SUMMER 2024

STUDENT UPDATE MEMORANDUM

to

FUNDAMENTALS OF PARTNERSHIP TAXATION

Cases and Materials

Eleventh Edition

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PREFACE

This Summer 2024 Student Update Memorandum brings *Fundamentals of Partnership Taxation* up to date by summarizing major developments since publication of the Eleventh Edition in June of 2019. It is organized to parallel the text, with cross references to chapter and topic headings and page numbers. The Memorandum covers developments through July 1, 2024, including selected provisions of the Inflation Reduction Act of 2022, Pub L. No. 117-169, 136 Stat. 1818, and provides our annual bipartisan overview of pending legislative proposals with potential impact on business enterprise taxation and how their prospects for enactment will be affected by the 2024 election results.

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 PARTNERSHIPS AND PARTNERS

B. INTRODUCTION TO CHOICE OF BUSINESS ENTITY

Page 4:

Proposed Tax Legislation. As noted in the text, the policies influencing the business enterprise taxation landscape have been in a periodic (some might say "constant") state of disequilibrium as part of a highly politicized tax legislative process. Enactment of major tax legislation has become virtually impossible during periods of divided government. Changes usually follow a shift in the balance of power, such as during Donald Trump's first year in office in 2017 with the enactment of the Tax Cuts and Jobs Act (first discussed at p. 7 of the casebook). But the individual tax rate reductions and many pro-business provisions from the 2017 Act, except the "permanent" reduction of the corporate income tax rate, were only temporary and are set to expire at the end of 2025 unless they are extended or made permanent. Some of the controversial revenue raisers in this legislation, such as the limit on deducting state and local taxes and the flat ban on deducting miscellaneous itemized deductions, also will expire, restoring the law as it was prior to 2018. All this leads to one inescapable prediction for the future – something will happen in 2025 even if Congress does nothing while watching the late December sunset. And even the life of "permanent" legislation is only guaranteed to last as long as the political majority that created it.

During his first 100 days in office, with the Democratic party in control of the House and Senate albeit by the narrowest of margins, President Biden unveiled a sweeping list of tax proposals as a major piece of an ambitious legislative package designed to roll back all or part of the 2017 tax cuts. https://home.treasury.gov/policy-issues/tax-policy/revenue-proposals. The plan would have raised individual and corporate tax rates, made major changes to the U.S. taxation of multinational businesses, and increased the budget for IRS enforcement and tax administration. More targeted revenue-raising measures were aimed at partnerships and S corporations, including a proposal to tax managers of certain types of investment partnerships on their allocable share of "carried interests" as ordinary income rather than long-term capital gain and subject that income to self-employment tax if the service provider's taxable income from all sources exceeds $400,000. As the process played out, however, the initial Biden administration blueprint lacked sufficient support in the Senate. A diluted version, which abandoned the individual and corporate tax rate increases and pivoted to alternative measures aimed at high-income taxpayers, narrowly passed the House as part of the Build Back Better Act (H.R. 5376), but amidst continuing political gridlock, even this watered-down legislation stalled and ultimately died in the Senate.

In 2022, President Biden resurrected the corporate and individual tax rate increases, floated a minimum income tax on taxpayers with a net worth of more than $100 million, refined the international tax reforms, and included a list of loophole closers many of which dated back to the Obama administration. See General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals, Dept. of the Treasury, March 2022, available at https://home.treasury.gov/system/files/131/General-Explanations-FY2023.pdf. After prolonged negotiations, a reworked and far less sweeping bill – known as the Inflation Reduction Act of 2022 – passed by the narrowest of margins and became law in August 2022. The major substantive business tax provisions were: (1) a 15 percent corporate minimum tax, (2) a new one percent excise tax on stock repurchases by certain publicly traded companies, and (3) a two-year extension of the Section 461(*l*) limitation on excess business losses. The Inflation Reduction Act also included provisions to increase funding for IRS enforcement, extend and expand various clean energy tax credits, and boost subsidies under the Affordable Care Act (a/k/a Obamacare).

In June 2023, the House Ways and Means Committee, which shifted to Republican control after the 2022 congressional elections, continued the debate by approving a set of mostly pro-business measures consolidated into a bill branded as the American Families and Jobs Act. Among other things, the Republican tax package would have halted the phase-out of 100 percent expensing under Section 168(k), suspended a controversial provision requiring amortization of research and experimentation expenses, relaxed the limitation on deduction of business interest, expanded the exclusion from gain for sales of Section 1202 qualified business stock, pared back clean energy tax incentives, and temporarily increased the individual standard deduction with a phase-out for higher-income taxpayers. The proposal to restore full expensing of R & E expenditures has long enjoyed substantial bipartisan support but efforts to reach a compromise on this relatively modest tax package failed because of disagreement over expanding the child tax credit, which remains high up on the Democrats' wish list.

As this Update Memorandum is being completed in early July 2024, the prospects for enactment of any tax legislation during the months leading up to the 2024 elections are slim to none. But with the 2017 tax cuts and many other provisions of the Tax Cuts and Jobs Act set to expire at the end of 2025, the tax policy debate has taken on greater urgency. In his fiscal year 2025 budget proposals, President Biden continued to advocate for increased individual and business taxes. See General Explanations of the Administration's Fiscal Year 2025 Revenue Proposals, Dept. of the Treasury, March 11, 2024, available at https://home.treasury.gov/system/files/131/General-Explanations-FY2025.pdf. Highlights relevant to the taxation of domestic business enterprises and their owners include:

- Increase the corporate income tax rate from 21 percent to 28 percent.
- Increase the corporate alternative minimum tax rate from 15 percent to 21 percent.
- Raise the excise tax rate on repurchase of corporate stock from 1 percent to 4 percent.
- Make permanent and strengthen the Section 461(l) limitation of business losses for individuals.
- Increase the top marginal individual income tax rate from 37 percent to 39.6 percent while ensuring that taxes will not increase for "middle class"

taxpayers with income of less than $400,000. (The $400,000 threshold has been embedded in this proposal for many years but, because it is not inflation-adjusted, marginal tax rates would increase for some "middle-class" taxpayers).

- Tax long-term capital gains and qualified dividends at ordinary income rates for taxpayers with adjusted gross income in excess of $1 million.
- Increase the net investment income tax rate from 3.8 percent to 5 percent for taxpayers with adjusted gross income in excess of $400,000.
- Add to the Code a 25 percent mark-to-market tax (which would tax unrealized appreciation) on individual taxpayers with net assets in excess of $100 million. A similar proposal has been advanced by Senator Ron Wyden (D-OR), the ranking minority member of the Senate Finance Committee.
- Strengthen current law (e.g., I.R.C. § 1061) by more broadly taxing as ordinary income "carried" (profits) interests of partners who render services to certain types of investment partnerships.

The Biden proposals also include provisions on international taxation, digital assets, specialized loophole closers, tax administration and compliance, and expansion of the child tax and earned income credits. Notably, they do not address the highly contentious issue of whether to extend the $10,000 cap on deducting state and local taxes and they do not include an annual wealth tax as proposed by Senator Elizabeth Warren and other progressive legislators.

As of early July 2024, former President Trump had not yet issued a detailed written set of tax proposals. Republican leaders in Congress have signaled that their highest priority is to make the 2017 individual tax cuts permanent and preserve or even reduce the 21 percent corporate income tax rate. In meetings with business leaders, candidate Trump reportedly supported lowering the corporate rate to 20 percent. Some Republican legislators would prefer a 15 percent rate while others, worried about exploding budget deficits, would be more comfortable with a rate as high as 25 percent. Mr. Trump also has floated a proposal to downsize or eliminate the income tax and replace it with higher tariffs and, in a campaign appearance in Nevada, he mentioned the idea of excluding tips from gross income. To reduce budget deficits, many Republicans would like to roll back or eliminate the costly clean energy credits added in 2023 by the Inflation Reduction Act and resist efforts to expand the child tax credit.

The results of the 2024 Presidential and congressional elections will have an enormous influence on the direction of future tax policy. Unless one political party has a landslide victory, the competing sides will need to forge a compromise, and negotiations may go down to the wire (meaning late December 2025). For a summary of the candidates' tax platforms that will be updated throughout the presidential campaign, see Tax Foundation, Tracking 2024 Presidential Tax Plans, https://taxfoundation.org/research/federal-tax/2024-tax-plans/.

Page 12-13:

Employment Tax Considerations. The wage basis for Social Security and self-employment tax was raised to $168,600 for 2024.

Following a period of increased scrutiny of limited partners and LLC members claiming the exemption from self-employment tax, the Tax Court near the end of 2023 issued a much-anticipated decision in Soroban Capital Partners LP v. Commissioner, 116 T.C. No. 12 (2023). The *Soroban Capital* case was unique in that it concerned taxpayers who were limited partners in an investment firm organized as a state law limited partnership, whereas prior cases involved owners of subchapter K entities who enjoyed limited liability in some other capacity (such as owners of an LLC or LLP). The limited partners in *Soroban Capital* provided significant services to the investment firm, receiving guaranteed payments for their services as well as distributive shares of partnership profits. The Tax Court rejected the partnership's contention that the limited partners' distributive shares of income were *per se* exempt from self-employment tax under Section 1402(a)(13) because of their state-law status as limited partners, highlighting that the statutory exclusion extends only to distributive shares of income "of a limited partner, *as such*." (Emphasis supplied.) The court interpreted this text as limiting the exclusion to passive investors who functioned solely as limited partners, an interpretation that aligned with the legislative purpose of the statutory provision. Hence, the Tax Court held that a functional examination of the limited partners' activities in the partnership was required to determine if the exclusion was appropriate, even in the context of a state law limited partnership.

CHAPTER 3. OPERATIONS OF A PARTNERSHIP: GENERAL RULES

C. LIMITATIONS ON PARTNERSHIP LOSSES

4. LIMITATION ON EXCESS BUSINESS LOSSES

Page 108:

The Coronavirus Aid, Relief, and Economic Security ("CARES") Act delayed application of the Section 461(*l*) limitation on excess business losses of noncorporate taxpayers until years after 2020. The American Rescue Plan Act of 2021 extended the provision through 2026, and the Inflation Reduction Act of 2022 further extended the provision through 2028. For 2024, the indexed thresholds in Section 461(*l*)(3) stand at $305,000 for single taxpayers and $610,000 for a married couple filing a joint return. The Biden administration has proposed to make Section 461(*l*) permanent.

Chapter 4. Partnership Allocations: Section 704(b)

B. Special Allocations Under Section 704(b)

2. The Section 704(b) Regulations: Basic Rules

c. Economic Effect

Page 129:

Deficit Restoration Obligations. The text describes instances in which a deficit restoration obligation will not be respected for purposes of the alternate test for economic effect pursuant to proposed regulations issued in 2016. Final regulations issued in 2019 largely adopt the approach of the proposed regulations. See T.D. 9874 (Sept. 13, 2019) (promulgating Reg. § 1.704-1(b)(2)(ii)(*c*)(*4*)).

d. Substantiality

Page 138:

Transitory Allocations. In the second full paragraph, the illustration of a transitory allocation assumes that Partner A has an expiring net operating loss from activities unrelated to the partnership. Since NOL carryforwards no longer expire (until an individual partner dies), the illustration should be changed to assume that at the beginning of year one Partner A knows he will incur a significant deductible expense in a business activity unrelated to the partnership. To help A enjoy the tax benefit from the deduction as soon as possible, the partners agree to allocate partnership income as described in the illustration.

e. Default Reallocations: The Partners' Interest in the Partnership

Page 146, footnote 98:

For a case illustrating the difficulty in determining the partners' interests in the partnership in the context of a failed attempt to comply with the alternate test for economic effect, see Clark Raymond & Co. v. Commissioner, T.C. Memo. 2022-105, 124 T.C.M. (CCH) 246.

CHAPTER 5. PARTNERSHIP ALLOCATIONS: INCOME-SHIFTING SAFEGUARDS

A. ALLOCATIONS WITH RESPECT TO CONTRIBUTED PROPERTY

3. DEPRECIATION OF CONTRIBUTED PROPERTY

Page 183:

Allocation of Depreciation under the Remedial Method: Effect of Section 168(k). In the discussion of the allocation of depreciation deductions under the remedial method, the text notes that the excess book basis may be depreciated using any applicable recovery period available to the partnership for newly acquired property. That is correct. However, the text goes on to suggest that the excess book basis therefore may be subject to 100 percent bonus depreciation under Section 168(k). That interpretation proved too ambitious and is incorrect.

Final regulations issued under Section 168(k) issued in 2019 adopt the position of proposed regulations issued in 2018 that remedial allocations under Section 704(c) do not qualify for the additional first-year depreciation deduction. See Reg. § 1.168(k)-2(b)(3)(iv)(A); Reg. § 1.704-3(d)(2). The preamble to the final regulations explains that, because the property was contributed to the partnership in a nonrecognition transaction under Section 721 and has a basis determined by reference to the transferor's basis in property, the requirement of Section 168(k)(2)(E)(ii)(II) is not satisfied (due to a failure to satisfy Section 179(d)(2)(C)). Furthermore, because the use of the property did not originate with the partnership, the property fails the "original use" requirement of Section 168(k)(2)(A)(ii). See T.D. 9874, at p. 28 (Sept. 13, 2019).

Note that the 100 percent "applicable percentage" of the additional depreciation allowance provided by Section 168(k) ended with property placed in service prior to 2023. Pursuant to Section 168(k)(6)(A), the applicable percentage is reduced to 60 percent for property placed into service during 2024, with 20 percent reductions following in each year thereafter until the provision phases completely for property placed in service after 2027.

CHAPTER 6. PARTNERSHIP LIABILITIES

B. RECOURSE LIABILITIES

Page 202:

Final Regulations. Final regulations issued in 2019 further restrict the general presumption that recourse liabilities will be satisfied by the partners regardless of their net worth. In addition to an exception for instances in which the facts and circumstances relating to a liability indicate a plan to circumvent or avoid the obligation, the final regulations provide an exception based on the reasonableness of the prospect of repayment. Specifically, the presumption that the liability will be satisfied by the partners does not apply if there is not a reasonable expectation that the obligor will have the ability to make the required payments if the obligation were to become due and payable. Reg. § 1.752-2(b)(6)(ii). In making this determination, the facts and circumstances to be considered are those that a third-party creditor would take into account in determining whether to extend a loan. Reg. § 1.752-2(k)(1). This effective creditworthiness inquiry substantially alters the baseline presumption that partners will satisfy their obligations regardless of net worth – rendering planning for liability allocations under Section 752 less certain but, perhaps, more accurate.

Page 207:

Bottom Dollar Payment Obligations. As described in the text, the Service issued temporary regulations in 2016 defining the scope of "bottom dollar payment obligations" that will not be respected as recourse obligations for purposes of Section 752. The Service largely adopted the temporary regulations through the issuance of final regulations in 2019. See T.D. 9877 (Oct. 9, 2019). In the process, the Service clarified the approach of this regime to obligations to make a capital contribution or to restore a deficit balance in a partner's capital account. Any such obligation other than one in which the partner is or would be required to (a) make the full amount of the partner's capital contribution or (b) restore the full amount of the partner's deficit capital account balance falls within the scope of a bottom dollar payment obligation for this purpose. Reg. § 1.752-2(b)(3)(ii)(C)(1)(iii).

Page 209:

Anti-Abuse Rule. The text describes how proposed regulations issued in 2016 articulated a non-exhaustive list of seven factors that may indicate a plan to circumvent or avoid a payment obligation, a standard which permits the Service to disregard the payment obligation under the anti-abuse rule. The Service formalized this approach through the issuance of final regulations under Section 752 in 2019. See T.D. 9877 (Oct. 9, 2019) (promulgating Reg. § 1.752-2(j)(3)(ii)(A)-(G)).

Chapter 7. Compensating the Service Partner

B. Partnership Equity Issued in Exchange for Services

5. Taxation of "Carried Interests"

b. Recharacterization of Gain: § 1061

Page 277:

In 2021, the Service promulgated final regulations under Section 1061 providing additional clarity to the operation of this recently enacted statute. T.D. 9945 (Jan. 7, 2021), 2021-5 I.R.B. 627. These regulations, summarized below, address many of the lingering questions highlighted in the text.

Scope of the Statute. In its most straightforward application, Section 1061(a) operates to recharacterize distributive shares of long-term capital gain to the holder of an applicable partnership interest (API) as short-term capital gain if the asset giving rise to the gain had been held by the partnership for more than one year but not more than three years. But that is not the exclusive scope of Section 1061(a). In defining the "Recharacterization Amount" subject to Section 1061(a), the regulations also include: (1) long-term capital gain realized on an actual sale of an API held for more than one year but not more than three years; (2) long-term capital gain realized under Section 731(a) on the deemed sale or exchange of an API held for more than one year but not more than three years as a result of a partnership distribution; and (3) long-term capital gains realized on the sale of property distributed with respect to API, provided the property has a holding period of more than one year but not more than three years in the hands of the partner on the date of disposition (considering tacked holding periods under Section 735(a)).[1] The regulations therefore reach all manners in which a partner may realize long-term capital gain with respect to an API in which the holding period of the underlying property or the API itself is less than three years.

The regulations clarified a few other distinct items relating to the scope of the statute. Amounts subject to recharacterization under Section 1061(a) include only those long-term capital gains that possess that characterization due to the holding period provisions of Section 1222. Importantly, the statute does not apply to Section 1231 gains that may give rise to long-term capital gain under Section 1231(a)(1).[2] Accordingly, long-term capital gains on depreciable property used in a trade or business or real property used in a trade or business are not subject to being recharacterized as short-term capital gain. Furthermore, the regulations clarify that the exception to the definition of an API for

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[1] Each category is first reduced by long-term losses realized within that category. The mechanics of determining the "Recharacterization Amount" – replete with defined terms – are set forth in Reg. § 1.1061-4.

[2] Reg. § 1.1061-4(b)(7)(i).

interests held by a corporation does not apply to interests held by S corporations (closing what would have been gaping loophole in the statute).[3]

Exclusion for Capital Interests. Pursuant to an exclusion from the definition of an applicable partnership interest, Section 1061 does not apply to a partnership capital interest.[4] The regulations provide additional guidance on the scope of this statutory exclusion, one that is critically important to the private equity industry. The regulations explain that an allocation of gains and losses will be considered to have been made with respect to a capital interest provided the allocation is determined and calculated in a manner *similar to* allocations made to unrelated non-service partners who have made significant aggregate capital contributions to the partnership (that is, more than five percent or more of the aggregate contributed capital).[5] The "similar to" standard leaves room for modest deviations, so long as the allocations to the service provider are "reasonably consistent" with those made to the unrelated non-service partners.[6] Specifically, the allocation to the service provider may be subordinated to the allocations to non-service partners, the allocation to the service provider need not be charged management fees or carried interest, and the service provider may be entitled to receive tax distributions (i.e., distributions to help partners pay income taxes on their distributive share of partnership income) even if the non-service partners are not.[7]

Private equity managers frequently acquire their capital interests through loans from the partnership or other partners. The regulations clarify that a capital interest acquired in such a manner – that is, through the use of proceeds of a loan made or guaranteed by the partnership, a partner, or any related party – will not benefit from the capital interest exclusion unless the partner is personally liable for repayment of the loan.[8]

Furthermore, private equity managers often receive an allocation of gain based on the book value of their partnership interest, which may include gains that have not yet been realized for tax purposes (e.g., gain arising from a revaluation of partnership assets). The regulations clarify that the capital interest exclusion from Section 1061 does not extend to capital attributable to unrealized gains. For the exclusion to apply, such gain must be realized for tax purposes and effectively reinvested in the partnership.[9]

Gains from Non-Portfolio Investments. Section 1061(b) authorizes "[t]o the extent provided by the Secretary," an exclusion for income or gain attributable to any asset not held for portfolio investment on behalf of third party investors. Presumably, this exclusion is intended to remove from the scope of Section 1061 gain attributable to the enterprise

[3] Reg. § 1.1061-3(b)(2). This aspect of the regulations confirms guidance previously provided by the Service in Notice 2018-18.
[4] I.R.C. § 1061(c)(4)(B).
[5] Reg. § 1.1061-3(c)(i), (iv).
[6] Reg. § 1.1061-3(c)(ii).
[7] Reg. § 1.1061-3(c)(ii)(A).
[8] Reg. § 1.1061-3(c)(v).
[9] Reg. §§ 1.1061-2(a)(1)(ii); 1.1061-3(c)(iii).

value (goodwill) of a business. The regulations under Section 1061 decline to give shape to this exclusion, instead reserving the matter for further study.[10]

Transfer of API to Related Party. One of the more cryptic aspects of Section 1061 is the provision contained in subsection (d) that applies in the context of a transfer of an API to a person related to the taxpayer (that is, a member of the taxpayer's family under Section 318(a)(1) or a person who performed a service within the calendar year or three preceding calendar years in the applicable trade or business in which or for which the taxpayer provided a service). Importantly, the regulations interpret this provision as applying only to transfers that constitute sales or exchanges on which gain is recognized for tax purposes – reversing the approach taken under proposed regulations, which extended to nonrecognition transactions.[11] Accordingly, Section 1061(d) does not apply in the context of gifts (rendering the example in the text inapposite).

With respect to a sale or exchange to which Section 1061(d) applies, the regulations determine the amount of long-term capital gain recharacterized as short-term by adopting a look-through approach with respect to the partnership's assets. The recharacterization amount is determined by reference to the net long-term capital gain on assets held for three years or less that would be recognized by the transferee partner if the partnership were to sell all of its assets for fair market value in a fully taxable transaction.[12] The recharacterization amount, however, is capped at the amount of long-term capital gain that the transferee partner recognizes on the sale or exchange.[13] Given that Section 1061(a) can apply to long-term capital gain realized on the sale of an API held for less than three years, Section 1061(d) therefore appears to target the potential avoidance of the statute through the sale of an API that has been held for more than three years to a related party.

As previewed earlier in this Update Memorandum, the Biden administration's tax proposals would take a different approach to carried interests by generally taxing as ordinary income (not short-term capital gain and without regard to holding period) a service partner's share of income from certain investment partnerships if the partner's taxable income from all sources exceeds $400,000. This same income also would be subject to self-employment tax. The most recent version of this proposal would take precedence over Section 1061 for taxpayers with taxable income over the $400,000 threshold for taxable years beginning after December 31, 2024. The administration's plan reflects continuing policy concerns (summarized at pages 270-271 of the text) that, even with Section 1061, the current system creates an inequitable and inefficient tax preference for highly compensated managers of investment partnerships.

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[10] Reg. § 1.1061-3(e); see also Preamble, Part IV, Section A.
[11] Reg. § 1.1061-5(b).
[12] Reg. § 1.1061-5(c).
[13] Reg. § 1.1061-5(a)(2).

CHAPTER 8. PROPERTY TRANSACTIONS BETWEEN PARTNERS AND PARTNERSHIPS

B. SALES AND EXCHANGES OF PROPERTY BETWEEN PARTNERS AND PARTNERSHIPS

2. DISGUISED SALES

Page 298:

Further Case Developments. In describing the disguised sale technique prior to the discussion of the *Canal Corp.* case, the casebook notes (p. 290) that the planning technique gained broader recognition when it was employed in the 2009 disposition of the Chicago Cubs baseball franchise by its then-parent corporation, Tribune Media. The Service challenged the transaction, and the Tax Court issued its opinion in the case in the fall of 2021. See Tribune Media Co. v. Commissioner, T.C. Memo. 2021-122. The *Tribune Media* case provides another helpful example of the disguised sale technique. Although the opinion represents something of a split decision for the taxpayer on the merits, the Tax Court respected the selling partner's guaranty of the primary liability used to finance the distribution for purposes of the Section 707(a)(2)(B).

Before delving into the specifics of the transaction at issue, the Tax Court provided a concise summary of the intended tax advantages of the disguised sale transaction:

> Suppose instead of selling property for cash, a person contributes the property to a partnership in exchange for a partnership interest. The contribution is not a taxable event, and the contributing partner's basis in the partnership interest is generally equal to the basis in the property at the time of the contribution. Under normative rules, if that partner receives a distribution of cash from the partnership in excess of the basis of the property at the time of the contribution, that excess distribution would be income. But economically, the transaction looks a lot like a sale: Property is transferred and cash is received. This is a disguised sale, and the Code and the regulations set forth rules on how to calculate the gain, if any.
>
> We can apply these same basis principles to a situation in which a person borrows against property before contributing it. We've already established that a person can borrow against property and the loan proceeds are generally not taxable. And we've already established that contributing property to a partnership is not a taxable event. If we combine these two transactions, a person could borrow against the property and then contribute the property to the partnership while retaining the loan proceeds and remaining liable on the loan. There would be no tax on that series of

> transactions. The contributing partner would have the loan proceeds in hand, be liable for repayment of the loan, and own a partnership interest with a basis equal to the basis of the property at the time of the contribution.
>
> Suppose instead of borrowing before contributing the property to the partnership, the person contributes the property and the partnership takes out the loan. The tax results follow the same basic rules we've already outlined. The person contributes the property, taking a basis in the partnership interest equal to the basis in the property at the time of contribution. As discussed above, this is a disguised sale, and the contributing partner will be taxed on the distribution under the disguised sale rules.
>
> But what if the contributing partner is personally liable on the loan? Assuming responsibility for that liability would result in an increase to the contributing partner's basis. As a result, that partner could receive a greater tax-free distribution because the partner's basis includes the combination of the basis in the property at the time of contribution plus the amount of liability assumed by the contributing partner. This relatively straightforward example is the debt-financed distribution exception to the disguised sale rule [Reg. § 1.707-5(b)(1).]

T.C. Memo. 2021-122, at 45-47 (footnotes omitted).

The core structure of the transaction at issue in *Tribune Media* was fairly straightforward. In soliciting bidders for the Cubs franchise, Tribune Media specified that the disposition would occur through a partnership holding the Cubs assets in which the purchaser would hold a 95 percent interest. Tribune Media would retain a 5 percent interest in the partnership, an interest the purchaser could acquire after 12 years.

Consistent with this structure and having identified the Ricketts family as the successful suitor for the franchise, Tribune Media transferred the assets associated with the Cubs franchise (including Wrigley Field) to Chicago Baseball Holdings, LLC ("CBH") having a fair market value net of associated liabilities of $735 million. Tribune Media's basis in the assets at the time was $146 million. The purchasing partner, Ricketts Acquisition LLC ("RAC"), an entity controlled by the Ricketts family, contributed $150 million to CBH.

In addition to these equity investments, CBH issued two categories of debt to finance the transaction. CBH borrowed $425 million from third party commercial lenders, with this borrowing being referred to as the Senior Debt. After maximizing its borrowing on the traditional market, CBH borrowed an additional $249 million from RAC Finance, an entity separately owned by the Ricketts family. This borrowing was subordinate to the Senior Debt, and as such was referred to as the Sub Debt.

Tribune Media provided a guaranty of collection for both the Senior Debt and the Sub Debt, which required the lenders to pursue all legal remedies against CBH before Tribune Media could be called on its guaranty. At the time the Cubs transaction closed, Tribune Media was in Chapter 11 bankruptcy with a cash position of approximately $300 million.

Considering the capital contributions and the borrowed proceeds, CBH held $824 million in cash in addition to the $735 million in Cubs assets. At closing, CBH made a special distribution of $705 million to Tribune Media. Tribune Media continued to own a 5 percent interest in CBH, with a 95 percent interest being held by RAC. (The net capital contributions by the parties would have suggested a 12 percent interest for Tribune and an 88 percent interest for RAC. However, taking the investment represented by the Sub Debt into account as a capital contribution on behalf of RAC corresponded precisely with the 5%/95% division of ownership.)

Tribune Media contended that its guaranty of both the Senior Debt and the Sub Debt provided sufficient basis to shield the $705 million distribution from generating gain under the debt-financed distribution rule of Reg. § 1.707-5(b)(1). The Service countered that the Sub Debt did not represent debt for tax purposes; rather, in substance it represented equity contributed on behalf of RAC (rendering Tribune Media's guaranty of that obligation irrelevant for tax purposes). The Service conceded that the Senior Debt represented debt for tax purposes but contended that Tribune Media's guaranty of the debt should be disregarded.

Regarding the portion of the transaction relating to the Sub Debt, the Tax Court comfortably determined that the arrangement represented equity instead of debt for tax purposes. Although the court engaged in an exhaustive review of 13 factors relevant to the debt/equity determination, a handful of factors proved most influential in its analysis. First, the Sub Debt did not have a fixed maturity date. Although the nominal term of the debt was 15 years, the subordination agreement provided that principal could not be paid prior to payment of the Senior Debt, and the holders of the Senior Debt could unilaterally extend the term of its financing. Second, the holder of the Sub Debt was closely aligned with RAC (owned by members of the same family), and CBH had maximized the debt financing available from third party lenders. Third, the proceeds of the Sub Debt were used to fund an acquisition of capital assets, more typical of an equity investment. Fourth, the marketing materials for the Sub Debt noted that "[i]nvestors should have the financial ability to sustain a complete loss of their investment," a warning more typical of the risk associated with an equity investment as opposed to debt. Lastly, the parties themselves treated the Sub Debt as an equity investment in determining the percentage ownership interests of CBH following closing. Tribune Media's guaranty of the Sub Debt therefore failed to generate additional basis for purposes of the debt-financed distribution rule.

With respect to the more traditional Senior Debt (which the Service conceded represented true debt), the Service challenged Tribune Media's guaranty on several grounds. First, the Service contended that Tribune Media's guaranty of collection did not sufficiently obligate it to pay under the constructive liquidation test, both literally and as a matter of economic substance. The Tax Court disagreed. As a literal matter, it determined that Tribune Media in fact could be called to pay the CBH's obligations under the Senior Debt in a worst-case scenario (as contemplated by the Section 752 regulations applicable to the transaction). The court was not persuaded that the obligation of Senior Debt holders to first exhaust their remedies against CBH rendered Tribune Media's guaranty contingent; rather, the court was satisfied that Tribune Media stood as the payor of last resort.

Next, the Tax Court dismissed the Service's invocation of the anti-abuse rule under Reg. § 1.752-2(j)(1) on grounds that numerous practical buffers existed to Tribune Media ever being called to pay on its guaranty. The Service viewed the Ricketts family as being the true guarantor of the debt in substance. The court disagreed, citing the absence of any formal obligation on the part of the Ricketts to satisfy the liabilities of CBH. In the process, the Tax Court distinguished the *Canal Corp.* case on grounds that the purchaser in that case used a thinly capitalized corporation as an intermediary to issue the guaranty. Additionally, the guaranty at issue in *Canal Corp.* related to principal only, and any payment on the guaranty provided the payor with an increased equity interest in the partnership. The court noted that these more egregious factors were lacking in Tribune Media's guaranty of the Senior Debt.

The Tax Court next dismissed the Service's invocation of the broader partnership anti-abuse regulation, Reg. § 1.701-2(a), noting that the regulation does not require each and every component of a partnership transaction (in this case, the guaranty of the Senior Deb) to have a business purpose. Conceding that Tribune Media viewed the likelihood of being called on the guaranty as remote, the Tax Court nonetheless explained that "We honor a guaranty if the guarantor has ultimate economic responsibility for the loan." On these terms, the Tax Court was satisfied.

Lastly, the Tax Court flatly rejected the Service's attempt to disregard the guaranty on substance-over-form grounds. Instead, the court found that the substance of the transaction aligned precisely with the form; that is, as a disguised sale intending to fall within the debt-financed distribution exception in the regulations. Hence, although the substance of the transaction may be a sale of the assets contributed to the partnership, the statute and regulations specifically contemplate when a transaction structured in this manner will successfully defer gain recognition.

On the whole, the Tax Court's opinion in *Tribune Media* should be welcome news for the tax-planning community. The general theme from the court's opinion in the case is that the use of a leveraged partnership to dispose of appreciated property is not necessarily abusive, even when the stated goal of the transaction is deferral of income recognition.

The *Tribune Media* case currently is pending before the Seventh Circuit Court of Appeals, with both the taxpayer and the Service appealing adverse determinations made by the Tax Court.

Allocation of Liability Regulations. In 2016, the Service signaled its intention to significantly curtail the use of liability allocations to circumvent the disguised sale rules by issuing temporary regulations treating *all* liabilities for this purpose as nonrecourse obligations to be allocated in accordance with the partners' interests in partnership profits. In June of 2018, the Service reversed course, issuing proposed regulations that would negate the 2016 temporary regulations. In 2019, the Service completed this reversal by promulgating final regulations returning to the landscape prior to the issuance of the 2016 temporary regulations. See T.D. 9876 (Oct. 9, 2019) (promulgating Reg. § 1.707-5(a)(2)). The debt-financed distribution technique nonetheless remains subject to challenge based on the relevant liability being treated as a bottom dollar payment obligation (and therefore disregarded as a recourse liability). Alternatively, the relevant liability could be disregarded under the anti-abuse rule, as was the case in *Canal Corp.*

CHAPTER 9. SALES AND EXCHANGES OF PARTNERSHIP INTERESTS

B. CONSEQUENCES TO THE BUYING PARTNER

Page 335:

Final regulations issued under Section 168(k) adopt a favorable approach with respect to the additional basis created in respect of the purchasing partner under Section 743(b). The regulations provide that, in determining whether the Section 743(b) basis adjustment meets the used property acquisition requirements of Section 168(k)(2)(E)(ii), each partner is treated as having owned and used the partner's proportionate share of the partnership property. The relevant inquiry is whether the transferee partner has used the portion of the partnership property to which the Section 743(b) adjustment relates, not whether the property has been previously used by the partnership. See Reg. § 1.168(k)-2(b)(3)(iv)(D). Hence, whether the purchasing partner is new to the partnership or an existing partner acquiring an additional interest, the additional basis created in respect of the purchased interest under Section 743(b) will be subject to the additional first-year depreciation deduction, provided the other requirements of Section 168(k) are satisfied.

Page 336:

In June of 2024, the Service issued a suite of administrative guidance signaling its intention to challenge basis adjustments resulting from transactions involving partnerships consisting of related parties (within the meaning of Section 267(b) and Section 707(b)) as partners – for example, a partnership owned equally by two controlled subsidiaries of a parent corporation. That guidance consisted of (1) Notice 2024-54, 2024-28 I.R.B. 24, describing two sets of forthcoming proposed regulations to address these transactions; (2) Proposed Regulations, "Certain Partnership Related-Party Adjustment Transactions as

Transactions of Interest," REG-124593-23, 2024-28 I.R.B. 40, signaling the Service's intention to require taxpayers to report participation in such transactions if they generate $5 million or more in positive basis adjustments in a single year; and (3) Rev. Rul. 2024-14, 2024-28 I.R.B. 18, detailing three examples of targeted transaction structures and stating the Service's intention to invoke the economic substance doctrine under Section 7701(*o*) (along with its associated strict-liability penalty structure) in this setting.

The administrative guidance takes aim at a range of transactions involving related-party partnerships that generate basis adjustments under Subchapter K, including (1) inside basis adjustments under Section 743(b) resulting from the transfer of a low-basis partnership interest to another partnership with a related party; (2) inside basis adjustments under Section 734(b) (addressed in Chapter 10) resulting from a non-liquidating distribution of high-basis property to one of two or more related partners having a low outside basis in its partnership interest; and (3) adjustments in the basis of property distributed in complete liquidation to related partners under Section 732(b) (addressed in Chapter 11).

Without delving into the specifics of these transactions, as a group they are designed to shift existing basis in partnership property to depreciable property or to property the parties intend to sell sooner. Although the party that would suffer the downside of such a basis shift normally would object to the transaction, the disadvantaged partner in these cases is related to the partner receiving the benefit. Hence, the natural limitation of parties acting at arm's length does not exist in this setting. As a whole, these transactions generate tax benefits across the related-party unit by increasing (or accelerating) cost-recovery deductions or by reducing taxable gains (or increasing losses) on dispositions of property. In the words of IRS Commissioner Werfel, partnerships employing these transactions "generate tax benefits without causing any meaningful change to the economics of their businesses."

Revenue Ruling 2024-14 details the Service's position that the tax benefits claimed by parties to these transactions already are subject to disallowance on economic substance grounds. Curiously, the ruling makes only cursory reference to the potential application of the partnership anti-abuse rule under Reg. § 1.701-2 (discussed in Chapter 14), despite that regulation being directly aimed at Subchapter K-specific tax benefits of this sort.

Chapter 10. Operating Distributions

B. Consequences to the Distributee Partner

1. Nonrecognition Rules on the Distribution

Page 344:

When a distributee partner receives property with a basis determined under Section 732, that distributee partner is not eligible for the additional first-year depreciation deduction under Section 168(k). Reg. § 1.168(k)-2(b)(3)(iv)(B). The property fails the original use requirement of Section 168(k)(2)(A)(ii) because it was used by the partnership, and the acquisition requirements of Section 168(k)(2)(E)(ii)(II) are not satisfied because the basis of the property is determined by reference to the partnership's basis in the distributed property.

C. Consequences to the Distributing Partnerships

Page 359:

Notwithstanding the general rule that any increase in basis under Section 734 is treated as newly purchased recovery property that is placed in service on the date of the distribution giving rise to the basis increase, the additional basis is not treated as satisfying the original use requirement of Section 168(k)(2)(A)(ii) or the used property requirement of Section 168(k)(2)(E)(ii)(I). See Reg. § 1.168(k)-2(b)(3)(iv)(C). Hence, the additional basis does not give rise to additional first-year depreciation.

Page 360, footnote 88:

See Clark Raymond & Co. v. Commissioner, T.C. Memo. 2022-105, 124 T.C.M. (CCH) 246 (finding that partnership failed to maintain capital accounts in accordance with the Section 704(b) regulations because it did not allocate gain inherent in customer-based intangibles among the partners' book capital accounts prior to reducing capital account balances by the fair market value of those intangibles upon distribution to exiting partners).

Page 360:

In June of 2024, the Service issued administrative guidance signaling its intention to challenge basis adjustments resulting from transactions involving partnerships consisting of related parties (within the meaning of Section 267(b) and Section 707(b)) as partners – for example, a partnership owned equally by two controlled subsidiaries of a parent corporation. One of the basis adjustments specifically targeted was the inside basis adjustment to a partnership under Section 734(b)(1) following a distribution of property to one of two or more related partners having a low basis in its partnership interest. The administrative guidance is summarized in greater detail on pages 16-17 of this Update Memorandum, *supra*.

CHAPTER 11. LIQUIDATING DISTRIBUTIONS

B. LIQUIDATION OF A PARTNER'S INTEREST

1. SECTION 736(b) PAYMENTS

Page 387:

In June of 2024, the Service issued administrative guidance signaling its intention to challenge basis adjustments resulting from transactions involving partnerships consisting of related parties (within the meaning of Section 267(b) and Section 707(b)) as partners – for example, a partnership owned equally by two controlled subsidiaries of a parent corporation. One of the basis adjustments specifically targeted was the basis determinations made under Section 732(b) when partnership assets are distributed to related partners in complete liquidation of a partnership. The administrative guidance is summarized in greater detail on pages 16-17 of this Update Memorandum, *supra*.

CHAPTER 15. S CORPORATIONS AND THEIR SHAREHOLDERS

D. TREATMENT OF THE SHAREHOLDERS

3. LOSS LIMITATIONS

a. IN GENERAL

Page 495:

The CARES Act delayed application of the Section 461(*l*) limitation on excess business losses of noncorporate taxpayers until years after 2020. The American Rescue Plan Act of 2021 extended the provision through 2026, and the Inflation Reduction Act of 2022 further extended it through 2028. For 2024, the indexed thresholds in Section 461(*l*)(3) are $305,000 for single taxpayers and $610,000 for a married couple filing a joint return. The Biden administration has proposed to make Section 461(*l*) permanent.