The impact of tax reform legislation on publicly traded partnerships

January 15, 2018

In brief
The 2017 tax reform reconciliation act (the Act), signed into law December 22 by President Trump, will significantly affect many US taxpayers including those in the energy sector and businesses operating in partnership solution.

Publicly Traded Partnerships (PTPs) and individuals who invest in PTPs need to be aware of a broad spectrum of changes that could have an impact on current business operations and income allocations. Both PTPs and their investors need to analyze the new provisions and how they could alter the partnership’s taxable income calculations as well as the investors’ specific tax position. Below is a brief summary of select provisions in the Act that are most relevant to PTPs and their investors, including provisions that are specific to partnerships as well as other provisions with broader applicability.

In detail
New deduction for qualified pass-through business income (Section 199A)

The Act provides a 20-percent deduction to individuals for qualified business income from a partnership, S corporation, or sole proprietorship. In general, qualified business income is the net amount of qualified items of income, gain, loss, and deduction with respect to each qualified trade or business of the taxpayer. Qualified items generally are items of income, gain, loss, and deduction effectively connected with the conduct of a qualified trade or business in the United States. Qualified business income does not include investment-type income (such as capital gains, dividends, and non-business interest) or reasonable compensation and guaranteed payments. A qualified trade or business generally is any business other than a ‘specified service trade or business’ (such as law, medicine, accounting, or financial services) or performing services as an employee.

Under the Act, in the case of an individual whose taxable income exceeds the relevant income thresholds noted below, the deduction for each qualified business’ income generally is capped at the greater of (a) 50 percent of the individual’s allocable share of W-2 wages with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property (the ‘W-2 wage limitation’). The W-2 wage limitation does not apply to an individual whose taxable income is less than $157,500 for a single filer ($315,000 for a joint filer). Above these thresholds, the W-2 wage limitation phases in over the next $50,000 of income ($100,000 for joint filers).

The W-2 wage limitation also does not apply to qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership (PTP) income, regardless of the
individual recipient’s taxable income. In the case of a holder of a PTP unit, qualified PTP income generally includes such unitholder’s allocable share of the PTP’s qualified items of income, gain, loss, and deduction. In addition, a unitholder’s qualified income also includes any amount of ordinary income recognized by the unitholder upon the sale or exchange of the PTP unit under Section 751(a). The 20-percent deduction sunsets (along with certain other provisions of the Act applicable to individuals) at the end of 2025.

PwC observation: The 20-percent deduction for qualified PTP income temporarily provides PTP investors a lower overall federal tax burden compared to investments in C corporations. An individual paying tax at the top marginal rate (37 percent) should pay tax on income earned through a PTP at a net rate of 29.6 percent (37 percent on 80 percent of the income). Under the Act, the tax imposed on C corporation income is reduced permanently to 21 percent. Thus, if the same income were earned by a C corporation and distributed to the same individual, the earnings would be taxed at 36.8 percent effective rate (21 percent corporate tax plus 20 percent tax on a dividend payment of 79 percent of the corporate income). Measured in this way, the rate difference between C corporations and PTPs under the Act is 7.2 percent. Under prior law, this difference was 8.6 percent.

PwC observation: Section 469(k) and the passive activity loss rules remain in effect with respect to a PTP unitholder’s allocable share of losses. Therefore, public unitholders subject to such provisions will continue to suspend any cumulative losses in excess of cumulative income allocated from the PTP. However, it is unclear under the Act whether the PTP unitholder’s annual allocable share of losses would be included in the unitholder’s overall calculation of qualified business income under Section 199A, potentially reducing or eliminating the amount of deduction available to the unitholder on other qualified passthrough income. Investors will require additional guidance on the interaction between Sections 469(k) and 199A with respect to losses allocated by PTPs.

PwC state tax observation: The Act clarifies that the 20-percent deduction is not allowed in computing adjusted gross income, but instead is allowed as a deduction reducing taxable income. The Act also clarifies that the deduction is available to individuals who claim itemized deductions as well as those who do not. Since many states adopt adjusted gross income as their starting point for determining the tax base for individuals, conformity issues are likely to arise. Unitholders are advised to consider the differing starting points for determining the state tax base.

Full expensing of certain property
The Act amends Section 168(k)(1)(A) by striking ‘50 percent’ and inserting ‘100 percent,’ thus allowing taxpayers to expense immediately the entire cost of certain depreciable assets acquired and placed in service after September 27, 2017 and before January 1, 2023 (with an additional year for certain aircraft and longer production period property). For qualified property placed in service in calendar years 2023, 2024, 2025, and 2026 (2024, 2025, 2026, and 2027 for certain aircraft and longer production period property), the applicable percentage is reduced to 80 percent, 60 percent, 40 percent, and 20 percent, respectively. In the case of qualified property acquired before September 28, 2017, and placed in service after September 27, 2017, certain phase-down percentages under current law will be applicable.

The Act makes several notable modifications to the definition of ‘qualified property’ under Section 168(k)(2). First, it expands the definition of qualified property by repealing the requirement that the original use of the property begin with the taxpayer. As a result, as long as such used property had not been used by the taxpayer at any time prior to the acquisition and meets the requirements of paragraphs (2)(A), (2)(B), (2)(C), and (3) of Section 179(d), it generally should be considered qualified property under Section 168(k) and eligible for immediate expensing. Second, the term ‘qualified property’ does not include, among other items, any property used in the trade or business of certain regulated public utilities as defined in Section 163(j)(7)(A)(iv), including property used in the trade or business of transporting gas or steam by pipeline if the rates for the service are regulated by a government agency (for example, FERC).

PwC observation: In addition to the impact on assets acquired or placed in service, PTPs will need to consider the impact of the full expensing provisions on Section 743(b) adjustments and Section 704(c) allocations arising after September 27, 2017. For taxpayers that do not wish to avail themselves of the immediate expensing provision, the ability to elect out of Section 168(k) would continue to exist. In addition, the Act provides for an election to continue to use 50-percent bonus depreciation for qualified property acquired and placed in service after September 27, 2017, for the first tax year ending after September 27, 2017.

PwC state tax observation: Since many states already decouple from or modify Section 168(k), continued nonconformity is expected in this area. Given the potential magnitude of the cost to states of conforming to
Section 168(k), additional states may enact legislation to decouple from the provision. Nonconformity raises many state issues, including the inability of taxpayers to elect 50-percent bonus in lieu of 100-percent bonus for state purposes, federal and state basis discrepancies, modifications required in computing state taxable income, and the financial statement implications associated with the potential book-to-tax differences from a state income tax perspective. Taxpayers should examine how states conform to or decouple from other provisions under Section 168, such as shortened recovery periods and full expensing for used property.

**Partnership technical termination**

For partnership tax years beginning after 2017, a partnership is treated as continuing to exist (i.e., there would be no ‘technical termination’) even if more than 50 percent of the total capital and profits interests of such partnership is sold or exchanged.

**PwC observation:** For most partnerships, this provision will simplify compliance as it eliminates the required short-period return when there has been a transfer of a majority interest. However, it will require greater diligence and negotiating for selling partners to control the return filing in the year they dispose of their interests. It also removes some flexibility partnerships had to eliminate accounting methods and certain tax elections without IRS approval.

**Gain or loss of foreign persons from disposition of interest in partnership with US trade or business**

The Act includes a provision treating gain or loss from the sale or exchange of a partnership interest by a non-US person as income effectively connected with a US trade or business to the extent that the transferor would have had effectively connected gain or loss if the partnership had sold all of its assets for their fair market value on the date of the interest sale or exchange. Under the provision, a transferee must withhold 10 percent of the transferor’s amount realized on the sale or exchange of a partnership interest unless the transferor certifies that it is not a nonresident alien or foreign corporation. The partnership must deduct and withhold from distributions to the transferee partner any amount that the transferee fails to withhold from the transferor.

Under the Act, the general provision treats gain or loss on the sale of certain partnership interests as effectively connected with a US trade or business if the transaction occurs as of November 27, 2017. However, withholding is required for sales or exchanges occurring after December 31, 2017.

The statute provides Treasury with broad regulatory authority to implement the withholding requirement and explicitly permits Treasury to provide exceptions from the new withholding requirement. In the case of PTPs, the Joint Explanatory Statement of the Committee of Conference on the tax reform legislation states, as an example, that ‘guidance may provide that if an interest in a publicly traded partnership is sold by a foreign partner through a broker, the broker may deduct and withhold the 10-percent tax on behalf of the transferee.’

On December 29, 2017, the IRS issued Notice 2018-08 (the ‘Notice’), which provides for a temporary suspension of the new withholding requirement for dispositions of an interest in PTPs (within the meaning of Section 7704(b)). While the Notice does not specify how long the temporary suspension will last, it states that Treasury intends future regulations or other guidance to address how to withhold, deposit, and report tax under the new withholding requirements for PTPs. Any such guidance will be prospective in nature (i.e., no retroactive withholding) and ‘will allow sufficient time to prepare systems and processes for compliance,’ the Notice states.

The Notice was issued in response to market concerns that application of the new withholding requirements in the context of PTPs would present significant practical problems, including:

- inability of a buyer/transferee of a PTP interest to identify the seller/transferor;
- uncertainty as to whether a partnership has ECI (and is therefore subject to withholding); and
- complications in determining the ‘amount realized’ under Section 752(d).

The Notice requests comments with respect to applying the new withholding requirement to PTPs, without specifying a deadline for such comments.

**PwC observation:** While the temporary suspension of withholding tax on dispositions of PTP units eliminates some of the administrative burden, unitholders should note that the substantive tax imposed under Section 64(c)(8) remains in effect for dispositions of partnership interests (both public and non-public) that occur on or after November 27, 2017. (For the IRS position on dispositions prior to that date, the Notice refers to Rev. Rul. 91-32.) This may require taxpayers to file a US federal income tax return.

**PwC state tax observation:** For state income tax purposes, the manner in which gains or losses from...
the sale of a partnership interest will be deemed to be state source income will ultimately depend on whether the underlying partner apportions or allocates the flow-through income it receives. Even for partners that typically only report income allocated from underlying state K-1’s, there could be a requirement to source gains or losses based on where the sold partnership was actually doing business. Several states have enacted “look-through” allocation and/or apportionment rules. Such rules typically differ depending on whether the owners of the partnership being sold are corporations, individuals, or partnerships. These rules typically require partners to source gains from the sale of the partnership, to the extent such gains constitute effectively connected income under federal income tax rules, to the locations where the underlying partnership being sold was doing business (i.e., where the partnership had property, payroll, and/or sales). It is possible that this federal change could spur states to revisit whether to enact additional ‘look-through’ state sourcing rules.

**Interest expense**

The Act repeals current Section 163(j), and replaces it with a new Section 163(j) interest limitation, which should broadly apply to the business interest expense of most large taxpayers (including both corporate and passthrough entities, and including entirely domestic entities and entities that are part of a US-parented or foreign-parented group), effective for tax years beginning after 2017. New Section 163(j) will limit an entity’s deduction for net business interest expense (i.e., the excess of business interest expense over business interest income), whether paid to a related or unrelated party, to 30 percent of the business’s ‘adjusted taxable income.’

For tax years beginning after December 31, 2017 and before January 1, 2022, the Act calculates adjusted taxable income using a tax EBITDA-based calculation. For tax years beginning January 1, 2022 and thereafter, the calculation of adjusted taxable income will not add back depreciation or amortization, resulting in a lower (or harsher) limitation than for the previous periods.

The Act does not provide for grandfathering existing debt. The Act allows unused deductions to be carried forward indefinitely (subject to change of control limitations). However, the Act also exempts from the limitation taxpayers with average gross receipts for the three-taxable-year period ending with the prior taxable year that do not exceed $25 million. The provision also does not apply to real property trades or businesses (at the taxpayer’s election) and to certain regulated public utilities.

In the case of partnerships, the Act calculates the net business interest expense limitation at the partnership level. A partnership deducts allowable net business interest expense against its non-separately stated income. For purposes of determining its adjusted taxable income, the Act requires a partner to ignore the partner’s distributive share of all items of income, gain, deduction, or loss of the partnership and instead include its share of the partnership’s ‘excess business income.’

The excess taxable income of a partnership is the partnership’s adjusted taxable income multiplied by a fraction the numerator of which is the unused portion of the partnership’s interest expense limitation and the denominator or which is the partnership’s total interest limitation. Thus, all of the adjusted taxable income of a partnership with no net business interest expense is excess taxable income; in the case of a partnership whose net business interest expense exceeds 30 percent of its adjusted taxable income, none of its adjusted taxable income is excess taxable income.

To the extent interest is not deductible at the partnership level, the carryforward of ‘excess business interest’ is at the partner level. Each partner’s interest expense carryforward is in proportion to its distributive share of non-separately stated income. The term ‘non-separately stated income’ is not defined in the Act, but a note in the Conference Committee report indicates that non-separately stated income is the ‘Ordinary business income or loss’ reflected on Form 1065 (U.S. Return of Partnership Income), and the partner’s distributive share is reflected in Box 1 of Schedule K-1 (Form 1065).

The carryforward is treated as if the partner incurred the interest expense in the next taxable year and may only offset the partner’s share of ‘excess taxable income’ of the partnership in such year, not business income from other sources. Each partner’s outside basis is reduced by its share of excess business interest. As a result, the basis is not available to support distributions. In the event of a disposition, special rules may apply to adjust the basis of a partnership interest previously reduced by an allocation of excess business interest.

**PwC observation:** Applying this provision to the unitholders of PTPs will require additional compliance and reporting by the partnership in order to ensure its partners have all relevant information with respect to the partnership’s interest expense limitation and excess taxable income in current and subsequent periods.
**PwC state tax observation:** For state income tax purposes, this is an area where divergence in conformity to the federal rules is possible. Further, it is unclear how the provision will be applied in combined and consolidated reporting states, since the limitation is applied to ‘the taxpayer’ which could mean an individual entity or an entire combined or consolidated group. States may also conform to or decouple from the federal interest deduction carryforward period. Similar to bonus depreciation, this may be an area where the state tax result will vary significantly from state to state.

**‘Deemed repatriation’ toll charge**

As part of a move to a territorial system, the Act imposes a toll charge on a US shareholder’s pro rata share of certain foreign subsidiaries’ previously untaxed foreign earnings (determined as of November 2, 2017 or December 31, 2017, whichever is higher). Generally, the post-1986 E&P of a controlled foreign corporation (CFC) or a foreign corporation that is at least 10 percent owned by a US shareholder will be within the scope of the toll charge. The US shareholder’s toll charge inclusion amount is treated as additional subpart F income. Historically, guidance has been limited to private letter rulings (PLRs) with respect to whether subpart F income constitutes qualifying income under Section 7704(d)(4), and related provisions. In a number of PLRs, the IRS ruled that inclusions under Section 951(a)(1)(A)(i) qualified as ‘other income’ for purposes of Section 851(b)(2), regardless of whether the amounts were distributed. Section 7704(d) provides that qualifying income includes any income that would qualify under Section 851(b)(2)(A). The IRS, citing the ‘other income rule,’ has previously ruled that the amount included for the partnership’s share of the CFC’s subpart F income is qualifying income under both Sections 851(b)(2)(A) and 7704, without regard to whether the CFCs distributed the amounts (for example, PLRs 20113018, 200728025, and 200722007). However, proposed regulations, issued on September 27, 2016, provide that an inclusion under Sections 951(a)(1)(A)(i) or 1293(a) is treated as a dividend for purposes of Section 851(b) only to the extent that the distribution requirement is met. The proposed regulations specifically provide that the inclusion does not qualify under the ‘other income rule,’ noting that absent a distribution there is no support for treating an inclusion under Section 951(a)(1)(A)(i) as a dividend under Section 851.

Without additional guidance from the IRS, the toll charge inclusion amount for PTPs that conduct operations through CFCs could have a dramatic effect on the annual qualifying income analysis for 2017. PTPs should consider the impact the toll charge inclusion amount, treated as subpart F income, will have on their qualifying income calculations.

**PwC state tax observation:** Most states generally decouple from the Subpart F income provisions, which may result in differing federal and state income calculations for PTPs. PTPs should consider state conformity provisions governing Subpart F income and evaluate any special disclosures necessary on K-1’s to the extent divergence from federal law exists.

**Other partnership provisions**

The Act adopts the following partnership provisions:

- The provision modifying the definition of ‘substantial built-in loss’ under Section 743(d) to provide that a substantial built-in loss also exists if the transferee partner would be allocated a net loss in excess of $250,000 upon a hypothetical sale and liquidation of the partnership.

- The provision modifying Section 704(d) to apply the outside basis limitation to a partner’s distributive share of charitable contributions and foreign tax

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**Percent rates proposed in the Senate bill.**

Foreign tax credits, if any, for the portion of earnings subject to the toll charge tax would be available to offset the tax.

The provision would permit a US shareholder to elect to pay the tax liability imposed under the toll charge tax over a period not to exceed eight years.

The provision is effective for the last taxable year of a foreign corporation that begins before January 1, 2018, and with respect to US shareholders, for the taxable years in which or with which such taxable years of the foreign corporation ends.

**PwC observation:** As noted above, the US shareholder’s toll charge inclusion amount is treated as additional subpart F income. Historically, guidance has been limited to private letter rulings (PLRs) with respect to whether subpart F income constitutes qualifying income under Section 7704(d)(4), and related provisions. In a number of PLRs, the IRS ruled that inclusions under Section 951(a)(1)(A)(i) qualified as ‘other income’ for purposes of Section 851(b)(2), regardless of whether the amounts were distributed. Section 7704(d) provides that qualifying income includes any income that would qualify under Section 851(b)(2)(A). The IRS, citing the ‘other income rule,’ has previously ruled that the amount included for the partnership’s share of the CFCs’ subpart F income is qualifying income under both Sections 851(b)(2)(A) and 7704, without regard to whether the CFCs distributed the amounts (for example, PLRs 20113018, 200728025, and 200722007). However, proposed regulations, issued on September 27, 2016, provide that an inclusion under Sections 951(a)(1)(A)(i) or 1293(a) is treated as a dividend for purposes of Section 851(b) only to the extent that the distribution requirement is met. The proposed regulations specifically provide that the inclusion does not qualify under the ‘other income rule,’ noting that absent a distribution there is no support for treating an inclusion under Section 951(a)(1)(A)(i) as a dividend under Section 851.

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**PwC state tax observation:** Most states generally decouple from the Subpart F income provisions, which may result in differing federal and state income calculations for PTPs. PTPs should consider state conformity provisions governing Subpart F income and evaluate any special disclosures necessary on K-1’s to the extent divergence from federal law exists.

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- The provision modifying Section 704(d) to apply the outside basis limitation to a partner’s distributive share of charitable contributions and foreign tax
credits. Currently, a partner may deduct its distributive share of the partnership’s charitable contributions regardless of its tax basis in the partnership.

**The takeaway**
The reform of US tax law is now here. It is time to evaluate current investments in light of the new law and make adjustments for future transactions.

**See also:**
- [Congress gives final approval to tax reform conference committee agreement](#) - December 20, 2017
- [Select business and international tax provisions in the Act that could have a significant impact on energy companies](#) - December 22, 2017

**Let’s talk**
If you would like to discuss this further, please contact:

**Master Limited Partnership**

Robert Baldwin  
(214) 754-4535  
robert.baldwin@pwc.com  

Michael Hauswirth  
(202) 346-5164  
michael.j.hauswirth@pwc.com  

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