

Chapter 3

Interest Expense Limit, Partnerships, and S corporations

TCJA:

New Interest Deduction
Limit

Section 163(j)

*Proposed Regulations
On 163(j)
REG-106089-18
(November 26, 2018)*

- **Effective Date:** Tax years ending after the date the FINAL regulations are published (inevitably 2019).
- Taxpayers **can rely on the §163(j) proposed regulations in TYBA 12/31/2017** so long as the taxpayers and their related parties consistently apply the regulations.

Statutory Effective Date

Tax years beginning
after December 31,
2017.

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Business interest expense for a tax year cannot exceed the sum of:

- a) the **business interest income**;
- b) 30% of the taxpayer's adjusted taxable income (ATI);
- c) the taxpayer's floor plan financing interest expense.

Carryforward. Disallowed business interest expense **is treated as business interest expense paid or accrued in the succeeding taxable year.**

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Draft Form

Form **8990**
(December 2018)
Department of the Treasury
Internal Revenue Service

Limitation on Business Interest Expense Under Section 163(j)

OMB No. 1545-0123

▶ Attach to your tax return.

▶ Go to www.irs.gov/Form8990 for instructions and the latest information.

Taxpayer name(s) shown on tax return

Identification number

Part I Computation of Allowable Business Interest Expense

Part I is completed by all taxpayers subject to section 163(j). Schedule A and Schedule B need to be completed before Part I when the taxpayer is a partner or shareholder of a pass-through entity subject to 163(j).

Section I—Business Interest Expense

1	Current year business interest expense (not including floor plan financing interest expense), before the section 163(j) limitation	1			
2	Disallowed business interest expense carryforwards from prior years. (Does not apply to a partnership)	2			
3	Partner's excess business interest expense treated as paid or accrued in current year (Schedule A, line 44, column (h))	3			
4	Floor plan financing interest expense. See instructions	4			
5	Total business interest expense. Add lines 1 through 4 ▶			5	

Section II—Adjusted Taxable Income

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Adjusted Taxable Income (ATI)

(Prop. Regs. provide a detailed definition well beyond the statute)

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ATI per 163(j)(8)(A)

Taxable Income **without regard to:**

- (i) Nonbusiness income, gain, deduction, loss, or loss;
- (ii) Any business interest expense or business interest income;
- (iii) Net operating loss deduction;
- (iv) Section 199A deduction; and,
- (v) TYBB January 1, 2022, any depreciation, amortization, or depletion.

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Scope

- Applies to all taxpayers, **including C corporations.**
- **The limit is calculated separately by the partnership and the partner (unless excepted).**
- **Gross Receipts Exemption:** §163(j)(1) [the **interest deduction limit**] does not apply if gross receipts, per §448(c), are \leq \$25 million.
- **Tax Shelters are not Exempt:** The gross receipts exemption does not apply to **tax shelters defined in §448(c)(3).**

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“Tax Shelter” (sec. 461(c)(3))

- A. “any enterprise (other than a C corporation) if ... required to be registered with any Federal or State agency having the authority to regulate the offering of securities for sale, and
- B. any **syndicate** (within the meaning of section 1256(e)(3)(B)), and
- C. any tax shelter (as defined in section 6662(d)(2)(C)(ii)).”

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Syndicate: “a partnership or any other entity [other than a C corporation] if **more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs.**” (Sec. 1256(e)(3)(B))

- No losses, not a syndicate (PLR 8753032)

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Tax Exempts

An organization subject to tax under section 511 includes only gross receipts taken into account in determining its **unrelated business taxable income.**

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Business Interest Expense

- The term **business interest expense** means interest expense that is properly allocable to a **non-excepted trade or business** or that is floor plan financing interest expense.
- **Business interest expense** also includes disallowed business interest expense carryforwards.
(Prop. reg. 1.163(j)-1(b)(2)(i))

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Excepted T-Bs (reg. 1.163(j)-1):

- (A) The trade or business of performing services as an employee.
- (B) Any electing real property trade or business.
- (C) Any electing farming business.
- (D) Any excepted regulated utility trade or business.

With a PSP, it causes the partner to also be shielded with respect to the business interest expense of that T-B; however, the gross receipts are included for purposes of determining if exempt from 163(j).

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Option to Elect Out Of §163(j) -- an "Excepted" T-B

Must be elected (irrevocable)
by the extended due date.

Attach statement titled:
"Section 1.163(j)-9 Election"

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Election Out for RPTBs

- A “real property trade or business” (RPTB) can elect out.
- An RPTB is any real property:
 - development,
 - redevelopment,
 - construction,
 - reconstruction,
 - acquisition,
 - conversion,
 - rental,
 - operation,
 - management,
 - leasing, or
 - brokerage trade or business. (sec. 469(c)(7)(C))

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Price of Election Out:

ADS For:

- 1) qualified improvement property (QIP) (20 yrs but TCJA technical correction required),
 - 2) residential rental property (RRP) (30 or 40 yrs), and
 - 3) nonresidential real property (NRP) (Section 168(g)(8)) (40 yrs).
- Election precludes bonus depreciation on the QIP, RRP and NRP.
 - But §179 remains available for QIP...
 - The election out is irrevocable.

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- Effective Date: “tax years beginning after 2017”
 - NOT property placed in service after 2017.
 - So electing taxpayer must depreciate property placed in service before 2018 using ADS.
 - So, residential real estate placed in service before 2017 must use 40 year ADS. (confirmed in Rev. Proc. 2019-3 (12/21/26))
- Rev. Proc. 2019-3 declares that the election is a “change in use” no 3115 or 481 adjustment (per CCH).
- If a taxpayer failed to switch to ADS, then a subsequent year change would be an accounting method change.

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JCT Blue Book Footnote 636

A technical correction may be necessary to reflect that an electing real property trade or business is also required to use ADS to depreciate its qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property (as defined under prior law) that was placed in service prior to 2018 and is owned by the taxpayer as of the beginning of the year of the election out of the interest limitation. Congress intends that an election out of the interest limitation and resulting required use of ADS be treated as a change in use of the property. See sec. 168(i)(5) and Treas. Reg. sec. 1.168(i)-4.

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New Prop. Reg. 1.469-9(b)(2)

- “The term real property includes land, buildings, and other inherently permanent structures that are permanently affixed to land. Any interest in real property, including fee ownership, co-ownership, a leasehold, an option, or a similar interest is real property under this section....”
 - **Does not include** property produced for sale that will be incorporated into real property such as windows, paint, bricks, nails, HVAC systems, etc..
 - **Does not include** “any trade or business that involves the cultivation and harvesting of plants, crops, or trees, or severing, extracting” or mining.

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“Buildings include the following assets if permanently affixed to land:

- houses;
- townhouses;
- apartments;
- condominiums;
- hotels;
- motels;
- stadiums;
- arenas;
- shopping malls;
- factory and office buildings;
- warehouses;
- barns;
- enclosed garages;
- enclosed transportation stations and terminals;
- and stores.”

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- **Real Property Operation:** "...means **handling, by a direct or indirect owner of the real property**, *the day-to-day operations of a trade or business...*, relating to the maintenance and occupancy of the real property that affect the availability and functionality of that real property used, or held out for use, by customers where payments received from customers are principally for the customers' use of the real property.
- **Real Property Management:** "...means **handling, by a professional manager**, *the day-to-day operations of a trade or business...*, relating to the maintenance and occupancy of real property that affect the availability and functionality of that property used, or held out for use, by customers where payments received from customers are principally for the customers' use of the real property.

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Real Property T-B Definition Applicable to REPs (unchanged).

"Trade or business. A **trade or business ...including any interest in rental real estate that gives rise to deductions under section 212.**" (Reg. 1.469-9(b)(1))

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Prop. Reg. 1.469-9(b)(2)(iii)

Ex. (1): A owns farmland and uses the land in A's farming business to grow and harvest crops.

- o Is **NOT** a real property trade or business.

Ex (2): B is a retired farmer and owns farmland that B rents exclusively to C to operate a farm.

- o **B IS in a real property trade or business (RPTB) "within the meaning of paragraph (b)(1) of this section" (§212 OK so NNN OK)**
- o **C is NOT engaged in an RPTB because a farming business.**

Ex. (3): D owns a building in which D operates a restaurant and bar.

- o **D is NOT engaged in an RPTB** because "payments by D's customers are principally for significant or extraordinary personal services..."

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Ex (4):

- **E owns a majority interest in an S corporation, X, that is engaged in the trade or business of manufacturing industrial cooling systems for installation in commercial building.**
- **E also owns a majority interest in an S corporation, Y, that purchases the industrial cooling systems from X and that installs, maintains, and repairs those systems in both existing commercial buildings and commercial buildings under construction.**
 - o **E, X and Y are NOT engaged in RPTBs.**

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Ex (5):

- F owns an interest in P, a limited partnership. P owns and **operates a luxury hotel**.
- G is a **professional manager** employed by M who **handles the day-to-day business operations** relating to M's provision of maid and janitorial services to M's various customers, including P.
 - **F and P are** in an RPTB.
 - **G and M are NOT** in an RPTBs.

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Related Party Rental Anti-Abuse Rule

An **RPTB cannot elect out** if it leases

- a) more than 80% of its real property to
- b) a trade or business,

if **50% of the direct and indirect ownership of both** are held by related parties under 267(b) and 707(b).

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Rev. Proc. 2018-59 -- Safe Harbor for Infrastructure Projects

- Treasury is “aware that there **may be uncertainty as to whether certain infrastructure arrangements** between private persons and governmental entities under which private persons maintain or provide other services with respect to core infrastructure property such as roads, bridges, or other similar property are included in the definition of a real property trade or business under section 469(c)(7)(C).”
- **They are eligible to elect RPTB treatment.**

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Election Out for a Farming Business

- Taxpayers engaged in a farming business can elect out.
- A farming business includes the traditional cultivation of land or the raising or harvesting of any agricultural or horticultural commodity.
- **Price of Election Out:** Must use **ADS** for any “property with a recovery period of 10 years or more which is held by an electing farming business” including land improvements, barns, and farm buildings.
 - The election is irrevocable.
 - Not a change in accounting method per **Rev. Proc. 2019-3**.
 - Election precludes bonus depreciation (Section 168(g)(1)(G))

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All C Corp. Interest Is Business Interest

- All interest paid on C corporation debt owed is business interest expense. Notice 2018-28 (April 2, 2018)
- All interest income on loans by a C corporation is business interest income.
- Includes the interest income and expenses of a **C corporation partner** even if investment interest at the partnership level.

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Example 1 (Reg. 1.163(j)-2(g) Ex. 1 Modified)

- X is a non-excepted business and not a tax shelter.
- During its taxable year ending December 31, 2019, X has:
 - Gross receipts of \$32 million.
 - ATI of \$10 million.
 - Business interest expense of \$5 million, which includes \$1 million of floor plan financing interest expense, and
 - Business interest income of \$2 million.

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C Corp X In 2019 (in thousands)	
Sales	30,000
Business Int. Inc.	<u>+ 2,000</u>
Gross Receipts	= 32,000
Cost of Goods Sold	10,000
Bus. Interest Exp.	5,000 (1,000 is floor plan int.)
Depreciation	3,000
Operating Exp.	<u>9,000</u>
Total CGS + Expenses	<u>27,000</u>
T.I. pre-163(j)	<u>5,000</u>

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C Corp X In 2019 (in thousands)	
Sales	30,000
Business Int. Inc.	<u>+ 2,000</u>
Gross Receipts	= 32,000
Cost of Goods Sold	10,000
Bus. Interest Exp.	5,000 (1,000 of floor plan int)
Depreciation	3,000**
Operating Exp.	<u>9,000</u>
Total CGS + Expenses	<u>27,000</u>
Taxable Income	<u>5,000</u>
Sum: <2,000> + 4,000* + 3,000 =	<u>5,000</u>
Adjusted Taxable Income	<u>10,000</u>

* \$5,000 of business interest minus \$1,000 of floor plan financing bus. int. expense.

**Depreciation added back until after 2021. Includes bonus but no add back for section 179

Recall:

Business interest expense for a tax year cannot exceed the sum of:

- a) the business interest income;
- b) 30% of the taxpayer's adjusted taxable income (ATI);
- c) the taxpayer's floor plan financing interest expense.

Section 163(j) Limit:	
Business Interest Income	2,000
30% x 10,000 of ATI =	3,000
Floor plan financing int. exp.	<u>1,000</u>
Total 163(j) Limit	<u>6,000</u>

X can deduct all \$5,000 of business interest expense in 2019

Example 2

(Reg. 1.163(j)-2(g) Ex. 2 Modified)

- Same as Example 1 except X has \$8 million of business interest expense instead of \$5 million.
 - The \$8 million again includes \$1 million of floor plan financing interest.

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C Corp X In 2019 (in thousands)	
Sales	30,000
Business Int. Inc.	<u>+ 2,000</u>
Gross Receipts	= 32,000
Cost of Goods Sold	10,000
Bus. Interest Exp.	8,000 (1,000 is floor plan int.)
Depreciation	3,000
Operating Exp.	<u>9,000</u>
Total CGS + Expenses	<u>30,000</u>
T.I. pre-163(j)	<u>2,000</u>

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C Corp X In 2019 (in thousands)	
Sales	30,000
Business Int. Inc.	<u>+ 2,000</u>
Gross Receipts	= 32,000
Cost of Goods Sold	10,000
Bus. Interest Exp.	8,000 (1,000 of floor plan int)
Depreciation	3,000
Operating Exp.	<u>9,000</u>
Total CGS + Expenses	<u>30,000</u>
Taxable Income	<u>2,000</u>
Sum: <2,000> + 7,000* + 3,000 =	<u>8,000</u>
Adjusted Taxable Income	<u>10,000</u>

* \$8,000 of business interest exp. minus \$1,000 of floor plan financing bus. int. exp.

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Section 163(j) Limit:	
Business Interest Income	2,000

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Section 163(j) Limit:	
Business Interest Income	2,000
30% x 10,000 of ATI =	3,000

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Section 163(j) Limit:	
Business Interest Income	2,000
30% x 10,000 of ATI =	3,000
Floor plan financing int. exp.	<u>1,000</u>
Total 163(j) Limit	<u>6,000</u>

X Corp. deducts \$6 million in 2019.

\$2 million carries forward to 2020.

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What if X Corp meets the “small business exemption” (> 25 mil.) in 2020?

- The **carried forward interest** of \$2 million frees up in 2020 (Prop. reg. 1.163(j)(3)(c)), i.e. is “deductible in that taxable year unless disallowed, deferred, or capitalized under another provision of the Code.” (Preamble)
- Section 163(j) does not apply.

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Example 3 (Reg. 1.163(j)-2(g) Ex. 3 Modified)

- During the 2019 taxable year, Y has taxable income of \$3 million (pre-§163(j)), which includes:
 - \$2 million of business interest income;
 - \$5 million of business interest expense, which includes \$1 million of floor plan financing interest expense;
 - \$2.5 mil. of net operating loss deduction under section 172; and
 - \$1.5 mil. of depreciation deduction under section 167.

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C Corp X In 2019 (in thousands)	
Sales	30,000
Business Int. Inc.	<u>+ 2,000</u>
Gross Receipts	= 32,000
Cost of Goods Sold	10,000
Bus. Interest Exp.	5,000 (1,000 is floor plan int.)
Depreciation	1,500
Operating Exp.	10,000
NOL Deduction	<u>2,500</u>
Total CGS + Expenses	<u>29,000</u>
Taxable Income (Pre-163(j))	<u>3,000</u>

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C Corp X In 2019 (in thousands)	
Sales	30,000
Business Int. Inc.	<u>+ 2,000</u>
Gross Receipts	= 32,000
Cost of Goods Sold	10,000
Bus. Interest Exp.	5,000 (1,000 of floor plan int)
Depreciation	1,500
Operating Exp.	10,000
NOL Deduction	<u>2,500</u>
Total CGS + Expenses	<u>29,000</u>
Taxable Income	<u>3,000</u>
Sum: <2,000> + 4,000* + 1,500 + 2,500 =	<u>6,000</u>
Adjusted Taxable Income	9,000

*5,000 business interest minus \$1,000 of floor plan financing interest expense.

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Section 163(j) Limit:	
Business Interest Income	2,000
30% x 9,000 of ATI =	2,700
Floor plan financing int. exp.	<u>1,000</u>
Total 163(j) Limit	<u>5,700</u>

X can deduct all \$5,000
of business interest
expense in 2019

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Gross Receipts Test of 448(c)(1)

"A corporation or partnership **meets the gross receipts test** of this subsection for any taxable year if the **average annual gross receipts of such entity for the 3-taxable-year period ending with the taxable year** which precedes such taxable year **does not exceed \$25,000,000.**"

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Worksheet in Draft Form 8990 Instructions

Average Annual Gross Receipts Worksheet Per Section 448(c)

	Column A	Column B	Column C
	1st preceding tax year	2nd preceding tax year	3rd preceding tax year
1. Annual gross receipts	\$	\$	\$
2. Plus annual gross receipts of related entities per aggregate rules	\$	\$	\$
3. Total annual gross receipts	\$	\$	\$
4. Average annual gross receipts (line 3 columns A+B+C divided by 3)	\$	\$	\$

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Form 8990 Draft Instructions

For purposes of section 163(j), a taxpayer with an ownership interest in a partnership or S corporation, must include a share of the partnership's or S corporation's gross receipts, in proportion to the partner's distributive share or S corporation's pro rata share of gross income, unless the partner and partnership, or S corporation shareholder and S corporation, are treated as a single person.

- To avoid partner inquiries, report gross receipts on Form 1065 K-1 Box 20

20	Other information

- Also to avoid inquiries, report each partner's share of PSP (or S corp) business interest expense if the PSP (or S corp) escapes §163(j).

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Gross Receipts Exemption:

- Taxpayers that **meet the gross receipts test** of section 448(c) are not subject to the section 163(j) limitation.
- The gross receipts test may be met at the PSP level (so no 163(j) limit), **yet failed at the partner level (thus the partner is subject to 163(j))**
- If exempt, the taxpayer **cannot** elect out of 163(j) (with say a real estate T-B), "because the taxpayer is already not subject to the section 163(j) limitation." (preamble).

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Example 4

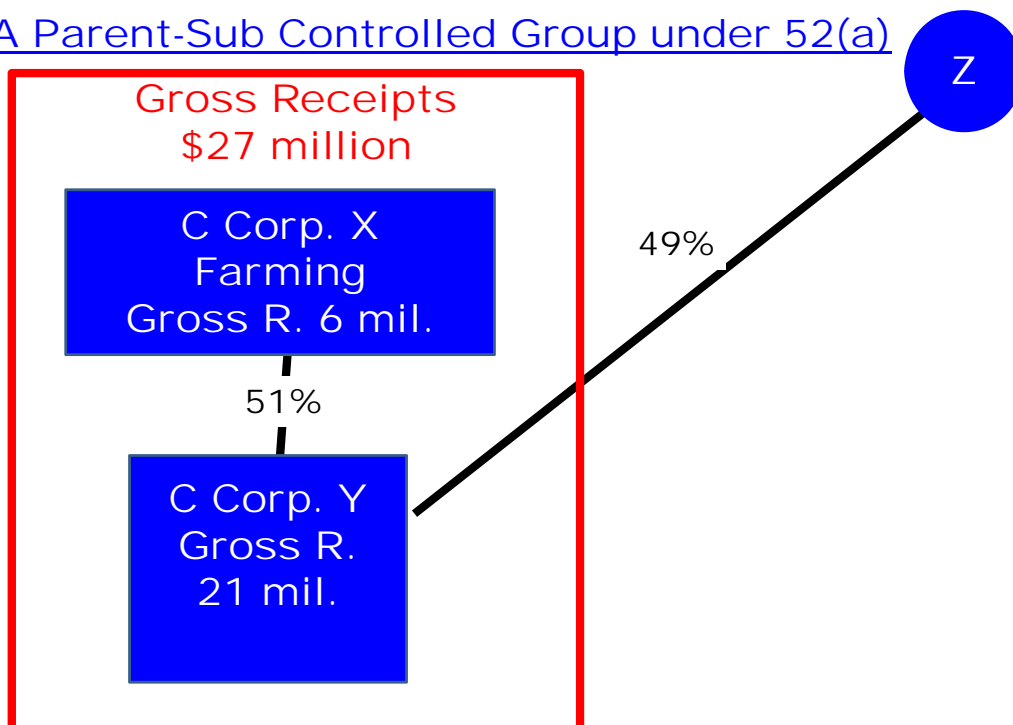
(Reg. 1.163(j)-2(g) Ex. 7 verbatim)

Facts.

- X and Y are domestic C corporations under common control, within the meaning of section 52(a) and §1.52-1(b).
- X's only trade or business is a farming business described in §1.263A-4(a)(4).
- During the taxable year ending December 31, 2019, X has average annual gross receipts under section 448(c) of \$6 million.
- During the same taxable year, Y has average annual gross receipts under section 448(c) of \$21 million.

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A Parent-Sub Controlled Group under 52(a)



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Analysis

- Because X and Y are under common control, they must aggregate gross receipts for purposes of section 448(c) and the small business exemption in §1.163(j)-2(d). See section 448(c)(2).
- Therefore, X and Y are both considered to have \$27 million in average annual gross receipts for 2019.
- X and Y must separately apply section 163(j) to determine any limitation on the deduction for business interest expense.
- Assuming X otherwise meets the requirements in §1.163(j)-9 in 2019, X may elect for its farming business to be an excepted trade or business.
 - Note, the failure to be exempt was determined first.
 - If not exempt, cannot elect out.

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Aggregation rules -- §448(c)(2)

"All persons treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414 shall be treated as one person for purposes of paragraph (1)." (§448(c)(2))

§52(a). [same controlled group of corporations" substituting > 50% for ≥ 80%].

52(b). Employees of T-Bs under common control, whether or not incorporated (Sch C, PSPs, S corps, C corp., Trust, Estate)

§414(m). Affiliated Service Group.

§414(o). Authority for anti-abuse regulations.

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Gross Receipts of Individual (Per Preamble)

- “For an individual taxpayer, it is intended that gross receipts include all items that a business entity could receive, including, but not limited to, business receipts and investment receipts.” (Preamble).

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Inherently Personal Items Excluded

“The only items that an individual taxpayer may exclude from gross receipts for the purpose of the section 163(j) small business exemption are inherently personal items. Inherently personal items include:

- Social Security benefits,
- personal injury awards and settlements,
- disability benefits, and
- wages received as an employee that are reported on Form W-2.” (Preamble)

See Prop. Reg. 1.163(j) – 6(d)(2)(ii)).

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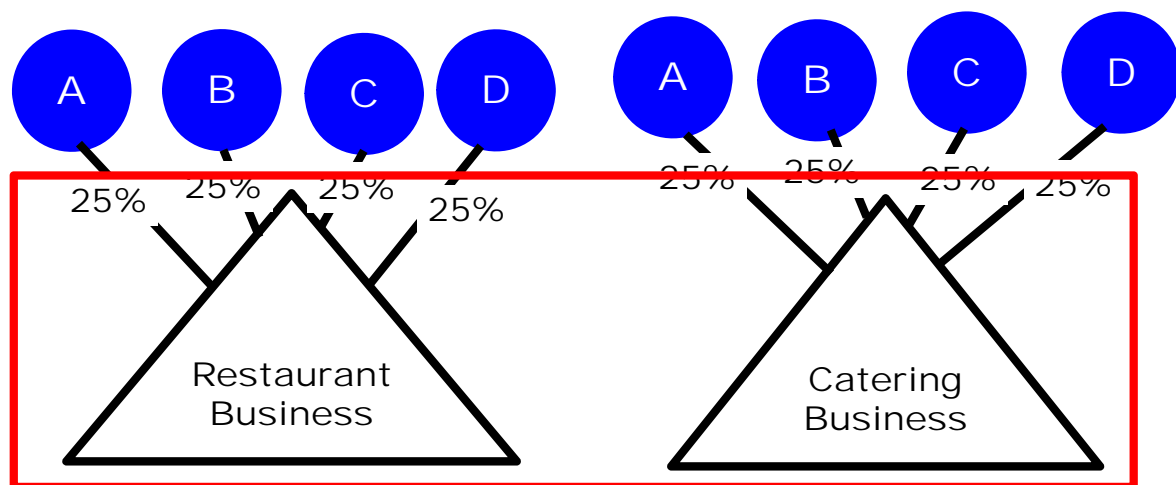
Reg. 1.52-1(d) – Brother-Sister Group

“The term ‘brother-sister group under common control’ means two or more organizations conducting trades or businesses if

- (i) the **same five or fewer persons who are individuals, estates, or trusts** own (directly and with the application of §1.414(c)-4(b)(1) **(options)**), a **controlling interest** of each organization” (Control interest is 80% or more)
- (ii) Taking into account **identical ownership** only, the five or fewer persons have “**effective control**” (= 50% or more ownership).

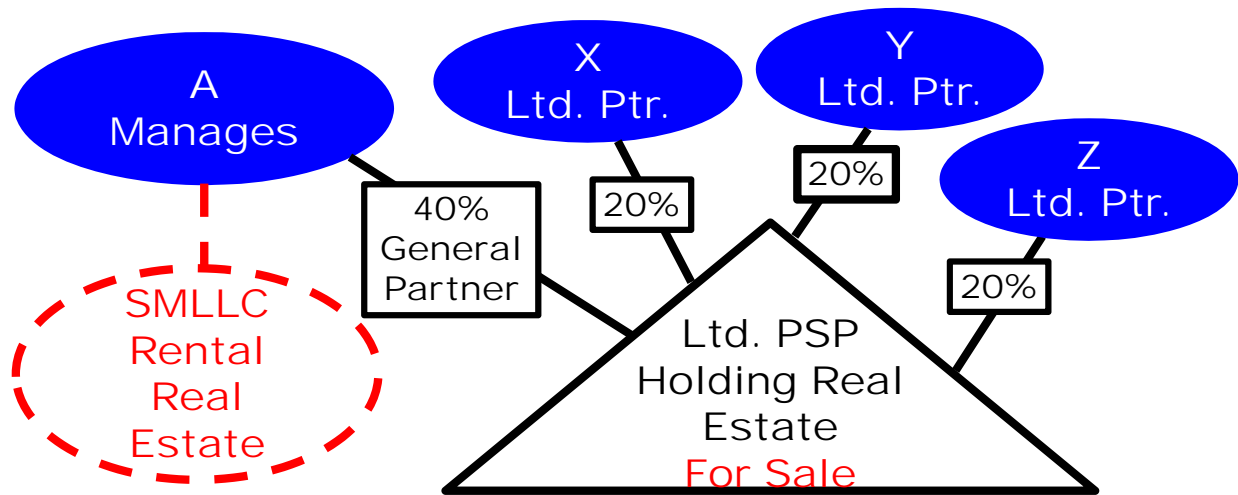
Family attribution: spouse, children (see §1563(e)(6)) e59

Brother-Sister Common Control (Reg. 1.52-1(d))



Five or fewer own 100% controlling interest (not merely 80%) and have effective control 100% (not merely 50%)

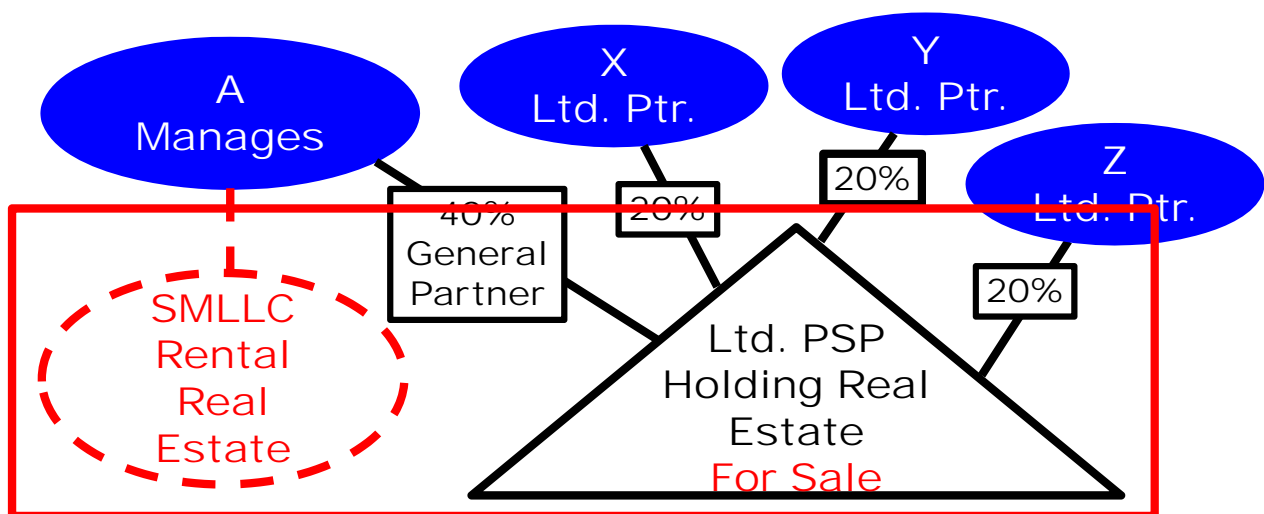
If A, X, Y, and Z are all unrelated?



- No "controlling interest" (only 40% not 80%) and no "effective control (only 40% not 50%).

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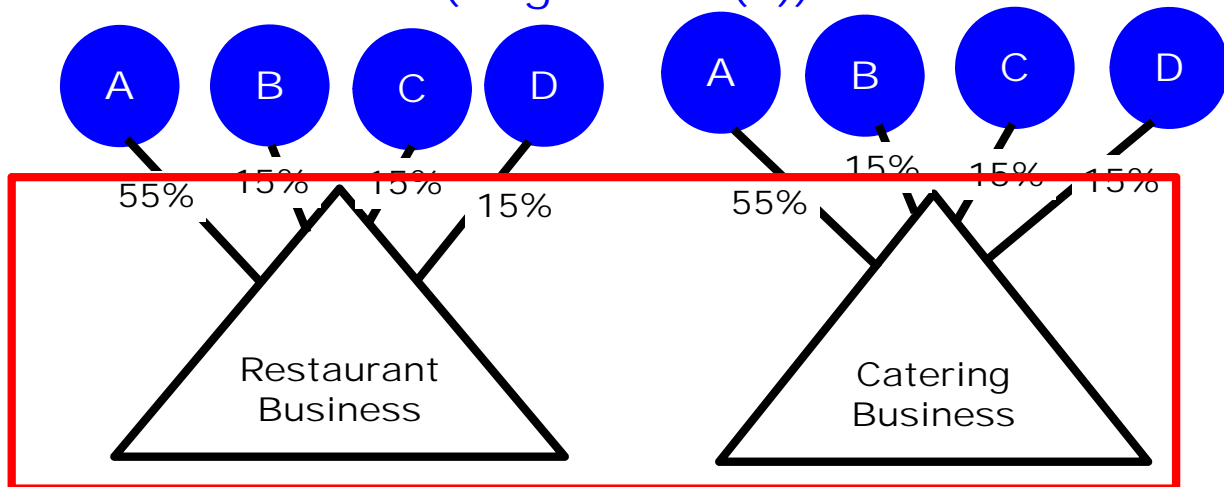
If A, X, and Y are related



- A has a "controlling interest" (80%) and "effective control" of 50% via family attribution so a brother-sister control group.

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Common Control (Reg. 1.52-1(d))



- The Two PSPs are brother sister common control (80/50)
- A has 55% of gross receipts from each PSP (more if aggregated)
- For B,C,D, will reflect 15% of gross receipts from each PSP.

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Ordering Rule for Noncorporate Taxpayers

§163(j) applies **after entity basis limits** but **before** the application of:

- §461(l) (business loss limits),
- §465 (at-risk limit), and
- §469 (passive loss rules)

Treatment of S Corporations and S shareholders

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Treatment of S Corporations

- Generally the same as C corporations
- First, compute the 163(j) limit on the deduction for business interest expense.
- The excess interest expense over the 163(j) limit in the current year is carried forward to the following year - **at the entity level (same as a C corporation)**.
- Unlike C corporations, with S corps the entity reports its **"Excess Taxable Income"** to S shareholders to help the shareholder increase ATI at the shareholder level (same for partners).

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Treatment of Partnerships and Partners

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Avoid filing Form 8990 if you can check the "Yes" Box on Form 1065, Sch B, Line 24

Yes | No

23	Did the PSP elect out for any real property T-B or farming T-B		
24	Did the PSP satisfy ONE the following conditions and is not an upper-tier PSP with EBIE:	-through	
a	(a) Gross receipts do not exceed 25 mil. in three prior years and not a tax shelter, or	3 tax years	✗
b	(b) The PSP only has business interest expense from and electing RPTP, electing Farm, or utility business.	s, (2) an	
If "No", complete and attach Form 8990			

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Assume PSP meets the gross receipts test -- draft Form 8990 Instructions

A pass-through entity that is a small business taxpayer does not allocate excess taxable income, excess business interest income, or excess business interest to its owners.

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Reg. Example (1) Modified to Thousands

- Assume that the PSP and Partners have gross receipts over 25 million and cannot elect out.
- X and Y are equal partners in partnership PRS.
- In Year 1, PRS has \$100K of ATI and \$40K of business interest expense.
- PRS allocates the items comprising its \$100K of ATI \$50K to X and \$50K to Y.
- PRS allocates its \$40K of business interest expense \$20K to X and \$20K to Y.

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PRS Partnership in 2019		Allocations	
		Partner X	Partner Y
Gross Receipts	200,000	100,000	100,000
Interest Exp.	- 40,000	-20,000	-20,000
Operating Exp.	<u>-100,000</u>	<u>-50,000</u>	<u>-50,000</u>
Net Income	<u>60,000</u>	<u>30,000</u>	<u>30,000</u>

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PRS Partnership in 2019		Allocations	
		Partner X	Partner Y
Gross Receipts	200,000	100,000	100,000
Interest Exp.	- 40,000	-20,000	-20,000
Operating Exp.	<u>-100,000</u>	<u>-50,000</u>	<u>-50,000</u>
Net Income	<u>60,000</u>	<u>30,000</u>	<u>30,000</u>
+ Interest Exp.	40,000	20,000	20,000
Adj. Tax. Inc (ATI) =	<u>100,000</u>		

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PRS Partnership in 2019		Allocations	
		Partner X	Partner Y
Gross Receipts	200,000	100,000	100,000
Interest Exp.	- 40,000	-20,000	-20,000
Operating Exp.	<u>-100,000</u>	<u>-50,000</u>	<u>-50,000</u>
Net Income	<u>60,000</u>	<u>30,000</u>	<u>30,000</u>
+ Interest Exp.	40,000	20,000	20,000
Adj. Tax. Inc (ATI) =	<u>100,000</u>		
Deductible BIE (30% x ATI)	30,000		
EBIE (40K - 30K)	10,000		

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Interest Allowed To Partnership (same as S corp.)

Interest Not Limited by section 163(j)(1) is:

- 1) "taken into account in determining" non-separately stated income or loss.
- 2) allocated the same as bottom line income or loss.
(Section 163(j)(4)(A))
- 3) Losses its character as business interest expense.

74

PRS Partnership in 2019		Allocations	
		Partner X	Partner Y
Gross Receipts	200,000	100,000	100,000
Interest Exp.	- 40,000	-20,000	-20,000
Operating Exp.	<u>-100,000</u>	<u>-50,000</u>	<u>-50,000</u>
Net Income	<u>60,000</u>	<u>30,000</u>	<u>30,000</u>
+ Interest Exp.	40,000	20,000	20,000
Adj. Tax. Inc (ATI) =	<u>100,000</u>		
Deductible BIE (30% x ATI)	30,000		
EBIE (40K - 30K)	10,000		
Line 22 of 1065 (60K + 10K)	70,000	35,000	35,000

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PRS Partnership in 2019		K-1 Allocations	
		Partner X	Partner Y
K-1 Net Business Income		35,000	35,000
K-1 Excess Bus. Int. Exp. (EBIE) (paid or accrued next year IF ETI)		5,000	5,000

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- The **excess business interest expense** is carried forward at the partner level.
- An **S corps. excess business interest expense** carries forward at the entity level.

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Partnership Draft K-1 for 2018 Box 13 – Other Deductions

13. Other deductions

- A Cash contributions (60%)
- B Cash contributions (30%)
- C Noncash contributions (60%)
- D Noncash contributions (30%)
- E Capital gain property to a 50% organization (30%)
- F Capital gain property (20%)
- G Contributions (100%)
- H Investment interest expense
- I Deductions—royalty income
- J Section 59(e)(2) expenditures
- K Excess business interest expense**

Partnerships
But Not
S Corps

J

↓

78

- **EBIE** is pushed forward to the partner's following tax year but is generally not treated as paid or incurred by the partner until the partner has **excess taxable income or excess business interest income** from that same partnership.
- **EBIE** must be allocated to partners the same as bottom line income or loss.
- The partner's outside basis is reduced by the partner's share of **EBIE**. (Section 163(j)(4)(B))

79

<u>PRS Partnership in 2019</u>	<u>K-1 Allocations</u>	
	Partner X	Partner Y
K-1 Net Business Income	35,000	35,000
K-1 Excess Bus. Int. Exp. (EBIE) (paid or accrued next year IF ETI)	5,000	5,000

<u>Partner Y:</u>	
PRS ATI to Partner Y	0
Sole-Prop. ATI	0
Total Partner Y ATI	0
Y's Bus. Int. Exp. Deduction Limit (30% x 0)	0
Sole-Prop. Bus. Interest Exp. (BIE)	20,000

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<u>PRS Partnership in 2019</u>	<u>K-1 Allocations</u>	
	Partner X	Partner Y
K-1 Net Business Income	35,000	35,000
K-1 Excess Bus. Int. Exp. (EBIE) (paid or accrued next year If ETI)	5,000	5,000

<u>Partner Y:</u>	
PRS ATI to Partner Y	0
Sole-Prop. ATI	0
Total Partner Y ATI	0
Y's Bus. Int. Exp. Deduction Limit (30% x 0)	0
Sole-Prop. Bus. Interest Exp. (BIE)	20,000
Deductible BIE	0
BIE treated as paid or accrued next year	20,000

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<u>PRS Partnership in 2019</u>	<u>K-1 Allocations</u>	
	Partner X	Partner Y
K-1 Net Business Income	35,000	35,000
K-1 Excess Bus. Int. Exp. (EBIE) (paid or accrued next year If ETI)	5,000	5,000

<u>Partner X:</u>	
PRS ATI to Partner X	0
Sole-Prop. ATI	100,000
Total Partner X ATI	100,000
X's Bus. Int. Exp. Deduction Limit (30% x 100K)	30,000
Sole-Prop. Bus. Interest Exp. (BIE)	20,000

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<u>PRS Partnership in 2019</u>	<u>K-1 Allocations</u>	
	Partner X	Partner Y
K-1 Net Business Income	35,000	35,000
K-1 Excess Bus. Int. Exp. (EBIE) (paid or accrued next year If ETI)	5,000	5,000

<u>Partner X:</u>	
PRS ATI to Partner X	0
Sole-Prop. ATI	100,000
Total Partner X ATI	100,000
X's Bus. Int. Exp. Deduction Limit (30% x 100K)	30,000
Sole-Prop. Bus. Interest Exp. (BIE)	20,000
Deductible BIE	20,000
BIE tr	Note that X cannot deduct the \$5,000
	From PRS because no ETI yet from PRS

83

Reg. Example (2) Modified To Thousands

- The facts are the same as in Example 1.
- In Year 2, PRS has:
 - \$200K of ATI,
 - \$0 of business interest income, and
 - \$30K of business interest expense.
- PRS allocates the items comprising its \$200 of ATI:
 - \$100K to X and
 - \$100K to Y.
- PRS allocates its \$30 of business interest expense:
 - \$15K to X and
 - \$15K to Y.

84

PRS Partnership in Year 2		Allocations	
		Partner X	Partner Y
Gross Receipts	300,000	150,000	150,000
Interest Exp.	- 30,000	-15,000	-15,000
Operating Exp.	<u>-100,000</u>	<u>-50,000</u>	<u>-50,000</u>
Net Income	<u>170,000</u>	<u>85,000</u>	<u>85,000</u>
+ Interest Exp.	30,000	15,000	15,000
Adj. Tax. Inc (ATI) =	<u>200,000</u>		

85

PRS Partnership in Year 2		Allocations	
		Partner X	Partner Y
Gross Receipts	300,000	150,000	150,000
Interest Exp.	- 30,000	-15,000	-15,000
Operating Exp.	<u>-100,000</u>	<u>-50,000</u>	<u>-50,000</u>
Net Income	<u>170,000</u>	<u>85,000</u>	<u>85,000</u>
+ Interest Exp.	30,000	15,000	15,000
Adj. Tax. Inc (ATI) =	<u>200,000</u>		
BIE Limit (30%x ATI)	60,000		
Deductible BIE	30,000		
EBIE	0		
Line 22 of 1065	170,000	85,000	85,000

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PRs Partnership in Year 2		Allocations	
		Partner X	Partner Y
Gross Receipts	300,000	150,000	150,000
Interest Exp.	- 30,000	-15,000	-15,000
Operating Exp.	<u>-100,000</u>	<u>-50,000</u>	<u>-50,000</u>
Net Income	<u>170,000</u>	<u>85,000</u>	<u>85,000</u>
+ Interest Exp.	30,000	15,000	15,000
Adj. Tax. Inc (ATI) =	<u>200,000</u>		
BIE Limit (30%x ATI)	60,000		
Deductible BIE	30,000		
EBIE	0		
Line 22 of 1065	170,000	85,000	85,000
Excess T.I. (200K - 100K)	100,000	Only \$100,000 of ATI was needed to deduct \$30K BIE	

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PRs Partnership in Year 2		K-1 Allocations	
		Partner X	Partner Y
K-1 Net Business Income		85,000	85,000
K-1 Excess T.I.		50,000	50,000

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Excess Business Interest Expense is treated as paid or incurred by the partner to the extent of **the partner's share of the same partnership's Excess Taxable Income**

(subsection (j)(4)(B)(ii)(I) modified by prop. regs.)

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<u>PRS Partnership in Year 2</u>	<u>K-1 Allocations</u>	
	Partner X	Partner Y
K-1 Net Business Income	85,000	85,000
K-1 Excess T.I.	50,000	50,000

<u>Partner Y:</u>	
ATI from PRS (Excess T.I.)	50,000
Y's Sole-Prop. ATI	<u>0</u>
Y's Total ATI	<u>50,000</u>
Y's BIE Limit (30% x 50,000)	15,000
	90

	<u>PRs Partnership in Year 2</u>		<u>K-1 Allocations</u>	
			Partner X	Partner Y
K-1 Net Business Income			85,000	85,000
K-1 Excess T.I.			50,000	50,000

<u>Partner Y:</u>	
ATI from PRS (Excess T.I.)	50,000
Y's Sole-Prop. ATI	<u>0</u>
Y's Total ATI	<u>50,000</u>
Y's BIE Limit (30% x 50,000)	15,000
BIE from PRS treated as paid or incurred in Yr. 2	5,000
Yr. 2 Sole-Prop. Bus. Interest Exp. (BIE)	20,000
Yr. 2 Sole-Prop. BIE carried from Yr. 1	<u>20,000</u>
Y's Total BIE	<u>45,000</u>
	91

	<u>PRs Partnership in Year 2</u>		<u>K-1 Allocations</u>	
			Partner X	Partner Y
K-1 Net Business Income			85,000	85,000
K-1 Excess T.I.			50,000	50,000

<u>Partner Y:</u>	
ATI from PRS (Excess T.I.)	50,000
Y's Sole-Prop. ATI	<u>0</u>
Y's Total ATI	<u>50,000</u>
Y's BIE Limit (30% x 50,000)	15,000
BIE from PRS treated as paid or incurred in Yr. 2	5,000
Yr. 2 Sole-Prop. Bus. Interest Exp. (BIE)	20,000
Yr. 2 Sole-Prop. BIE carried from Yr. 1	<u>20,000</u>
Y's Total BIE	<u>45,000</u>
Deductible in Year 2	15,000
BIE Treated as Paid or Accrued in Year 3	30,000
	92

	<u>PRs Partnership in Year 2</u>		<u>K-1 Allocations</u>	
			Partner X	Partner Y
			85,000	85,000
K-1 Net Business Income			85,000	85,000
K-1 Excess T.I.			50,000	50,000

<u>Partner X:</u>	
ATI from PRS (Excess T.I.)	50,000
X's Sole-Prop. ATI	<u>100,000</u>
X's Total ATI	<u>150,000</u>
X's BIE Limit (30% x 150,000)	45,000
	93

	<u>PRs Partnership in Year 2</u>		<u>K-1 Allocations</u>	
			Partner X	Partner Y
			85,000	85,000
K-1 Net Business Income			85,000	85,000
K-1 Excess T.I.			50,000	50,000

<u>Partner X:</u>	
ATI from PRS (Excess T.I.)	50,000
X's Sole-Prop. ATI	<u>100,000</u>
X's Total ATI	<u>150,000</u>
X's BIE Limit (30% x 150,000)	45,000
BIE from PRS treated as paid or incurred in Yr. 2	5,000
Yr. 2 Sole-Prop. Bus. Interest Exp. (BIE)	20,000
Yr. 2 Sole-Prop. BIE carried from Yr. 1	<u>0</u>
X's Total BIE	<u>25,000</u>
	94

<u>PRS Partnership in Year 2</u>		<u>K-1 Allocations</u>	
		Partner X	Partner Y
K-1 Net Business Income		85,000	85,000
K-1 Excess T.I.		50,000	50,000

<u>Partner X:</u>	
ATI from PRS (Excess T.I.)	50,000
X's Sole-Prop. ATI	<u>100,000</u>
X's Total ATI	<u>150,000</u>
X's BIE Limit (30% x 150,000)	45,000
BIE from PRS treated as paid or incurred in Yr. 2	5,000
Yr. 2 Sole-Prop. Bus. Interest Exp. (BIE)	20,000
Yr. 2 Sole-Prop. BIE carried from Yr. 1	<u>0</u>
X's Total BIE	<u>25,000</u>
Deductible in Year 2	25,000
BIE Treated as Paid or Accrued in Year 3	0

Reg. Example (3) Modified To Thousands

- The facts are the same as in Example 1.
- In Year 2, PRS has:
 - \$0 ATI,
 - \$60 of business interest income, and
 - \$40K of business interest expense.
- PRS allocates the \$60,000 of Bus. Int. Inc.:
 - \$30K to X and
 - \$30K to Y.
- PRS allocates its \$40 of business interest expense:
 - \$20K to X and
 - \$20K to Y.

PRS Partnership in Year 2		Allocations	
		Partner X	Partner Y
Bus. Int. Inc.	60,000	30,000	30,000
Bus. Op. Inc.	300,000	150,000	150,000
Interest Exp.	- 40,000	-20,000	-20,000
Operating Exp.	<u>-300,000</u>	<u>-150,000</u>	<u>-150,000</u>
Net Bus. Inc.	<u>20,000</u>	<u>10,000</u>	<u>10,000</u>
- Bus. Int. Inc.	- 60,000	15,000	15,000
+Bus. Int. Exp.	+40,000		
Adj. Tax. Inc (ATI)	= <u>0</u>		

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PRS Partnership in Year 2		Allocations	
		Partner X	Partner Y
Bus. Int. Inc.	60,000	30,000	30,000
Bus. Op. Inc.	300,000	150,000	150,000
Interest Exp.	- 40,000	-20,000	-20,000
Operating Exp.	<u>-300,000</u>	<u>-150,000</u>	<u>-150,000</u>
Net Bus. Income	<u>20,000</u>	<u>10,000</u>	<u>10,000</u>
- Bus. Int. Inc.	- 60,000	15,000	15,000
+Bus. Int. Exp.	+40,000		
Adj. Tax. Inc (ATI)	= <u>0</u>		
BIE Limit: (\$0 (30% x 0) + \$60,000 (Bus. Int. Inc.))	60,000		
Deductible BIE	40,000		

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PRs Partnership in Year 2		Allocations	
		Partner X	Partner Y
Bus. Int. Inc.	60,000	30,000	30,000
Bus. Op. Inc.	300,000	150,000	150,000
Interest Exp.	- 40,000	-20,000	-20,000
Operating Exp.	<u>-300,000</u>	<u>-150,000</u>	<u>-150,000</u>
Net Bus. Income	<u>20,000</u>	<u>10,000</u>	<u>10,000</u>
- Bus. Int. Inc.	- 60,000	15,000	15,000
+Bus. Int. Exp.	+40,000		
Adj. Tax. Inc (ATI)	= <u>0</u>		
BIE Limit: (\$0 (30% x 0) + \$60,000 (Bus. Int. Inc.))	60,000		
Deductible BIE	40,000		
Line 22 of 1065	20,000	10,000	10,000
Excess Bus. Int. Inc.	20,000	10,000	10,000

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PRs Partnership in Year 2		K-1 Allocations	
		Partner X	Partner Y
K-1 Net Business Income		10,000	10,000
K-1 Excess Bus. Int. Inc.		10,000	10,000

<u>Partner Y:</u>	
ATI from PRS (\$0 Excess T.I.)	0
Y's Sole-Prop. ATI	<u>0</u>
Y's Total ATI	<u>0</u>
Y's Excess BII (Bus. Int. Inc.)	10,000
Y's BIE Limit (0 (30% x 0) + 10K (BII))	10,000

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<u>PRS Partnership in Year 2</u>		<u>K-1 Allocations</u>	
		Partner X	Partner Y
K-1 Net Business Income		10,000	10,000
K-1 Excess Bus. Int. Inc.		10,000	10,000

<u>Partner Y:</u>	
ATI from PRS (\$0 Excess T.I.)	0
Y's Sole-Prop. ATI	<u>0</u>
Y's Total ATI	<u><u>0</u></u>
Y's Excess BII (Bus. Int. Inc.)	10,000
Y's BIE Limit (0 (30% x 0) + 10K (BII))	10,000
BIE from PRS treated as paid or incurred in Yr. 2	5,000
Yr. 2 Sole-Prop. Bus. Interest Exp. (BIE)	20,000
Yr. 2 Sole-Prop. BIE carried from Yr. 1	<u>20,000</u>
Y's Total BIE	<u><u>45,000</u></u>
	101

<u>PRS Partnership in Year 2</u>		<u>K-1 Allocations</u>	
		Partner X	Partner Y
K-1 Net Business Income		10,000	10,000
K-1 Excess Bus. Int. Inc.		10,000	10,000

<u>Partner Y:</u>	
ATI from PRS (\$0 Excess T.I.)	0
Y's Sole-Prop. ATI	<u>0</u>
Y's Total ATI	<u><u>0</u></u>
Y's Excess BII (Bus. Int. Inc.)	10,000
Y's BIE Limit (0 (30% x 0) + 10K (BII))	10,000
BIE from PRS treated as paid or incurred in Yr. 2	5,000
Yr. 2 Sole-Prop. Bus. Interest Exp. (BIE)	20,000
Yr. 2 Sole-Prop. BIE carried from Yr. 1	<u>20,000</u>
Y's Total BIE	<u><u>45,000</u></u>
Deductible in Year 2	10,000
BIE Treated as Paid or Accrued in Year 3	35,000
	102

<u>PRS Partnership in Year 2</u>		<u>K-1 Allocations</u>	
		Partner X	Partner Y
K-1 Net Business Income		10,000	10,000
K-1 Excess Bus. Int. Inc.		10,000	10,000

<u>Partner X:</u>	
ATI from PRS (\$0 Excess T.I.)	0
Y's Sole-Prop. ATI	<u>100,000</u>
Y's Total ATI	<u>100,000</u>
Y's Excess BII (Bus. Int. Inc.)	10,000
Y's BIE Limit (30,000 (30% x 0) + 10,000 (BII))	40,000
	103

<u>PRS Partnership in Year 2</u>		<u>K-1 Allocations</u>	
		Partner X	Partner Y
K-1 Net Business Income		10,000	10,000
K-1 Excess Bus. Int. Inc.		10,000	10,000

<u>Partner X:</u>	
ATI from PRS (\$0 Excess T.I.)	0
Y's Sole-Prop. ATI	<u>100,000</u>
Y's Total ATI	<u>100,000</u>
Y's Excess BII (Bus. Int. Inc.)	10,000
Y's BIE Limit (30,000 (30% x 0) + 10,000 (BII))	40,000
BIE from PRS treated as paid or incurred in Yr. 2	5,000
Yr. 2 Sole-Prop. Bus. Interest Exp. (BIE)	20,000
Yr. 2 Sole-Prop. BIE carried from Yr. 1	<u>0</u>
Y's Total BIE	<u>25,000</u>
	104

<u>PRS Partnership in Year 2</u>		<u>K-1 Allocations</u>	
		Partner X	Partner Y
K-1 Net Business Income		10,000	10,000
K-1 Excess Bus. Int. Inc.		10,000	10,000

<u>Partner X:</u>	
ATI from PRS (\$0 Excess T.I.)	0
Y's Sole-Prop. ATI	<u>100,000</u>
Y's Total ATI	<u>100,000</u>
Y's Excess BII (Bus. Int. Inc.)	10,000
Y's BIE Limit (30,000 (30% x 0) + 10,000 (BII))	40,000
BIE from PRS treated as paid or incurred in Yr. 2	5,000
Yr. 2 Sole-Prop. Bus. Interest Exp. (BIE)	20,000
Yr. 2 Sole-Prop. BIE carried from Yr. 1	<u>0</u>
Y's Total BIE	<u>25,000</u>
Deductible in Year 2	25,000
BIE Treated as Paid or Accrued in Year 3	0

105

Complete Disposition Of Partnership Interest

If a partner disposes of all or substantially all of a partnership interest, outside basis is **increased immediately before the disposition** by the amount of the excess (if any) of

- (a) the **amount of the basis reduction** over
 - (b) the **portion of any excess business interest expense** allocated to the partner which has **previously been treated as business interest expense paid or accrued by the partner,**
- o Whether or not the transaction is taxable.
 - o No deduction is allowed to the transferor or transferee for any ***Excess Business Interest Expense*** resulting in a basis increase.

107

What if the PSP's gross receipts are below \$25 mil. in 2019 thus exempt, but partner A is subject to 163(j)?

108

- “If a partnership or S corporation is not subject to section 163(j) because it is exempt (\geq 25 mil.), the exempt entity **does not calculate the section 163(j) limitation under §1.163(j)-2 and these regulations.**” (Reg. 1.163(j)-6(m)(1))
- Because an exempt entity is not subject to section 163(j)(4), it does not take its deduction for business interest expense into account in determining its non-separately stated taxable income or loss ... **and retains its character as business interest expense.** (Reg. 1.163(j)-6(m)(1))

109

- “Thus, if a **partner or S corporation** shareholder is allocated business interest expense from an exempt entity, **that allocated business interest expense will be subject to the partner’s or S corporation shareholder’s section 163(j) limitations.**” (Reg. 1.163(j)-6(m)(1))

110

- “Additionally, contrary to the general rule ..., a partner or S corporation shareholder **includes items of income, gain, loss, or deduction of such exempt entity when calculating its ATI.**”
- “Finally, **business interest income** of such exempt entity is included in the partner’s or S corporation shareholder’s section 163(j) limitation regardless of the exempt entity’s business interest expense amount.”
(Reg. 1.163(j)-6(m)(1))

111

Ownership of pass-through entities not subject to the section 163(j) limita-

tion. If you are subject to the section 163(j) limitation and are an owner of a pass-through entity that is not subject to the section 163(j) limitation, you must include your share of the pass-through business interest expense, adjusted taxable income, and business interest income on lines 1, 13, and 23, respectively. **You must request the pass-through entity to separately state, in sufficient detail, the items necessary to figure these amounts.**

**Draft
Instructions
to
Form 8990**

e112

REG-104397-18 (Aug. 8, 2018)

Impact of Proposed Bonus Depreciation Regs. on Partnerships

1) Section 743(b) adjustments – Bonus Depreciation May be OK

- Regs. take aggregate view of PSPs. -- a purchase of used property from the selling partner.
- Not qualified if a sale to a related party.
- Buyer cannot have a prior depreciable interest in the PSP property.
 - But OK if buyer is an existing partner.
- Buyer can elect bonus even if PSP elects out.
- Doesn't work for inheritance of PSP interest.

- 2) Section 734 adjustments – **No Bonus Deprec.**
 - Because the 734 adjustment is an entity level adjustment to the basis of PSP property, it fails to qualify due to prior use of the property by the partnership.
- 3) Section 704(c) adjustments – No Bonus Deprec.
- 3) The section 732 basis of distributed property – No Bonus Depreciation

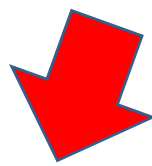
115

Special Rule:

- If qualified property is transferred to in a **step-in-the-shoes transaction (such as §§721/723)**, in the same tax year qualified property is placed in service by the transferor, then:
 - Bonus depreciation is allocated between transferor and transferee
 - **Transferor** counts the month property is **placed in service**.
 - **Transferee** counts the month in which the property is **transferred**.

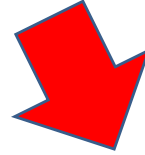
116

754 Election Activates



Sec.
743

Sales, Exchanges,
Deaths



Sec.
734

Distributions

117

- **Section 754 elections** are more important than pre-TCJA to eliminate inside gain representing:
 - 1250 Capital Gain
 - **1245 and 1250 Recapture for Bonus Depreciation and section 179;**
 - **Unrealized Trade Receivables** of Cash Basis Business;
 - **Appreciated Inventory Items of Cash Basis Business.**
 - Unique importance for **foreign persons to minimize inside gain.**

118

TCJA
Carried
Interests

New Section 1061

Background
on Profits
Only
Interests

Rev Proc 93-27

IRS Administrative Concession For Vested Profits Only Interest

121

Rev Proc 93-27

Profits Interest **not taxable** if **NOT**:

- 1) A **substantially certain** and predictable stream of income.
- 2) Disposed of **within two years** of receipt.
- 3) A limited partnership interest in a **publicly traded partnership**.

122

Profits Interest Definition

A partnership interest
other than
a capital interest.

123

Capital Interest Definition

A "**capital interest** is "an interest that would give the holder a **share of the proceeds** if the partnership's assets were sold at fair market value and then the proceeds were **distributed in a complete liquidation** of the partnership."

124

IRS Concession for Forfeitable Profits Only Interest -- Rev. Proc. 2001-43

Grant and Vesting are tax free if:

- 1) Otherwise **meet Rev. Proc. 93-27**
- 2) Treat **grantee as a partner** (K-1)
- 3) **No compensation deduction** upon **either grant or vesting.**

125

TCJA

*No Change in
Rev. Proc. 93-27*

Or

Rev. Proc. 2001-43

126

TCJA General Rules

- Holding period for LTCG treatment is **more than 3 years** for certain **profits-only PSP interests for services**.
- Applies only to “applicable partnership interests”.
- Sales of **capital assets** held for **3 years or less** are **recharacterized as STCG**.
- May apply to activities that are NOT a trade or business (investments) under other code sections.

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Effective Date

- Tax years beginning after December 31, 2017.
- The provision does not sunset.
- No relief for applicable partnership interests created before 2018.

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Applicable Partnership Interest

- A PSP interest transferred to a partner for services in an “**applicable trade or business**”.
- **Applicable trade or business** is:
 - a) Raising or returning capital and
 - b) Either:
 - 1) Investing in or disposing of *specified assets*, or
 - 2) *Developing specified assets*.

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- *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.

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Developing (per Senate Report)

- “**Developing specified assets** takes place, for example, if it is represented to investors, lenders, regulators, or others that the value, price, or yield of a portfolio business may be **enhanced or increased** in connection with **choices or actions** of a service provider or of **others acting in concert** with or at the direction of a service provider.”
- “Merely voting shares owned **does not amount to development**; for example, a mutual fund that merely votes proxies received with respect to shares of stock it holds is not engaged in development.”

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Exceptions

- **Corporate Partners.** Partnership interests held by a corporation are excluded from section 1016.
 - **IRS Notice 2018-18 (March 1, 2018).** IRS says **S Corporations** are not eligible for the exclusion from section 1016.
- **Capital Interests.** Partnership interests received in exchange for capital escape section 1061.
 - Right to share in capital must be “commensurate with” capital contributed **or** value of PSP interest taxable under section 83.

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PSP Agreement Language Suggested in House Report

“[I]f the partnership agreement provides that the partner's share of partnership capital is commensurate with the amount of capital he or she contributed (as of the time the partnership interest was received) compared to total partnership capital, the partnership interest is not an applicable partnership interest to that extent.”

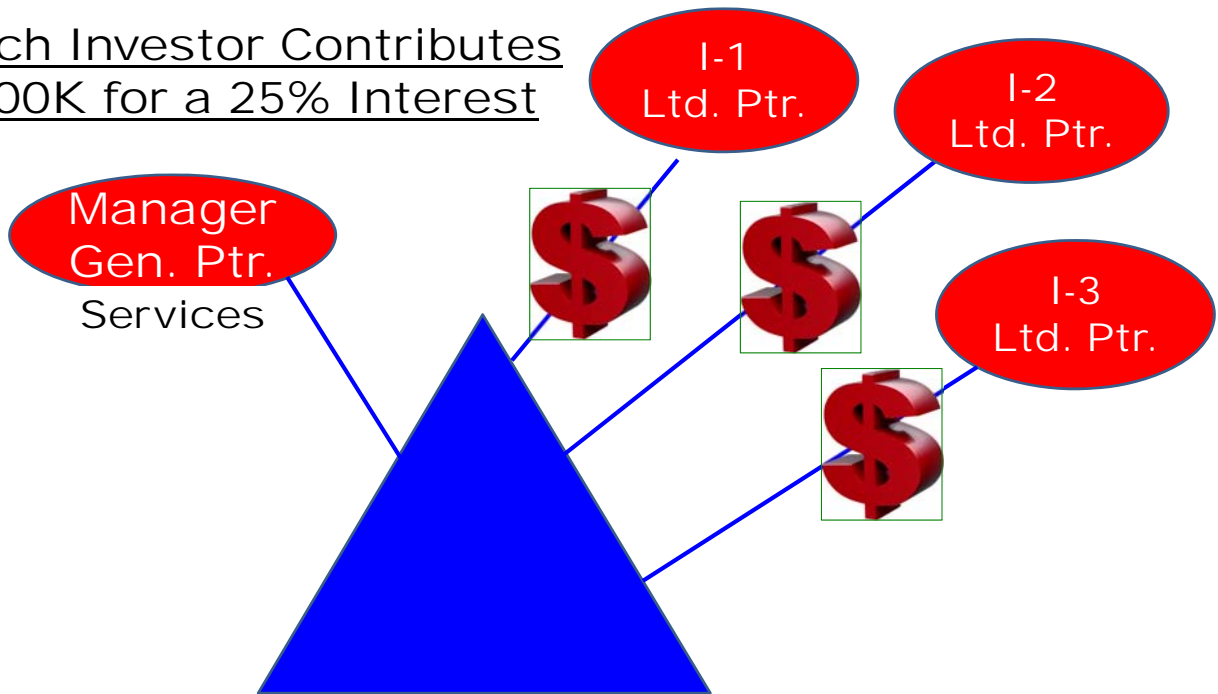
133

Example 1 -- Exception for Capital

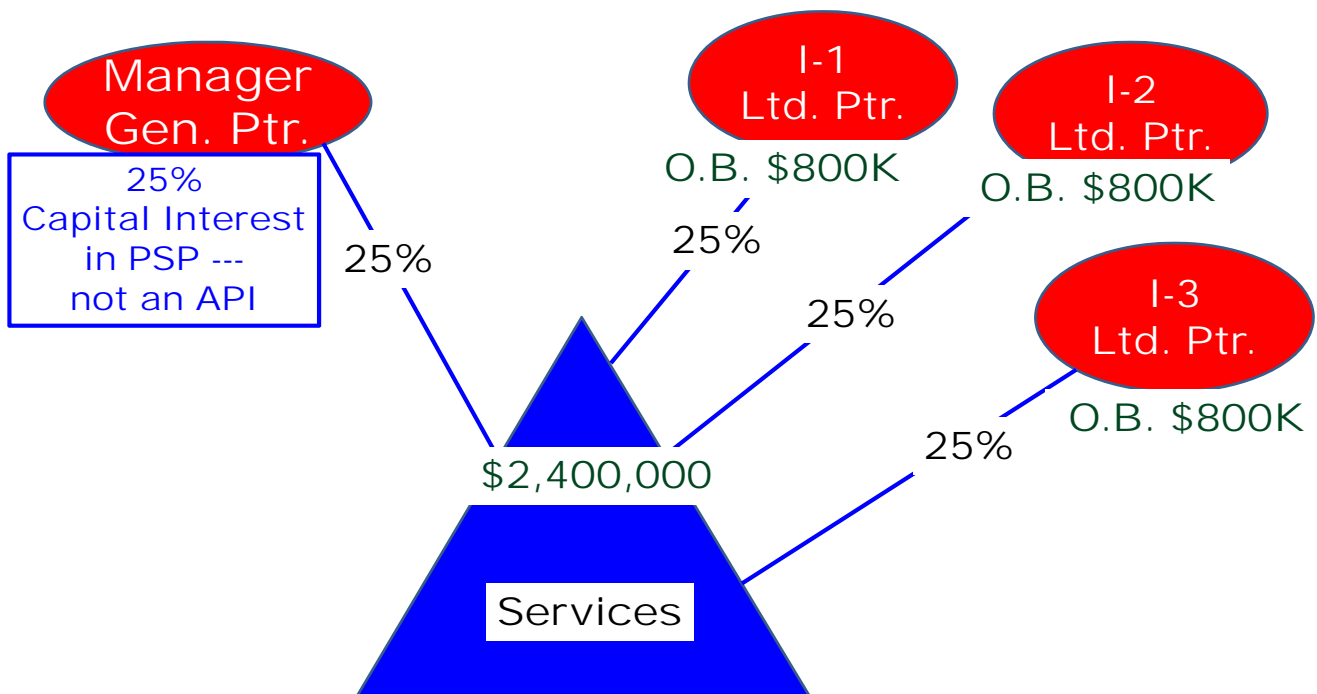
- Hedge fund manager, M, and three investors (I-1, I-2, and I-3) form a partnership.
- Each investor contributes \$800,000 and manager agrees to provide services for a fully vested 25% capital interest.

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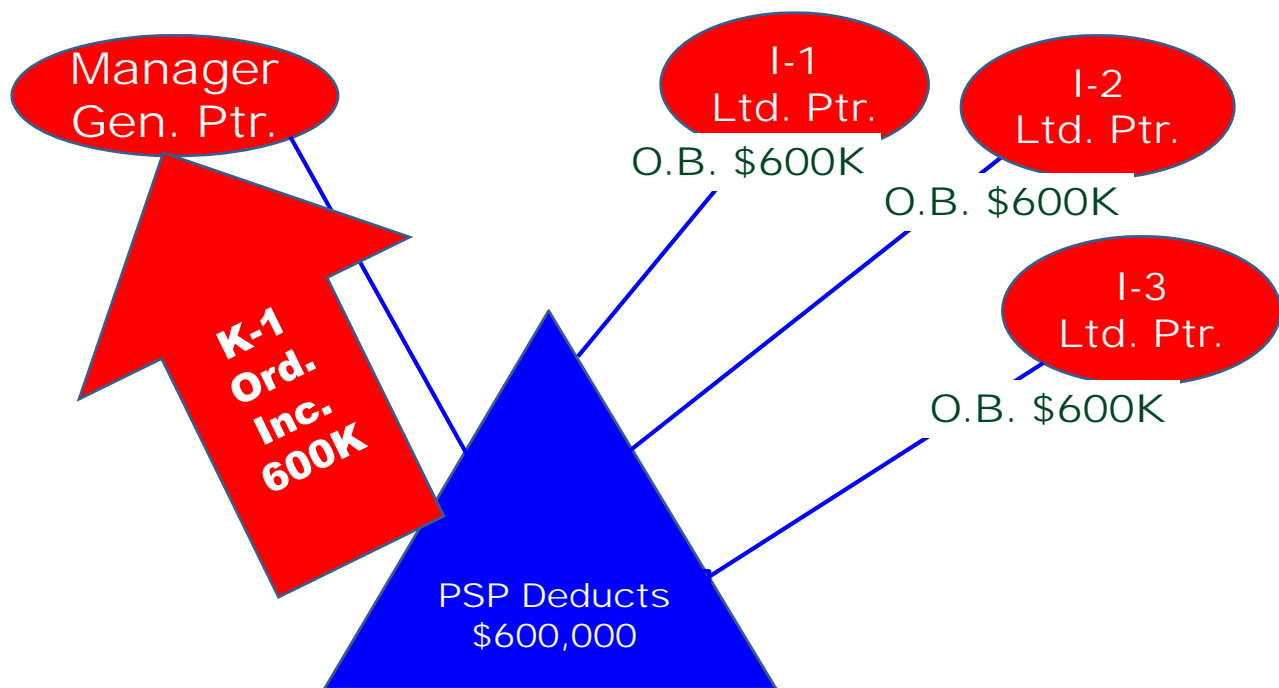
Each Investor Contributes \$800K for a 25% Interest



135



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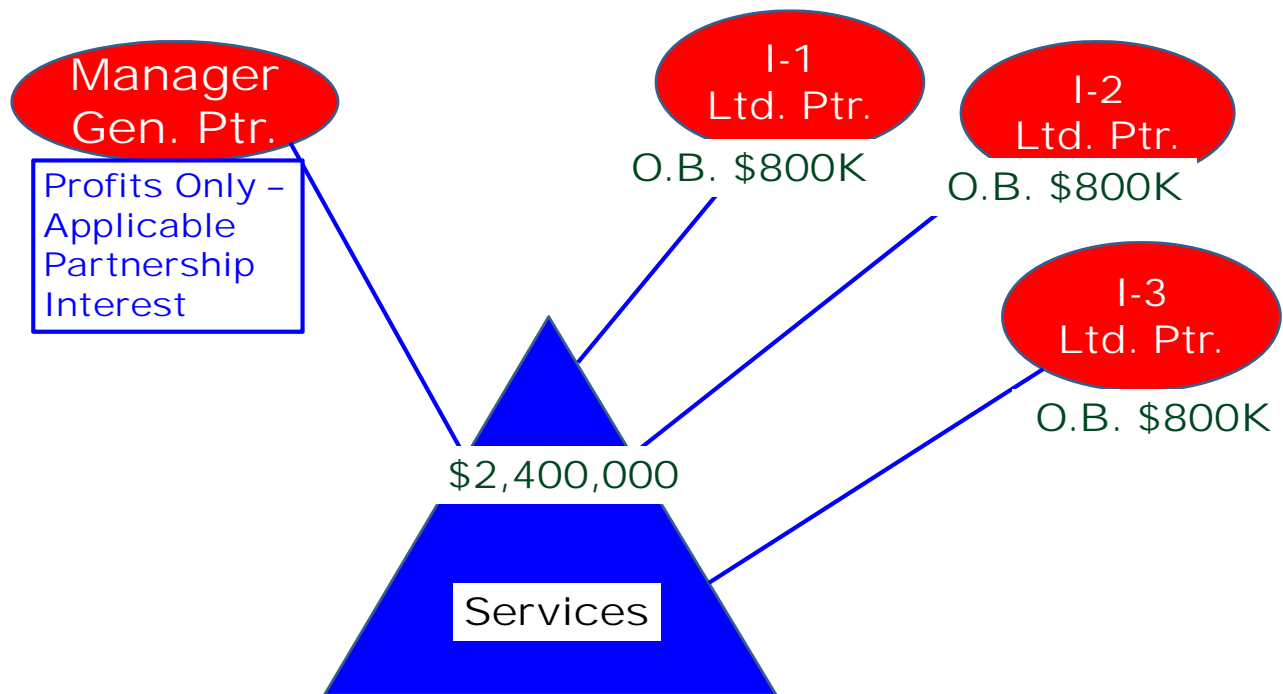
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Example 2 – Applicable PSP Interest (API)

Same facts as Example (1) but:

- M is entitled to a **20% profits interest**, after all of the investors **are returned their capital**, plus a 10% return on their invested capital.
- No current taxable income to M per Rev. Proc. 93-27 (unchanged in TCJA).
- An **API** so the **new 3 year holding period rules for carried interests** apply.

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Role of Section 83

With respect to an applicable partnership interest, the new law applies **“notwithstanding section 83 or any election in effect under section 83(b).”**

(section 1061(a)(2) flush language).

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Look-Thru Rule for Transfers to Related Persons

For transfers to related parties, the taxpayer **must recognize as STCG** the taxpayer's share of gain on assets of the partnership not held for more than three years. Section 1061(d).

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Example 3 – PSP Sale of Capital Asset

- M was granted a 20% applicable partnership interest (API) in **December of 2014**.
- In 2018, the partnership sells a capital asset with a holding period of **30 months** for a gain of \$1,000,000.
 - By the sale date, she **held her API more than 3 years**.

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Sec. 1231 Assets Escape Sec. 1061

- Section 1061(a) only applies to assets referred to in section 1222 which address the "sale or exchange of a capital asset held for more than 1 year".
- Section 1231 assets are NOT capital assets under section 1222.

TCJA: Outside Basis Loss Limit Applied to Charitable Contributions And Foreign Taxes (Sec. 704(d))

- Post-TCJA a partner with zero outside basis is not allowed to deduct (per sec. 704(d))
 - charitable contributions, and
 - foreign taxes (described in sec. 901).
- Charitable contributions of property, the O.B. limit applies to the adjusted basis of the property.

Effective Date

Applies to partnership tax years
beginning after
December 31, 2017.

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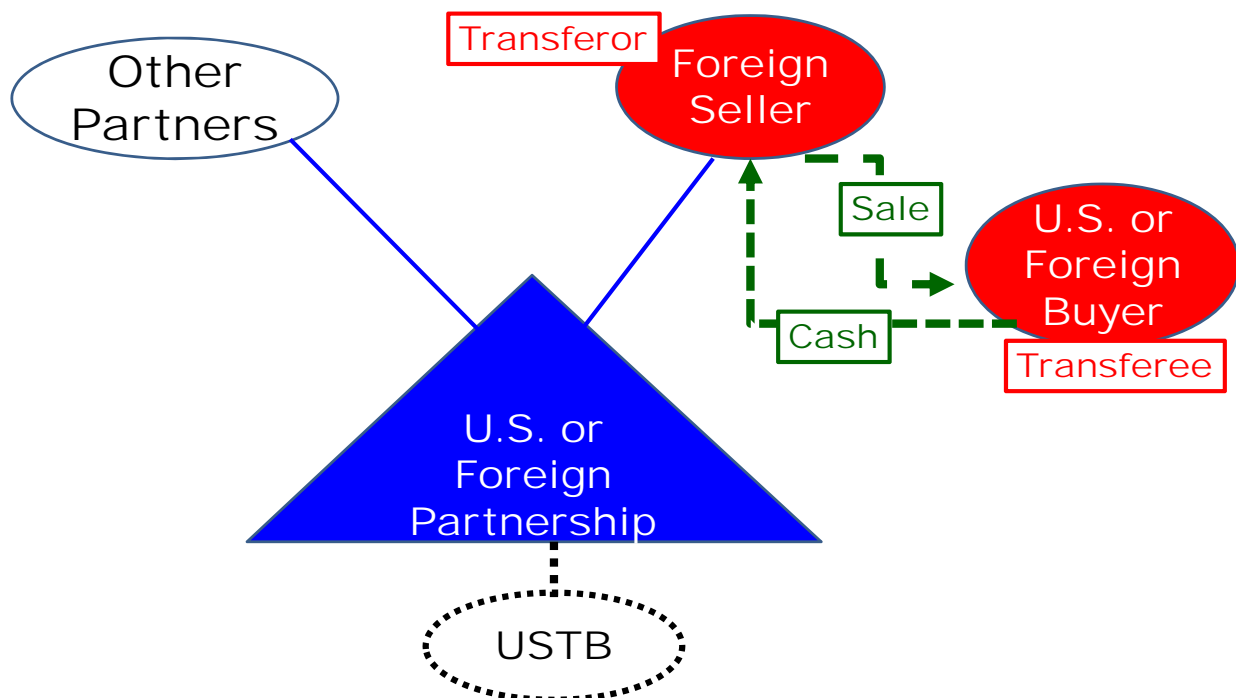
Look-Thru Rule for
Disposition Gain of
Nonresident Partners

(Secs. 864(c)(8) and
1446(f))

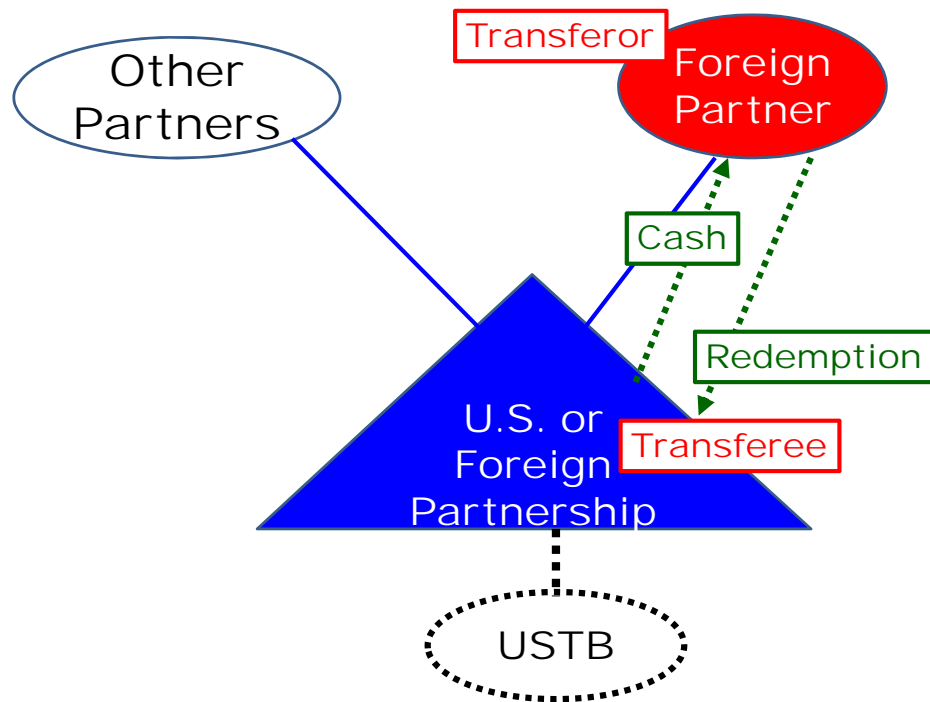
New Effectively Connected Income

- Applies to partners who are **nonresident alien individuals or foreign corporations**.
- **Outside gain of loss** on any disposition is effectively connected gain (ECG) or loss (ECL) **to the extent of the partner's inside built-in ECG or ECL on partnership property**.
- **Inside ECG or ECL** must allocated per distributive share of nonseparately stated taxable income.

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New Withholding Obligations

- The transferee must withhold 10% of the amount realized by the transferor.
- If the transferee fails to adequately withhold, the partnership is liable ("backstop" withholding).
- Forms and the withholding tax are due **within 20 days of the disposition.**
 - Forms 8288 and 8288A modified.
 - **No penalties or interest** if due on or before **May 31, 2018** (Notice 2018-29 §5)

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Effective Dates

- 1) The provision making gain or loss **ECG** or **ECL** is effective for sales, exchanges, or other dispositions occurring on or after **November 27, 2017**.
- 2) The new withholding rules are effective for sales, exchanges, or other dispositions **after Dec. 31, 2017**.

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Publicly Traded PSP Interest Withholding Relief - IRS Notice 2018-8

- No withholding by transferee until IRS guidance is published.
- Foreign transferor must still recognize gain.

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Withholding Relief for non-PTP PSPs IRS Notice 2018-29 (4/2/2018)

- If Transferor **Certifies**:
 - Non-Foreign Status -- affidavit or Form W-9.
 - No Realized Gain.
 - Had **ECTI < 25%** in 3 Prior Tax Years.
- PSP **certifies** that **ECG < 25%** of total inside gain.
- No withholding **for now** on **nonrecognition transactions**.

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- PSP can rely on its books or a certificate from transferee to determine **outside basis of distributee partner**.
- No backstop withholding on PSP until further guidance.

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Expanded Definition of Built-in Loss For Mandatory Section 743(b) Adjustment

- Background
 - Basis adjustments are mandatory if the partnership has a section 754 election in effect, or if there is a “substantial built-in loss.”
 - A “substantial built-in loss” exists if the partnership’s adjusted basis in its property is \$250,000 greater than the fair market value of partnership property.
- Per the TCJA: a “substantial built-in loss” also exists if the transferee would be allocated a net loss in excess of \$250,000 in a hypothetical disposition immediately after the transfer. (section 743(b)(1)(B))

Elimination of Deemed Terminations (Sec. 708(b)(1))

- The TCJA **repeals the deemed termination rules** for partnership tax years beginning after Dec. 31, 2017.
- **No changes** to the **actual termination rules** under section 708(b)(1)(A) (now (b)(1)).

S Corporation TCJA Changes

Changes To Electing Small Business Trusts

- Allows nonresident alien individual to be a current beneficiary of an ESBT.
- The **charitable contribution deduction of an ESBT** is not determined by the rules for trusts but rather by the rules applicable to individuals.

So 60% limit and five year carryforward provisions applicable to individuals apply to the portion of an ESBT holding S corporation stock.

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Effective Date:

- The nonresident alien beneficiary provision takes effect on January 1, 2018.
- The change to the charitable deduction applies to tax years beginning after December 31, 2017.

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Modification of Treatment of S Corporation Conversions to C Corporations

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If S status is **revoked within 2 years of TCJA enactment**, and the S corp. is eligible then:

- **Cash Distributions after the PTTP** are characterized based upon the ratio of AAA/E&P.

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Eligible if:

- (1) Is an S corporation on **12/21/2017** (the day before TCJA enactment);
- (2) **During the two-year period beginning on 12/22/2017** revokes its S corporation election under Section 1362(a);
- (3) All of the owners on the date the S corporation election is revoked are the **same owners (and in identical proportions)** as the owners on the date of such enactment.

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- **Section 481 adjustment for accounting method changes:**

A "6 tax year period beginning in the year of change" whether positive or negative.

- Rev. Proc. 2018-44 (8/22/2018) allows "automatic permission for change" in method for eligible terminated S corp:
 - For required change from cash to accrual.
 - For optional change from cash to accrual.
 - Rev Proc. does not apply to other changes.

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