BACK TO THE FUTURE FOR C CORPORATIONS?

EXAMINING THE CHOICE OF ENTITY ANALYSIS AFTER TCJA

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Historically, the choice of entity selection for taxpayers was frequently a challenging decision. The advent of the limited liability company and its hybrid identity (i.e., corporate-like legal characteristics and *potentially* passthrough-like tax treatment), made the decision a little less daunting. With the promulgation of the "check-the-box" regulations, the scales were that much more tilted towards passthrough treatment. As the pre-distribution corporate tax rate was close to the highest individual tax rate, passthrough treatment was typically the preferred choice. Even after the reduction in rates for most dividends paid to individuals from the highest ordinary income rates to those for capital gains, the double tax rendered passthrough tax treatment the default choice for most businesses.

The passage of the Tax Cuts and Jobs Act (the "TCJA") has caused taxpayers and their advisors to rethink the choice of entity decision.[2] As the TCJA has altered the rules for vast swaths of the Internal Revenue Code,[3] the decision has become more challenging and more dependent on the unique facts and circumstances of the particular business and its investors.

At a high level, as a result of the TCJA, C corporations may provide taxpayers with a lower effective tax rate—especially if they plan on reinvesting profits rather than making regular distributions. Further, C corporations, unlike their passthrough rivals, are *clearly* eligible for the effectively reduced tax rates under the new GILTI and FDII (each defined below) provisions of the Code. Finally, C corporations still maintain their historical advantages with respect to tax compliance, avoidance of the self-employment tax, the availability of tax-free business combinations, and generally greater access to capital markets.

On the other hand, many of the historical benefits of passthrough treatment are still alive and well after the TCJA's enactment. Such benefits include the ability to provide for special allocations, the passthrough of business losses (albeit the amount of such losses may be somewhat curtailed), typically more efficient exit structures, and more efficient estate planning (i.e., a basis step up in the business assets) to name a few. Further, and perhaps most importantly, passthroughs (and not C corporations) may be eligible for a special 20% deduction on certain qualifying income. In addition, certain TCJA provisions (e.g., the 80% limitation on net operating losses) coupled with the uncertainty as to how long the relatively low corporate tax rates and related tax benefits such as FDII will remain in place, especially in light of the current U.S. political climate and growing federal budget deficits and debt, may make corporations less desirable than prior to enactment.

In all, today's choice of entity analysis is far from obvious or "cookie-cutter" as it may have appeared to be just a year or so ago. This outline attempts to explain the TCJA's most relevant changes to the tax law on that very analysis. We will discuss how each of the major new business-related provisions of the TCJA operate and the role that they may play in making the all-important entity classification decision. Let's begin![4]

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[1] This paper was truly a team effort. The following colleagues were of tremendous assistance in the drafting of this paper: Andrew Eisenberg, Joseph Goldman, Chris Hanfling, Sean Jackowitz, Francis Muracca II, Angelika Nazarenko, Jessica Nichols, Richard Nugent, Patrick O'Brien, Christian ("Cap") Pritchett, Dennis Rimkunas, Lesley Roe, and Kelly Rubin. Their efforts and insights are greatly appreciated. Finally, a special thanks to my secretary, Denise Chisolm, for all her help editing and formatting this document.

[2] Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, Pub. L. No. 115–97, 131 Stat. 2054 (2017). This legislation is more commonly referred to as the "Tax Cuts and Jobs Act."

[3] All "IRC §" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" references are to the regulations thereunder.

[4] At the time this paper was submitted, the tax law was, and remains, in great flux. Proposed regulations, notices, and other guidance have been and continue to be released weekly, if not daily, with a potentially dramatic impact on the discussion below. Further, the possibility of technical corrections and other tax legislation remains, albeit

I. ENTITY TAX CLASSIFICATION AND RESULTING TAX CONSEQUENCES

A. “Check-the-Box” Classification of Entities.

1. Default/Elective Regimes and Entity Classification Steps. In 1996, the U.S. Department of the Treasury (“Treasury”) issued proposed regulations to replace regulations that it had issued in 1960. These proposed regulations were finalized in 1997 and they are commonly referred to as the “Check-the-Box” regulations (the “CTB Regulations”). *See* Treas. Reg. §§ 301.7701-1 to -4.

a. Under the CTB Regulations, an organization must first determine whether it is an entity for federal tax purposes. Treas. Reg. § 301.7701-1(a). For example, a joint venture or other contractual arrangement where participants carry on a trade, business, or financial operations and divide the profits therefrom is such an entity. In contrast, a cost-sharing arrangement, a mere co-ownership of property, or a joint undertaking merely to share expenses are generally not treated as entities for federal tax purposes.

b. If the arrangement is an entity, is it a business entity? Treas. Reg. § 301.7701-2(a). A business entity is an entity recognized for federal tax purposes (including an entity with a single owner) that is not a trust or subject to special treatment.

c. Eligible Business Entity vs. *Per Se* Corporation. If the arrangement is a business entity, is it an “eligible entity”? Treas. Reg. § 301.7701-2.

(1) Eligible Business Entity. Any business entity that is not a *per se* corporation is an “eligible entity.” Treas. Reg. § 301.7701-2(b).

(2) *Per Se* Corporation. In contrast, a business entity organized under federal or state law referred to as a “corporation,” “body corporate,” or “body politic” is a *per se* corporation and may not elect to be treated as a partnership or a disregarded entity (“DRE”). Further, an association under Treas. Reg. § 301.7701-3 is a *per se* corporation as is each foreign entity listed in Treas. Reg. § 301.7701-2(b)(8).

d. Default Status. If a business entity is an eligible entity, it defaults into one of the following categories: (i) if a business entity is a domestic eligible entity, such entity will be treated as a partnership if it has two or more members, or a DRE if it has a single owner, and (ii) if a business entity is a foreign eligible entity, such entity will be treated as a partnership if it has two or more members and at least one member does not have limited liability, a corporation if all its members have limited liability, or a DRE if it has one owner and such owner does not have limited liability. For purposes of the default rules, limited liability exists if a member has no personal liability for debts or claims against the entity determined based on local law and the entity’s organizational documents.

e. The Check-the-Box Election. If a business entity is an eligible entity, it may elect its classification instead of being classified by default. Treas. Reg. § 301.7701-3(c). An eligible entity with at least two members may elect to be a corporation or a partnership. An eligible entity with a single owner can elect to be classified as a corporation or a DRE.

(1) A check-the-box election is made by filing Form 8832, which requires a U.S. Employer Identification Number (an “EIN”) for such eligible entity. An EIN may be obtained by filing Form SS-4.

(2) The Election’s Effective Date. If a date is specified on the form, that date is the effective date of the election. Otherwise, the date the form was filed is the effective date. That said, the effective date cannot be more than seventy-five days before or twelve months after the filing date. Treas. Reg. § 301.7701-3(c)(1)(iii).

(3) Changes in Classification. Once a check-the-box election is made for an entity, that entity cannot again change its classification by making another check-the-box election during the sixty months succeeding the effective date of the initial election, subject to two exceptions: (i) an election upon the entity’s formation is disregarded, so the sixty-month restriction does not apply, and (ii) if the entity has never been “relevant” for U.S. federal tax purposes (e.g., a foreign entity has always

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remote, a possibility depending on the outcome of the 2018 midterm elections. Please keep this all in mind as you read.

been owned, directly and indirectly, by foreign persons) or has not been relevant for the past 60 months, then a check-the-box election as of the first day of relevance is treated as an election on formation and the sixty-month restriction does not apply. Treas. Reg. § 301.7701-3(c)(1)(iv).

2. The U.S. Tax Consequences of Classification Changes.

a. Partnership to Corporation. The partnership is deemed to: (i) contribute all of its assets and liabilities to the corporation in exchange for stock in the corporation, and (ii) immediately thereafter liquidate by distributing the stock of the corporation to its partners. Treas. Reg. § 301.7701-3(g)(1)(i).

b. Corporation to Partnership. The corporation is deemed to: (i) transfer all of its assets and liabilities to its shareholders in liquidation, and (ii) immediately thereafter the shareholders are deemed to transfer the assets and liabilities to a newly formed partnership. Treas. Reg. § 301.7701-3(g)(1)(ii).

c. Corporation to DRE. The corporation is deemed to distribute its assets and liabilities to its single shareholder in liquidation. Treas. Reg. § 301.7701-3(g)(1)(iii).

d. DRE to Corporation. The owner is deemed to contribute the assets and liabilities to the corporation in exchange for the stock in the corporation. Treas. Reg. § 301.7701-3(g)(1)(iv).

e. DRE to Partnership under Rev. Rul. 99-5—A Two-Step Fiction.

(1) Step 1: Purchase of a portion of an interest in a DRE from the existing owner of the DRE. The historical owner of a DRE is treated as selling a proportionate share of each asset of the DRE to the buyer of an interest(s) in the DRE. The proportionate share of the assets deemed to be sold corresponds to the buyer's interest in the DRE being purchased (i.e., a purchase of a 50% interest in the DRE corresponds to the purchase of a 50% interest in each asset). The historical owner/seller recognizes gain or loss, if any, on the deemed sale of the assets under IRC § 1001(a).

(2) Step 2: Contribution of property to a DRE. A new partnership is deemed to be formed by the two persons contributing assets to a partnership in exchange for proportionate interests in such partnership. The historical owner of the DRE is treated as contributing the DRE's assets and the new partner of the DRE is treated as contributing other property to a newly formed partnership. The non-recognition rules of IRC § 721 apply.

f. Partnership to DRE under Rev. Rul. 99-6.

(1) Situation 1: Purchase of a Partnership Interest from an Existing Partner by the other Partner. The partnership is treated as making a liquidating distribution of all of its assets to each partner. Immediately following the deemed liquidation, the buying partner is treated as purchasing from the other partner the assets distributed to such other partner in the deemed liquidation. The selling partner is treated as selling its partnership interest to the buying partner and recognizes gain or loss, if any, resulting from the sale under IRC §§ 741 and 751. The buying partner is treated as receiving a liquidating distribution from the partnership with respect to its existing interest in the partnership and recognizes gain or loss, if any, under IRC § 731(a).

(2) Situation 2: Purchase of a Partnership Interest by a Third Party. The partners are treated as selling their respective partnership interests to a third party and recognize gain or loss, if any, under IRC §§ 741 and 751. The third party is treated as buying the partnership assets from the partners who are deemed to have received such assets from the partnership in a deemed liquidation of the partnership.

B. **Entity Categories.**

1. C Corporations. Certain corporations are taxed under the Subchapter C rules of Chapter 1 of Subtitle A of Title 26. Such corporation's income is subject to two levels of taxation: (i) at the entity level when the corporation earns income, and (ii) at the shareholder level when earnings are distributed in the form of dividends. Corporate losses are deductible only against corporate income and do not pass through to the shareholders.

a. Distributions.

(a) Individual Shareholders. Individuals are taxed at lower (capital gain) rates on dividends received from domestic corporations and qualified foreign corporations ("qualified dividends"). IRC § 1(h)(11).

(b) Dividends from tax exempt corporations, mutual savings banks, and IRC § 404(k) dividends are excluded from the definition of "qualified dividends."

(c) If a taxpayer takes a dividend into account as investment income under IRC § 163(d)(4)(B), that dividend is excluded from the definition of "qualified dividends," even if it otherwise meets all of the requirements under IRC § 1(h)(11). IRC § 1(h)(11)(D).

(d) A taxpayer must also hold the stock on which the dividends are paid for a period of more than sixty days during the 121-day period that begins sixty days before the dividend is declared (i.e., a share becomes ex-dividend). IRC § 1(h)(11)(B)(iii)(I).

(e) A "qualified foreign corporation" is any foreign corporation that is not a surrogate foreign corporation, within the meaning of IRC § 7874(a)(2)(B) (i.e., the foreign corporation did not acquire a domestic corporation that resulted in a 60% inversion), or a passive foreign investment company (a "PFIC") within the meaning of IRC § 1297 (discussed *infra* in Section I.B.9.a.(4)), and is one of the following: (i) a corporation organized in a possession of the United States; (ii) a corporation eligible for treaty benefits (with certain exceptions); **or** (iii) a corporation whose stock is traded on an established securities market in the United States.

(2) Domestic Corporate Shareholders. IRC § 243 permits corporate shareholders to deduct from taxable income a percentage of dividends received from a domestic corporation:

(a) A 50% deduction is allowed for dividends paid by one corporation to another, IRC § 243(a)(1);[5]

(b) A 65% deduction is allowed if the corporate shareholder owns at least 20% of stock of the distributing corporation by vote and value, IRC § 243(c);[6]

(c) A 100% deduction is allowed for dividends paid by affiliated corporations, as defined under IRC § 1504(a) (except that certain insurance companies and corporations with an election under IRC § 936 in effect for the taxable year do not apply), out of earnings and profits accumulated during an "affiliation year."

(3) There is no corporate level deduction for distributions to shareholders with respect to stock (i.e., treated as dividends under IRC § 301(c)(1)).

b. Deductions.

(1) Reasonable Compensation.

(a) A corporation may reduce the amount of its taxable income by the amount of reasonable compensation paid to its officers or employees. *See* IRC § 162(a)(1).

(b) Reasonable compensation to shareholders who also act as a corporation's officers or employees may be deductible, but if the payment does not meet the following requirements, it may be treated as a dividend (i.e., non-deductible): (i) payments are not made in proportion to stock ownership and are not otherwise tied to stockholdings;[7] (ii) a shareholder must provide services and such services may not be broadly supervisory;[8] (iii) the corporation must intend the

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[5] IRC § 243(a)(1) was amended by the TCJA to apply to taxable years beginning after December 31, 2017. For taxable years beginning before January 1, 2018, IRC § 243(a)(1) provides a 70% deduction. *See* Pub. L. No. 115-97, § 13002.

[6] Before it was amended, IRC § 243(c) allowed an 80% dividends-received deduction ("DRD") for dividends received from a 20% owned corporation. *See id.* § 13002(a)(2)(A).

[7] *See* Treas. Reg. § 1.162-7(b)(1) ("[i]f . . . the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the . . . payments are a distribution of earnings upon the stock.").

[8] *See Chesapeake Mfg. Co. v Comm'r*, 23 T.C.M. (CCH) 1284 (T.C. 1964), *aff'd sub nom*. *Chesapeake Mfg. Co. v. Comm'r*, 347 F.2d 507 (4th Cir. 1965).

payment as compensation;[9] (iv) the corporation must authorize the payment;[10] and (v) the purported compensation payment represents a reasonable amount of compensation for the services rendered taking into account all relevant facts and circumstances.[11]

(2) Deduction of Interest.

(a) IRC § 163(a) generally allows a deduction for interest paid or accrued by a taxpayer (including a corporate taxpayer). Where there is proportionality between the shareholders and the creditors, a larger share of corporate funds may be distributed to the shareholder-creditors (albeit the underlying treatment of any corporate notes issued to shareholders may be susceptible to an equity recharacterization).

(b) Corporations are subject to several limitations on the deductibility of their interest expense.

(i) If the debt instrument is an equity interest in substance, the interest payment will be recharacterized as a dividend and the principal payment to the shareholder-creditor will be recharacterized as a redemption, which may qualify as a dividend-equivalent redemption under IRC § 302(b) and (d).

(A) The determination of whether an instrument is truly a debt instrument or a disguised equity interest depends on all relevant facts and circumstances. The factors the courts and the Internal Revenue Service (the "Service") frequently analyze in determining whether an instrument is debt or equity include: (i) the intent of the parties, (ii) the instrument holder's position relative to the general creditors of the issuer (i.e., subordination), (iii) the source of payments on the instrument (e.g., whether the payments will be made only out of earnings), (iv) the instrument holder's default remedies, (v) the presence or absence of a maturity date, (vi) the capitalization and ratio of debt-to-equity of the debtor, (vii) whether there is proportionality or identity between the debtor's shareholders and creditors, (viii) the commerciality of the debt instrument, and (ix) voting rights.[12]

(B) Congress attempted to bring more clarity to the debt-equity analysis by enacting IRC § 385 and granting Treasury broad authority to issue regulations governing debt-equity determinations. Treasury issued final and temporary regulations under IRC § 385 in 2016, albeit the effective date for certain provisions has been delayed.[13] The common law factors are still applicable to the debt-equity determination as Treasury explicitly referred to such factors in Treas. Reg. § 1.385-1(b).

(ii) IRC § 163(j) restricts the deduction of business interest expense to 30% of adjusted taxable income.[14]

(iii) The Code contains several additional interest deduction limitations. Some of these additional limitations include interest paid on an "applicable high yield debt obligation" under IRC § 163(i), certain interest payable in equity under IRC § 163(l), interest payable on certain obligations not in registered form under IRC § 163(f), and interest on certain indebtedness incurred by a

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[9] *Elec. & Neon, Inc. v. Comm'r*, 56 T.C. 1324, 1340 (1971), *acq. recommended by* IN RE: ELECTRIC & NEON, INC., ET AL., 1973 WL 34706 (Service AOD Mar. 2, 1973), and *acq.,* Service Announcement Relating to: *Elec. & Neon, Inc., Jimenez* (Service ACQ Dec. 31, 1973), and *aff'd sub nom. Elec. & Neon, Inc. v. Comm'r*, 496 F.2d 876 (5th Cir. 1974), and *aff'd sub nom. Jiminez v. Comm'r*, 496 F.2d 876 (5th Cir. 1974).

[10] *Mores Steel Co. v. Comm'r*, 41 T.C.M. (CCH) 782 (T.C. 1981).

[11] *See* Treas. Reg. § 1.162-7(b)(1).

[12] *See, e.g., Hardman v. United States*, 827 F.2d 1409, 1411-12 (9th Cir. 1987); *Crawford Drug Stores, Inc. v. United States*, 220 F.2d 292, 295 (10th Cir. 1955); *Ragland Inv. Co. v. Comm'r*, 52 T.C. 867 (1969), *aff'd*, 435 F.2d 118 (6th Cir. 1970); *Zilkha & Sons, Inc. v. Comm'r*, 52 T.C. 607 (1969); *Full Serv. Beverage Co. v. Comm'r*, T.C. Memo 1995-126, 69 T.C.M. (CCH) 2221; *see also* Notice 94-47, 1994-1 C.B. 357; *Fin Hay Realty Co. v. Comm'r*, 398 F.2d 694 (3d Cir. 1968); *Scriptomatic, Inc. v. United States*, 555 F.2d 364, 368 (3d Cir. 1977).

[13] On October 13, 2016, Treasury released final and temporary IRC § 385 regulations regarding the treatment of debts between related parties. *See* T.D. 9790. On April 12, 2017, President Trump signed an Executive Order requiring Treasury to review "significant" tax regulations issued in 2016 and to withdraw or modify those regulations that it found to be burdensome. After the required review, Treasury announced that it intended to replace the documentation requirements under IRC § 385 regulations with less burdensome rules but keep the recharacterization of debt as equity regulations. *See* Notice 2017-36 (Treasury announced a 12-month delay in the effective date of the documentation requirements).

[14] IRC § 163(j) is discussed in detail in Section III.F.

corporation to acquire stock or assets of another corporation under IRC § 279. This list is far from exhaustive.

2. S Corporations. An S corporation is a small business corporation that does not have more than 100 shareholders, does not have shareholders other than individuals, estates, certain trusts, and certain tax exempt organizations, has no non-resident alien shareholders, and does not have more than one class of stock.[15] S corporations are taxed under Subchapter S rules of Chapter 1 of Subtitle A of Title 26. Under the rules of Subchapter S, the income and losses of S corporations pass through to their shareholders. As a result, the taxation of S corporations has the following characteristics:

a. Generally, no Corporate-Level Tax. S corporations are not subject to corporate income tax under IRC § 11, the accumulated earnings tax under IRC § 531, or the personal holding company tax under IRC § 541. *See* IRC § 1363. There are additional restrictions applicable to S corporations including, among other restrictions:

(1) IRC § 1375(a) imposes a corporate level income tax on an S corporation if such S corporation has pre-conversion C corporation accumulated E&P and more than 25% of such S corporation's gross receipts are passive investment income. S corporation status is terminated if an S corporation has excess passive investment income and pre-conversion C corporation accumulated E&P for three consecutive years. IRC § 1362(d)(3).

(2) With respect to C corporations converting to S corporations, IRC § 1374 imposes a "built-in gain" tax on such S corporations upon a disposition of appreciated assets in the 5-year period beginning on the date of the conversion.

b. S Corporation Taxable Income. Calculated in the same manner as the taxable income of an individual, with certain modifications.

c. Net Operating Losses ("NOLs"). S corporation NOLs are passed through to the S corporation's shareholders and may not be carried back[16] or carried forward by the S corporation. Such NOLs are treated as ordinary losses of the shareholders and deductible up to the amount of the net operating loss limitation. The NOLs from the C corporation years may not be carried forward to future S corporation years, except that such NOLs may be used to offset the IRC § 1374 "built-in gains."

d. Distributions to S Corporation Shareholders.

(1) S Corporations without C Corporation E&P.[17] The taxation of the distribution depends on the shareholder's basis in his or her S corporation stock. Thus, distributions result in a return of basis until basis is reduced to zero followed by a capital gain to the extent of the excess.

(2) S Corporations with C Corporation E&P. In general, tax-free distributions can be made to the extent of the S corporation's accumulated adjustment account ("AAA") which consists of the S corporation's net income or loss for all S corporation years less any distributions made from AAA in prior years. IRC § 1368(c)(1); Treas. Reg. § 1.1368-2(a)(2), (3). Distributions from AAA reduce a shareholder's stock basis and then result in capital gain to the extent of any excess. Further, any distributions in excess of AAA are treated as made from accumulated E&P resulting in an IRC § 301 distribution.

e. IRC § 199A. For taxable years beginning after December 31, 2017, S corporation shareholders with qualified business income ("QBI") from the S corporation are allowed a deduction under IRC § 199A (discussed in detail in Section II.B. *infra*).

3. Partnerships. The rules of Subchapter K of Chapter 1 of Subtitle A of Title 26 apply to partnerships. Generally, for federal income tax purposes, a partnership is treated as a flow through to

[15] In addition, this corporation cannot fall into the status of "ineligible" corporation. An "ineligible corporation" is a financial institution that uses the reserve method of accounting, an insurance company, a domestic international sales corporation ("DISC"), or former DISC. IRC § 1361(b)(2). The "small business" requirement seems to be applicable only to the number of shares the S corporation can have outstanding because there is no limitation on the amount of income (provided it is not passive income) or on the number of employees to qualify as an S corporation.
[16] The carryback provision was repealed by Pub. L. No. 115-97, § 13302.
[17] E&P means the accumulated E&P of a corporation from prior C corporation years.

its partners and is not taxed as an entity.[18] Accordingly, the items of income, deduction, credit, and loss pass through to each partner based on the partner's distributive share of these items.

a. Partnership's Income Computation. A partnership is required to compute and report its taxable income as an entity on an information return (i.e., Form 1065). Among other items, NOLs are not included in the computation of the partnership's taxable income, but are taken into account by each partner based on his or her distributive share. The availability of NOL carrybacks or carry forwards depends on each partner's individual facts and circumstances.

b. Partners' Distributive Share. With a few exceptions, partners are taxed on their distributive shares of partnership items regardless of whether the distribution is actually made. A partner's outside basis is (i) increased with each allocation of his or her distributive share of income, increase in allocable share of partnership debt, and contributions, and (ii) decreased with each distribution of cash or property to the partner, decrease in allocable share of partnership debt, and allocation of a distributive share of loss. A partner's ability to take losses immediately is subject to limitations that defer losses to later years. Such limitations include, (i) the partner's outside basis in his or her partnership interest (IRC § 704), (ii) the partner not having a sufficient amount at risk with respect to the activity that generated the loss (IRC § 465), (iii) losses that are passive activity losses and the partner does not have passive activity income (IRC § 469), and (iv) for taxable years beginning after December 31, 2017 and ending before January 1, 2026, excess business losses allocated to the partner. (IRC § 461(l)).

c. IRC § 199A 20% Deduction. Individual partners may be eligible for the IRC § 199A deduction on certain pass-through income from a partnership (subject to a number of requirements and exceptions). For a detailed discussion of IRC § 199A, *see* Section II.B. *infra*.

4. Publicly Traded Partnerships.

a. In General. In general, IRC § 7704 treats publicly traded partnerships ("PTPs") as corporations for U.S. federal income tax purposes. Unless a PTP falls into one of the exceptions in IRC § 7704(c), the rules of Subchapter C, rather than Subchapter K, apply. This results in double taxation of the entity's earnings, dividends to its partners (instead of tax-free distributions to the extent of the partners' basis in the partnership), and, in some cases, reduction in the basis of stock (outside basis of the partners) if the partners' bases increased as a result of the partnership's liabilities.

b. Certain PTPs are Excepted from C Corporation Treatment.

(1) A PTP is not treated as a C corporation if at least 90% of PTP's income is "qualifying income," which includes most categories of passive income and income derived from activities with respect to certain natural resources. IRC § 704(d).[19]

(2) If a PTP would qualify as a Registered Investment Company ("RIC") if it were a domestic corporation, the PTP is not treated as a C corporation unless the PTP's principal activity is buying and selling commodities. IRC § 7704(c)(3).

(3) Certain "existing partnerships" are not treated as C corporations.[20]

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[18] *But see* IRC § 6225 (imposing an "imputed underpayment" on the partnership). Also, in some situations, a partnership is treated as an entity. For example, for purposes of determining a U.S. shareholder in a foreign corporation, a domestic partnership is treated as a U.S. person. *See* IRC §§ 957(c), 7701(a)(30).

[19] Passive income includes interest, dividends, real property rents, gains from the sale of real property, gains from the sale or disposition of capital assets, and income from the sale of commodities of a partnership that does not qualify for an exception in IRC § 7704(c)(3). IRC § 704(d)(1)(A)-(D) and (F)-(G). Natural resources income includes income and gains derived from the exploration, development, mining or production, processing, refining, transportation, or marketing of any mineral or natural resources. IRC § 704(d)(1)(E).

[20] When IRC § 7704 was enacted in 1987, Congress delayed its application for 10 years for partnerships that were PTPs on December 17, 1987 (or filed appropriate paperwork with State or Federal agencies to be classified as PTPs on or before December 17, 1987). *See* Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330, 1330-405, § 10211(c)(2)(A) (1987). However, if the partnership added a line of business that was substantial, its status as an "existing partnership" would be terminated, and it would be treated as a C corporation going forward unless other exceptions applied. *Id.* § 10211(c)(2)(B). In 1997, Congress delayed the application of IRC § 7704 to "existing partnerships" indefinitely as long as they were PTPs on December 17, 1987 and have since not added a substantial line of business.

5. Real Estate Investment Trusts.

a. Organizational Requirements. To qualify for real estate investment trust ("REIT") status, an entity must be a corporation, trust, or association and must: (i) be managed by one or more trustees or directors; (ii) have transferable shares or certificates of beneficial interest; (iii) qualify for taxation as a domestic corporation, but for the provisions in IRC § 856; (iv) not be a financial institution or an insurance company; (v) have 100 or more persons who are beneficial owners; (vi) not be a closely held corporation as defined in IRC § 542(a)(2) subject to a reasonable cause exception; and (vii) file an election to be treated as a REIT with electing entity's tax return as required in IRC § 856(c)(1). Further, in order to elect REIT status, an entity must be a calendar year taxpayer. IRC § 859.

b. Additional REIT Requirements. If a C corporation elects REIT status and has accumulated E&P, such E&P must be distributed before the end of the first REIT year (IRC § 857(a)(2)), and if an electing C corporation has a net built-in gain in its assets, the rules of IRC § 1374 apply, unless the corporation elects to be subject to deemed sale treatment on the conversion date. Treas. Reg. § 1.337(d)-7(b)(1)(i).

c. REIT Asset and Income Tests. REITs must satisfy both an asset test at the close of each quarter of the taxable year and satisfy a gross income test at the close of each taxable year.

d. Taxation of REITs. A REIT's taxable income is calculated in a manner similar to that of C corporations, with certain exceptions such as that no dividend-received deductions ("DRDs") are allowed under IRC §§ 243 and 245A. However, the major advantage of electing REIT status is that a REIT is entitled to a deduction for dividends paid to its shareholders. IRC § 857(b)(2)(B). As a result, a REIT may minimize or escape entity-level taxation by distributing its earnings to its shareholders as dividends.

e. Taxation of REIT Shareholders.

(1) In General. REIT shareholders are taxed on REIT distributions in a manner similar to that of the shareholders of a C corporation. Dividends that are designated by a REIT as capital gain dividends are taxed at capital gain rates. A REIT may designate its dividends as capital gain dividends to the extent of its net capital gains for a given taxable year. IRC § 857(b)(3)(B).

(2) Special REIT Dividend Rules. REIT dividends are: (i) not eligible for a DRD; (ii) not treated as dividends from a domestic corporation for purposes of determining whether a dividend from a foreign corporation is eligible for a DRD under IRC § 245; and (iii) subject to certain exceptions, not eligible for "qualified dividend" status under IRC § 1(h). IRC § 857(c)(2). From 2018 through 2025, REIT shareholders are eligible for the IRC § 199A deduction (discussed in detail in Section II.B. *infra*).

6. Cooperatives. Generally, a cooperative is an organization established for the purpose of purchasing and marketing the products of its members ("patrons"). The characteristic features that distinguish a cooperative from a C corporation, aside from taxation, are that (i) the earnings are allocated to the patrons based on the quantity or value of each patron's business with the cooperative ("patronage") and not based on the equity interest in the corporation, and (ii) the patrons have equal voting power regardless of how many shares they own or how much business they transact with the cooperative.

a. Taxable income. Generally, the taxable income of cooperatives is computed in the same manner as that of corporations (e.g., deductions for business expenses and interest are allowed). Treas. Reg. § 1.1382-2(a). In addition to deductions normally allowed for corporations, cooperatives are allowed a deduction for distributions to their patrons. Additional deductions are available to exempt farmers cooperatives.

b. Cooperative NOLs. NOLs under IRC § 172 are generally allowed, but with certain limitations with respect to patronage vis-à-vis non-patronage gains and losses.

c. Availability of IRC § 199A Deduction. A deduction under IRC § 199A(g) is allowed for domestic production income of agricultural and horticultural cooperatives;[21] the agricultural

[21] Under the transition rule, the deduction under § 199A is disallowed for certain payments received by a taxpayer from specified agricultural or horticultural cooperatives in a taxable year beginning after December 31, 2017 but that are attributable to income deductible under the repealed IRC § 199 for the taxable income of the cooperative

or horticultural cooperative may elect to pass through this deduction to its members, IRC § 199A(g)(2)(A) and (D). *See* Section II.B. for more detail on the IRC § 199A deduction generally and its availability for specified agricultural and horticultural cooperatives ("Farm Coops").

7. Personal Service Corporations. Generally, a personal service corporation ("PSC") is a vehicle to incorporate certain personal service businesses that are prohibited from being organized as traditional corporations under the state law (e.g., medical, legal, architectural, and accounting businesses). PSCs are typically closely held and their shareholders are also the PSC's employees. The common reason for incorporating a PSC is to keep income earned through the provision of personal services at the corporate level by having the PSC pay a relatively low salary to employee-shareholders and by making relatively large distributions that qualify as "qualified dividends" under IRC § 1(h)(11). However, much of the tax planning associated with PSCs has been curtailed by statutes, regulations, and Service revenue rulings.

a. Corporation may be Disregarded as an Entity. If the creation of a PSC serves only the purpose of avoiding individual income tax on income earned through the provision of personal services, the IRS argued on several occasions, not always successfully, that such PSC must be disregarded and its income must be immediately taxable to the shareholder-employees.

b. Reallocation of Income under IRC § 482. IRC § 482 is commonly known as a "transfer pricing" provision because it allows the Service to reallocate items of income, deduction, credits, and other similar items among related parties based on arms' length principles that compare the allocations of such items between unrelated parties. Applying this principle to a PSC and a PSC employee-shareholder, the compensation paid to the employee-shareholder must be comparable to the compensation paid by other corporations to unrelated parties. This standard will be satisfied if the corporation pays a reasonable compensation commensurate with the value of the services provided by the employee-shareholder. Further, certain tax benefits may be disallowed under IRC § 269. For a discussion on IRC § 269, *see* Section III.D.2. *infra*.

c. IRC § 269A. IRC § 269A allows the Secretary to reallocate a corporation's income, deductions, credits, and other tax items between a PSC and its employee-shareholders (where such employee-shareholder owns 10% or more of the PSC directly or through modified IRC § 318 attribution) if *all* four of the following criteria apply: (i) the corporation's principal activity is the performance of personal services; (ii) the services are substantially performed by employee-shareholders; (iii) substantially all of the corporation's services are performed for or on behalf of a single other corporation, partnership, or entity; and (iv) the principal purpose for forming, or availing of, such corporation is the avoidance or evasion of federal income tax by reducing the income of, or securing the benefit of any expense, deduction, credit, exclusion, or other allowance for, any employee-owner that would not otherwise be available. Query whether IRC § 269A can apply to an incorporation that satisfies prongs (i) through (iii) when the principal purpose for the incorporation is to obtain the 21% corporate rate?

8. Trusts.

a. Grantor Trusts. Establishing a trust may provide a tax advantage to the grantor of the trust (i.e., the person who puts property into the trust) by shifting income from the grantor's high tax bracket to a lower tax bracket of the trust beneficiary. There are several types of grantor trusts, such as revocable trusts, life insurance trusts, asset protection trusts, charitable trusts, and spendthrift trusts. If the grantor has power over or an interest in the trust identified in IRC §§ 672-679, the grantor must include the income, deductions, and credits attributable to the portion of the trust that the grantor is treated as owning in the grantor's taxable income, deductions, and credits. *See generally* IRC §§ 672-679. If under the terms of the grantor trust, the income on which the grantor was taxed is distributed to a third-party beneficiary, such distribution is treated as a non-taxable gift to the third-party beneficiary from the grantor, within the meaning of IRC § 102(a).

b. Ordinary Trusts. Ordinary trusts are governed by the rules in Subchapter J. Generally, property is placed in the trust for the benefit of a beneficiary to generate income that the beneficiary can use for a specific purpose. Such purpose is usually identified in the terms of the trust.

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beginning before January 1, 2018. Deductions under the former IRC § 199 are allowed for such payments. *See* An Act to Provide for Reconciliation Pursuant to Titles II and Title IV of the Concurrent Resolution on the Budget for Fiscal Year 2018, Pub. L. No. 115-97, § 13305, 131 Stat. 2054 (2017); Consolidated Appropriations Act, Pub. L. No. 115-141, Div. T, § 101, 132 Stat. 348 (2018).

The beneficiary is taxed on the distributions from the trust. The distribution of the trust corpus is excluded from income under IRC § 102(a) as a gift. If the income is not distributed, the trust is taxed on the accumulated income. If the accumulated income is later distributed to the beneficiary, the beneficiary is taxed on these amounts, but the taxes paid by the trust on these amounts are generally creditable against the beneficiary's tax liability. That said, if the beneficiary has unrestricted power to draw against the trust's income or corpus, such beneficiary may be taxed in the same manner as grantors who are treated as owning an interest in a trust within the meaning of IRC §§ 672-679. Such tax treatment may result in tax liability to the beneficiary without actual distribution of income from the trust.

(1) The character of the income in the hands of the beneficiary when distributed generally retains the same character as when incurred by the trust. For example, capital gains incurred by the trust that are distributed to the beneficiary are taxed as capital gains to the beneficiary. Tax exempt interest earned by the trust and distributed to the beneficiary is treated as tax exempt interest in the hands of the beneficiary.

(2) A trust's taxable income is computed similarly to that of an individual's taxable income, subject to modifications under IRC § 642. The trust's taxable income is reduced by the lesser of (i) the distributable net income calculated under IRC § 643 and (ii) the sum of the distributions required to be made currently under the terms of the trust and other distributions made by the trust during the taxable year. After the trust's taxable income is adjusted for these amounts, the trust's remaining amount of income is subject to the tax rates under IRC § 1(e).

9. Foreign Entities. Special rules apply to foreign entities depending on the tax treatment of the entity for U.S. federal income tax purposes.

a. Foreign entities that are treated as corporations. Generally, earnings of foreign corporations are not taxed in the United States until distributed to their domestic shareholders. However, the following exceptions apply:

(1) Effectively Connected Income. Income effectively connected to a U.S. trade or business ("ECI") earned by a foreign corporation (and, where a U.S. tax treaty is applicable, attributable to a U.S. permanent establishment) is generally subject to U.S. federal income tax.

(2) Controlled Foreign Corporations ("CFC"). A United States shareholder of a CFC must include its proportionate share of Subpart F income of the CFC regardless of whether distributed. A United States shareholder is a U.S. person who owns at least 10% by vote *or* value (taking into account modified IRC § 318 attribution under IRC § 958) of stock in a foreign corporation (an "IRC § 958 U.S. Shareholder").[22] A CFC is a foreign corporation more than 50% of which (by either vote or value) is owned by one or more IRC § 958 U.S. Shareholders. Subpart F income includes passive type income (e.g., dividends, interest, royalties, and gains from the sale of capital assets) and certain other types of easily-movable income between related parties, subject to certain exceptions. The TCJA added new IRC § 951A, which requires a IRC § 958 U.S. Shareholder of a CFC to include its pro rata share of global intangible low-taxed income ("GILTI") applicable to taxable years of CFCs that begin after December 31, 2017. The taxation of U.S. shareholders of CFCs is discussed in more detail in Section IV.

(3) Deferred Foreign Income Corporations ("DFIC"). New IRC § 965 (sometimes referred to as the "transition tax") requires an IRC § 958 U.S. Shareholder of a DFIC to take its proportionate share of previously untaxed post-1986 foreign earnings of such DFIC into account as Subpart F income. The taxation of IRC § 958 U.S. Shareholders of DFICs is discussed in more detail in Section IV.

(4) PFICs. Any U.S. person who directly or indirectly holds any stock in a PFIC must pay an interest charge on its "excess distributions." A PFIC is a foreign corporation whose gross income consists of 75% or more of passive income or 50% or more of the average value of its

[22] The definition of U.S. shareholder was amended by TCJA. Pub. L. No. 115-97, § 14214. Before the amendment, the term included only those U.S. persons who owned at least 10% of the total combined voting power of the foreign corporation. *See id.* Further, the TCJA expanded the definition of U.S. shareholder for purposes of determining whether a foreign corporation is a CFC by repealing IRC § 958(b)(4), which provided that a U.S. person was not to be treated as owning stock that was owned by a related foreign person. *See id.* § 14213. For example, as a result of the repeal, each foreign subsidiary of a foreign-parented multinational with at least one U.S. subsidiary is a CFC.

assets consists of assets that produce or that are held for the production of passive income. IRC § 1297(a)(1). Excess distributions include gain on the disposition of PFIC stock and certain distributions made by a PFIC. Some relief is available under the qualified elective fund ("QEF") and mark-to-market ("MTM") regimes, each of which is subject to a number of requirements. *See* IRC §§ 1293-1295 and § 1296, respectively.

b. Foreign Entities Treated as Partnerships. The income of U.S. partners from foreign partnerships is subject to the rules of Subchapter K. A U.S. partner is allowed to take a direct foreign tax credit under IRC § 901 for the foreign taxes paid by the partnership. For purposes of determining the U.S. shareholder status of a foreign corporation, a foreign partnership is ignored and each U.S. partner is treated as holding his share of the stock in the foreign corporation based on his partnership interest. *See*, *e.g.*, Treas. Reg. § 1.1248-1(a)(4).

c. Foreign Entities Disregarded for U.S. Tax Purposes. A U.S. person who owns a foreign entity that is disregarded for U.S. federal income tax purposes is immediately taxed on the income of the DRE as it is earned. The direct foreign tax credit under IRC § 901 is available to the U.S. person.

d. Hybrid and Reverse Hybrid Foreign Entities. A hybrid foreign entity is a foreign entity that is treated as a DRE for U.S. federal income tax purposes, but is treated as a corporation for foreign tax purposes. A reverse hybrid foreign entity is a foreign entity treated as a corporation for U.S. federal income tax purposes but is disregarded for foreign tax purposes. Treatment of the same items under the U.S. tax rules may be different from the treatment under foreign tax rules because of the mismatch in classification. To address the perceived abusive use of such mismatches, Congress enacted a number of provisions in the TCJA including new IRC § 245A(e) which denies the benefits of the new participation exemption of IRC § 245A for certain distributions treated as dividends for U.S. tax purposes, but as a deductible payment for foreign tax purposes and new IRC § 267A which denies a deduction for a "disqualified related party amount" paid by a U.S. person pursuant to a "hybrid transaction." Each of these provisions is discussed in more detail in Section IV.

C. Special Industries.

Certain industries were uniquely impacted by the TCJA. Some of the new rules impacting these industries are summarized below.

1. Real Estate.

a. Depreciation. All three categories of qualified real property ("qualified leasehold improvement property," "qualified restaurant property," and "qualified retail improvement property") were combined into a single term "qualified improvement property" ("QIP") in IRC § 168(e). The three categories were consolidated into a single category in an effort to reduce the burden of determining whether a portion of real property is eligible for bonus depreciation. However, due to a drafting error, the fifteen-year and twenty-year recovery periods under the Alternative Depreciation System ("ADS") do not apply to QIP, which makes QIP ineligible for IRC § 168(k) 100% bonus depreciation absent a legislative technical correction.

b. Ability to Elect Out of IRC § 163(j) Interest Limitation. A real property trade or business that elects out of the interest expense deduction limitation in IRC § 163(j) is required to use ADS to depreciate its nonresidential real property, residential rental property, and qualified improvement property. IRC §§ 163(j)(10), 168(g)(1)(F), (g)(8). The ADS recovery period for residential rental property is reduced from forty to thirty years. IRC § 168(g)(2)(C)(iii).

c. Real Estate Exempt from Repeal of Like-Kind Exchanges. The nonrecognition of gain or loss under IRC § 1031 is limited to real property that is not held primarily for sale. Pub. L. No. 115-97, § 13303.

2. Banking. Members of an affiliated group (within the meaning of IRC § 1504(a)) that also includes a bank are subject to a rate increase of 1% under IRC § 59A (the "BEAT") and are subject to the BEAT if just 2% (as opposed to 3% for non-bank groups) of their total deductible payments are to related foreign persons. Further, the BEAT could apply to payments under a total loss-absorbing capacity ("TLAC") instrument which are instruments that U.S. regulations require global systematically important banking organizations ("GSIBs") to issue. In addition, the BEAT generally exempts certain derivative payments subject to a MTM regime but embedded interest payments are not eligible for such an exemption.

3. Oil & Gas Businesses. Subpart F income no longer includes foreign-base company oil related income. IRC § 954(a). Further, oil and gas exploration costs are not required to be capitalized and amortized over a fifteen-year period like R&D costs of other industries under IRC § 174.

4. Farming.

a. The TCJA repealed the requirement that property used in a farming business use the 150% declining balance method and provided for a five-year recovery period for machinery or equipment used in a farming business. Pub. L. No. 115-97, § 13203.

b. IRC § 461(j) limited the deductibility of excess farm losses for taxpayers other than C corporations if the taxpayer received certain farm subsidies. The TCJA suspended this specific limitation on excess farm losses in lieu of the new general limitation on excess business losses.

c. Ability to Elect Out of IRC § 163(j) Interest Limitation. A farming business that elects out of the IRC § 163(j) interest expense deduction limitation is required to use ADS to depreciate property with a recovery period of ten years or more. IRC §§ 163(j)(7)(C), 168(g)(1)(G); Pub. L. No. 115-97, §§ 13205, 13301.

d. NOL Two-Year Carryback Still Available. The elimination of the two-year NOL carryback does not apply to farming businesses. IRC § 172(b)(1)(B); Pub. L. No. 115-97, § 13302.

e. Specified Agricultural and Horticultural Cooperatives. The TCJA repealed IRC § 199, which provided a deduction for income attributable to domestic production activities. IRC § 199 was not limited to farming-related activities. A transition rule continues to apply to now-repealed IRC § 199 for qualified payments received by patrons from Farm Coops in taxable years beginning after December 31, 2017, if such payments are attributable to qualified production activities in taxable years beginning before January 1, 2018. Consolidated Appropriations Act of 2018, Pub. L. No. 115-141, Div. T., § 101(c) (2018).[23] Although IRC § 199A is also applicable to Farm Coops or their patrons, IRC § 199A provides for special rules for such taxpayers. *See* IRC § 199A(g). Further, the IRC § 199A deduction is not permitted when the IRC § 199 transition rule applies. Consolidated Appropriations Act of 2018, Div. T., § 101(c). For a more detailed discussion on the application of IRC § 199A to Farm Coops, *see* Section II.

5. Personal Services. The IRC § 199A deduction is not available to taxpayers with passthrough income from specified service businesses in the field of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services. IRC § 199A(d)(2)(A). Taxpayers with passthrough income from architecture and engineering service business are not subject to the exclusion from the IRC § 199A deduction because this type of business is not on the list of "specified service businesses." *See* Section II for more detail.

6. Auto Dealerships. The IRC § 163(j) limitation on interest deduction has special provisions for floor plan financing, which may affect the interest expenses paid by auto dealerships. IRC § 163(j)(1), (j)(9). Also, the application of the IRC § 168(k) bonus depreciation deduction to auto dealerships' qualifying property may have tax results that are different from those for taxpayers other than auto dealerships.

II. EFFECTIVE RATES – CONSIDERATIONS POST-TCJA

A. The New U.S. Federal Income Tax Rates.

1. Individual U.S. Federal Income Tax Rates.

a. Ordinary Income Tax Rates. Applicable after December 31, 2017, the TCJA resulted in a change to both the U.S. federal income tax rates and brackets. Starting in 2018, the income limits for all tax brackets and all filers will be adjusted for inflation and will be as provided below. The top marginal income tax rate of 37% will hit taxpayers with taxable income of $500,000 and higher for single filers and $600,000 and higher for married couples filing jointly. In all, seven tax rates apply for individuals: 10%, 12%, 22%, 24%, 32%, 35%, and 37%. Such rates are effective for tax years beginning after December 31, 2017, and before January 1, 2026. For calendar-year taxpayers (nearly all

[23] The full name of the enacted legislation is "An Act to amend the State Department Basic Authorities Act of 1956 to include severe forms of trafficking in persons within the definition of transnational organized crime for purposes of the rewards program of the Department of State, and for other purposes" (hereinafter, the "Consolidated Appropriations Act of 2018").

individuals), this means that the provisions are effective from 2018 through 2025. Subsequently, absent future legislative action, the individual rates will revert back to the 2017 rates.

Rate	For Unmarried Individuals	For Married Individuals Filing Joint Returns	For Heads of Households
10%	$0-$19,524	$0-$19,049	$0-$13,599
12%	$9,050-$38,699	$19,050-$77,399	$13,600-$51,799
22%	$38,700-$82,499	$77,400-$164,999	$51,800-$82,499
24%	$82,500-$157,499	$165,000-$314,000	$82,500-$157,499
32%	$157,500-$199,999	$315,000-$399,999	$157,500-$199,999
35%	$200,000-$499,999	$400,000-$599,999	$200,000-$499,999
37%	Over $499,999	Over $599,999	Over $499,999

b. Qualified Dividend and Capital Gain Tax Rates. The TCJA did not change the individual qualified dividend and capital gain tax brackets. The TCJA did, however, introduce the seven new tax brackets for ordinary income discussed above. As a result, qualified dividends and capital gains now have their own independent brackets.

Qualified Dividends & Capital Gains Tax Rates	For Single Filers	For Married Individuals Filing Joint Returns	For Heads of Households
0%	$0-$38,600	$0-77,200	$0-$51,700
15%	$38,601-$425,800	$77,201-$479,000	$51,701-$452,400
20%	Over $425,800	Over $479,000	Over $452,400

c. Treatment of Carried Interest.

(1) Prior Law. In general, a person receiving a partnership interest in exchange for services, often called a "carried interest" or "profits interest," is treated as a partner on receipt of the interest and, when the partnership recognizes a capital gain (for instance, if it sells a capital asset), the carried interest holder recognizes its distributive share of the partnership's capital gain. If the partnership holds a capital asset for more than one year before selling it, the gain from the sale generally is long-term capital gain, which flows through to the carried interest holder and is taxed at the preferential long-term capital gains rate for individuals (generally a maximum federal rate of 23.8%).

(2) Special Three-Year Holding Period Requirement for Carried Interests. The TCJA adds new IRC § 1061, which changes this treatment slightly by preventing a carried interest holder from receiving long-term capital gains from partnership sales of capital assets held for less than three years (or, potentially, from the interest holder's sale of the interest itself within three years of receipt). Two provisions appear intended to focus this rule on investment funds: (i) the call for regulations to be issued exempting assets "not held for portfolio investment on behalf of third-party investors"; and (ii) the new three-year requirement applies only to carried interests granted in certain investment-related businesses. *See* IRC § 1061(b), (c)(2). Several other exceptions can also apply, and the new provision contains a variety of technical rules and definitions. Importantly, the TCJA does not change the general U.S. federal income tax treatment of carried interests and in particular does not appear to alter the treatment of carried interests under IRC § 83 or to cause the grant of a carried interest to be treated as compensation for services issued by the partnership to an individual acting in a non-partner capacity under the rules of IRC § 707(a)(2)(A).

(3) Possible Impact on Investment Fund Managers. This change, which applies to taxable years beginning after December 31, 2017, will have varying impacts on fund managers

because of the business realities of the industries in which most carried interests are granted. Private equity fund managers will likely be less affected by this change because private equity funds routinely hold investments for longer than three years. Hedge funds managers whose funds invest in more liquid assets may have a harder time meeting the three-year-holding-period requirement. Generally, the change also does not apply to carried interests issued to executives and managers outside the investment fund industry.

d. Net Investment Income Tax on Certain Passive Income. IRC § 1411 generally imposes a 3.8% Medicare tax on net investment income ("NII") of U.S. individuals, trusts, and estates that have incomes above threshold amounts. IRC § 1411(a)(1). This tax does not apply to individuals who are neither residents nor citizens of the United States. IRC § 1411(e). NII is defined for this purpose to mean any income falling into one of the following three categories (net of allocable expenses):

(1) Income from interest, dividends, annuities, royalties, and rents, except when those items are derived in the ordinary course of a trade or business not described in Category 2 below;

(2) Other gross income derived in a trade or business involving trading in financial instruments or commodities, or from an active trade or business in which the taxpayer is passive (for example, income from the taxpayer's investment in a business activity in which he does not materially participate); and

(3) Net gain from the disposition of property, except when that property is held in a trade or business not described in Category 2 above. *See* IRC § 1411(c).[24]

2. Trust and Estate Income Tax Rates. The TCJA also provides, for tax years 2018 through 2025, a new table under IRC § 1(j)(2)(E) of ordinary income tax rates and thresholds for trusts and estates (subject to adjustment for inflation for years after 2018) as shown in the chart below.

Tax Rate	**Thresholds**
10%	$0-$2,550
24%	$2,551-$9,150
35%	$9,151-$12,500
37%	Over $12,500

The TCJA retains the preferential rates for qualified dividend and long-term capital gain income under IRC § 1(j)(5) but adjusts the thresholds as shown in the chart below.

Tax Rate	**Thresholds**
0%	$0-$2,600
15%	$2,601-$12,700
20%	Over $12,700

3. Corporate U.S. Federal Income Tax Rates.

a. Permanent Reduction from 35% to 21%. The TCJA reduces the corporate income tax rate, set forth in IRC § 11, from 35% to 21%, generally effective for taxable years beginning after December 31, 2017, and eliminates all brackets and graduated rates applicable to corporate income under prior law. The reduced corporate income tax rates, unlike those for individuals, trusts, and estates, are permanent (i.e., they do not sunset and revert back to the old higher corporate tax rates absent

[24] Gain from the sale or redemption of an interest in any entity that is treated as a partnership or S corporation for U.S. tax purposes will also be taken into account as NII to the extent of the net gain that is attributed to the partnership's or S corporation's assets as of the time of the sale or redemption. IRC § 1411(c)(4).

legislative action). The TCJA also repeals the separate tax rate applicable to personal service corporations.

b. Corporate AMT Repealed. The TCJA also repeals the corporate alternative minimum tax (the "AMT").

(1) Rationale for Repeal. The corporate AMT has generally applied to the extent a corporation's tentative minimum tax, based on a 20% rate, exceeds its regular tax, by reducing certain tax incentives and deductions. Such a repeal is consistent with historical policy concerns that had under-laid the corporate AMT, with its tax rate threshold of 20%, as such concerns have significantly eroded as a result of the top corporate tax rate reduction from 35% to 21%.

(2) Effective Date and Use of AMT Credits. The corporate AMT repeal is effective for taxable years beginning after December 31, 2017. Going forward, any corporate AMT credit (i.e., the corporation's prior AMT liabilities) may offset the regular tax liability for any taxable year after 2017. In addition, the AMT credit is refundable for any taxable year beginning after 2017 and before 2022 in an amount equal to 50% (100% for taxable years beginning in 2021) of the excess credit for the taxable year.

4. Rate Comparisons between C Corporations and Passthroughs.[25]

a. Comparison of Pre- and Post-TCJA Rates with No Distributions.

Business Entity	Pre-TCJA	Post-TCJA	Differential
PTE with only active income and no PTED	39.6%	37.0%	-2.6%
PTE with only passive income and no PTED	43.4%	40.8%	-2.6
PTE with only active income and full PTED	39.6%	29.6%	-10%
PTE with only passive income and full PTED	43.4%	33.4%	-10%
C corporation retaining all earnings (i.e., no distributions)	35.0%	21.0%	-14%

b. Comparison of Pre- and Post-TCJA with Distribution of All Earnings Annually.

	Active with no PTED	Passive with no PTED	Active with PTED	Passive with PTED	Active Post-2025	Passive Post-2025
FTE Rate	37.0%	40.8%	29.6%	33.4%	39.6%	43.4%
C Corporation Rate[26]	39.8%	39.8%	39.8%	39.8%	39.8%	39.8%
Differential	-2.8%	+1.0%	-10.2%	-6.4%	-0.2%	+3.6%

c. Summary Chart.

Domestic Owner	**Business Entity**

[25] As discussed below, IRC § 199A provides that certain income earned through a passthrough or fiscally-transparent entity (a "FTE") is eligible for a 20% deduction.
[26] This row assumes that the C corporation shareholder is an individual eligible for the IRC § 1(h)(11) reduced rate on qualifying dividends.

	Corporation		Passthrough
	Distribution	No Distribution	
Individual with PTED and IRC § 1(h)(11)	1) $100 @ 21% = $79 2) $79 @ 23.8% = **$60.20**	$100 @ 21% = **$79**	$100 @ 29.6% = **$70.40**
Individual without PTED, but with IRC § 1(h)(11)	1) $100 @ 21% = $79 2) $79 @ 23.8% = **$60.20**	$100 @ 21% = **$79**	$100 @ 37% = **$63**
Individual without PTED and IRC § 1(h)(11)	1) $100 @ 21% = $79 2) 79 @ 37% = **$49.77**	$100 @ 21% = **$79**	$100 v37% = **$63**
Corporation owning less than 20%	1) $100 @ 21% = $79 2) $79 – 50% DRD = $39.5 @ 21% = **$70.70**	$100 @ 21% = **$79**	$100 @ 21% = **$79**
Corporation owning 20% or more, but not IRC § 1504 Corporate Owner	1) $100 @ 21% = $79 2) $79 – 65% DRD = $27.65 @ 21% = **$73.19**	$100 at 21% = **$79**	$100 at 21% = **$79**
IRC § Corporate Owner	1) $100 @ 21% = $79 2) $79 – 100% DRD = $0 @ 21% = **$79**	$100 at 21% = **$79**	$100 at 21% = **$79**

5. Certain Passthrough Advantages. Certain entities not taxed as corporations still retain some advantages over corporations notwithstanding the lower corporate rate, however. As depicted in the charts above, depending upon on the structure, how quickly the business is expected to turn a profit, whether the business owners expect to make distributions of profits or reinvest them, and when the owners plan on selling the business, certain business owners operating through partnerships and sole proprietorships and shareholders of REITs would still be expected to have a lower cumulative U.S. federal income tax burden on most income than is earned at the entity level and then distributed or allocated.

6. Certain Corporate Advantages. If an investor does not plan to receive distributions during the life of an investment and instead pursues a "hold-and-sell" strategy, or if the PTED or REIT requirements cannot be met, holding an investment in corporate form may now be a more attractive structure than it previously had been.

B. <u>Qualifying for the IRC § 199A Deduction for Domestic QBI.</u>

a. Overview.

b. IRC § 199A provides for a deduction of up to 20% by non-C corporation taxpayers on certain domestically derived business income.

c. The deduction is not available for either W-2 wage income or income earned by C corporations.

d. Certain taxpayers' income otherwise eligible for the deduction, notwithstanding that their income exceeds a threshold amount, may be limited under IRC § 199A because of (i) the type of trade or business engaged in by the taxpayer, (ii) the amount of W-2 wages paid with respect to the trade or business, or (iii) the taxpayer's basis in certain assets relating to a qualifying trade or business immediately after such assets were acquired.

e. IRC § 199A also allows individuals and some trusts and estates up to a 20% deduction on their combined qualified REIT dividends ("QRDs") and qualified PTP income ("QPI"). Such income is not limited by W-2 wages or unadjusted basis in qualified property as described in Section II.B.6. below.

IRC § 199A Deduction: Income Levels and Limitations

	Most Service Businesses	**Other Businesses**
Taxable income less than $315,000 (married, joint return)	Deduction = 20% of QBI (see below for further refinements to the QBI deduction)	Deduction = 20% of QBI (see below for further refinements to the QBI deduction)
Taxable income greater than $415,000 (married, joint return)	No deduction	Deduction limited to the greater of wage limit or wage/asset basis limit
Taxable income greater than $315,000 but less than $415,000 (married, joint return)	Deduction phased out ratably for income between $315,000 and $415,000	Wage limit and wage/asset basis limit are phased in for income between $315,000 and $415,000

(For other taxpayers, the income phase-out ranges are $157,500 and $207,500)

2. High Level Calculation of the Deduction. The IRC § 199A deduction is the lesser of the taxpayer's (i) "*combined qualified business income amount*" or (ii) an amount equal to 20% of the excess (if any) of taxable income of the taxpayer for the taxable year over the net capital gain of the taxpayer for the taxable year.

a. Combined Qualified Business Income Amount Defined. Combined qualified business income amount is defined as an amount equal to (i) the sum of the amounts described in Section II.B.2.b. immediately below for each "qualified business income" ("QBI") carried on by the taxpayer, plus (ii) 20% of the aggregate amount of qualified REIT dividends and qualified PTP income of the taxpayer for the taxable year. IRC § 199A(b)(1). For the definition of, and further discussion on, QTB, see II.B.4. below.

b. Deductible Amount for each QTB. With respect to each QTB carried on by the taxpayer, an amount equal to the lesser of (a) 20% of the taxpayer's "qualified business income" ("QBI") with respect to each QTB or (b) the greater of (i) 50% of the W-2 wages with respect to the QTB *or* (ii) the sum of 25% of the W-2 wages with respect to the QTB plus 2.5% of the unadjusted basis immediately after acquisition ("UBIA") of all qualified property ((i) and (ii) collectively referred to as the "Wage Limitation," and (a) and (b) collectively referred to as the "QBI Component Calculation"). IRC § 199A(b)(2). For the definition of, and further discussion on, QBI, W-2 wages, and qualified property, *see* II.B.3., II.B.5., and II.B.6., respectively.

3. Qualified Business Income, Qualified REIT Dividends, and Qualified PTP Income.

a. QBI is defined as the net amount of qualified items of income, gain, deduction, and loss with respect to any QTB of the taxpayer (excluding any REIT dividends, qualified cooperative dividends, or PTP income). IRC § 199A(c); Prop. Treas. Reg. § 199A-1(b)(4).

(1) Such items must be effectively connected with the conduct of a U.S. trade or business and included or allowed in determining income for the taxable year. IRC § 199A(c)(3)(A); Prop. Treas. Reg. § 1.199A-3(b)(2).

(a) A U.S. partner of a partnership operating a trade or business in both the United States and a foreign country would only include items of income, gain, deduction, and loss effectively connected with a U.S. trade or business. Qualified Business Income Deduction, 83 Fed. Reg. 40884, 40892 (Aug. 16, 2018) (to be codified at 26 C.F.R pt 1).

(b) An S corporation shareholder engaged in a trade or business in both the United States and a foreign country would only take into account the items of income, gain, deduction, and loss effectively connected to the portion of the business conducted by the S corporation in the United States, determined by applying the principles of IRC § 864(c). Qualified Business Income Deduction, 83 Fed. Reg. at 40892 (Aug. 16, 2018).

(c) A nonresident alien is considered engaged in a U.S. trade or business if the partnership of which such individual is a member is so engaged. IRC § 875(1); Qualified Business Income Deduction, 83 Fed. Reg. at 40892.

(d) The following items are taken into account for purposes of computing QBI:

(e) IRC § 751 gain. Prop. Treas. Reg. § 1.199A-3(b)(1)(i).

(f) A partnership's deduction of guaranteed payments, an S corporation's deduction for reasonable compensation to a shareholder, and a partnership's deduction for payments described in IRC § 707(a) for services rendered by a partner with respect to a QTB provided, in each case, such items are properly allocable to QTB and otherwise deductible. Treas. Reg. § 1.199A-3(b)(1)(ii); Prop. Treas. Reg. § 1.199A-3(b)(2)(ii)(H).

(g) In general, IRC § 481 adjustments arising in taxable years ending after December 31, 2017. Prop. Treas. Reg. § 1.199A-3(b)(1)(iii).

(h) In general, previously disallowed losses or deductions allowed in the taxable year provided the disallowed loss or deduction occurred in a taxable year ending after December 31, 2017. Prop. Treas. Reg. § 1.199A-3(b)(1)(iv).

(i) NOLs disallowed under IRC § 461(*l*). Prop. Treas. Reg. § 1.199A-3(b)(1)(v).

(j) Patronage dividends. Prop. Treas. Reg. § 1.199A-3(b)(2)(ii)(B).

(k) Wage expenses regardless of whether the Wage Limitation applies. Prop. Treas. Reg. § 1.199A-3(b)(4).

(2) The following items are *not* taken into account for purposes of computing QBI:

(a) Income attributable to a guaranteed payment for the use of capital. Prop. Treas. Reg. § 1.199A-3(b)(1)(ii).

(b) NOLs other than NOLs disallowed under IRC § 461(*l*). Prop. Treas. Reg. § 1.199A-3(b)(1)(v).

(c) Capital gains and losses; dividends, income equivalent to a dividend, and payments in lieu of dividends described in IRC § 954(c)(1)(G); interest income not properly allocable to a QTB; gains and losses in commodity-related transactions and excess foreign currency gains; items of income related to notional principal contracts, amounts received from an annuity not received in connection with a QTB; qualified REIT dividends and PTP income; reasonable compensation received by an S corporation shareholder; and any payment described in IRC § 707(a) received by a partner for services rendered with respect to the QTB. Prop. Treas. Reg. § 1.199A-3(b)(2)(ii)(A)-(J).

(d) Allocation of Items among Multiple QTBs. Prop. Treas. Reg. § 1.199A-3(b)(2)(ii)(A). Regulations allow for the use of any reasonable method based on all facts and circumstances. Different methods for different items of income, gain, deduction, and loss permitted provided reasonable. Taxpayers must be *consistent* from one taxable year to the next.

b. Qualified REIT Dividends ("QRDs")

(1) QRDs is defined as any dividend from a REIT received during the taxable year which is not (i) a capital gain dividend as defined under IRC § 857(b)(3), and (ii) qualified dividend income as defined under IRC § 1(h)(11). IRC § 199A(e)(3); Prop. Treas. Reg. § 1.199A-3(c)(2)(i).

(2) Holding Period Requirement. REIT dividends are not qualified REIT dividends if the REIT stock has been held for less than forty-five days, taking into account the principles of IRC § 243(c)(3) (excluding the day of acquisition but including the day of disposition and turning off IRC § 1223) and IRC § 243(c)(4) (reducing the holding period for periods where the risk of loss is diminished). Prop. Treas. Reg. § 1.199A-3(c)(2)(ii).

c. Qualified PTP Income (QPI)

(1) QPI is defined as the sum of (i) the net amount of a taxpayer's allocable share of income, gain, deduction, and loss from a PTP as defined in IRC § 7704(b) that is not taxed as a corporation under IRC § 7704(c), plus (ii) any gain or loss attributable to PTP assets giving rise to ordinary income under IRC § 751(a) or (b) attributed to the PTP's trades or businesses. IRC § 199A(e)(5); Prop. Treas. Reg. § 1.199A-3(c)(3)(i).

(2) In determining a taxpayer's allocable share of income, gain, deduction, and loss from a PTP, the rules of Prop. Treas. Reg. § 1.199A-3(b) apply. Prop. Treas. Reg. § 1.199A-3(c)(3)(ii).

4. Qualified Trade or Business.

a. A QTB is any trade or business other than a specified service trade or business ("SSTB") or the trade or business of performing services as an employee. IRC § 199A(d)(1).

(1) "Trade or business" ("TB") is defined in the proposed regulations as an IRC § 162-TB other than the TB of performing services as an employee. Prop. Treas. Reg. § 1.199A-1(b)(12).

(2) No taxpayer may claim an IRC § 199A deduction for wage income, regardless of the amount of taxable income. Prop. Treas. Reg. § 1.199A-5(a)(3).

(3) Rental or licensing of tangible or intangible property that does not qualify as a TB under IRC § 162 is still treated as a TB for purposes of IRC § 199A, if the property is rented or licensed to a TB that is commonly controlled (i.e., 50% or more common ownership using limited family attribution) with the renter/licensor-TB. Prop. Treas. Reg. § 1.199A-1(b)(12).

b. Aggregation Rule.

(1) Prop. Treas. Reg. § 1.199A-4 provides rules to allow individuals to aggregate TBs, treating the aggregate as a single TB for purposes of the QBI Component Calculation.

(2) Taxpayer Election. Taxpayers may elect whether to aggregate TBs (or not) and which TBs to aggregate with other TBs (or not). Prop. Treas. Reg. § 1.199A-4(a). However, TB-ownership by family members under the Prop. Treas. Reg. § 1.199A-4(b)(3) attribution rules (i.e., attributing spouses, children, grandchildren, and parents) are treated as actually owned regardless of whether the taxpayer elects to apply the aggregation rule.

(3) Prop. Treas. Reg. § 1.199A-4(b)(1) provides that TBs may be aggregated provided ***all five*** of the following requirements are satisfied:

(a) The same person or persons, directly or indirectly, owns 50% or more of each TB to be aggregated (capital ***or*** profits interest for partnerships) (the "50%-Test") taking into account family attribution rules under Prop. Treas. Reg. § 1.199A-4(b)(3).

(b) The 50%-Test is satisfied for the majority of the taxable year.

(c) Each TB to be aggregated must be on the same taxable year excluding short years.

(d) None of the TBs to be aggregated is a SSTB.

(e) Based on all facts and circumstances, the to-be-aggregated TBs satisfy at least two of the following three factors: (i) TBs provide products or services that are the same or customarily offered together; (ii) TBs share facilities or share significant centralized business elements; and (iii) TBs are operated in coordination with, or reliance upon, one or more of the TBs in the would-be-aggregated group.

(4) Multiple owners of a TB are not required to aggregate in the same manner (or aggregate at all).

(5) If a taxpayer elected to aggregate two or more TBs, such TBs must be aggregated for purposes of computing QBI, W-2 wages, and UBIA of qualified property.

(6) Consistency Requirement. Once TBs are aggregated, they must remain aggregated for subsequent taxable years unless one or more of the aggregation rule's five requirements is no longer satisfied.

c. SSTBs.

(1) In general, if a TB is a SSTB, the IRC § 199A deduction is not available even if an item of income is derived from an activity that is not itself an ineligible service activity.

(2) The SSTB limitation does not apply to individuals with taxable income below the threshold amount as discussed in the chart accompanying Section II.B.1. above.

(3) Except for a *de minimis* rule, SSTBs include services in the fields of health; law; accounting; actuarial science; performing arts; consulting (including lobbying); athletics; financial services; brokerage services (excluding real estate agents and brokers and insurance agents and brokers); investing and investment management (excluding directly managing real property); trading; dealing in securities, partnership interests, or commodities; or any TB where the principal asset of the TB is the *reputation or skill* of its employees or owners (an "RSTB"). Prop. Treas. Reg. § 199A-5(b)(1).

(4) An RSTB includes income in exchange for: (i) endorsing a product; (ii) an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity; and (iii) appearing at an event or on any media format.

(5) *De Minimis Rule*. If the taxpayer has $25 million or less in gross receipts for a taxable year, a TB is not a SSTB if less than 10% (5% if greater than $25 million) of the TB's gross receipts are attributable to the performance of services in a field described in Prop. Treas. Reg. § 199A-5(c)(1).

(6) Anti-Abuse Rule. (Anti-crack-and-pack provision). An SSTB includes a TB that provides 80% or more of its property or services to a SSTB if there is 50% or more common ownership of the TBs (using the IRC § 267(b) and 707(b) relatedness rules). If the 80%-test is not satisfied, but the 50%-test is satisfied, the portion of the TB that provides property or services to the related SSTB is treated as a SSTB. Prop. Treas. Reg. § 1.199A-5(c)(2).

5. W-2 Wages.

a. W-2 wages means, with respect to any person, the amounts described in IRC § 6051(a)(3), (8) paid by such person with respect to employment of employees by such person during the taxable year ending during such taxable year. Prop. Treas. Reg. § 1.199A-2(b)(2).

b. W-2 wages must be allocated to the TBs that generated the respective wages. Prop. Treas. Reg. § 1.199A-2(b)(3).

6. UBIA of Qualified Property.

a. A TB's "qualified property" for a taxable year is IRC § 167(a) depreciable tangible property (i) which is held and available for use in the TB at the close of the taxable year, (ii) which is used at any point during the taxable year in the TB's production of QBI, **and** (iii) the depreciable period for which has not ended before the close of the individual's or RPE's taxable year. Prop. Treas. Reg. § 1.199A-2(c)(1)(i).

b. Improvements to qualified property are treated as separate qualified property. Prop. Treas. Reg. § 1.199A-2(c)(1)(ii).

c. Anti-Abuse Rule. Property otherwise treated as qualified property will not be so treated if it is acquired within sixty days of the end of the taxable year and disposed of within 120 days without having been used in the TB for at least forty-five days prior to the disposition, unless the taxpayer demonstrates that the principal purpose for the acquisition and disposition was not to increase the IRC § 199A deduction. Prop. Treas. Reg. § 1.199A-2(c)(1)(iv).

d. Anti-Abuse Authority not Reflected in Proposed IRC § 199A Regulations. IRC § 199A(h)(1) provides that "[t]he Secretary shall apply rules similar to the rules of under [IRC § 179(d)(2)] in order to prevent the manipulation of the depreciable period of qualified property using transactions between related parties." The proposed IRC § 199A regulations do not include any such rules.

7. Deduction for Farm Coops or Their Patrons. A deduction under IRC § 199A(g) is allowed for the domestic production income of Farm Coops. Farm Coops may elect to pass through this deduction to their members. IRC § 199A(g)(2)(A), (D).

a. The Farm Coop Deduction. Farm Coops are permitted a deduction equal to 9% of the lesser of qualified production activities income ("QPAI") or taxable income. IRC § 199A(g)(1).

b. The Patron Deduction. Patrons are permitted a deduction with respect to the portion of QPAI attributable to qualified payments from their Farm Coop, but Farm Coops are denied the 199A(g)-deduction if patrons take the deduction. IRC § 199A(g)(2)(C). The patrons, in essence, are eligible for the IRC § 199A deduction but are required to reduce their combined QBI by the lesser of (i) 9% of QBI property allocable to qualified payments from its Farm Coop and (ii) 50% of the W-2 wages allocable to such qualified payments. IRC § 199A(b)(7), (g)(2).

c. Oil-Related Farm Coops. IRC § 199A(g)(5)(E) reduces the amount of a Farm Coop's IRC § 199A deduction, where such cooperative has oil-related activities, by 3% of the lesser of (i) the oil-related QPAI for the taxable year, (ii) the QPAI of the Farm Coop for the taxable year, or (iii) its taxable income.

8. Application to Trusts, Estates, and Beneficiaries.

a. Non-Grantor Trusts and Estates: Hybrid Treatment. In general, a trust or estate is treated as an RPE to the extent that it allocates QBI and other items to its beneficiaries and as an individual to the extent that it retains QBI and other items. Prop. Treas. Reg. § 1.199A-6(d)(1). The threshold amount applicable to such trusts and estates is $157,500 (before taking into account any IRC § 651 or § 661 distribution deduction) for any taxable year beginning before 2019 (thereafter increased for cost of living adjustments). Prop. Treas. Reg. § 1.199A-6(d)(3)(iii).

b. Grantor Trusts. To the extent the grantor or another person is treated as owning all or part of a trust under IRC §§ 671-679, such person computes its IRC § 199A deduction as if he or she directly conducted the activities of the trust with respect to the portion of the trust treated as owned by the grantor or another person. Prop. Treas. Reg. § 1.199A-6(d)(2).

c. Anti-Abuse Rules.

(1) Trusts formed or funded with a significant purpose of receiving an IRC § 199A deduction will not be respected for purposes of IRC § 199A. Prop. Treas. Reg. § 1.199A-6(d)(3)(v). This anti-abuse rule applies to taxable years ending after December 22, 2017.

(2) Prop. Treas. Reg. § 1.643(f)-1 provides that for purposes of Title 26, chapter 1, subchapter J of the Code, two or more trusts will be aggregated and treated as a single trust if (i) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (ii) if a principal purpose for establishing such trusts or for contributing such cash or other property to such trusts is the avoidance of U.S. federal income tax. For purposes of this rule, spouses will be treated as one person. No other attribution rules appear to apply.

C. <u>IRC § 1202 "Small Business" Stock.</u>

1. Exclusion. Certain gain recognized by a non-corporate taxpayer on the sale or exchange of "qualified small business stock" held for more than five years may be excluded. *See* IRC § 1202.

2. Amount of Exclusion.

a. Percentage. Due to changes in the law, the percentage of gain excluded varies depending on when the stock was acquired.

(1) In the case of "qualified small business stock" acquired after September 27, 2010, 100% of the gain may be excluded. IRC § 1202(a)(4).

(2) In the case of "qualified small business stock" acquired after February 17, 2009, and on or before September 27, 2010, 75% of the gain may be excluded. IRC § 1202(a)(3).

(3) In the case of "qualified small business stock" acquired on or before February 17, 2009, 50% of the gain may be excluded. IRC § 1202(a).

b. Per-Issuer Cap. A per-issuer limitation applies on the gain from a single issuer that a taxpayer may exclude, equal to the greater of $10 million or ten times the adjusted bases of all qualified stock of the issuer that the taxpayer disposed of during the tax year. IRC § 1202(b).

3. Qualified Small Business Stock. Qualified small business stock is stock issued after August 10, 1993, in a "qualified small business" that is acquired by a noncorporate taxpayer at original issue (directly or through an underwriter) for money or property (other than stock) or as compensation for services (other than underwriting), provided that the issuing corporation did not buy any of its own stock from the taxpayer (or persons related to him) within the four years beginning two years before the issue date. IRC § 1202(c)(1), 1202(c)(3)(A). Stock is ineligible if the corporation, within the two years beginning one year before the issue date, redeems more than 5% by value of its stock. IRC § 1202(c)(3)(B).

4. Qualified Small Business. A domestic C corporation (other than certain excluded types of corporations) is a qualified small business if (i) the corporation's aggregate gross assets do not exceed $50 million at the time of issue and (ii) it is engaged in the active conduct of one or more qualified trades or businesses (i.e., any business other than certain professional service providers and other specified businesses). IRC § 1202(d), 1202(e).

III. CONSIDERATIONS OTHER THAN RATES POST-TCJA

A. Company's Plan to Distribute Profits.

1. Historical Perspective.

a. Pass-Through Entities. Owners of pass-through entities are taxed on their allocable shares of taxable income of such entities on a current basis, regardless of whether distributions are made. Accordingly, the operating agreements of pass-through entities generally provide for tax distributions to supply a means for owners of such entities to pay their tax liabilities in respect of taxable income attributable to their ownership of such entities.

b. C Corporations. Organizing as a C corporation was historically more attractive where there was an expectation that earnings would be reinvested rather than paid out to shareholders. Businesses considering this strategy also had to consider the potential applicability of certain regimes penalizing taxpayers for failing to distribute an adequate amount of earnings. *See* Section III.A.2. *infra*.

c. PFICs. Congress adopted the PFIC rules in 1986 because of concerns that U.S. persons were using foreign corporations both to avoid current taxation and to convert ordinary income into capital gains. Domestic shareholders of PFICs are by default subject to the "excess distribution" regime, requiring a domestic shareholder to include certain amounts in its gross ordinary income (possibly taxable at higher marginal tax rates) that would otherwise be taxable as dividends or capital gains at lower rates. In addition, there may be a punitive interest charge for prior deferral of taxable income to produce the economic equivalent of current taxation. *See* IRC § 1291. By making a qualified electing fund election ("a QEF election"), domestic shareholders may be able to mitigate some of these adverse consequences by including in income certain amounts currently (i.e., without deferral). A domestic shareholder that has a valid QEF election in place with respect to a PFIC is required to include in gross income, as ordinary income, its pro rata share of the ordinary earnings of the PFIC for that year, and as long-term capital gain, its pro rata share of the net capital gain of the PFIC for the year. *See* IRC §§ 1293-1295.

d. Foreign Personal Holding Companies. Congress adopted rules on foreign personal holding companies in 1937 but repealed these rules in 2004. IRC §§ 551-558, Pub. L. No. 108-

357, title IV, § 413(a)(1), 118 Stat. 1506 (repealed 2004). Congress was concerned that U.S. persons may form a foreign corporation to accumulate income and thereby avoid current U.S. taxes on the income. The rules on foreign personal holding companies limited the ability of U.S. persons to achieve that result. If those rules applied, U.S. persons that owned the stock of the foreign corporation would be required to pay current taxes on certain income of the foreign corporation, even if the corporation did not make any distributions.

2. Penalty Taxes on Undistributed Earnings Post-TCJA. The TCJA has substantially lowered the corporate tax rate and thereby widened the gap between the corporate and individual tax rates. This may further incentivize organizing as a C corporation with an intention to retain earnings. Taxpayers that do so should be wary of two penalty regimes that could result in adverse tax consequences to a corporation that fails to distribute dividends—the accumulated earnings tax and the personal holding company tax.

a. IRC § 532 Accumulated Earnings Tax.

(1) In General. The accumulated earnings tax (the "AET") applies to a domestic or foreign corporation "formed or availed of" for the purposes of avoiding income tax on its shareholders or the shareholders of any other corporation "by permitting earnings and profits to accumulate instead of being divided or distributed." IRC § 532(a). This tax is more likely to be imposed on (but not limited to) closely held corporations because it is easier to establish a tax avoidance purpose in that context.[27]

(2) Exceptions. The AET does not apply to personal holding companies, tax-exempt corporations, PFICs, and S corporations. IRC § 532(b). Also, the first $250,000 of any corporation's accumulated E&P are generally exempt (unless the corporation is a mere holding or investment company). IRC § 535(c).

(3) Burden of Proof. A corporation's unreasonable accumulation of E&P is "determinative" of the forbidden purpose, although the corporation may negate that proof by a preponderance of the evidence. IRC § 533(a). Generally, the Service has the burden of proving an unreasonable accumulation. That said, a corporation's being a "mere holding or investment company" is *prima facie* proof of the forbidden purpose. IRC § 533(b). A corporation can escape the AET by demonstrating that its earnings were retained for the reasonable needs of the business. IRC §§ 533(a), 537; *but see United States v. Donruss Co.*, 393 U.S. 297 (1969) (avoidance of tax "need not be the sole, dominant, controlling, or impelling motive; it is sufficient if it is one of the motives for the accumulation.").

(4) Reasonable Needs of the Business. As alluded to above, IRC § 533 excepts from AET accumulations for the "reasonable anticipated needs of the business." Treas. Reg. § 1.537-2 provides a non-exclusive list of acceptable reasons for accumulations. Some examples include business expansion, business acquisition, retirement of indebtedness, and the procurement of working capital.

(5) Consent Dividends. Corporations can avoid or reduce its AET by paying IRC § 565 "consent dividends." Reliance on consent dividends may be necessary as the Service has concluded that taxpayers remain subject to the AET notwithstanding that the corporation contains limited or no liquid assets. *See* CCA 201653017; *Network Systems Corp. v. United States*, 814 F. Supp. 778 (D. Minn. 1993) (court provided that "[w]hile accumulated E&P is often associated with large quantities of liquid assets, they are distinctly different concepts in taxation—the AET cannot be applied solely based on large accumulations of liquid assets, as the AET applies when E&P accumulates to excessive levels."). *But see Ivan Allen Co. v. United States*, 422 U.S. 617 (1975) (providing that "the 'business needs of a corporation are linked to and a function of the corporation's liquidity.").

(6) Computation of Tax. The amount of the penalty tax is currently 20% of the corporation's accumulated taxable income (i.e., taxable income with certain adjustments). IRC § 531.

b. IRC § 542 Personal Holding Company Regime.

(1) In General. The personal holding company tax is imposed on the "personal holding company income" of a personal holding company ("PHC"). IRC § 541. A PHC is a corporation if (i) more than 50% of the stock of such corporation is owned by no more than five individuals during

[27] Conference Committee Report to Pub. L. No. 98-369, H.R. Rep. No. 98-861 (1984) (Conf. Rep.).

the last half of the taxable year and (ii) at least 60% of the corporation's adjusted ordinary gross income for the taxable year at issue is personal holding company income. IRC § 542(a).

(2) Personal Holding Company Income.

(a) In General. Personal holding company income ("PHCI") is passive income, and consists of, subject to several exceptions, (i) dividends, interest, royalties, and annuities, (ii) rents, (iii) certain mineral, oil, and gas royalties, (iv) copyright royalties, (v) produced film rents, (vi) amounts received as compensation by certain shareholders for the use of, or the right to use, tangible property of a corporation, (vii) amounts received under a contract under which the corporation is to furnish personal services if some person other than the corporation has the right to designate the individual that is to perform the services, and (viii) amounts includible in computing the taxable income of the corporation from estates, trusts, and beneficiaries. IRC § 543(a).

(b) Subpart F Inclusions. An important exception, especially in light of the changes to the Code's international tax regime under the TCJA, to the inclusion of dividends was added to the Code in 2014 as new IRC § 543(a)(1)(C). The relatively new exception excludes dividends from CFCs to their IRC § 958 U.S. Shareholders from the definition of PHCI. Further, Treasury and the Service previously had issued guidance providing that the determination as to whether Subpart F inclusions under IRC § 951(a) are to be characterized as PHCI is determined under the so-called character-of-amount-passthrough concept (the "CAP concept"). *See* Treas. Reg. § 1.951-1(a)(3) (providing that "[f]or purposes of determining whether [an IRC § 958 U.S. Shareholder] which is a domestic corporation is a [PHC], . . . the character of the amount includible in gross income of such domestic corporation under [Reg. § 1.951-1(a)(3)] shall be determined as if such amount were realized directly by such corporation from the source from which it is realized by the [CFC]."); *see also* Rev. Rul. 76-403, 1976-2 C.B. 229. Under this concept, Subpart F income that does not satisfy the definition of PHCI (treating the CFC as a domestic corporation) should not be treated as PHCI to an IRC § 958 U.S. Shareholder when included under IRC § 951(a).

(c) IRC § 951A GILTI Inclusions. Unfortunately, Congress failed to include a reference to IRC § 543 in IRC § 951A(f)(1)(A) which provides that "any [GILTI] included in gross income under [IRC § 951A(a)] shall be treated in the same manner as an amount included under [IRC §] 951(a)(1)(A) for purposes of applying [certain other Code sections]." Further, the proposed IRC § 951A regulations do not formally expand the CAP concept to GILTI. Query whether IRC § 951A(f)(1)(B), which provides that "[t]he Secretary shall provide rules for the application of [IRC § 951A(f)(1)(A)] to other provisions of [Title 26] in any case in which the determination of [S]ubpart F income is required to be made at the level of the [CFC]," is self-executing, enabling taxpayers to rely on the CAP concept for purposes of exempting certain (or possibly all) GILTI inclusions under IRC § 951A from the definition of PHCI.

(3) Computation of Tax. The amount of the penalty tax is currently 20% of the corporation's undistributed PHCI (i.e., taxable income with certain adjustments). IRC §§ 541, 545.

B. <u>Use of Losses.</u>

1. Historical Perspective.

a. C Corporations. C corporations, in essence, trap losses such that a taxpayer is not able to offset past or future taxable income by carrying the NOLs back two years or forward twenty years as a deduction against income. However, if not useable within such time period, NOLs expire and disappear.

b. Partnerships and S Corporations. Partnerships and S corporations generally were not permitted to use an NOL. However, partners or S corporation shareholders could use their pro rata share of the partnership's or S corporation's business losses to offset income from other sources. Such losses were subject to the passive loss limitation regimes of IRC §§ 467 and 469.

2. Impact of New NOL Rules.

a. C corporations.

(1) NOLs Arising in Tax Years Post-December 31, 2017.

(a) Corporations may only offset 80% of their taxable income.

(b) NOLs may be carried forward indefinitely (previously limited to twenty years), but subject to specific exceptions, there is no carryback period (previously two years).

(c) The changes to carryback and carry forward provisions are effective for NOLs arising in tax years *ending* after December 31, 2017. The 80% limitation applies to NOLs arising in tax years *beginning* after December 31, 2017. The difference in effective dates was apparently a drafting error. It is unlikely that the Treasury has the authority to "fix" this mistake by regulations.

(d) As written, IRC § 172, as modified under the TCJA, provides that a fiscal-year taxpayer with a tax year ending after December 31, 2017 (for example, a retailer with a January 31, 2018 year-end) may not carry back NOLs arising in the February 1, 2017 to January 31, 2018 period and may not carry back NOLs arising in the same period that are specified liability losses for the ten-year period allowed under prior law.

(e) By contrast, a calendar-year taxpayer with a tax year ending December 31, 2017 *may* use the carryback and specified liability loss provisions arising in the January 1, 2017, to December 31, 2017, period. The same problem does not arise for the 80% limitation because this provision applies only to losses arising in tax years beginning after December 31, 2017.

(2) NOLs Arising in Tax Years Prior to January 1, 2018. NOLs existing prior to January 1, 2018 are governed by the pre-TCJA NOL rules, meaning NOLs may be carried back two years, may be carried forward for a maximum of twenty years, and there is no limit on the percentage of taxable income that may be offset by NOLs. This is true even if the NOL is utilized after 2017.

(a) Taxpayers must distinguish between NOLs arising prior to January 1, 2018, and NOLs arising after December 31, 2017, when computing NOL deductions.

(b) Taxpayers may consider changing taxable years in order to generate or expand NOLs for pre-2018 tax years.

(i) For fiscal year entities considering conversion to a calendar year, the effective date of the NOL provisions may be a relevant consideration. Note, however, that entities must obtain permission from the Service to change accounting periods and are required to show a valid business reason for doing so other than tax avoidance. Absent extenuating circumstances, a company that has changed its tax year may not do so again for ten years.[28]

(ii) Alternatively, there may be benefits to converting to cash, accrual, or hybrid accounting methods in order to maximize pre-2018 losses. Many businesses do not have the flexibility to choose between accounting methods. Most businesses that have inventory, for example, are required to use the accrual method, at least for sales and purchases, unless their average annual gross receipts do not exceed $25 million. *See* IRC § 471(c); Treas. Reg. § 1.446-1(c)(2). In addition, C corporations with average annual gross receipts over $25 million that are not personal service corporations generally must use the accrual method. *See* IRC § 448(b)(3), (c).

(iii) Consider the impact of an IRC § 481(a) adjustment.[29] Whether IRC § 481(a) adjustments are positive or negative determines the spread period for the adjustment. Taxpayers generally take a net negative IRC § 481(a) adjustment into account in the year of change, but take a net positive IRC § 481(a) adjustment into account over four years. The increase or decrease in net income, and the time period over which the IRC § 481(a) adjustment is accounted for, may impact NOL calculations.

(c) Example. A calendar year corporation generates a $200,000 NOL in 2018 followed by $100,000 of taxable income in 2019. The corporation can offset 80% of its 2019 taxable income with the 2018 NOL, leaving $20,000 of taxable income. The remaining $120,000 of the 2018 NOL may be carried forward indefinitely. If, under the same facts, the corporation also has a $100,000 NOL carryforward from 2017, the $100,000 of taxable income in 2019 may be fully offset by

[28] For taxpayers seeking to change accounting periods for reasons unrelated to tax planning, it may be worthwhile to bear in mind that new carryback and carryforward restrictions apply only to NOLs generated in taxable years ending after December 31, 2017 and structuring a new accounting period to maximize pre-2018 NOLs will provide more flexibility in utilizing NOLs in the future.

[29] A change in the method of accounting generally requires an adjustment under IRC § 481(a) to prevent duplication or omission of income or deductions when the taxpayer computes its taxable income under a method of accounting different from the method used to compute taxable income for the preceding taxable year. The adjustment may increase income (positive adjustment) or decrease income (negative adjustment).

the $100,000 NOL from 2017, and the $200,000 NOL from 2018 carries forward indefinitely to offset up to 80% of future taxable income in a given year.

(3) Capital Losses. The TCJA did not change capital loss carryforward or carryback rules. As under prior law, capital losses may be carried back two years and carried forward five years. Only capital gains can offset capital losses for purposes of calculating net losses.

(4) Certain Insurance Companies. Property and casualty insurance companies, but not life insurance companies, may carry back NOLs two years and carry forward NOLs twenty years following the tax year of the loss. IRC § 172(b)(1)(C). The 80% limitation under IRC § 172(a)(2) does not apply to such insurance companies. IRC § 172(f)(2).

(5) Exceptions for Farming Losses. Losses incurred in the trade or business of farming may be carried back two years (previously five years) and may be carried forward indefinitely. *See generally* IRC § 172(b)(1)(B). If the NOL consists of both farming and nonfarming losses, the two losses are treated separately. IRC § 172(b)(1)(B)(iii).

(6) Application of IRC §§ 381 and 382. IRC § 381 continues to apply to NOLs acquired in IRC § 332 liquidations and IRC § 368 asset reorganizations. IRC § 382 continues to apply to changes in corporate ownership of a loss corporation.

(7) Notable Provisions Repealed under the TCJA.

(a) IRC § 172(f) is repealed. Under prior law, IRC § 172(f) allowed a ten-year carryback of losses arising from specified liabilities. Specified liabilities included limited deductible expenditures for product liability, land reclamation, nuclear power plant decommissioning, dismantling of drilling platforms, remediation of environmental contamination, and workers' compensation payments.

(b) As discussed in more detail in Section II.A.3.b. above, the corporate AMT was revoked. Under the old corporate AMT, the NOL carryforward offset only 90% of AMT income, leaving 10% subject to the AMT.

(c) The corporate equity reduction transaction (or CERT) rules were also repealed.

(8) Implications and Opportunities.

(a) Challenges for Start-Ups. The new NOL provisions pose a particular threat to capital-intensive startups likely to incur heavy losses for several years before showing a profit. Companies in this category now face tax liability for a minimum of 20% of taxable income and may never fully realize the tax benefits of NOLs in the early years of the business. This is particularly likely where annual losses are substantial and margins in profitable years are slim. Although NOLs no longer expire after 20 years, the 80% limitation and the inability to carry back NOLs suggest that it frequently will take longer to fully utilize NOLs. In addition, when considering the time value of money, there is a substantial cost associated with the longer time frame necessary to realize the tax benefit of NOLs generated in a business's early years.

(b) Implications for Deferred Tax Assets. Under prior law, businesses could argue that loss carryforwards would expire before full utilization, thereby establishing valuation allowances or partially offsetting deferred tax assets. NOLs incurred pre-2018 may still expire, but NOLs incurred going forward will not. With indefinite carryforwards, businesses should consider whether it remains appropriate to maintain a valuation allowance to offset deferred tax assets associated with NOL carryforwards.

b. Passthrough Entities. Under IRC § 461(*l*), any excess business loss of taxpayers *other than C corporations* are disallowed in the current year. Generally, an excess business loss ("EBL") is a business loss exceeding $500,000 in the case of joint filers or $250,000 otherwise. An EBL above this amount is treated as part of the taxpayer's NOL carryforward to the following year. These NOL carryforwards are subject to the 80% limitation under IRC § 172.

(1) Historical Limits. Under prior law, business losses recognized by individuals could reduce nonbusiness income (such as salaries, fees, interest, dividends, and capital gains) without limitation. The effect of IRC § 461(*l*) is to limit the use of non-passive business losses in the year they are incurred.

(2) Temporary Provision. IRC § 461(*l*) is set to expire in 2026, applying only to tax years beginning after December 31, 2017, and before January 1, 2026. IRC § 461(*l*)(1).

(3) Partnerships and S Corporations. For partnerships and S corporations, the limitation on EBL applies at the partner or shareholder level. Each partner's distributive share or shareholder's pro rata share of items of income, gain, deduction, or loss of the partnership or S corporation is taken into account by the partner or shareholder in applying the EBL rules to the individual's tax year with or within which the partnership's or S corporation's tax year ends. IRC § 461(*l*)(4).

(4) Defining EBL. EBL for the taxable year is defined as the excess, if any, of: (i) the taxpayer's aggregate deductions for the taxable year attributable to trades or businesses of the taxpayer, determined without regard to whether or not such deductions are disallowed for such tax year under the EBL limitation over (ii) the sum of (a) the taxpayer's aggregate gross income or gain for the tax year attributable to trades or businesses, plus (b) $250,000, adjusted for inflation, or $500,000 in the case of a joint return.[30] IRC § 461(l)(3)(A).

(5) Ordering Rule. The EBL limitation is applied after the application of the following provisions limiting an individual taxpayer's ability to use business losses: (i) limitations based on an owner's tax basis in the entity (*see* IRC §§ 1366 and 704(d)); (ii) limitations based on "at-risk basis" (*see* IRC § 465); and (iii) limitations based on the passive activity rules (*see* IRC § 469). If a loss is disallowed under the passive activity loss rules, any deductions or income from that passive activity would not be considered in the determination of whether a taxpayer has an EBL. *See* IRC § 461(l)(6).

(6) Current uncertainties regarding how to define "business income" and "business losses" for IRC § 461(l) purposes.

(a) Wages and guaranteed payments from the business generating the losses are not clearly (albeit likely) considered non-business income.

(b) The treatment of above-the-line deductions associated with guaranteed payments and Schedule C income, including deductions for half of self-employment tax, self-employed health insurance, and qualified plan contributions.

(c) The treatment of above-the-line expenses allocable to a partnership or S corporation under Notice 89-35.[31]

(d) The treatment of interest income reported on Schedule B.

(e) Whether interest income reported on Schedule K, such as when a partnership earns nominal interest on its checking account, should be treated as business income or portfolio income.

(f) The treatment of itemized deductions.

(g) Permitted state and local tax deductions. Income taxes allocable to a trade or business are permitted.

(h) The treatment of ordinary gains and losses from the sale of "business assets."

(i) Gain or loss on the sale of the business itself.

(j) IRC § 751 hot assets. As IRC § 751 hot assets would otherwise generate ordinary business income, any gain on the sale of a partnership interest characterized as

[30] The $250,000 amount is adjusted for inflation for tax years beginning after December 31, 2018. The amount will be increased by $250,000 multiplied by the cost-of-living-adjustment determined under IRC § 1(f)(3) for the calendar year in which the tax year begins. If the increase is not a multiple of $1,000, then the increase is rounded to the nearest multiple of $1,000. IRC § 461(l)(3)(B).

[31] Notice 89-35 addresses the allocation of interest expense in connection with certain transactions involving FTEs and the allocation of interest expense on debt proceeds received in cash or deposited in an account. Notice 89-35 expands on Temp. Treas. Reg. § 1.163-8T of the Income Tax Regulations (T.D. 8145, 52 FR 24,996), which provides rules for allocating interest expense for purposes of applying the passive activity loss limitation in IRC § 469, the investment interest limitation in IRC § 163(d), and the personal interest limitation in IRC § 163(h).

ordinary business income under IRC § 751 should be treated as business income. The remaining capital gain or loss is currently an open question.

(k) IRC § 1231 gain. Although still unclear, *see* Section II.B. for possible analogous guidance.

(l) Capital gains and losses.

(7) Current uncertainty regarding whether the EBL rules apply to trusts and estates. Because trusts and estates generally compute taxable income in the same way as individuals, unless specifically directed otherwise, the EBL rules likely apply to trusts and estates.

(a) Simple trusts, complex trusts, and estates. The general rule likely applies, such that EBLs convert to NOLs usable by the trust or estate. Complications arise if the trust or estate incurs an EBL in its final year. Open issues include:

(b) Does the EBL disappear?

(c) Is the EBL treated as an NOL that succeeded to the property under IRC § 642(h)?[32]

(d) Does the EBL rule not apply in the final year? If yes, and the EBL is large enough to cause the trust to suffer a loss in its final year, it appears that the loss would be passed to the beneficiary under IRC § 642(h), becoming a miscellaneous itemized deduction disallowed between 2018 and 2025, such that the EBL disappears.

c. Implications for Choice of Entity.

(1) The new rules for utilizing business losses are less favorable to taxpayers than prior law—both for C corporations and noncorporate taxpayers. Changes to the use of losses under the TCJA likely impact the choice of entity determinations to a much lesser extent than do other changes, such as the reduction of the corporate tax rate and the availability of the IRC § 199A deduction.

(2) Passthrough entities regularly generating annual losses exceeding $500,000 (or $250,000, if not filing a joint return) may need to reconsider their tax structure in light of the limitations imposed by the EBL rules. Businesses may consider reorganizing to include both profit and loss centers in the same organization in an effort to keep net losses below the $500,000 or $250,000 cap. Businesses may also consider dividing partnership or S corporation businesses in order to keep net losses below the dollar limit, keeping in mind current anti-abuse provisions (e.g., IRC § 269(a)) as well as possible regulatory limitations in yet-to-be-promulgated regulations.

(3) Startups or other businesses organized as C corporations that had previously relied on zero income tax liability under the prior NOL rules may need to revisit budgeting or tax planning considerations in light of the changes to NOL treatment.

C. <u>Exit Strategy.</u>

1. Time Horizon for Exit.

a. As under prior law, the longer an individual intends to actively remain in the business, the more the IRC favors organizing as a corporation (taking advantage of the lower corporate rate for a longer period of time). The lower rate under the TCJA shortens the number of years necessary to realize the benefits of using the corporate form over a FTE.

b. Further, as discussed above, unlike the 21% corporate tax rate which is "permanent," the reduced individual tax rates, including the IRC § 199A 20% deduction, sunset at the end of 2025.

2. Exit Method.

[32] Treas. Reg. § 1.642(h)-1 provides that if, at the time of termination, a trust or an estate has an NOL carryover under IRC § 172 or a capital loss carryover under IRC § 1212, or has deductions in excess of gross income for the taxable year of termination, then the carryover or the excess may be allowed as a deduction to the beneficiaries succeeding to the property of the trust or estate. IRC § 642(h).

a. Sale of Business. In addition to not wanting to assume any target company liabilities, a potential buyer may pay a premium to purchase business assets over equity because the purchase of assets generates benefits such as the ability to depreciate and amortize the acquired assets.

(1) Partnerships. Generally, an asset sale can be accomplished more tax efficiently when the assets are held by a FTE because the gain is only subject to a single level of tax. In general, sellers of partnership interests pay tax at capital gains rates (except to the extent the IRC § 751 "hot assets" are sold, the gain on which is generally taxed at ordinary income tax rates). Further, the buyer can take a cost basis in the underlying partnership assets by making an IRC §§ 754 or 732(d) election providing for a step up in basis in the acquired assets.

(2) S Corporations. The sale of S corporation stock can be structured as an asset sale by making either an IRC § 336(e) or an IRC § 338(h)(10) election treating the sale of the stock as a deemed sale of the S corporation's assets, and such sales are generally only subject to one level of tax.

(3) C Corporations. As discussed above, the purchase of a C corporation's assets results in two levels of tax—a corporate level tax on the corporation's sale of the assets to the unrelated buyer and shareholder level tax treated as either a dividend or a sale or exchange depending upon various facts and circumstances. Although IRC §§ 336(e) and 338(g) elections may be available in certain circumstances, such elections mimic the asset sale treatment described in the previous sentence. *See* Section IV.C.4. *infra* for a discussion on the impact of making an IRC § 338(g) election on the sale of a CFC.

(4) IRC § 1202 Stock. As discussed above, another reason for possibly selecting classification as a C corporation over a FTE is the IRC § 1202 gain exclusion for "qualified small business stock," available only to certain C corporation shareholders. If all the requirements are satisfied, a shareholder can exclude up to 100% of the gain from the sale of the stock. This gain exclusion, in combination with the new, lower 21% corporate tax rate, may make the C corporation form attractive for certain businesses. That said, IRC § 1202 does not allow a purchaser to depreciate or amortize the purchase price in an asset sale because it applies to stock sales. Businesses susceptible to latent liabilities are less likely to benefit from IRC § 1202 because of asset sale prohibition.

b. Exit at Death (Estate Planning Considerations)

(1) The TCJA doubles the unified credit amount from $11M to $22M over which estates are taxed at 40% (a temporary provision until 2026).

(2) A flow-through entity may be a better vehicle for wealth accumulation and wealth transfer.

D. Historical Anti-Abuse Provisions.

1. Economic Substance Doctrine.

a. Case Law Origins. The courts have developed the economic substance doctrine as a means of denying tax benefits to taxpayers who enter into transactions that have no material substance beyond creating such tax benefits. *See*, *e.g.*, *Gregory v. Helvering*, 293 U.S. 465 (1935); *Knetsch v. United States*, 364 U.S. 361 (1960); *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); *Am. Elec. Power Co., Inc. v. United States*, 326 F.3d 737 (6th Cir. 2003); *ACM Partnership v. Comm'r*, 157 F.3d 231 (3d Cir. 1998).

b. Codification. In 2010, Congress codified certain aspects of the economic substance doctrine in IRC § 7701(o). Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409(a) (2010). IRC § 7701(o)(1) adopted a *conjunctive* test for determining whether a transaction possesses economic substance. Specifically, the test provides that in any transaction to which the economic substance doctrine is relevant, the transaction will be treated as having economic substance only if (i) the transaction changes in a meaningful way (apart from U.S. federal income tax effects) the taxpayer's economic position, and (ii) the taxpayer has a "substantial purpose" (apart from U.S. federal income tax effects) for entering into the transaction. IRC § 7701(o)(1). IRC § 7701(o) does not supersede the body of jurisprudence that has developed regarding economic substance, instead providing that the determination of whether the economic substance doctrine is relevant to a transaction must first be made as if IRC § 7701(o) had never been enacted. IRC § 7701(o)(5)(C).

c. "Basic Business Transactions" and the Elusive "Angel List." The legislative history provides that IRC § 7701(o) is not intended to alter the treatment of certain "basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages." H.R. Rep. No. 111-443, at 296. Included among the non-exclusive list of such "basic business transactions" are: (i) capitalizing a business with debt or equity; (ii) a U.S. person's decision to use a foreign or domestic corporation to make a foreign investment; (iii) choosing to enter into a transaction that constitutes a "corporate organization *or* a reorganization under subchapter C"; and (iv) using a related party in a transaction, provided the arm's length standard of IRC § 482 and other applicable concepts are satisfied. *See also* LB&I Directive 04-0711-015 (July 15, 2011).

(1) The Service has stated that it does not intend to issue any formal "angel list" of transactions that are exempted from IRC § 7701(o). *See* Notice 2010-62 at 412.

(2) The Service has also stated that it will not issue private letter rulings or determination letters regarding whether the economic substance doctrine is relevant or whether a particular transaction complies with the requirements of IRC § 7701(o). *See* Notice 2010-62 at 412; *see also* Rev. Proc. 2016-3 at § 3.02(1).

(3) When asked whether guidance would be forthcoming in light of tax reform as to the incorporation of a business to take advantage of lower corporate tax rates, Associate Chief Counsel, Corporate responded that, in their view, guidance was not needed.

2. IRC § 269(a) Acquisitions Made to Evade or Avoid Income Tax. IRC § 269(a) provides that:

(1) if any person or persons acquire, directly or indirectly, control of a corporation (at least 50% of the vote or value of its stock), or

(2) any corporation acquires, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation, and the principal purpose for the acquisition is the evasion or avoidance of federal income tax through securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Service may disallow the deduction, credit, or allowance.

a. Potential for Application?

(1) Transfer by a partnership of CFC stock to a domestic corporation to obtain a 50% deduction against IRC § 951A GILTI inclusions.

(2) Incorporation of a FTE (e.g., a partnership or a sole proprietorship) for the sole purpose of achieving the lower 21% corporate tax rates.

b. Limitations to Application. There is extensive authority to the effect that IRC § 269(a) does not apply to disallow benefits that are intended by Congress to be granted provided that specified requirements are met, and the result should be the same for benefits that are intended by the Service, through its regulations, to be granted provided that specified requirements are met.

(1) Service Guidance. Rev. Rul. 84-154, 1984-2 C.B. 61 (acquisition by newly organized holding corporation of all of the stock of target affiliated group where part of the plan was for target to pay a qualifying dividend to the holding corporation; 100% dividends received deduction allowed for the dividend and IRC § 269 not discussed); Rev. Rul. 76-363, 1976-2 C.B. 90 (IRC § 269(a) does not apply to the acquisition of control of an S corporation to secure Subchapter S benefits); Rev. Rul. 70-238, 1970-1 C.B. 61 (IRC § 269(a) does not apply to the acquisition of control of a Western Hemisphere Trade Corporation ("WHTC") to obtain WHTC benefits); Rev. Rul. 70-223, 1970-1 C.B. 79 (acquisition of control of target followed by merger of acquiring into target, rather than liquidation of target into acquiring, in order to preserve target tax attributes; preservation of tax attributes allowed and IRC § 269(a) not discussed).

(2) Judicial Authorities. *Supreme Investment Corp. v. United States.*, 468 F.2d 370 (5th Cir. 1972) (IRC § 269(a) does not apply to the acquisition of control of target followed by a liquidation of target in order to obtain a stepped up basis in target's assets without recognizing built-in gain in an installment note owned by target, as allowed by IRC §§ 334(b)(2) and 336 as then in effect);

Achiro v. Comm'r, 77 T.C. 881 (1981) (IRC § 269(a) does not apply to the organization of a corporation to obtain corporate retirement benefits); *Rocco, Inc. v. Comm'r*, 72 T.C. 140 (1979) (questioning whether IRC § 269(a) can apply to the acquisition of control of target in order to change accounting methods); *Modern Home Fire & Casualty Ins. Co. v. Comm'r*, 54 T.C. 839 (1970), *acq.*, 1970-2 C.B. xx (IRC § 269(a) does not apply to acquisition of control of an S corporation to secure Subchapter S benefits); *Alinco Life Ins. Co. v. United States*, 373 F.2d 226 (Cl. Ct. 1967) (IRC § 269(a) does not apply to the acquisition of control of a life insurance company in order to obtain the benefits of life insurance company taxation) (*dictum*); and *Siegel v. Comm'r*, 45 T.C. 566 (1966), *acq.*, 1966-2 C.B. 7 (IRC § 269(a) does not apply to the acquisition of control of a foreign corporation in order to obtain deferral of taxation of the corporation's income).

3. Partnership Anti-Abuse Rule. The partnership anti-abuse regulations promulgated under IRC § 701 (the "Partnership Anti-Abuse Regulations") provide that if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate tax liability in a manner that is inconsistent with the intent of Subchapter K, the Service can recharacterize the transaction for federal income tax purposes so as to achieve tax results that are consistent with the intent of Subchapter K, taking into account the applicable statutory and regulatory provisions and the pertinent facts and circumstances.

a. The Partnership Anti-Abuse Regulations provide that "even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Commissioner can determine, based on all the particular facts and circumstances, that to achieve tax results that are consistent with subchapter K—(1) the purported partnership should be disregarded . . . , (2) one or more of the purported partners of the partnership should not be treated as a partner, (3) the methods of accounting . . . should be adjusted to clearly reflect . . . income, (4) the partnership's items of income, gain, loss, deduction, or credit should be reallocated, or (5) the claimed tax treatment should otherwise be adjusted or modified." Treas. Reg. § 1.701-2(b).

b. The Partnership Anti-Abuse Regulations also provide that Subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. The Anti-Abuse Regulations articulate three requirements which the Treasury Department deems to be necessary in order for a transaction to comport with the intent of Subchapter K: (i) a partnership must be "bona fide" and each partnership transaction or series of related transactions must be entered into for a "substantial business purpose"; (ii) the form of each partnership transaction must be respected under substance over form principles; and (iii) the tax consequences under Subchapter K to each partner of partnership operations and of transactions between the partner and the partnership generally must "accurately reflect the partners' economic agreement and clearly reflect the partners' income." Treas. Reg. § 1.701-2(a).

E. Expensing and Bonus Depreciation Under IRC §§ 168(k) and 179.

1. Introduction.

a. Prior Law. IRC §§ 168(k) and 179 were both enacted to allow additional depreciation deductions for certain property in the year placed in service.

(1) Prior to the TCJA, IRC § 168(k) allowed an additional depreciation deduction (sometimes referred to as "bonus" depreciation) of 50% of the basis of certain types of depreciable property used in a trade or business, as long as taxpayers placed the property in service within a specified range of tax years. IRC § 168(k) also required that an asset's "original use" (i.e., the first use in which the property was employed, by any taxpayer) begin with the taxpayers depreciating the asset, subject to certain exceptions, including an exception for seller-lessees in sale-leaseback arrangements.

(2) Before passage of the TCJA, IRC § 179 allowed an additional deduction of up to $500,000 in the year in which eligible property was placed in service. The amount of that deduction phased out for taxpayers that placed more than $2,000,000 of such property in service during the taxable year, and was also capped at the taxable income derived by the taxpayer from any trade or business. Given these limitations, IRC § 179 has had limited utility.

b. Post-TCJA. The TCJA modified IRC §§ 168(k) and 179, as well as the modified accelerated cost recovery system ("MACRS") and ADS more broadly.

(1) The TCJA amended IRC § 168(k) to generally provide for 100% bonus depreciation for qualified property placed in service after September 27, 2017, and before January 1, 2023. Beginning in 2023, the percentage decreases 20% each year, and unless extended, IRC § 168(k) will sunset for property placed in service on or after January 1, 2027. The exception to the "original use" rule for sale-leaseback transactions was removed, and an important new exception was added allowing a deduction for used property acquired from unrelated parties by purchase.

(2) The TCJA also expanded the maximum deduction and phaseout thresholds under IRC § 179 to $1,000,000 and $2,500,000, respectively. Unlike the TCJA's modifications to IRC § 168(k), the increases to the IRC § 179 limitation amounts are not currently scheduled to sunset.

(3) In August 2018, Treasury released proposed regulations (the "Proposed EBD Regulations") which provide further guidance on IRC § 168(k) as modified by the TCJA. Additional First Year Depreciation Deduction, 83 Fed. Reg. 39292 (Aug. 8, 2018) (to be codified at 26 C.F.R. 1). Taxpayers may, at their election, rely on the Proposed EBD Regulations with respect to qualified IRC § 168(k) property acquired and placed in service after September 27, 2017, for tax years ending (i) on or after September 28, 2017, and (ii) before the taxpayer's taxable year that includes the date of the final regulations' adoption in the Federal Register. Prop. Treas. Reg. § 1.168(k)-2(g)(2)(i).

2. Post-TCJA IRC § 168(k). IRC § 168(k) in many cases provides a depreciation deduction equal to cost in the year qualified property is placed in service.

a. Qualified Property. "Qualified property" for purposes of IRC § 168(k) includes (i) property eligible for accelerated depreciation under IRC § 168 with a recovery period of twenty years or less; (ii) deductible computer software, as defined in IRC § 167(f)(1)(B); (iii) water utility property, as defined in IRC § 168(e)(5); and (iv) certain qualified film or television productions, and qualified live theatrical productions, as defined in IRC § 181(d) and (e), respectively. IRC § 168(k)(2)(A)(i). To qualify for IRC § 168(k), such property generally must be placed in service before January 1, 2027,[33] and either be originally used by the taxpayer, or satisfy the new exception to the original use rule for used property (described below). IRC § 168(k)(2)(A)(ii), (iii). For purposes of determining whether property has a recovery period of twenty years or less, the recovery period applicable for MACRS property under IRC § 168(c) is used. Treas. Reg. § 1.168(k)-1(b)(2)(i)(A); Prop. Treas. Reg. § 1.168(k)-2(b)(2)(i)(A).

b. Alternative Depreciation System. Certain property is excepted from accelerated depreciation under IRC § 168 and must be depreciated under ADS. IRC § 168(g). Property which must be depreciated under the ADS is ineligible for the IRC § 168(k) depreciation deduction. IRC § 168(k)(2)(D).

c. Acquisition Date. Depreciable property generally is eligible for a full IRC § 168(k) deduction under the TCJA,[34] but only if the property was acquired by the taxpayer after September 27, 2017,[35] or acquired pursuant to a written binding contract entered into by the taxpayer after September 27, 2017.[36] For self-created property, the taxpayer must begin manufacturing, constructing, or producing the property after September 27, 2017. Prop. Treas. Reg. § 1.168(k)-2(b)(5)(iv).

d. The "Original Use" Rule and Used Property.

(1) A property's original use is "the first use to which the property is put, whether or not that use corresponds to the use of the property by the taxpayer." Treas. Reg. § 1.168(k)-1(b)(3)(i); Prop. Treas. Reg. § 1.168(k)-2(b)(3)(ii)(A).

(2) Significantly, the TCJA modified the "original use" rule of IRC § 168(k) to allow certain previously used property to qualify for a deduction as well. IRC § 168(k)(2)(A)(ii), (E)(ii). To qualify, used property must be acquired in such a way as to satisfy the requirements to qualify as

[33] Longer production property is afforded an additional year to be placed in service (i.e., before January 1, 2028) in order to qualify for 100% bonus depreciation.
[34] Property acquired on or before September 27, 2017 can still qualify for a partial IRC § 168(k) deduction.
[35] There are a series of special rules in Prop. Treas. Reg. § 1.168(k)-2(b)(5), some of which arguably extend bonus depreciation to property acquired on or before September 27, 2017 (e.g., specified plants acquired on or before that date but grafted afterwards in a qualifying manner).
[36] Note that the Proposed EBD Regulations define the term "binding contract" for purposes of IRC § 168(k). *See* Prop. Treas. Reg. § 1.168(k)-2(b)(5)(iii).

"purchased" for IRC § 179 purposes (which requirements are discussed below) and must not have been used by the taxpayer at any time prior to the acquisition. IRC § 168(k)(2)(E)(ii).

(3) The Proposed EBD Regulations provide that if a taxpayer initially acquires a depreciable interest in a portion of IRC § 168(k)-eligible property and subsequently acquires an additional depreciable interest in the same property, the additional interest is not treated as having been previously used by the taxpayer. Prop. Treas. Reg. § 1.168(k)-2(b)(3)(iii)(B)(*2*). However, if a taxpayer holds a depreciable interest in a portion of the property, sells that portion, and subsequently acquires a depreciable interest in another portion of the same property, the taxpayer will be treated as previously having held a depreciable interest in the property up to the amount of the portion the taxpayer held prior to the sale. *Id*.

e. Placed in Service. For general depreciation purposes, property is first placed in service when first placed in a condition or state of readiness and availability for a specifically assigned function, whether in a profit-seeking activity or otherwise. Treas. Reg. § 1.167(a)-11(e)(1). Regulations clarify how to apply this rule to property depreciable under IRC § 168(k). Treas. Reg. § 1.168(k)-1(b)(5); Prop. Treas. Reg. § 1.168(k)-2(b)(4).

f. Series of Related Transactions. The Proposed EBD Regulations provide that for purposes of testing the acquisition of used property under IRC § 168(k)(2)(E)(ii), in the case of a "series of related transactions," a single transfer of property is treated as directly occurring between the original transferor and the ultimate transferee, and the relation between those two parties is tested immediately after the last transaction in the series. Prop. Treas. Reg. § 1.168(k)-2(b)(3)(iii)(C). The parties' related status is part of what determines whether used property is qualified property for purposes of bonus depreciation.

g. Opt-Out Election. Taxpayers may elect out of bonus depreciation under IRC § 168(k). Treas. Reg. § 1.168(k)-1(e); Prop. Treas. Reg. § 1.168(k)-2(e). Electing out could be beneficial for taxpayers with expiring credits in the year the eligible property is placed in service. Otherwise, in light of the changes to IRC § 172 providing for unlimited NOL carryforwards, taxpayers have less reason to opt out of IRC § 168(k) than they did prior to the TCJA.

3. Post-TCJA IRC § 179.

a. IRC § 179 Property. IRC § 179 property generally is any tangible property depreciated under MACRS or the accelerated cost recovery system (or certain computer software described in IRC § 197(e)(3)(A)(i)) that is IRC § 1245 property (or, at the taxpayer's election, qualified real property) and that is acquired by purchase for use in the taxpayer's active conduct of a trade or business.[37] IRC § 179(d)(1); Treas. Reg. § 1.179-4(a).

b. Purchase. For purposes of IRC § 179, "purchase" means any acquisition of property, but the property generally must (i) not have been acquired from a person whose relationship with the taxpayer is described in IRC § 267 (excluding siblings from the definition of family in IRC § 267(c)(4)) or IRC § 707(b); (ii) not have been acquired by one component member of a controlled group from another component member of the same controlled group; and (iii) not have a basis determined (a) by reference to the transferor's basis in the property, or (a) under IRC § 1014 (relating to property acquired from a decedent). IRC § 179(d)(2). For purposes of requirement (ii) above, "controlled group" has the same meaning as that term is given under IRC § 1563(a), except that a 50% threshold is used rather than the applicable 80% threshold. IRC § 179(d)(7). In addition, for purposes of determining the "cost" eligible for deduction under IRC § 179, the cost of property does not include so much of that property's basis as is determined by reference to the basis of other property held at any time by the acquiring taxpayer (e.g., where the property is received in a nonrecognition exchange). IRC § 179(d)(3). The requirements of IRC § 179(d)(2) and (3) are also used to determine whether used property is eligible for bonus depreciation. IRC § 168(k)(2)(E)(ii).

c. Placed in Service. Property is first placed in service when first placed in a condition or state of readiness and availability for a specifically assigned function, whether in a profit-seeking activity or otherwise. Treas. Reg. § 1.179-4(e).

d. Opt-In Election. Unlike IRC § 168(k), taxpayers must elect to apply IRC § 179 to IRC § 179 property. Treas. Reg. § 1.179-5.

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[37] Certain property described in IRC § 50(b) is excluded from this definition.

e. Ordering Rule. Where property is eligible for both IRC § 168(k) and IRC § 179, IRC § 179 is taken into account first. Treas. Reg. § 1.168(k)-1(a)(2)(iii).

4. Choice of Entity Considerations.

a. C Corporation Considerations.

(1) Earnings & Profits. Under the Proposed EBD Regulations, the IRC § 168(k) depreciation deduction is not taken into account in determining E&P. Prop. Treas. Reg. § 1.168(k)-2(f)(7).

(2) BEAT. "Base erosion payments" for purposes of the BEAT rules include payments to related foreign parties in connection with the acquisition from such parties of property eligible for depreciation (or amortization in lieu of depreciation). IRC § 59A(d)(2). If taxpayers do depreciate property so acquired, depreciation deductions taken with respect to such property are treated as "base erosion tax benefits" (which are added back to a taxpayer's income in determining its "modified taxable income," and thus may result in a taxpayer having a, or increasing its, BEAT liability). IRC § 59A(c)(2)(A)(ii). A "related party" for BEAT purposes generally means: (i) any 25%-owner (by vote or value) of the taxpayer; (ii) any person who is related within the meaning of IRC § 267(b) or 707(b)(1) to the taxpayer or any 25%-owner of the taxpayer; or (iii) any other person who is related within the meaning of IRC § 482 to the taxpayer. IRC § 59A(g)(1). It is thus possible that a taxpayer could be unrelated to a person for purposes of bonus depreciation eligibility but related to that person for BEAT purposes. For more detail about the BEAT, *see* Section IV.B.5. *infra*.

(3) IRC §§ 338 and 336(e) Elections. The Proposed EBD Regulations (following the government's interpretation of prior law) provide that property deemed to have been acquired by a new target corporation as a result of an IRC §§ 336(e) or 338 election will be considered acquired by purchase for purposes of IRC § 179. Prop. Treas. Reg. § 1.179-4(c)(2). Because IRC § 168(k) cross-references the "purchase" requirements under IRC § 179 to determine whether previously used property is eligible for IRC § 168(k), property treated as acquired by a new target corporation pursuant to an IRC § 336(e) or 338 election may be eligible for IRC § 168(k).

(4) FDII and GILTI. The FDII and GILTI provisions of the TCJA are calculated in part based on the "qualified business asset investment" of certain domestic corporations or CFCs, respectively, a concept which looks to the basis of certain tangible assets. IRC §§ 951A(d) and 250(b)(2)(B). IRC § 168 provides that tangible property used predominantly outside the United States must be depreciated using the ADS. IRC § 168(g)(1)(A). "Qualified property" for purposes of IRC § 168(k) does not include any property to which the ADS applies. IRC § 168(k)(2)(D). Consequently, IRC § 168(k) has no application to the types of property which could affect multinationals' FDII and GILTI planning. For more detail about FDII and GILTI, *see* Sections IV.B.3. and 4. *infra*.

(5) IRC § 382. IRC § 382 generally limits the use of NOL carryforwards following a change in control of a loss corporation. The amount of the IRC § 382 limitation can be modified due to recognition of built-in gains and losses in the assets of the loss corporation existing prior to its change in control. IRC § 382(h). Notice 2003-65 provides guidance in calculating some tax items for IRC § 382(h) purposes, and some of the calculation methods described in that Notice explicitly rely on depreciation deductions. However, in May 2018, Treasury released Notice 2018-30, 2018-21 IRB 610, which disregards IRC § 168(k) in making calculations under Notice 2003-65.

b. Consolidated Group Considerations.

(1) The Same Consolidated Group Rule. For purposes of determining whether a member of a consolidated group that acquires used property previously held a depreciable interest in the property that would prevent the member from taking a deduction under IRC § 168(k), the Proposed EBD Regulations treat the member as previously having held a depreciable interest in all property in which any current or previous member of the group had a depreciable interest while a member of the group. Prop. Treas. Reg. § 1.168(k)-2(b)(3)(iii)(B)(*3*)(*i*).

(2) The Inbound Consolidated Group Rule. If a member of a consolidated group acquires property and as part of a series of related transactions, a corporation that had a depreciable interest in the property becomes a member of the same consolidated group, the Proposed EBD Regulations prohibit the IRC § 168(k) deduction. Prop. Treas. Reg. § 1.168(k)-2(b)(3)(iii)(B)(*3*)(*ii*). The rationale for this rule appears to be that if the same consolidated group acquires a target corporation's assets as well as its stock, the transaction is similar to one in which the

target's stock is bought first and then the target's assets are transferred elsewhere within the group, in which case the target's historical property would not be eligible for bonus depreciation.

(3) The Outbound Consolidated Group Rule. If, in a series of related transactions, a member of a consolidated group acquires property, and the transferee of such property ceases to be a member of the consolidated group, whether the taxpayer is a member of the group is tested immediately after the last transaction in the series (the "Last Step Test"). Prop. Treas. Reg. § 1.168(k)-2(b)(3)(iii)(B)(*3*)(*iii*).

(4) The rules discussed in (1) through (3) above provide general consistency with a similar rule in the IRC § 338 regulations. Treas. Reg. § 1.338-3(b)(3)(ii)(C) provides, in the case of a series of transactions effected pursuant to an integrated plan to dispose of target stock, that relatedness is tested immediately after the last step of the series for purposes of determining if a "qualified stock purchase" has occurred. The Last Step Test seems to make clear that property which has already been held within a consolidated group may be treated as bonus depreciation-eligible in the hands of a transferee-member of that group, provided that member leaves the consolidated group as part of the same overall transaction. On the other hand, the Proposed EBD Regulations appear to foreclose bonus depreciation planning where the relevant assets will remain in the consolidated group. *See* Prop. Treas. Reg. § 1.168(k)-2(b)(3)(iii)(B)(3)(i).

c. Partnership Considerations.

(1) IRC § 704(c) Remedial Allocations, Distributed Property, and IRC § 734(b) Adjustments. The Proposed EBD Regulations provide that remedial allocations under IRC § 704(c) do not satisfy the "original use" or replacement use requirement to be eligible to use depreciation under IRC § 168(k). Prop. Treas. Reg. §§ 1.168(k)-2(b)(3)(iv)(A), 1.704-3(d)(2). The Proposed EBD Regulations reach the same conclusion with respect to any property whose basis is determined under IRC § 732 (property distributed by a partnership) and any basis increase in depreciable property under IRC § 734(b) (partnership property whose basis is adjusted as a result of a distribution to a partner). Prop. Treas. Reg. § 1.168(k)-2(b)(3)(iv)(B), (C).

(2) IRC § 743(b) Adjustments. In contrast, the Proposed EBD Regulations do allow basis adjustments under IRC § 743(b) to be depreciated under IRC § 168(k). Prop. Treas. Reg. § 1.168(k)-2(b)(3)(iv)(D). IRC § 743(b) provides for basis adjustments to partnership property when a partner sells its partnership interest, if the partnership has an IRC § 754 election in effect. Under the Proposed EBD Regulations, each partner of a partnership is treated as having a depreciable interest in the partner's proportionate share of partnership property. *Id.* IRC § 743(b) adjustments may be depreciated under IRC § 168(k) if (i) neither the transferee partner nor a predecessor thereof has ever had any depreciable interest in the portion of the property deemed to be acquired by the acquiring partner to which the IRC § 743(b) adjustment is allocated, and (ii) the transfer of the partnership interest that gave rise to the basis increase must otherwise satisfy the used property requirements described above. *Id.* Thus, even if a relatively small interest in the partnership is sold, an incoming partner (or existing partner purchasing the selling partner's interest) generally can receive the benefit of an IRC § 168(k) deduction. The preferential treatment of IRC § 743(b) adjustments (as compared to IRC § 734(b) adjustments) may influence the structure of a partner's departure from the partnership.

(3) Property Placed in Service and Contributed to Partnership in Same Year. Under existing law, when a taxpayer acquires and places property in service, and then contributes the property to a partnership in the same year, the IRC § 168(k) deduction is allocated between the taxpayer and the partnership according to the number of months within the year that each held the property. Treas. Reg. § 1.168(k)-1(f)(1)(iii). The Proposed EBD Regulations provide that in such a case, if any partner in the partnership previously held a depreciable interest in the contributed property, all of the IRC § 168(k) deduction is allocated to the transferor partner, rather than to the partnership, to avoid the possibility of any part of the deduction being allocated to the partner(s) that previously held a depreciable interest in the contributed property.

5. Comparison Points. If it is likely that one or more investors in a business may eventually buy out some of the other investors' interests, a partnership might be the most desirable vehicle from an IRC § 168(k) perspective. Regardless of what percentage of the underlying business the purchaser is buying, or whether the purchaser is already a partner, the purchaser may be able to deduct the relevant IRC § 743(b) adjustment immediately. If the contemplated business is expected to have several different investors who may exit the business at different times, a partnership may be the preferable vehicle, because it will not be necessary for 80% or more of the business to change hands (i.e.,

a qualified stock purchase as defined under IRC § 338) for a purchaser to become eligible for IRC § 168(k) depreciation. If no one shareholder will own at least 80% of the contemplated business, or if it is not expected that there will be an eventual sale to a third-party purchaser of at least 80% of the equity of the new business within a 12-month period, then IRC §§ 336(e) and 338 elections may not be available. In such situations, a partnership may be preferable.[38]

F. Limitations on Interest Deductibility under New IRC § 163(j).

1. Overview of Prior Law. In general, the pre-TCJA version of IRC § 163(j) ("Old IRC § 163(j)") limited the amount of interest expense a *domestic corporation* could deduct. For Old IRC § 163(j) to apply, each of the following four conditions had to be satisfied:

a. A domestic corporation or a U.S. branch of a foreign corporation had to pay interest to a related person, or to an unrelated person (such as a third-party bank) if there is a "disqualified guarantee" of the underlying debt;

b. The recipient of the interest must be exempt from U.S. tax on some portion of the income (or subject to a reduced rate of tax under a treaty);

c. The interest-paying corporation did not meet the debt-to-equity ratio safe harbor (i.e., 1.5 or less); and

d. The corporation's net interest expense had to exceed 50% of its adjusted taxable income plus any excess limitation carryforward.

2. Post-TCJA. The new iteration of IRC § 163(j) also limits the amount of business interest expense a taxpayer may deduct in a taxable year. However, the new version applies to taxpayers engaged in business in almost any form, with very limited exceptions. Unlike Old IRC § 163(j), which focused on debt between, or connected to, related parties, the new version generally applies to all business debt incurred by a taxpayer, including third-party debt. More specifically, IRC § 163(j) now limits a taxpayer's interest expense deductions to the sum of: (i) the taxpayer's ""business interest income for the taxable year, (ii) 30% of the taxpayer's "adjusted taxable income" for the tax year, and (iii) the taxpayer's "floor plan financing interest" for the tax year. IRC § 163(j)(1)(A)-(C).

a. Business Interest Income. Business interest income is the amount of interest income includible in gross income "properly allocable to a trade or business." Business interest income excludes investment income within the meaning of IRC § 163(d). IRC § 163(j)(6).

b. Adjusted Taxable Income. Adjusted Taxable Income ("ATI") is the taxable income of the taxpayer with certain adjustments as specified in IRC § 163(j)(8).

(1) EBITDA. ATI is similar to EBITDA until 2022. Until 2022, ATI *excludes*: (i) income and deduction items not related to the trade or business; (ii) any business interest and business interest income; (iii) any NOL that could offset taxable income; (iv) any deduction allowed under IRC § 199A; and (v) any deduction allowed for depreciation, amortization, or depletion.

(2) EBIT. After 2022, ATI becomes similar to EBIT as it will include deductions for depreciation, amortization, and depletion. Thus, the ATI calculation will result in a lower amount of ATI than pre-2022, and, accordingly, a smaller allowable interest expense deduction. It is important to note that most other foreign jurisdictions use a formula similar to EBITDA to calculate ATI for purposes of their respective interest expense deduction limitation provisions.

(3) Interaction with IRC § 199A. The permanent exclusion of the IRC § 199A deduction from the calculation of ATI benefits those taxpayers eligible for the IRC § 199A deduction. Such taxpayers are eligible for a 20% deduction of their taxable income, but that amount is added back to their ATI, providing them a higher allowable deduction under IRC § 163(j).

c. Floor Plan Financing Interest Expense. Floor plan financing interest expense ("FPFIE") is interest paid or accrued on indebtedness used to finance the acquisition of motor vehicles held for sale or lease and secured by the inventory acquired. A motor vehicle includes a self-propelled vehicle designed for transporting persons or property on a public street or highway, a boat, and farm machinery or equipment. IRC § 163(j)(9).

[38] *See* Section VI.C.1. *infra*.

d. Example of the General Operation of the IRC § 163(j) Limitation. Assume that, for 2018, Corporation X, a calendar year taxpayer, has $2,000 of business interest income, $100,000 of ATI, and $3,000 of floor plan financing interest. It has $40,000 of business interest expense. IRC § 163(j) limits X's business interest deduction to $35,000, the sum of its business interest income of $2,000, 30% of its ATI of $100,000 ($30,000), and its floor plan financing interest of $3,000. Thus, for the 2018 tax year, X can deduct $35,000 of its business interest expense and can carry forward the disallowed $5,000 to the 2019 taxable year.

3. Carryforward of Disallowed Interest Expense.

a. In General. As with disqualified interest under Old IRC § 163(j), current IRC § 163(j) provides that interest expense for which a deduction is disallowed can be carried forward and treated as business interest paid or accrued in the following tax year. IRC § 163(j)(2). IRC § 163(j) does not limit how far into the future the disallowed deduction can be carried forward.

b. Pre-TCJA Carryforward of Disqualified Interest. The new version of IRC § 163(j) is effective for taxable years beginning after December 31, 2017. Interim guidance from Treasury, Notice 2018-28, confirmed that a taxpayer with disqualified interest under Old IRC § 163(j)(1)(A) for the last taxable year beginning before January 1, 2018, may carry forward that interest as business interest to the taxpayer's first taxable year beginning after December 31, 2017.

4. Exemption for Certain Small Businesses. Qualifying small businesses are generally exempt from the IRC § 163(j) limitation. IRC § 163(j)(3). Thus, for a qualifying small business, none of its otherwise deductible interest expense will be limited under IRC § 163(j).

a. A business is a qualifying small business if it produces $25,000,000 or less in average annual gross receipts for the three taxable years preceding the current taxable year. IRC §§ 163(j)(3), 448(c).

b. Taxpayers cannot qualify for the small business exemption, however, by creating multiple entities that each independently satisfy the annual gross receipts limitation. Certain related parties must aggregate their receipts for purposes of measuring gross receipts. *See* IRC § 448(c)(2) (all persons treated as a single employer under IRC § 52(a) or (b) or IRC § 414(m) or (o) are treated as one person for purposes of IRC 448(c)(1)). This includes a controlled group of corporations under IRC § 52(a), employees of partnerships and proprietorships that are under common control under IRC § 52(b), affiliated service groups under IRC § 414(m), and any group falling under the catchall anti-avoidance provision in IRC § 414(o). Specifically, IRC § 414(o)(1) prevents the use of separate organizations to avoid taxation requirements.

5. Application to Partnerships. New IRC § 163(j)(4) contains special rules for partnerships—some follow the entity approach, and others follow the aggregate approach. Specifically, the limitation for partnerships is applied at the partnership level. To the extent that the partnership's business interest expense is less than the deduction limit, the partners may be entitled to use the excess limitation in determining their allowable deduction for their separate, non-partnership interest expense.

a. In General. Each partnership must determine its ATI and disallowed interest expense at the partnership level. IRC § 163(j)(4)(A)(i). If the partnership generates any disallowed interest expense, the expense must be carried forward at the partner level. IRC § 163(j)(4)(B)(i)(II). The disallowed interest expense will be treated as excess business interest which is allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership. IRC § 163(j)(4)(B)(i). Excess business interest can then offset certain "excess taxable income" generated *by the same partnership*. IRC § 163(j)(4)(B)(ii).

b. Excess Taxable Income. Excess taxable income ("ETI") is a partner-level attribute created when the partnership does not generate interest deductions at least equal to 30% of the partnership's ATI. IRC § 163(j)(4)(C). It equates to a percentage of ATI equivalent to the unused limitation divided by the total limitation.

(1) The ETI formula is:

$$\frac{(30\%\text{ of ATI}) - (\text{net interest expense, reduced by any FPFIE}) \quad \text{X} \quad \text{ATI}}{(30\%\text{ of ATI})}$$

(2) ETI can be used by a partner to absorb prior disallowed interest from the partnership or to increase the partner's partner-level ATI so that the partner can use partner-level interest deductions that might otherwise have been disallowed. *See* IRC § 163(j)(4)(B)(ii). Specifically, when a partner is allocated ETI from a partnership, the ETI is allocated to offset any previously disallowed excess interest expense from such partnership from prior tax years. If there is no disallowed interest expense from prior years (or if ETI exceeds the amount of disallowed interest expense from prior years), IRC § 163(j) does not provide that the unused ETI can be carried forward. However, the remaining ETI can be used to increase that partner's partner-level ATI.

c. Basis and Carryforward Rules. Special basis and carryforward rules apply for excess partnership interest expense disallowed under IRC § 163(j). The partner must reduce its basis in its partnership interest by the disallowed portion of interest expense. Immediately prior to the sale of its partnership interest, such partner would then increase its basis in such partnership interest. IRC § 163(j)(4)(B)(iii)(I). However, when a partner transfers partnership interests, disallowed interest deduction carryforwards will be canceled and converted into additional outside tax basis in the partner's partnership interests. IRC § 163(j)(4)(B)(iii)(II).

d. No Double Counting. Notice 2018-28 clarifies that forthcoming regulations will prevent "double counting" of income and expense items for purposes of the limitation. For example, Notice 2018-28 provides that partners may not include their share of a partnership's floor plan financing interest in the calculation of their annual business interest expense deduction limitation.

e. Partnership Example. Assume that a partnership has two partners who each own a 50% interest in the partnership. In 2018, the partnership generates $10,000 of disallowed interest expense. Each partner is allocated $5,000 of the disallowed interest expense and carries that amount forward to 2019. Each partner also reduces its adjusted basis in the partnership interest by $5,000. Assume that in 2019, the partnership is able to deduct its entire interest expense for 2019 and generates ETI of $20,000. Each partner is allocated $10,000 of the ETI. To use the ETI, each partner first applies the ETI to its share of the disallowed interest expense from 2018 (i.e., $5,000). The remaining $5,000 of ETI does not carry forward to 2020, but it can be used to increase each partner's individual ATI for 2019.

f. Practical Considerations and Open Issues for Partnerships.

(1) Participation in Multiple Partnerships. Taxpayers participating in multiple joint venture partnerships cannot use ETI from one venture to offset the excess partnership interest expense of another. Accordingly, taxpayers may consider consolidating multiple partnerships into one partnership, if certain partnerships are generating more interest expense than others.

(2) Basis Reduction. If a partnership has a disallowed interest expense, a partner must reduce its basis by its pro rata amount of that disallowed interest expense. This basis reduction may limit the partner's ability to receive tax-free cash distributions and other partnership deductions.

(3) Exit Strategy. IRC § 163(j)(4) prescribes the partner-level consequences of a disposition of a partnership interest. However, the provision does not detail the partner-level consequences if the partnership is terminated entirely.

(a) Disposition of a Partnership Interest. If partnership interests with a disallowed interest deduction carryforward are transferred or sold (whether or not the disposition is a nonrecognition transaction), such disallowed interest deduction carryforwards will be *permanently* disallowed and converted into outside basis in the transferred partnership interest. IRC § 163(j)(4)(B)(iii)(II).

(b) Terminating Partnerships. The carryforward rules are silent as to what happens when a partner terminates its interest in the partnership before utilizing the full amount of its excess business interest carryforward. It is not clear whether such carryforward remains a "personal" tax attribute thereby allowing the partner to continue to deduct it after the partnership terminates. Until Treasury issues relevant guidance on the issue, partners considering terminating their partnership should take note of this uncertainty.

(4) Tiered Partnerships. Without further regulatory guidance, it is unclear how IRC § 163(j)'s mechanics will apply to tiered partnerships, particularly depending on which tier has the business expense, and which tier has business income.

(5) Corporate partners. Notice 2018-28 provides that Treasury plans to issue regulations clarifying whether a corporation owning a partnership interest may have investment income under IRC § 163(d). Although currently unclear, it appears more likely that future regulations will recharacterize a C corporation's share of partnership investment interest as business interest, thus potentially subjecting corporate partners to the IRC § 163(j) limitation.

6. Application to S Corporations. S corporations will be treated similarly to partnerships for purposes of the limitation on interest deductions. Specifically, IRC § 163(j)(4)(D) provides that "[r]ules similar to the rules of [IRC § 163(j)(4)(A) and (C)] shall apply with respect to any S corporation and its shareholders." IRC § 163(j)(4)(D).

a. IRC § 163(j)(4)(A) provides that the limitation will be applied at the partnership level. IRC § 163(j)(4)(C) contains the formula for determining ETI after taking the limitation into account. Accordingly, for S corporations, like for partnerships, the interest deduction limitation is computed at the entity level, but any disallowed interest or ETI of the entity is allocated pro rata to each shareholder.

b. It is worth noting that IRC § 163(j)(4)(D) does *not* provide that rules similar to the rules of IRC § 163(j)(4)(B) shall apply to S corporations. IRC § 163(j)(4)(B) contains the carryforward and basis adjustment rules applicable to partnerships.

c. Regarding S corporations, Notice 2018-28 provides that (i) the rules for C corporations regarding business interest expense and income are not applicable to S corporations (i.e., S corporation interest expense and income are not automatically considered "properly allocable to a trade or business"), and (ii) rules similar to those on a partner's share of business interest income and floor plan financing will apply to S corporations and their shareholders (i.e., the "no double counting" rules will apply equally to partnerships and S corporations).

7. Trade-Specific Exemptions. The business interest limitation applies only to interest "properly allocable to a trade or business," but "trade or business" is not specifically defined within the provision. Rather, IRC § 163(j) contains a list of industries that are *excluded* from the definition of "trade or business." IRC § 163(j)(7).

a. "Trade or Business" Defined. The definition of "trade or business" under IRC § 163(j) does not include: (i) the trade or business of performing services as an employee (i.e., employee salaries are not included in ATI); (ii) any electing real property trade or business; (iii) any electing farming business; or (iv) regulated public utilities.

(1) Electing Real Property Trade or Business. "Electing real property trade or business" means "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business." *See* IRC §§ 163(j)(7)(B), 469(c)(7)(C). This definition includes a broad range of real property businesses, including REITs. Electing real property trade or businesses are required to use ADS for any nonresidential real property, residential rental property, and qualified improvement property. IRC § 163(j)(10)(A). Once a real property trade or business elects to be exempt from IRC § 163(j), the election is irrevocable. IRC § 163(j)(7)(B). Practically speaking, real property trades or businesses will almost always make the election as the reduced annual depreciation deductions from the marginal stretching of the lives of certain of its assets (and possible loss of bonus depreciation under IRC § 168(k)) will almost always pale in comparison to the disallowed interest expense deductions under IRC § 163(j) in light of the leverage typically found in the real estate industry.

(2) Electing Farming Business. "Electing farming business" means farming businesses as defined in IRC § 263(A)(e)(4) and specified agricultural or horticulture cooperatives as defined in IRC § 199A(g)(3). Electing farming businesses are required to use ADS for any property with a recovery period of 10 years or more. IRC § 163(j)(10)(B). Once a farming business elects to be exempt from IRC § 163(j), the election is irrevocable. IRC § 163(j)(7)(C).

(3) Regulated Public Utilities. A business qualifies under the exemption if it furnishes or sells (i) electrical energy, water or sewage disposal services, (ii) gas or steam through a local distribution system, or (iii) transportation of gas or steam by pipeline; and in each case the rates for the furnishing or sale are established by a public body. IRC § 163(j)(7)(A)(iv).

b. Taxpayers with Multiple Trades or Businesses. It is unclear without further Treasury guidance how a taxpayer with multiple lines of business should allocate its indebtedness in order to calculate its limitation under IRC § 163(j). Such guidance is expected.

c. Ineligibility for Bonus Depreciation under IRC § 168(k). Qualified property under IRC § 168(k) is eligible for bonus depreciation. *See generally* Section III.E. *supra* for a detailed discussion of IRC § 168(k) and bonus depreciation. Qualified property excludes any property primarily used in a trade or business described in IRC § 163(j)(7)(A)(iv). IRC § 168(k)(9)(A). Accordingly, any of the above defined businesses not subject to IRC § 163(j), whether by election or by status alone, is not entitled to bonus depreciation.

8. Choice of Entity Analysis and IRC § 163(j).

a. Multinational Corporations. As a result of IRC § 163(j) multinational corporations may find it attractive to restructure their borrowings more evenly on a global basis, rather than concentrate their debt in the United States. That said, several other factors may make such a restructuring challenging (e.g., foreign currency exchange exposure, the relative shallowness of the non-U.S. public debt markets, the European Commission's anti-tax avoidance directive, and the implementation of related Base Erosion and Profit Shifting initiatives by individual governments around the globe). Further, the new quasi-territorial U.S. tax system (i.e., the, albeit limited, participation exemption under new IRC § 245A) for foreign earnings may cause multinationals to revisit both the form of their cash pools (i.e., notional versus physical pooling) as well as the jurisdictional location of its members. With respect to the latter, although some global groups may attempt to establish the often elusive truly global cash including U.S. and non-U.S. members, Congress's failure to repeal IRC §956 may render such cash pools a bridge too far.

b. Closely-Held Businesses Subject to IRC § 163(j). Owners and their businesses should consider their debt-equity structure taking into account IRC § 163(j) and the relative tax rates of the owners and the business. An individual in the top tax bracket that loans to her business (other than a sole proprietorship) would pay tax at 40.8% (37% plus the 3.8% net investment income tax) on interest income. The benefit to the business would be only 21% if the business were taxed as a C corporation but would be 29.6% for a pass-through eligible for the 20% IRC § 199A deduction.

G. <u>Accounting Methods-Related Considerations.</u>

1. Cash vs. Accrual Method of Accounting. If a partnership that used the cash method of accounting converts to a C corporation and the business averages over $25 million in gross receipts, it may be required to convert to the accrual method of accounting and pick up income on its accounts receivable, unless it qualifies for an exception.

a. Prior Law. C corporations and partnerships with C-corporation partners were exempt from having to use an accrual method of accounting if their annual gross receipts were $5 million or less. The threshold that exempts certain taxpayers (C corporations and tax shelters) from the requirement to use the accrual method of accounting was increased under the tax reform bill from $5 million to $25 million. Exceptions are also made for farming businesses and qualified personal service corporations to the extent that their average annual gross receipts do not exceed $25 million. In general, partnerships with no corporate shareholders were permitted to use the cash method of accounting regardless of the amount of its gross receipts.

b. Current Law. For tax years beginning after December 31, 2017, the $5 million threshold under the prior law was increased to $25 million for C corporations and partnerships with C-corporation partners. Further, the $25 million limit is adjusted for inflation for tax years beginning after 2018. IRC § 448(a), (c). Exceptions are also made for farming businesses and qualified personal service corporations to the extent their average annual gross receipts do not exceed $25 million. In general, partnerships with no corporate shareholders are still permitted to use the cash method of accounting regardless of the amount of their gross receipts.

c. Changing from Accrual to Cash Method. Corporations and partnerships with C-corporation partners that are presently using the accrual method of accounting but now fall under the $25 million gross receipts threshold should consider filing an accounting method change to adopt to the cash method of accounting. Under prior guidance (Rev. Proc. 2017-30), such a change was not considered an automatic change. In May 2018, the Service issued Rev. Proc. 2018-31, 2018-22 IRB, which provides an updated list of accounting changes to which its automatic change procedures apply. In Section 15 of Rev. Proc. 2018-31, as modified by Rev. Proc. 2018-40, IRB 2018-34, the Service provides the

procedures by which certain taxpayers may obtain automatic consent to change their method of accounting to a new method established under the TCJA.

2. S Corporation Conversions to C Corporations. Under IRC § 481(d), any IRC § 481(a) adjustment of an eligible terminated S corporation attributable to the revocation of its S corporation election (i.e., a change from the cash method to an accrual method) is taken into account ratably during the six-taxable-year period beginning with the year of change. An eligible terminated S corporation is any C corporation which (i) was an S corporation the day before the enactment of the TCJA, (ii) during the two-year period beginning on the TCJA enactment date revokes its S corporation election under IRC § 1362(a), and (iii) all of the owners on the S corporation election revocation date are the same owners (and in identical proportions) as the owners on the TCJA enactment date. IRC § 481(d)(2). Taxpayers that satisfy the three requirements above may now spread the IRC § 481(a) adjustment ratably over six tax years, as opposed to four tax years, beginning with the year of the accounting method change. IRC § 481(d)(1).

IV. INTERNATIONAL TAX CONSIDERATIONS

A. Hybrid Entities and Payments.

1. Certain Payments Disregarded. Under IRC § 267A, interest or royalty payments to a related party (generally, "related" is defined as more than 50% ownership, directly or by attribution) are not deductible if made pursuant to a "hybrid transaction" or by or to a "hybrid entity" to the extent the recipient (i) does not include such amount in income under the tax law of the country in which it is a resident or is subject to tax, or (ii) may deduct such amount.

a. Hybrid Transaction. In a "hybrid transaction," the payment is treated as interest or a royalty for U.S. tax purposes, but not under the tax law of the country in which the recipient is resident or subject to tax.

b. Hybrid Entity. An entity is a "hybrid entity" if the recipient of the interest or royalty payment is fiscally transparent for U.S. tax purposes but not under the tax law of the country in which the entity is resident or subject to tax, or vice versa.

2. Hybrid Dividends. Under IRC § 245A, special rules apply to a dividend received by an IRC § 958 U.S. Shareholder from a CFC that would otherwise be entitled to the IRC § 245A participation exemption, when the CFC receives a deduction or other tax benefit. *See* IRC § 245A(e).

a. Participation Exemption Unavailable. The deduction under IRC § 245A(a) is denied for hybrid dividends.

b. Denial of Foreign Tax Credits. No foreign tax credit or deduction is allowed for any hybrid dividend received by, or any amount included in the gross income of, an IRC § 958 U.S. Shareholder even though the IRC § 245A participation exemption is unavailable.

c. Treatment as Subpart F Income. If a CFC receives a hybrid dividend from another CFC, the hybrid dividend is treated as Subpart F income of the receiving CFC. Any IRC § 958 U.S. Shareholder with respect to the CFC includes its pro rata share of the hybrid dividend in gross income.

3. IRC § 199A Deduction Generally Unavailable. As discussed above, IRC § 199A applies to all noncorporate taxpayers, whether such taxpayers are domestic or foreign. However, QBI includes items only to the extent they are effectively connected with the conduct of a trade or business within the United States. *See* IRC § 199A(c)(3)(A)(i); Prop. Treas. Reg. § 1.199A-3(b)(2)(i)(A). For a more detailed discussion on IRC § 199A, *see* Section II.B.

B. Overview of the Other Significant International-Related Changes under the TCJA.

1. IRC § 965 Transition Tax. IRC § 965(a) provides that for the last taxable year of a deferred foreign investment corporation (a "DFIC") that begins before January 1, 2018, the Subpart F income of the corporation is increased by the greater of (i) the accumulated post-1986 deferred foreign income of such corporation determined as of November 2, 2017, and (ii) the accumulated post-1986 deferred foreign income of such corporation determined as of December 31, 2017 (November 2 and December 31 each being an "E&P Measurement Date"). A DFIC is, with respect to an IRC § 958 U.S. Shareholder, any specified foreign corporation ("SFC") of the IRC § 958 U.S. Shareholder that has accumulated post-1986 deferred foreign income greater than zero on an E&P Measurement Date. *See*

IRC § 965(d)(1). An SFC is defined as a CFC or a foreign corporation of which one or more domestic corporations is an IRC § 958 U.S. Shareholder. An IRC § 958 U.S. Shareholder may offset the IRC § 965 inclusion with E&P deficits from CFCs and other foreign corporations with respect to which one or more domestic corporations is a U.S. shareholder (generally, 10% ownership, by vote or value). *See* IRC § 965(b). The tax is imposed at either a 15.5% or 8% rate, depending on the aggregate foreign cash position of the U.S. shareholder. IRC § 965(c). The liability under IRC § 965 may be paid in back-loaded installments over eight years, at the shareholder's election. *See* IRC § 965(h).

a. Corporations. For corporations that are IRC § 958 U.S. Shareholders, foreign tax credits are available under the general rules of IRC §§ 960 and 902 but only 55.7% or 77.1% of the amount of foreign taxes paid are credited, depending on whether the taxes were assessed on cash or non-cash earnings. *See* IRC § 965(g)(1). The IRC § 78 gross up for the foreign tax credits allowed under IRC § 965 applies but is likewise reduced. IRC § 965(g)(4).

b. Individuals. The rates described above are achieved through a partial participation exemption, (i.e., a deduction from gross income equal to the amount necessary for the IRC § 965 income to be taxed at a 15.5% or 8% rate, as applicable). IRC § 965(c)(1). However, the amount of the deduction is based on the corporate tax rate under IRC § 11, not the individual tax rate under IRC § 1. IRC 965(c)(2)(A). Accordingly, for individuals, IRC § 965 income may be taxed at rates higher than 15.5% or 8%, as applicable.[39]

c. Election to be Treated as a C Corporation.

(1) Election Generally. Under IRC § 962(a), an individual who is a U.S. shareholder of a CFC may elect to have his or her Subpart F income taxed at corporate income tax rates. However, under IRC § 962(d), when an actual distribution is made, the shareholder has gross income to the extent the distribution exceeds the tax he or she has previously paid on the distributed earnings.

(2) Relevance to IRC § 965. By making an IRC § 962 election, an individual shareholder may be (i) taxed on the IRC § 965 inclusion at the corporate tax rate, which may be lower than the individual's marginal tax rate and (ii) entitled to credits for a portion of foreign taxes paid on foreign earnings subject to IRC § 965. If an election is made, the gross income subject to tax at corporate rates is the amount included under IRC § 965(a), plus the gross-up under IRC § 78, over the deduction under IRC § 965(c). No other deductions are allowed. Prop. Treas. Reg. § 1.962-1(b)(1)(i)(B).

(3) Availability of Election. The IRC § 962 election may only be made by an individual (including a trust or estate) who is an IRC § 958 U.S. Shareholder with respect to a DFIC, including by reason of attribution under IRC § 958(b). Prop. Treas. Reg. § 1.962-2(a).

d. S Corp Shareholders. By election, shareholders of an S corporation that has income under IRC § 965 may defer their IRC § 965 liability. IRC § 965(i)(1). The shareholder must make the election to defer its IRC § 965 liability with respect to the S corporation on its tax return for the taxable year which includes the close of the applicable taxable year of the S corporation. *See* IRC § 965(i)(8).

(1) Triggering Event. The IRC § 965 liability is deferred for S corporation shareholders until a "triggering event" occurs, namely (i) the corporation ceases to be an S corporation, (ii) a liquidation or sale of substantially all the assets of the S corporation (or similar circumstances), or (iii) a transfer of the shareholder's stock in the S corporation, including by reason of death or othewise. IRC § 965(i)(2)(A). If the shareholder transfers less than all of his or her shares in the S corporation, the transfer is only a triggering event for the portion of the taxpayer's net tax liability with respect to the S corporation as is properly allocable to the transferred stock. *See* IRC § 965(i)(2)(B).

(2) Transferee Agreement. For any triggering event resulting from the disposition of the shareholder's stock in the S corporation, the shareholder can enter into a transfer agreement transferring the liability to the transferee. IRC § 965(i)(2)(C). The transferee must be a single United States person that is not a domestic pass-through entity. Prop. Treas. Reg. § 1.965-7(c)(3)(iv)(B)(1). The transfer agreement must be filed with the Service. Prop. Treas. Reg. § 1.965-

[39] In the proposed IRC § 965 regulations, Treasury and the Service decided not to provide an adjustment. The preamble to the proposed regulations explained that "this result was anticipated by Congress. . . . [I]ndividuals may make an election under [IRC §] 962." *See* Guidance Regarding the Transition Tax under [IRC §] 965 and Related Provisions, Reg-104226-18, 83 Fed. Reg. 39514, 39538 (Aug 9, 2018).

7(c)(3)(iv)(B)(2). The transferor remains jointly and severally liable for any unpaid amounts with respect to the IRC § 965 liability. Prop. Treas. Reg. § 1.965-7(c)(3)(iv)(D)(2).

(3) Installment Election. Upon the occurrence of a triggering event with respect to an S corporation, an S corporation shareholder may make an election under IRC § 965(h) to pay the IRC § 965 liability over eight years. *See* IRC § 965(i)(4).

(4) Affirmative Use of S Corporations. Will an individual's transfer of his or her stock in a non-calendar year specified foreign corporation to an S corporation followed by the making of an election under IRC § 965(i) be respected? Such a transaction may be subject to the anti-abuse rule contained in the proposed IRC § 965 regulations. *See* Prop. Treas. Reg. § 1.965-4(c).

2. The Participation Exemption. IRC § 245A implements the new territorial system ushered in under the TCJA and provides a 100% dividend received deduction for certain dividends. It is only available to *corporations* that are IRC § 958 U.S. Shareholders of the foreign corporation.

a. Requirements.

(1) In General. IRC § 245A provides for a deduction with respect to the foreign source-portion of a dividend received by a domestic corporation from an SFC.[40] An SFC does not include any foreign corporation which is a PFIC with respect to the IRC § 958 U.S. Shareholder and which is not also a CFC.[41]

(2) Foreign-Source Portion. The amount of the dividends received deduction allowed to a domestic corporation that is an IRC § 958 U.S. Shareholder under IRC § 245A is equal to the foreign-source portion of such dividend. The portion of the dividend treated as foreign-source is equal to the proportion of the SFC's undistributed foreign earnings relative to its total undistributed earnings.[42] The term "undistributed earnings" means the undistributed E&P (computed in accordance with IRC §§ 964(a) and 986) of the SFC as of the close of the taxable year in which the dividend in issue is distributed, without diminution by reason of dividends distributed during such taxable year.[43] "Undistributed foreign earnings" means the portion of the undistributed earnings which is attributable to neither (i) income of the SFC which is effectively connected with the conduct of a trade or business within the United States and subject to tax under Chapter 1 of the Code,[44] nor (ii) a dividend received (directly or through a wholly owned foreign corporation) from a domestic corporation at least 80% of the stock of which (by vote and value) is owned (directly or through such wholly owned foreign corporation) by the SFC.[45]

(3) Holding Period. No deduction is allowed under IRC § 245A in respect of any dividend on any stock unless that stock is held by the taxpayer for at least 366 continuous days during the 731 day period beginning on the date which is 365 days before the date on which such stock becomes ex-dividend with respect to such dividend.[46] For this purpose, the taxpayer is treated as holding the stock for any period only if (i) the payor of the dividend is an SFC at all times during the holding period, and (ii) the taxpayer is an IRC § 958 Shareholder with respect to such SFC at all times during the holding period.[47]

(4) Effective Date. IRC § 245A is applicable to distributions made after December 31, 2017.

b. Sales of CFCs. Any amount treated as a dividend under IRC § 1248 may be eligible for the participation exemption under IRC § 245A. IRC § 1248(j).

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[40] No credit under IRC § 901 or deduction is allowed for any taxes paid or accrued (or treated as paid or accrued) with respect to any dividend for which a deduction is allowed under IRC § 245A.
[41] IRC § 245A(b).
[42] IRC § 245A(c)(1).
[43] IRC § 245A(c)(3).
[44] IRC §§ 245(a)(5)(A), 245A(c)(3)(A).
[45] IRC §§ 245(a)(5)(B), 245A(c)(3)(B).
[46] IRC § 246(c)(5)(A). The concept of "ex-dividend" is relevant to publicly-traded shares and is determined under stock exchange rules. It generally refers to the period after which an acquirer of stock would no longer be entitled to receive a declared dividend of such stock.
[47] IRC § 246(c)(5)(B).

c. Hybrid Dividends. As discussed above, special rules apply to a dividend received by an IRC § 958 U.S. Shareholder from a CFC that would otherwise be entitled to the IRC § 245A participation exemption, when the CFC receives a deduction (or other tax benefit).

3. Global Intangible Low Tax Income. IRC § 951A imposes a tax on an IRC § 965 U.S. Shareholder on the "global intangible low tax income" ("GILTI") with respect to such IRC § 965 U.S. Shareholder's CFCs. IRC § 951A was enacted to provide a minimum tax on CFC income that exceeds a deemed return on tangible property.

a. Determination of GILTI. GILTI is determined on an IRC § 958 U.S. Shareholder by IRC § 958 U.S. Shareholder basis and for any taxable year is equal to a U.S. shareholder's "net CFC tested income" over its "net deemed tangible income return."

(1) "Net CFC Tested Income" is the IRC § 958 U.S. Shareholder's pro rata share of the "tested income" of each CFC over its pro rata share of the tested loss of each CFC. Tested income includes all income other than income effectively connected to a U.S. trade or business, Subpart F income, Subpart F income excluded under the high-tax exception (i.e., where the foreign tax rate is above 18.9%), foreign oil and gas income, and related person dividends, and is reduced by allocable deductions (including taxes). IRC § 951A(c).

(2) "Net deemed tangible income return" is a deemed 10% return applied to a U.S. shareholder's "qualified business asset investment" ("QBAI") (i.e., the average of the aggregate adjusted basis of depreciable tangible property used in a trade or business to produce tested income as of the end of each quarter (but only if held by tested income CFCs)) less interest expense taken into account in determining tested income to the extent not taken into account in determining an IRC § 958 U.S. Shareholder's net tested income. IRC § 951A(b)(2).

(3) GILTI is allocated among a IRC § 958 U.S. Shareholder's CFCs in proportion to its share of the aggregate tested income of the U.S. shareholder's CFCs. IRC § 951A(f)(2). It is generally included in gross income in the same manner as Subpart F income.

b. Corporate IRC § 958 U.S. Shareholders. Corporate IRC § 958 U.S. Shareholders are entitled to (i) the crediting of foreign taxes paid at the CFC level, but capped at 80%, and (ii) a reduced corporate rate, achieved through a deduction of 50% of the GILTI amount under IRC § 250, reduced to 37.5% for years beginning after 2025. As a result, where the foreign tax rate on GILTI is 13.125% or more, there would usually be no incremental U.S. tax paid by a corporate IRC § 958 U.S. Shareholder with respect to its GILTI (prior to taking into account the expense allocation rules of IRC § 861).

(1) Foreign Tax Credits. An IRC § 958 U.S. Shareholder that is a domestic corporation is deemed to have paid, for foreign tax credit purposes, foreign income taxes equal to 80% of the domestic corporation's inclusion percentage (the domestic corporation's GILTI over its aggregate tested income), multiplied by the aggregate tested foreign income taxes. IRC § 960(c). The IRC § 78 gross-up applies for 100% of the amount of deemed paid foreign income taxes. GILTI taxes are subject to a separate basket limitation and cannot be carried back or forward. IRC § 904(c), (d)(1)(A). It appears that foreign taxes paid by a tested loss CFC are not creditable. *See* H.R. Rep. No. 115-466, at 518 n. 1538 (2017) (Conf. Rep.).

(2) IRC § 250 Deduction. IRC § 250 provides a deduction equal to 50% of the GILTI amount, which is intended to reduce the effective U.S. tax rate on GILTI to 10.5% (increased to 13.125% after 2025). It is available only for domestic corporations but not REITs, RICs or S corporations. *See* H.R. Rep. No. 115-466, at 498. The deduction cannot exceed current taxable income.

c. Individual IRC § 958 U.S. Shareholders. The GILTI deduction does not apply to individuals, and individuals cannot claim foreign tax credits with respect to GILTI. Therefore, there is essentially a 37% deemed dividend tax on GILTI for U.S. shareholders that are individuals.

(1) IRC § 962 Election. The IRC § 962 election, discussed above, may be available, but it is unclear whether the IRC § 250 deduction is available to individuals making such an

election. Therefore, the benefit of the IRC § 962 election may be limited to reducing the statutory U.S. tax rate to 21% and the availability of 80% IRC § 960 foreign tax credits.[48]

(2) Net Investment Income. Under current regulations, inclusions under IRC § 951(a) are generally taken into account as net investment income. Treas. Reg. § 1.1411-10(b). It is currently unclear whether GILTI would be treated similarly.

d. IRC § 958 U.S. Shareholders that are Passthroughs. The GILTI deduction does not apply to FTEs, and FTEs also cannot claim foreign tax credits with respect to GILTI. Further, absent guidance, it is unclear whether a partner or shareholder of a FTE may make an IRC § 962 election with respect to a CFC if such person is not a direct IRC § 958 U.S. Shareholder.

4. Foreign Derived Intangible Income. IRC § 250 provides a deduction that reduces the U.S. tax rate to 13.125% for domestic *corporations* on foreign-derived intangible income ("FDII") from export sales and services. The reduced rate is achieved through a deduction of 37.5%, reduced to 21.875% (corresponding to a 16.406% rate) for years beginning after 2025. The deduction is limited to current taxable income. The FDII deduction is intended to avoid treating intangible income earned offshore more favorably than intangible income earned within the United States and, accordingly, provides a favorable rate to exports, leases, and licenses of intangible property outside the United States.

a. Requirements. The activity must be conducted in the United States (not in a foreign branch). Export sales (including licensing and rent) must be to a foreign (ultimately unrelated) purchaser and for foreign use, established to the satisfaction of the Secretary. Export services must be provided to a foreign person or with respect to foreign property.

b. Determination. FDII is equal to a deemed intangible income, multiplied by the ratio of foreign-derived deduction eligible income to deduction eligible income.

(1) "Deemed intangible income" is equal to the excess of a domestic corporation's deduction eligible income over 10% of the QBAI of the domestic corporation (similar to GILTI). IRC § 250(b)(2).

(2) "Deduction eligible income" is the excess of the domestic corporation's gross income (but excluding Subpart F income, GILTI, financial services income, dividends received from CFCs, domestic oil and gas extraction income, and foreign branch income), over deductions (including taxes) properly allocable to such gross income. IRC § 250(b)(3).

(3) "Foreign-derived deduction eligible income" is deduction eligible income derived in connection with property sold by the taxpayer to any person who is not a U.S. person for foreign use, or services provided by the taxpayer that are provided to any person, or with respect to property, located outside the United States. IRC § 250(b)(4).

c. Choice of Branch or CFC.

(1) Income from sales to CFCs is eligible, so long as property is ultimately sold by the CFC or used by the CFC in providing services to an unrelated foreign person. IRC § 250(b)(5)(C). Income from sales to foreign branches is not eligible, and it is currently unclear whether sales of products manufactured in the United States by a C corporation and sold to third-party customers through such C corporation's foreign branch engaged in business outside the United States are eligible. *See* IRC § 250(b)(3)(A)(i)(VI); *see also* IRC § 987 and the regulations thereunder (rules for determining the income attributable to a foreign branch).

d. Illegal Export Subsidy? FDII may face numerous challenges from foreign countries and other governing bodies as an illegal export subsidy under WTO rules. As a result, choice of entity planning is challenging in light of the potentially short-lived nature of the FDII deduction.

5. Base Erosion and Anti-Abuse Tax. New IRC § 59A imposes a base erosion and anti-abuse tax ("BEAT") on certain high-revenue *corporate* taxpayers. Generally, the tax is a 10% levy on the amount of deductible payments, or payments to purchase depreciable or amortizable property, made by the corporation to its non-U.S. affiliates. It only applies to (i) C corporations (not RICs, REITs, or S corporations) that are domestic corporations or otherwise taxable in the United States, (ii) that

[48] As of the date of publication, a proposed regulatory package that we anticipate will address whether the IRC § 250 deduction as it relates to GILTI is available for individuals making an IRC § 962 election, has not been published.

average $500 million of gross revenue over a three-year period, and (iii) have a "base erosion percentage" of 3% (or 2% in the case of certain financial institutions). In determining whether the gross receipts test is satisfied, all members of the IRC § 52(a) group (determined without the exception for foreign corporations) of which the tested corporation is a member are treated as a single person.

C. Recommended Structures Post-TCJA.

1. Considerations for Noncorporate IRC § 958 U.S. Shareholders. As described above, IRC § 958 U.S. Shareholders that are not C corporations are subject to harsher treatment under the new international regime. Therefore, where an individual owns CFC stock directly or through a partnership or S corporation, it may be prudent to convert the CFC into a partnership or a DRE (collectively, an "FTE") for U.S. federal income tax purposes. This foreign FTE may be structured as a disregarded branch or as a foreign partnership, with somewhat different consequences. Alternatively, it may be prudent to contribute the CFC stock to a new domestic C corporation that can act as a "blocker." Some of the relevant considerations include:

a. U.S. Tax Rate on GILTI. Where the CFC is held through a blocker C corporation, GILTI will generally be subject to a 10.5% U.S. federal income tax rate when earned (reduced by 80% of any available foreign tax credits) and then again, generally, at a 23.8% U.S. federal income tax rate when distributed by the blocker to the individual shareholder. Where the CFC is held by an individual (directly or through an FTE), GILTI will generally be subject to a 37% tax rate when earned without any foreign tax credits, and not taxed again when distributed. Finally, if the individual CFC shareholder makes an IRC § 962 election, the GILTI will be subject to tax at a 21% U.S. federal corporate income tax rate (reduced by 80% of any available foreign tax credits) and again at a *likely* 23.8% U.S. federal income tax rate when distributed to the individual shareholder.

b. U.S. Tax Rate on Foreign FTE. Conversely, where a U.S. individual operates the foreign activities through foreign FTEs (owned directly or indirectly through FTEs), the foreign earnings generally will be subject to tax at a 37% U.S. federal income tax rate with full foreign tax credits available and not taxed again when distributed.

c. Foreign Tax Rate. As described above, a key difference between CFCs and foreign FTEs is the availability of foreign tax credits. Therefore, if the foreign activities are subject to high foreign tax rates, an FTE structure is more likely to be efficient, as the high foreign tax will offset the 37% U.S. federal income tax.

d. Use of Losses. If the foreign activities are operated through an FTE structure, losses incurred by the FTEs may be used to offset domestic income (subject to the limitations described in Section III.B.), while the use of such losses is not permitted when operating through CFCs.

e. QBAI Return. If the foreign activities have significant QBAI, a CFC structure may be more efficient in order to benefit from the reduction in GILTI.

f. Subpart F Income. If a CFC earns mostly Subpart F income, the IRC § 250 deduction is of less significance. In other words, the TCJA may not have changed the relative benefits of CFC or foreign FTE classification for such operations.

g. Foreign Tax Credits. With the TCJA's modification of IRC § 904, foreign taxes imposed on CFCs are now in different baskets than foreign taxes imposed on foreign FTEs. Therefore, the availability of other income or excess foreign tax credits for cross-credit planning may significantly impact the choice between a foreign FTE or CFC structure.

h. Expense Allocation. The allocation of U.S. expenses (perhaps most importantly, interest, research and development, and stewardship expenses) to foreign income can reduce the ability to use foreign tax credits. Therefore, a domestic C corporation blocker with no expenses may be a more efficient holding structure for foreign operations where there are material allocable expenses elsewhere in the domestic structure.

i. Intercompany Payments. In a CFC structure, payments by the CFC to a U.S. person may qualify for reduced tax rates under the FDII rules if the recipient is a corporation or the IRC § 199A rules if the U.S. person is an individual (or an FTE with a U.S. individual owner). In either case, converting to a disregarded foreign branch structure may eliminate that benefit because the inbound payment will be disregarded and therefore not result in income eligible for the FDII or IRC § 199A deduction. Structuring may be necessary to ensure that the foreign branch is treated as a separate entity from the U.S. recipient in order to qualify for the FDII or IRC § 199A deductions, as applicable.

j. BEAT. Payments by a domestic C corporation to a CFC or regarded FTE may trigger BEAT liability, while payments to a disregarded foreign branch likely will not. Individuals and FTEs owned by individuals are not subject to the BEAT.

k. Distribution Timing. Although the adoption of the GILTI rules generally eliminated deferral available under prior law, placing CFCs in a domestic C corporation results in synthetic deferral. Foreign earnings are subject to tax at the blocker corporation level and taxed to the individual shareholders when distributed by the blocker corporation. Given the expense allocation concerns raised above, the blocker corporation is unlikely to have other activities in which to reinvest funds, essentially resulting in the same earnings lockout as existed under prior law.

2. Considerations for Corporate IRC § 958 U.S. Shareholders. Given that the 21% U.S. federal corporate income tax rate and expense allocation rules generally apply to both Subpart F inclusions and foreign branch or partnership income, the decision to operate foreign activities through CFCs or foreign FTEs should be reviewed. Although CFCs earning significant non-Subpart F income are likely to be more efficient remaining as CFCs due to the reduced GILTI tax rate, domestic corporations may have more flexibility to decide whether to operate foreign subsidiaries earning mostly Subpart F income or subject to effective foreign tax rates in excess of 21% as CFCs or FTEs. Many of the issues addressed above are also relevant to this analysis.

3. Classification of Lower-Tier CFCs. In addition to reviewing the holding structure for foreign activities, taxpayers using CFC structures should review whether to operate their foreign activities through multiple tiers of CFCs or as multiple FTEs underneath a single CFC.

a. Foreign Tax Credits. Foreign taxes paid by deficit CFCs generally cannot be credited against GILTI even if the CFC's IRC § 958 U.S. Shareholder has a net GILTI inclusion. Therefore, collapsing CFC structures into a single entity may permit credits for more foreign taxes paid.

b. Distribution Planning. Pre-TCJA, the taxation of inbound dividends meant that significant planning was required to permit return of basis distributions or distributions of high-tax earnings while keeping low-tax earnings underneath the distributing CFC. These strategies are no longer as relevant, so maintaining separate CFCs may be less important.

c. Hybrid Entities. A structure with a single CFC that owns foreign FTEs is likely to involve the use of hybrid entities because many foreign FTEs are not treated as fiscally transparent for all foreign tax purposes. As described above, IRC § 267A eliminates deductions for certain payments to hybrid entities. Although the contours of these rules are uncertain, electing to treat foreign subsidiaries as FTEs may increase the likelihood of deduction disallowances. Further, many foreign jurisdictions are implementing anti-hybrid rules that may also be implicated.

d. Jurisdiction of Formation. Several key exceptions to Subpart F are applied with reference to the jurisdiction of formation of the CFC. Collapsing CFCs into a single regarded corporation may impact the ability to qualify for one or more of these exceptions.

4. Foreign Derived Intangible Income. As described above, FDII deductions are only available to domestic C corporations. Conversely, IRC § 199A deductions are not available to C corporations.

a. Some types of activities could potentially qualify for either benefit, in which case the decision should be made whether to engage in the activity through a C corporation or FTE. In making this decision, the larger FDII deduction should be compared to the cost of the tax on dividend distributions by the domestic C corporation as it will not be possible to qualify for both the IRC § 250 FDII deduction *and* the IRC § 199A deduction.

b. Some income can only qualify for one benefit but not the other. Income from sales to U.S. customers can qualify for IRC § 199A but not FDII. Conversely, income from foreign sales where there are no U.S. activities can qualify for FDII in situations where IRC § 199A would be unavailable. Further, FDII is not subject to the wage cap imposed on IRC § 199A deductions.

5. Sales of CFCs.

a. IRC § 338(g) Elections.

(1) Prior Law. Under prior law, when a U.S. acquirer would purchase a foreign target corporation, the U.S. acquirer would usually make an election under IRC § 338(g). An IRC

§ 338(g) election, as discussed above, is generally available for taxable acquisitions of corporations from unrelated parties, and causes the target to be treated for U.S. tax purposes as having sold all of its assets to a new corporation and liquidated. The tax attributes of the target corporation are eliminated, and it receives a step-up in the basis of its assets to fair market value. In the case of a foreign target corporation, unlike a domestic corporation, the deemed asset sale frequently was not subject to U.S. taxation under prior law. Under prior law, the benefits of an IRC § 338(g) election for a foreign target usually outweighed the costs, and so such elections were frequently made as a routine matter. The elimination of tax attributes, in particular E&P and foreign taxes paid, would permit the acquirer to determine the character of future distributions and related foreign tax credits more easily. In addition, the step-up in basis would permit additional amortization and depreciation deductions, which would reduce Subpart F income and, subject to significant limitations, possibly permit the parent to utilize more excess foreign tax credits than if the election had not been made. Finally, the election would eliminate the risk that a purchaser would be required to include Subpart F income earned in the pre-acquisition period. However, the previously tax income ("PTI") accounts and foreign taxes paid would be lost, and any U.S. property of the foreign target subject to the grandfather exception to IRC § 956 would lose grandfather status for certain assets acquired before the corporation became a CFC. (IRC § 956 generally provides that a CFC is deemed to make a distribution to its U.S. shareholders to the extent of its investments in certain U.S. property). In addition, a U.S. seller could have recognized additional Subpart F income, depending on the nature of the target's assets, which generally would be offset by reduced gain on the sale, converting capital gain (subject to a reduced rate of tax for individuals) into ordinary income.

(2) Current Law. Under current law, these benefits and costs are significantly different, so acquirers will need to reconsider the utility of IRC § 338(g) elections.

(a) Upper-Tier CFC Selling Lower-Tier CFC.

(i) Participation Exemption. The new participation exemption under IRC § 245A means that distributions out of the foreign E&P of the foreign target corporation will not be subject to tax, and further eliminates the availability of foreign tax credits for the foreign E&P. Therefore, retaining untaxed E&P of a foreign target corporation may be beneficial to the acquirer.

(ii) Investments in U.S. Property. Foreign taxes paid will still be relevant to the extent that the foreign corporation makes an investment in U.S. property subject to IRC § 956. Where the untaxed E&P of a foreign target was subject to sufficiently high foreign taxes, it may be beneficial for an acquirer to cause the target corporation to invest in U.S. property.

(iii) Previously Taxed Income Accounts. Foreign subsidiaries of U.S. companies will normally have significant PTI accounts, and the elimination of those accounts may be undesirable.

(iv) Subpart F, GILTI and QBAI. The step-up in asset basis also presents new considerations. The increased depreciation and amortization deductions may reduce the amount of Subpart F income and GILTI generated by the foreign corporation. Further, the increase in asset basis may increase the QBAI. Similarly, the elimination of grandfather status for U.S. property for purposes of IRC § 956 may be less significant of a cost, given that many CFCs will have limited or no income other than GILTI or Subpart F income.

(b) U.S. Corporation Selling First-Tier CFC. The consequences of an IRC § 338(g) election on a U.S. corporate seller of a first-tier CFC are significantly different. All gain recognized by the first-tier CFC in the deemed asset sale generally will be GILTI subject to tax at 50% of the normal corporate rate, unless the income would otherwise be Subpart F income or is sheltered by the QBAI. The GILTI inclusion likely will increase the seller's basis in the CFC stock, potentially replacing the entire amount of gain on the sale with a lower-taxed GILTI inclusion. However, it may also replace gain that is untaxed by reason of the IRC § 245A participation exemption with a taxable GILTI inclusion.[49]

b. Check-and-Sell Transactions. In addition to IRC § 338(g) elections, another common acquisition structure was the check-and-sell transaction.

[49] N.B. In the case of an individual seller, however, the election may convert low-taxed capital gain into high-taxed ordinary income.

(1) Prior Law. Gain recognized by a CFC on the sale of stock generally is Subpart F income but gain on the sale of business assets generally is not. Therefore, sellers would frequently elect to treat the CFC subsidiaries of CFC sellers as disregarded entities immediately prior to the sale to cause the sale to be treated as a sale of business assets not subject to current U.S. tax.

(2) Current Law. Under current law, although the same check-and-sell transaction would reduce Subpart F income, gain from the sale of business assets would generally be GILTI and subject to current U.S. tax. The reduced U.S. rate may be beneficial for corporate U.S. shareholders of CFC sellers, depending on the relevant foreign tax rate, but the GILTI inclusion may change the desirability of such structures.

c. Check-and-Sell vs. IRC 338(g) Election Alternatives. Where a CFC sells a lower-tier CFC to an unrelated buyer, the seller generally can choose between a check-and-sell transaction or requesting that the buyer make an IRC § 338(g) election. From the buyer's perspective both alternatives are treated as asset purchases, with generally the same consequences. The seller, however, may not be indifferent between the two alternatives. Although many of these considerations existed under prior law, the implications of these considerations under the current international tax regime may be quite different.

(1) Sales at a Gain. In the check-and-sell alternative, the gain or loss from the asset sale is included in the determination of income—and therefore GILTI and Subpart F income—of the CFC seller, while an IRC § 338(g) election causes those amounts to be recognized by the CFC target. The results of these alternatives under the rules for offsetting income and deductions and claiming foreign tax credits may be materially different. For example, if the target or seller has significant deficits in the year of the sale, those deficits could reduce GILTI generated on the sale, which, as discussed above, could result in the U.S. shareholder being unable to claim credits for foreign taxes imposed on the sale. This may not be relevant in cases where the seller is a CFC that benefits from a participation exemption under local law.

(2) Sales at a Loss. Where the sale is at a loss, such loss could offset GILTI otherwise generated in the year, similarly preventing the U.S. shareholder's ability to credit allocable foreign taxes. Further, different rules apply for using CFC losses to offset Subpart F income depending on whether the losses and income are considered earned by the same CFC. These and other considerations should be reviewed when determining the structure for the disposition of a lower-tier CFC.

V. STATE AND LOCAL TAX CONSIDERATIONS POST-TCJA.

A. Limitation on State and Local Tax Deduction.

C corporations may fully deduct state and local taxes under IRC § 162, as may the non-corporate owners of flow-through entities if such taxes are paid or accrued in carrying on a trade or business or in an activity engaged in for the production of income. The TCJA, however, imposes a $10,000 limitation on state and local tax deductions in computing federal taxable income for individuals. The benefit of receiving a full deduction at the corporate level must be weighed against the impact of the double taxation of corporate earnings.

B. Possible Entity-Level Tax on FTEs.

Connecticut now imposes a tax at the entity level for FTEs. New York is considering similar legislation.

C. Franchise/Net Worth Taxes.

Certain states impose franchise or net worth taxes solely on corporations (i.e., FTEs are typically exempt from such tax regimes).

D. S Corporation to C Corporation Conversions.

S corporation to C corporation conversions may have unanticipated state and local tax consequences depending on the jurisdiction.

1. Income Recharacterization Concerns. Some states, for example, do not have an individual income tax but do have a corporate income tax. If shareholder-employees increase their

compensation to eliminate the corporate income tax, depending upon the type of business and other factors, they may incur more U.S. federal income tax than they save in state taxes.

2. Jurisdictional Sourcing Differences. For the sourcing of service revenue, different states use different methods for C corporations and FTEs. For example, some states use the costs-of-performance method (i.e., sourced based where services performed) for both C corporations and FTEs while other states use market-based sourcing (i.e., sourced based on customer location) for C corporations but not for FTEs. As a result, more than 100% of a business's income could be subject to tax—possibly 200% if work is performed in one state and all of the customers are in another state subjecting the business to state tax on 200% of its income.

3. Possible Side Effects of the IRC § 199A Deduction. FTEs may be inclined to begin hiring their own employees instead of independent contractors in order to receive the benefits of IRC § 199A. A possible negative side effect of such hiring may be the creation of income tax nexus in additional states to the extent such employees live in states outside the business's state(s) of operation. This, in turn, could result in increased state income tax filing requirements and related compliance costs, state tax liabilities at the entity level, and state tax liabilities for the owners that will not be deductible at the entity level.

4. State Treatment of the IRC § 965 Transition Tax. For corporate taxpayers, if the deemed IRC § 965 inclusion amount is included in their state taxable income, questions arise as to whether it will be eligible for the state's dividends-received deduction. In certain states, such as New York, corporations are not subject to the deemed dividend regime of Subpart F and thus, are likewise not subject to the IRC § 965 transition tax. *See* S. 7509-C/A 9509-C (2018) (New York's 2018-2019 budget bill (the "NYBB") clarifying that E&P subject to the IRC§ 965 transition tax are "exempt CFC income," and therefore are not subject to New York State or City corporate tax). Individuals (including partnerships and S corporations), however, are subject to the tax. *See* Important Notice N-18-4 (N.Y.S. Dep't of Taxation & Fin., Apr. 2018) (providing that individuals (including S corporations) are subject to the IRC § 965 transition tax and, unlike for U.S. federal income tax purposes, individuals are not eligible to make the IRC § 965(h) installment election and S corporations are not eligible to make the IRC§ 965(i) deferral election). Query whether individual New York residents are eligible to make an IRC § 962 election and, if so, whether such an election would convert deferred foreign earnings otherwise subject to New York State tax under IRC § 965 into "exempt CFC income"? Other states, such as California, have decided not to conform to IRC § 965. That said, U.S. taxpayers with untaxed foreign earnings may have a large taxable repatriation dividend for California state tax purposes should they distribute foreign earnings to their U.S. shareholders.

5. State Treatment of GILTI. States will need to decide whether to follow IRC § 951A and the new GILTI regime, and if so, whether to modify the treatment for state and local tax purposes. In New York, for example, the NYBB is silent as to GILTI. As a result, GILTI and the IRC §250 deduction are taken into account in the determination of New York State and City taxable income. The NYBB also limits the subtraction modifications related to IRC §78 gross-up amounts to dividends not deducted under IRC §250.

6. State Treatment of the FDII Deduction. States will need to decide whether the IRC § 250 deduction for FDII will be available for state and local tax purposes. For example, the NYBB provides that the deduction is disallowed for purposes of computing New York State and City taxable income.

7. State Treatment of the IRC §163(j) Interest Deduction Limitation. States will need to decide whether they will conform to the IRC § 163(j) interest expense limitation and how the limitation would apply at a state level.

VI. POSSIBLE CHOICE OF ENTITY RELATED PLANNING OPPORTUNITIES.

A. C Corporation to S Corporation Conversion.

One possible approach post-TCJA is an attempt to have one's cake and eat it too—that is, to elect C corporation status for federal income tax purposes to conduct the taxpayers' business to take advantage of the 21% corporate rate (assuming there is not an intention to make significant distributions for the short and medium term) and then convert the C corporation from an S corporation (assuming the corporation satisfies the Subchapter S requirements) when there is a sense that a sale of the business is about five years away. Such an approach obviously requires the owners and their advisors to be able to

time their exit a half decade in advance. It is also worth noting that the initial years of a business frequently generate NOLs. The C corporation form generally is not efficient as such NOLs are trapped at the C corporation level—deferred until the corporation turns a profit (if ever)—whereas the FTE structure allows such NOLs to be used by the venture's owners currently to offset other income (subject to certain limitations many of which are discussed above).

B. Ownership Structure.

1. Special Allocations? Another possible approach is to elect partnership status for U.S. federal income tax purposes whereby the partnership is owned by a combination of individuals, S corporations, and C corporations while having the partnership allocate its capital and income streams to the partners in an effort to the maximize the benefits of lower tax rates (e.g., possibly allocating the U.S. source, IRC § 199A eligible income to the individuals and S corporation partners while allocating FDII-qualifying earnings along with Subpart F and GILTI inclusions to C corporation partners to take advantage of the IRC § 250 deduction and the generally lower corporate rates). Such a structure, however, would require the special allocations to have substantial economic effect under IRC § 704(b) and the regulations thereunder—a potential hurdle that will frequently be too high assuming that the partners wish to share proportionately in the profits and losses of each line of business (as opposed to tracking interests). Further, such a structure could run afoul of any of the above discussed anti-abuse rules including the Partnership Anti-Abuse Regulations. A related, possibly more feasible, strategy also could entail reclassifying all lower-tier CFCs as disregarded entities to possibly increase the availability of foreign tax credits while eliminating multiple levels of taxation. Further, such a structure could help defer minority partners' federal income tax on entry while providing them possible liquidity on exit by including an up-C mechanism whereby C corporation and non-C corporation partners would contribute appreciated assets to the partnership whereby the non-C corporation partners would receive partnership interests possessing the right to exchange such interests for new issuances of the C corporation partner's stock at some later date. Under such a structure, the non-C corporation partners would continue to benefit from the IRC § 199A deduction while the C corporation partner possibly would be eligible for the IRC § 250 deduction for its FDII-qualifying earnings and GILTI inclusions.

2. Simplified Foreign Structure. Pre-TCJA, U.S. multinationals typicaly had complex structures relating to their foreign subsidiaries—structures with high- and low-tax chains, super holding company structures, structures to avoid Subpart F, and "spaghetti" structures resulting from decades of complex repatriation planning—to name a few. With the passage of the TCJA, including the partial participation exemption under IRC § 245A and the GILTI provisions of IRC § 951A among other major changes to the U.S. federal international tax regime, these structures have been, and continue to be, revisited. Now some taxpayers will implement structures to plan into generating Subpart F income (a blasphemy less than a year ago and counterintuitive to decades of international tax planning) in order, perhaps to qualify for the high tax exception[50] (possibly avoiding a Subpart F inclusion while ensuring eligibility of the related E&P for the IRC § 245A DRD) rather tha incurring a GILTI inclusion (even taking into account that the IRC § 250 would reduce the inclusion by half). To that end, taxpayers may decide to reclassify their lower-tier CFCs as disregarded entities for U.S. federal income tax purposes to possibly increase the availability of foreign tax credits while eliminating multiple levels of taxation.

C. Bifurcating the Business.

Alternatively, an existing business may be able to be bifurcated or broken up into silos to ensure that several of the federal income tax benefits and potential lower rates are available to the maximum extent possible.

1. Businesses Historically Conducted by a C Corporation. Where the businesses were historically conducted by a C corporation ("Distributing") and there are businesses eligible for the IRC § 199A deduction, such businesses possibly could be (i) contributed to a newly formed C corporation ("Controlled"), followed by (ii) the tax-efficient distribution of Controlled under IRC § 355, followed by (iii) Controlled electing S corporation status and thereby becoming eligible for the IRC § 199A deduction. Alternatively, in certain circumstances, it may be possible for Distributing to cause a taxable

[50] The high-tax exception under IRC § 954(b)(4) was not modified by the TCJA. Its computation, however, is affected by two other changes: (i) the lowering of the corporate tax rate from 35% to 21% which reduces the threshold for high taxed income from 30.5% to 18.9%; and (ii) the foreign taxes associated with an item of income will be determined on the basis of actual taxes attributed to the income (as opposed to post-1986 E&P and tax pools).

distribution of the Controlled stock to Distributing's shareholders pursuant to an IRC § 336(e) election (provided that no shareholders, taking into account the attribution rules of IRC § 318, are deemed to own 50% or more of Distributing immediately after the distribution) followed by Controlled electing S corporation status and thereby becoming generally eligible for the IRC § 199A deduction. In such a case, Controlled, once an S corporation, may (i) be eligible for the IRC § 199A deduction (provided Distributing is not engaged in a SSTB or if so engaged, the anti-"cracking and packing" rule of Prop. Treas. Reg. § 1.199A-5(c)(2), discussed above in Section II.B.4.c(6), does not apply, (ii) be eligible for bonus depreciation under IRC § 168(k) for its eligible assets at the higher individual rates,[51] and (iii) have stepped-up basis for purposes of calculating the available IRC § 199A deduction.[52]

2. Businesses Historically Conducted by a Partnership. Where the businesses were historically conducted by a partnership and some of the businesses are eligible for the PTED while others are some combination of (i) ineligible for the PTED, (ii) earning significant foreign source income, and (iii) shareholders of CFCs (the "Other Businesses"), the historical partnership might consider (i) distributing the Other Businesses to the partners followed by the partners contributing the Other Businesses to a domestic C corporation or (ii) contributing the Other Businesses to a domestic C corporation. As a result, to the extent one or more of the Other Businesses is not eligible for the PTED, the lower corporate tax rate would be available, provided the partners/shareholders do not wish to have the businesses make distributions for some period of time. Second, to the extent the Other Businesses earn foreign source income which is not eligible for the PTED, such income could also benefit from the lower corporate tax rate subject to the same caveat above. Third, to the extent the Other Businesses own CFCs, any GILTI income would be eligible for the IRC § 250 deduction (subject to a 10.5% rate prior to the application of the IRC § 861 allocation rules) which may not be available if the GILTI regulations do not extend the IRC § 962 election to the IRC § 250 deduction for GILTI. Fourth, to the extent the Other Businesses earn FDII-qualifying income, such income would be eligible for the IRC § 250 FDII deduction—a deduction only eligible to domestic C corporations.

[51] The taxable distribution scenario assumes that the distribution did not qualify for IRC § 355(a) treatment. In the event that IRC § 355(a) applied to the distribution but either IRC § 355(d) or (e) applied such that the distribution was still taxable at the Distributing level and thus still eligible for an IRC § 336(e) election, Controlled is *not* deemed to liquidate. Treas. Reg. § 1.336-2(b)(2). As a result, Controlled would not be a "new target corporation" under Prop. Treas. Reg. § 1.179-4(c)(2) and thus, notwithstanding the IRC § 336(e) election, not treated as acquiring Controlled's assets in a "purchase" for purposes of IRC § 168(k).

[52] As noted in Section II.B.6.d. above, although IRC § 199A(h)(1) gives Treasury authority to draft rules similar to the rules under IRC § 179(d)(2) "to prevent the manipulation of the depreciable period of qualified property using transactions between related parties," such rules were not included in the proposed IRC § 199A regulations. It may be worth noting that in a fact pattern similar to the taxable spin off described above in this Section VI.C.1., a rule similar to the one adopted under Prop. Treas. Reg. § 1.179-4(c)(2) should be adopted on similar policy grounds.