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BDO KNOWS: TAX REFORM

SUBJECT

TAX REFORM – IMPACT TO PARTNERSHIPS AND PARTNERS

SUMMARY

On Friday, December 22, President Trump signed sweeping tax reform (the "Act") into law. The Act provides the most comprehensive update to the tax code since 1986, and includes a number of provisions of particular interest to partnerships and their partners. This alert addresses the following provisions:

- Recharacterization of Certain Long-Term Capital Gains
- Taxation of Gain on the Sale of Partnership Interest by a Foreign Person
- Repeal of Technical Termination Rules under Section 708(b)(1)(B)
- Modification of the Definition of Substantial Built-in Loss in the Case of a Transfer of a Partnership Interest under Section 743(d)
- Charitable Contributions and Foreign Taxes Taken into Account in Determining Basis Limitation under Section 704(d)
- Like-Kind Exchange Transactions under Section 1031

DETAILS

Repeal of Technical Termination Rules (708(b)(1)(B))

The Act repeals the technical termination rules under Section 708(b)(1)(B) for tax years beginning after 2017. No changes were made to the actual termination rules under Section 708(b)(1)(A). Repeal of the technical termination rule is generally a favorable development, since it will eliminate the need to restart depreciation upon the sale or exchange of more than 50 percent capital and profits interest in a partnership. Additionally, the Act will alleviate the common occurrence of failing to properly identify transactions, giving rise to technical terminations, which leads to late filing of required tax returns, failure to make appropriate elections, and imposition of penalties.

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However, technical terminations are sometimes used to eliminate unfavorable elections, and the creation of a "new" partnership entity is oftentimes required in connection with international investments in U.S. joint ventures. While it may be possible to continue structuring transactions to achieve these objectives, the simplicity of triggering a technical termination will be eliminated.

Recharacterization of Certain Long-Term Capital Gains (Sections 1061 & 83)

Under general rules, gain recognized by a partnership upon disposition of a capital asset held for at least 1-year will be characterized as long-term capital gain. Additionally, the sale of a partnership interest held for at least 1-year results in long-term capital gain except to the extent Section 751 applies. For tax years beginning after December 31, 2017, long-term capital gain will only be available with respect to "applicable partnership interests" to the extent the capital asset giving rise to the gain has been held for at least 3-years.

An applicable partnership interest is defined to include any partnership interest transferred, directly or indirectly, to a partner in connection with the performance of services by the partner, provided that the partnership is engaged in an "applicable trade or business." An applicable trade or business means any activity that is conducted on a regular, continuous, and substantial basis consisting of raising or returning capital and either (1) investing in, or disposing of, specified assets (or identifying specified assets for such investing or disposition) or (2) developing such specified assets. For purposes of this provision, specified assets include securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing, and an interest in a partnership to the extent of the partnership's proportionate interest in any of the foregoing.

Consistent with the intent to limit applicability of these rules, the Act provides that applicable partnership interests do not include (A) a partnership interest held directly or indirectly by a corporation or (B) a capital interest in a partnership commensurate with the partner's capital contributions or the value of the interest subject to tax under Section 83 upon receipt or vesting. However, the fact that an individual may have recognized taxable income upon acquisition of an applicable partnership interest or made a Section 83(b) election with respect to such applicable partnership interest does not change the three-year holding period requirement.

Based on the definitions of applicable partnership interests, applicable trades or businesses, and specified assets, it appears that this rule is targeted at hedge funds and real estate funds with relatively short-term holding periods, i.e., more than one year but less than three years.

Private equity and venture capital funds generally have a longer holding period and are unlikely to be affected to the same degree. However, care will need to be taken to ensure the holding period requirements are satisfied in all cases. Further, determination of a partner's share of capital gains "commensurate with the amount of capital contributed" will likely require detailed record-keeping and tracking of partner Section 704(b) and tax basis capital accounts.

Taxation of Gain on the Sale of Partnership Interest by a Foreign Person (Sections 864(c) and 1446)

Revenue Ruling 91-32 generally provides that a foreign partner will recognize effectively connected income (ECI) on a sale of a partnership interest to the extent a sale of underlying partnership assets would give rise to an allocation of ECI to the transferor partner. The revenue ruling effectively adopts an aggregate approach to determining ECI notwithstanding the entity approach mandated by Section 741. In the recently decided case of *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner*, the Tax Court ruled that the taxpayer's gain on sale of its partnership interest was not ECI despite the fact that a sale of the partnership's assets would have generated ECI allocable to the partner, effectively rejecting Rev. Rul. 91-32.

Under the Act, gain recognized on the sale or exchange of a partnership interest will be treated as ECI to the extent the transferor would be allocated ECI upon a sale of assets by the partnership. This provision would effectively re-characterize otherwise non-ECI capital gain from the sale of partnership interest into ECI. Additionally, the Act provides that Treasury shall issue regulations as appropriate for application of the rule in exchanges described in Sections 332, 351, 354, 355, 356, or 361 and may issue regulations permitting a broker, as agent for the transferee, to deduct and withhold the tax equal to 10 percent of the amount realized on the disposition. The provision treating gain or loss on the sale of a partnership interest as ECI would be effective for transactions on or after November 27, 2017, while the provision related to withholding would be effective for sales or exchanges after December 31, 2017.

This proposal effectively codifies the holding Revenue Ruling 91-32 and reverses the Tax Court's decision in *Grecian Magnesite*. As a result of the coordination of allocable gain on a hypothetical sale of partnership assets with total ECI, accurate tracking of Section 704(c) built-in gain and losses will become significantly more important.

Modification of the Definition of Substantial Built-in Loss in the Case of a Transfer of a Partnership Interest (Section 743(d))

Section 743(b) provides for an adjustment to the basis of partnership property upon the sale or exchange of a partnership interest providing the partnership has a Section 754 election in effect or where the partnership has a substantial built-in loss. Section 743(d) currently provides that a partnership has a substantial built-in loss with respect to a transfer of an interest in a partnership if the partnership's adjusted basis in all of its property exceeds the fair market value of such property by more than $250,000. Under this existing rule, it's possible that a transferee partner could acquire a partnership interest with respect to which there is a built-in loss of more than $250,000 without there being a mandatory basis adjustment because the partnership does not have an overall built-in loss meeting the threshold.

The Act modifies the definition of a substantial built-in loss for purposes of Section 743(d). Under the Act, in addition to the present-law definition, a substantial built-in loss also exists if the transferee partner would be allocated a loss in excess of $250,000 upon a hypothetical disposition by the partnership of all partnership's assets in a fully taxable transaction for cash equal to the assets' fair market value, immediately after the transfer of the partnership interest. This provision would apply to transfers of partnership interests occurring after December 31, 2017.

It is not clear whether a relatively high number of partnership interest transfers will be captured under this rule. However, given the negative consequences of a potential downward basis adjustment it will become even more critical that partnerships properly track each partner's Section 704(b) and tax basis capital accounts. Failure to accurately track capital accounts could lead to incorrect downward adjustments resulting in increased exposure to both the transferring and non-transferring partners.

Charitable Contributions and Foreign Taxes Taken into Account in Determining Basis Limitation (Section 704(d))

Under the general rules of Section 704(d), a partner's ability to deduct its distributive share of partnership losses is limited to the extent of the partner's outside tax basis in the partnership interest. However, this limitation does not apply to a partner's allocable share of charitable contributions or foreign tax expenditures. As a result, a partner may be able to deduct its share of a partnership's charitable contributions and foreign tax expenditures even to the extent they exceed the partner's basis in its partnership interest. The Act modifies the Section 704(d) loss limitation rule to take into account charitable contributions and foreign taxes. However, in the case of a charitable contribution of property where the fair market value exceeds the adjusted tax basis the Section 704(d) basis limitation would not apply to the extent of the partner's allocable share of this excess. This provision applies to taxable years beginning after December 31, 2017.

This rule change will increase the importance of ensuring accurate calculation of a partner's tax basis. Although partners are generally required to determine their own tax basis, it's not uncommon for partners to look to the partnership to provide relevant data including tax basis capital and liability allocations. The increased importance of outside tax basis calculations will place more pressure on partnerships to accurately track partner capital as well as determining proper liability allocations under Section 752.

Like-Kind Exchanges of Real Property (Section 1031)

For exchanges entered into after December 31, the Act limits application of Section 1031 to transactions involving the exchange of real property that is not held primarily for sale. Section 1031 no longer applies to personal property including personal property that is associated with real property. A transition rules applies for exchanges that began before January 1, 2018. Consequently, if the taxpayer has started a deferred exchange prior to January 1, 2018, Section 1031 may still be applied to the transaction even though completed after December 31, 2017.