ABA Tax Midyear Meeting 2019

What You Need to Know About the Recent Guidance Issued Under the 2017 Tax Act

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Jose Carrasco (Moderator): Senior Manager, Grant Thornton LLP

Sam Kamyans: Partner, Baker & McKenzie LLP

Nancy Langdon: Managing Director, PricewaterhouseCoopers LLP
Agenda

A. Limitation on Interest Deductions, Section 163(j)
   1. Definition of interest
   2. Partnership overview
   3. ATI and Partnerships
   4. Examples

B. Qualified Opportunity Zones, Sections 1400Z-1, -2

C. Effectively Connected Income, Section 864(c)(8)

D. Miscellaneous
1 Interest Deduction Limitations
Definition of Interest

- New Section 163(j) business interest expense limitation = Business interest income + (Adjusted taxable income (ATI) x 30%) + Floor Plan Financing Interest Expense

- The proposed regulations include as interest all manner of interest (stated and unstated) and items similar to interest (bond premium amortization, market discount, etc.).

- Section 163(j) broadens the definition of “interest” to include items not otherwise treated as interest for U.S. federal income tax purposes, including:
  - Substitute interest payments;
  - Debt issuance costs;
  - Guaranteed payments;
  - Commitment fees (but only if some amount of financing is actually provided);
  - Certain amounts with respect to derivatives that affect the taxpayer’s effective cost of borrowing (such as gain or loss on an interest rate swap); and
  - Certain amounts that alter a taxpayer’s effective yield with respect to a debt instrument held by the taxpayer.
Partnership Overview

- Partnership level application.
- Applies only to business interest expense (“BIE”).
- Investment interest income/expense allocated to a corporate partner treated as business interest income/expense at the partner level, thereby applying 163(j) at the partner level.
- Treats guaranteed payments for the use of capital as interest expense.
- If a partnership has deductible BIE, the BIE is not subject to further Section 163(j) limitations at the partner level.
- Section 163 rules do not have any effect on the validity or effect of partnership Section 704 allocations.
Adjusted Taxable Income and General Partnership Principles

- For tax years beginning before January 1, 2022, ATI is roughly equivalent to EBITDA, and for taxable years beginning January 1, 2022, ATI is roughly equivalent to EBIT.

- Section 743(b), Section 704(c)(1)(C) and remedial items are not taken into account for computing the Section 163(j) limitation.

- Section 734(b) adjustments are taken into account for computing the Section 163(j) limitation.

- Cannot use excess business interest expense ("EBIE") from one partnership to offset excess taxable income ("ETI") from a separate partnership.
  - As applied to the same partnership, $1 of ETI frees up $1 of EBIE to be used in the partner’s application of the Section 163(j) rules at its level.

- Sale of “substantially all” of an interest in a partnership.
Example

Facts:
- PRS has $100 of gross income and no deductions, $60 of BIE.
- PRS allocates all items equally between A and B.

Partnership-level:
- ATI = $100
- Section 163(j) limit = $30, $100 x 30%
- Excess Taxable Income (ETI) = $0

Partner allocations:
- A is allocated $50 ATI, and $15 of BIE.
- B is allocated $50 of ATI, and $15 of BIE.
- PRS has $30 of EBIE that is allocated $15 to each partner

Partner-level:
- Each of A and B is allocated $35 of income, and $15 of disallowed interest expense.
- Each partner reduces its outside basis by the amount of the $15 EBIE and is carried forward at the partner level.
Future Guidance

- Mergers & Divisions
- Self-charged interest
- Tiered partnerships
2 Qualified Opportunity Zones
Qualified Opportunity Zone Overview

**Investor**
- Property sold (basis $400, value $1,000)

**Unrelated buyer**
- $1,000 cash
- $600 gain

$600 contribution
- **Timing:** within 180 days of step 1.
- **Effect:** Deferral of entire $600 gain until earlier of 12/31/26 or disposition.

**Investor**

**Qualified Opportunity Fund (QOF)**

**Corporation**

**partnership**

At least 90% of $600 invested as equity in Qualified Opportunity Zone (QOZ) Property (reduced to 70% in qualified lower-tier entity).
- **Timing:** 90% tested twice a year (6 month point and end of year).
- **Effect:** Failure to satisfy QOF status results in penalty. Any shortfall on the 90% is penalized at the tax underpayment rate. Broader QOF disqualification risk if shortfall continues.

**Tax Benefits**
- **Deferral of unrelated tax gain:** the $600 is deferred until up to 12/31/26 (or earlier sale)
- **Up to 15% exclusion of unrelated gain:** after a 5-year hold investor increases basis by 10% of the $600, or $60; at 7-year point basis increases another 5% or $30.
- **Potential complete exemption of post-contribution QOZ Property gain:** If Investor has not sold within 10 years after Step 1, no tax on post-contribution appreciation in QOF interests.

**QOZ Property is limited to equity investments in trade or business property that is either (i) newly purchased from unrelated person or (ii) substantially improved (building improvements exceed building cost basis) within 30 months of acquisition.**
Timeline – Individual Investor

- **November 1, 2018**: Sell capital asset
- **April 15, 2019**: file Form 8949 with individual income tax return (assuming no extension)
- **April 30, 2019**: deadline for contributing capital to QOF.
- **June 30, 2019**: Deadline for contributing capital to a partnership if individual investor recognizes capital gain through a partnership.
Timeline – Fund

December 1, 2018: Receive funds from investors.

March 15, 2019/September 15, 2019: File Form 8996 to certify partnership as a QOF effective December 1, 2018.

Draft detailed written business plan no later than June 30, 2019.

May 30, 2021: Funds must be deployed to qualify for QOZ benefits.
Qualified Opportunity Zones

- The Proposed Regulations provided considerable clarity and helpful guidance.

- Partnership questions remain (presumably addressed in partnership-specific reg package):
  - Debt financed distributions/dispositions
  - Nonrecourse deductions
  - Liquidity concerns in 2026
  - Basis step up to fair market value
Effectively Connected Income
Non-U.S. Partner’s Effectively Connected Gain or Loss (“ECG/L”) – Section 864(c)(8)

● Total ECG/L limited to “outside gain.”
  ● Determined under general tax principles e.g., take liabilities into account.
  ● Apply Sections 741 and 751

● Hypothetical partnership level transaction, combined with an anti-stuffing rule to prevent abuse, determines each partner’s share of ECG/L for purposes.

● FIRPTA coordination
  ● If Section 864(c)(8) applies to a transaction, no application of Section 897(g)
  ● Exceptions under 897(k) and (l) (QFPF) incorporated into Section 864.

● Proposed Regulations expressly exclude 1446 guidance, but note an intent to provide such guidance “expeditiously.”
  ● Certifications in the meantime
4 Miscellaneous
Other Key Provisions from TCJA Affecting Partnerships

• Section 199A qualified business income deduction
  • Computational, definitional, and anti-avoidance rules
    • Proposed regulations published on August 16, 2018
    • Final regulations currently in review at OMB

• Section 168(k) immediate expensing
  • Proposed regulations published on August 8, 2018

• Section 1061 partnership interests held in connection with services

• Section 951A inclusion of global intangible low-taxed income by United States shareholders
  • Proposed regulations published on October 10, 2018