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STUDENT SUPPLEMENTAL UPDATE MEMORANDUM

to

FUNDAMENTALS OF PARTNERSHIP TAXATION

Cases and Materials

Tenth Edition

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PREFACE

This January 2018 Student Supplemental Update Memorandum brings the 2017 Student Update Memorandum to the Tenth Edition of *Fundamentals of Partnership Taxation* up to date by summarizing the relevant provisions of the tax reform legislation popularly known as the Tax Cuts and Jobs Act and enacted into law on December 22, 2017 under the title, "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," Pub. L. No. 115-97 (hereinafter "the Act"). The Update Memorandum is organized to parallel the text, with cross references to chapter and topic headings and page numbers. The discussion includes citations to sections of the Act and, selectively, to the affected provisions of the Internal Revenue Code.

The discussion in the Update Memorandum is intended as a general summary of the major provisions of the Act affecting partnerships (including LLCs) and S corporations and their partners and shareholders, and as a preview of some of the Act's implications. There is more to digest, and expanded coverage can be expected in the Summer 2018 Update Memorandum to be published in July.

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

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CHAPTER 1. AN OVERVIEW OF THE TAXATION OF CORPORATIONS AND SHAREHOLDERS

B. INTRODUCTION TO CHOICE OF BUSINESS ENTITY

Page 4:

Impact of the 2017 Act on Influential Policies and Choice of Entity. The core infrastructure of Subchapter K was left relatively untouched by the Tax Cuts and Jobs Act, as were the structural provisions of Subchapter C and Subchapter S in the corporate context. But many of the influential policies previewed at pages 4 to 12 of the text, and how they relate to one another, have changed dramatically, with profound implications on the choice of entity for a business, capital structure, compensation policy, and much more. This update provides an overview of the highlights and some initial observations on how they may influence taxpayer behavior.

Congress rejected the radical step of eliminating the double tax regime of Subchapter C and instead moderated its bite by lowering the corporate income tax rate to 21 percent – a 40 percent decrease from the 35 percent top rate that has been in place for many years. As enacted, this rate cut is permanent, but of course nothing is ever "permanent" in the Code especially with the shifting of political winds. The top individual rate fell only slightly, from 39.6 to 37 percent, and the individual tax cuts are "temporary" (they are scheduled to expire in 2026 unless they are extended or made permanent). The 20 percent maximum rate on long-term capital gains and qualified dividends also was left unchanged and the 3.8 percent tax on net investment income for taxpayers above certain thresholds was retained. The end result of all this is that for the first time in over thirty years, the corporate rate is significantly lower than the highest individual marginal rates. Business taxpayers also will be allowed to deduct 100 percent of the cost of both new and used equipment (this temporary change phases out gradually beginning in 2023). But, in a rough justice trade-off, taxpayers are now subject to a limit on the deduction of net business interest expense.

Finally, to level the playing field between C corporations and pass-through business entities that are not taxed at the entity level (partnerships, limited liability companies, S corporations and sole proprietorships), Section 199A of the Code allows individual taxpayers, trusts and estates to deduct 20 percent of their share of "qualified business income." For those who qualify for this deduction, their business income is effectively taxed at a top rate of 29.6 percent instead of 37 percent (29.6 percent is 37 percent multiplied by the 80 percent of taxable qualified business income after the deduction). This represents a 25 percent reduction from the pre-2018 top rate of 39.6 percent – much less than the corporate rate reduction but considerably more than the small rate cut for wage earners. The bad news is that the 20 percent deduction is subject to a nasty web of special rules and limitations that are previewed later in this chapter in connection with S corporations and in more depth in the update to Chapter 3.

At page 7 of the text, we summarized the influential policies relating to corporate and individual rates as follows:

> For now, the conventional wisdom is that, in most cases, the modest increase in tax rates for high-income individuals is not sufficient to tip the scales toward conducting business as a C corporation for most closely held companies. A lower top corporate rate, which has been proposed repeatedly and enjoys bipartisan support, would alter the analysis. Reduced rates for C corporations would revive their use as an attractive refuge from the more onerous individual tax rates unless, as some have suggested, future legislation couples a corporate rate reduction with tax relief for pass-through entities.

As predicted, the Act has once again tinkered with tax rates and, in so doing, altered these influential policies. A major takeaway is that closely held businesses that previously chose to operate as sole proprietorships or pass-through entities to avoid the double tax may want to reconsider using C corporations because of the dramatically lower corporate tax rate. As in the good old days, corporations may be "an attractive refuge" as long as strategies can be employed to minimize, defer or, where possible, completely avoid a second layer of tax at the shareholder level. The ideal tax plan would be to leave the earnings in the corporation to compound at the preferential rate until the business is sold or liquidated. Better still, shareholders should wait until they die, when their stock basis is stepped up to fair market value, completely eliminating any shareholder-level tax on the unrealized appreciation up to the date of death. The choice of entity decision is far more nuanced, however, involving many other variables such as the type of business, whether a shareholder also works for the company and is (or should be) paid reasonable compensation, employment tax issues, the shareholder's need to withdraw earnings to pay for personal consumption, the availability of business deductions and credits that may reduce a C corporation's tax liability, other opportunities for tax savings through tax-preferred fringe benefits and deferred compensation planning, the impact of state and local taxes, and myriad of other considerations unique to special situations. The new 20 percent deduction on qualified business income also must be evaluated for those who qualify for it, and it may tip the scales back toward use of a pass-through entity for all or part of the business.

CHAPTER 3. OPERATIONS OF A PARTNERSHIP: GENERAL RULES

B. TAX CONSEQUENCES TO THE PARTNERS

Before the text beginning at the top of page 77, insert a new heading "1. BASIC RULES," and at the bottom of page 79, add the following new section:

2. DEDUCTION FOR QUALIFIED BUSINESS INCOME

Code: § 199A (selectively)

Introduction. While the Tax Cuts and Jobs Act of 2017 is headlined by the reduction of the top corporate income tax rate from 35 to 21 percent, lawmakers who favored significant tax reductions for business taxpayers were concerned about providing relief for public companies and other businesses organized as C corporations to the exclusion of "small businesses," which often are conducted by sole proprietorships, partnerships, LLCs, or S corporations. To level the playing field, Section 11011(a) of the Act adds to the Code new Section 199A, which provides a temporary (through taxable years beginning before 2026) income tax deduction to individuals, trusts and estates of 20 percent of the "qualified business income" from these pass-through vehicles. When fully available, the deduction effectively lowers the tax rate applicable to this income from 37 to 29.6 percent for the highest income taxpayers. This deduction is not allowed in computing adjusted gross income and thus does not affect limitations based on AGI, but it is available to taxpayers who do not otherwise itemize deductions. I.R.C. §§ 62(a); 63(b)(3).

At its most basic level, Section 199A permits an individual to deduct 20 percent of the qualified business income generated through a sole proprietorship, a partnership, or an S corporation. I.R.C. § 199A(a)(1)(A), (b)(1)(A), (b)(2)(A). As will quickly become apparent, the "qualified" modifier is ubiquitous in Section 199A. In particular, qualified business income consists of the net amount of qualified items of income, gain, deduction and loss with respect to each qualified business of the taxpayer. I.R.C. § 199A(c)(1).

Qualified Business Income Defined. As a starting point, "qualified business income" ("QBI") is the net amount of qualified items of income, gain, deduction and loss that are effectively connected with the conduct of a trade or business within the United States and which are included or allowed in determining taxable income for the relevant year. I.R.C. § 199A(c)(3)(A). Consistent with the intention to limit the deduction to operating income, the definition excludes a broad range of investment income: capital gains or losses, dividend income (or payments in lieu of dividends), interest income, net gains from commodities transactions, net foreign currency gains, net income from notional principal contracts, and annuity income. I.R.C. § 199A(c)(3)(B). Furthermore, the definition does not extend to compensation or similar payments an individual receives from a business. Hence, qualified income under Section 199A does not include reasonable compensation paid to the taxpayer from a qualified business for services rendered or, in the context of a partnership or LLC, it does not extend to any guaranteed payment made to the taxpayer under Section 707(c) in connection with the provision of services. I.R.C. § 199A(c)(4).

Qualified Trade or Business. For taxpayers who fall below critical taxable income thresholds established under Section 199A (discussed below), the scope of a qualified trade or business is remarkably broad. It includes any trade or business other than a trade or business of providing services as an employee. I.R.C. § 199A(d)(1)(B). Accordingly, an employee in her capacity as such cannot benefit from the Section 199A deduction. Rather,

the deduction is limited to independent contractors, sole proprietors, and owners of S corporations, partnerships, and LLCs. But, as discussed below, this otherwise broad reach is restricted considerably for high-income taxpayers who are engaged in trades or businesses involving the performance of services in certain specified fields.

Taxable Income Limitation. In all cases, the Section 199A deduction may not exceed 20 percent of the taxpayer's total taxable income (determined without reference to the Section 199A deduction) reduced by net capital gain. I.R.C. § 199A(a)(1)(B), (e)(1).

To illustrate a straightforward application of Section 199A, assume A, a single taxpayer who does not itemize deductions, practices law as a solo practitioner. Over the course of the year, her practice generates $140,000 of legal fees and $2,000 of interest income from her business deposits. A incurs $40,000 of deductible expenses attributable to her practice, and she has no other sources of income. In this case, A is engaged in a qualified trade or business under Section 199A, as she is not providing services in an employee capacity. While her net income from the practice totals $102,000, only $100,000 constitutes QBI because the $2,000 of interest income is excluded from the definition. A's taxable income (without the Section 199A deduction) would be $90,000 ($102,000 minus a $12,000 standard deduction). Accordingly, A may deduct 20 percent of the lesser of (1) her $100,000 of QBI from the law practice or (2) the $90,000 of taxable income amount. Thus, A's Section 199A deduction is $18,000, reducing her final taxable income to $72,000. The $18,000 deduction has the effect of reducing A's average tax rate on the income from her law practice. Note that if A were an associate in a law firm and her wages as an employee were $100,000, she would not be entitled to any deduction under Section 199A

Income-Based Thresholds: In General. The basic application of Section 199A becomes considerably more complex once a taxpayer reaches certain taxable income thresholds. Those thresholds – determined without reference to the deduction otherwise provided by Section 199A – are $157,500 for a single taxpayer and $315,000 for married taxpayers filing jointly, with each figure being indexed for inflation after 2018. Once these thresholds are reached, Section 199A imposes two independent limitations: (1) it excludes certain specified service-predominant activities from the definition of a qualified trade or business, and (2) it imposes a cap on the amount otherwise deductible under Section 199A, determined by reference to a percentage of the W-2 wages paid by the business (i.e., wages paid to its employees) or by references to a lesser percentage of W-2 wages paid and the cost of its depreciable property used in the production of QBI. These limitations, addressed in more detail below, are fully phased in when taxable income reaches $50,000 above the threshold amount for single taxpayers (that is, $207,500 in 2018) and $100,000 above the threshold amount for married taxpayers filing jointly (that is, $415,000 in 2018). Within the phase-in range, the limitations are each applied based on the ratio by which the taxable income of the taxpayer over the threshold amount bears to $50,000 for single taxpayers, or $100,000 for married taxpayers filing jointly. I.R.C. § 199A(b)(3)(B). For purposes of simplicity, the discussion below will refer to the limitations as applied in their fully phased-in form to "high-income taxpayers."

Limitation for Specified Service Businesses. For high-income taxpayers, Section 199A excludes any "specified service trade or business" from the definition of a qualified trade or business. I.R.C. § 199A(d)(1)(A), (3). A specified service trade or business for this purpose includes any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, and any trade or business the principal asset of which is the reputation or skill of one or more of its employees or owners. I.R.C. § 199A(d)(2); see also I.R.C. § 1202(e)(3)(A). Investment managers and traders in securities are also included in the "specified service trade or business" category, and architects and engineers are excluded. I.R.C. § 199A(d)(2). As explained in the legislative history of the Act, the taxable income thresholds at which the exclusion for a specified service trade or business applies was intended by Congress "to deter high-income taxpayers from a attempting to convert wages or other compensation for personal services to income eligible for the 20 percent deduction under the provision." The exclusion, however, applies without regard to the taxpayer's subjective motivation. For instance, returning to the basic example above, if A were married and filed a joint return with her husband B who earned $350,000 in salary as an employee, A's law practice would no longer constitute a qualified trade or business for purposes of Section 199A.

W-2 and Qualified Property Limitations. In addition to limitations on the activities that will constitute a qualified trade or business, high-income taxpayers face limitations on the amount that can be deducted under Section 199A. Whereas the deduction under Section 199A generally is equal to 20 percent of QBI, for high-income taxpayers that amount is subject to a cap determined by reference to the greater of: (1) 50 percent of the "W-2 wages" with respect to the qualified trade or business, or (2) the sum of 25 percent of the "W-2 wages" with respect to the trade or business plus 2.5 percent of the unadjusted basis immediately after acquisition of all "qualified property" used in the trade or business. I.R.C. § 199A(b)(2)(B).

The scope of "W-2 wages" for purposes of this limitation includes the total amount of wages subject to income tax withholding, compensation paid into qualified retirement accounts, and certain other forms of deferred compensation paid to the employees of the business. I.R.C. § 199A(b)(4). For labor-intensive businesses, the figure determined by 50% of W-2 wages paid by the business likely will serve as the relevant cap on the amount deductible from that trade or business for purposes of Section 199A.

For capital-intensive businesses (e.g., real estate), however, an alternate cap exists. It starts with 25 percent of W-2 wages paid by the trade or business and adds to this amount 2.5 percent of the unadjusted basis (immediately after acquisition) of "qualified property." Qualified property for this purpose encompasses tangible property—real or personal—of a character subject to depreciation (hence, not land) that is held by and available for use in a qualified trade or business at the close of the taxable year, which is used in the production of qualified business income, and for which the depreciable period of the property has not ended before the close of the taxable year. I.R.C. § 199A(b)(6)(A). In light of the legislation's introduction of broad-based expensing of equipment purchases, the depreciable period of property for purposes of Section 199A ends upon the later of (a) 10

years after the date the property is placed in service, or (b) the last day of the last full year in the applicable recovery period that would apply to the property under Section 168. I.R.C. § 199A(b)(6)(B).

Special Apportionment Rules. The application of the Section 199A to sole proprietors is fairly straightforward, as there can exist only one owner of such business. Accordingly, references to the qualified income, W-2 wages, and qualified property of the trade or business include all such amounts generated by the trade or business. However, for pass-through entities, such as partnerships and LLCs and S corporations that have more than one owner, these amounts must be apportioned among the respective owners. Section 199A provides special rules for this purpose. I.R.C. § 199A(f). Each partner or shareholder takes into account only her "allocable share" of each item of income, gain, deduction and loss from the qualified trade or business. While the allocable share of a shareholder in an S corporation will be based on pro-rata stock ownership, presumably the allocable share of partner in Subchapter K entity will be based on the partner's distributive share of the item under Section 704(b). With respect to determining the cap applicable to taxpayer's deduction under 199A, those amounts too will be determined by reference to the partner or shareholder's allocable share of the W-2 wages and unadjusted basis of qualified property in the trade or business. I.R.C. § 199A(f)(1)(A)(ii). Again, the allocable shares of S corporation shareholders will be based on pro-rata stock ownership. A partner's allocable share of W-2 wages will be determined by reference to the manner wage expenses are allocated among the owners, and a partner's allocable share of the unadjusted basis of qualified property will be determined by such partner's share of depreciation with respect to the property. Special allocations of deductions attributable to wages and depreciation therefore will become relevant for purposes of determining the amount of a partner's Section 199A deduction.

Examples. The examples below illustrate the operation of Section 199A in two basic situations.

Example 1. C holds a 25 percent ownership interest in an LLC that operates a restaurant, and C's allocable share of net operating income from the LLC totals $100,000 for the year. C also earns $200,000 of taxable income from sources unrelated to the business, subjecting him to the high-income limitations imposed by Section 199A. The LLC pays its employees $120,000 in wages over the course of the year, and the restaurant (which leases its building) has $400,000 of unadjusted basis in restaurant equipment and furnishings used in the business for which the recovery period under Section 168 remains unexpired.

C's deduction under Section 199A is equal to the lesser of: (1) 20 percent of C's allocable share of qualified income from the trade or business (note that it is not a specified service trade or business), or (2) the greater of: (a) 50 percent of the C's allocable share of the W-2 wages paid by the LLC or (b) 25 percent of C's allocable share of the W-2 wages paid by the LLC plus 2.5 percent of the unadjusted basis of qualified property used in the company's trade or business. Assuming that C's allocable share of all tax items from the business is based on his 25 percent ownership, the starting point for calculating C's

deduction under Section 199A is 20 percent of $100,000, or $20,000. However, this amount is capped by the greater of the following two amounts: 50 percent of C's $30,000 share of W-2 wages paid by the LLC ($15,000) or 25 percent of C's $30,000 share of W-2 wages paid by the LLC ($7,500) plus 2.5 percent of C's $100,000 share of the unadjusted basis of qualified property held by the LLC ($2,500). Accordingly, C's deduction under Section 199A is capped at the higher of these two amounts, which is $15,000.

Example 2. D owns a 10 percent interest in a limited partnership that owns and operates a commercial office building purchased for $550 million, $50 million of which was allocated to the underlying land. The partnership generates $50 million of net rental income for the year, and it pays its employees W-2 wages of $500,000. In the absence of any cap, D's deduction under Section 199A would equal 20 percent of his $5 million allocable share of net rental income, or $1 million. If this amount were capped at 50 percent of D's $50,000 allocable share of W-2 wages paid by the partnership, the deduction would be reduced significantly to $25,000. However, the alternate cap of 25 percent of D's 50,000 allocable share of W-2 wages ($12,500) when added to 2.5 percent of D's $50 million allocable share of the unadjusted basis of the commercial office building ($1.25 million) produces a cap on D's Section 199A deduction of $1,262,500. Accordingly, D's $1 million deduction under Section 199A based on 20 percent of his qualified income from the partnership and is not subject to the limitation.

C. LIMITATIONS ON PARTNERSHIP LOSSES

1. BASIS LIMITATIONS

Page 80:

Section 13502 of the Act corrects what appeared to be a technical glitch in the operation of the Section 704(d) loss limitation to charitable contributions and foreign taxes. Whereas Section 704(d) generally limits a partner's distributive share of loss to the partner's basis in the partnership interest, the regulations interpreting this provision exempted charitable contributions and foreign taxes from this limitation. Reg. § 1.704-1(d)(2). The amendment adds Section 704(d)(3) to provide that the limitation takes into account the partner's share of charitable contributions as defined in Section 170(c) and foreign taxes described in Section 901. However, if the charitable contribution consists of property having a value in excess of its adjusted basis, the loss limitation does not apply to the extent of the partner's share of the excess value. This approach is consistent with the ability of an individual generally to deduct the fair market value of property contributed to charity even though the appreciation in the property had not been included in the tax base.

Page 94:

Add the following new section:

4. LIMITATIONS ON EXCESS BUSINESS LOSSES

Code: § 461(*l*).

Partners who materially participate in a business activity that operates at a loss will now be impacted by new Section 461(*l*) (added by Section 11012 of the Act), which disallows a current deduction for "excess business losses" of noncorporate taxpayers. This limitation applies after the application of the passive activity loss rules in Section 469. I.R.C. § 461(*l*)(6). An "excess business loss" is the aggregate deductions of the taxpayer attributable to all of the taxpayer's trades or businesses (determined without regard to this limitation) reduced by the sum of: (1) the aggregate gross income or gain of the taxpayer for the taxable year which is attributable to such trades or businesses, and (2) a threshold amount that in 2018 is $500,000 for married filing jointly taxpayers and $250,000 for all others (the threshold amounts are indexed for inflation beginning in 2019). I.R.C. § 461(*l*)(3). The loss limitation applies at the partner level to the partner's distributive share of all tax items from trades or businesses attributable to the entity. I.R.C. § 461(*l*)(4). Any disallowed excess business loss is carried forward and treated as part of the taxpayer's net operating loss carryforward in subsequent taxable years, subject to the new rule allowing NOLs only up to 80 percent of taxable income. I.R.C. § 461(*l*)(2).

Section 461(*l*) applies to taxable years beginning after December 31, 2017 and before January 1, 2026. I.R.C. § 461(*l*)(1).

CHAPTER 7. COMPENSATING THE SERVICE PARTNER

B. PARTNERSHIP EQUITY ISSUED IN EXCHANGE FOR SERVICES

5. POLICY ISSUES: TAXATION OF CARRIED INTERESTS

Page 259:

While tax treatment of carried interests for years has been the subject of lively policy debates and periodic elaborate legislative solutions, the private equity industry proved adept at preserving the favorable tax landscape for fund managers – even in the face of opposing public opinion. However, the industry's stalwart defense finally yielded to a small degree. Section 13309 of Act provides a fairly modest legislative response to the carried interest phenomenon by imposing a three-year holding period in determining a fund manager's distributive share of long-term capital gain attributable to a partnership profits interest received in connection with the provision of services. The corrective legislation is described in more detail below.

Scope of Application. Section 13309 of the Act introduced new Code Section 1061, which provides special rules for taxpayers holding an "applicable partnership interest,"

which generally is a partnership interest transferred to or held by a taxpayer in connection with the performance of substantial services by the taxpayer in any "applicable trade or business." I.R.C. § 1061(c)(1). An applicable trade or business, in turn, encompasses any activity conducted on a regular, continuous, and substantial basis which consists of (a) raising or returning capital, and (b) investing in or developing a range of "specified assets" consisting of a broad range of financial investments including securities, commodities, option, derivatives, and cash equivalents, as well as real estate held for rental or investment. I.R.C. § 1061(c)(2) & (3). The scope of an applicable trade or business cannot be avoided by utilizing tiered partnerships, as the definition of a specified asset also includes a partnership interest to the extent the partnership holds financial instruments or real estate described above. *Id.*

Section 1061 contains some important exceptions to the scope of the equity interests covered by the statute. First, an applicable partnership interest does not include a partnership interest held by a corporate taxpayer. I.R.C. § 1061(c)(4)(A). Additionally, an applicable partnership interest does not include a capital interest in a partnership that provides the taxpayer with the right to share in partnership capital in a manner commensurate with either the amount contributed to the entity (determined at the time of the receipt of the interest) or the amount included in the taxpayer's gross income under Section 83 at the time of receipt. I.R.C. § 1061(c)(4)(B). Hence, Section 1061 does not apply to a partnership capital interest actually purchased by the taxpayer or effectively purchased by the taxpayer for tax purposes through inclusion of the value of the capital interest in gross income upon receipt.

Corrective Tax Treatment. The approach taken by Section 1061 to the treatment of carried interests is by no means elaborate. Rather than treating the allocation as ordinary income or imputing a loan of capital to correspond with the profits interest giving rise to the allocation, Section 1061 simply lengthens the holding period for determining long-term capital gain in this context. That is, the statute converts to short-term capital gain the excess of (a) the taxpayer's distributive share of long-term capital gain over the (b) the taxpayer's distributive share of long-term capital gain determined by imposing a 3-year holding period for long-term treatment. I.R.C. § 1061(a). Allocations of long-term capital gain in this setting with respect to assets held for less than three years therefore will be subject to ordinary income tax rates. The good news for the partner is that these allocations still may be offset by capital losses.

Exclusion for Non-Portfolio Investments. The statute provides the IRS with authority to exclude from Section 1061 income or gain attributable to any asset not held by the partnership for portfolio investment on behalf of third parties. I.R.C. § 1061(b). Accordingly, Section 1061 may not apply to all long-term capital gains attributable to an applicable partnership interest. However, in the context of a typical private equity fund, this potential exclusion will have little if any application.

Relevance of Section 83. One persistent issue that arises in connection with partnership profits interests received for services is the potential application of Section 83 to the receipt of the interest. Rather than resolving this issue, Section 1061 continues to

punt on the matter. Section 1061 provides that the statute's conversion of certain long-term capital gains to short-term capital gains applies notwithstanding Section 83 or any election in effect under Section 83(b). I.R.C. § 1061(a) (flush language). In other words, Section 83 cannot be interpreted as somehow overriding or negating application of Section 1061.

Application in Context of Sale of Interest. If Section 1061 were to apply only to allocations of long-term capital gain with respect to an applicable partnership interest, taxpayers would be tempted to avoid application of the statute through sales of partnership interests to related parties. Section 1061 forecloses this avoidance opportunity by providing that the transferring partner shall include in gross income as short-term capital gain the excess of so much of the taxpayer's long-term capital gains with respect to the interest for the taxable year "attributable to the sale or exchange of any asset held for not more than 3 years as is allocable to such interest." I.R.C. § 1061(d)(1)(A). The statute thus appears to apply only to long-term capital gains realized from the sale of partnership assets that otherwise may be allocable to the related party purchasing the interest (as opposed to long-term capital gain realized upon the sale of the interest under Section 741). To avoid the prospect of double counting, the statute reduces the amount of long-term capital gain converted to short-term capital gain in this setting by the amount so converted by reason of the Section 1061(a) general rule. I.R.C. § 1061(d)(1)(B).

Congress recognized that more information from taxpayers may be needed to effectively carry out the goals of the corrective legislation. The statute therefore directs the Secretary to require reporting by taxpayers to provide information necessary to carry out the purpose of the section. I.R.C. § 1061(e). Additionally, the statute directs the Secretary to promulgate regulations or to issue guidance under Section 1061 as may be necessary or appropriate to carry out the purposes of the section. I.R.C. § 1061(f).

New Section 1061 applies to taxable years after 2017.

CHAPTER 9. SALES AND EXCHANGES OF PARTNERSHIP INTERESTS

B. CONSEQUENCES TO THE BUYING PARTNER

Page 309:

Mandatory Inside Basis Adjustment for Partnership with Substantial Built-in Loss. Section 13502 expands the definition of a substantial built-in loss that triggers mandatory inside basis reductions under Section 743(b). Whereas a substantial built-in loss previously was defined solely by reference to the excess of the partnership's basis in all of its property over the adjusted basis of such property (I.R.C. § 743(d)(1)(A)), Section 743(d)

now applies a similar standard at the partner level. That is, a substantial built-in loss also exists if the sale of all partnership property in a fully taxable transaction would cause the transferee partner to be allocated loss in excess of $250,000. I.R.C. § 743(d)(1)(B). The expansion of the definition of a substantial built-in loss under Section 743(d) therefore addresses the prospect of the mandatory basis step-down being avoided through the use of special allocations of items of significant loss to the transferee partner.

The expanded definition of a substantial built-in loss under Section 743(d) applies to sales of partnership interests after 2017.

CHAPTER 12. PARTNERSHIP TERMINATIONS AND MERGERS

B. PARTNERSHIP TERMINATIONS FORCED BY STATUTE

Page 422:

Act Section 13504 eliminates the "technical termination" provision of former Section 708(b)(1), which provided that a partnership generally was treated as being terminated if 50 percent or more of total interest in partnership capital and profits was sold or exchanged within a 12-month period. The provision previously served as a trap for the unwary in situations where the deemed liquidation of the partnership triggered gain at the partner level under Section 731. On the other hand, the technical termination rule provided taxpayers with a vehicle to avoid otherwise irrevocable elections made at the partnership level by structuring sales that would technically terminate the partnership's existence for tax purposes. Whether for better or worse, a partnership no longer will be terminated by the sale of a partnership interest (provided the entity continues to have more than one owner).

CHAPTER 15. S CORPORATIONS AND THEIR SHAREHOLDERS

B. ELIGIBILITY FOR S CORPORATION STATUS

Page 462:

Electing Small Business Trusts. Section 13541 of the Act amends the Code to permit electing small business trusts to have nonresident alien beneficiaries, expanding the ESBT's role in international estate planning. I.R.C. § 1361(c)(2)(B)(v). Section 13542 of the Act provides that the charitable contributions deduction for the portion of an ESBT holding S corporation stock is determined under the rules in Section 170 (e.g., percentage limitations and carryovers) applicable to individuals rather than the rules in Section 642(c)

applicable to trusts. I.R.C. § 641(c)(2)(E). This amendment addresses an arcane technical issue beyond the coverage in the text but, for those who are interested, its effect is generally favorable to ESBTs that make distributions to charitable beneficiaries.

D. TREATMENT OF THE SHAREHOLDERS

2. LOSS LIMITATIONS

A. IN GENERAL

Page 475:

Limitations on Excess Business Losses. Like partners and other taxpayers engaged in a trade or business, S corporation shareholders who materially participate in a business activity that operates at a loss will now be impacted by new Section 461(*l*) (added by Section 11012 of the Act), which disallows a current deduction for "excess business losses" of noncorporate taxpayers. See the update to Chapter 3, at page 9, supra.

Page 485:

After the carryover paragraph, insert the following new section and redesignate the topic heading that follows it as "4. SALE OF S CORPORATION STOCK":

3. DEDUCTION FOR QUALIFIED BUSINESS INCOME

The new 20 percent deduction for qualified business income, discussed in the update to Chapter 3, at pages 4-8, supra, is also relevant to shareholders of S corporations.

E. DISTRIBUTIONS TO SHAREHOLDERS

Page 490:

Distributions after Conversion from S to C Corporation Status. As described in the text, distributions from S corporations generally are treated as coming first from the corporation's accumulated adjustments account ("AAA") and, when relevant, any excess is treated as coming from earnings and profits generated by the corporation when it was a C corporation or carried over under Section 381 as a result of a tax-free transaction such as a merger. I.R.C. § 1368. If an S corporation's S election terminates, causing it to become a C corporation, the Code provides special rules for cash distributions made during a post-termination transition period ("PTTP"), which generally is one year. I.R.C. § 1377(b). A cash distribution during the PTTP is treated as a reduction of basis to the extent it does not exceed the S corporation's AAA, but after the PTTP expires, distributions are treated as

coming first from earnings and profits and taxed as a dividend to that extent. I.R.C. § 1371(e)(2).

Section 13543(b) of the Act provides additional relief in the S to C corporation conversion scenario by providing that, for cash distributions made after the expiration of the PTTP, the AAA shall be allocated to the distribution, and the distribution shall be chargeable to accumulated earnings and profits, in the same ratio as the amount of the AAA bears to the amount of the accumulated E & P. To qualify for this relief provision, the corporation must: (1) have been an S corporation on December 21, 2017 (the day before the date of enactment of the Act); (2) revoke its S election within the two-year period beginning on the date of enactment; and (3) have the same owners on the date its S election is revoked and in the same proportions as on the date of enactment. I.R.C. §§ 1371(f); 481(d)(2).

F. TAXATION OF THE S CORPORATION

Page 491:

Tax on Certain Built-in Gains. Effective for taxable years beginning after December 31, 2017, the reduction to the highest corporate income tax rate results in a corresponding reduction of the Section 1374 tax rate from 35 to 21 percent.

Tax on Passive Investment Income. Effective for taxable years beginning after December 31, 2017, the reduction of the highest corporate income tax rate results in a corresponding reduction of the Section 1375 tax rate from 35 to 21 percent. In the illustration at pages 709-710 of the text, X's liability will be reduced from $1,750 to $1,050 ($5,000 x 21%).

G. COORDINATION WITH OTHER INCOME TAX PROVISIONS

1. SUBCHAPTER C

Page 504:

Change of Accounting Method on Conversion of S Corporation to C Corporation. With the corporate income tax rate reduced to 21 percent, some S corporations may choose to revoke their S elections and become C corporations. Since C corporations generally are required to use the accrual method of accounting, the conversion may require the corporation to change from the cash to the accrual method, triggering certain adjustments under Section 481 in computing taxable income. To provide relief in this situation, Section 13543 of the Act permits any such Section 481 adjustments arising from a change in accounting method caused by an S to C conversion to be taken into account ratably over six tax years. I.R.C. § 481(d).