

Now, for the Rest of the Story: Choice of Entity & Acquisition Structuring after the '17 TCJA

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Tax Cut and Jobs Act of 2017 (TCJA)

Changes Relevant to Partnership Transactions

- • Section 168(k) (expensing) and Final & Proposed Regulations
- • Section 199A (pass through deduction) and Regulations
- • Section 163(j) (limit on interest deduction) and Proposed Regulations
- 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.)

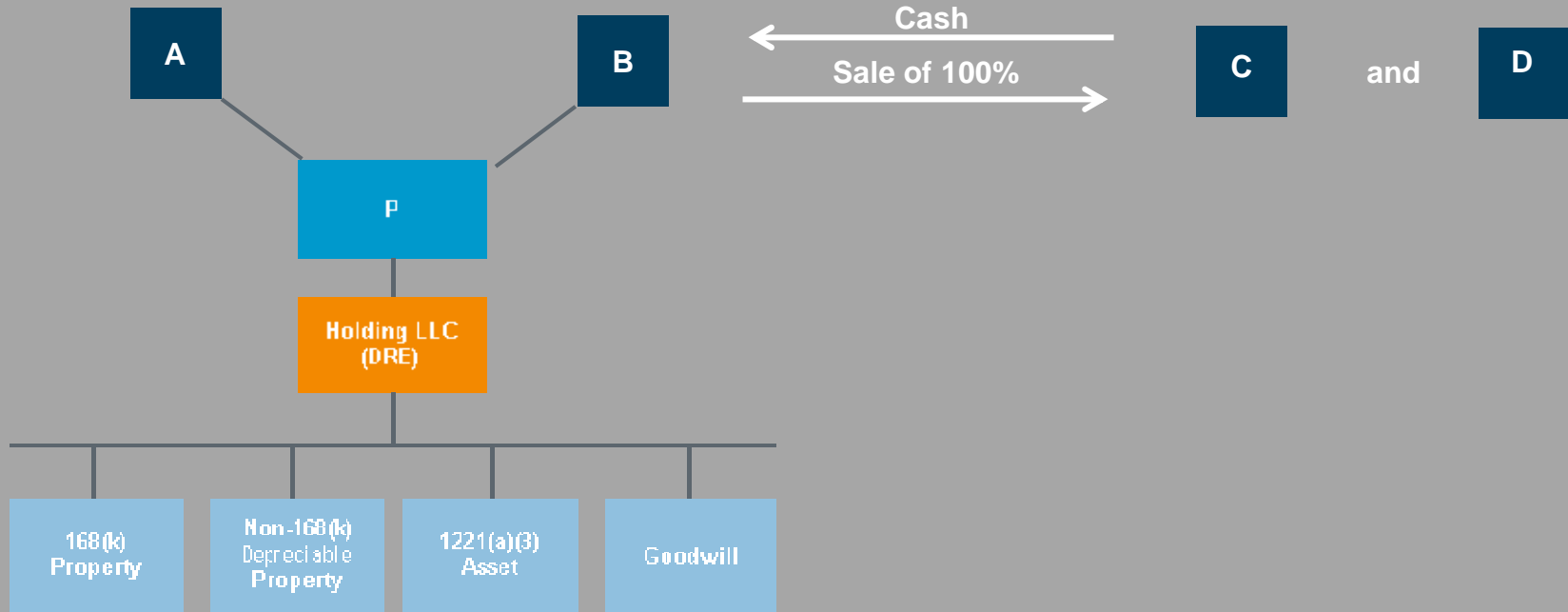
Post TCJA Partnership Issues

- Three common ways to get a tax basis step up in the partnership acquisition context
 - Buy an interest in an existing partnership
 - Partner gets step up (Section 743 basis)
 - Partnership redeems an existing partner
 - Partnership may get a partial step up (Section 734 basis)
 - Buy assets and hold in partnership form (or buy an interest in a DRE in a Rev. Rul. 99-5, Situation 1 transaction)
 - Partnership gets step up (actual asset basis)

Post TCJA Partnership Issues

- The three forms of transactions are treated differently under various rules
- • New 100% expensing for tangible property under Section 168(k)
- • New interest deductibility limitations under Section 163(j)
- • New 20% deduction under Section 199A for certain types of pass-through income
- • New carried interest holding period requirement of Section 1061
- • Possible differences for the seller in the application of Section 1235
- Given the tax stakes, the question is whether form will always be respected

Purchase of 100% of Partnership Interests or Assets



Purchase of 100% of Partnership Interests or Assets

- 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 equals 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 Partnership Interests or Assets

168(k) Property:

- If actual asset sale, full fair market value of eligible assets expensed; if interest sale with Section 754 election, only gain inherent in the eligible assets is expensed pursuant to Section 743(b).

- Non-168(k) Depreciable Property:

- If actual asset sale, depreciation recovery 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.

Sections 1221(a)(3) & 1235

- Section 1221(a)(3) now includes any “patent, invention, model or design (whether or not patented), a secret formula or process, a copyright, a literary, musical or artistic composition, a letter or memorandum, or similar property, held by a taxpayer whose personal efforts created such property.”
- Section 751(d) treats any property that would be considered “property other than a capital asset and other than property described in section 1231” as a hot asset.
- Under section 1235, a transfer of a patent (or patentable property) is “considered the sale or exchange of a capital asset held for more than one year ” if the transferor is an individual whose efforts created the property or if the transferor is an individual (other than an employer of the creator) who acquired the patent before it was reduced to practice.

Sections 1221(a)(3) & 1235

- Congress did not repeal Section 1235 when it added patents to Section 1235.
- Pursuant to Reg. Section 1.1235-2(d)(2), although a partnership cannot qualify as an individual whose efforts created the property, individual partners can be holders to the extent of their pro rata interests in a patent.
- Query whether, by virtue of Reg. Section 1.1235-2(d)(2), the sale of a partnership interest in a partnership holding a self-created patent would avoid 751(a) treatment, or whether Reg. Section 1.1235-2(d)(2) is limited to a sale by the partnership of the patent.

Purchase of 100% of Partnership Interests or Assets

- Section 199A– Section 743 adjustment does not give rise to UBIA.
- Bonus Basis Adjustment (“BBA”):
 - If interests are sold rather than assets, entity remains in existence and buyers indirectly inherit BBA adjustments. Note that this is the case even in the case of a 100% acquisition that is otherwise treated as an asset purchase for tax purposes.
- Section 1061:
 - If purchase interests rather than assets (other than in a 99-6 transaction), no restart in holding of assets (relevant if, for example, C receives a profits interest governed by Section 1061).

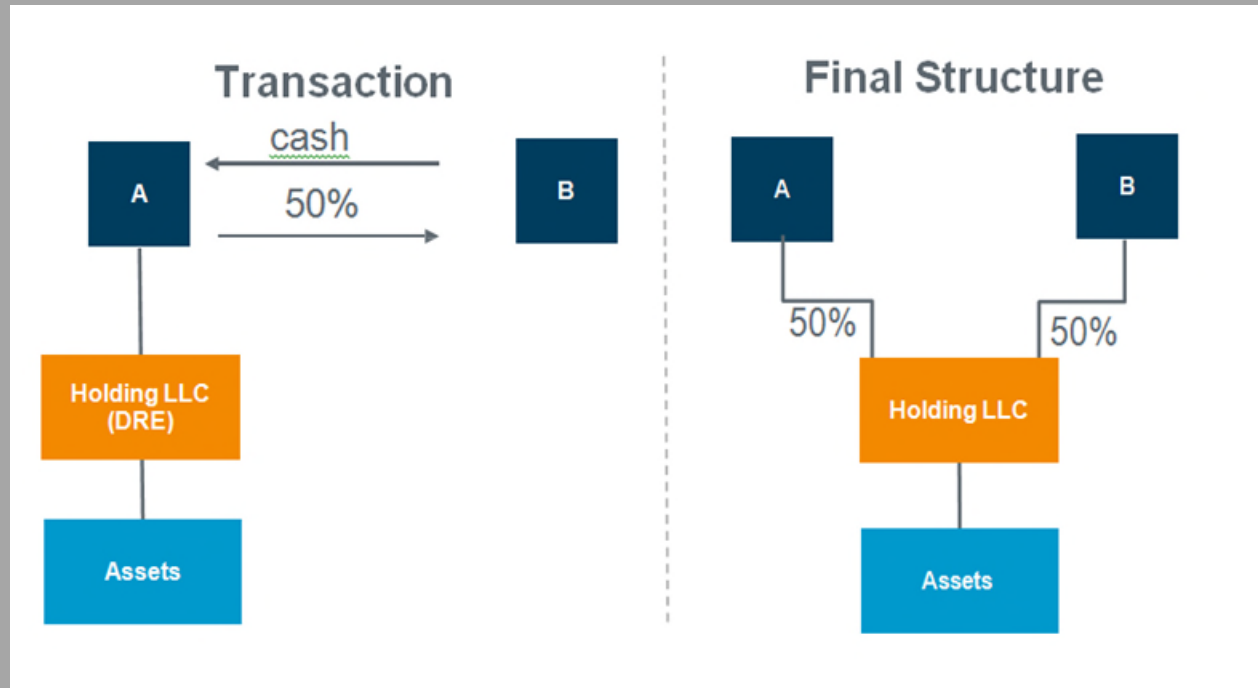
Section 163(j) issues

- 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.

Purchase of 100% of Partnership Interests or Assets

- Section 734 vs. Section 743:
 - If the transaction is structured as a purchase of partnership interests and financed with partnership level debt, the distribution of the debt proceeds to sellers (A and B) may give rise to a Section 734 adjustment.
 - Consider ordering impact on the size of the Section 734 and 743 adjustments.
- Consider:
 - Impact under Section 168(k)
 - Impact on sellers.

Rev. Rul. 99-5: Buying a Partial interest in a DRE



Rev. Rul. 99-5: 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 % of A's ownership interest is treated as purchase of a 50 % undivided interest in each asset and (immediately thereafter) a contribution of such undivided interests to a partnership.
- • Section 168(k) deduction at transferor level. Treas.Reg. Sec. 1.168-2(g)(1)(iii).
- • Result: new partnership, but undivided half interest in assets were sold.

Rev. Rul. 99-5: Buying a Partial interest in a DRE

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?
 - See Prop. Reg. 1.168(k)-2(b)(3)(iii)(C). (2019)
 - Solely for purposes of 163(k)(2)(E)(ii) (and Treas. Reg. 1.168(k)-2(b)(3)(iii)(A)), the relationship between parties under section 179(d)(2)(A) or (B) in a series of related transactions is tested immediately after each step in the series, and between the original transferor and the ultimate transferee immediately after the last transaction in the series. A series of related transactions may include, for example, a transfer of partnership assets followed by a transfer of an interest in the partnership that owned the assets; or a disposition of property and disposition, directly or indirectly, of the transferor or transferee of the property.

Buying a Partial interest in a DRE

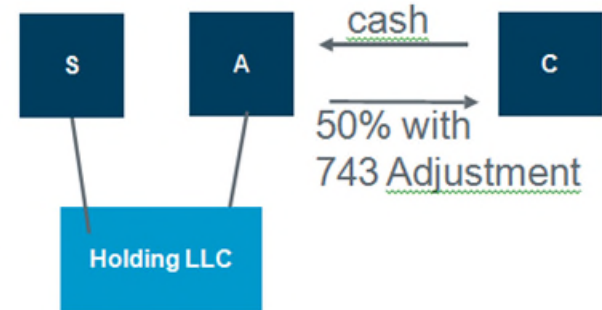
Beginning



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).

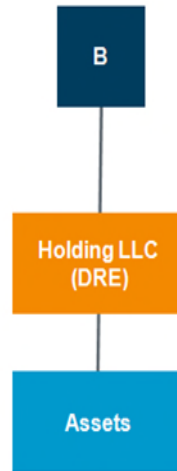
Step 2:
A sells a 50% interest in Holding LLC to C.



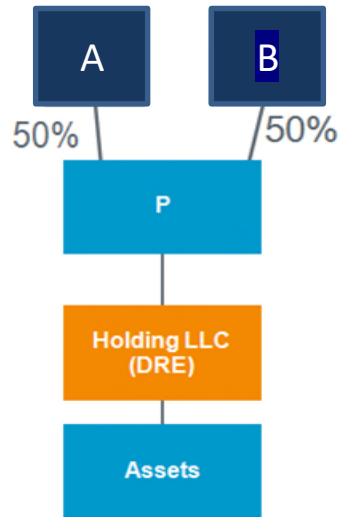
PARTNERSHIP FORMED BEFORE THE SALE

- Prop. Reg. 1.168(k)-2(b)(3)(iii)(C) should not apply because the relationship between parties under section 179(d)(2)(A) or (B).
 - Solely for purposes of 163(k)(2)(E)(ii) (and Prop. Reg. 1.168(k)-2(b)(3)(iii)(A)), the relationship between parties under section 179(d)(2)(A) or (B) in a series of related transactions is tested immediately after each step in the series, and between the original transferor and the ultimate transferee immediately after the last transaction in the series. A series of related transactions may include, for example, a transfer of partnership assets followed by a transfer of an interest in the partnership that owned the assets; or a disposition of property and disposition, directly or indirectly, of the transferor or transferee of the property.

Buying a Partnership Interest



Buying a Partnership Interest



Buying a 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)?

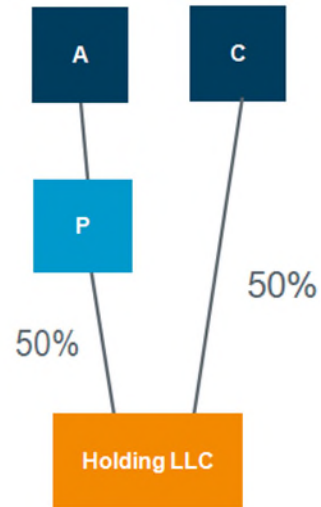
Buying an Undivided Interest in Partnership Assets

Transactional Steps

Step 1:
P sells 50% interest in Holding LLC (DRE) to C; Holding LLC becomes a partnership.

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).

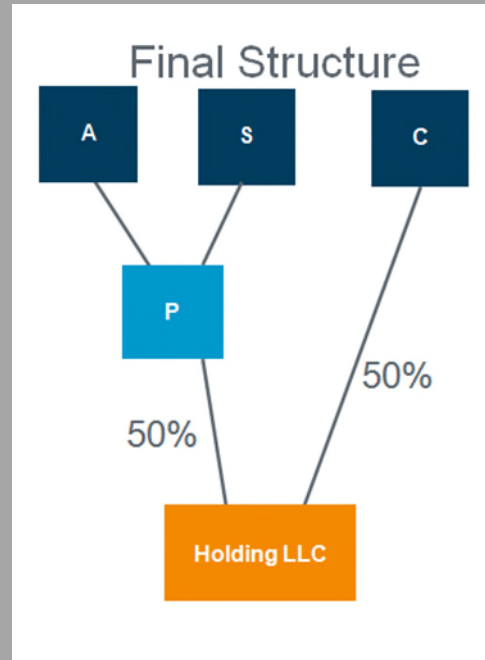
Final Structure



Buying an Undivided Interest in Partnership Assets

- Old Partnership Terminates
- 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).

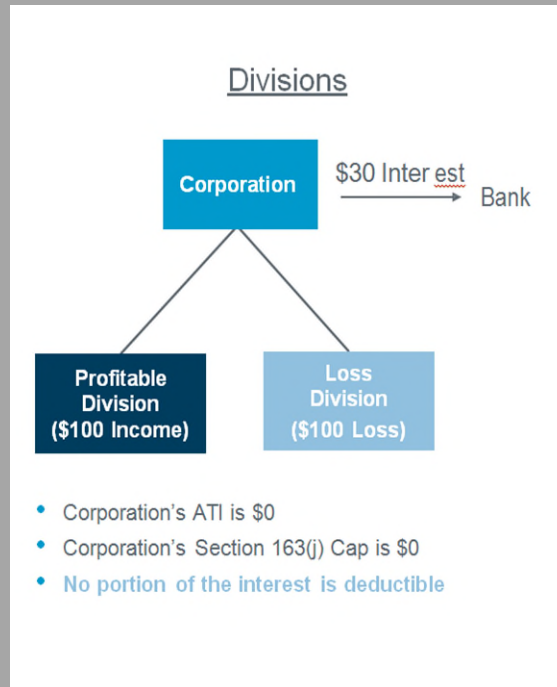
Buying an Undivided Interest in Partnership Assets



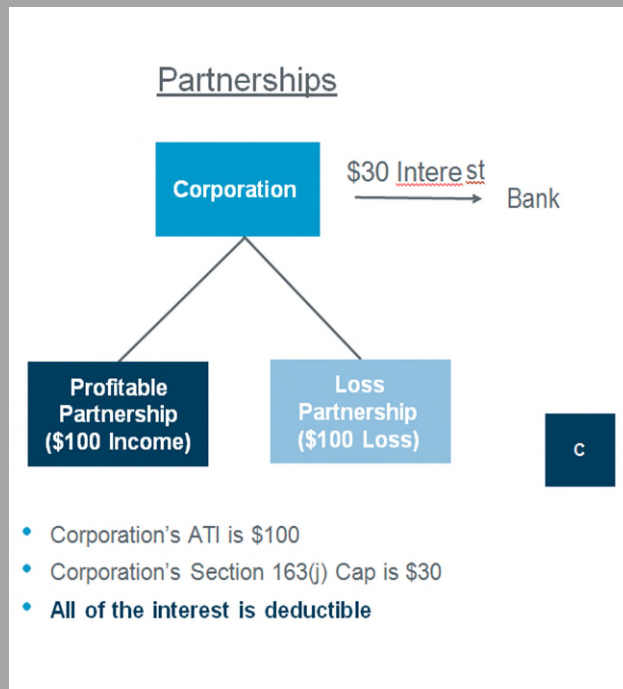
Buying an Undivided Interest in Partnership Assets

- Old Partnership survives
- 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.

Section 163(j) Planning



Section 163(j) Planning



Section 163(j) Planning

- Two basic Takeaways
- Structure to increase Section 743 adjustment and reduce Section 734 adjustment
 - ✓ Allows for improved treatment under Section 163(j)
 - ✓ Also better result under Section 168(k) expensing than a Section 734 adjustment
 - ✓ Also creates QBIA under Section 199A
- Location of debt
 - ✓ Borrow debt at or above all of the earnings to maximize ATI for purposes of Section 163(j) (consider effect on real estate exception)
 - ✓ House the Section 743 adjustment in a holding partnership

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