Tax Saving Opportunities for Partnerships, Limited Liability Companies, and S Corporations

PARTNERSHIPS

Regulations governing the allocation of partnership income and loss can sometimes lead to unanticipated results. The allocation of losses may be particularly sensitive to routine changes in partnership liabilities. Even if these changes do not affect allocations, they may trigger income to the partners in certain circumstances. Contributions, distributions, and interest transfers can also present income recognition issues. Many of these issues depend on the position of the partnership at the end of its taxable year. Therefore, unforeseen tax consequences can often be mitigated with year-end planning. For example, the implementation of loan guarantees or indemnification agreements can sometimes prevent tax problems related to partnership liabilities.

For tax years beginning after December 31, 2017, significant and generally unfavorable changes have been made to the way partnership returns will be audited by the IRS. The new rules may cause a partnership itself to become liable for underpayments of federal tax by its members and former members relating to their respective shares of partnership income. Various elections are available that may allow a partnership to reduce or eliminate its potential liability, including elections to push tax liabilities out to the partners to whom the adjustments are allocable, to reduce deemed underpayment amounts to reflect the character of the affected items and tax status of the partners, or in limited circumstances to avoid the new audit rules entirely. Changes to partnership agreements and ownership structures may be necessary to take full advantage of these elections. Partnerships should discuss the appropriate actions with their tax advisors.

A partnership must generally file its federal income tax return by the 15th day of the third month following the end of its taxable year (unless such date falls on a weekend or holiday, in which case the filing date is the next day that is not a Saturday, Sunday, or holiday), but an automatic extension of six months is available upon request. As a result, the due date of a partnership return for the year ending December 31, 2018, can be extended until September 16, 2019.

LIMITED LIABILITY COMPANIES

Generally, the same federal tax rules that apply to a partnership also apply to a two-or-more member limited liability company (LLC) that is properly classified as a partnership, rather than a corporation, under applicable income tax regulations. Under these same regulations, a single-member LLC owned by an individual can choose to be classified either as a disregarded entity, i.e., sole proprietorship (Schedule C business), or as a corporation, and a single-member LLC owned by a corporation can choose to be classified as a disregarded entity, i.e., part of its corporate owner or a division, or as a separate corporate subsidiary.

S CORPORATIONS

All pass-through entities, including partnerships and S corporations, should evaluate their choice of entity as a result of tax reform and the new reduced corporate tax rate. The new Section 199A deduction resulting from tax reform may reduce a pass-through owner's maximum individual effective tax rate from the highest rate, 37 percent, to 29.6 percent. Converting from a pass-through entity to a C corporation or vice versa requires complex analysis and planning, and is not covered under this newsletter. Your advisor can be consulted regarding choice of entity considerations, analysis, and planning.

Shareholders of existing S corporations should consider the following year-end planning tips:

- Shareholders must have basis in their stock or in loans to the corporation in order to take advantage of anticipated losses. Basis may be increased by additional capital contributions or direct shareholder loans to the corporation.

- If the corporation has earnings and profits (E&P) on hand which were accumulated during the time it was a regular C corporation, any additional investments in the corporation by the shareholders should be made as loans, rather than as capital contributions, to avoid taxable dividends if these investments are later returned to the shareholders. Shareholder loans should always be well-documented.
- After a shareholder's basis in stock of an S corporation has been reduced to zero, the shareholder's basis in a loan to the corporation is reduced by pass-through losses and increased by the pass-through of subsequent years' income. Because loan repayments may produce taxable income for the shareholder, they should be timed, if possible, to result in the least amount of tax. Advances should be evidenced by a written document in order to obtain favorable capital gain treatment if gain will result when the loan is repaid. Delaying loan repayments beyond 12 months (for long-term capital gain treatment) will allow any gain to be taxed at the lower (20 percent) capital gains tax rate.
- Distributions to shareholders which exceed the corporation's accumulated adjustments account (AAA) may result in inadvertent dividends if the corporation has E&P accumulated from the time it was a C corporation. Therefore, distributions should be delayed if the amount of the AAA balance at year-end is uncertain.
- Dividends received by non-corporate shareholders from domestic and qualified foreign corporations are taxed at a maximum 20 percent rate. Accordingly, S corporations with C corporation E&P should avoid making an actual or a deemed dividend distribution of this E&P, unless there are other compelling reasons for generating taxable dividend income.
- Consider making gifts of S corporation stock to shift income between family members. Gifts of nonvoting stock may be made to keep voting control, if desired.
- Under certain conditions, an S corporation that sells appreciated property will be subject to tax on "built-in gains" (generally the property's appreciation prior to the corporation becoming an S corporation). A built-in gain is determined as follows:

Example:	
Total gain on asset's sale	$1,000,000
Less appreciation accruing while an	
S corporation	300,000
Built-in gain	$ 700,000

If an S corporation has sold property and recognized built-in gains, it should consider offsetting these gains by recognizing built-in losses. Alternatively, the built-in gains tax may be deferred or, in some circumstances, eliminated if the corporation's taxable income can be eliminated.

Caution: Estimated taxes must be paid on net recognized built-in gains. (These estimates cannot be based on the preceding year's tax, if any.)

The built-in gains tax generally applies only to gains recognized during a specified recognition period. Although the recognition period was ten years when originally enacted, changes enacted by Congress over several recent years have resulted in the permanent reduction of the recognition period to five years. Thus, the tax will not be imposed if the S corporation had completed a five-year recognition period at the time the built-in gain is recognized. The tax applies when an S corporation has converted from C corporation status, but it also applies to assets that an S corporation has acquired from a C corporation in a tax-free transaction.

Other less recent changes have made more corporations eligible to become S corporations. For instance, financial institutions not using the reserve method of accounting can become S corporations; S corporations can have up to 100 shareholders and in determining the number of shareholders, extended family groups can be treated as a single shareholder; certain tax-exempt organizations can be shareholders; S corporations can hold controlling interests in other corporations; and wholly-owned domestic subsidiaries of S corporations can be disregarded as entities separate from their parent S corporations if an election is made by the S corporation.

In addition, income allocable to an employee stock ownership plan (ESOP) as a shareholder of an S corporation is not currently taxed, but rather is taxed to the ESOP beneficiary at the time of distribution.

SPECIAL CONSIDERATIONS FOR PASS-THROUGH ENTITIES

Recharacterization of Certain Long-Term Capital Gains under Section 1061

Gain recognized by a partnership upon sale of a capital asset held for at least one year will generally be characterized as long-term capital gain. However, capital gains recognized after December 31, 2017, with respect to “applicable partnership interests” will be treated as long-term capital gains if the capital asset has been held for at least three years.

An applicable partnership interest typically includes profit-only interests received in connection with the performance of services by the partner if the partnership is engaged in an “applicable trade or business.” An applicable trade or business includes any activity conducted on a regular, continuous, and substantial basis consisting of raising or returning capital and either (1) investing in, or disposing of, specified assets (or identifying specified assets) or (2) developing such specified assets. Specified assets include securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing, and an interest in a partnership to the extent of the partnership’s proportionate interest in any of the foregoing.

Partnerships that issue applicable partnership interests and are engaged in an applicable trade or business should ensure procedures are in place to accurately track holding periods in investment companies and assets bearing in mind the multiple holding periods that can result from “add-on” investments. Further, determination of a partner’s share of capital gains will likely require detailed record-keeping and tracking of partner Section 704(b) and tax basis capital accounts.

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

Revenue Ruling 91-32 generally provides that a foreign partner will recognize effectively connected income (ECI) on a sale of a partnership interest to the extent a sale of underlying partnership assets would give rise to an allocation of ECI to the transferor partner. In *Grecian Magnesite Mining*, *Industrial & Shipping Co*., *SA v. Commissioner*, the Tax Court rejected the holding in Rev. Rul. 91-32 thereby avoiding U.S. taxation to the selling foreign partner. The 2017 tax reform act effectively codifies the holding of Revenue Ruling 91-32 and reverses the Tax Court’s decision in *Grecian Magnesite*. As a result, gain recognized on the sale or exchange of a partnership interest will be treated as ECI to the extent the transferor would be allocated ECI upon a sale of assets by the partnership.

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

The 2017 tax reform act repeals the technical termination rules under Section 708(b)(1)(B) for tax years beginning after 2017. Repeal of the technical termination rule is generally a favorable development, since it will eliminate the need to restart depreciation upon the sale or exchange of more than 50 percent capital and profits interest in a partnership. Additionally, the 2017 tax reform act will alleviate the common occurrence of failing to properly identify transactions, giving rise to technical terminations, which leads to late filing of required tax returns, failure to make appropriate elections, and imposition of penalties.

However, technical terminations are sometimes used for tax planning purposes. Alternatives will now need to be considered since the relative simplicity of triggering a technical termination has been eliminated.

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

Under the general rules of Section 704(d), a partner's ability to deduct its distributive share of partnership losses is limited to the extent of the partner's outside tax basis in the partnership interest. As originally enacted, this limitation did not apply to a partner's allocable share of charitable contributions or foreign tax expenditures. The 2017 tax reform act modifies the Section 704(d) loss limitation rule to take into account charitable contributions and foreign taxes. However, in the case of a charitable contribution of property where the fair market value exceeds the adjusted tax basis the Section 704(d) basis limitation would not apply to the extent of the partner's allocable share of this excess. This provision applies to taxable years beginning after December 31, 2017. Taxpayers that have historically been able to benefit from this exception will need to be aware of the potential decrease in their overall tax deductions.

Like-Kind Exchanges under Section 1031

Following tax reform, the Section 1031 like-kind exchange rules are now limited to transactions involving the exchange of real property that is not held primarily for sale. Section 1031 no longer applies to any other property, including personal property that is associated with real property. This provision is effective for exchanges completed after December 31, 2017, unless the taxpayer had initiated a forward or reverse deferred exchange prior to December 31, 2017. These changes will represent a significant departure from prior law. Taxpayers will need to be mindful of this limitation in real property transactions as well as exchanges of assets consisting of both real and personal property.

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

Section 743 requires a mandatory negative tax basis adjustment upon the sale or exchange of a partnership interest if the partnership has a substantial built-in loss. A partnership generally has a substantial built-in loss if the partnership's adjusted tax basis in all of its property exceeds the fair market value of such property by more than $250,000. The 2017 tax reform act modified the definition of a substantial built-in loss. Under the 2017 tax reform act, in addition to the present-law definition, a substantial built-in loss also exists if the transferee partner would be allocated a loss in excess of $250,000 upon a hypothetical disposition by the partnership of all partnership's assets in a fully taxable transaction for cash equal to the assets' fair market value, immediately after the transfer of the partnership interest. This provision would apply to transfers of partnership interests occurring after December 31, 2017.

Given the negative consequences of a potential downward basis adjustment it will become even more critical that partnerships properly track each partner's Section 704(b) and tax basis capital accounts. Failure to accurately track capital accounts could lead to incorrect downward adjustments resulting in increased exposure to both the transferring and non-transferring partners.

New Centralized Partnership Audit Regime

Effective for tax years beginning in 2018 partnerships will be audited by the IRS under an entirely new regime. Under the new regime, tax adjustments resulting from partnership audits will generally be assessed at the partnership level. This enables the IRS to collect tax due on partnership adjustments at the entity level, thereby effectively imposing an entity-level tax on partnerships. Although it may be possible for a partnership to "push-out" this obligation to its partners, this election will result in a higher rate of underpayment interest. Also, unlike the TEFRA rules, the new regime applies to all partnerships regardless of size or number of partners, unless the partnership is eligible to elect out and does so in a timely manner. Typically, partnerships eligible to opt out must have 100 or fewer partners and all partners must be individuals, C corporations, foreign entities that would be treated as a C corporation if domestic, S corporations (although each shareholder is counted as a separate partner for the 100 or fewer requirement) or an estate of a deceased partner. Importantly, partnerships with partners that include other partnerships, single-member LLCs, grantor trusts, or nominee partners will prevent a partnership from opting out of the new rules regardless of the number of partners.

This new IRS audit regime has created a number of unanswered questions and significant concern over the manner in which partnerships will be audited and potentially subjected to imputed underpayment obligation. Given these concerns, it is very important that all partnership/LLC members and managers discuss with their legal counsel and professional tax advisors changes that will most likely need to be made to the governing documents. The most significant of these changes will be the determination and identification of a designated “partnership representative” (PR). Unlike the “Tax Matters Partner” under the formerly applicable unified audit procedures, the PR will have significant decision making power and authority that will have significant impact on all partners and the partnership in the event of an examination. In addition to the PR designation, there will be several matters the partnership/LLC owners will need to consider with respect to various elections, allocations, and the payment of IRS assessments. It is highly recommended that all aspects of the new rules be considered in conjunction with any potential updates or amendments to the governing documents.