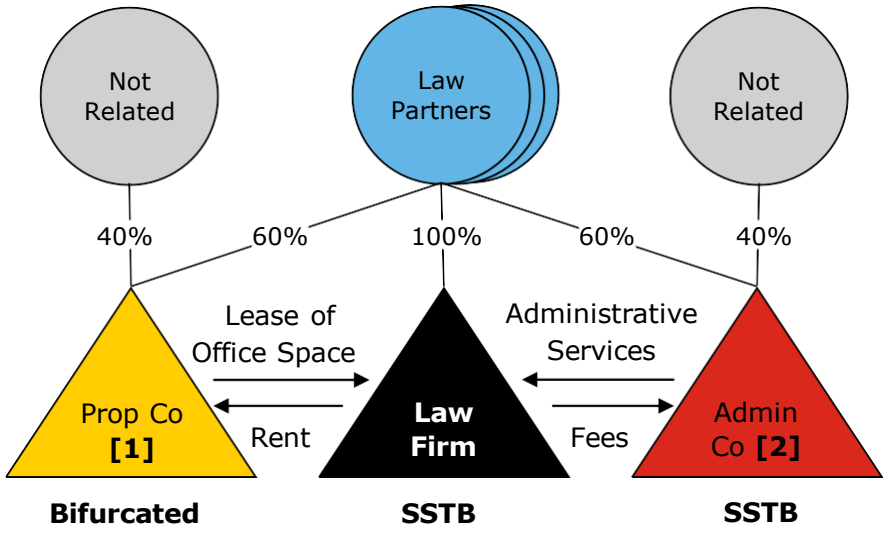


Specified service trade or business

Anti-abuse rule

- The final regulations removed what was known as the "80 percent rule" under the proposed regulations.
- The final regulations provide that if a trade or business provides property or services to an SSTB and there is a 50 percent or more common ownership of the trade or business, the portion of the trade or business providing property or services to the 50 percent or more commonly-owned SSTB will be treated as a separate SSTB with respect to related parties.

[1] PropCo owns an office building and leases 30% of the office space to other unrelated companies.

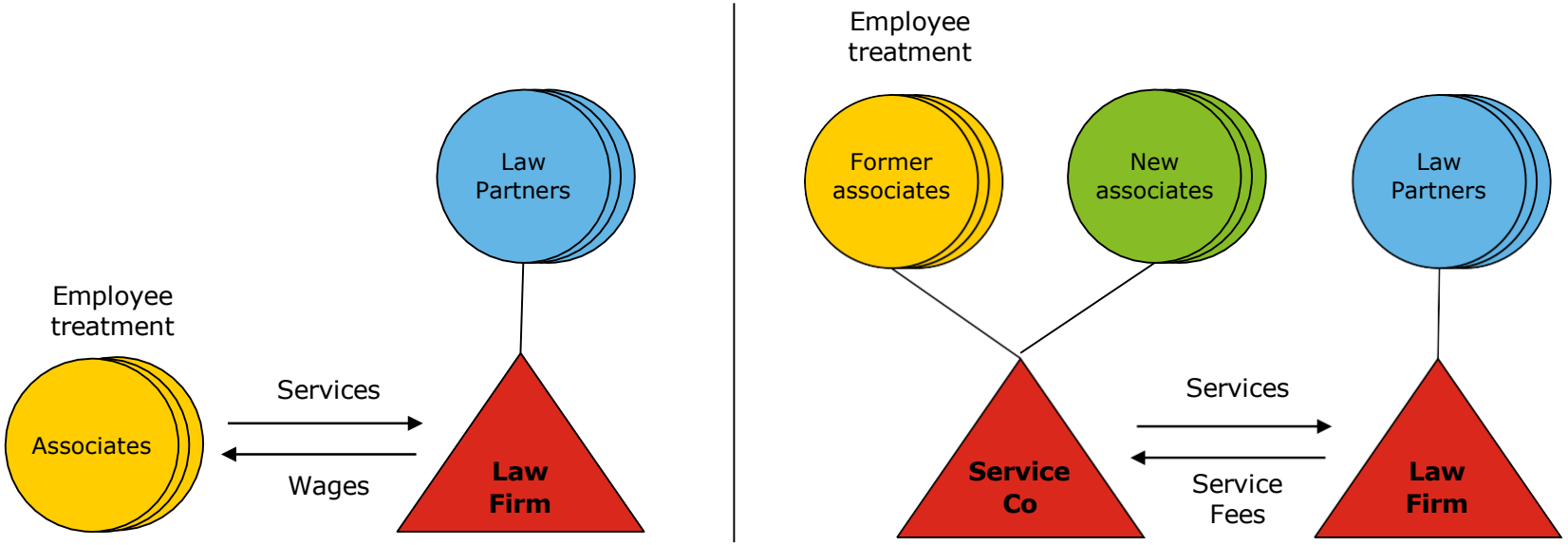


[2] AdminCo only provides administrative services to the law firm.

Specified service trade or business

Anti-abuse rule – Former employee presumption

There is a rebuttable presumption that a former employee providing substantially the same services in a different capacity is still an employee for section 199A purposes.**[1]**



[1] In response to the comments, the final regulations provided a three-year lookback rule with respect the rebuttable presumption.

Individual and Entity Aggregation rules

How to determine which trades or businesses MAY be aggregated

RPEs, individuals, estates and trusts can aggregate trades or businesses

Ownership

Does the same person or group of persons, directly or **by attribution**, own 50% or more of each trade or business to be aggregated?

Clarifications:

- Sections 267(b) and 707(b) attribution rules apply to the ownership test
- A C corporation may constitute a part of the ownership group

Taxable year

Does such ownership exist for the majority of the applicable taxable year, **including the last day of the taxable year**?

Are all items attributable to each trade or business to be aggregated reported on returns with the same taxable year?

No SSTB

Are any of the trades or businesses to be aggregated an SSTB?

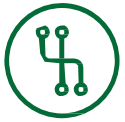
Necessary factors

Do the trades or businesses exhibit at least 2 of the following 3 factors?

1. Products, **property**, or services provided are **the same** or **customarily provided together**

2. Shared facilities or **shared significant centralized business elements**

3. Operated in coordination with, or reliance on, one or more of the businesses in the aggregated group



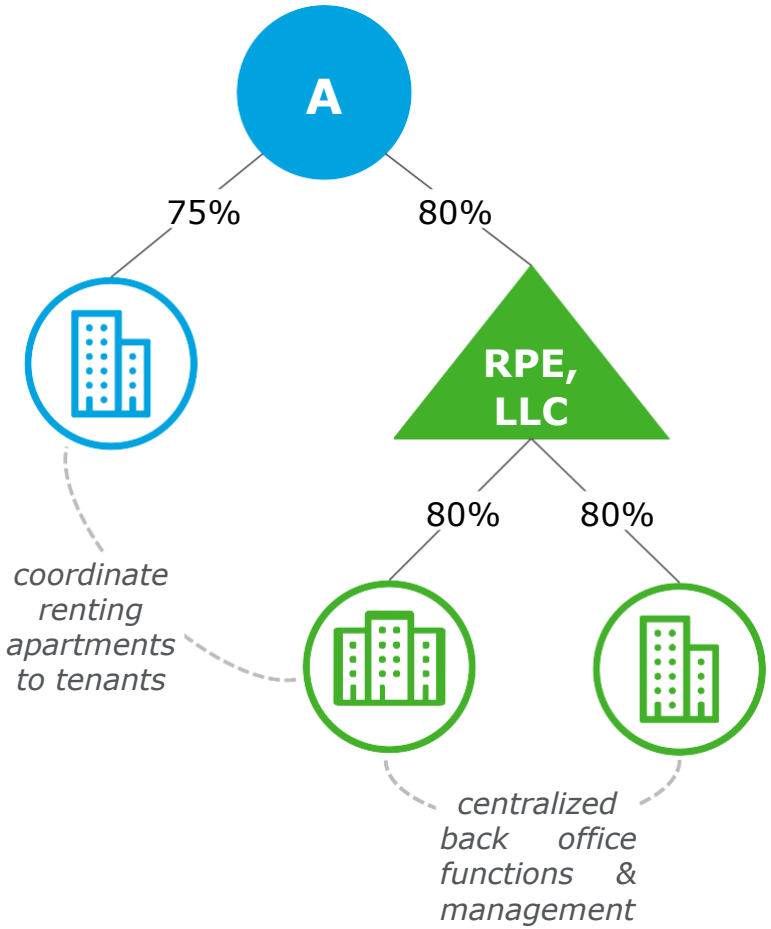
Entity-level aggregation

The final regulations permit an individual and an RPE to aggregate. An RPE may aggregate trades or businesses it operates directly or through lower-tier RPEs.

- An individual or upper-tier RPE may not separate the aggregated trade or business of a lower-tier RPE, but instead must maintain the lower-tier RPE's aggregation.
- An individual or upper-tier RPE may aggregate additional trades or businesses with the lower-tier RPE's aggregation if all of the aggregation requirements are met including the ownership test.
- The resulting aggregation must be reported annually by the RPE and by all owners of the RPE.
  - Each RPE in a tiered structure is subject to the disclosure and reporting requirements.

Entity-level aggregation – Example

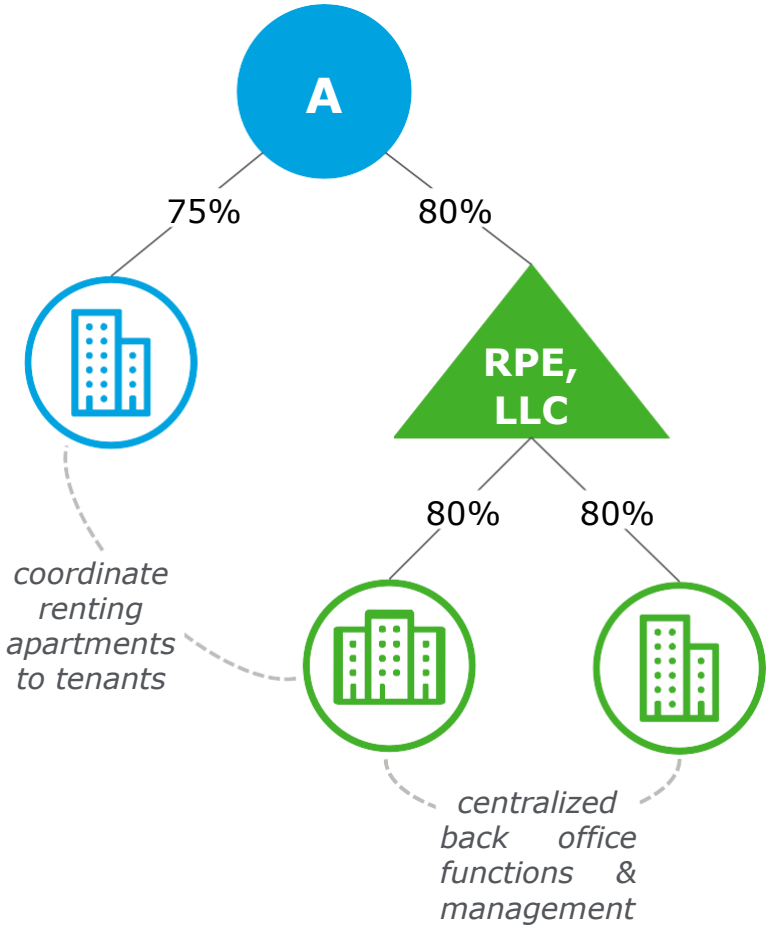
- **A owns:**
  - 75% of a residential apartment building
  - 80% of RPE, LLC
- **RPE, LLC owns:**
  - 80% of the interests in a residential condominium building
  - 80% of the interests in a residential apartment building
- **Additional facts:**
  - RPE, LLC's residential condominium building and residential apartment building operations share centralized back office functions and management
  - A's residential apartment building and RPE, LLC's residential condominium and apartment building operate in coordination with each other in renting apartments to tenants



Entity-level aggregation – Example (cont.)

Analysis

- RPE, LLC may aggregate its residential condominium and apartment building operations
  - **Ownership test**: Met as RPE, LLC owns more than 50% of each trade or business
  - **Necessary factors test**: Met because the businesses are of the same type of property and share centralized back office functions and management
- Note that, if RPE, LLC aggregates its residential condominium and apartment building operations, A may not disaggregate those operations
- However, A may also add its residential apartment building operations to RPE, LLC's aggregated residential condominium and apartment building operations
  - **Ownership test**: Met as A owns more than 50% of each trade or business
  - **Necessary factors test**: Met as the businesses operate in coordination with each other



Aggregation reporting requirements

- The final regulations retain the requirements for annual disclosure and consistent reporting of aggregated trades or businesses.
- The final regulations provide that a taxpayer's failure to aggregate trades or businesses will not be considered to be an aggregation under this rule; that is, later aggregation is permitted.
- The final regulations do not generally allow for an initial aggregation to be made on an amended return as this would allow aggregation decisions to be made with the benefit of hindsight.
  - **However**, final regulations allow taxpayers to **amend initial aggregation on amended returns for only the 2018 taxable year**.

Definition of qualified business income (QBI)

Determination of Qualified Business Income (QBI)

Can the following items be included in determining QBI?

Yes

Ordinary gains and losses
Deductions for guaranteed payments and other service payments to partner under 707(a)
Wages paid by an S corporation to a shareholder as reasonable compensation
Losses previously disallowed, suspended, or limited in taxable years ending after 12/31/2017, but currently allowed **[1]**
Guaranteed payments for the use of capital ("GPUC") properly allocated to a trade or business
Section 481 adjustments arising in taxable years ending after 12/31/2017
Deductible portion of tax on self-employment income under section 164(f), self-employed health insurance deduction under section 162(l), and the deduction for contributions to qualified retirement plans under section 404

No

Dividends or dividend equivalents
Non-business interest income
Effectively connected income that is not attributable to a business
Capital gains or losses
Income from guaranteed payments and other service payments to partners under 707(a)
Wages received by an S corporation shareholder as reasonable compensation
Current year losses that are disallowed, suspended, limited, or carried over
Losses disallowed, suspended, or limited in years ending before 1/1/2018 **[1]**
GPUC that are not properly allocated to a trade or business
Section 954 transactions, including commodities, foreign exchange and notional principal contracts

[1] Such losses will be utilized on a first-in, first-out (FIFO) basis.

Deloitte.

Section 163(j) Proposed Regulations
(REG-106089-18, 83 Fed. Reg. 67490 (12/28/2018))

Interest Deduction Limitation
General Overview

- General Rule – New Section 163(j) limits business interest expense (BIE) deduction to the sum of:
  - Business interest income (BII)
  - 30% of adjusted taxable income (ATI), and
  - The taxpayer's floor plan financing interest for taxable year
- The limitation does not apply to—
  - The trade or business of performing services as an employee;
  - Any electing real property trade or business;
  - Any electing farming business; or
  - Certain regulated public utilities.
- Proposed Regulations released November 26, 2018; Federal Register publication on December 28, 2018
  - Effective for taxable years ending after the date final regulations are published
  - Taxpayers may elect to apply the regulations for taxable years beginning after December 31, 2017, if certain conditions are met.

Application to Partnerships
General Overview (Continued)

- Section 163(j) applies at both the partnership and partner level
  - Section 163(j)(4) provides that Section 163(j) should be applied at the **partnership level.**
    - Thus partnerships deduct the business interest expense allowed by Section 163(j).
    - But a partnership does not treat business interest expense not allowed as a deduction for any tax year as business interest expense paid or accrued by the partnership in the succeeding tax year.
    - Instead, the disallowed amount creates a partner-level tax attribute **(excess business interest expense - "EBI").**
      - Partnership EBI is allocated in the same manner as non-separately computed income.
      - EBI allocated to a partner may only be deducted by that partner in succeeding tax years to the extent the partner is allocated **excess business interest income ("EBII")** or **excess taxable income ("ETI")** from the same partnership.
      - EBII is the amount of partnership business interest income that exceeds business interest expense.

Application to Partnerships
General Overview (Continued)

- A **partner** must perform its own 163(j) calculation
  - A partner must compute its ATI without regard to the partner's distributive share of any items of income, gain, deduction, or loss from a partnership
  - However, a partner may increase its ATI by the partner's distributive share of the partner's ETI which is allocated to each partner in the same manner as the partnership's non-separately stated taxable income or loss
- **Ordering**: ETI allocated to a partner must first be applied against any EBI allocated by the same partnership and carried forward by the partner
  - Once all EBI has been treated as used by the partner as a result of the ETI allocation, then any additional ETI is taken into account by the partner in computing the partner's ATI

Partnership Level Computation
General Overview (Continued)

- Section 163(j) limitation applies at the partnership level only to business interest expense (BIE); not applicable to other types of interest such as investment interest expense
    - Broad definition of interest under proposed regulations
        - For example, guaranteed payments for use of capital are treated as interest for 163(j) purposes
    - **Corporate partner exception** - Any allocable share of investment interest income or expense is treated as business interest income or expense from a qualified trade or business at the corporate partner level
- Allowable BIE is taken into account in determining the non-separately stated taxable income or loss of the partnership
    - Partnership's deductible business interest expense loses its character at the partner level for purposes of Section 163(j)
    - No longer subject to limitation at the partner level (*i.e.*, not retested)

Partnership ATI
Special Considerations

- Generally, partnership ATI is determined in accordance with rules for determining ATI in nonpartnership situations
- Special adjustments to a partnership's ATI:

Include:

  - Section 734(b) adjustments

Do not include:

  - Section 743(b) adjustments
  - Built-in-loss amounts under Section 704(c)(1)(C)
  - Section 704(c) remedial allocations

The items above that are not included in a partnership's ATI would be included in the partner's ATI

Excess Business Interest Expense

Effect on Partner Basis; Partnership Interest Disposition

- Partner's adjusted basis is reduced, but not below zero, by the amount of allocated EBI
- Both deductible and EBI are subject to Section 704(d) loss limitation rules.
- New rules for dispositions (sale, exchange, redemption) of partnership interest to provide for an increase in outside basis for unused carried-forward EBI
  - A disposition of all or **substantially all** of a partnership interest will **increase** the partner's adjusted basis in the partnership immediately before the disposition by the remaining amount of excess interest (if any)
  - A disposition of **less** than substantially all of its interest will **not increase** the partner's adjusted basis

The term "substantially all" is not defined in the proposed regulations

Complex 11-Step Process

Allocate Business Interest Expense and Section 163(j) items

- 11-step process for allocating excess section 163(j) items
  - Would assist in getting excess items to be allocated in the same manner as nonseparately stated taxable income or loss of the partnership
    - Represents effort to coordinate partnership-level determination of 163(j) items with specially allocated amounts under section 704
  - Steps are a mix of entity and aggregate approaches
    - Initial steps require the partnership to allocate and test items at the entity-level
    - Remaining steps require the partnership to analyze and test items at the partner-level
    - Upon completion - Total amount of deductible business interest expense and section 163(j) excess items allocated to each partner will equal the total amount of deductible business interest expense and section 163(j) excess items

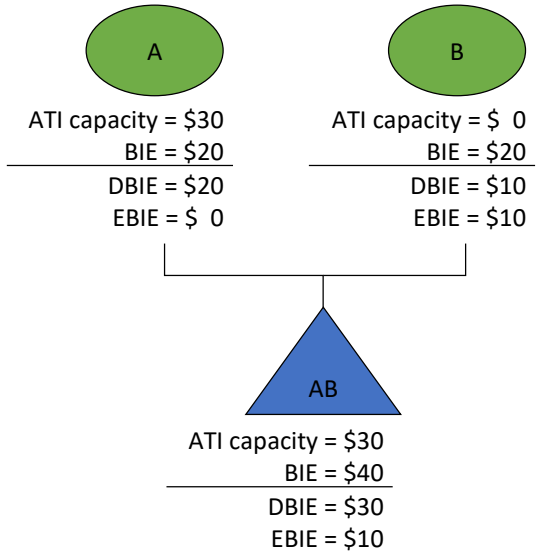
Steps do not affect any other provision under the Internal Revenue Code, such as Section 704(b)

11-Step Process—Example 1 (reallocation of business interest income excess amounts)

- Facts: Partnership AB has $30 of business interest income and $40 of business interest expense. All of the $30 business interest income is allocated solely to A. The $40 of business interest expense is allocated $20 to each of A and B.
  - A has been allocated more allocable business interest income ($30) than allocable business interest expense ($20). Thus, A has $10 of allocable business interest income *excess*.
  - B has been allocated less allocable business interest income ($0) than allocable business interest expense ($20). Thus, B has $20 of allocable business interest income *deficit*.
  - AB cannot have both excess business interest income and excess business interest expense in the same year; so there is a reallocation of allocable business interest income excess to partners with allocable business interest income deficits to reconcile the partner-level calculations with the partnership-level result.
    - Proportionately reduce each partner's excess amount (A's excess amount is reduced by $10);
    - Then proportionately reduce each partner's deficit amount to reflect the reallocation of the benefit of the excess amounts (B's deficit amount is reduced by $10).
  - As a result, A has $20 of deductible business interest expense, and B has $10 of deductible business interest expense and $10 of excess business interest expense.

11-Step Process—Example 2 (reallocation of ATI excess amounts)

- Facts: Partnership AB has $100 of ATI (and no business interest income), all allocated to A. AB has $40 of business interest expense, allocated $20 to each of A and B.
  - Here--A's ATI capacity is 30% of A's final allocable ATI (*i.e.*, 30% of $100, or $30). The 30% gross down is parallel to the partnership's adjustment to its ATI under section 163(j)(1)(B).
  - Following the 30% gross down, these facts closely resemble the facts in example 1 ($100 of ATI is capable of deducting the same amount of business interest expense as $30 of business interest income).
  - A similar reallocation occurs, and results in the same answer as in example 1.
  - Note, the reallocation of excess amounts relating to ATI occurs after the reallocation of excess amounts relating to business interest income.



Federal Bar Association

Partnership Other Key provisions and Reserved Items

- Proposed regulations left several key areas unaddressed, including:
  - Partnership mergers and divisions
  - Self-charged lending of loans between partners and partnerships
  - Tiered partnerships
- The IRS and Treasury Department have requested comments