Domestic Tax Planning for Partnerships: Effect of 2017 Tax Act and Recent Guidance

Partnerships and LLC Committee
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Section of Taxation

Dana L. Trier, Davis Polk & Wardwell LLP, Moderator
Bahar A. Schippel, Snell & Wilmer
David H. Schnabel, Davis Polk & Wardwell LLP

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Sales, Contributions and Redemptions: The Importance of Form in the Partnership Context Under the TCJA
Sales, Contributions and Redemptions

Principal Relevant Statutory Changes and Regulations
- Section 168(k) (expensing) and Proposed Regulations
- Section 199A (passthrough deduction) and Proposed Regulations
- Section 163(j) (limit on interest deduction)

Other Relevant Statutory Changes
- Section 1061 (carried interest)
- Section 708(b) (repeal of technical termination rule)
- Section 1221(a)(3) (extension of self-created property rules to patents, etc.)

Other Relevant Changes
- BBA Partnership Audit Regulations
- Section 1446(f) (withholding on dispositions of partnership interests)
Basic Facts:

- P currently has two partners (A and B).
- C and D (unrelated individuals) wish to purchase P’s entire business for cash.
- Business is eligible for Section 199A deduction.
- P has four assets (as shown).
  - Each asset has basis of 50x and value of 100x
  - Non-168(k) depreciable property has 5 years of depreciation remaining.
  - Inside basis generally equal outside basis.

Should the transaction be structured as a purchase of 100% of the partnership interests or a purchase of assets?
Purchase of 100% of the Partnership Interests or Assets—Certain Considerations

- 168(k) Property:
  - If actual asset sale, full value expensed; if interest sale with Section 754 election, only gain is expensed pursuant to Section 743(b).

- Non-168(k) Depreciable Property:
  - If actual asset sale, depreciation recover period starts over for “entire” asset.
  - If partnership interest sale, existing basis is depreciated over remaining historic recovery period but Section 743 SBA is generally depreciated over a new recovery period except as to 704(c) layers subject to remedials.

- 1221(a)(3) Asset gain:
  - See Section 751.
  - Any planning opportunities?
  - May be better to hold through an S corp and sell stock?
Purchase of 100% of the Partnership Interests or Assets—Certain Considerations Continued

Section 199A:
- Section 743 adjustment does not give rise to UBIA.

BBA:
- If interests are sold rather than assets, entity remains in existence and buyers indirectly inherit BBA adjustments.

Section 1061:
- If purchase interests rather than assets, no restart in holding of assets (relevant if, for example, C receives a profits interest governed by Section 1061).
Section 163(j) relevant issues:

- In the partnership context, Section 163(j) is all about location, location, location.

- If step-up is effected as a Section 743 adjustment to the partners (C and D) rather than a step up in partnership assets, will tend to increase Section 163(j) capacity for interest expense on partnership level (P) debt but potentially reduce Section 163(j) capacity for interest expense on partner (C and D) level debt.

- What if C is allocated $9 of losses from the partnership, C has $9 of business income from unrelated activities and C has $3 of business interest expense?
Purchase of 100% of the Partnership Interests or Assets—Certain Considerations Continued

- Section 734 vs. Section 743:
  - If buy partnership interests and finance with partnership level debt, distribution of the debt proceeds to sellers (A and B) may give rise to Section 734 adjustment.
  - Consider ordering impact (distribute debt proceeds and then use equity financing to purchase remainder across the top or do the same transaction in reverse) on the size of the Section 734 and 743 adjustments.

- Consider:
  - Impact under Section 168(k).
  - Impact on sellers.
Buying a Partial Interest in a DRE
—Partnership Formed in the Transaction
—Existing Owner Retains an Interest

- Rev. Rul. 99-5 treatment – B’s purchase of 50 percent of A’s ownership interest is treated as purchase of 50 percent undivided interest in each asset and (immediately thereafter) a contribution of such undivided interests to a partnership.
- Result: new partnership, but undivided half interest in assets were sold.
Buying a Partial Interest in a DRE  
—Partnership Formed in the Transaction  
—Existing Owner Does Not Retain an Interest

- Intent of the proposed regulations seems to be that Holding LLC takes the Section 168(k) deduction.
- If treat property as first sold to B and C, are they treated as having placed in the property in service?
- Is the property treated for certain Section 168(k) purposes as sold directly to Holding LLC?
  - Solely for purposes of 163(k)(2)(E)(ii) (and Prop. Reg. 1.168(k)-2(b)(3)(iii)(A)), in the case of a series of related transactions, the property is treated as directly transferred from the original transferor to the ultimate transferee, and the relationship between the original transfer and the ultimate transferee is tested immediately after the last transaction in the series.
Buying a Partial Interest in a DRE—Partnership Formed Before the Sale

- Prop. Reg. 1.168(k)-2(b)(3)(iii)(C) should not apply.
  - Solely for purposes of 163(k)(2)(E)(ii) (and Prop. Reg. 1.168(k)-2(b)(3)(iii)(A)), in the case of a series of related transactions, the property is treated as directly transferred from the original transferor to the ultimate transferee, and the relationship between the original transfer and the ultimate transferee is tested immediately after the last transaction in the series.

**Transactional Steps:**

**Step 1:**
- S (an affiliate of A) becomes an owner of Holding LLC and Holding LLC becomes a partnership (various ways of doing this).

**Step 2:**
- A sells a 50% interest in Holding LLC to C.
Buying a Partial Interest in a DRE — Texas Two Step

- Consider general tax principles.
  - Solely for purposes of 163(k)(2)(E)(ii) (and Prop. Reg. 1.168(k)-2(b)(3)(iii)(A)), in the case of a series of related transactions, the property is treated as directly transferred from the original transferor to the ultimate transferee, and the relationship between the original transfer and the ultimate transferee is tested immediately after the last transaction in the series.
Buying a Portion of a Business Held in Partnership Form --Buying an Outstanding Partnership Interest

- If transaction structured as simple sale of 50% of the partnership interests, same basic result as discussed previously when selling 100% of the partnership interests to multiple buyers.
  - As a result of Section 743, expensing treatment to C as to SBA allocable to assets eligible for expensing.
  - Partnership remains alive. Same treatment under BBA rules and Section 199A as sale of all the interests.
- What if sale of undivided interest in assets would be better (e.g. because of expensing)?
Buying a Portion of a Business Held in Partnership Form
--Buying an Undivided Interest in Partnership Assets
--Old Partnership “Terminates”

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<thead>
<tr>
<th>Beginning</th>
<th>Transactional Steps</th>
<th>Final Structure</th>
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<tbody>
<tr>
<td>A  50%</td>
<td></td>
<td>A 50%</td>
</tr>
<tr>
<td>B  50%</td>
<td>Step 1: P sells 50% interest in Holding LLC (DRE) to C; Holding LLC becomes a partnership.</td>
<td>C 50%</td>
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<tr>
<td>P (DRE)</td>
<td>Step 2: P redeems out B’s interest in P for cash received from C; P is now a disregarded entity owned by A so that A is treated as a partner in Holding LLC (now a partnership).</td>
<td>Holding LLC (DRE) 50%</td>
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- Can P allocate all the income of the sale to B? Is this allocation stuffing or like stuffing? Does it matter that this sale is of an undivided interest in all assets?

- Is this viewed as sale of undivided interest in assets to C followed by contribution to a new partnership, or is Holding LLC just a continuation of P, and the transaction is recast to be simply a sale of B’s interest in P to C? See Section 708(a) and 708(b)(1).
Buying a Portion of a Business Held in Partnership Form
--Buying an Undivided Interest in Partnership Assets
--Keep the Old Partnership Alive

Beginning

Transactional Steps:

Final Structure

- Does this structure solve the continuation issue?
- If the form is respected, we have a Rev. Rul. 99-5 (sit. 1) transaction as to DRE, and Holding LLC treated as a new partnership.
- Same allocation question.
Carried Interest Planning Under Section 1061
Carried Interest Planning: In Kind Distribution

- Partnership P owns solely stock of X Corp. A, B and C are partners in P. C is the carried interest partner.
- At a time that the X Corp. stock has been held for two years, and A, B and C have held their partnership interests for two years, P would like to sell the X stock to D for a price much larger than that P paid for the stock.
- Is there a way, C can get capital gain treatment on the carry?
Carried Interest Planning: In Kind Distribution (cont.)

- Does Section 1061(a) apply? Compare Section 735.
- Can these transactions be recast under *Court Holding* or similar principles as a sale by P?
- What factors are relevant to the tax treatment of this transaction?

**Beginning**

```
  C
 / \
A   B
 P
```

**X stock**

**Transactional Steps**

**Step 1:**
In connection with the liquidation of P, and consistent with Reg. Sec. 1.704-1(b)(2)(iv)(e)(1), the capital accounts of P are revalued to reflect the value of X stock; C’s capital account thus reflects the carry.

**Step 2:**
P is liquidated, and shares of X are distributed to A, B and C in accordance with their capital accounts.

**Step 3:**
A, B and C individually sell the X stock to D.
Assume instead that P owns stock in two different companies (X and Y) and wishes to sell only the X stock to D after two years. Thus, P revalues capital accounts to reflect X’s value, and distributes the X stock to each of the partners, who sell the stock to D?

What issues are raised in this case compared to the liquidation case?