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Tax Reform and Publicly Traded Partnerships

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by Megan J. Whitlock, Robert A. Swiech, Washington National Tax*

The passage of tax reform brought many substantive changes to the Internal Revenue Code. This article considers certain changes that affect natural resource publicly traded partnerships, discusses issues surrounding implementation of the new rules for these partnerships, and identifies issues for which further guidance may be necessary.

Note that this article focuses solely on natural resource type publicly traded partnerships and does not examine financial publicly traded partnerships.

The 2017 Act

Tax reform[1] signed by the president on December 22, 2017 (the "2017 Act") is viewed by the Master Limited Partnership Association as favorable[2] for the publicly traded partnership ("PTP") industry. Importantly, the 2017 Act did not change the rules allowing PTPs to qualify for treatment as partnerships for federal income tax purposes. However, tax reform layers on additional complexities for

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* Megan J. Whitlock is a senior manager in the Passthroughs group of Washington National Tax ("WNT") (Dallas). Robert A. Swiech is a director in the Tax Credits and Energy Advisory Services group of WNT (Houston).

1 Pub. L. No. 115-97. Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

2 Master Ltd. P'ship Assoc., MLPA Statement on Tax Bill (Dec. 23, 2017), https://www.mlpassociation.org/mlpa-statement-on-tax-bill/.

PTPs and their unitholders. Key areas of the 2017 Act discussed in this article that affect PTPs[3] and unitholders include:

- Section 199A[4] – Deduction for Qualified Business Income
- Section 163(j)[5] – Business Interest Expense Limitation
- Section 168(k)[6] – Increased Expensing
- Section 708(b)(1)(B)[7] – Repeal of Technical Termination of Partnerships
- Section 743(d)[8] – Modification of Substantial Built in Loss
- Section 704(d)[9] – Loss Limitations
- Section 864(c)[10] – Gain or Loss of Foreign Persons from Sale or Exchange of Partnership Interest Engaged in Trade or Business in the United States
- Section 1446(f)[11] – Withholding on Dispositions of Partnership Interests
- Section 965(a)[12] – Mandatory Repatriation of Deferred Foreign Income Applicable to U.S. Shareholders
- Section 951A[13] – Current Year Inclusion of GILTI by U.S. Shareholders

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[3] Section 7704(a) - (c). Section 7704(a) of the Omnibus Budget Reconciliation Act of 1987 treats PTPs as corporations for federal income tax purposes except as provided under section 7704(c), which allows a PTP to be taxed as a partnership if 90 percent or more of its gross income consists of qualifying income.

[4] Pub. L. No. 115-97, §11011, effective for tax years beginning after December 31, 2017, and shall not apply to tax years beginning after December 31, 2025.

[5] Pub. L. No. 115-97, §13301, effective for tax years beginning after December 31, 2017.

[6] Pub. L. No. 115-97, §13201, effective for assets placed in service after December 31, 2017, but before December 31, 2027.

[7] Pub. L. No. 115-97, §13504, effective for tax years beginning after December 31, 2017.

[8] Pub. L. No. 115-97, §13502, effective for transfers of partnership interests after December 31, 2017.

[9] Pub. L. No. 115-97, §13503, effective for tax years beginning after December 31, 2017.

[10] Pub. L. No. 115-97, §13501, effective for sales, exchanges and dispositions on or after November 27, 2017.

[11] Pub. L. No. 115-97, §13501, conforming amendments, effective for sales, exchanges and dispositions after December 31, 2017.

[12] Pub. L. No. 115-97, §14103, effective for the last tax year of a deferred foreign income corporation beginning before January 1, 2018.

[13] Pub. L. No. 115-95, §14201, effective for tax years of foreign corporations beginning after December 31, 2017, and to tax years of U.S. shareholders in which such tax years of foreign corporations end.

Key Provisions for PTPs and Unitholders

Section 199A Deduction for Qualified Business Income

The 2017 Act added a new section 199A that creates a potential deduction of 20 percent of qualified business income from partnerships, S corporations, and sole proprietorships. To qualify for the new section 199A deduction, a taxpayer other than a C corporation must have qualified business income ("QBI") from a qualified trade or business ("QTB"), qualified REIT dividends, or qualified publicly traded partnership income ("QPTPI").[14] Taxable income is first computed without regard to the section 199A deduction;[15] consequently, QBI is computed after applying the basis limitation rules for partnerships under section 704(d), the section 465 at-risk rules, and the section 461(l) rules dealing with excess business losses.[16] The definition of QPTPI[17] in section 199A(e)(5) is the sum of:

- The net amount of the taxpayer's allocable share of each qualified item of income, gain, deduction, and loss (as defined in subsection 199A(c)(3)[18] and determined after the application of 199A(c)(4))[19] from a publicly traded partnership (as defined in section 7704(a))[20] that is not treated as a corporation under section 7704(c),[21] plus

- Any gain recognized by the taxpayer upon disposition of its interest in the partnership to the extent the gain is treated as an amount realized from the sale or exchange of property other than a capital asset under section 751(a).

A cursory reading of this Code section may lead one to believe that all qualifying income as defined in section 7704(d) from a PTP is potentially QBI.[22] However, the application of section 199A(c)(3) and (4) imposes limitations on PTPs that are similar to those imposed on non-PTP entities by making investment type income ineligible for the deduction. In particular, items subject to the exception for

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14 Section 199A(c)(1).

15 Section 199A(e)(1).

16 The deduction does not reduce net investment income under chapter 2A because section 199A is applicable only for income taxes under chapter 1. Section 199A(f)(3).

17 Section 199A(e)(5).

18 Section 199A(c)(3) states that for purposes of this section qualified items of income, gain, deduction, and loss mean items of such that are effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c)) and included or allowable in determining taxable income for the year.

19 Section 199A(c)(4) states that qualified business income shall not include reasonable compensation paid to the taxpayer for services with respect to the trade or business, any guaranteed payments under section 707(c) and section 707(a) payments made to a partner for services rendered with respect to the trade or business.

20 Section 7704(a) generally, a publicly traded partnership shall be treated as a corporation.

21 Section 7704(c) provides an exception for a PTP to be taxed as a partnership if 90 percent or more of its gross income consists of qualifying income.

22 While the statute specifically references qualified business income it is important to note that in fact this amount may be a loss and this might be a detriment against other income.

investment type income[23] include short and long term capital gains and losses, dividends, dividend equivalents, interest income other than interest income properly allocable to a trade or business, foreign currency gain,[24] commodities transactions[25] (including futures and forwards), amounts received from an annuity that is not in conjunction with a trade or business, and any item of deduction or loss allocable to the items previously described. For example, dividend income is qualifying PTP income as described in section 7704(d), but it is not QPTPI for purposes of section 199A because it is listed as an exception in section 199A(c)(3)(B)(ii).

Note that although mineral royalty income is not listed in the statutory language as excluded investment type income, given its classification as investment type income in other parts of the statute, it is reasonable to conclude that mineral royalty income is excluded for purposes of section 199A.[26] Also note that in order to avoid a double benefit of lower rate treatment arising when 1231 gains exceed section 1231 losses and all of the gains and losses are generally treated as long-term capital gains and losses,[27] it seems likely that 1231 gain is not treated as capital gain for purposes of section 199A as it arises from a trade or business.

On the other hand, PTPs receive more favorable section 199A treatment than other partnerships in two regards. First, section 199A deductions for partners in other partnerships are subject to significant limitations: the lesser of (1) 20 percent of QBI or (2) the greater of (a) 50 percent of W-2 wages with respect to the qualified trade or business or (b) the sum of 25 percent of W-2 wages of the qualified trade or business plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property. By contrast, partners in PTPs are not subject to these limitations on their section 199A deductions. Second, for partners in partnerships other than PTPs it is not entirely clear whether section 751(a) gain on the sale of a partnership interest is eligible for the section 199A deduction. This benefit is expressly allowed for partners in PTPs, however. It will be important for PTPs (barring further reporting guidance from the IRS) to identify for their unitholders the income that is potentially eligible for the deduction in footnote disclosures to each partner's Schedule K-1.

Section 163(j) Business Interest Expense Limitation

The 2017 Act amends section 163(j) to impose a new and substantial limit on the deductibility of business interest expense. The limitation is applied at the filer level and special rules are provided for the application of the limitation to partnerships.[28] The calculation of the limitation excludes investment

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23 Section 199A(c)(3)(B).

24 As defined in section 954(c)(1)(D).

25 As defined in section 954(c)(1)(C).

26 This conclusion does not apply to oil and gas royalties held by a taxpayer as a dealer or trader primarily for sale to customers in the ordinary course of its trade or business, these royalties are not a capital asset by reason of section 1221(1) and any gain or loss on the sale or exchange of the royalties are ordinary gain or loss.

27 Section 1231(a).

28 Section 163(j)(4).

interest income and investment interest expense within the meaning of section 163(d). Generally, interest expense is now limited to the sum of business interest income for the tax year plus 30 percent of adjusted taxable income ("ATI").[29]

For tax years beginning after December 31, 2017, and before January 1, 2022, ATI is equal to taxable income other than items not allocated to a trade or business, business interest income and expense, and deductions for depreciation, amortization, and depletion,[30] the 20 percent deduction for qualified business income under section 199A, and net operating losses. The computation of ATI changes for tax years beginning after December 31, 2021, because ATI will include items of depreciation, amortization, and depletion. In calculating ATI for midstream PTPs, the exclusion of depreciation will likely be a very material item and will tend to boost their section 163(j) limitations. However, these PTPs should be mindful that depreciation will be included in the calculation of ATI starting in 2022.[31]

If excess business interest expense ("Excess BIE") is allocated to a partner, it is subject to a carryforward, and is treated as business interest expense ("BIE") paid or accrued by the partner in a future tax year to the extent that the partner is allocated excess taxable income ("ETI") from the partnership. Additional rules are provided to take into account any Excess BIE upon disposition of the partnership interest.

It is worth highlighting that the new law does not contain a provision to "grandfather" existing liabilities or a provision to address intercompany obligations. The IRS has issued guidance in the form of Notice 2018-28 stating that it intends to issue regulations to clarify that taxpayers with disallowed business interest expense from years prior to 2018 will be able to carry that interest expense forward and then apply the new section 163(j) limitations to the disallowed amount.

It is also worth noting that a trade or business for purposes of this interest expense limitation does not include certain regulated public utilities including the trade or business of (1) electrical energy, water, or sewage disposal services; (2) gas or steam through a local distribution system; or (3) transportation of gas or steam by pipeline, if the rates for the furnishing or sale have been approved or established by governmental bodies (the "public utilities exclusion").[32] PTPs should consider whether the public utilities exclusion applies. This exclusion is particularly relevant to PTPs engaged in the midstream business because these PTPs often operate pipelines subject to federal regulations. Such PTPs will face issues regarding how to allocate their interest expense between eligible and ineligible trades or businesses.

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[29] Section 163(j)(1)(A) and (B).

[30] Note that any depreciation and depletion included in cost of goods sold, which is an adjustment to determine gross income, cannot be added back for purposes of ATI.

[31] Depletion and IDC are generally not included as partnership level items and thus not included as part of ATI. These items are treated similarly to section 743(b) adjustments and are specially allocated to partners.

[32] Section 163(j)(7)(A)(iv). As a trade-off, trades or businesses subject to the public utilities exclusion (and therefore not subject to the interest expense limitations of section 163(j)) are not considered to have qualified property for purposes of full expensing under section 168(k) (described more fully below).

PTPs should also consider how the section 163(j) limitation will affect intercompany lending and how limitations will flow between entities in the ownership structure. This is important because the limitation is determined at the partnership level and may result in “silos” where excess business income from one partnership may not be used to increase the interest expense limitation of another partnership. Notice 2018-28 states that future regulations are expected to clarify allocations among related entities.

Finally, some of the elements essential in the calculation of the limitation at the partner level mentioned above—such as ATI, ETI, and Excess BIE—should be provided to unitholders by PTPs. Barring future guidance, these elements will need to be footnoted as part of the Schedule K-1 packages.

Section 168(k) Increased Expensing

The 2017 Act amends section 168(k) to allow for temporary 100 percent expensing for qualified property.[33] While bonus depreciation is not a new concept in the tax law,[34] this provision is different from those in prior laws because it allows for the full expensing of used property.[35] Requirements to expense used property include: the original use must begin with the taxpayer; the property must not have been used at any time prior to the acquisition by the taxpayer or a related party; and the requirements of sections 168(k)(2)(A), 168(k)(2)(B), 168(k)(3) and 179(d) must be satisfied.

Bonus depreciation is a cost recovery tool used by companies to lower taxable income for the current year instead of recovering the cost over the useful life of the asset. PTPs, however, typically rely on depreciation expense to provide what is known as “tax shield” or “shield” for their investors, meaning that the amount of cash distributed generally exceeds the allocation of taxable income to the common unitholder (generally due to depreciation expense) allowing a deferral of tax on income so long as the distribution is less than the investor’s basis. The notion of reducing taxable income may seem favorable, but in the context of PTPs this is not always the case since a full reduction of basis in the first year reduces the ability to shield income to unitholders in subsequent years and additional bonus depreciation may not benefit the unitholder if there are losses suspended under section 469. Thus, PTPs may elect out of bonus depreciation for any class of property for any tax year.[36] Historically, many PTPs elected out of bonus depreciation because the benefit of income shield in subsequent years is reduced as a result of the passive loss rules of section 469. Full expensing also potentially subjects a larger portion of income to recapture under section 1245 if asset are sold and increased 751(a) gain if the units are sold.

Full expensing in PTPs also may affect purchases and sales of units in the market. PTPs use a section 754 election in conjunction with the remedial method under section 704(c) in order to allow the buyer of a partnership unit an adjustment to basis of partnership property under section 743(b) that should offset

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[33] Section 168(k)(2) defines qualified property to generally include property which has a recovery period of 20 years or less.

[34] Economic Stimulus Act of 2008, Pub. L. No. 110-185. The Economic Stimulus Act of 2008 introduced a temporary 50 percent first year bonus depreciation deduction that was later extended.

[35] Section 168(k)(2)(A)(ii).

[36] Section 1.168(k)-1(e).

any inherent share of gain in the assets. This is done because the buyer typically does not know who the seller is or what tax attributes are inherent in the units. The use of these adjustments allows the units to be "fungible" from a market perspective.

Historically, adjustments under section 704(c) and 743(b) were not eligible for bonus depreciation because bonus depreciation was only allowed for new property. This is not as clear under the 2017 Act

since the new provision allows for full expensing of used property so long as the property was not used by the taxpayer at any time prior to the acquisition and the acquisition of the property meets the requirements of sections 179(d)(2) and (d)(3).

Basis adjustments under section 743(b) were historically not eligible for bonus depreciation[37] under the regulations, but query whether the general rule in the regulations applies to the change made to section 168(k) by the 2017 Act (i.e., possible full expensing of used property)? Section 1.743-1(j)(4)(i)(B)(1) for purposes of section 168 says generally:

> [I]f the basis of a partnership's recovery property is increased as a result of the transfer of a partnership interest, then the increased portion of the basis is taken into account as if it were newly-purchased recovery property placed in service when the transfer occurs. Consequently, any applicable recovery period and method may be used to determine the recovery allowance with respect to the increased portion of the basis.

However, the regulation further describes application to the remedial allocation method in section 1.743-1(j)(4)(i)(B)(2) used by PTPs as follows:

> If a partnership elects to use the remedial allocation method described in §1.704-3(d) with respect to an item of the partnership's recovery property, then the portion of any increase in the basis of the item of the partnership's recovery property under section 743(b) that is attributable to section 704(c) built-in gain is recovered over the remaining recovery period for the partnership's excess book basis in the property as determined in the final sentence of §1.704-3(d)(2). Any remaining portion of the basis increase is recovered under paragraph (j)(4)(i)(B)(*1*) of this section.

In light of the language of the current regulations and the requirements of section 168(k) under the 2017 Act it remains unclear as to whether a positive 743(b) basis adjustment ("step-up") is eligible for expensing and, if so, to what extent. Further, if some unitholders opted to expense their eligible portion 743(b) basis adjustments, but others did not, the inconsistent treatment may raise concerns regarding unit fungibility. Hence, clarification is needed to determine how the new section 168(k) will apply to partnerships, including the interaction with section 754 and section 704(c). In addition, consideration should be given as to how the states will respond to the changes to section 168(k).

[37] Section 1.168(k)-1(f)(9).

Calculations under section 704(c) present issues similar to those for basis adjustments under section 743(b). PTPs' use of the remedial method means that potentially the full amount of built-in gain of contributed property may be eligible for full expensing. The outcome of the full expensing would mean an immediate remedial depreciation deduction in the amount of the notional remedial item created resulting from the ceiling rule limitation (equals the difference between the 704(b) book basis and tax allocation limited by ceiling rule) allocated to the noncontributing partner, and an immediate ordinary income inclusion to the contributing partner equal to the amount of the remedial deduction. Section 1.704-3(d)(2) provides:

> The remainder of the partnership's book basis in the property (the amount by which book basis exceeds adjusted tax basis) is recovered using any recovery period and depreciation (or other cost recovery) method (including first-year conventions) available to the partnership for newly purchased property (of the same type as the contributed property) that is placed in service at the time of contribution.

In light of the revisions to section 168(k), if the step-up is truly treated as newly purchased property by an unrelated party that is not part of a tax-free carryover basis transaction, the 2017 Act may allow remedial allocations under section 704(c) to utilize full expensing. PTPs would likely need a high level of comfort on both expensing of section 743(b) adjustments and section 704(c) adjustments in order to assure that their units remained fungible.

Another aspect of full expensing relates to the allocation of value among the partnership assets upon capital account revaluation and for purposes of basis step-up to the assets. In some instances, PTPs may assume the fair market value of tangible assets equals the net tax basis of those assets and may allocate any residual value to goodwill under section 197 or, for upstream PTPs, to the oil and gas properties. Goodwill and oil and gas properties are not qualified property for purposes of full expensing under section 168(k). Thus, it may be beneficial for PTPs to evaluate the residual methodology of value allocation in light of the full expensing rules in the 2017 Act.[38]

Full expensing may have implications for the structure of future acquisitions by PTPs. First, the purchase of qualifying assets may result in the ability of the PTP to fully expense the cost of the acquisition. If the PTP already owns an interest in a lower-tier partnership, the acquisition of the remaining partnership interests in a transaction subject to Revenue Ruling 99-6 may also result in the ability to fully expense the cost of qualifying property of the lower-tier partnership.

Second, the 2017 Act amended the rules of section 1031 to limit eligibility for like-kind exchange treatment to real property. However, if qualifying personal property is sold and the proceeds reinvested, it is possible that the impact of the gain recognized may be mitigated by the ability to fully expense the replacement property.

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[38] As of February 26, 2018, the IRS Large Business and International division has announced the identification and selection of 13 campaigns. https://www.irs.gov/businesses/large-business-and-international-launches-compliance-campaigns.

Third, it has historically been common for a PTP to acquire property by having a sponsor/partner transfer property to the PTP in exchange for money and capital in the PTP. Although such a transaction could result in the recognition of gain under the disguised sale rules of section 707, if properly structured, it is possible that the transfer of money is not treated as proceeds on a sale, provided it qualifies as a reimbursement of capital expenditures under section 1.707-4. Specifically, capital expenditures that are incurred two years prior to the transfer by the partner to the partnership, are

incurred with respect to organization and syndication costs (as described in section 709) or property transferred to the partnership by the partner to the extent that the reimbursement does not exceed 20 percent of the fair market value at the time of transfer. Note that the 20 percent limitation does not apply if the fair market value of the transferred property does not exceed 120 percent of the partner's adjusted basis in the transferred property at the time of transfer. The 120 percent test shall apply on a property by property basis, but limited grouping of property is possible so long as no single property's fair market value exceeds one percent of the total fair market value of the aggregated property and is not greater than the lesser of $1 million or 10 percent of the total fair market value of all property (excluding money and marketable securities as defined in section 731(c)) transferred to the partnership.

Section 708(b)(1)(B) Repeal of Technical Termination of Partnerships

The 2017 Act repealed the rules related to "technical terminations" of partnerships under section 708(b)(1)(B). Technical terminations occurred when, within a 12-month period, there was a sale or exchange of 50 percent or more of the total interest in partnership capital and profits. In the context of PTPs, technical terminations could happen due to market volatility and frequent sales or purchases of units. During times of extreme market fluctuation, it was possible to technically terminate a PTP multiple times in one year.[39] PTPs were often unaware of the termination until after the end of the tax year due to the time lag of broker reporting to the partnerships. The onus of multiple reporting periods, short year returns, filing of new partnership-level elections,[40] and the large number of K-1 recipients make the technical termination repeal beneficial to PTPs from an administrative perspective.

The repeal of the technical termination rules have other implications for PTPs. First, certain states may still recognize a technical termination such that a determination of whether there has been a sale or exchange of 50 percent or more of the partnership interests will still be required. Also, with the elimination of two short period returns, there could be additional considerations in the context of PTP acquisitions of interest in lower-tier partnerships, such as who will control the filing of the tax return for

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[39] The issue was so prevalent during the 2008 time period the IRS Industry Issue Resolution ("IIR") program issued IR-2008-110 (September 25, 2008) and took measures to provide relief for PTPs, allowing PTPs to file a single set of Schedule K-1s for the second short period (assuming only one technical termination in the year) instead of two separate K-1 schedules for the first and second short period.

[40] Partnership level elections common for PTPs include, for example the section 754 election to adjust basis on a transfer or distribution as well as other elections that determine the partnership's tax treatment of partnership items. A list of elections can be found at William S. McKee, William F. Nelson, and Robert L. Whitmire, Federal Taxation of Partnerships and Partners ¶ 9.01[7], at 9-42 through 9-44 (4th ed. 2011).

the tax year of the change in ownership. Query whether language should be included in transaction documents to dictate terms of return filing, maintenance of proper books, records and what rights if any selling partner retains for year-end procedures?

Section 743(d) Modification of Substantial Built in Loss

The 2017 Act modified the definition of "substantial built-in-loss" for transfers of partnership interests under section 743(d). Section 743(d) is applicable when an election under section 754 to adjust the basis of the partnership property has not been made. This provision will be relevant to PTPs if there are lower-tier partnerships in the ownership structure that do not have 754 elections. The PTP itself will not be affected since it has 754 elections in place. The new provision of the 2017 Act expands the definition "substantial built-in-loss" to include situations in which the transferee partner would be allocated loss in excess of $250,000 if partnership assets were sold immediately after the partnership is transferred. As a result valuations and allocations may become more important in the context of any transfer of an interest in a lower-tier partnership.

Section 704(d) Loss Limitations

The 2017 Act revised the loss limitations under section 704(d) to correct a technical flaw. Under section 704(d), a partner's distributive share of partnership loss (including capital loss) is allowed only to the extent of the adjusted basis of the partner's interest in the partnership ("outside basis") at the end of the partnership year during which the loss occurred. Losses allocated in excess of the partner's outside basis are suspended until the partner's outside basis is positive. A partnership calculates its taxable income in the same manner as an individual, except that deductions for foreign taxes and charitable contributions are not allowed to the partnership.[41] The Treasury regulations do not include the partner's share of partnership charitable contributions and foreign taxes paid or accrued for purposes of basis limitations. The failure to include these items in the limitation has been viewed as a technical flaw.[42] The 2017 Act modified this provision to include a partner's distributive share of the partnership's charitable contributions[43] and foreign taxes paid or accrued[44] for purposes of the loss limitations. PTPs should note this change and ensure the partnership computations are updated to include these items.

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41 Section 703(a)(2)(B) and (C). Section 703(a)(2) provides that other deductions are not allowed to the partnership, notwithstanding that the partnership's taxable income is computed in the same manner as an individual's taxable income, specifically: personal exemptions, net operating loss deductions, certain itemized deductions for individuals, or depletion.

42 *See* McKee ¶ 11.05[1][b], *supra* note 39, at 11-214. ("…failure to include charitable contributions in the §704(d) limitation is an apparent technical flaw in the statute. Because of it, a zero-basis partner may reap the benefits of a partnership charitable contribution without an offsetting decrease in the basis of his interest, whereas a fellow partner who happens to have a positive basis may do so only at the cost of a basis decrease.").

43 As defined in section 170(c).

44 As described in section 901.

Section 864(c) Gain or Loss of Foreign Persons from Sale or Exchange of Partnership Interest Engaged in Trade or Business in the United States and Section 1446(f) Withholding on Dispositions of Partnership Interests

The 2017 Act addresses foreign persons that sell or exchange partnership interests of a partnership that is engaged in a United States trade or business on or after November 27, 2017.[45] The new section 864(c)(8) overrules the Tax Court opinion in *Grecian Magnesite Mining v. Commissioner.*[46] The section

provides that gain or loss from the sale or exchange of a partnership interest is effectively connected income ("ECI") to the extent that the transferor would have had effectively connected gain or loss if the partnership sold all its asset for fair market value as of the date of sale or exchange.[47] Note that gain treated as ECI for purposes of this provision is reduced by the amount that would be ECI under the provisions of section 897 established by the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA").

In the case of PTPs this is relevant for any interests in mines, wells, or other natural deposits located in the United States or Virgin Islands or interests in certain domestic corporations, unless it is established that the corporation was not a U.S. real property holding corporation.[48] Pipelines and other midstream assets are also typically treated as FIRPTA assets.

The new statute under 864(c)(8) does not appear to take a pure "aggregate" approach.[49] The statutory language seems to limit the effectively connected gain or loss to the amount of gain or loss realized from the sale or exchange of a partnership interest. This result appears to be different from the approach taken in section 751(a), in which ordinary "hot asset" gain may be recognized in excess of the gain recognized on the sale of the partnership interest. PTPs must be aware of this provision in order to properly report items to their foreign investors for purposes of tax liabilities. This provision is applicable to the sale or transfers of interests on or after November 27, 2017.

This section further provides for mandatory withholding under new section 1446(f) of tax equal to 10 percent of the amount realized on the disposition. The statute further states that the transferee shall be required to deduct and withhold this amount. The amount of withholding does not necessarily reflect the taxpayer's U.S. tax liability and does not eliminate the taxpayer's requirement to file a U.S. tax return.[50] Withholding under section 1446(f) applies to transactions occurring after December 31, 2017. This provision is particularly onerous for PTPs since transfers of units are handled through a broker

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45 See David F. Chan, *New Section 1446(f) Withholding – A Possible Outline for Public Guidance*, Bloomberg Tax Daily Tax Report (Feb. 8, 2018), for a full discussion H.R. 1, section 13501 and Notice 2018-8.

46 149 T.C. No. 3 (July 13, 2017) (rejecting government position in Rev Rul. 91-32, 199101 C.B. 570) (notice of appeal filed by the IRS on December 15, 2017).

47 As described in section 864(c)(8)(B).

48 Section 897(c)(1).

49 *See* McKee ¶ 1.02[1], *supra* note 39, at 1-8.

50 Section 1.6012-2(g)(2).

intermediary and not by the actual partnership itself. Notice 2018-8 issued on December 29, 2017, provided temporary relief to PTPs for purposes of section 1446(f) and temporarily suspended the application of the provision as it applies to interests in PTPs.[51] The notice states that guidance will be prospective and will include transition rules to allow sufficient time to prepare systems and processes for compliance. During the reprieve provided by Notice 2018-8, it is important for PTPs to consider how to meet compliance requirements in the future. Items for consideration include: possible mandatory 10 percent withholding by the broker upon transfers of units from unitholders flagged as foreign, enhanced calculations to establish ECI gain from the PTP, and requests for affidavits from unitholders designated as foreign stating that the transferor is not a foreign person along with the transferor's U.S. taxpayer identification number.

Currently the withholding agent under this provision is the nominee. The nominee for this purpose is a domestic person that holds an interest in a PTP on behalf of a foreign person (typically the unit broker who then reports the information to the PTP).[52] The nominee is treated as the withholding agent only to the extent of the amount specified in the qualified notice given to the nominee by the PTP. If a nominee is designated as the withholding agent, the obligation to withhold is imposed solely on the nominee. The nominee must report the distributions and withheld amounts on Forms 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*, and 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*.

Section 965(a) Mandatory Repatriation of Deferred Foreign Income Applicable to U.S. Shareholders and Section 951A Current Year Inclusion of GILTI by U.S. Shareholders

The 2017 Act substantially eliminated the deferral of taxation on certain foreign earnings by mandating that certain U.S. shareholders of foreign corporations include in income as a subpart F inclusion their ratable share of certain accumulated earning and profit ("E&P") of foreign corporations ("Mandatory Repatriation Provision"). The mandatory inclusion under 965 may be reduced by an allocable portion of the shareholder's share of the E&P deficit of a foreign corporation. Separately, the 2017 Act added new section 951A, which requires a U.S. shareholder of a controlled foreign corporation[53] ("CFC") to include in income on an annual basis its global intangible low-taxed income ("GILTI"). Domestic partnerships can be U.S. shareholders for purposes of these provisions.

The new provisions bring up unique issues for PTPs in connection with the requirement that to avoid corporate treatment at least 90 percent of a PTP's gross income constitute "qualifying income" as defined in section 7704(d). The 2017 Act does not specifically address whether the subpart F inclusion required under the Mandatory Repatriation Provision or the new GILTI inclusion would be considered

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[51] Within the meaning of section 7704(b).

[52] IRS.gov, Rules Applicable to Publicly Traded Partnerships, https://www.irs.gov/individuals/international-taxpayers/rules-applicable-to-publicly-traded-partnerships (last updated May 2, 2018).

[53] As generally defined in section 957(a).

PTP qualifying income.[54] Further analysis based on the relevant facts and circumstances would be necessary to determine whether the inclusions would be treated as qualifying income for PTP purposes.

On March 13, 2018, the IRS released an FAQ document to answer questions related to the Mandatory Repatriation Provision of section 965 on 2017 tax returns[55]. The FAQs answered items such as:

- Who is required to report amounts under section 965 on a 2017 tax return?
- How are amounts under section 965 reported on a 2017 tax return?
- Is there any other reporting in connection with section 965 required on a 2017 tax return?
- What elections are available with respect to section 965 on a 2017 tax return?
- Who can make an election with respect to section 965 on a 2017 tax return?
- When must an election with respect to section 965 be made?
- How is an election with respect to section 965 made on a 2017 tax return?
- Is a Form 5471 with respect to all specified foreign corporations with respect to which a person is a United States shareholder required to be filed with the person's 2017 tax return, regardless of whether the specified foreign corporations are CFCs?
- Are domestic partnerships, S corporations, or other passthrough entities required to report any additional information to their partners, shareholders, or beneficiaries in connection with section 965?
- How should a taxpayer pay the tax resulting from section 965 for a 2017 tax return?
- If not already filed, when should an individual taxpayer electronically file a 2017 tax return?
- If a person has already filed a 2017 tax return, what should the person do?

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[54] In PLR 201818001, a taxpayer requested a ruling because its subpart F income inclusion under the Mandatory Repatriation Provision could cause it to fail to satisfy the 90 percent qualifying income test under section 7704(c). The IRS found that if the taxpayer failed to meet the gross income requirements under section 7704(c), then the failure was inadvertent within the meaning of section 7704(e). As a result, the taxpayer would be treated as continuing to meet the PTP gross income requirements for the year of inclusion. The PLR stated that no opinion was expressed as to whether the 965 subpart F inclusion is qualifying income under section 7704(d).

[55] IRS.gov, Questions and Answers about Reporting Related to Section 965 on 2017 Tax Returns, https://www.irs.gov/newsroom/questions-and-answers-about-reporting-related-to-section-965-on-2017-tax-returns (last updated May 22, 2018).

The FAQs confirm that domestic partnerships may not make any section 965 related elections on behalf of their partners. On April 2, 2018, the IRS issued Notice 2018-26, which provides additional guidance on certain Mandatory Repatriation Provision elections.

Continuing as a PTP?

A threshold question raised by the 2017 Act is whether a PTP should consider converting to a C corporation. One very important aspect of the 2017 Act was lowering the tax rate for C corporations from 35 percent to 21 percent. However, distributions from a corporation still may be subject to a second level of tax. Furthermore, although the maximum rate for individuals is 37 percent, the unitholders of many PTPs will be entitled to the 20 percent deduction under section 199A. Thus, although at first blush there is a large difference between the corporate and individual highest tax rate, once a second level of tax and the potential of the 20 percent deduction are taken into account the difference in the effective tax rate is reduced. [56] For partnerships that are weighing a conversion to a C corporation, other factors beyond double taxation must be considered. For instance, when C corporations make dividend distributions there is an increased cost of maintaining incentive distribution rights ("IDRs") to the sponsor and regulatory changes for midstream companies.[57]

Although there have been a few announcements related to PTPs converting to C corporations,[58] most PTPs continue to mull their tax status. One reason perhaps is that the main benefit of C corporation status would be the lower tax rate of 21 percent, while deferring the second level of tax by retaining earnings. PTPs, however, thrive off regular distributions to unitholders. PTPs may also be wondering whether an increase in the corporate tax rate could occur in the relatively near future. In such a case, a PTP could be "trapped" as a C corporation due to the high cost of converting back to pass-through status (i.e., double tax under sections 331 and 336).

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[56] Note the following table provides a comparison between C corporation taxation and PTPs assuming the highest individual rate and a deduction 20 percent of qualified business income under section 199A.

	C Corporation	PTP
Federal Tax Rate	21%	0% (PTPs are taxed at the individual level)
Qualified Dividend Rate	20%	0%
Individual Tax Rate	N/A	37%
Section 199A Deduction	N/A	20%
Effective Rate	36.8%	29.6%

[57] Note on March 15, 2018, the Federal Energy Regulatory Commission stated that it no longer planned to allow oil and gas pipeline PTPs to recover an income tax allowance in cost-of-service rates. While not all pipelines have the cost-of-service rates, those that do will be required to reduce their rates to come into compliance with the policy. Press Release, Fed. Energy Regulatory Comm., FERC Revises Polices, Will Disallow Income Tax Allowance Cost Recovery in MLP Pipeline Rates (Mar. 15, 2018).

[58] Reuters, Private Equity Firm Ares to Be Corporation Following U.S. Tax Reform (Feb. 15, 2018). *See also* Press Release, Tallgrass Energy GP, Tallgrass Energy Announces Agreement for Tallgrass Energy GP to Acquire Tallgrass Energy Partners (Mar. 25, 2018).

Still, one significant countervailing consideration exists. PTPs typically do not attract tax-exempt investors (who don’t like unrelated business taxable income, or UBTI) and non-U.S. investors (who don’t like effectively connected U.S. income and withholding hassles). Converting to C corporation status would make PTPs significantly more attractive to these type of investors. Certain private equity funds that operate as PTPs are including this factor in their analysis of choice of entity after the 2017 Act. That is, even with a slightly higher rate, the access to additional sources of capital and other financial factors may tip the scales toward operating as a C corporation, particularly if a number of investors are already subject to corporate taxation.

Conclusions

The 2017 Act generally is considered favorable for PTPs. As is highlighted above, tax reform has the potential to affect virtually every aspect of the business of a PTP: How should acquisitions be done in light of full expensing? What should the leverage model be for the PTP going forward? Will my investors benefit from the 20 percent deduction? How will the PTP address any foreign investor withholding concerns? How will the states respond to tax reform? What additional information do I need to gather to facilitate investor reporting? Does it still make sense to be a partnership for federal tax purposes? To address these questions PTPs should closely examine their existing ownership structures, agreements, and procedures to evaluate if changes need to be made. PTPs must be also be aware of additional items that must now be captured and included in unitholders’ Schedule K-1 packages. Partnership modeling tools and other resources are available to analyze the additional items that need to be captured following tax reform.

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