Provision: Under the provision, the definition would be moved to Code section 7701, which provides generally applicable definitions. The provision would be effective on the date of enactment.

JCT estimate: According to JCT, the provision would have no revenue effect over 2014-2023.

Part 2 – Partnerships

Considerations for Subtitle G, Part 2:

- The partnership provisions are generally drawn from Option 1 of the Committee's March 12, 2013, discussion draft, and reflect a more incremental approach to passthrough reform.
- The partnership provisions establish additional limits on the use of partnerships as tax avoidance structures without interfering with the legitimate business operations of partnerships, clarify confusing areas of partnership law, and better align partnership rules with the relevant S corporation rules.

Sec. 3611. Repeal of rules relating to guaranteed payments and liquidating distributions.

Current law: Under current law, guaranteed payments made by a partnership to a partner generally are payments made without regard to the income of the partnership and are for services or for the use of capital (e.g., loans) provided by the partner. Guaranteed payments are distinct from a partnership distribution of income or capital, and from payments by the partnership to a partner not acting in his capacity as a partner. Guaranteed payments generally are deductible by the partnership and includible in the partner's taxable income.

Current law also provides rules for treating payments made in the liquidation of a retiring or deceased partner's partnership interest. Such payments are treated either as (1) a distributive share or guaranteed payment or (2) payments in exchange for the partner's interest in partnership property. For a deceased partner, income earned prior to death (i.e., income in respect of a decedent) is includible in the deceased partner's gross income in the year of death, and special rules apply for determining the basis of the partnership interest in the hands of the successor partner.

Provision: Under the provision, the rules relating to guaranteed payments to partners would be repealed. Thus, payments received by partners would constitute either payments in their capacity as partners (i.e., part of their distributive shares of partnership income or loss) or in their capacity as non-partners (i.e., as an independent third party). In addition, the provision would repeal the special rule for deceased or retiring partners that treats certain payments in liquidation as guaranteed payments, subjecting such payments to the general rules applicable to the transaction (e.g., the provisions relating to payments of deferred compensation) or the applicable rules governing income in respect of a decedent. The provision would be effective for tax years beginning after 2014 and transfers to decedents made after 2014. In addition, the provision would apply to payments made in liquidation to partners retiring or dying after 2014.

JCT estimate: According to JCT, the provision would increase revenues by $0.3 billion over 2014-2023.

Sec. 3612-3614. Mandatory adjustments to basis of partnership property in case of transfer of partnership interests; Mandatory adjustments to basis of undistributed partnership property; Corresponding adjustments to basis of properties held by partnership where partnership basis adjusted.

Current law: Under current law, if a partnership makes a one-time election, or if the partnership has a substantial built-in loss (i.e., the partnership's adjusted basis in its property exceeds the fair market value by more than $250,000) immediately after a transfer of a partnership interest by a partner, the partnership must make adjustments to the basis of partnership property. Similar rules apply in the case of a partnership distribution of property to a partner. The adjustments are intended to account for (1) the difference that can arise between a partner's adjusted basis in the partnership property and the partner's basis in his partnership interest and (2) the difference in the partnership's adjusted basis in its property with respect to partners who do not receive distributions of property. Certain securitization partnerships and electing investment partnerships are exempt from the basis-adjustment requirement with respect to substantial built-in losses in certain instances. When basis adjustments are required under current law, no corresponding adjustments are required by upper- or lower-tier partnerships owning an interest in the partnership making the basis adjustment.

Provision: Under the provision, mandatory adjustment of a partnership's basis in partnership property would be required when a partner transfers his interest in a partnership or a partnership distributes property to a partner. These rules would also apply to securitization and electing investment partnerships. In addition, corresponding adjustments would be required in cases involving tiered partnerships. The provision would be effective for transfers and distributions after 2014.

JCT estimate: According to JCT, the provisions would increase revenues by $1.1 billion over 2014-2023.

Sec. 3615. Charitable contributions and foreign taxes taken into account in determining limitation on allowance of partner's share of loss.

Current law: Under current law, a partner generally may only deduct certain expenditures and losses (including capital losses) of a partnership to the extent of the partner's adjusted basis in his partnership interest. Charitable contributions and foreign taxes paid by a partnership are not subject to this limitation and, as a result, can be deducted even if they exceed the partner's basis.

Provision: Under the provision, a partner would be required to take into account charitable contributions and foreign taxes paid by a partnership in calculating the limitation on the partner's share of losses, conforming the partnership rules to the S corporation rules and thus preventing a partner from deducting losses in excess of basis. The provision would be effective for tax years beginning after 2014.

JCT estimate: According to JCT, the provision would increase revenues by $0.9 billion over 2014-2023.

<u>Sec. 3616. Revisions related to unrealized receivables and inventory items.</u>

Current law: Under current law, gain or loss from the sale or exchange of a partnership interest generally is treated as gain or loss from a capital asset. Gain is treated as ordinary income, however, on the sale or exchange of a partnership interest when the partnership holds unrealized receivables (i.e., uncollected payments for goods or services) or appreciated inventory (i.e., appreciated more than 120 percent). Certain distributions by a partnership to a partner are also treated as sales or exchanges when a partnership holds unrealized receivables or substantially appreciated inventory.

Provision: Under the provision, any distribution of an inventory item would be treated as a sale or exchange between the partner and the partnership, eliminating the requirement that inventory be substantially appreciated in value to trigger gain recognition. The provision also would simplify the definition of an unrealized receivable by providing that the term include any property other than an inventory item, but only to the extent of the amount that would be treated as ordinary income if the property were sold for its fair market value. The provision would be effective for distributions and partnership tax years beginning after 2014.

JCT estimate: According to JCT, the provision would increase revenues by $0.8 billion over 2014-2023.

<u>Sec. 3617. Repeal of time limitation on taxing precontribution gain.</u>

Current law: Under current law, if a partner contributes appreciated property to a partnership, the partner does not recognize gain or loss at the time of the contribution, but the pre-contribution built-in gain or loss is preserved in the contributing partner's capital account. If the partnership subsequently distributes the property to another partner within seven years of the contribution, the contributing partner generally recognizes the pre-contribution gain or loss. Similar rules apply if the contributing partner receives other property of the partnership within seven years in what amounts to a disguised sale of the originally contributed property.

Provision: Under the provision, a partner who contributes property with pre-contribution built-in gains or losses to a partnership would be required to recognize the pre-contribution gain or loss when the partnership distributes such property. No limitation period would apply. The provision would be effective for property contributed to a partnership after 2014.

JCT estimate: According to JCT, the provision would increase revenues by $0.4 billion over 2014-2023.

Sec. 3618. Partnership interests created by gift.

Current law: Under current law, a person is treated as a partner if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether such interest was obtained by purchase or gift from another person. In the case of a partnership interest purchased by one family member from another, the interest is treated as created by gift and the fair market value of the interest is treated as donated capital to the partnership. Current law also provides special rules to prevent donors of partnership interests from assigning income with respect to services that the donor performs for the partnership or with respect to the donor's contributed capital.

Provision: Under the provision, the rule would be clarified to provide that a person is treated as a partner in a partnership in which capital is a material income-producing factor whether such interest was obtained by purchase or gift and regardless of whether such interest was acquired from a family member. The rules preventing assignment of income would continue to apply to transfers of partnership interests by gift. The provision would be effective for tax years beginning after 2014.

JCT estimate: According to JCT, the provision would increase revenues by $0.8 billion over 2014-2023.

Sec. 3619. Repeal of technical termination.

Current law: Under current law, a partnership terminates only if: (1) no part of any business, financial operations, or venture of the partnership continues to be carried on by any of its partners, or (2) within a 12-month period there is a sale or exchange of 50 percent or more of the total interests in partnership capital and profits. The second type of termination is commonly referred to as a technical termination. When a technical termination occurs, the business of the partnership continues in the same legal form, but the partnership must make new elections for various accounting methods, depreciation lives, and other purposes.

Provision: Under the provision, the technical termination rule would be repealed. Thus, the partnership would be treated as continuing even if more than 50 percent of the total capital and profits interests of the partnership are sold or exchanged, and new elections would not be required or permitted. The provision would be effective for tax years beginning after 2014.

JCT estimate: According to JCT, the provision would increase revenues by $0.5 billion over 2014-2023.

Sec. 3620. Publicly traded partnership exception restricted to mining and natural resources partnerships.

Current law: Under current law, a publicly traded partnership is a partnership the interests in which are traded on an established securities market or are readily tradable on a secondary market. A publicly traded partnership generally is treated as a C corporation for Federal tax purposes. An exception from such treatment applies to a publicly traded partnership (other than a regulated investment company, management company or unit investment trust) if 90 percent or more of the partnership's gross income is qualifying income. Qualifying income includes: interest, dividends, capital gains, and rents from real property; income and gains from certain activities relating to minerals or natural resources (e.g., mining, production, refining, and transporting); and income and gains from certain commodities and derivatives.

Provision: Under the provision, the special exceptions for publicly traded partnerships would be repealed other than for partnerships with 90 percent of their income from activities relating to mining and natural resources (e.g., mining, production, refining, and transporting). Thus, publicly traded partnerships would generally be treated as C corporations. The provision would be effective for tax years beginning after 2016.

JCT estimate: According to JCT, the provision would increase revenues by $4.3 billion over 2014-2023.

Sec. 3621. Ordinary income treatment in the case of partnership interests held in connection with performance of services.

Current law: Under current law, a partner holding a partnership interest includes in income his distributive share of partnership income and gain (whether or not actually distributed). The character of partnership items passes through to the partners as if the items were realized directly by the partners. A partner's basis in the partnership interest is increased by any amount of gain included in the partner's income and is decreased by any losses. Money distributed to the partner by the partnership is taxed to the extent the amount exceeds the partner's basis in the partnership interest. Similarly, when a partner sells his partnership interest, gain generally is recognized to the extent the amount received exceeds the partner's basis in the partnership interest. The extent to which such gain is capital in character depends on the holding period and special partnership rules that recharacterize capital gains as ordinary income in certain cases.

It is common for partnerships to be used for investment purposes. In particular, private equity funds are organized as partnerships. In a typical private equity fund, the general partner contributes a small amount of capital and manages the assets, typically stock of companies, in exchange for a profits interest (or "carried interest") in the partnership (generally a 20-percent profits interest). Limited partners provide the additional capital needed to acquire assets. In addition, the general partner is paid regular fees for managing the assets, which generally consists of improving the operations, governance, capital structure and strategic position of companies. In general, gain from the sale of stock of the companies owned by the fund results in capital gain. Thus, the general partner that manages the partnership will receive a distribution of capital gain based on his profits interest when the partnership sells the stock of any company owned by the partnership.

Provision: Under the provision, certain partnership interests held in connection with the performance of services would be subject to a rule that characterizes a portion of any capital gains as ordinary income. This rule would apply to partnership distributions and dispositions of partnership interests. An applicable partnership interest would include any interest transferred, directly or indirectly, to a partner in connection with the performance of services by the partner, provided that the partnership is engaged in a trade or business conducted on a regular, continuous and substantial basis consisting of: (1) raising or returning capital, (2) identifying, investing in, or disposing of other trades or businesses, and (3) developing such trades or businesses. The provision would not apply to a partnership engaged in a real property trade or business.

The recharacterization formula generally would treat the service partner's applicable share of the invested capital of the partnership as generating ordinary income by multiplying that share by a specified rate of return (the Federal long-term rate plus 10 percentage points), intended to approximate the compensation earned by the service partner for managing the capital of the partnership. The recharacterization amount would be determined (but not realized) on an annual basis and tracked over time. To the extent a service partner contributes capital to the partnership, the result would be less capital gain being characterized as ordinary income. Any distribution or gain from the sale of a partnership interest (i.e., a realization event) then would be treated as ordinary to the extent of the partner's recharacterization account balance for the tax year. Amounts in excess of the recharacterization account balance would be capital gain. The invested capital of a partnership is, as of any day, the total cumulative value, determined at the time of contribution, of all money and other property contributed to the partnership on or before such day. Partner loans to the partnership and indebtedness entitled to share in the equity of the partnership would qualify as invested capital.

If a taxpayer, at any time during a tax year, holds directly or indirectly more than one applicable partnership interest in a single partnership interest, all interests in a partnership would be aggregated and treated as a single interest.

The provision would be effective for tax years beginning after 2014.

Considerations:

- Current law generally taxes the profits derived from the development and sale of property in the ordinary course of a trade or business as ordinary income, not capital gain. In contrast, the inherent enterprise value of a successful business, which is recognized by the owners only when the business is sold or liquidated, generally is treated as capital gain.
- A partnership (e.g., private equity fund) that is in the business of raising capital, investing in other businesses, developing such businesses, and ultimately selling them, is in the trade or business of selling businesses. The businesses bought and sold by the partnership are its inventory.
- For the tax law to be applied consistently, the profits derived by such an investment partnership and paid to its managing partners through management fees and a profits interest in the partnership (generally referred to as a carried interest), should be treated as ordinary income.
- The provision is intended to provide such consistent treatment by treating a portion of the annual earnings of a qualifying partnership as ordinary income. To the extent a

managing partner invests capital in the partnership or extraordinary gains are realized, the earnings would still be taxed as capital gains.

- The provision is designed to clarify a murky area of the tax law to provide consistent outcomes for similarly situated taxpayers through rules that are administrable and avoid the unintended adverse consequences of previous proposals to address this issue.

JCT estimate: According to JCT, the provision would increase revenues by $3.1 billion over 2014-2023.

Sec. 3622. Partnership audits and adjustments.

Current law: Under current law, three different regimes exist for auditing partnerships. For partnerships with 10 or fewer partners, the IRS generally applies the audit procedures for individual taxpayers, auditing the partnership and each partner separately. For most large partnerships with more than 10 partners, the IRS conducts a single administrative proceeding (under the so-called TEFRA rules, which were adopted as part of the Tax Equity and Fiscal Responsibility Act of 1982) to resolve audit issues regarding partnership items that are more appropriately determined at the partnership level than at the partner level. Under the TEFRA rules, once the audit is completed and the resulting adjustments are determined, the IRS must recalculate the tax liability of each partner in the partnership for the particular audit year.

A third audit regime applies to partnerships with 100 or more partners that elect to be treated as Electing Large Partnerships (ELPs) for reporting and audit purposes. A distinguishing feature of the ELP audit rules is that unlike the TEFRA partnership audit rules, partnership adjustments generally flow through to the partners for the year in which the adjustment takes effect, rather than the audit year. As a result, the current-year partners' share of current-year partnership items of income, gains, losses, deductions, or credits are adjusted to reflect partnership adjustments relating to a prior year audit that take effect in the current year. The adjustments generally do not affect prior-year returns of any partners (except in the case of changes to any partner's distributive share).

Provision: Under the provision, the current TEFRA and ELP rules would be repealed, and the partnership audit rules would be streamlined into a single set of rules for auditing partnerships and their partners at the partnership level. Similar to the current TEFRA rule excluding partnerships with fewer than 10 partners, the provision would permit smaller partnerships with 100 or fewer partners (other than partners that generally are passthrough entities themselves) to opt out of the new rules, in which case the partnership and partners would be audited under the general rules applicable to individual taxpayers.

Under the streamlined audit approach, the IRS would examine the partnership's items of income, gains, losses, deductions, credits and partners' distributive shares for a particular year of the partnership (the "reviewed year"). Any adjustments would be taken into account by the partnership (not the individual partners) in the year that the audit or any judicial review is completed (the "adjustment year"). Partnerships would have the option of demonstrating that the adjustment would be lower if the adjustment included partner-level information from the reviewed year rather than imputed amounts based solely on the partnership's information in such year. A partnership would also have the option of initiating an adjustment for a reviewed year, such as when it believes additional payment is due, with the adjustment taken into account in the adjustment year. In cases in which the partnership believes a refund is due, the partnership would continue to file an amended return and provided amended information returns to each partner. The provision would be effective for partnership tax years ending after 2014, with partnerships permitted to elect to apply the new rules for any partnership tax year beginning after the date of enactment.

JCT estimate: According to JCT, the provision would increase revenues by $13.4 billion over 2014-2023.

Part 3 – REITs and RICs

Considerations for Subtitle G, Part 3:

- Since 1960, real estate investment trusts (REITs) have provided a tax-efficient vehicle for average investors to acquire diversified and passive interests in real estate.
- Recently, several companies that operate as taxable C corporations have explored converting into REITs for the purpose of avoiding corporate income tax.
- The REIT rules were not intended to facilitate erosion of the corporate tax base by allowing operating companies to convert from taxable C corporations into REITs.
- Some of these provisions would discourage erosion of the corporate tax base by making it more difficult for operating companies to convert into REITs, and by limiting REIT-eligible assets to those assets that are more closely related to real estate.
- At the same time, other provisions would improve the REIT rules as they apply to traditional REITs, making the REIT structure a more attractive investment vehicle.

<u>Sec. 3631. Prevention of tax-free spinoffs involving REITs.</u>

Current law: Under current law, a corporation is permitted to distribute (or spin off) to shareholders the stock of a controlled corporation on a tax-free basis if the transaction satisfies certain requirements. One such requirement is that both the distributing corporation and the controlled corporation must be engaged immediately after the distribution in the active conduct of a trade or business that has been conducted for at least five years. In 2001, the IRS ruled that a REIT could satisfy the active trade or business requirement for tax-free spin-off transactions, even though gain on the sale of property that is stock in trade of a REIT, or property that is includible in inventory of a REIT, does not satisfy the REIT income tests.

Provision: Under the provision, the 2001 IRS ruling would be overturned, so that REITs could not satisfy the active trade or business requirement for tax-free spin-off transactions. In addition, neither a distributing corporation nor a controlled corporation would be permitted to elect to be treated as a REIT for ten years following a tax-free spin-off transaction. The provision generally would be effective for distributions after February 26, 2014.