Chapman and Cutler LLP

Chapman Client Alert

December 21, 2017 Current Issues Relevant to Our Clients

Impact of New Tax Law on Securitization Transactions

On December 20, 2017 Congress passed (and President Trump is expected to sign into law) the act commonly referred to as the Tax Cuts and Jobs Act of 2017 (the "Act"). Although no provision of the Act was designed specifically to address securitization transactions, two new sets of rules are likely to have significant effects on at least some securitization transactions. In addition, the Act makes changes to other rules that are likely to have a more modest impact on the securitization market. These other changes are noted at the end of this Client Alert.

Summary:

- Deductions for net business interest expense are limited to 30% of a business's taxable income (with certain adjustments). **This limitation could cause a corporate issuer, or the equity holders in a pass-through issuer, in a securitization transaction to recognize phantom income from the issuer's inability to realize the full tax benefit of its interest expense**.

- 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 US person in order to avoid withholding tax on the disposition of its interest. If the transferee does not receive the certification it will be required to withhold 10% of the amount paid to the transferor. 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. **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).**

Effective Dates

The limitation on deduction of business interest is effective for interest paid in (or accrued with respect to) taxable years beginning after December 31, 2017. 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 transfers of an interest in a partnership engaged in a US 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). 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 US 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.

Interest Disallowance

Overview and Effects.

With exceptions for (i) taxpayers with gross receipts less than an applicable threshold (generally $25 million) or operating in certain industries, neither of which exceptions are likely to be relevant for securitizations, and (ii) floor plan financing interest,[1] taxpayers such as partnerships and corporations (but not REMICs)[2] 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")[3] and (ii) 30% of adjustable taxable income ("ATI," and business interest income and 30% of ATI collectively, "Total Capacity"). Disallowed business interest expense deductions are carried over indefinitely and can be used to offset future Total Capacity. 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.

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; any item of income, gain, deduction, or loss not properly allocable to a trade or business; any NOL under section 172; and, in the case for taxable years beginning before January 1, 2022, any deduction allowed for depreciation, amortization, or depletion. 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.

This limitation on business interest expense may curtail the securitization of any number of assets that aren't debt instruments and, thus, don't 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 will 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.[4] 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 (which may lower the 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 US 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.

<u>Application to Partnerships and Partners</u>.

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).

Technical Analysis

For ease of presentation, the highly technical discussion contained in the following four paragraphs is illustrated in Examples 4-6 below. Less technically inclined readers may wish to skip directly to those examples prior to continuing with this Client Alert.

In the case of a partnership, the business interest expense limitation is applied first at the partnership level, and then at the partner level. To the extent that 30% of the partnership's ATI is not utilized to support its business interest expense, such amount ("Excess ATI Capacity") is allocated to the partners, who can use it to support non-partnership business interest expense for that partner's current taxable year. Any amount not so used is lost. However, any such allocations to partners 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). There does not appear to be a similar rule that allocates to the partners the 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 it from the partnership or supporting its own business interest expense (but hopefully this was an oversight that will be corrected in a technical corrections act).[5] Rather, any such excess may remain unutilized at the partnership level (but nevertheless subject to taxation at the partner level). See Example 6, below.

Excess business interest expense incurred by the partnership is allocated to the partners and carried forward at the partner level. However, only the partner's allocable share of the partnership's Excess ATI Capacity (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 ATI Capacity 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 ATI Capacity not used by the partner to allow for the current deduction of carried forward partnership business interest) 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 would not enter into the calculation of Excess ATI Capacity, 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. There is no rationale for why partners cannot utilize their prior disallowed business interest expense to the extent of future partnership business interest income — if this interpretation is correct, it may be an unintended consequence of the special partnership rules in the statute, particularly given that corporations and other non-partnership entities can deduct their previously disallowed business interest expense to the extent of future business interest income.

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). 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). 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).

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 ATI Capacity (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). This rule will make it disadvantageous for sponsors with their own significant capacity to deduct business interest expense to establish securitization partnerships (including 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.

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 likely be treated as business interest expense with respect to such corporate partner.[6] 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 controlled foreign corporation (a "CFC"). 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. Consequently, because earnings and profits are reduced by the otherwise disallowed business interest expense deductions, the equity holders effectively reap the tax benefits of the disallowed business interest expense, since it reduces the amount of their income inclusions. See Example 3, below.

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 x 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 (or $72 more) of business interest expense, its extra capacity 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 x 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).

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 and $150 of business interest expense. 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 be able to only utilize such allocation against 30% of XYZ Partnership's future ATI (as opposed to using it to offset XYZ Partnership's future excess business interest income). ABC Corp's basis in its interest in XYZ Partnership is reduced by $20 to $60.

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 ATI Capacity in 2019. ABC Corp increases its basis back to $80 and 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 $50 of business interest expense. Thus, XYZ Partnership has $50 of net business interest income (which could support an additional $50 of business interest expense). Its ATI could further support $60 ($200 x 30%) of additional business interest expense at the XYZ Partnership level. However, 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, and the $50 of excess business interest expense capacity may be lost (although the interest income would still be allocated out to the partners for the purposes of Subchapter K). ABC Corp and DEF Corp can each use the $30 allocation to offset business interest income (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. But see endnote 5, below for an alternative interpretation of the Act.

Transfer of Partnership Interests

Under Revenue Ruling 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 US 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 US trade or business if those assets were sold by the partnership immediately prior to the sale or exchange. 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 US trade or business generally is foreign-source and, thus, generally is not subject to US tax.

The Act not only rejects the holding of the Tax Court and generally adopts the IRS's position in Revenue Ruling 91-

32, but also implements a withholding mechanism to compel collection of the applicable tax.[7] Thus, if a partnership (including a trust, LLC, participation agreement, or other entity or arrangement characterized for US federal income tax purposes as a partnership) is engaged in a US trade or business, a transferor will be required to give a certification to the transferee that it is a US person in order to avoid a 10% withholding tax on the proceeds of sale, exchange or other disposition. 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. If the partnership fails to so withhold it likely will be required to pay the amount of lost withholding tax out of its own funds. It is not clear what happens if a partnership is required to withhold, but the transferee disposes of its partnership interest before the full amount of withholding has been withheld by the partnership.[8]

The above 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.

The Act provides that the above 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. Such an application would be quite cumbersome and difficult to administer (not to mention grossly unfair in many cases).

The Act does not provide that a certification from the partnership to the effect that it is not engaged in a US 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 US trade or business. It is possible that future regulations will provide such a rule.

This potential partnership liability is another example of the creeping taxation of partnerships at the entity level. With very limited exceptions, partnerships are not subject to entity-level taxation. However, under prior law that is first becoming effective in 2018, 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 to push out the liability to its partners. Under the Act, partnerships may now also be liable for tax arising from a failure to withhold where a transferee partner failed to withhold after not obtaining the relevant certification.

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 US 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 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 US 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 US trade or business (which 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-US investor from holding the equity of the issuer in connection with a US trade or business. Such a prohibition is designed to avoid causing the issuer (under current law) to be required to withhold on allocations of income to a non-US partner. Adding such a prohibition may be advisable now for an additional reason. Holding a partnership interest in connection with a US trade or business of the partner may cause the new transferor certification requirement to apply even though the partnership itself is not so engaged in a US trade or business. 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.[9]

Where an issuer is a partnership that is or may be engaged in a US 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. Where a security is highly likely to be treated as, but is not clearly, debt for US 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.

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 and certain other information about the beneficial owner. However, because no specified penalty currently applies for non-compliance, compliance with this requirement is not universal.

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. Alternatively, partnerships may decide to certificate their partnership equity (and require appropriate certifications in connection with any transfers).

Other Changes that may Impact Securitizations

- The Act precludes individuals from claiming miscellaneous itemized deductions, which previously were allowed to the extent that such deductions exceeded 2% of the individual's adjusted gross income (and were disallowed in their entirety for individuals subject to the alternative minimum tax). This temporary repeal — scheduled to expire after 2025 — will prevent individual equity owners from taking deductions with respect to allocable fees such as servicing and swap expenses paid by securitization vehicles that are treated for tax purposes as trusts or partnerships that are not engaged in a trade or business.

- The Act expands the definition of "United States shareholder" with respect to a controlled foreign corporation ("CFC") to include holders of 10% of the value of the foreign corporation. Previously, a holder of certificates, subordinated notes, or other equity interests in a corporation was required to hold 10% of the voting power of a potential CFC in order to constitute a United States shareholder. Some taxpayers took the position that their securities did not possess the requisite voting power, since they did not confer the right to vote for members of the board of directors (or for others performing a similar function). This change would preclude that argument. The Act also eliminates the requirement that a CFC must be controlled for 30 uninterrupted days before subpart F income inclusions are triggered, in part to prevent taxpayers from avoiding the CFC rules by manipulating the consecutive days that an entity would otherwise qualify as a CFC.

- The Act 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 IFRS filings). Previously, such income generally was only required to be recognized once the "all events test" was satisfied — i.e., once all of the events have occurred that fix the taxpayer's right to receive such income, and the amount of such income can be determined with reasonable accuracy. Apart from generally accelerating income recognition and tax liability, this change in accounting may create uncertainty and potential timing mismatches for many holders.

- The Act disallows the use of "excess business losses" by non-corporate taxpayers, instead converting such unused losses into a net operating loss ("NOL") carryover. Very generally, an excess business loss for the taxable year is the excess of aggregate deductions of the taxpayer attributable to trades or businesses of the taxpayer over 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). The Act also imposes a limitation on the use of current NOL deductions equal to 80% of the taxpayer's taxable income, generally eliminates the use of NOL carrybacks, and allows for NOLs to be carried forward indefinitely. These changes may create loss deferral issues for holders of equity interests in pass-through securitization structures.

- The Act imposes new reporting obligations upon the direct or indirect acquisition of a life insurance contract by a transferee that has no substantial family, business, or financial relationship with the insured, and provides that certain favorable exceptions to the current "transfer for value" rules are not applicable to such reportable transfers. The Act also clarifies that "cost of insurance" adjustments are not required in determining the tax basis of a life insurance or annuity contract. These changes will affect equity investors in securitization vehicles that invest in life insurance contracts.

- Section 1031 was amended to prohibit like-kind exchanges involving personal property (such as automobiles and farm equipment). This could require sponsors or other equity owners of securitization vehicles owning such assets to incur increased gain recognition on any replacement of those assets and thereby negatively impact the securitizations of such assets.

For More Information

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1 The 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.

2 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 section 163(d) of the Internal Revenue Code of 1986 (the "Code"). Pursuant to Treasury Regulation § 1.860C-2(b)(4), a REMIC is not treated as carrying on a trade or business for purposes of section 162, and ordinary operating expenses are deductible under section 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 section 212, should not be treated as allocable to a trade or business.

All section references herein are to the Code.

3 Some securitization vehicles, including almost all 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 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 *US* trade or business. Thus, CLOs and other offshore issuers, which generally receive tax opinions that they are not engaged in a US trade or business, may nevertheless be subject to this new rule if they are in fact engaged in a trade or business (*e.g.*, trading in debt instruments as opposed to being a mere investor).

4 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 are not subject to the interest disallowance rule) because longer-dated, higher yielding sequential pay classes tend to have a much longer maturity than faster-paying, lower yielding classes, 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 deductions).

5 It is possible that Congress intended (and there is an interpretation of the Act) that such excess business interest income would flow through to a partnership's partners under general partnership tax rules. However, 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 ATI Capacity (which does not include business interest income). It would be bizarre for Congress to intend that a partner can utilize its share of a partnership's excess business interest income against the partner's non-partnership business interest expense, while intending that a partner may not utilize such amount against the disallowed business interest expense of the very partnership that generated such excess business interest income. On the other hand, that may be no more bizarre than Congress permitting a corporation to use its directly-earned future excess business interest income to offset its previously disallowed business interest expense deductions, while not permitting a partnership or its partners to employ the same rule.

6 See the Conference Report accompanying the Act (the "Conference Report"), footnote 688 (because a corporation has neither investment interest nor investment income within the meaning of section 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).

7 The amount of any tax imposed under this section is reduced by any tax imposed with respect to the disposition of a US real property interest under section 897 of the Code (the FIRPTA provisions). The Act directs the Treasury to promulgate regulations that may be appropriate to apply the new rules to tax-free exchanges described in sections 332, 351, 354, 355, 356, or 361.

8 It is also 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 entity may no longer be in existence at the time the IRS asserts a tax liability, such persons may also 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 and withhold the tax equal to 10% of the amount realized on the disposition of a partnership interest to which the provision applies. 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.

9 We note that the Treasury issued regulations under section 1446 that required a partnership to withhold on distributions to a partner that has given it an IRS Form W-8ECI regardless of whether the partnership itself was engaged in a US trade or business. Although section 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.

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