Aggregate vs. Entity Theory after TCJA

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1

Topics

- Section 168(k)
- Section 199A
- New Section 163(j)
- BEAT
- Sections 864(c)(8) and 1446(f)

2

Aggregate vs. Entity Principles

- Subchapter K is an amalgam of disparate and conflicting rules that treat a partnership as an aggregate of its partners in some cases and as a separate entity in others.
- Whether aggregate principles or entity principles are applied to a particular factual scenario depends on which set of principles is more appropriate in that context.
- The legislative history to the 1954 Code states:
  1. Both the House provisions and the Senate amendment provide for the use of the "entity" approach in the treatment of the transactions between a partner and a partnership which are described above. No inference is intended, however, that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the internal revenue laws <u>if the concept of the partnership as a collection of individuals is more appropriate</u> for such provisions.

Aggregate vs. Entity Principles (cont'd)

- The determination of whether aggregate or entity principles should apply in a specific case is particularly challenging when implementing a new tax regime prior to the issuance of regulations or other guidance.
- Under Section 702(b), the distinction drawn between "separately stated" items and non-separately stated items is really an aggregate/entity distinction.
- Under Section 702(b), a partner must take into account <u>separately</u> its distributive share of certain partnership items, including capital gains and losses, dividends and foreign taxes.

Aggregate vs. Entity Principles (cont'd)

- Under Treas. Reg. § 1.702(b)-1(a)(8)(ii), a partner must also take into account separately any partnership item which, if received directly by the partner, would affect the US tax liability of the partner or any other person.
  1. For example, if a partner is a CFC, income of the partnership that would be treated as subpart F income if earned directly by the partner must be separately stated.

5

First Year Expensing of PP&E

- Prior to the TCJA amendments, taxpayers could immediately deduct a substantial percentage of the cost of most tangible personal property as "bonus depreciation" under Section 168(k).
  1. The amount of the deduction varied from year-to-year (it was 50% in 2017), but was limited to the cost of "original use" (i.e., new) property.
- The TCJA significantly expanded the scope of Section 168(k), allowing taxpayers to deduct 100% of the cost of such property without regard to whether it is new or used.
  1. The 100% deduction will be phased out over a five-year period beginning in 2023.
  2. The deduction is not available for goodwill, IP and other intangible assets.

6

First Year Expensing of PP&E (cont'd)

- The amount of the deduction is not capped and is available to all taxpayers regardless of their size or income.
- For target companies with substantial PP&E, the TCJA amendments significantly increased the relative tax benefits of asset deals over stock deals (including stock deals treated as asset deals), especially for non-corporate buyers.

7

The "Anti-Churning" Limitations of Section 168(k)

- Bonus depreciation is not available on PP&E acquired before the effective date of the TCJA amendments.
- According to the House Report, the TCJA amendments were intended to apply to "[used] property purchased in an arm's-length transaction" (H.R. 1, 115th Cong. §3101).
- Under special "anti-churning" limitations, bonus depreciation is also not available on used PP&E acquired <u>after</u> the effective date if:
  1. the PP&E was "used by taxpayer" <u>before</u> the acquisition;
  2. the taxpayer acquired the PP&E from a related party; or
  3. the taxpayer acquired the PP&E in a tax-free exchange, a carryover basis transaction or from a decedent.

8

The "Anti-Churning" Limitations of Section 168(k) (cont'd)

- Investments in property subject to the anti-churning limitation are not regarded as new even though they are made after the effective date. They are more like old investments that have been recycled.
- How do the anti-churning limitations apply to basis adjustments to PP&E under Sections 743(b), 734(b) and 704(c)?
- Do they treat a partnership as an aggregate or an entity?

9

Basis Adjustments to PP&E: Are They Eligible?

- Suppose a partnership with a Section 754 election in effect holds appreciated PP&E and --
    1. a partner sells a partnership interest in the partnership to X (an unrelated party); or
    2. the partnership distributes cash in excess of basis to a withdrawing partner.
- Following the sale or redemption, the partnership increases its basis in the PP&E, allowing X (Section 743(b)) or the continuing partners (Section 734(b)) to claim stepped-up depreciation during future periods.
- Or suppose a partner contributes appreciated PP&E with a zero basis to a partnership in a Section 721 exchange and that the partnership elects to apply the "remedial method" under Section 704(c) to the pre-contribution gain.

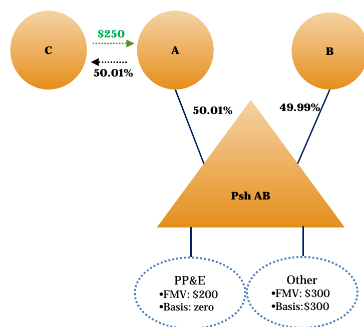
10

Basis Adjustments to PP&E: Are They Eligible?(cont'd)

- Following the contribution, the non-contributing partners of the partnership are allocated book and "remedial" tax depreciation on the PP&E on a fully stepped-up basis.
- In each of these cases, the step-up in PP&E is deemed to constitute a direct purchase of "new" PP&E with a new placed-in-service date and is recovered under Section 168 over the original useful life of the PP&E.
- Under Section 168(k), the <u>actual</u> purchase of such property is clearly eligible for first year bonus depreciation unless the "anti-churning" limitations apply.

11

Case #1: Basis Adjustments under Section 743(b)

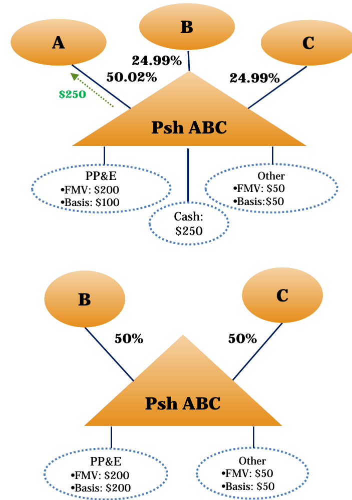


- Under the anti-churning limitations, bonus depreciation is also not available on PP&E acquired from a related party.
  1. Partnerships and greater than 50% partners are treated as related parties. Did C acquire the PP&E from Psh AB or from A?
  2. Although C is related to Psh AB, it is <u>not</u> related to the selling partner.

- Psh AB owns zero-basis PP&E with a value of $200. A, a 50.01% partner with an outside basis of $50, sells its interest in Psh AB to C for $250.
- Under Section 743(b), Psh AB steps up the inside basis of the PP&E to $200 for the benefit of C as the transferee partner.
- Under the Section 168(k) anti-churning limitations, bonus depreciation is not available on PP&E "used by the taxpayer" before the acquisition.
  1. Who is the taxpayer? If Psh AB is the taxpayer, bonus depreciation is not available because Psh AB used the property before A transferred its interest to C.
  2. But as the transferee partner, only C is entitled to the stepped-up depreciation.

12

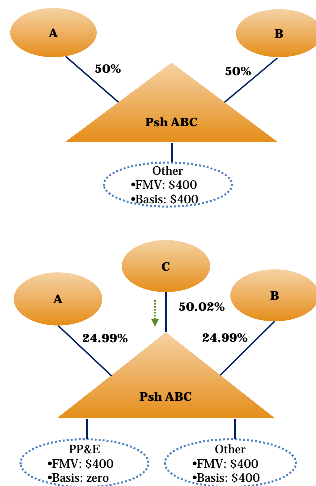
Case #2: Basis Adjustments under Section 734(b)



- Psh ABC owns PP&E with a basis of $100 and a value of $200. Psh ABC distributes $250 of cash to A, a partner with an outside basis of $150, in a complete redemption.
- Under Sections 734(b), Psh ABC steps up the inside basis of the PP&E by the $100 of gain recognized by A in the distribution.
- Under the anti-churning limitations, bonus depreciation is not available on PP&E "used by the taxpayer" before the acquisition.
  1. Who is the taxpayer? Psh ABC clearly used the property before the withdrawal of A.
  2. But didn't B and C also use the property before the withdrawal of A?
- Under the anti-churning limitations, bonus depreciation is not available on PP&E acquired from a related party.
  1. Who bought the PP&E from A: Psh ABC, a related partnership, or B&C, who are unrelated to A?

13

Case #3: "Notional" Basis Adjustments under the Remedial Method



- C contributes zero basis PP&E with a value of $400 to Psh ABC in exchange for a 50.02% interest in Psh ABC. Psh ABC reports the $400 of pre-contribution gain under the remedial method of Section 704(c).
- Under the remedial method, Psh ABC allocates remedial depreciation on the PP&E contributed by C to A&B equal to the <u>actual</u> depreciation A&B would have claimed if they had purchased their share of the contributed PP&E in a taxable transaction for $200.
- Under the anti-churning limitations, bonus depreciation is not available on PP&E acquired in a tax-free transaction (including a Section 721 exchange).
- Under the anti-churning limitations, bonus depreciation is also not available on PP&E acquired from a related party.
  1. Although C is not related to A or B, C is related to Psh ABC.
  2. Did Psh ABC acquire the PP&E from C, who is related to Psh ABC but not to A & B, or from A & B?

14

Section 199A: Overview

- 20% deduction for non-corporate taxpayers
  1. Deduction generally applies to "qualified business income" (QBI) from a "qualified trade or business" (QTB).
     - Deduction also applies to qualified REIT income, qualified publicly traded partnership income, and qualified cooperative dividends.
  2. Deduction reduces the effective tax rate on QBI to 29.6%.
  3. Does not apply to taxable years beginning after December 31, 2025.
- The 199A deduction for each QTB is the lesser of 20% of either:
  1. QBI, or
  2. the greater of (x) 50% of the W-2 wages properly allocable to the QTB, and (y) the sum of (i) 25% of the W-2 wages properly allocable to the QTB, plus (ii) 2.5% of the unadjusted basis of all qualified property used in the QTB.

15

Section 199A: Overview (cont'd)

- Wage, property, and specified service trade or business limitations are phased in for high-income taxpayers.
- In the case of a partnership, the deduction, and the components of the limitation, are determined at the partner level.

16

Section 199A: Qualified Business Income

- QBI generally includes income, gain, deductions, and losses to the extent the amounts would have been (i) treated as ECI in the hands of a non-US person, and (ii) taken into account in determining taxable income for a tax year.
- Exclusions:
  1. Investment income (including capital gains)
  2. Guaranteed payments for services under Section 707(c) and, to the extent provided in regulations, any payment under Section 707(a) for services rendered to the QTB
     - However, guaranteed payments for capital are <u>not</u> excluded
  3. Reasonable compensation paid by a QTB for services rendered (e.g., where the business is conducted through an S corporation)

17

Section 199A: Qualified Trade or Business

- A QTB is any trade or business other than (i) a specified service trade or business (SSTB), or (ii) performing services as an employee.
- Types of SSTBs:
  1. Specifically includes health, law, accounting, consulting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services (but excludes engineering and architecture).
  2. Any trade or business where the principal asset is the reputation or skill of one or more of the employees or owners.
  3. Investing; investment management; and trading or dealing in securities, partnership interests, or commodities.

18

Application to Partnerships

- Under Section 199A, whether a business is qualified or not is determined at the partnership level.
- However, each partner is required to take into account each qualified item of income, gain, deduction or loss for purposes of determining the amount of the deduction available to such partner.
- Can you split an existing business into multiple businesses in order to avoid SSTB status? What if those businesses are conducted through multiple entities? What if it is a new business that is conducted through multiple entities?
- Once a qualified trade or business has been appropriately identified, do items retain their character as QBI through tiered partnerships?

19

Is there a Qualified Trade or Business?

- Section 446(d) rules may provide a methodology for when a taxpayer can separately identify a trade or business conducted directly by it.
- This provision permits a taxpayer engaged in more than one business to use different accounting methods for each trade or business.
- Under Treas. Reg. § 1.446-1(d), two trades or businesses must be "separate and distinct" for a taxpayer to be eligible to use different methods of accounting for the businesses.
- Section 446(d) rules are less helpful with respect to issues posed by tiered partnerships and other partnerships under common control.
- Instead, Section 469 principles may be instructive.

20

Is there a Qualified Trade or Business? (cont'd)

- "Appropriate economic unit" factors under Section 469:
  (1) similarities and differences in types of trade or businesses;
  (2) extent of common control; (3) extent of common ownership;
  (4) geographical location; and (5) interdependencies between or among activities.
  1. Can help taxpayers identify whether income streams should be treated as a single trade or business or multiple trades or businesses.
  2. Could also inform whether income from a SSTB could taint other QBI, denying a deduction in respect of that income.
- Section 469 also treats each partner as engaged in the business of the partnership.
  1. Limits the ability of taxpayers to structure the same trade or business differently with different tax results.

21

Entities engaged in multiple QTBs

- Grouping under Section 469
  1. Entity approach to activities conducted through partnerships.
  2. Two-step process under Treas. Reg. § 1.469-4(d)(5)(i):
     - The partnership determines groupings in respect of entity-level activities, then
     - Each partner applies the grouping rules in respect of its allocable share.
- Policy reasons support the first step, an entity-level grouping determination.
  1. Partnerships are better positioned to make this determination; more access to information.
  2. Ensures consistent treatment among partners.

22

Entities engaged in multiple QTBs (cont'd)

- But, Section 469 allows elective grouping.
  1. Elective grouping may not be appropriate under Section 199A, where Congress specifically intended to prevent certain taxpayers from qualifying from the reduced pass-through rate.

Calculation of W-2 Wages

- To what extent can W-2 wages paid by a person related to a partner be taken into account for purposes of the wage limitation?
- C corporation that is related to a partnership provides services to such partnership. Can the wages of the employees of the related C corporation be taken into account?
- Can a partnership make special allocations of wage expenses and depreciation deductions to specific partners?

Qualified Property

- Section 199A(f)(1)(A)(iii) and (flush language): Determine partners' shares of unadjusted basis of property held by a partnership immediately after acquisition of the property. Do these percentages change if the partners' interests in the entity change or a new partner is admitted?

25

Transfers of partnership interests

- Interplay between QBI determination and principles under Sections 704(c), 734 and 743.
- Section 199A(f)(1): Determine a partner's allocable share of unadjusted basis of property "in the same manner as the partner's . . . allocable share of depreciation."
  1. Does depreciation refer to Section 704(b) book depreciation or tax depreciation?
  2. What if adjusted basis of property has been depreciated to zero (e.g., short useful life or accelerated depreciation)?

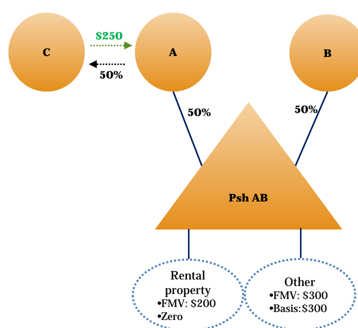
26

Transfers of partnership interests (cont'd)

- Regulations under Section 743 and Section 734 could lead to different conclusions when measuring a partner's share of the unadjusted basis of tangible assets. Compare:
  1. Treas. Reg. § 1.743-1(j)(1), which provides that the Section 743 adjustment does not affect a partner's capital account or change how the partnership calculates income under Section 703.
  2. Treas. Reg. § 1.743-1(j)(2), which adjusts the purchasing partner's distributive share of income to take into account additional depreciation as a result of the adjustment.

27

Case #1: Basis Adjustments under Section 743(b)



- Psh AB owns rental property with a basis of $0 and a value of $200. A, a 50% partner with an outside basis of $50, sells its interest in Psh AB to C for $250.
- Under Section 743(b), Psh AB steps up the inside basis of the rental property to $200 for the benefit of C as the transferee partner.
- Is the increased basis under Section 743(b) included in computing the unadjusted basis in qualified property used in the QTB?

28

New Section 163(j) — Overview

- A taxpayer generally cannot deduct business interest expense for a taxable year to the extent that such interest exceeds the sum of (a) the taxpayer's business interest income, and (b) 30% of the taxpayer's adjusted taxable income (ATI) for such taxable year.
- "Adjusted taxable income" is business income computed without regard to any NOL carryovers, business interest income or expense, and, solely for taxable years beginning before January 1, 2022, any depreciation, amortization or depletion deductions.
- Certain types of interest, including interest paid by an electing real property trade or business, are excluded from the application of Section 163(j).

29

New Section 163(j) — Partnerships

- Section 163(j) applies at the partnership level. Why?
- Any deduction for business interest expense is taken into account in determining the partnership's non-separately stated taxable income or loss.
- Each partner's ATI is (1) determined without regard to such partner's distributive share of any tax item of the partnership and (2) increased by such partner's distributive share of the partnership's excess taxable income (ETI).
- ETI is effectively the portion of a partnership's ATI that is not needed to absorb the partnership's business interest expense under Section 163(j).

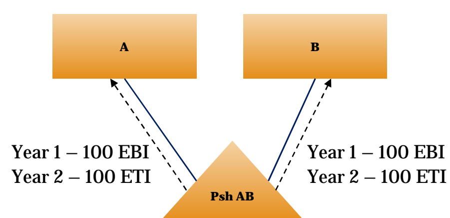
30

New Section 163(j) — Partnerships (cont'd)

- Any partnership business interest expense that is disallowed under Section 163(j) is allocated to each partner in the same manner as the partnership's non-separately stated taxable income or loss.
- Such excess business interest expense is treated as business interest expense paid or accrued by the partner in the next succeeding taxable year in which the partner is allocated ETI from the partnership, but only to the extent of such ETI.
- Any ETI allocated to a partner in excess of the portion used to free up carried forward excess business interest from such partnership will be taken into account as ATI when computing the partner's own Section 163(j) limitation.

31

Effect of ETI on Excess Business Interest Carry Forwards

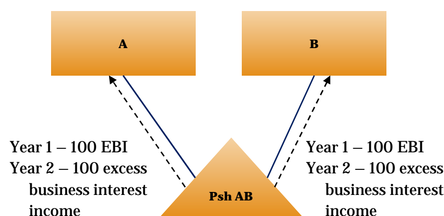


- Does that mean that all 100 of EBI (rather than 30) of A and B is treated as paid in year 2?
- If so, is EBI freed up by allocations of ETI freely usable or still subject to each partner's limitation in year 2?

- In year 1, Psh AB allocates 100 of excess business interest expense (EBI) to each of A and B, which carry that EBI forward to year 2.
- In year 2, Psh AB allocates 100 of ETI to each of A and B.
- Under Section 163(j)(4)(B)(ii)(I), EBI is treated as business interest paid or accrued by the partner to the extent of ETI allocated to the partner.

32

Effect of Excess Business Interest Income on Excess Business Interest Carry Forwards

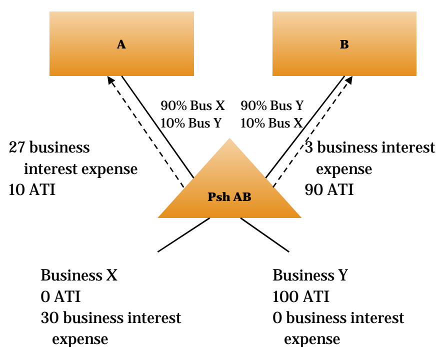


- Because EBI is usable by a partner only to the extent that the partner is allocated ETI from the same partnership, the allocation of excess business interest income would appear not to allow A and B to use their carried forward EBI.
- Nevertheless, such excess business interest income should be usable by A and B to offset, dollar for dollar, other business interest expense incurred by them.

- In year 1, Psh AB allocates 100 of EBI to each of A and B, which carry that EBI forward to year 2.
- In year 2, Psh AB allocates 100 of excess business interest income to each of A and B.
- ETI does not technically include excess business interest income.

33

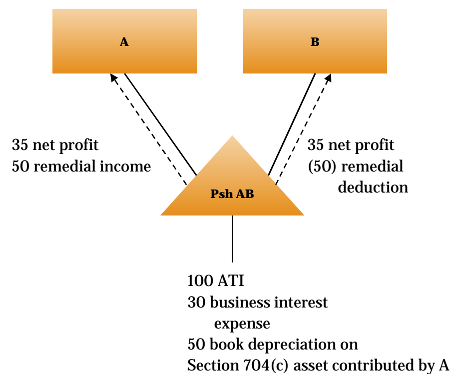
Effect of Special Allocations



- Psh AB allocates the results of Business X 90% to A and 10% to B and the results of Business Y 10% to A and 90% to B.
- Applied at the Psh AB level, Section 163(j) does not apply to disallow any of Psh AB's business interest expense because its business interest expense (30) does not exceed 30% of its ATI.
- This is true even though the amount of business interest expense allocated to A greatly exceeds its allocable share of ATI.
- Once Psh AB's business interest expense is determined not to be subject to disallowance under Section 163(j), it flows through as a non-separately stated item, and thus apparently is not subject to further disallowance.

34

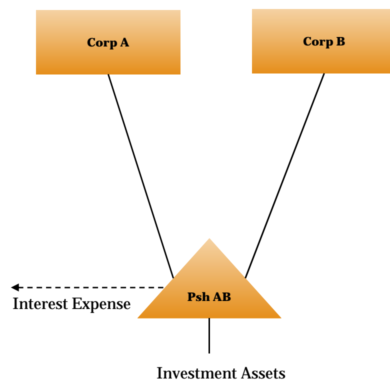
Effect of Remedial Allocations



- Psh AB allocates its items 50% each to A and B.
- Psh AB also uses the remedial allocation method under Section 704(c) for a low basis asset contributed by A, resulting in a remedial item of 50.
- Applied at the Psh AB level, Section 163(j) does not apply to disallow any of Psh AB's business interest expense because its business interest expense (30) does not exceed 30% of its ATI.
- This is true even though the amount of the remedial deduction allocated to B equals its allocable share of ATI.

35

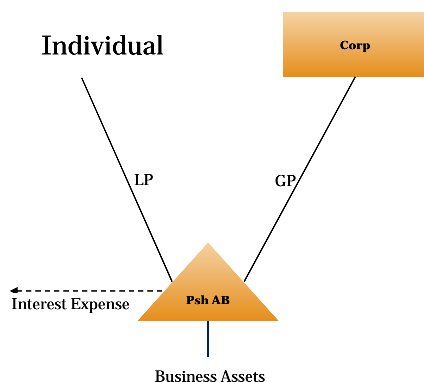
Interaction of Section 163(j) and Section 163(d)



- As determined at the partnership level, the interest expense is investment interest (although the application of the investment interest limitation is done at the partner level).
- Section 163(j)(5) provides that the term "business interest" does not include "investment interest" within the meaning of Section 163(d).
- The Committee Report for the TCJA and Notice 2018-28 indicate that all interest expense of a corporation is business interest (although neither addresses the treatment of investment interest allocated to a corporation by a partnership).
- Is the interest expense allocated to the corporate partners business interest for purposes of Section 163(j)?

36

Interaction of Section 163(j) and Section 163(d) (cont'd)



- As determined at the partnership level, the interest expense is business interest.
- Under Rev. Rul. 2008-12, however, partnership business interest allocated to a non-corporate partner that does not materially participate in the partnership's business is characterized as investment interest in the hands of the partner.
- Does the Section 163(j) limitation apply to all of the partnership's interest expense (or just to Corp's share of such interest expense)?
- Is the interest expense allocated to the individual subject to the investment interest limitation?

37

BEAT & Base Erosion through Partnerships

- Base Erosion and Anti-Abuse Tax (BEAT).
  1. The BEAT imposes a separate 10% minimum tax on US corporate taxpayers with more than $500 million in gross receipts that make significant "base erosion payments" (BEPs).
  2. BEPs are generally treated as significant if they exceed 3% of total deductions.
  3. Although drafted more broadly, the primary target of new Section 59A appears to be foreign-owned US corporations (including "inverted" companies).
  4. The BEAT minimum tax is equal to the greater of the taxpayer's regular tax liability and 10% of its "modified taxable income," which (among other things) adds back the deductible BEP payments.
  5. Section 59A(d)(1) defines a BEP as "any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer and with respect to which a deduction is allowable …"

38

BEAT & Base Erosion through Partnerships (cont'd)

- A foreign payee of the taxpayer is treated as related if:
  1. it is a "25% owner" of the taxpayer; or
  2. it is related to the taxpayer or a 25% owner of the taxpayer under Sections 267(b) or 707(b)
  3. -- for this purpose, modified Section 318 attribution rules apply
- Although a "foreign person" includes a foreign partnership, §59A does not address payments of deductible amounts to or by foreign partnerships or domestic partnerships.
  1. Suppose a US Corp makes a deductible payment to a related foreign partnership with unrelated foreign (or domestic) partners?
  2. Suppose a US Corp is a partner of a foreign or domestic partnership and the partnership makes deductible payments to a foreign person who is related to US Corp?

39

BEAT & Base Erosion through Partnerships (cont'd)

- Is a partnership always treated as an "aggregate" for this purpose or is it ever a separate entity?
- Should aggregate vs. entity treatment depend on whether the partnership is domestic or foreign?

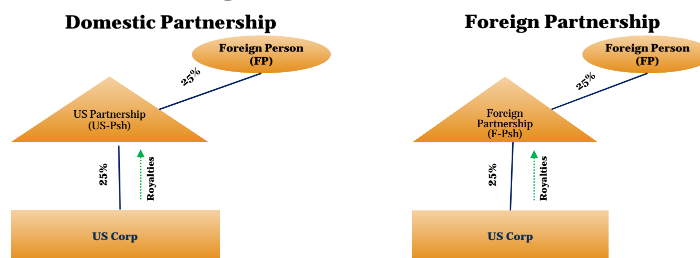
40

BEAT — Aggregate vs. Entity Principles

- Under the BEAT tax, if a partnership receives a payment that, if received directly by a foreign partner, would be a BEP, it should be separately stated even though the foreign partner (like a CFC) is not subject to tax on the income because it affects the liability of "any other person."
- Similar principles should apply to payments by a partnership (e.g., a payment by a partnership with a US corporate partner to a foreign person that would be treated as a BEP if paid directly by the US corporate partner should be treated as paid directly by the US corporate partner).
- Under Treas. Reg. § 1.701-2(e), the IRS has the authority to treat a partnership as an aggregate of its partners to carry out the purposes of any provision of the Code unless the provision clearly treats a partnership as an entity.

41

Deductible Payments to a Partnership with Foreign Partners (Case #1)



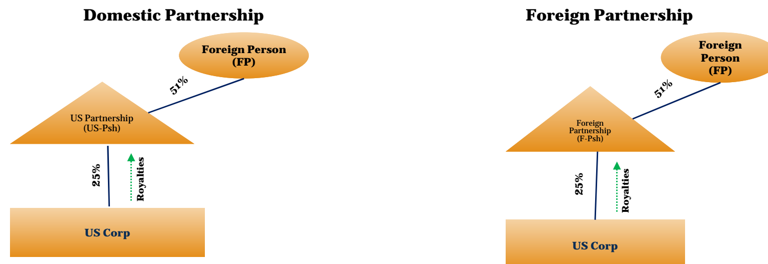
- While US-Psh is related to US Corp because it is a "25% owner" of US Corp, it is not foreign.
- While FP is foreign, it is not related to US Corp as a 25% owner (after Section 318 attribution) or to US-Psh (under Section 707(b)).
- Because no foreign payee is related to US Corp, the royalties are not BEPs.

- As a foreign partnership, F-Psh is both foreign and related to US Corp as a 25% owner.
- While FP is foreign, it is not related to US Corp as a 25% owner (after Section 318 attribution) or to F-Psh (under Section 707(b))
- Are the royalties BEPs?
  1. What does the domicile of an intermediate partnership have to do with base erosion?
  2. Should F-Psh re-domesticate or distribute the stock of US Corp to FP?
- Should the entire royalty be treated as a BEP or just FP's 25% distributive share?
- What if all of the partners of F-Psh were domestic?

42

Deductible Payments to a Partnership with Foreign Partners (Case #2)

Domestic Partnership **Foreign Partnership**



- While US-Psh is related to US Corp as a "25% owner", it is not a foreign person
- FP is related to US Corp because it is related to a 25% owner of US Corp (even though it only owns 12.5% of the stock)
- What portion of the royalties are BEPs:
  1. 51%, because that is FP's distributive share of the royalty?
  2. 0%, because US-Psh is disregarded as an aggregate and FP is not related to US Corp as a 25% owner?
- Although aggregate treatment seems like the right answer here, why does Section 59A include Section 707(b) relationships?

- Both of F-Psh and FP are related foreign payees.
- Now what portion of the royalties are BEPs:
  1. 100%, because 100% of the royalties were paid to a related foreign party (i.e., F-Psh)?
  2. 51%, because FP is the true taxpayer and the deemed royalty payment to FP (through F-Psh) should be limited to its distributive share?
  3. 0%, because F-Psh is disregarded as an aggregate and FP is not related to US Corp under aggregate principles?
- Should F-Psh be treated as an entity for purposes of determining "relatedness" and as an aggregate for purposes of determining the "BEP portion" of the royalty?

43

Deductible Payments by a Partnership with US Corporate Partners

Domestic Partnership **Foreign Partnership**

- FP is a foreign related party to US Corp.
- If US Corp is a partner of a domestic partnership and the royalty payment to FP is made by the domestic partnership, what percentage of the royalty here is a BEP?
- Here, aggregate principles should govern.
- Under Treas. Reg. § 1.702(b)-1(a)(8)(ii), US Corp should be treated as paying a royalty directly to FP to the extent of its distributive share of the royalty (i.e., 50%).
- The BEP to FP is $50.

- FP is a foreign related party to US Corp.
- Because a BEP is a deductible payment to a foreign person, the domicile question is less important when the partnership is a payor of the amount in question.
- As in the case of a domestic partnership, aggregate principles should govern.
- The BEP to FP is $50.

44

Exit Considerations – Sale of ECI Partnership Interest

- The US Tax Court's decision in the *Grecian Magnesite* (2017) case held that gain from the complete redemption of a foreign person's interest in a partnership owning US trade or business assets was not subject to US tax as ECI. This decision refused to follow IRS Rev. Rul. 91-32, which would have treated a portion of the foreign person's gain as ECI. The Tax Court's decision in *Grecian Magnesite* is currently under appeal to the DC Circuit.

45

Exit Considerations – Sale of ECI Partnership Interest (cont'd)

- Section 864(c)(8) effectively overrides *Grecian Magnesite* by providing that gain (or loss) of a foreign partner from its sale, exchange or other disposition of all or any portion of its interest in a partnership that conducts a US trade or business is ECI (or effectively connected loss) to the extent of the partner's distributive share of the partnership's gain or loss that would have been ECI (or effectively connected loss) if the partnership had sold all of its assets at their FMV as of the date of the sale, exchange or other disposition.

46

Exit Considerations – Sale of ECI Partnership Interest (cont'd)

- Section 864(c)(8) does not use a pure aggregate approach – where the foreign partner would recognize the same amount of effectively connected gain or loss as it would upon an actual disposition of partnership assets. Instead, the provision only recharacterizes as effectively connected gain or loss an amount not exceeding the gain or loss actually recognized by the foreign partner with respect to the disposition.
- The provision further provides:
  1. For purposes of this subparagraph, a partner's distributive share of gain or loss on the deemed sale shall be determined in the same manner as such partner's distributive share of the non-separately stated taxable income or loss of such partnership.
  2. What does this provision mean?

47

Exit Considerations – Sale of ECI Partnership Interest (cont'd)

- New Section 1446(f) requires the transferee of a partnership interest to withhold 10% of the amount realized on the transfer, if any portion of the gain (if any) from the transferor's disposition of the interest would be treated under Section 864(c)(8) as ECI and the transferor does not certify that it is a US person.
- If a transferee fails to withhold any amount required to be withheld under Section 1446(f), the partnership is required to deduct and withhold from distributions to the transferee a tax in an amount equal to the amount the transferee failed to withhold (plus interest).

48

Notice 2018-29

- On April 2, 2018, Treasury and the Internal Revenue Service released Notice 2018-29, announcing an intention to issue proposed regulations under Sections 864(c)(8) and 1446(f). The Notice provides that, before the issuance of regulations, taxpayers may rely on the rules described in the Notice.

Notice 2018-29 (cont'd)

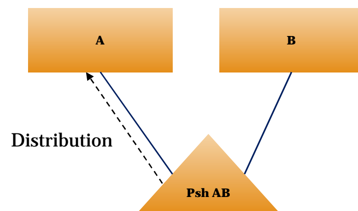
- The Notice provides two exceptions where USTB assets are insignificant:
  1. Insignificance Test #1: No withholding is required if the foreign partner ("FP") certifies that for FP's "immediately prior" taxable year and the two taxable years that preceded it, FP's allocable share of the ECI of the partnership ("OP") in each such year was less than 25% of FP's total distributive share of OP's income for that year.
  2. Insignificance Test #2: No withholding is required if OP provides a certification within 30 days before the transaction that if OP were to sell all of its assets at their fair market value, the amount of gain that would be ECI (including FIRPTA gain) would be less than 25% of the total gain.

Notice 2018-29 (cont'd)

- The Notice also provides that Treasury and the IRS intend to issue regulations providing that no withholding is required under Section 1446(f) upon the transfer of a partnership interest if the transferee receives a notice from the transferor that a non-recognition provision applies to the transfer.
- The Notice states, however, that the government is studying the appropriate treatment of non-recognition transactions under Section 864(c)(8).
- When a partnership is a transferee of a partnership interest by virtue of making a distribution in which no gain is recognized, the partnership is not required to withhold.

51

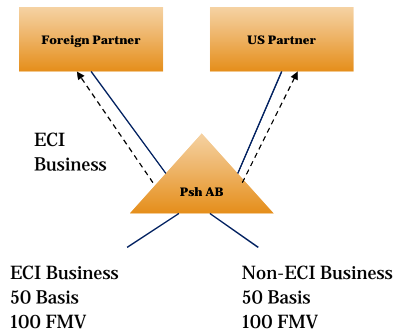
Treatment of Partnership Distributions



- Partner A has an interest in Psh AB with a basis of 20 and a fair market value of 100.
- If Psh AB makes a distribution to A of up to 20, no gain or loss is recognized by A. Under Notice 2018-29, Psh AB would not be required to withhold with respect to the distribution.
- What if Psh AB distributes 30 to A?
- Does withholding apply to:
  1. 10 (the amount of gain recognized)?
  2. 30 (the full amount of the distribution)?

52

Treatment of Partnership Distributions (cont'd)



- Psh AB distributes the ECI business to Foreign Partner.
- Does Section 864(c)(8) apply?
- What if instead Psh AB distributes the non-ECI business to Foreign Partner?
- What if instead Psh AB distributes the ECI business to US Partner?