Impact of Tax Cuts and Jobs Act on Securitization Transactions

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Colman J. Burke, Steven L Kopp, and David Z. Nirenberg provide an informative and detailed discussion of the effect of the tax legislation on securitization transactions.

On December 22, 2017, President Trump signed into law the act commonly referred to as the Tax Cuts and Jobs Act (the "*Act*"). Although no provision of the Act was designed specifically to address securitizations, two new sets of rules are likely to have significant effects on at least some securitization transactions. These rules—(i) a new limitation on the deduction for business interest expense and (ii) a requirement that the transferee of an equity interest in a partnership engaged in a U.S. trade or business withhold 10% of the amount realized unless the transferor certifies that it is a U.S. person—are discussed in detail in Part I, below.

The Act makes changes to other rules that are likely to have a more modest impact on the securitization market. These rules—(i) the elimination of miscellaneous itemized deductions, (ii) new Subpart F rules, including changes to the definitions of "controlled foreign corporation" (CFC) and "United States shareholder" (U.S. shareholder), (iii) requiring accelerated income accrual based on financial reporting, (iv) new rules relating to excess business losses and NOLs, (v) new rules relating to life settlements, and (vi) a new limitation on Code Sec. 1031 exchanges to real estate—are summarized in Part II, below.

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I. Significant Changes

A. Summary

i. Limitation on Deduction for Business Interest Expense

Deductions for net business interest expense are limited to 30% of a business's taxable income (with certain adjustments).[1] In the case of a partnership, the business interest expense limitation is applied first at the partnership level, and then at the partner level.[2] This limitation could cause a corporate issuer, or the equity holders in a passthrough issuer, in a securitization transaction to recognize phantom income due to the issuer's inability to realize the full tax benefit of its interest expense.

ii. Transfers of Partnership Interests

The transferor of an equity interest in an entity taxable as a partnership that is engaged in a trade or business in the United States must provide the transferee with a certification indicating that the transferor is a U.S. person in order to avoid withholding tax on the disposition of its interest.[3] If the transferee does not receive the certification, it will be required to withhold 10% of the amount realized by the transferor.[4] If the certification is not provided and the transferee does not withhold the requisite amount, the partnership is required to withhold such amount (and interest thereon) from future distributions to the transferee.[5] These documentation and withholding requirements could restrict the liquidity of certain partnership interests, including notes or other securities classified as partnership interests for federal income tax purposes (as partnerships institute procedures to ensure the delivery and collection of these certifications), and could force transferees and partnerships to withhold even if the transferor would not ultimately be subject to tax on the sale (and ultimately would be entitled to a refund of any such withholding).

B. Effective Dates

The limitation on deduction of business interest expense is effective for interest paid in (or accrued with respect to) taxable years beginning after December 31, 2017.[6] It applies to all entities and obligations, regardless of whether they are formed or issued, respectively, prior to such date.

The requirement to deliver a non-foreign person certification to avoid withholding on the transfer of an interest in a partnership engaged in a U.S. trade or business is effective for transfers of such interests after December 31, 2017 (although the operative provision imposing the tax on such transfers is effective for transfers of interests on or after November 27, 2017).[7] These rules also apply to partnerships regardless of whether they were formed prior to the applicable effective date. Partnerships that are (or are at any material risk of being determined to be) engaged in a U.S. trade or business will need to determine whether they should (and, in the case of pre-existing partnerships, whether they have the power under their constituent documents to) adopt or institute procedures to compel delivery and collection of certifications.

C. Limitation on Deduction for Business Interest

i. Overview and Effects

With exceptions for (i) taxpayers with gross receipts less than an applicable threshold (generally $25 million)[8] or operating in certain industries,[9] neither of which exceptions are likely to be relevant for securitizations, and (ii) floor plan financing interest,[10] taxpayers such as partnerships and corporations (but not REMICs)[11] are permitted to deduct interest expense that is allocable to a trade or business ("business interest expense"), only to the extent of the sum of (i) interest income that is allocable to a trade or business ("business interest income")[12] and (ii) 30% of adjusted taxable income ("ATI," and the sum of business interest income and 30% of ATI, "Total Capacity").[13] Disallowed business interest expense deductions are carried over indefinitely and can be used against future Total Capacity.[14] Total Capacity that is not used to support the deductibility of business interest expense, however, cannot be carried over to succeeding taxable years. In the case of a partnership, the rules (discussed in "Application to Partnerships and Partners," below) are somewhat modified and applied at both the partnership and partner levels.[15]

ATI for these purposes means the taxable income of the taxpayer computed, in pertinent part, without regard to (i) any business interest income or business interest expense; (ii) any item of income, gain, deduction, or loss not properly allocable to a trade or business; (iii) any NOL under Code Sec. 172, and for taxable years beginning before January 1, 2022; (iv) any deduction allowed for depreciation, amortization, or depletion.[16] The calculation of ATI without taking into account depreciation and similar non-cash deductions will increase the taxpayer's ATI and thus increase the permitted amount of deductible business interest expense.

The limitation on business interest expense may make it more difficult (economically) to securitize assets that are not debt instruments and, thus, do not generate business interest income, such as leases, fees, power production payments, and life settlements, among others. Absent the realization of business interest income, business interest expense deductions may only be taken to the extent of 30% of the entity's ATI. Even after adding back depreciation and other similar deductions to ATI, a significant amount of business interest expense deductions may be disallowed. This interest disallowance rule will have less of an impact on the securitization of debt instruments such as CLOs but, even in debt securitizations, the limitation can adversely impact the transaction if phantom income (which is not carried forward under the Act) is followed by disallowed phantom losses.[17] The impact on securitizations of lease receivables from personal property may be ameliorated by the allowance of bonus depreciation and accelerated deductions provided elsewhere in the Act[18] (which may lower securitization vehicles' taxable income enough to offset the loss of business interest expense deductions), but that would require a fact-specific analysis.

Some strategies that may work in particular circumstances to alleviate the effects of the business interest expense limitation rule include:

- Reducing business interest expense by structuring lower rated securities as partnership equity, rather than as debt.
  - However, partnership equity may not be a suitable investment for (i) foreign investors because of potential withholding tax and U.S. trade or business risk or (ii) pension plans and other tax-exempt investors due to ERISA limitations and the taxability of debt-financed income.
- Reducing business interest expense by using derivatives (rather than debt) to transfer credit, prepayment, and extension risk and possibly even to raise funds.
  - However, many of those strategies convert business interest expense into capital losses (and often deferred capital losses), which may not be desirable for many issuers and equity holders.
- Increasing ATI by compensating managers with partnership equity, rather than fees.

ii. Application to Partnerships and Partners

Complex rules applicable to business interest expense of partnerships may disadvantage partnerships (and any disregarded entities that have a significant risk of recharacterization as partnerships) for sponsors that have significant Total Capacity to deduct business interest expense that is accrued directly (and not indirectly through a partnership).

a. Technical Analysis. In the case of a partnership, the business interest expense limitation is applied first at the partnership level, and then at the partner level.[19] To the extent that 30% of the partnership's ATI is not utilized to support its business interest expense, such amount ("Excess Taxable Income") is allocated to each partner, who can use it to support non-partnership business interest expense for that partner's current taxable year.[20] Any such allocation of partnership Excess Taxable Income, however, must first be used by the partners to offset any previously disallowed business interest expense of the partnership that was allocated to them (as discussed in the paragraph below).[21] There is no rule permitting any allocation of partnership Excess Taxable Income not so used (either with respect to previously disallowed partnership business interest expense or partner separate business interest expense) to be carried over; so, any such excess allocation is lost.

There is no specific rule allocating to the partners any excess of a partnership's business interest income over its business interest expense for the purposes of either offsetting disallowed business interest expense previously allocated to them from the partnership or supporting their own separate business interest expense. Rather, such excess may remain unutilized at the partnership level (but nevertheless subject to taxation at the partner level). See Example 6, below. There is no apparent policy reason for not permitting partners the use of excess partnership business interest income, and in fact, it makes little obvious sense. The fundamental point of new Code Sec. 163(j)—to limit business interest expense deductions, to the extent they exceed business interest income—was evidently thought by Congress to be appropriately relaxed by permitting additional business interest expense deductions to the extent of 30% of ATI. Why would Congress permit a partner to utilize (as an offset to its own non-partnership related business interest expense) its distributive share of a partnership's Excess Taxable Income, but preclude the utilization of its distributive share of the partnership's actual business interest income—the very item that is permitted in the first instance as an offset to business interest expense? Logically, if any portion of the partnership's income was excluded for this purpose, one would expect it to be the partners' distributive shares of Excess Taxable Income, not their shares of business interest income—which, dollar for dollar, represents the very income that is otherwise permitted to offset business interest expense when earned in the same entity during the same taxable year. Hopefully, this was an oversight that will be corrected in a technical corrections act or by administrative guidance providing either that any net business interest income is passed through to a partnership's partners as a separately stated item of interest income or, alternatively (as indicated in text below), that net business interest income is included in a partnership's Excess Taxable Income.[22]

Excess business interest expense incurred by the partnership is allocated to the partners and carried forward at the partner level.[23] However, only the partner's allocable share of the partnership's Excess Taxable Income (which, as indicated above, excludes all business interest income) can be used to support a partner's deduction of such carried forward excess business interest expense. In other words, if the partnership has business income other than business interest income and the full 30% of such income (*i.e.,* ATI) is not offset by the partnership's business interest expense, a partner's allocable share of such Excess Taxable Income can be used to permit the deduction of the partnership's previously disallowed business interest expense that had been allocated to the partner. As indicated above, any excess amount (*i.e.,* any amount of allocable Excess Taxable Income not used by the partner to allow for the current deduction of carried forward partnership business interest) then may be used by the partner to offset its non-partnership business interest expense for the partner's current (and only its current) taxable year. But if a partnership has more business interest income than business interest expense, such excess business interest income may not (absent technical corrections or administrative guidance as suggested in the preceding paragraph) enter into the calculation of Excess Taxable Income, and such excess partnership business interest income may not be available to partners to permit them to utilize the disallowed business interest expense previously allocated to them. See Example 4, below, for an illustration of this problem and the discussion above, for a criticism of this rule. Again, there is no rationale for why partners should not be able to utilize their prior disallowed business interest expense to the extent of future partnership business interest income.[24] A partner must reduce (but not below zero) its basis in its partnership interest by any allocation of the partnership's disallowed business interest expense, even though such allocation gave rise to no current deduction (although any subsequent deduction of carried forward business interest as described in the previous paragraph would not give rise to any further downward basis adjustment).[25] However, upon a disposition of the partnership interest, the partner's basis would be increased immediately before the disposition by the amount of unused excess business interest expense (regardless of whether gain is recognized in whole or in part).[26] Thus, the partner will, upon disposition of its partnership interest, be able to utilize the disallowed portion of any business interest expense that was not ultimately deducted, although this methodology will convert ordinary deduction into deferred capital loss (or reduced capital gain).

The Act makes changes to other rules that are likely to have a more modest impact on the securitization market.

A partnership's excess business interest expense is allocated to partners to use in the future, and solely to be deducted to the extent of their allocable share of the partnership's Excess Taxable Income (or as additional basis to be used in the calculation of gain or loss on disposition), even where partners, apart from their interest in the partnership, have current, unused capacity for the deduction (*i.e.,* in situations in which they could have deducted the business interest expense if they accrued it directly).[27] There is no sound reason for such a rule and, unless it is fixed, this rule will make it disadvantageous for sponsors with their own significant capacity to deduct business interest expense to establish securitization partnerships (including LLCs and other entities taxable as partnerships). Where a sponsor uses a disregarded entity as the issuing vehicle and issues only securities that are expected to be characterized as debt for tax purposes, this rule could still have an adverse effect on it if any of the classes of debt are recharacterized as partnership equity.

b. Additional Considerations. Where a partnership does not have enough activity to be considered to be engaged in a trade or business, there would be no business interest expense disallowance at the partnership level. Under general partnership principles, however, the partnership's interest expense would be allocated to its partners and, although not certain, such interest expense allocated to a corporation would very likely be treated as business interest expense with respect to such corporate partner.[28] Similarly, partnership interest income should flow through to the partners and, in the case of a corporation, would likely be treated as business interest income.

The risks and disadvantages described above in respect of partnerships may be mitigated in certain cases by holding partnership equity through either a passive foreign investment company for which a "qualified electing fund" election is made (a "QEF") or a CFC.[29] Under the rules for QEFs and CFCs, the amount of income an equity holder is required to take into account each year is limited to the entity's current earnings and profits, and the interest disallowance rule does not appear to preclude the reduction in earnings and profits by the disallowed business interest expense.[30] Consequently, because earnings and profits are reduced by the otherwise disallowed business interest expense deductions, the equity holders effectively reap the tax benefit of the disallowed business interest expense, since it reduces the amount of their income inclusions. See Example 3, below.

iii. Examples

The above rules can be illustrated by the following examples.

Example 1. In 2018, XYZ Corp has $100 of business interest income, $120 of business interest expense, and $40 of ATI (which, as indicated above, excludes any business interest income or business interest expense in its calculation). XYZ Corp's ATI generates $12 ($40 × 30%) of excess capacity, which can be used to offset $12 of the $20 of net business interest expense. Thus, it has $8 of business interest expense that is disallowed in 2018 and carried forward to succeeding taxable years.

Example 2. Same facts as Example 1, except XYZ Corp has only $40 of business interest expense. Although its ATI and business interest income would have supported $112 ($40 × 30% + $100) of business interest expense, its extra capacity ($112 – $40, or $72) is lost and does not carry forward.

Example 3. Same facts as Example 1, except each of the shareholders of XYZ Corp has made a QEF election with respect to its shares in XYZ Corp and XYZ Corp's ATI is $20. XYZ Corp's ATI could support $6 ($20 × 30%) of additional business interest expense and, thus, $14 of business interest expense is disallowed. However, since the earnings and profits of XYZ Corp are zero ($100 + $20 – $120) in 2018, the equity holders of XYZ Corp do not have to take any income into account (effectively getting the full benefit of the business interest expense deduction).[31]

Example 4. XYZ Partnership is owned 40% by ABC Corp and 60% by DEF Corp. ABC Corp has a basis in its interest in XYZ Partnership of $80. In 2018, XYZ Partnership has $100 of business interest income, $150 of business interest expense, and no ATI. ABC Corp and DEF Corp are allocated $20 and $30, respectively, of XYZ Partnership's disallowed business interest expense and reduce their bases in their interests in XYZ Partnership by such amounts. However, the corporate partners may only be able to utilize such allocation against their allocable share of XYZ Partnership's future Excess Taxable Income (and not, under the broader reading of the statute discussed above, against XYZ Partnership's future excess business interest income).[32] XYZ Partnership may decide to take the position, however, that future excess business interest income should be allocated to its partners to use against their own unrelated business interest expense. See "Limitation on Deduction for Business Interest—Application to Partnerships and Partners—Technical Analysis," above for a discussion of the position that Excess Taxable Income should encompass excess business interest income or, alternatively, that a partner should be able to offset its unrelated business interest expense with its distributive share of excess business interest income.

Example 5. Same facts as Example 4, except that ABC Corp sells its interest in XYZ Partnership on December 31, 2019, and XYZ Partnership did not have any Excess Taxable Income in 2019. ABC Corp increases its basis back to $80 and effectively decreases its gain (or increases its loss) by the amount of its unused business interest expense.

Example 6. XYZ Partnership is owned 50% by ABC Corp and 50% by DEF Corp. XYZ Partnership earns $100 of business interest income, has $200 of ATI, and has $30 of business interest expense. Thus, XYZ Partnership has $70 of net business interest income (which could therefore have supported an additional $70 of business interest expense). Its ATI could further support $60 ($200 × 30%) of additional business interest expense at the XYZ Partnership level. However, it is possible that only the $60 ($30 each) is allocated to XYZ Partnership's partners for the purposes of either offsetting disallowed business interest expense previously allocated to it from the partnership or supporting its own business interest expense,[33] and that the $70 of excess business interest income is lost at the partnership level (although the excess business interest income would still be taken into account in computing the partnership's net income that is allocated to its partners). ABC Corp and DEF Corp can each use the $30 allocation to offset business interest expense (if any) in the taxable year in which the allocation is made. To the extent not utilized in that year, such excess capacity is lost and not carried forward for any purpose.[34]

Example 7. MF Partnership is a master fund and an investor (and not a trader) in debt instruments. USFP is a domestic partnership feeder fund catering to U.S. individual investors and OSFC is an offshore corporation feeder fund set up for all other investors.

Each of USFP and OSFC owns 50% of MF Partnership and engages in no other activity other than owning its interest in MF Partnership and borrowing funds to acquire and carry that investment. MF Partnership has \$100 of interest income and has no other income or expense. Each of USFP and OSFC has \$40 of interest expense and no other expenses or income other than the \$50 distributable share of MF Partnership's interest income. MF Partnership has no business interest income or expense under Code Sec. 163(j) (since it is a mere investor and its income is not allocable to a trade or business); thus, Code Sec. 163(j) does not apply to it.

USFP is allocated \$50 of interest income from MF Partnership and has \$40 of interest expense. Because neither MF Partnership nor USFP is engaged in a trade or business, Code Sec. 163(j) does not apply to USFP (although its partners will take account of its allocated interest income and its directly incurred interest expense for purposes of Code Sec. 163(d)).

While the statute should be clarified to ensure the following result, OSFC's interest expense is business interest expense and OSFC's \$50 share of MF Partnership's interest income is taken into account as business interest income in determining OSFC business interest expense allowance.[35] Accordingly, OSFC is entitled to deduct the entire \$40 of business interest expense.

Example 8. Same facts as Example 7, except MF Partnership is a trader in debt instruments. MF Partnership again has no interest expense; thus, Code Sec. 163(j)'s interest limitation rule does not apply to it. As in Example 7, OSFC's interest expense is business interest expense. Whether OSFC's \$50 share of MF Partnership's business interest income is taken into account as business interest income in determining OSFC's business interest expense allowance depends on whether partnership net business interest income flows through to partners.[36]

As in the case of OSFC, whether USFP's \$50 share of MF Partnership's business interest income is taken into account (in some manner) depends on whether partnership net business interest income flows through to partners.[37]

However, does MF's business interest income flow through to USFP, and if so, what is the character of that income? Is it investment income subject to the Code Sec. 163(d) limitation, or is it business interest income under Code Sec. 163(j)(6)? If net business interest is held to flow through to a partnership's partners (whether due to a court's holding, technical corrections act, or IRS guidance), the IRS likely would continue to follow the implication of Rev. Rul. 2008-12 and treat such excess interest income as Code Sec. 163(d) investment income with respect to USFP.[38]

D. Transfers of Partnership Interests

i. Overview

Under Rev. Rul. 91-32, a foreign person's gain or loss from the sale or exchange of a partnership interest would be treated as effectively connected with the conduct of a U.S. trade or business to the extent that any unrealized gain or loss in the partnership's assets would be treated as effectively connected with the conduct of a U.S. trade or business if those assets were sold by the partnership immediately prior to the sale or exchange.[39] However, a 2017 Tax Court case rejected the logic of that ruling and instead held that gain or loss on the sale or exchange by a foreign person of an interest in a partnership that is engaged in a U.S. trade or business generally is foreign-source and, thus, generally is not subject to U.S. tax.[40]

The Act not only rejects the holding of the Tax Court and generally adopts the IRS's position in Rev. Rul. 91-32 but also implements a withholding mechanism to compel collection of the applicable tax.[41] Thus, if a partnership (including a trust, LLC, participation agreement, or other entity or arrangement characterized for U.S. federal income tax purposes as a partnership) is engaged in a U.S. trade or business, a transferor will be required to give a certification to the transferee that it is a U.S. person in order to avoid a 10% withholding tax on the amount realized on the sale, exchange, or other disposition.[42] The statute does not prescribe any particular form to avoid withholding—it merely requires the transferor to furnish to "the transferee an affidavit … stating, under penalty of perjury, the transferor's United States taxpayer identification number and that the transferor is not a foreign person."[43] Thus, in the absence of administrative guidance, no specific form should be required, and a Form W-9 should suffice.[44] If the transferee does not withhold such amount, the partnership itself is required to withhold such amount (plus applicable interest) on any future distributions to the transferee.[45] If the partnership fails to so withhold, it likely will be liable for the amount of lost withholding tax.[46] The requirement that the partnership withhold from distributions to the transferee strongly suggests that if the transferee disposes of its partnership interest before the full amount of withholding has been withheld by the partnership, no further withholding will be required by the partnership.[47]

Notably, the amount to which the 10% withholding applies is the amount realized, not the proceeds of sale. Because the amount realized includes a partner's share of the partnership debt, in the context of securitizations (which tend to utilize significant amounts of debt financing), the amount realized may be a significant multiple of the sale proceeds.[48] This could create a withholding liability well in excess of the actual tax owed on the disposition, and (depending on partnership leverage and allocation of partnership debt) potentially even an amount greater than the sales proceeds itself.

The statute does not limit the amount of required withholding to the amount of the transferor's tax liability, for example, by taking account of the transferor's basis in the partnership interest. However, the statute does permit the transferor or transferee to request the IRS to reduce the amount otherwise due, and Notice 2018-08[49] invites comments on procedures for requesting a reduced amount required to be withheld, including how to determine an appropriate reduced amount and whether such procedures should be automatic or require approval by the IRS.[50]

ii. Issues in Application

The partnership transfer rule could apply to sale/repurchase agreements ("REPOs"), securities lending agreements, and certain non-taxable transactions in which tax ownership is transferred with respect to an underlying partnership interest, if the applicable transaction is not treated for federal income tax purposes as indebtedness secured by the partnership interest. Although REPOs are often treated as debt instruments for tax purposes, the right of the "buyer" to return equivalent securities (as opposed to the actual securities transferred to it from the "seller") could cause the transaction to be characterized for federal income tax purposes as a sale coupled with a forward contract. Thus, in the case of a REPO involving partnership equity, certifications may need to be collected on both the sale and the repurchase. Similar issues arise with securities lending transactions.

Another issue arises if a partner transfers beneficial ownership of a partnership interest, but the partnership is not aware of the transaction and does not participate in the transaction (for example, by admitting the transferee as a partner). Hopefully, regulations will provide that the partnership will not be liable for any withholding tax in such a case.[51] Further, distributions from partnerships could be treated as a sale or exchange from the perspective of a partner (if the distribution reduces the partner's basis below zero),[52] and such disposition could be subject to these rules even though the partnership may not even know the partner's actual basis.

The Act provides that the above-described rule also applies to indirect dispositions of partnership interests, although neither the Act nor the Conference Report expand on this language. Thus, it is unclear whether the IRS will attempt to apply the "indirect" language to a transfer of an interest in a corporation that holds a partnership interest. It is possible that the IRS might attempt to apply the statute to situations involving a corporate blocker whose sole asset consists of a partnership interest, but any broader application to corporate owners of partnership interests would seem likely to raise issues of fairness as well as administrability. It is also unclear if or how the IRS will apply the statute to tiers of partnerships. Presumably, the IRS will apply the statute to a transfer of an interest in an upper-tier partnership that owns an interest in a lower-tier partnership, but it is not certain if they would also apply it to a transfer of a lower-tier partnership by an upper-tier partnership. In addition, if they applied it in the latter case, it is unclear whether they would look through the upper-tier partnership to its beneficial owners. For example, if the upper-tier partnership was a U.S. partnership that had non-U.S. partners, would the upper-tier partnership be subject to withholding with respect to such partners? Other difficult issues arise where there is gain on effectively connected assets and losses on other effectively connected assets (or where not all assets are partnership interests). The imposition of withholding on distributions to an intermediary entity will also be problematic, as such entity may have difficulty allocating such withholding to the indirect owner that caused such withholding. The Act does not provide that a certification from the partnership to the effect that it is not engaged in a U.S. trade or business will suffice to shield the transferee from liability for failure to withhold if it turns out that the partnership is in fact engaged in a U.S. trade or business.[53] It is possible that future regulations will provide such a rule.

For taxable years beginning after December 31, 2017, the Act precludes individuals, estates and trusts from claiming any miscellaneous itemized deductions for regular income tax purposes.

iii. Risk Reduction for Securitization Vehicles

Where, as is typical for certain types of securitizations (*e.g.,* CLOs), the issuing special purpose vehicle is designed not to be engaged in a U.S. trade or business and has received a legal opinion or advice that it will not be so treated, the issuer likely will not need to collect, and transferees may not require, transferor certifications. However, even in this case, there is a risk that the IRS may disagree with the opinion and/or the transaction may be managed in a way that causes the facts assumed by counsel to be erroneous. Cautious transferees may insist upon receiving the certification (especially where the transferor is a U.S. person and can readily give it). For the reasons discussed in the next paragraph, transferees may also request a certification from a foreign transferor that it is not holding its interest in connection with a U.S. trade or business (which otherwise generally would require the transferor to give the partnership an IRS Form W-8ECI).

In many cases, securitization vehicles that are partnerships for tax purposes prohibit any non-U.S. investor from holding its equity in connection with such investor's U.S. trade or business. Such a prohibition is designed to

This limitation could cause a corporate issuer, or the equity holders in a passthrough issuer, in a securitization transaction to recognize phantom income due to the issuer's inability to realize the full tax benefit of its interest expense.

avoid the counterintuitive requirement (under current law) whereby the issuer would then be required to withhold on allocations of income to a non-U.S. partner that is required to file U.S. federal income tax returns and pay tax on a net income basis. Adding such a prohibition may be more advisable now, as holding a partnership interest in connection with a U.S. trade or business of the partner may cause the new transferor certification requirement to apply. Although as currently drafted the Act does not expressly apply to this situation, the Treasury is given authority in the Act to promulgate regulations to effectuate the purpose of the provision.[54]

Where an issuer is a partnership that is or may be engaged in a U.S. trade or business, or is a disregarded entity that may be recharacterized as such a partnership if a class of debt is recharacterized as equity for federal income tax purposes, it will be necessary to provide for the collection of these certifications from transferors of its equity interests. As indicated above, the transferor's share of the partnership's liabilities will be included in the amount realized, which is subject to withholding. Accordingly, in addition to collecting transferor certifications, the issuer will need to provide transferors and transferees with these data. Partnerships concerned that they might be engaged in a U.S. trade or business will need to ensure that they can obtain all relevant information in connection with the transfer of a partnership interest, including the sales price and any amount withheld. Otherwise, partnerships will be unable to determine the amount (if any) of their own withholding requirements. Such partnerships will also need to ensure that (i) they have no gross-up obligation in the event they are required to withhold on transferees that fail to properly withhold and (ii) transferees agree to indemnify for the partnerships' failures to withhold on the transferees (after the transferees fail to withhold on the transferors). Of course, transferees may not be amenable to giving an indemnity to a partnership that is expected to operate such that it is not engaged in a U.S. trade or business. Where a security is highly likely to be treated as, but is not clearly, debt for U.S. federal income tax purposes, there will be tension between establishing procedures that force transferees to collect and turn over to the issuer the transferor certifications and making the securities easy to transfer. In addition, pre-existing partnerships may not have the power (or perhaps the will) to cause compliance with the partnership transfer rules and/or manage the risk to the partnership with respect to such rules.

Where partnership equity (or potential equity) is held through a clearing organization (such as DTC) or other intermediaries, a partnership may not even be aware of a transfer of a partnership interest. Current law requires persons holding partnership interests as nominees to inform the relevant partnership of the name of, and certain other information about, the beneficial owner.[55] However, because no specified penalty currently applies for non-compliance, compliance with this requirement is not universal.[56]

It may be possible for partnership issuers to utilize "daisy chain" investor letters outside of the normal clearing process of book-entry ownership record systems. However, such investor letter mechanisms depend on investor compliance rather than oversight by any transfer agent or other similar party and, accordingly, will not necessarily ensure tax documentation compliance. Thus, even when employing the "daisy chain" mechanism, partnerships may retain significant risk of incurring withholding agent liability should that compliance not occur. Concerned partnerships may decide to certificate their partnership equity (and require appropriate certifications in connection with any transfers) and general partners or other managers of such partnerships may consider their own exposure to partnership liability under constituent documents, applicable local law or applicable U.S. federal income tax theories of transferee or "responsible person" liability for taxes not appropriately withheld.

II. Other Changes That May Impact Securitizations

A. Elimination of Miscellaneous Itemized Deductions

i. Background

Under prior law, individuals, estates and trusts were permitted to claim itemized deductions for certain miscellaneous expenses, to the extent that those expenses exceeded (in the aggregate) 2% of the taxpayer's adjusted gross income ("AGI").[57] The deductions that were permitted (subject to this aggregate 2% floor) included miscellaneous investment related expenses allowable under Code Sec. 212, *i.e.*, ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income.[58] Taxpayers also were allowed this deduction (subject to the 2% floor) with respect to allocable expenses incurred through passthrough entities (including partnerships, REMICs and grantor trusts).[59] However, no deduction for miscellaneous itemized deductions was allowed for purposes of the individual alternative minimum tax.[60]

ii. Change Under the Act and Impact

For taxable years beginning after December 31, 2017, the Act precludes individuals, estates and trusts from claiming any miscellaneous itemized deductions for regular income tax purposes.[61] As with most other changes made by the Act to the individual income tax, this repeal is technically a temporary suspension, scheduled to expire for taxable years beginning after December 31, 2025.[62] However, during the years to which it applies, its effect will be to prevent individual, trust and estate equity owners in securitizations structured as pass-throughs, *e.g.*, as trusts or partnerships (as well as REMICs), from taking deductions with respect to allocable fees such as servicing and swap expenses paid by the related securitization vehicle, unless such vehicle is sufficiently "active" to be regarded as engaged in a trade or business for tax purposes (thus allowing for such deductions under Code Sec. 162.[63] There may be the potential in some transactions to mitigate the adverse impact of the deduction disallowance and income whipsaw through an integration or similar election.[64]

B. Subpart F, CFCs and U.S. Shareholders

i. Background

Under the "subpart F" provisions of the Code, the principal anti-avoidance regime aimed at ensuring current taxation of "portable" offshore income earned by U.S. persons through foreign corporations, the U.S. generally taxes each 10% "United States shareholder" of a CFC on its share of certain specified and relatively "mobile" (*i.e.*, easily relocatable) types of income earned by the CFC. Such income generally includes interest and interest equivalents (as well as other passive investment income).[65]

As a threshold matter, subpart F historically established the requisite 10% ownership interest of a U.S. shareholder in a foreign corporation necessary for its application by looking to a U.S. person's ownership of "10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation."[66] Yet subpart F drew this U.S. shareholder line, focused on voting power, while more broadly classifying a foreign corporation as a CFC by looking to whether U.S. shareholders owned more than 50% of *either* "(1) the total combined voting power of all classes of stock of the corporation entitled to vote; *or (2) the total value of the stock* of the corporation."[67] The basic definitional structure of subpart F was augmented by various stock attribution rules treating various indirect ownership arrangements as causing a U.S. person to possess the requisite ownership of voting power so as to constitute a U.S. shareholder[68] and employed (in regulations) various anti-avoidance provisions aimed specifically at recharacterizing "[a]ny arrangement to shift formal voting power away from

> *With respect to NOLs, the Act limits a taxpayer's use (including by C corporations) of current NOL deductions to 80% of the taxpayer's taxable income, generally eliminates the use of NOL carrybacks, and allows for NOLs to be carried forward indefinitely.*

United States shareholders of a foreign corporation."[69] Nevertheless, prior to the Act, the determination of U.S. shareholder status (and thus by implication CFC status) began with the foreign corporation's voting shareholders.

The application of subpart F also required that, before U.S. shareholders are taxed under subpart F, the foreign corporation in which they are a shareholder must constitute a CFC "for an uninterrupted period of 30 days or more."[70] This 30-day requirement did not necessarily result in any reduction in such shareholder's subpart F income once the 30-day time period had elapsed—the income inclusion was determined from the time the foreign corporation first became a CFC[71]—but it certainly could have permitted U.S. shareholders to completely avoid subpart F inclusions (by manipulating the consecutives days the entity qualified as a CFC).

ii. Changes Under the Act and Impact

First, the Act expands the definition of "United States shareholder" with respect to a CFC to include not only holders of 10% of the total combined voting power of a foreign corporation but also holders of 10% of the total value of a foreign corporation.[72] As a result, a holder of certificates, subordinated notes, or other equity interests in a foreign corporation amounting to 10% or more of such corporation's value will be treated as a U.S. shareholder. An investor will no longer be able to avoid U.S. shareholder status on the basis that its investment does not possess the requisite voting power, on account of, for example, not conferring any right to vote for members of the board of directors (or for others performing a similar function).[73]

Second, the Act eliminates the requirement that a CFC be controlled for 30 uninterrupted days before subpart F income inclusions are triggered.[74] This change will prevent taxpayers from avoiding the CFC rules by manipulating the consecutive days that an entity would otherwise qualify as a CFC.[75]

C. Accelerated Income Accrual Based on Financial Reporting

i. Background

As a general matter, a taxpayer is required to include an item in gross income no later than the time of its actual or constructive receipt, unless the item properly is accounted for in a different period under the taxpayer's method of accounting.[76] For an accrual method taxpayer, an amount generally is included in gross income when the "all events test" is met, *i.e.*, when (i) all the events have occurred that fix the right to receive such income and (ii) the amount thereof can be determined with reasonable accuracy.[77] Interest on a debt instrument held by an accrual method taxpayer generally must be included in income during the year it accrues.[78] Original issue discount ("OID") generally accrues regardless of whether the taxpayer is otherwise an accrual basis taxpayer, and is includible in gross income as interest over the term of the debt instrument, regardless of when the stated interest (if any) is paid. It accrues in an amount equal to the sum of the daily portions of the OID for each day during the taxable year the holder held such debt instrument.[79] Special rules govern the accrual of OID with respect to prepayable debt instruments (including REMIC regular interests), as well as pools of debt instruments the payments on which may be accelerated by reason of prepayment of underlying debt instruments, in each case generally based on a reasonable prepayment assumption, and subject to adjustment for actual prepayments.[80]

ii. Change Under the Act and Impact

The Act generally requires an accrual method taxpayer subject to the "all events test" for an item of gross income to recognize such income no later than the taxable year in which such income is taken into account as revenue in an "applicable financial statement" (*e.g.,* certain SEC or International Financial Reporting Standards filings).[81] There is no equivalent rule for deductions. Apart from suggesting a general potential acceleration of income recognition and tax liability, this change in accounting may create uncertainty and potential timing mismatches for many holders. In part, this is due to having an effective date that generally applies the change to "taxable years beginning after December 31, 2017,"[82] causing its application to extend to income-generating assets spanning pre- and post-Act law without specifying the necessary coordination (*e.g.,* to avoid double income inclusions).[83] Presumably in light of the particular difficulties to be settled in applying the change in accrual methodology to recognition of OID, the Act provides for a special effective date with respect to OID, applying the new rules only to taxable years beginning after December 31, 2018[84]—but even that allowance seems lacking (*e.g.,* in failing to address whether the change applies to a market discount debt instrument).[85]

Neither Code Sec. 451(a) nor the legislative history addresses the scenario in which book income accrues slower than taxable income in early years and faster in later years. The policy behind Code Sec. 451(a) would not be furthered by accelerating taxable income inclusions in the later years to match book income, when such income had already been taken into account for tax purposes. Presumably, the appropriate test should be whether book income exceeds taxable income on a cumulative basis—an approach that offers the added benefit of working for both existing and new transactions. However, it may be more difficult administratively and as a compliance matter to require Code Sec. 451(a) calculations to be made on anything other than an annual basis, especially considering the wide array of assets to which the new rules apply, and uncertainty regarding whether and how aggregating of assets or activities might also be allowed.

D. Excess Business Loss Disallowance and NOL Haircut

i. Background

The Code provides for a variety of loss limitations applicable to non-C corporation taxpayers, including limitations applicable to their business income, such as the passive activity loss limitations imposed by Code Sec. 469 on passive business activity (which very generally restricts the deduction of losses arising from business activity in which a taxpayer does not materially participate).[86]

Separately, the Code provides for the deduction of a "net operating loss," or an NOL deduction, generally equal to the excess of a taxpayer's business deductions over its gross income, which deduction generally could be carried back two years, and then carried forward 20 years, to offset taxable income in such years.[87]

ii. Changes Under the Act and Impact

The Act disallows the use of "excess business losses" by all non-C corporation taxpayers.[88] Very generally, an excess business loss for the taxable year is the excess of (i) the aggregate deductions of the taxpayer attributable to the trades or businesses of the taxpayer over (ii) the sum of aggregate gross income or gain of the taxpayer attributable to such trades or businesses plus a threshold amount ($500,000 in the case of a joint return).[89] In the case of business activity conducted through a partnership or S corporation, the aggregation and disallowance is applied at the individual taxpayer level.[90] Any excess business loss that is disallowed is treated as a NOL deduction, available for carryover to subsequent years.[91] With respect to NOLs, the Act limits a taxpayer's use (including by C corporations) of current NOL deductions to 80% of the taxpayer's taxable income, generally eliminates the use of NOL carrybacks, and allows for NOLs to be carried forward indefinitely.[92]

Depending on the facts, the excess business loss disallowance rules could create loss deferral issues for individual investors in passthrough securitization structures that generate economic losses (or phantom losses as phantom income reverses) if those structures are sufficiently "active" so as to engage in business activity.[93] More broadly, the NOL changes—and in particular the limitation on NOLs to 80% of current taxable income—could similarly affect both individual and corporate investors allocated losses from a securitization (*i.e.,* deferring losses to the extent that the 80% limit applies to prevent an investor from fully and finally using a loss carryforward). While many investors may have adequate other income to absorb a loss carryforward, highly structured entities—*e.g.,* commercial paper or medium-term note conduits, which tend to "zero out" their taxable income—could suffer what might amount to a permanent disallowance, to the extent there ultimately was not sufficient other taxable income to absorb a loss carryforward.[94]

As with most of the other changes made by the Act that are generally applicable to individuals, the excess business loss disallowance rules apply for taxable years beginning after December 31, 2017, and before January 1, 2026.[95] The NOL changes, however, generally apply to NOLs arising in taxable years beginning after December 31, 2017 (*i.e.,* continuing after the termination of the effectiveness of the excess loss rules and subsequent reversion to pre-Act law).[96]

E. Life Settlement Changes

i. Background

Secondary market investment in life insurance contracts is subject to a variety of special tax rules. The threshold and seminal consideration is the Code's general exclusion from federal income tax provided for amounts received under a life insurance contract paid by reason of the death of the insured.[97] However (subject to certain exceptions), under rules known as the "transfer for value" rules, if a life insurance contract is sold or otherwise transferred, the amount paid by reason of the death of the insured that is excludable generally is limited, and may not exceed the sum of (1) the actual value of the consideration, and (2) the premiums or other amounts subsequently paid by the transferee of the contract.[98]

ii. Changes Under the Act and Impact

First, the Act imposes new reporting obligations upon acquirers of a direct or indirect acquisition of a life insurance contract if the acquirer has no substantial family, business, or financial relationship with the insured.[99] An indirect acquisition includes the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract.[100] In connection with such reportable transfers (a "reportable policy sale") or other transfers of a life insurance contract to a foreign person, issuers of life insurance contracts are also required to report certain information, including the seller's basis in the contract.[101] Insurers are also required to report payment information and an estimate of the buyer's basis in the contract in connection with the payment of a death benefit under a life insurance policy that was transferred in a reportable policy sale.[102] These provisions are effective with respect to policy sales and payments occurring after December 31, 2017.[103]

Second, the Act provides that in determining the basis of a life insurance or annuity contract, no adjustment is made for mortality, expense, or other reasonable charges incurred under the contract, reversing (and doing so retroactively with respect to transactions entered into after August 25, 2009) the position of the IRS in Rev. Rul. 2009-13,[104] that on sale of a cash value life insurance contract, the insured's (seller's) basis is reduced by the cost of insurance.[105]

Third, the Act provides that the favorable exceptions to the "transfer for value" rules[106] do not apply in the case of a transfer of a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale—thereby increasing the circumstances under which some portion of the death benefit ultimately payable under such a contract will be includable in income.[107] Like the reporting rules to which they relate, this change is applicable to transfers after December 31, 2017.[108]

These changes (in particular, the reporting obligations) may affect equity investors in securitization vehicles that invest in life insurance contracts as well as the vehicles themselves. The new reporting obligations also affect insurers—although it is the extension of reporting by insurers specifically with respect to transfers of policies to foreign investors that may diminish foreign investors' appetite for life insurance contracts or securitization vehicles owning such contracts, to the extent it may suggest heightened scrutiny toward the position that the payment of a death benefit to such an investor should constitute capital gain (and not be subject to withholding as "fixed and determinable, annual or periodical" income).[109] The basis and transfer for value changes may also affect—favorably and unfavorably, respectively—computations regarding the taxable income of issuers, as well as of investors who invest in the equity of such issuers.

F. Limitation of 1031 Exchanges to Real Estate

i. Background

Under Code Sec. 1031 as in effect prior to its amendment by the Act, no gain or loss generally is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like kind" that is to be held for productive use in a trade or business or for investment. If Code Sec. 1031 applies to an exchange of properties, gain or loss generally is deferred, and the basis of the property received in the exchange is equal to the basis of the property transferred; this basis is increased to the extent of any gain recognized as a result of the receipt of other property or money in the exchange and decreased to the extent of any money received by the taxpayer.[110] The holding period of qualifying property received includes the holding period of the qualifying property transferred.[111]

ii. Change Under the Act and Impact

Generally effective with respect to exchanges completed after December 31, 2017, the Act amends Code Sec. 1031 to prohibit like-kind exchanges involving personal property.[112] As a result, auto and farm equipment manufacturers (as well as other companies that lease assets to consumers)—which historically have used a like-kind exchange program to defer gain on the disposition of property returned at the end of a lease—will no longer be able to avail themselves of the benefits of Code Sec. 1031. The most significant effect of this elimination of like-kind exchanges with respect to personal property will be to increase the cost to sponsors or other equity owners of securitization vehicles owning such assets due to the increased gain recognition on asset replacements. A less consequential effect may be a streamlining of the related asset replacement mechanisms in securitization documentation (which will no longer need to navigate the conditions previously necessary for Code Sec. 1031 compliance).

The most significant effect of this elimination of like-kind exchanges with respect to personal property will be to increase the cost to sponsors or other equity owners of securitization vehicles owning such assets due to the increased gain recognition on asset replacements.

[*] The authors would like to thank Christie R. Galinski for her help and comments on this article.

[1] Code Sec. 163(j). Although the statute refers to "business interest," for ease of presentation, the discussion in this article will use the term "business interest expense" (except when quoting the Code or other authorities). All section references herein are to the Internal Revenue Code of 1986 (the "Code") unless otherwise indicated.

[2] Code Sec. 163(j)(4).

[3] Code Secs. 864(c)(8) and 1446(f).

[4] Code Sec. 1446(f)(1).

[5] Code Sec. 1446(f)(4).

[6] Section 13301(c) of the Act.

[7] Section 13501(c) of the Act.

[8] Code Secs. 163(j)(3) and 448(c).

[9] Code Sec. 163(j)(7)(A).

[10] Code Sec. 163(j)(1)(C)'s add back of floor plan financing interest effectively exempts deductions for such interest from the provision. *See also* Code Sec. 163(j)(4)(C)(i)(II) (reducing net business interest expense by floor plan financing interest in the calculation of excess taxable income). Floor plan financing interest is interest on indebtedness used to finance the acquisition of motor vehicles held for sale to retail customers and secured by the inventory so acquired. Code Sec. 163(j)(9).

[11] Although the Act does not explicitly exempt REMICs from the interest limitation rule, such rule only applies to interest expense and interest income allocable to a trade or business and does not impact investment interest within the meaning of Code Sec. 163(d) of the Internal Revenue Code of 1986 (the "Code"). *See* Code Sec. 163(j)(5) (definition of business interest expense) and Code Sec. 163(j)(6) (definition of business interest income). Pursuant to Reg. §1.860C-2(b)(4), a REMIC is not treated as carrying on a trade or business for purposes of Code Sec. 162, and ordinary operating expenses are deductible under Code Sec. 212 (a provision generally allowing individuals to claim deductions for expenses that are not connected to a trade or business). Consequently, the Act's interest limitation rule should not apply to REMICs since a REMIC's interest expense, which is deductible under Code Sec. 212, should not be treated as allocable to a trade or business.

[12] Some securitization vehicles, including fixed investment trusts characterized as grantor trusts, may not be engaged in a trade or business (because their activity is sufficiently limited to investing, rather than trading, in assets). However, other securitization vehicles either clearly will be engaged in a trade or business or will be subject to significant risk of being considered to be so engaged. In addition, we note that the critical issue is whether the entity is engaged in a trade or business—not whether it is engaged in a *U.S.* trade or business. Thus, CLOs and other offshore issuers, which generally receive tax opinions that they are not engaged in a U.S. trade or business, may nevertheless be subject to this new rule if they are in fact engaged in a trade or business (*e.g.,* because they trade in debt instruments as opposed to being mere investors).

[13] Code Sec. 163(j)(1).

[14] Code Sec. 163(j)(2).

[15] Code Sec. 163(j)(4).

[16] Code Sec. 163(j)(8).

[17] The amount of anticipated phantom income and phantom losses will need to be modeled by the structurer to determine the ultimate impact on the securitization. In very general terms, in a typical offering of an SPV issuer of multiple-class sequential pay bonds backed by a fixed pool of assets, some phantom income often will be realized in early years and followed by a corresponding amount of phantom losses in subsequent years. This results from the distribution over time of the yields that are used in calculating the SPV's income and deductions. The combination of income based on assets generating a relatively fixed yield and deductions based on funding securities having an escalating yield (because longer maturity funding classes would normally be sold with higher yields) produces the pattern of phantom income and losses previously described. This effect—which is most pronounced in REMICs (which, as indicated in *supra* note 11, are not subject to the interest disallowance rule) because longer-dated, higher yielding sequential pay classes (which are endemic to REMICs) tend to have a much longer maturity than faster-paying, lower yielding classes (also commonly found in REMICs)—is mitigated somewhat in CLOs and other securitizations that either (i) pay off sequential classes relatively quickly after their immediate senior classes are retired and/or (ii) are supported by substantial equity (as opposed to debt generating additional business interest expense deductions).

[18] Under prior law, 50% first-year bonus depreciation under Code Sec. 168(k) applied to certain property placed in service through 2019 and was beginning to phase out. However, the Act generally extended bonus depreciation under Code Sec. 168(k) through December 31, 2026, and provides 100% first-year bonus depreciation for qualified property placed in service between September 27, 2017, and January 1, 2023. The bonus depreciation phases down to 20% in 2026 (or 2027 for certain property with longer production periods).

[19] Code Sec. 163(j)(4). The statute does not explicitly provide any exception for partners that are not themselves engaged in a trade or business, instead assuming that each partner has (or could have) ATI, and implying that each is subject to Code Sec. 163(j). Under that reading, Code Sec. 163(j) generally would (at least partially) overrule Rev. Rul. 2008-12, 2008-1 CB 520, which provides that (i) interest expense of a partnership that trades in securities is a separately stated item and (ii) since a limited partner's distributive share of the interest paid or accrued on the indebtedness of such partnership is allocable to the trading activity of the partnership and is not a passive activity, it is investment interest described in Code Sec. 163(d)(3) (when allocated to a partner who does not materially participate in that trading activity) and subject to the investment interest limitation in Code Sec. 163(d)(1). This conclusion is further supported by Code Sec. 163(j)(4)(A), which provides that the subsection shall be applied at the partnership level and that any deduction for business interest expense shall be taken into account in determining the partner's *non-separately stated* taxable income or loss of the partnership. Although Code Sec. 163(j)(5) and (6) provide that business interest expense and business interest income, respectively, do not include investment interest or investment income, respectively, within the meaning of Code Sec. 163(d), the determination of whether interest income or interest expense qualifies as business interest income or business interest expense is made at the partnership level, prior to determining the character of any such income or expense that may be allocated to the partners. It not only would create havoc but also would violate the explicit mandate of Code Sec. 163(j)(4)(A) for a partnership to have to separately state its business interest income and business interest expense for some partners, but not for others. Essentially, the alternative reading would require a partnership to characterize its interest income and interest expense (*e.g.,* as investment income or investment interest within the meaning of Code Sec. 163(d)) by first determining how such income and expense would be treated for each and every partner based on their own circumstances (*e.g.,* by reference to their material participation).

Although Rev. Rul. 2008-12 did not address the treatment of the partner's allocable share of the partnership's interest income, its holding supports the proposition that any such interest income would constitute net investment income within the meaning of Code Sec. 163(d)(4), since such investment income would, under Rev. Rul. 2008-12, be attributable to property held for investment. It is not clear, however, if Code Sec. 163(j) was meant to override Rev. Rul. 2008-12's apparent separate statement treatment with respect to net interest income. If Code Sec. 163(j) was meant to overrule Rev. Rul. 2008-12 with respect to net interest income, a limited partner in a trading partnership would no longer be able to offset its own Code Sec. 163(d) investment interest expense with its separately stated distributive share of the partnership's Code Sec. 163(j) net business interest income. This presumably would be because either net business interest income does not flow through to partners under Code Sec. 163(j) (*see infra* note 22 and accompanying text) or any net business interest income retains its character as *business* interest income when it flows through to partners—producing a result that would be (i) detrimental to limited partners who had Code Sec. 163(d) investment interest expense that they wished to offset with Code Sec. 163(d) net investment income, but (ii) favorable to limited partners who had non-related Code Sec. 163(j) business interest expense that they wished to offset with Code Sec. 163(j) business interest income. If a partnership's Code Sec. 163(j) net business interest income is determined to flow through to its partners as a separately stated item, then it is likely that the IRS would continue to follow the implication of Rev. Rul. 2008-12 and treat it as Code Sec. 163(d) investment income with respect to limited partners that do not materially participate in a trading partnership. However, such a rule would require treating business interest income and business interest expense as part of non-separately stated income *to the extent they offset each other* while treating only any net business interest income as a separately stated item. *See* Example 8, below.

20 Code Sec. 163(j)(4)(A)(ii)(II). The partner's ATI is increased by its distributive share of the partnership's Excess Taxable Income. Specifically, the Excess Taxable Income is the gross amount of the partnership's ATI not utilized by the partnership to offset the partnership's business interest expense. In other words, if Partnership AB, owned 50% by partners A and B, has $80 of ATI, $30 of business interest income, and $50 of business interest expense, its ATI would be able to offset an additional $24 of net business interest expense. But since Partnership AB has only $20 ($50 – $30) of net business interest expense, it would have $4 of unused capacity, which under the statute should be shared equally ($2) by each of its partners. The calculation of Excess Taxable Income requires the $4 to be divided by 30% to yield the $13.33 Excess Taxable Income. (All calculated numbers are subject to rounding.) The calculation is done in this manner to ensure that when 50% ($6.66) of the Excess Taxable Income is allocated to partners A and B, such partners will each be able to utilize $2 ($6.66 × 30%), first to the extent of any previously disallowed business interest expense allocated to them from partnership AB, and second to the extent of their own business interest expense unrelated to Partnership AB. (*But see* the last paragraph of this endnote for an alternative, taxpayer-favorable methodology for utilizing Excess Taxable Income to offset previously disallowed business interest expense.) For those interested in the mathematical derivation, Code Sec. 163(j)(4)(C) provides that "[t]he term 'excess taxable income' means, with respect to any partnership, the amount which bears the same ratio to the partnership's adjusted taxable income as (i) the excess (if any) of (I) the amount determined for the partnership under paragraph (1)(B), over (II) the amount (if any) by which the business interest of the partnership, reduced by the floor plan financing interest, exceeds the business interest income of the partnership, bears to (ii) the amount determined for the partnership under paragraph (1)(B)." The amount determined under paragraph (1)(B) refers to the 30% of partnership ATI, or $24 in the above example. Continuing with our example, (Excess Taxable Income)/$80 (ATI) = [(the amount under paragraph (1)(B)) – (the net business interest expense)]/(the amount under paragraph (1)(B), or ($24-$20)/$24, or $4/$24, or $1/$6. Note that the $4 in the numerator represents the net "unused" business interest expense at the partnership level, consisting of $24 (30% of ATI), reduced by $20, the excess of $50 over $30. Thus, ETI/$80 = $1/$6, or ETI = $80/$6, or $13.33.

As indicated above, the $13.33 of Excess Taxable Income passes through to partners A and B prior to multiplying such amount by 30%. This creates an unusual result. If Partnership AB had no prior disallowed interest expense, partners A and B would increase their adjusted taxable income by $6.66 each and 30% of that increase would yield $2 of extra capacity (the "right" answer). *See* Code Sec. 163(j)(4)(A)(i) (the adjusted taxable income of each partner of a partnership is increased by its distributive share of such partnership's Excess Taxable Income) and Code Sec. 163(j)(1)(B) (30% of a partner's adjustable taxable income can be used to offset such partner's excess business interest expense). However, if Partnership AB has previously disallowed interest expense, then the statute actually appears to permit each partner to offset such interest expense with 100% (as opposed to 30%) of Excess Taxable Income. *See* Code Sec. 163(j)(4)(B)(ii) (no mechanism in statute to limit utilization of Excess Taxable Income against previously disallowed business interest expense by 30% thereof). Obviously, this must not have been intended. Nevertheless, taxpayers may attempt to exploit this apparent error by relying on the statute's plain meaning. To the extent such taxpayers are also honoring the plain meaning of other aspects of Code Sec. 163(j) (which, as discussed in this section "Technical Analysis," have serious flaws, potential discrepancies, and in some cases, make no sense), the IRS may have difficulty attacking such adherence. Courts generally only will refuse to apply literally the plain text of a provision in certain unusual situations. Such situations typically involve language that is ambiguous or results that are clearly contrary to unequivocally expressed Congressional intent or are otherwise absurd. *See, e.g., D.A. Gitlitz,* SCt, 2001-1 USTC ¶50,147, 531 US 206, 219–220, 121 SCt 701 (the Supreme Court upheld a taxpayer's plain language reading of Code Sec. 1366(a)(1)(A) even though the taxpayer would (in the IRS's view) wrongly experience a "double windfall," stating "because the Code's plain text permits the taxpayers here to receive these benefits, we need not address this policy concern"). *See also National Life Ins.*, CA-2, 96-2 USTC ¶50,509, 103 F3d 5, 8 ("[t]he plain meaning of legislation should be conclusive, except in the rare cases in which the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters," quoting *Ron Pair Enters.*, SCt, 89-1 USTC ¶9179, 489 US 235, 242, 109 SCt 1026); *J.E. Holroyd*, CA-2, 84-1 USTC ¶9423, 732 F2d 1122. Since the underlying statute (Code Sec. 163(j)) is riddled with issues (and the legislative history is scant), it may be difficult for the IRS to convincingly proffer any particular application as representative of Congressional intent.

21 Code Sec. 163(j)(4)(B)(ii)(II) (flush language). *See also* the Conference Report accompanying the Act (the "*Conference Report*") at 232, which provides that any business interest expense "that is not allowed as a deduction to the partnership for the taxable year is allocated to each partner in the same manner as non-separately stated taxable income or loss of the partnership … and a partner may deduct its share of the partnership's [excess business interest expense] … *only against* excess taxable income attributed to the partner by the partnership … " (emphasis added).

22 Even in the absence of guidance, some commentators, tax practitioners and taxpayers likely will take the position that the Act permits excess business interest income to flow through to a partnership's partners under general partnership principles (to support the partners' own separate business interest expense but not their allocable share of the partnership's previously disallowed business interest expense), since the statute only explicitly prohibits (and provides rules for) the pass-through of net business interest *expense*. *See* Code Sec. 702(a). *See also* James M. Peaslee & David Z. Nirenberg, FEDERAL INCOME TAXATION OF SECURITIZATION TRANSACTION AND RELATED TOPICS (5th ed. Forthcoming), Chapter 9, Part C ("Peaslee & Nirenberg"). However, while that position reflects a reading of the statute that is sensible as a policy matter and may have been consistent with the drafters' intentions, it is not without risk. Code Sec. 163(j)(4)(A)(ii) provides that "the adjusted taxable income of each partner of [a] partnership … (I) shall be determined without regard to such partner's distributive share of the non-separately stated taxable income or loss of such partner, and (II) shall be increased by such partner's distributive share of such partnership's [Excess Taxable Income]." Proponents of the above-mentioned argument will undoubtedly point

out that the quoted language relates to the determination of a partner's share of ATI, not net business interest income. Similarly, they will proffer that Code Sec. 163(j)(4)(A)(i), which provides that "in the case of any partnership … this subsection shall be applied at the partnership level and any deduction for business interest shall be taken into account in determining the non-separately stated taxable income or loss of the partnership," technically only applies to the *deduction* of business interest expense and not the *inclusion* of business interest income. But, as discussed below in the text, the current language of the Act explicitly states that a partner's allocable share of a partnership's previously disallowed business interest expense can only be utilized against the partner's share of the partnership's future Excess Taxable Income (which does not include business interest income). It would be anomalous to provide that a partner may utilize its share of a partnership's excess business interest income against the partner's non-partnership business interest expense, while simultaneously providing that a partner may not utilize such amount against the previously disallowed business interest expense of the very partnership that generated such excess business interest income. As stated in the text, one would hope that a technical corrections act or administrative guidance might clarify that a partnership may pass through the excess of its business interest income over its business interest expense.

Code Sec. 163(j)(4)(B)(ii) (flush language at the end) provides that the amount of Excess Taxable Income allocated to a partner from a partnership "shall not be taken into account under paragraph (1)(A)" until the partnerships' previously disallowed business interest expense is reduced to zero—but this reference to "paragraph (1)(A)" appears to be a mistake. Code Sec. 163(j)(1) provides that "(1) IN GENERAL.—The amount allowed as a deduction under this chapter for any taxable year for business interest shall not exceed the sum of (A) the business interest income of such taxpayer for such taxable year, plus (B) 30 percent of the adjusted taxable income of such taxpayer for such taxable year … " Accordingly, it appears that the reference to paragraph (1)(A) should have been to paragraph (1)(B), since the latter is the paragraph that permits the utilization of ATI to offset business interest expense. If, however, the reference to "paragraph (1)(A)" was in fact intended, then the drafters may have contemplated that Excess Taxable Income could include business interest income, and that a partnership's excess business interest income could be passed through to its partners. However, that interpretation would mean that the definition of Excess Taxable Income was incorrectly drafted. In addition, if Excess Taxable Income was intended to include business interest income, then the reference to "paragraph (1)(A)" should have been to both "paragraphs (1)(A) and (1)(B)," in order to encompass both types of income. *See* the Conference Report at 232, which provides that any business interest expense "that is not allowed as a deduction to the partnership for the taxable year is allocated to each partner in the same manner as nonseparately stated taxable income or loss of the partnership … and a partner may deduct its share of the partnership's [excess business interest expense] … only against excess taxable income attributed to the partner by the partnership … " Nevertheless, as indicated in the text above, there is no rational basis for denying partners the ability to utilize their allocable share of a partnership's excess business interest income to offset their non-partnership related business interest expense. Such an interpretation effectively puts partnerships at a competitive disadvantage since other entities (*e.g.,* corporations) can utilize future excess business interest income to offset prior disallowed business interest expense. It also means that there could be a significant difference in the treatment of an investment trust depending on whether it is characterized as a grantor trust or as a partnership, and in the treatment of a partnership depending on whether it is a trader or an investor—distinctions that often are far from clear in practice.

23 Code Sec. 163(j)(4)(B).

24 Under either an entity or aggregate approach of partnerships, partners should be permitted to directly or indirectly utilize future net business interest income. Unfortunately, the IRS may read legislative language with respect to a partner's utilization of Excess Taxable Income as clearly limiting the passing through of net business interest income (even though such a reading would lead to a non-sensical result) and a technical correction act may be required to change and harmonize multiple provisions of the statute to construct a rational rule.

25 Code Sec. 163(j)(4)(B)(iii)(I).

26 Code Sec. 163(j)(4)(B)(iii)(II).

27 Code Sec. 163(j)(4)(B)(i) and (ii).

28 Code Sec. 702(a). *See* the Conference Report, footnote 688 (because a corporation has neither investment interest nor investment income within the meaning of Code Sec. 163(d), interest income and interest expense of a corporation is properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of the provision). *See* Example 7 for an illustration of this principle.

29 See Code Secs. 951 (amounts included in gross income of "United States shareholders" of a CFC) and 1293 (current taxation of income from holders making a QEF election).

30 *See* Code Secs. 1293(e) (ordinary earnings is the excess of earnings and profits over its net capital gain, and net capital gain shall not exceed earnings and profits) and 952(c)(1)(A) (subpart F income of any CFC shall not exceed the earnings and profits of such corporation for such taxable year). In general, disallowed deductions should still reduce a corporation's earnings and profits since earnings and profits represent a corporation's economic (as opposed to tax-related) earnings and income, except of course in the handful of instances where specific statutory exceptions dictate otherwise. *See, e.g.*, Code Sec. 312(m) (subject to an exception for a foreign corporation that is not a CFC, a corporation's earnings and profits are not reduced for any interest expense for which a deduction would not be allowable under Code Sec. 163(f) (related to registered obligations)).

31 *See supra* note 30 and accompanying text.

32 *But see* last paragraph of note 20, *supra*, for a discussion of an apparent error in the statute permitting each of partners ABC Corp and DEF Corp to offset previously disallowed interest expense with 100% of Excess Taxable Income (*i.e.,* each partner's share of the gross amount of Excess Taxable Income and not 30% thereof).

33 *See supra* note 22 and accompanying text for a discussion of whether net business interest income can flow through to partners. *See also* last paragraph of note 20, *supra*, for a discussion of an apparent error in the statute permitting each of partners ABC Corp and DEF Corp to offset previously disallowed interest expense with 100% of Excess Taxable Income (*i.e.,* each partner's share of the gross amount of Excess Taxable Income and not 30% thereof).

34 *But see supra* note 22 and accompanying text, for a discussion suggesting that excess business interest income, if not included as part of Excess Taxable Income, should, as a policy matter, flow through to partners to utilize against their own unrelated business interest expense.

35 *See supra* note 28.

36 *See supra* note 22 and accompanying text. The determination of whether net business interest income flows through to either partner will not be affected by MF Partnership having zero business interest expense—*i.e.,* the outcome obviously should be the same whether MF Partnership has $1 or $0 of business interest expense.

37 *See supra* note 22 and accompanying text.

38 *See supra* note 19, for a discussion of Rev. Rul. 2008-12.

39 Rev. Rul. 91-32, 1991-1 CB 107.

40 *Grecian Magnesite Mining, Industrial & Shipping Co., SA, v. C.I.R.*, 149 TC No. 3, Dec. 60,968 (2017).

41 The amount of gain required to be treated as effectively connected with a U.S. trade or business is limited to the amount of gain (if any) realized on the applicable disposition of the partnership interest. Specifically, new Code Sec. 864(c)(8)(A) provides, "Notwithstanding any other provision of this subtitle, if a nonresident alien individual or foreign corporation owns, directly or indirectly, an interest in a partnership which is engaged in any trade or

business within the United States, gain or loss on the sale or exchange of all (or any portion of) such interest shall be treated as effectively connected with the conduct of such trade or business to the extent such gain or loss does not exceed the amount determined under subparagraph (B)." Paragraph (B) provides "The amount determined under this subparagraph with respect to any partnership interest sold or exchanged (i) in the case of any gain on the sale or exchange of the partnership interest, is (I) the portion of the partner's distributive share of the amount of gain which would have been effectively connected with the conduct of a trade or business within the United States if the partnership had sold all of its assets at their fair market value as of the date of the sale or exchange of such interest, or (II) zero if no gain on such deemed sale would have been so effectively connected, and (ii) in the case of any loss on the sale or exchange of the partnership interest, is (I) the portion of the partner's distributive share of the amount of loss on the deemed sale described in clause (i)(I) which would have been so effectively connected, or (II) zero if no loss on such deemed sale would be have been so effectively connected." While the statute could be clearer, the gain on the hypothetical sale of the partnership's assets should be the net effectively connected gain (that is, taking account of the sale of any assets that would give rise to an effectively connected loss).

The amount of any tax imposed under this section is reduced by any tax imposed with respect to the disposition of a U.S. real property interest under Code Sec. 897 of the Code (the FIRPTA provisions). Code Sec. 864(c)(8)(C). The Act directs the Department of the Treasury (the "Treasury") to promulgate regulations that may be appropriate to apply the new rules to tax-free exchanges described in Code Secs. 332, 351, 354, 355, 356, or 361. Code Sec. 864(c)(8)(E).

42 Code Sec. 1446(f)(1).

43 Code Sec. 1446(f)(2).

44 A similar requirement in the context of FIRPTA withholding under Code Sec. 1445 does not require any particular form. Reg. §1.1445-2(b)(2)(i). *But see* Notice 2018-08 discussed *infra* in note 47 (the Treasury and the IRS request guidance on what forms should be required to assist taxpayers in their compliance).

45 Code Sec. 1446(f)(4).

46 This potential partnership liability is another example of recently evolving taxation of partnerships at the entity level. With very limited exceptions, partnerships are not subject to entity-level taxation. However, under pre-Act law that is first becoming effective in 2018 (Code Sec. 6221(a)), a partnership may become subject to partnership-level taxation in the case of an audit of the partnership's income tax return, unless the partnership makes an effective election either to push out the liability to its partners (Code Sec. 6226) or to elect out of the new partnership audit regime (Code Sec. 6221(b)). Under the Act, partnerships may now also be liable for tax arising from a failure to withhold where a transferee partner fails to withhold after not obtaining the relevant certification.

47 An alternative interpretation would require every transferee to perform due diligence regarding whether *any* prior transferee (all the way back to the first post-Act transferee) failed to properly withhold on the transfer of the same interest. It is unclear whether a trustee or paying agent of a partnership that is making distributions will be liable as a withholding agent, responsible person, or otherwise, for failure to withhold on partnership distributions to a transferee that failed to properly withhold upon its purchase. Accordingly, such persons may seek to be indemnified by the partnership for any such failure to withhold. As the partnership may no longer be in existence at the time the IRS asserts a tax liability, such persons also may seek an indemnity from the transferee.

The Conference Report indicates that the Treasury may provide guidance permitting a broker, as agent of the transferee, to deduct the withholding tax equal to 10% of the amount realized on the disposition of a partnership interest. Conference Report at 369. For example, such guidance may provide that if an interest in a partnership whose interests are publicly traded is sold by a foreign partner through a broker, the broker may deduct and withhold the 10% tax on behalf of the transferee. In Notice 2018-08, 2018-7 IRB 352 (Dec. 29, 2017) (the "Notice"), the Treasury and the IRS announced that they were suspending the application of the new withholding requirement in the case of a disposition of publicly traded partnership interests (within the meaning of Code Sec. 7704(b)) until regulations or other guidance have been issued under new Code Sec. 1446(f). The Notice indicated that a transferee of an interest in a publicly traded partnership typically will not be able to determine whether the transferor partner is foreign or domestic or whether any portion of a transferor partner's gain would be treated under new Code Sec. 864(c)(8) as effectively connected gain. This may be the case because publicly traded partnership interests are generally held in street name by a broker and transferred through a clearinghouse. Moreover, a particular sale may be aggregated with other sales and purchases of partnership interests by other customers of the same broker. As a result, it may be difficult for a transferee to determine whether it must withhold under new Code Sec. 1446(f). This temporary suspension is limited to dispositions of interests that are publicly traded and does not extend to non-publicly traded interests. The Treasury and the IRS requested comments on whether a temporary suspension of new Code Sec. 1446(f) for partnership interests that are not publicly traded partnership interests is needed and what additional guidance, or forms and instructions, may be needed to assist taxpayers in applying new Code Secs. 864(c)(8) and 1446(f).

48 *See* Code Sec. 752(d) and Reg. §1.752-1(h).

49 Notice 2018-08 is discussed in *supra* note 47.

50 Code Sec. 1446(f)(3). *Compare* Reg. §1.1445-3 (amount required to be withheld on FIRPTA disposition can be adjusted to reflect the transferor's maximum tax liability). It is unlikely, however, that FIRPTA-type procedures (which generally require an application to be sent to, and reviewed, by the IRS) could be implemented in a workable manner (since closing of sales of interests in partnerships tends to occur quickly (as opposed to sales of real property that historically have taken months).

51 *See* William B. Brannon, *Lingering Partnership Classification Issues (Just When You Thought It Was Safe to Go Back into the Water)*, 1 Fla. Tax Rev. 197, 222–224 (1993) (discussing Rev. Rul. 77-137, 1977-1 CB 178, and more generally the effectiveness of partnership interest transfers for tax purposes even though effected without partnership knowledge); *compare* Reg. §1.7704-1(d) (very generally, transfers of a partnership interest are not taken into account for purposes of determining whether interests in a partnership are traded on an established securities market or a secondary market or the substantial equivalent thereof, unless the partnership participates in the establishment of the market, recognizes transfers by redeeming the transferor or admitting the transferee as a partner, or otherwise recognizes any rights of the transferee).

52 Code Sec. 731(a).

53 *Compare* Code Sec. 1445(b)(3) (exemption from Code Sec. 1445 withholding where a non-publicly traded domestic corporation provides an affidavit that an interest in the corporation is not a U.S. real property interest).

54 We note that the Treasury issued regulations under Code Sec. 1446 that require a partnership to withhold on distributions to a partner that has given it an IRS Form W-8ECI regardless of whether the partnership itself is engaged in a U.S. trade or business. Reg. §1.1446-2(b)(2)(ii). Although Code Sec. 1446's broad definition of "effectively connected income," which includes income *treated* as effectively connected income, may have been the impetus for such regulation, we think it is possible that the Treasury will seek to extend this new rule to the circumstance described in the text.

55 Code Sec. 6031(c).

56 Reg. §1.6031(c)-1T(j) (penalties reserved).

57 Code Sec. 67(a). Itemized deductions were further reduced under prior law Code Sec. 68(a) by the lesser of (i) 3% of the excess of adjusted gross income over a threshold amount and (ii) 80% of the amount of itemized deductions allowable for the year. Code Sec. 68 was suspended under the Act for taxable years beginning after December 31, 2017, and

prior to January 1, 2026. Code Sec. 68(f).

[58] Code Sec. 212(1). Allowance under Code Sec. 212 (and thus under Code Sec. 67(a)) extended to such investment-related expenses only to the extent not otherwise addressed in other provisions either allowing for their deduction, *e.g.*, Code Sec. 163 (relating to interest) and Code Sec. 164 (relating to taxes), or disallowing their deduction, *e.g.*, Code Sec. 265(a)(1) (relating to expenses incurred that are allocable to tax-exempt interest).

Deductions for bad debts are not miscellaneous itemized deductions.

[59] Code Sec. 67(c) and Reg. §§1.67-2T, 1.67-3, and 1.67-3T.

[60] Code Sec. 56(b)(1)(A)(i).

[61] Code Sec. 67(g).

[62] Code Sec. 67(g).

[63] Fixed investment trusts taxable as grantor trusts will not be engaged in a trade or business. The trade or business status of other securitization vehicles will often not be clear. Some investors and issuers have taken the position that a particular vehicle is so engaged notwithstanding conducting limited business activity, in order to avoid otherwise applicable limitations on the deductibility of investment expenses under Code Secs. 67, 68, and 163(d). However, this position may have increased the risk that the issuer was a publicly traded partnership taxable as a corporation because the issuer would no longer be able to rely on the passive income safe harbor. *See* Code Secs. 7704(c) (a publicly traded partnership generally will not be treated as a corporation if 90% of its gross income is comprised of passive income) and 7704(d) (passive income does not include interest derived in the conduct of a financial business). An issuer taking the position that it is engaged in a trade or business and concerned about publicly traded partnership status would instead need to rely on an alternative exception, such as the private placement safe harbor of Reg. §1.7704-1(h). The new limitations on the deductibility of business interest discussed in Part I.C., above, also may affect the decision to treat securitization vehicles as engaged in a trade or business.

[64] For example, with an integration election under Reg. §1.1275-6 with respect to a debt instrument issued by the taxpayer, the combination of a "qualifying debt instrument" and a "§ 1.1275-6 hedge" is treated for tax purposes as a single transaction that is a synthetic debt instrument, effectively converting nondeductible swap expense to interest expense.

[65] Code Secs. 951 through 964.

[66] Code Sec. 951(b). Reg. §1.957-1(b)(1) provides that stock is voting stock if it confers the power to vote for the person(s) having authority to exercise the powers normally exercised by the board of directors of a domestic corporation.

[67] Code Sec. 957(a).

[68] Code Sec. 958.

[69] Reg. §1.957-1(b)(2).

[70] Code Sec. 951(a)(1).

[71] Code Sec. 951(a)(2)(A).

[72] Code Sec. 951(b). This change is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders with or within which such taxable years of a foreign corporation end. Section 14214(b) of the Act.

[73] *See supra* note 66, discussing the requisites for stock to constitute voting stock.

[74] Code Sec. 951(a)(1). This change also is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders with or within which such taxable years of a foreign corporation end. Section 14215(b) of the Act.

[75] Section 14213 of the Act also eliminates the rule in 958(b)(4) that provides that specified subparagraphs of Code Sec. 318(a)(3) will not apply to cause a U.S. person to be considered to own stock owned by a non-U.S. person. In other words, the new provision requires "downward attribution" from a foreign person to a related U.S. person in circumstances in which present law does not so provide. Thus, a U.S. subsidiary of a foreign parent constructively owns the foreign stock owned by the foreign parent for purposes of Code Sec. 958(b). (Similar rules apply for non-corporate investors.) Read literally, this rule can lead to unintended results. For example, if a U.S. person buys 10% of a foreign corporation, such as a CLO issuer, the rest of whose stock is owned by non-U.S. shareholders, the U.S. investor cannot simply assume that the issuer is not a CFC, because if a non-U.S. holder that owns more than 40% of the issuer also owns 100% of a U.S. subsidiary (or is a partner in a U.S. partnership), the issuer will be a CFC under the new law. The new rule does not apply for purposes of Code Sec. 958(a). Thus, the *pro rata* share of a CFC's subpart F income that a U.S. shareholder is required to include in gross income under Code Sec. 951(a) continues to be determined based on its direct or indirect ownership of the CFC, without application of the new downward attribution rule. Consequently, the new rule affects whether the entity is a CFC (and whether the U.S. shareholder has to accrue subpart F income), but does not impact the amount of any such inclusions.

In addition, CLOs using "blocker" corporations to avoid U.S. trade or business risk (*e.g.*, to hold, manage or liquidate assets that they are not able to hold directly) may be surprised to find that their non-U.S. blockers are transformed into CFCs simply by virtue of simultaneous ownership by the CLO of a U.S. blocker (to whom the non-U.S. blocker stock would be attributed). While avoiding such simultaneous ownership may sidestep CFC treatment and fallout (ignoring the scenario described in the previous paragraph), there are various tax and non-tax considerations that invariably will impact the decision to use a U.S. or non-U.S. blocker (and such considerations may vary with the type of asset being placed into the blocker). Thus, the CLO's interest may not coincide with that of any particular U.S. shareholder that could be adversely impacted by the creation of a CFC subsidiary.

The legislative history indicates that section 14213 of the Act was not intended to cause a foreign corporation to be treated as a CFC with respect to a U.S. shareholder that is not a related person with respect to the applicable U.S. person that is, under the new rule, causing the entity to constitute a CFC. *See* the Conference Report at 507, text accompanying footnote 1529 (citing Committee Print, Reconciliation Recommendations Pursuant to H. Con. Res. 71, S. Prt. 115-20 (December 2017), at 378, as reprinted on the website of the Senate Budget Committee, available at *www.budget.senate.gov/taxreform*). In other words, the legislative history indicates that a U.S. person that is not related to the U.S. shareholder that would not, absent this rule, be a U.S. shareholder, is not treated as a U.S. shareholder of a CFC to the extent the entity would not constitute a CFC absent this new provision. It is likely that this rule will be fixed to reflect this intent in a technical corrections act, and possible that the IRS will apply the rule as intended by the legislative history even prior to the enactment of a technical correction.

[76] Code Sec. 451(a).

[77] *See* Reg. §§1.446-1(c)(1)(ii) and 1.451-1(a).

[78] Code Secs. 61(a)(4) and 451.

[79] Code Sec. 1272.

[80] Code Sec. 1272(a)(6).

[81] Code Sec. 451(b). The Act's definition of "applicable financial statement" is relatively detailed, but many (if not most) taxpayers required to be on an accrual method of tax accounting seem likely to have such a financial statement and, thus, be required to conform their tax accounting to any earlier income recognition reflected in such statements. Although a taxpayer may avoid this rule with respect to an item subject to a special tax rule allowing for deferral or other special method of tax accounting, this generally would not be applicable in the case of items of interest or, as discussed below, OID on securitization debt.

[82] Section 13221(c) of the Act.

[83] The statute does not specifically provide that the tax basis of an asset is increased to the extent income is accelerated under Code Sec. 451(a), but that must certainly be the case.

[84] Section 13221(e) of the Act.

[85] Although the Act does except from its financial statement conformity requirement "any item of gross income in connection with a mortgage servicing contract," it makes no similar provision for any other debt-related income items that might be subject to the rules of Code Secs. 1271 through 1288. Code Sec. 451(b)(1)(B)(ii). In fact, the legislative history makes clear that, outside the mortgage servicing context, the rules of those Code provisions are *not* special rules or methods of accounting that might trump the financial statement

conformity change. *See* Conference Report at 276. However, its application to market discount bonds is still not clear. *See* Peaslee & Nirenberg, Chapter 8, Part 3.

[86] Code Sec. 469. In addition, Code Sec. 461(j) limited the deduction of "excess farm losses" by non-C corporation taxpayers in certain circumstances, which the Act now suspends. Code Sec. 461(*l*)(1).

[87] Code Sec. 172.

[88] Code Sec. 461(*l*).

[89] Code Sec. 461(*l*)(3).

[90] Code Sec. 461(*l*)(4).

[91] Code Sec. 461(*l*)(2).

[92] Code Sec. 172(a)(2), (b)(1)(A), and (b)(1)(B).

[93] As noted in *supra* note 63, the trade or business determination is sometimes unclear, and taxpayers at times may be motivated to take the position even with respect to a limited activity securitization vehicle that it is engaged in a trade or business, a position which, once taken, may be difficult to distinguish and avoid in later years when it might not be advantageous by reason of implicating the excess business loss rules. *But see* Reg. §1.881-1(a) and (b) (for purposes of determining whether a foreign corporation is engaged in a trade or business within the United States, each year stands alone). Yet whether the trade or business position is taken with respect to a securitization for tax advantage or is simply clearly reflective of the facts, the prospect for suffering loss deferral by reason of the excess business loss rules may be muted (or deferred) in significant part by the application of the Code Sec. 469 passive activity loss rules, which rules are applied first. Code Sec. 461(*l*)(6).

[94] This issue of a conduit's ability to offset losses in one year against income in another tends to reinforce the general advisability for such vehicles to invest in securities that are debt for tax purposes, which tends to produce interest income on financed assets that "matches up" with the interest expense and deductions on the debt incurred to carry the assets (in contrast to the heightened income/deduction mismatches that can occur in such vehicles should the assets be equity interests).

[95] Code Sec. 461(*l*)(1).

[96] Section 13302(e) of the Act.

[97] Code Sec. 101(a)(1).

[98] Code Sec. 101(a)(2). Specifically, these exceptions suspend the transfer for value limitation on the exclusion for transfers in which (1) the transferee's basis in the contract is determined in whole or in part by reference to the transferor's basis in the contract or (2) the transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer. Code Secs. 101(a)(2)(A) and 101(a)(2)(B).

Two of the more noteworthy IRS authorities in the life settlement area addressing other tax issues affected by the Act are Rev. Rul. 2009-13, 2009-21 IRB 1029 and Rev. Rul. 2009-14, 2009-21 IRB 1031, which generally relate to the character of taxable amounts (ordinary or capital) and to a taxpayer's basis in a life insurance contract.

[99] Code Sec. 6050Y.

[100] Code Sec. 6050Y(d)(2) (referencing Code Sec. 101(a)(3)(B)).

[101] Code Sec. 6050Y(b)(1).

[102] Code Sec. 6050Y(c) and (d).

[103] Section 13520(d) of the Act.

[104] Rev. Rul. 2019-13 is discussed briefly in *supra* note 98.

[105] Code Sec. 1016(a)(1)(B). This is a favorable change for taxpayers.

[106] These favorable exceptions are those made for carry-over basis transfers and transfers to parties related to the insured, discussed in *supra* note 98.

[107] Code Sec. 101(a)(3). This change primarily will affect carry-over basis transfers that previously were accorded favorable treatment.

[108] Section 13522(c) of the Act.

[109] Code Secs. 871(a)(1)(A) and 881(a)(1); Reg. §§1.871-7(b)(1) and 1.881-2(b)(1). Although neither Rev. Rul. 2009-13 nor Rev. Rul. 2009-14 explicitly so hold in the context of a foreign investor in a life insurance contract, the latter ruling (in discussing Situation 1) does confirm the IRS' view that the payment of a death benefit under a term life insurance contract is not a transaction giving rise to capital gain, while the former ruling (in discussing Situation 1) confirms their view not only that a surrender of a cash value life insurance contract to the insurer does not produce capital gain but also that Code Sec. 1234A does not change that result.

[110] Code Sec. 1031(a)(1) and (d).

[111] Code Sec. 1223(1).

[112] Code Sec. 1031(a)(1).