Recent tax developments for partnerships and S corporations

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2020 update:
Pass-through entities

2020 Updates - Summary

<u>Significant Items Impacting 2020 Tax Compliance:</u>

- Business Interest Expense Regulations [Section 163(j)]
- Impact of CARES Act
- Payroll Protection Program Loan Forgiveness
- Form 1065 K-1 Reporting: Partner Capital Account Analysis
- State Income Tax “Workaround”
- Carried Interest Regulations [Section 1061]
- Changes coming from Biden administration?

Business Interest Expense Limitation Regulations [Section 163(j)]

- The interest expense limitation rules were significantly altered and their applicability was expanded as Section 163(j), in its current form, was enacted as part of the Tax Cuts and Jobs Act in 2017. Section 163(j) may disallow current deduction of business interest to the extent it exceeds a certain percentage of "adjusted taxable income".
  - Section 163(j) is applied to partnership business indebtedness at the partnership level. If a partnership's interest deduction is limited, the deferred/"excess" expense is allocated to partners, and future deductibility allowed once a partner is allocated excess business taxable income allowing them to deduct at the partner level.
  - For an S-Corporation, unlike partnerships, the limitation on business interest expense is carried forward at the S Corporation level and potentially deducted by the S Corporation in a future tax year.
- Proposed Regulations were released in 2018, providing some direction, but many unanswered questions.
- CARES Act – March 2020 – provided some relief to limitations
- Final regulations and new proposed regulations published on September 14, 2020. Effective for tax years beginning on or after November 13, 2020, however may be applied for tax years beginning after December 31, 2017 if adopted in their entirety and consistently across related parties.
- Interest expense currently limited by a company's tax "EBIDTA" through tax year 2021. Beginning in tax year 2022, limited to a company's tax "EBIT".

CARES Act with some relief for Interest Expense Deductions

CARES Act enacted March 2020 – still awaiting issuance of final regulations on 163(j)

- Modified the limitation from 30% of ATI to 50% of Adjusted Taxable Income for 2019 and 2020 tax years
    - Effective date for partnerships delayed until January 1, 2020.
    - Partners able to deduct 50% of EBIE allocated to a partner for a 2019 taxable year, can automatically be treated as deductible interest expense in the partner's first taxable year beginning in 2020, not subject to 163(j) limitations.
- Taxpayers can elect to use the 2019 ATI for the tax year 2020 limitation

Business Interest Expense Limitation Regulations [Section 163(j)]

Highlights of Final Regulations:

- Added clarification related to the definition of interest expense – removed a number of more problematic items from what was a overbroad definition of interest in the initial proposed regulations.
  - Clarified deferred financing fees not included for this purpose
  - Specific to partnerships - Includes elimination of classifying guaranteed payments for the use of capital as an amount treated as interest for 163(j)
- Define adjusted taxable income (“ATI”) as the tentative taxable income of the taxpayer with certain adjustments.
- Added clarification “COGS” depreciation, amortization, and depletion for purposes of computing adjusted taxable income.
- “Claw back” adjustments to ATI for disposals of certain property – clarifies intension by Congress that the ATI addbacks allowed from 2018-2021 are timing – in essence, reverses prior depreciation, amortization, and depletion adjustments on disposition
- To the extent a partnership’s interest expense is deductible under 163(j), that interest expense is not subject to further limitation under 163(j) at the partner level.
- Retains the complex 11-step process for allocating deductible business interest expense and excess items. Only exception is for pro-rata partnerships.

Business Interest Expense Limitation Regulations [Section 163(j)]

<u>Highlights of 2020 Proposed Regulations:</u>

- In a tiered partnership structure, excess business interest expense (“EBIE”) is carried forward by the upper-tier partnership(s) (“UTP”) and not passed through to those upper-tier partnership partners. The proposed rules to track UTP EBIE would add significant complexity to the already complex section 163(j) regime for partnerships.
- Self-charged interest addressed where there is a direct lending partner. The lending partner is deemed to receive an allocation of EBIE equal to the lesser of (1) its EBIE from the borrowing partnership for the tax year, or (2) the interest income on the loan for the tax year. Not applicable to S-Corporations.
- Partial dispositions of a partnership interest result in basis increased for proportional amount of previously allocated EBIE. Corresponding rules for partnerships to adjust tax basis of partnership proper accordingly. However, adjustment is not depreciable or amortizable by partnership and would not increase basis of ordinary-income producing assets.
- In accordance with CARES Act, 50% of 2019 EBIE treated as paid or accrued by partner in tax year 2020 if partnership interest is disposed of in either 2019 or 2020 tax year. A taxpayer may elect to not have this provision apply.

Impact of CARES Act on Pass-Through Entities

- Enacted March 2020

Highlights of CARES Act:

- Corrected “Qualified Improvement Property” oversight of 2017 Tax Cuts and Jobs Act
- Issuance of Payroll Protection Program “PPP” Loans with anticipated forgiveness, employee retention credit, Sick/Family leave credit, and deferral of employer-portion of payroll taxes.
- Intended availability to increase current interest expense deductions through temporary adjustments to percentage allowed to ATI
- The IRS also provided a short period for BBA partnerships to file an amended return rather than an AAR, but that period expired on September 29, 2020.

Payroll Protection Program "PPP" Loan Forgiveness

- November 19, 2020 Treasury released Revenue Ruling 2020-27 and Revenue Procedure 2020-51
- 2020-27 provides guidance on deduction of expenses related to PPP loan proceeds
  - Not deductible by Company in 2020 if taxpayer has reasonable expectation of PPP Loan being forgiven.
- 2020-51 issued safe-harbor rules that allow a taxpayer to claim a deduction in the taxpayer's 2020 tax year for certain otherwise deductible eligible 2020 expenses if the taxpayer received a PPP loan that the taxpayer expects to be forgiven after its 2020 tax year and in a later year the taxpayer is denied PPP loan forgiveness, in whole or in part, or the taxpayer decides not to request PPP loan forgiveness

Unanswered Questions:

- State and local considerations for treatment of Federal tax-exempt income.
- Impact on investor/owner basis in pass-through entity: *non-deductible expense in 2020 but tax-exempt income in 2021?*
- Impact on other items such as 199A wage reporting or QREs for R&D credit.

Section 163(j) Changes and CARES Act

<u>Items of consideration for year-end planning:</u>

- Analyze opportunities to amend prior year returns, or file AARs for BBA partnerships, to adopt final Regulations for interest expense limitation changes, for QIP “fix”

  *Note limitation on AAR refund opportunity – important to understand taxpayers taxable situation in year filing AAR

- Analyze utilization of 2019 or 2020 ATI for purposes of determining current year interest limitations – 2020 taxable position? Election to apply the more restrictive 30% of ATI limit? 2021 tax position? Loss carryback vs. future tax rate?
- Analyze benefit of Proposed Regulations regarding basis adjustments for 2019 EBIE on 2019 dispositions.
- Analyze benefit of Proposed Regulations regarding self-charged interest for partners with significant notes with partnership and subsequently reporting EBIE.
- Analyze impact of PPP Loan forgiveness on 2020 tax reporting.
- Don’t forget state impact of any/all of these planning considerations

Form 1065 K-1 Reporting: Partner Capital Account Analysis

- Notice 2020-43: June 2020 - Proposed Methods: Modified Outside Basis and Modified Previously Tax Capital
- Draft Form 1065 Instructions released October 2020
- Beginning with Partnership returns for tax year 2020 tax year – must calculate partner capital accounts using the transactional approach for the tax-basis method. Prior k-1 reporting allowed a partner's capital account to be reported under other methods, such as using GAAP or Section 704(b).
- Transactional approach- reports partner contributions, the partner's share of net income or loss, withdrawals and distributions, and other increases or decreases using tax basis principles.
- 2020 is the key to resetting beginning capital – instructions allow this to be done on various methods: transactional, modified outside basis, modified previously tax capital, or 704(b) method. Consistency requirement across partners.
- The IRS will not assess a penalty for any errors in reporting a partnership's partners' beginning capital account balances on Schedules K-1 if the partnership takes ordinary and prudent business care in following the form instructions to calculate and report the beginning capital account balances.

Form 1065 K-1 Reporting: Partner Capital Account Analysis

Items of consideration for year-end planning:

- Determination of most appropriate method of reporting beginning of year partner capital balance. Compilation of information for appropriate reporting and disclosures.

SALT Deduction and “Workarounds”

- TCJA placed a $10k cap on the amount of state and local taxes (“SALT”) that can be deducted under IRC Sec. 164(a).
  - Effective for tax years beginning after 12/31/2017 and before 1/1/2026.
  - Real and personal property taxes, income taxes, sales and use taxes.
- Proposed workarounds designed to provide federal deductions and state credits for contributions to:
  - State funds
  - Private charities
  - Private schools
- IRS promulgated regulations prohibiting those workarounds.
- Entity level pass-through deductions for partnerships and S corporations.

SALT Deduction and “Workarounds”

- IRS Notice 2020-75, “Forthcoming Regulations Regarding the Deductibility of Payments by Partnerships and S Corporations for Certain State and Local Income Taxes,” issued on 11/09/2020.
- Per the IRS press release, “the proposed regulations will clarify that State and local income taxes imposed on and paid by a partnership or S corporation on its income are allowed as a deduction by the partnership or S corporation in computing its non-separately stated taxable income or loss for the taxable year of payment, and therefore are not subject to the State and local tax deduction limitation for partners and shareholders who itemize deductions.”
- Applicable to payments made on or after 11/09/2020 as well as payments made in a partnership or S corporation tax year ending after 12/31/2017 and before 11/09/2020.

SALT Deduction and "Workarounds"

- Seven states have adopted entity-level taxes:

Connecticut	New Jersey	Wisconsin
Louisiana	Oklahoma	
Maryland	Rhode Island	

- Key features:
  - Federal deduction at the entity level.
  - State credit at the partner level or exclude that portion of the income that was subject to the entity tax.

- Connecticut is the only state on the list above that is mandatory.

SALT Deduction and “Workarounds”

Sounds great, but …

- Which taxpayers would benefit from entity level tax paid?
  - Classic multi-state issue.
- The credit mechanism should match – state should allow the entity level payment to apply to an individual income tax liability.
- Multi-state businesses may have partners in a state with an entity level tax, but some of the partners might have little or no tax liability in that state.
- What are the chances that more states will pass new tax laws?

Proposed Regulations – Carried Interest [IRC 1061]

Highlights of the proposed regulations:

- **Applicable partnership interest defined** The issuance of proposed regulations also has narrowed the exceptions to the definition of API. For instance, the exception for corporations is limited to interest held by C corporations but not by S corporations. The exclusion of the capital interests from the definition of API is likely to create further complexity for funds that do not subject all partners to the same fee and carry provisions.
- **Holding period.** The three-year holding period is determined by reference to the owner of the asset that is sold regardless of whether the asset is the API held directly by the ultimate taxpayer or an asset held by an entity in which the taxpayer has an API (including lower-tier partnerships and assets held by lower-tier partnerships).
- **Look-through rule.** The proposed regulations apply a look-through rule for the direct or indirect sale of an API with a holding period exceeding three years if one of two circumstances apply:
  - If at least 80% of the assets of the entity in which the API is held are capital assets that, if disposed of, would be treated as held for three years or less
  - In certain tiered partnership situations

Proposed Regulations – Carried Interest [IRC 1061]

- **Transfers to related persons.** Section 1061(d) provides rules that generally treat nontaxable transfers of an API held for three years or less to a related party as taxable and subject to the rules under IRC Section 1061. The proposed regulations apply these rules to otherwise unrecognized net built-in capital gain from either the underlying assets of an entity in which an API is held or an API with a holding period of three years or less. For this purpose, a related person generally is a spouse, child, grandchild, or parent; a person who provides investment advisory services within the same calendar year as, or the three years preceding, the transfer; or a pass-through entity owned by either of the foregoing.
- **Aggregation of gains and losses.** The proposed regulations aggregate gains and losses from multiple interests at the ultimate beneficial owner level before determining the amount subject to recharacterization.
- **Disapplication to certain assets.** The proposed regulations clarify that IRC Section 1061 does not apply to IRC Section 1231 gains or qualified dividend income, which might be a planning opportunity for certain investment partnerships.
- **Carried interest waivers.** The preamble to the proposed regulations cautions that a waiver of rights to distribution of gains from a partnership might not be effective to defeat application of IRC Section 1061 and could be challenged by the IRS.
- **Effective date.** The regulations are proposed to be effective for taxable years beginning on or after the date final regulations are published. However, taxpayers and partnerships generally can rely on the proposed regulations for tax years beginning before the final regulations are issued if they consistently follow the proposed regulations for tax years beginning on or after Dec. 31, 2017.

Biden tax plan: impact on pass-through entities

Biden tax plan

Notable revenue-raising proposals

- Raise top marginal tax rate 2.6% for income over $400,000
- Phase out the section 199A deduction on certain passthrough business income for taxpayers with income of more than $400,000
- Additional application of the 12.4 percent social security payroll tax to wages of more than $400,000, including income from self-employment
- Tighten rules for classifying workers as employees versus independent contractors
- Tax capital gains and dividends at the same rate as ordinary income for taxpayers with income of more than $1 million
- Estate tax adjusted to 2009 levels – possibly 45% rate and reduced exemption amount

Any questions?

Thank you

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