

# IRC 163(j) Business Interest Deduction Limitation Rules and How to Avoid Them

WEDNESDAY, JUNE 19, 2019, 1:00-2:50 pm Eastern

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# IRC 163(j) Business Interest Deduction Limitation Rules and How to Avoid Them

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June 19, 2019

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**Strafford**

**IRC 163(j) Business Interest Deduction Limitation Rules**

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June 19, 2019

# Overview of New Section 163(j)

# Section 163(j)

## Overview of the Statute

- Repealed prior section 163(j) limitations on the deductibility of a corporation's "disqualified" interest expense, which included interest paid to a related person that is not subject to tax (e.g., a foreign person).
- Replaced prior rules with new section 163(j), which now limits deductions for all "business interest" ("**BIE**").
- Effective for taxable years beginning after December 31, 2017.
- New section 163(j) applies to limit the deduction for BIE of all "taxpayers" –
  - **Individuals** (section 163(d) also applies to investment interest).
  - **Partnerships** – the limitation is applied at the partnership level with rules intended to preclude potential double counting by partners (S corporations treated similarly).
  - **Corporations** – the limitation is applied to a consolidated group as if it is one taxpayer.
  - **Small businesses** excluded (defined as those with average gross receipts over a three-year period of less than \$25 million).

# Section 163(j)

## General rules

- New section 163(j) applies to every business – regardless of its form – and disallows the deduction for **BIE** in excess of the sum of:
  - (i) Business interest income (**“BII”**),
    - Any interest income “properly allocable to a trade or business”
  - (ii) **30% of the business’s adjusted taxable income (“ATI”)**, and
    - Taxable income without regard to certain amounts, including:
      - Non-business items;
      - BII or BIE;
      - Deductions with respect to net operating losses (“NOLs”) and the passthrough deduction (section 199A); and
      - For taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization or depletion
  - (iii) **floor plan financing interest (“FPFI”)**
    - Generally, interest expense related to the acquisition of motor vehicles, including boats and farm equipment, for sale or lease

# Section 163(j)

## Overview of Proposed Regulations

- Proposed regulations under section 163(j) and related provisions (the “Proposed Regulations”) were released on November 26, 2018.
- Except as otherwise provided, the Proposed Regulations are proposed to be effective for taxable years ending after the date that the Treasury decision adopting the regulations as final is published in the Federal Register.
- In general, taxpayers are permitted to apply the Proposed Regulations to taxable years beginning **after December 31, 2017, provided that the taxpayer (and related parties) consistently apply all of the rules in the Proposed Regulations** to those taxable years.
- The Proposed Regulations state that the limitation under section 163(j) generally applies after other interest expense limitations and that interest expense capitalized into the basis of assets is not subject to limitation under section 163(j).

# Definitions of ATI and BIE

# Section 163(j)

## Definition of adjusted taxable income

- Generally, **ATI** is a taxpayer's **taxable income without regard to**:
  - Non-business items;
  - BII or BIE;
  - Deductions with respect to NOLs and section 199A; and
  - For taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization or depletion.
- The statutory language grants the Secretary authority to make adjustments.
- For taxable years beginning before January 1, 2022, ATI may be thought of as similar to EBITDA (and is sometimes referred to as "tax EBITDA" for this purpose).

# Section 163(j)

## Definition of business interest

- The statutory language defines BIE as “any interest paid or accrued on indebtedness properly allocable to a trade or business” and does not include “investment interest” under section 163(d).
- The Proposed Regulations define “interest” expansively, including items not traditionally considered interest. The Proposed Regulations set forth four categories of items treated as interest, with specific items identified:

### **(1) Interest on indebtedness and items treated as interest under the Code or Regulations**

- Includes items such as original issue discount (“OID”), market discount, repurchase premium and deferred payments treated as interest under section 483.

### **(2) Significant non-periodic payments on swaps**

- These rules apply to non-cleared swaps, and would follow previous law regarding treating a significant non-periodic payment as a separate loan and an on-market swap. The Proposed Regulations reserve on the treatment of cleared swaps.

# Section 163(j)

## Definition of business interest (*cont'd*)

### **(3) Other items treated as interest**

- This category covers items not traditionally considered interest, including certain items deductible under section 162. This category includes, but is not limited to:
  - Substitute interest payments under securities lending and repo transactions
  - Items from derivatives that alter a taxpayer's cost of borrowing or effective yield
  - Loan commitment fees if any portion of the financing is actually provided
  - Debt issuance costs subject to Treas. Reg. § 1.446-5
  - Guaranteed payments for the use of capital under section 707(c)
  - Income on factored receivables

### **(4) Anti-avoidance rule**

- Any deductible expense or loss incurred in a transaction or series of related transactions in which the taxpayer secures the use of funds for a period of time if such expense or loss is predominantly incurred in consideration for the time value of money.

# Overview of the Business Interest Limitation and Partnerships

# Section 163(j) and Partnerships

## Defined Terms

- **Interest** is defined broadly and includes guaranteed payments for the use of capital.
- **BIE** is interest expense properly allocable to a non-excepted trade or business.
- **Excess Taxable Income (“ETI”)** generally equals:

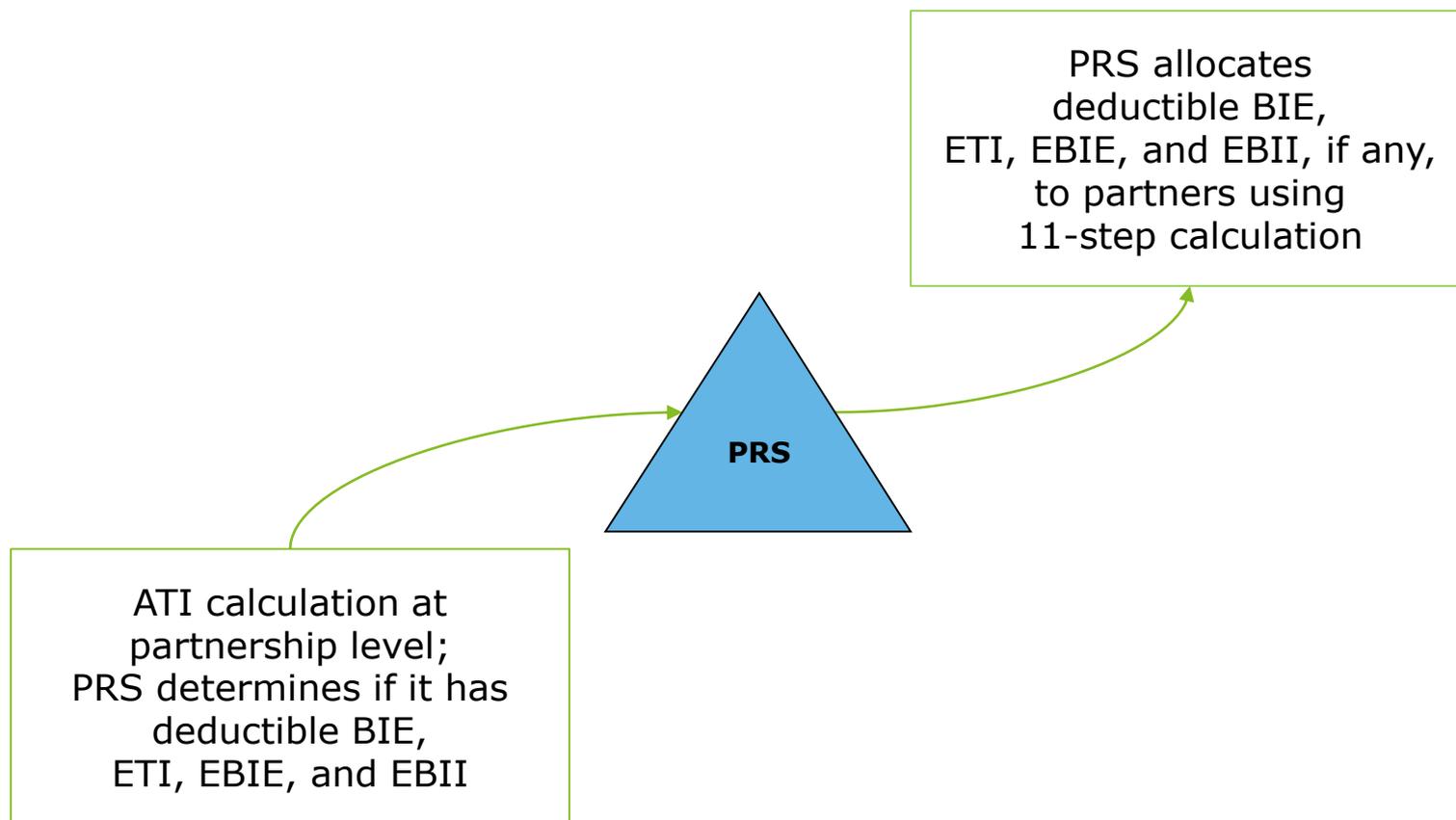
$$\text{Partnership ATI} \times \frac{(\text{ATI} \times 30\%) - (\text{BIE} - \text{FPFI} - \text{BII})}{(\text{ATI} \times 30\%)}$$

Generally, this is the amount of the partnership’s ATI in excess of the ATI needed to support the partnership’s interest deduction.

- **Excess Business Interest Expense (“EBIE”)** means, with respect to a partnership, the amount of disallowed BIE of the partnership for a taxable year.
- **Excess Business Interest Income (“EBII”)** means, with respect to a partnership, interest income in excess of BIE.

# Section 163(j) and Partnerships

## Limitation determined at the partnership level



## Section 163(j) and Partnerships

### Limitation determined at the partnership level (cont.)

- If BIE is limited at the partnership level, partners receive an allocation of **EBIE that is carried forward at the partner level.**
- If a partnership has excess ATI (excess capacity to deduct interest), partners receive an allocation of ETI. **ETI frees up EBIE previously allocated from that partnership and is included in the partner's ATI.**
- BIE that is deductible at the partnership level is taken into account in determining non-separately stated income or loss and is not subject to the section 163(j) limit at the partner level.
  - This interest retains its character as “interest” for other purposes (*e.g.*, passive activity loss rules).

## Section 163(j) and Partnerships

### Limitation determined at the partnership level (cont.)

- Gain or loss from the sale of a partnership interest is **generally included in the partner's ATI** to the extent the partnership owns only "non-excepted trade or business assets," or is included in the partner's ATI in a proportionate amount to the extent the partnership owns both excepted and non-excepted trade or business assets.
- The gain from the sale of a partnership interest is not included in ATI to the extent gain reflects depreciation, amortization, or depletion that were added back to ATI.
  - A double benefit would otherwise result because the amount of the gain that would be reflected in the partner's ATI in respect of the sale or other disposition would reflect the decreased basis in such assets as a result of the depreciation, amortization, or depletion.

# Section 163(j) and Partnerships

## Calculation of EBIE

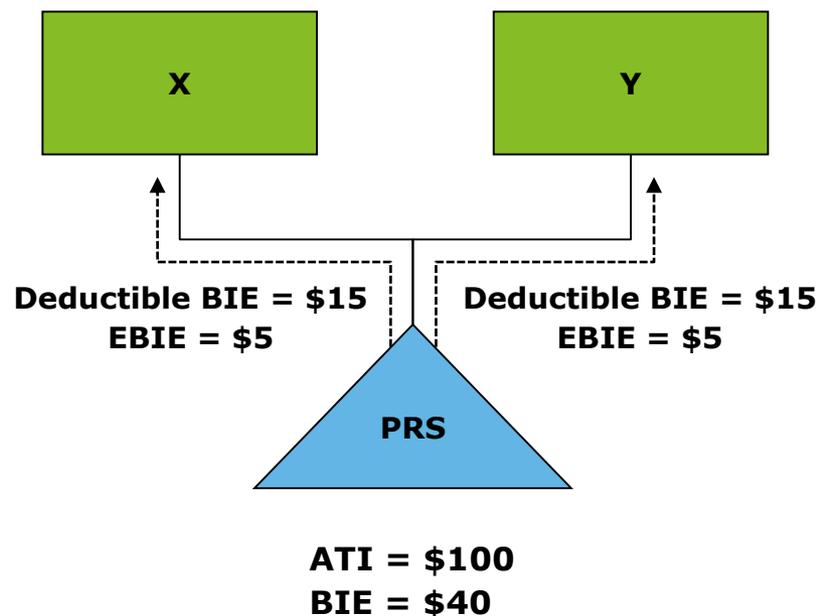
### Example 1a:

#### Facts

X and Y are equal partners and agree to allocate items of PRS *pro rata*.

#### Partnership-level analysis

- PRS Deductible BIE = \$30  
= BII \$0 + (30% x ATI \$100) + FPMI \$0
- PRS EBIE = \$10  
= BIE \$40 - Deductible BIE \$30
- PRS will allocate \$5 of EBIE to each of X and Y



*For simplicity, it is assumed that the debtor does not meet the small business exception as applied under section 448(c).*

# Section 163(j) and Partnerships

## Calculation of ETI

### Example 2a:

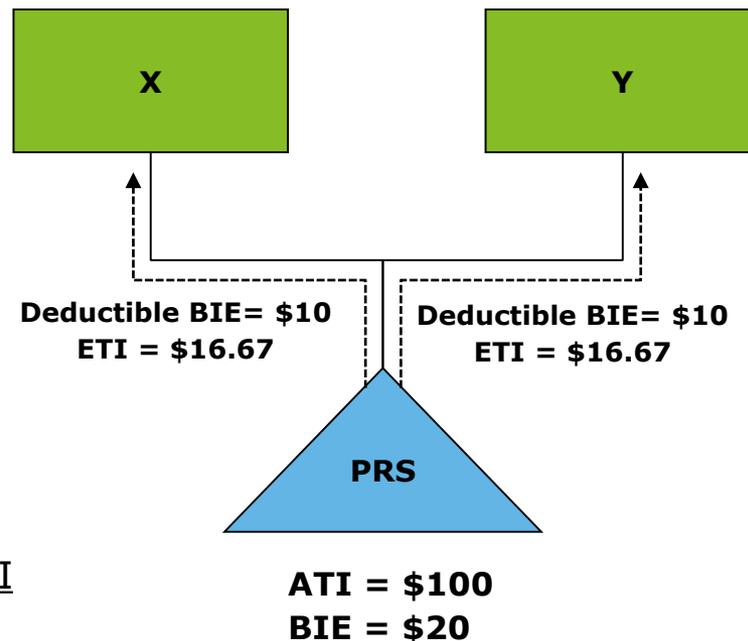
#### Facts

X and Y are equal partners and agree to allocate items of PRS *pro rata*.

#### Partnership-level analysis

- PRS Deductible BIE = \$20  
 $\leq$  BII \$0 + (30% x ATI \$100) + FPGI \$0
- PRS ETI = \$33.33  
 = PRS ATI \$100 x  

$$\frac{(\text{ATI } \$100 \times 30\%) - (\text{BIE } \$20 - \text{FPGI } \$0 - \text{BII } \$0)}{(\text{ATI } \$100 \times 30\%)}$$
- PRS will allocate \$16.67 of ETI to each of X and Y



*For simplicity, it is assumed that the debtor does not meet the small business exception as applied under section 448(c).*

# Section 163(j) and Partnerships

## Calculation of ETI with BII

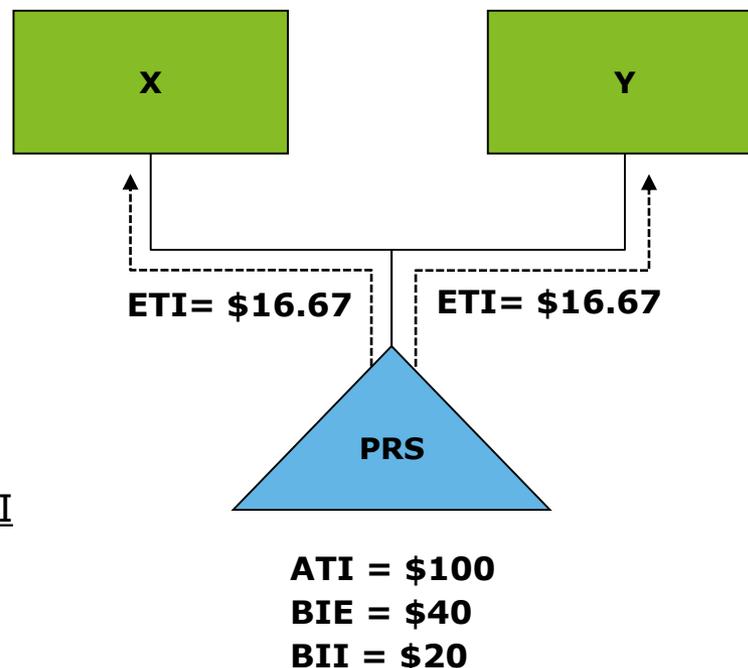
### Example 3a:

#### Facts

X and Y are equal partners and agree to allocate items of PRS *pro rata*.

#### Partnership-level analysis

- PRS Deductible BIE = \$40  
 $\leq$  BII \$20 + (30% x ATI \$100) + FPGI \$0
- PRS ETI = \$33.33  
= PRS ATI \$100 x  
$$\frac{(\text{ATI } \$100 \times 30\%) - (\text{BIE } \$40 - \text{FPGI } \$0 - \text{BII } \$20)}{(\text{ATI } \$100 \times 30\%)}$$
- PRS will allocate \$16.67 of ETI to each of X and Y



*For simplicity, it is assumed that the debtor does not meet the small business exception as applied under section 448(c).*

# 11-Step Calculation

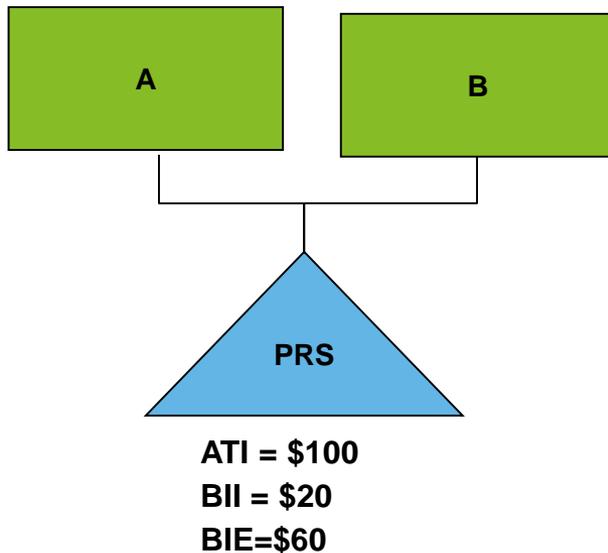
# 11-Step Calculation

## In general

- Does not change section 704 allocations.
- Purpose is to determine which partner is allocated deductible BIE, ETI, EBII, or EBIE, when allocations are not *pro rata*.
- This will be an issue any time a partnership specially allocates income or loss, *e.g.*, partnership with gross income preferred and partnership with section 704(c) property.

# 11-Step Calculation

## In general (cont.)



Before 11-Step Calculation			
	A	B	Total
Allocable ATI	\$100	\$0	\$100
Allocable BII	\$10	\$10	\$20
Allocable BIE	\$30	\$30	\$60

After 11- Step Calculation			
	A	B	Total
Deductible BIE	\$30	\$20	\$50
EBIE allocated	\$0	\$10	\$10
ETI allocated	\$0	\$0	\$0

# 11-Step Calculation

1. Determine PRS section 163(j) limitation and other items.
2. Determine each partner's allocable share of section 163(j) items used in PRS section 163(j) calculation.
3. Compare each partner's allocable BII to such partner's allocable BIE.
4. Determine each partner's final allocable BII excess.
5. Determine each partner's remaining BIE.
6. Determine each partner's final allocable ATI.
7. Compare each partner's ATI capacity ("ATIC") amount—30 percent of ATI—to such partner's remaining BIE.
8. Determine each partner's priority amount and usable priority amount. The adjustments under Step 8 are required if, and only if, PRS has:
  - a. An EBIE greater than \$0 under Step 1;
  - b. A total negative allocable ATI greater than \$0 under Step 6; and
  - c. A total ATIC excess amount greater than \$0 under Step 7.
9. Determine each partner's final ATIC excess amount.
10. Determine each partner's final ATIC deficit amount.
11. Allocate deductible BIE and section 163(j) excess items to the partners.

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# IRC 163(j) Business Interest Deduction Limitation Rules and How to Avoid Them

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June 19, 2019 Strafford Presentation

## Section 163(j) Exceptions

- Investment Interest
  - Trading partnerships
  - Real estate investments
- Small business exemption
  - Aggregation rules
  - Not allowed for “tax shelters”
- Electing real property trade or business
  - Effect on depreciation
  - Election for REITs
  - Interaction with small business exemption

# Section 163(j) Business Interest Deduction Limitation

- Deductible interest expense generally limited to 30% of adjusted taxable income (ATI)
  - ATI is basically equal to EBITDA in 2018 through 2021
  - ATI is basically equal to EBIT in 2022 and later (though there is a campaign to “bring back the DA”)
  
- See also state/local tax conformity (or lack thereof)

## Federal Revenue Effects

- Joint Committee on Taxation estimates that section 163(j) will raise \$253.4 billion in federal revenues in 2018 through 2027
- For comparison:
  - Section 461(l) excess business loss limitation -- \$149.7 billion
  - Base erosion and anti-abuse tax (BEAT) -- \$149.6 billion
  - GILTI -- \$112.4 billion
  - Parking and transportation fringe changes -- \$17.7 billion
  - Section 451(b) book-tax income conformity -- \$12.6 billion
  - Repeal of partnership technical termination -- \$1.6 billion

# Investment Interest

- Section 163(j)(5): For purposes of this subsection, the term “business interest” means any interest paid or accrued on indebtedness properly allocable to a trade or business. **Such term shall not include investment interest (within the meaning of subsection (d)).**
- Section 163(d)(1): a non-corporate taxpayer’s deductible investment interest is limited to net investment income.
- Section 163(d)(3)(A): Investment interest is generally any interest allocable to property held for investment, other than any interest that is part of section 469 passive activity income/loss.

## Example 1: Investment Partnership

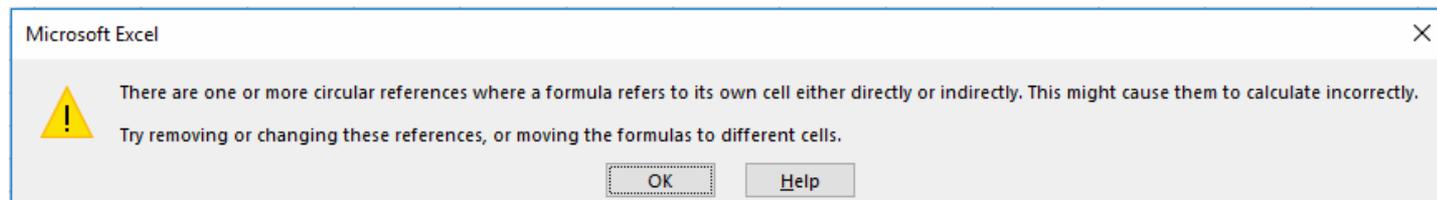
- Individual A and domestic corporation B are equal partners in partnership AB, which has \$200 of interest expense allocable to stocks and bonds held for investment.
  - Partnership AB allocates \$100 of interest expense to each partner.
  - Individual A: \$100 of interest expense is investment interest expense, not subject to section 163(j), but deduction is limited to 100% of net investment income.
  - Corporation B: \$100 of interest expense is business interest at the partner level, potentially subject to section 163(j) and limited to 30% of ATI.

## Example 2: Trading Partnership

- Individual A and domestic corporation B are equal partners in partnership AB, which has \$200 of interest expense allocable to a trading business of stocks, bonds, and commodities. Individual A does not materially participate in the trading activity.
  - Partnership AB: \$200 of interest expense is subject to section 163(j) at the partnership level, limited to 30% of ATI.
  - Individual A: allowed interest expense is also investment interest expense at the partner-level, with deduction limited to 100% of net investment income. See **section 163(j)(5)(A)(ii) (property held for investment includes any interest in a trade or business activity that is not a passive activity and with respect to which the taxpayer does not materially participate)**.
  - Corporation B: no partner-level limitation.

# Property Held for Investment

- Section 163(d)(5)(A)(i): **property held for investment** shall include any property which produces income of a type described in section 469(e)(1):
  - Section 469(e)(1)(i) interest, dividends, annuities, and royalties,
  - Section 469(e)(1)(ii) Gain or loss attributable to the disposition of property producing income of a type described in clause (i) or **held for investment**.
- Treas. Reg. 1.469-2T(c)(3)(i)(D): property held for investment is “within the meaning of section 163(d).”



# Personal Interest

- Section 163(h): a non-corporate taxpayer cannot deduct any “personal interest,” which is any interest other than:
  - Interest allocable to a trade or business,
  - Section 163(d) investment interest,
  - Interest taken into account in passive activity income or loss,
  - Home mortgage interest,
  - Section 6601 interest on unpaid estate tax, and
  - Section 221 student loan interest.

## Example 3: Investment Real Property

- Individual investor has \$100 of interest expense allocable to a net leased real property, which does not rise to the level of a rental trade or business. The investor does not materially participate in the rental activity.
  - Not subject to section 163(j) because not a trade or business.
  - Not subject to section 163(d) investment interest limitation because it is a passive activity.
  - **No limitation on deductible interest (same as pre-TCJA law).**

## Example 4: Investment Real Property (cont'd)

- Individual investor has \$100 of interest expense allocable to a net leased real property, which does not rise to the level of a rental trade or business. The investor is a section 469(c)(7) real estate professional and materially participates in the (aggregated) rental activity.
  - Not subject to section 163(j) because not a trade or business.
  - Not part of passive activity income or loss, due to real estate professional status and material participation in the rental activity.
  - Subject to section 163(d) investment interest limitation?
    - If yes, deduction limited to 100% of net investment income.
    - If no, interest may be personal interest that is not deductible.

## Example 5: Vacant Land

- Individual investor has \$100 of interest expense allocable to vacant land held for investment.
  - Not subject to section 163(j) because not a trade or business.
  - Not part of passive activity income or loss, due to land not being held in a trade or business activity or rental activity.
  - Subject to section 163(d) investment interest limitation?
    - If yes, deduction limited to 100% of net investment income.
    - If no, interest may be personal interest that is not deductible.

# Business vs Nonbusiness

- Longstanding case law since the 1930s on a taxpayer's status as trader versus an investor in stocks and securities
- Collateral consequences include:
  - TCJA disallowance of non-interest investment expense deductions in 2018-2025
  - Section 199A pass-through business income deduction
  - Section 461(l) excess business loss rules
  - State income tax rules, including disallowance of investment interest expense and other itemized deductions

## Small business exception

- Some law firms and other commentators state that small businesses with <\$25 million of gross receipts need not worry about section 163(j).
- Reality is more complicated.
- Section 163(j)(3):
  - In the case of any taxpayer which meets the gross receipts test of section 448(c) for any taxable year, [section 163(j)] shall not apply to such taxpayer for such taxable year.
  - Apply **aggregation rules** of section 448(c)(2).
  - Does not apply to a **tax shelter** prohibited from using the cash receipts and disbursements method of accounting.

## Section 448(c) gross receipts test

- Average annual gross receipts for three prior years does not exceed \$25 million (adjusted for inflation, \$26 million in 2019).
- Gross receipts generally includes:
  - Total sales and amounts received for services
  - Gross gains for dispositions of capital assets and business assets
  - Interest, dividends, rents, royalties, annuities
  - Share of partnership and S corporation receipts (including small businesses and electing real property trades or businesses)
  - Treas. Reg. 1.163(j)-2(d)(2) – exception for inherently personal items like W-2 wages, Social Security benefits, disability

## Aggregation to reach \$25 million threshold

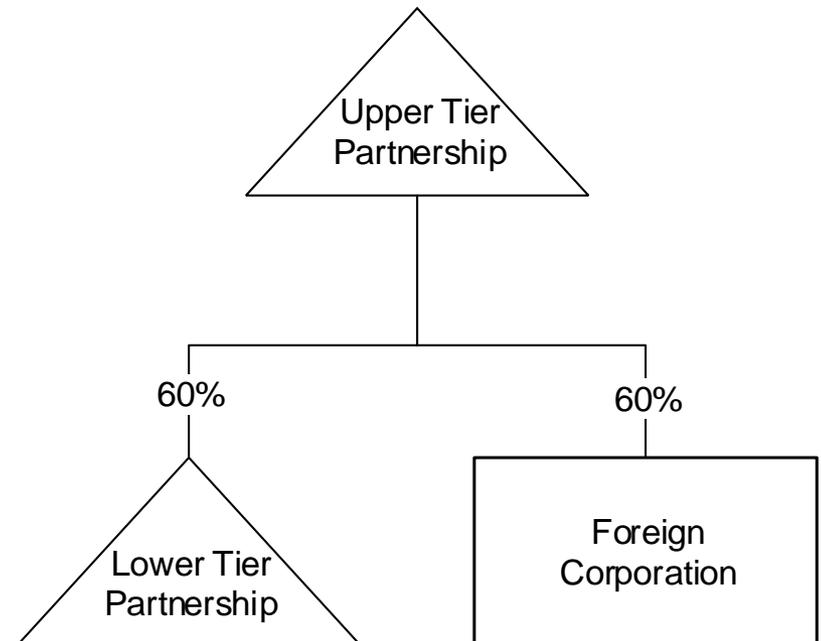
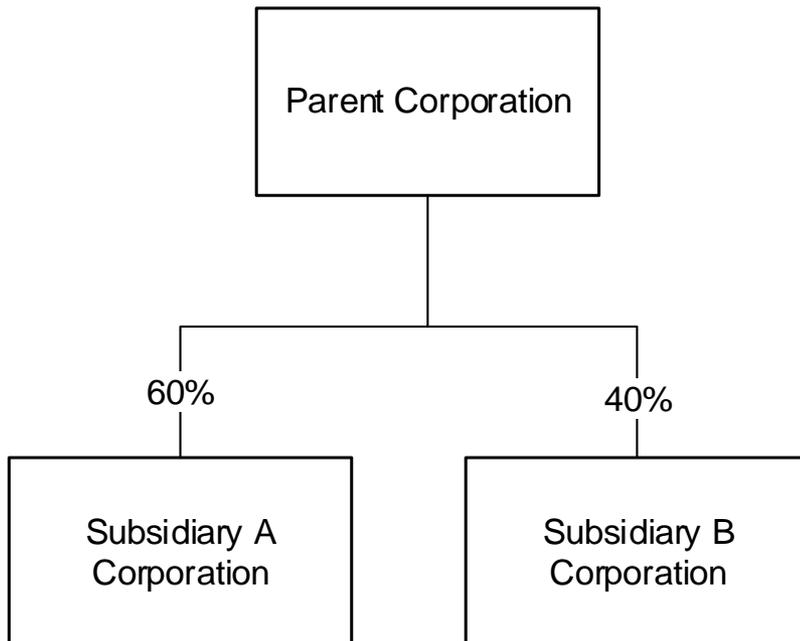
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- Parent-subsidary aggregation
- Brother-sister aggregation
- Section 414(m)(2)(A) aggregation of service organizations and their owners
- Section 414(m)(2)(B) aggregation of service organizations and their service providers
- Section 414(m)(5) aggregation of management companies and their principal customers



# Parent-sub subsidiary aggregation

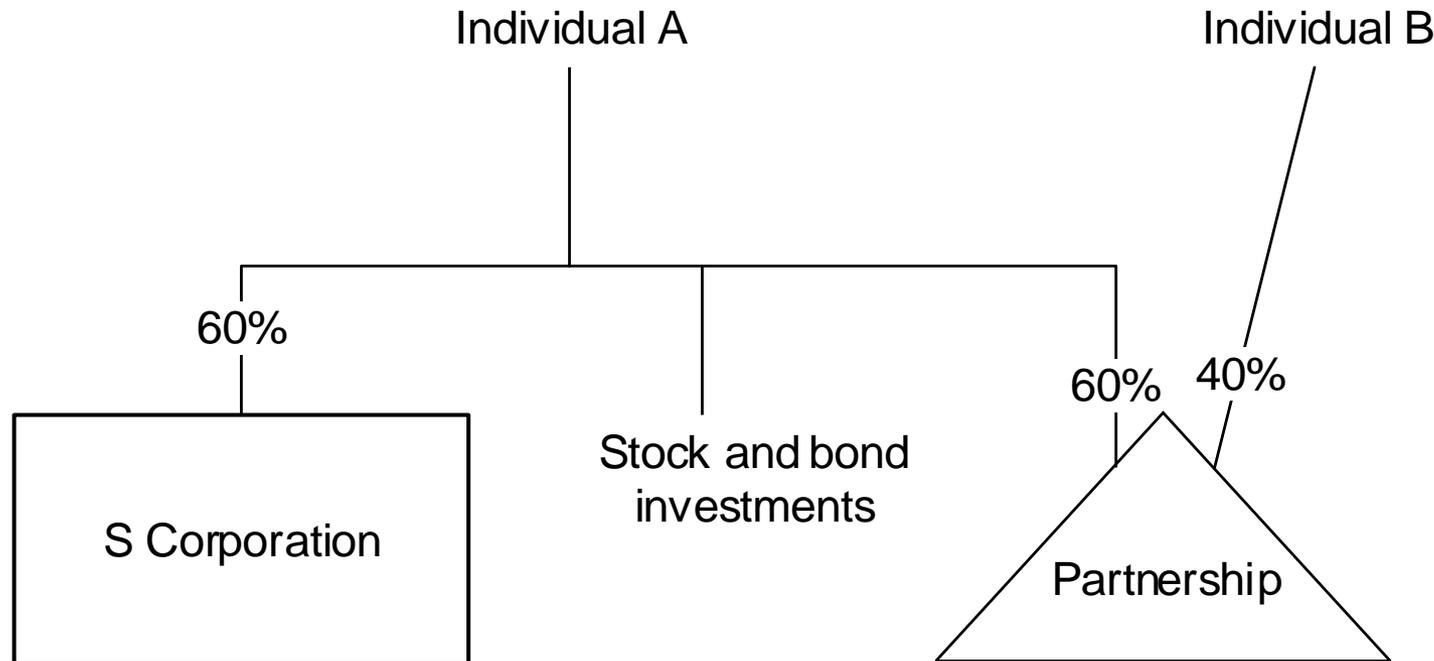
- More than 50% ownership through a parent entity and chain(s)



## Parent-subsidary aggregation (cont'd)

- Upper-Tier Partnership acquired its 60% interest in Lower-Tier Partnership on June 1, 2018
  - Upper-Tier Partnership includes Lower-Tier Partnership's gross receipts in 2015, 2016, and 2017
- Upper-Tier Partnership reduced its interest in Lower-Tier Partnership from 60% to 40% on February 1, 2019
  - 50% ownership test can be met for any day of the year
  - Contrast with section 1563(b) "component member" rules and Prop. Treas. Reg. 1.59A-2(c) BEAT rules, which generally look at ownership only on last day of taxable year
- Special rules if members use different periods as taxable years

# Parent-subsidary aggregation (cont'd)



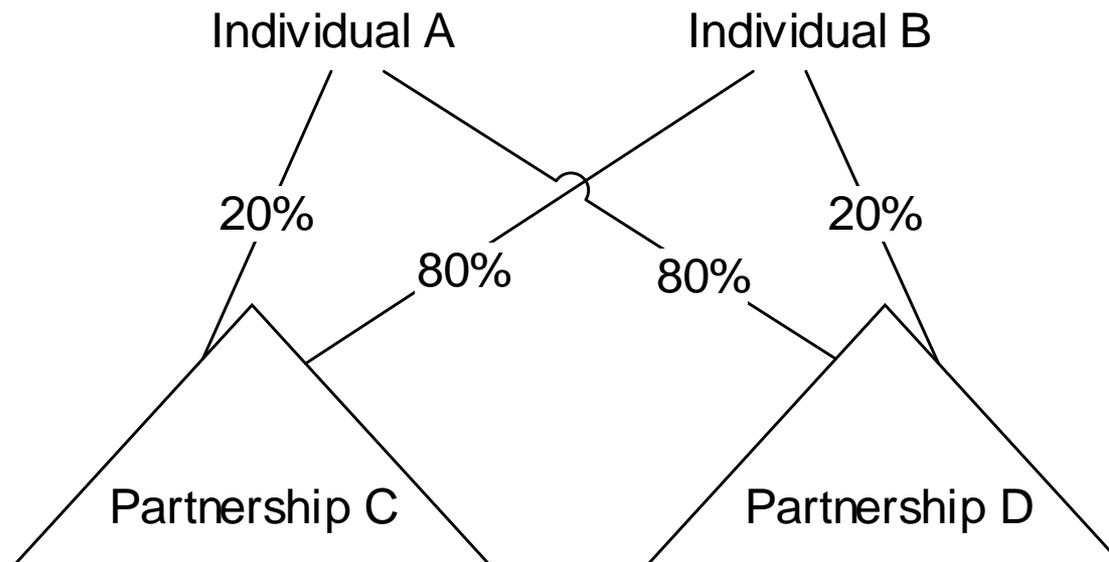
- Section 163(j)(3): “In the case of any taxpayer which is not a corporation or a partnership, the gross receipts test of section 448(c) shall be applied in the same manner as if such taxpayer were a corporation or partnership.”

## Parent-subsubsidiary aggregation: constructive ownership

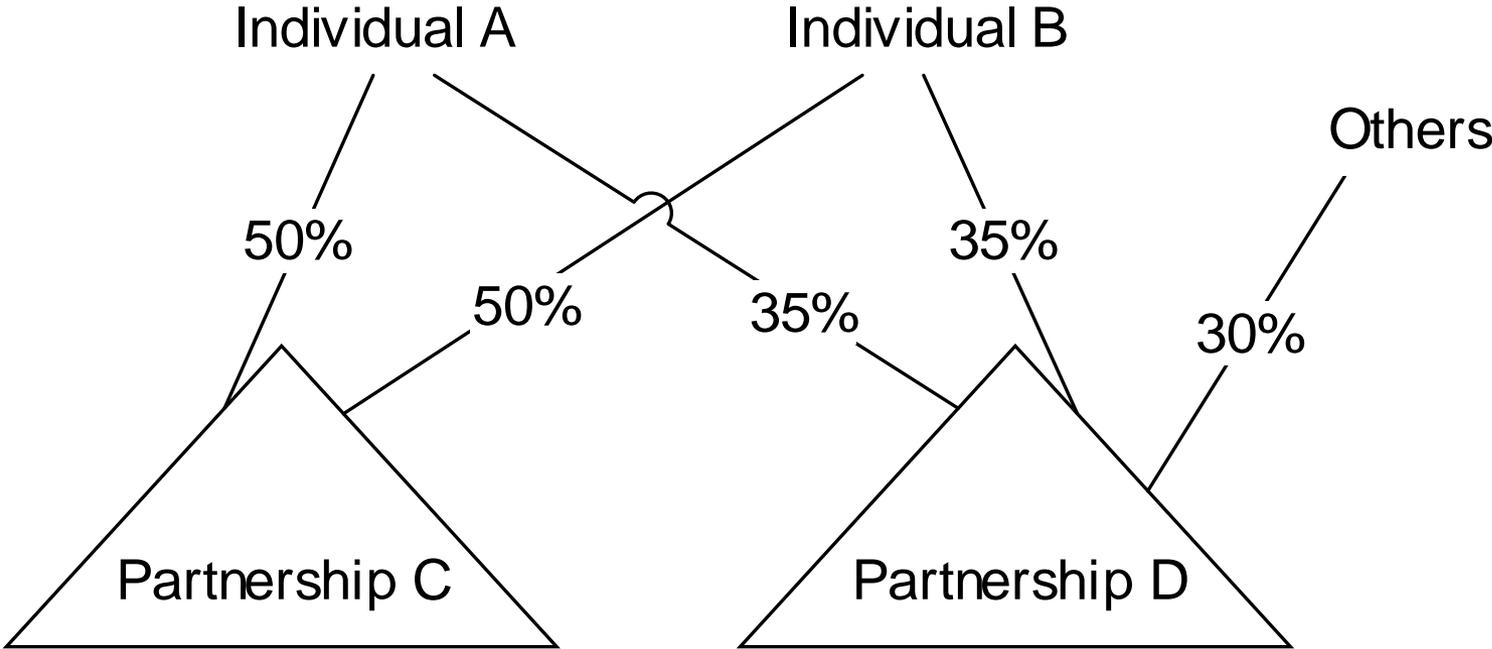
- Section 448(c)(1) refers to section 52(a) and section 52(b), which refer to section 1563
- Section 1563(d)(1):
  - option attribution,
  - attribution through a 5% or greater interest in a partnership, and
  - some attribution through trust and estates
- Treas. Reg. 1.52-1(c)(1)(ii):
  - option attribution only

# Brother-sister aggregation

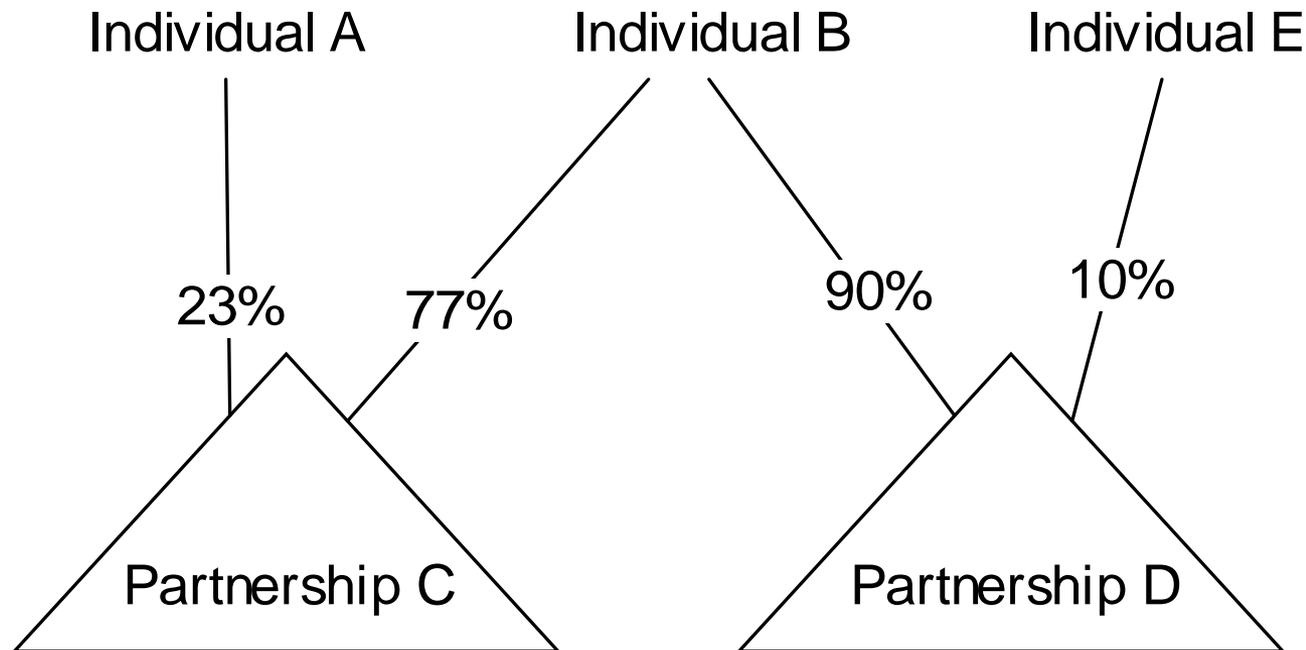
- Five or fewer individuals (or trusts, etc.) own
  - at least 80% of both entities, and
  - more than 50% of both entities, taking into account the ownership of each person only to the extent such ownership is identical for each entity



# Brother-sister aggregation (cont'd)



## Brother-sister aggregation (cont'd)



- See *United States v. Vogel Fertilizer Co.*, 455 U.S. 16 (1982) – 80% test counts only persons who own interests in both entities.

# Brother-sister aggregation: constructive ownership

## ■ Great Typo Mystery of Section 52

- 1987 version of Treas. Reg. 1.52-1(d)(1):

(i) The same five or fewer persons who are individuals, estates, or trusts own (directly and with the application of § 11.414(c)-4), singly or in combination, a controlling interest of each organization; and

(ii) Taking into account the ownership of each person only to the extent that person's ownership is identical with respect to each organization, such persons are in effective control of each organization.

- 1.414(c)-4(b)(1) is option attribution
- No T.D. or other explanation

- 1988 version of Treas. Reg. 1.52-1(d)(1):

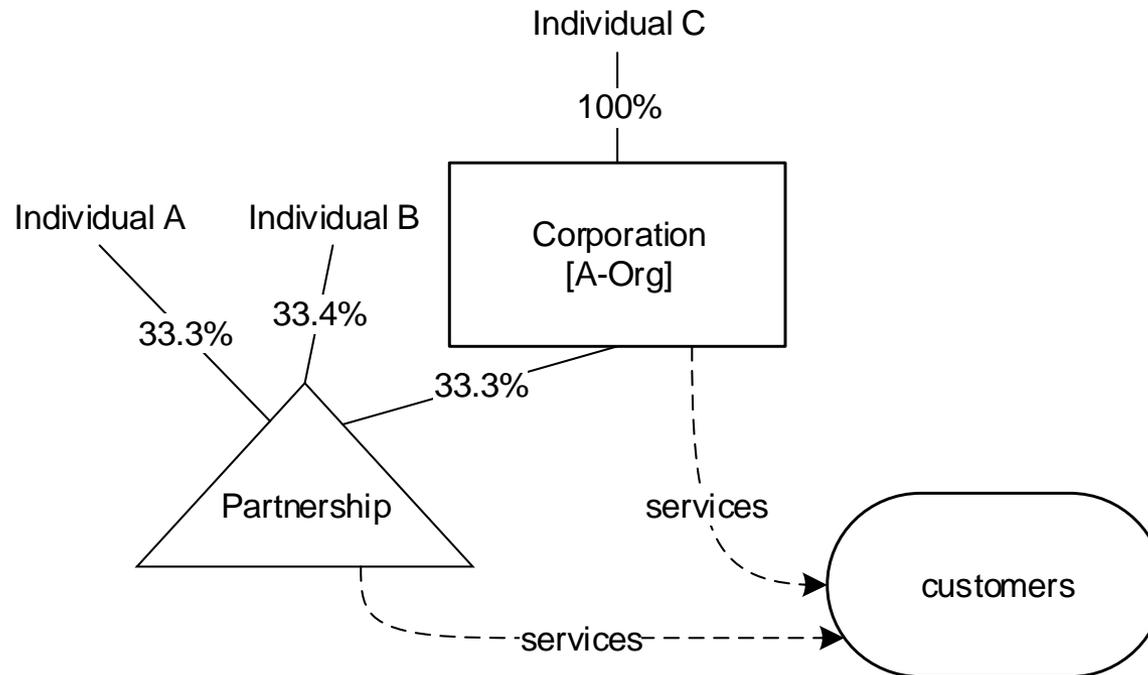
(i) The same five or fewer persons who are individuals, estates, or trusts own (directly and with the application of § 1.414(c)-4(b)(1), a controlling interest of each organization; and

(ii) Taking into account the ownership of each person only to the extent that person's ownership is identical with respect to each organization, such persons are in effective control of each organization.

## Brother-sister aggregation: constructive ownership

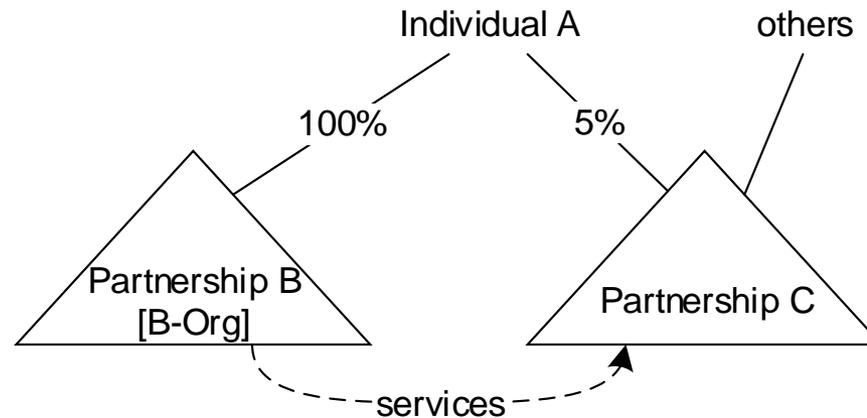
- Section 1563 and Treas. Reg. 1.414(c)-4:
  - option attribution,
  - attribution through a 5% or greater interest in a partnership,
  - some attribution through trust and estates,
  - attribution through 5% or more of the stock of a corporation, and
  - some family attribution with spouse, children (different rules for minor children), grandchildren, parents, grandparents
  
- Current official version of Treas. Reg. 1.52-1(d)(1)(i):
  - option attribution only

# Service organizations and their owners



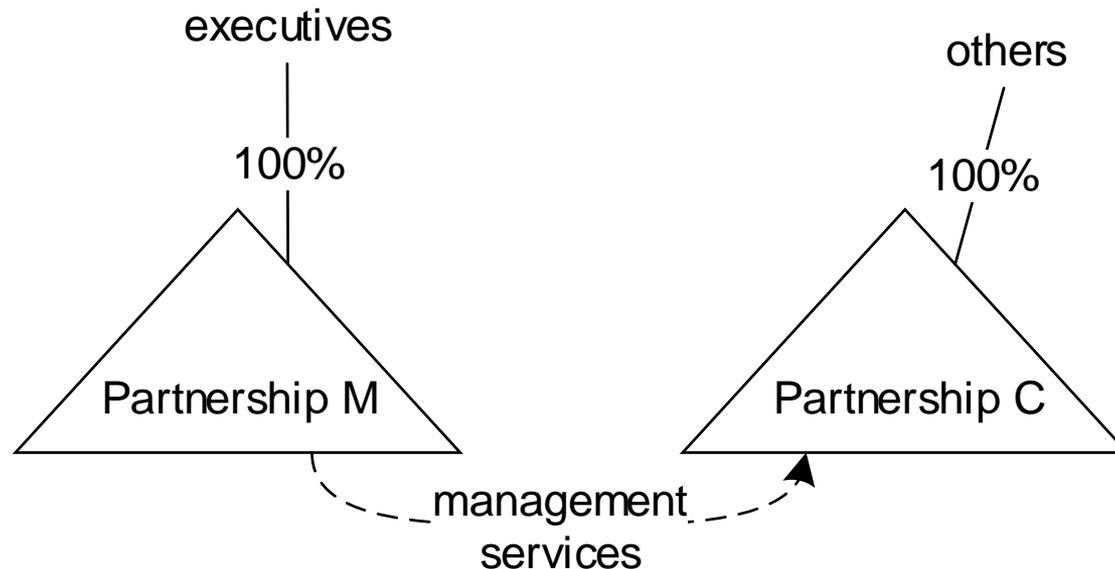
- Response to *Garland v. Commissioner*, 73 T.C. 5 (1979), which allowed Corporation to set up a pension plan for just individual C. Also *Kidde v. Commissioner*, 69 T.C. 1055 (1978) (pre-ERISA law).

# Service organizations and their service providers



- A significant portion (generally over 5-10%) of B's business is the performance of services to C.
- Services are of a type historically performed by employees of C in C's service field as of December 13, 1980.

# Management companies and their principal customers



- M's principal business is performing, on a regular and continuous basis, management functions for C and related organizations

# Tax shelters

- Small business does not apply to a “tax shelter”:
  - any syndicate, which is a partnership or other entity (other than a C corporation) if more than 35 percent of its losses during the tax year are allocable to limited partners or limited entrepreneurs,
  - any enterprise (other than a C corporation) if interests in that enterprise have ever been offered for sale in any offering that has to be registered with any federal or state agency (that regulates the offering of securities for sale),
  - any entity, plan or arrangement, if its significant purpose is the avoidance or evasion of federal income tax.

## Syndicate examples

- LLC incurs \$100 of tax losses, which is allocated \$10 to a managing member and \$90 to non-managing members.
  - LLC is a tax shelter because more than 35% of losses are allocated to persons who do not actively participate in the management of the entity.
- LLC incurs \$100 of tax losses, which is allocated \$50 to an S corporation managing member and \$50 to non-managing members.
  - See *Burnett Ranches Ltd. v. United States*, 753 F.3d 143 (5th Cir. 2014), non-acq. A.O.D. 2017-01 (IRS continues to believe that a separate legal entity, such as an S corporation, cannot actively participate in management).

## Syndicate examples (cont'd)

- LLC has \$100 of taxable income, which is allocated \$10 to a managing member and \$90 to non-managing members.
  - No losses allocated to limited partners or limited entrepreneurs, so not a tax shelter.
  - For this purpose, taxable income does not include gains and losses from the sale of capital assets or section 1231 assets.
- What if the LLC has a tax loss if it is a small business and section 163(j) does not apply, but the LLC has taxable income if it is a tax shelter and section 163(j) applies to disallow some interest expense?
  - Circularity may be resolved by analogy to Treas. Reg. 1.448-1T(b)(3).

## Effect of small business exception

- For a partnership or S corporation, pass-through of section 163(j) items to the partners or shareholders
- Section 163(j) applies at the partner or shareholder level, unless the partner or shareholder also qualifies for the small business exception
- If a partnership or S corporation becomes a small business in a later year (e.g., stops being a tax shelter), any interest expense carryovers are allowed at the partner level or S corporation level

## Real Property Trade or Business (RPTB) election

- Section 163(j)(7)(B) allows a real property trade or business to irrevocably elect out of section 163(j).
  - Any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business, under section 469(c)(7)
  - Prop. Treas. Reg. 1.469-9(b)(2): real property operation and management generally includes hotels

## Effect of RPTB election on depreciation

- Qualified improvement property switches to 20 year ADS recovery period and no bonus depreciation if fixed with technical correction (technical correction also for pre-2018 qualified leasehold improvement property, restaurant property, retail improvement property, to 39 years)
- Pre-2018 residential rental property switches to 40 year ADS recovery period (instead of 27.5 years under GDS)
- Residential rental property (placed in service in 2018 and later) switches to 30 year ADS recovery period
- Nonresidential real property switches to 40 year ADS recovery period (instead of 39 years under GDS)
- **ADS not required for personal property or other real property** (e.g., land improvements or single purpose agricultural structures)

## RPTB election and small business exemption

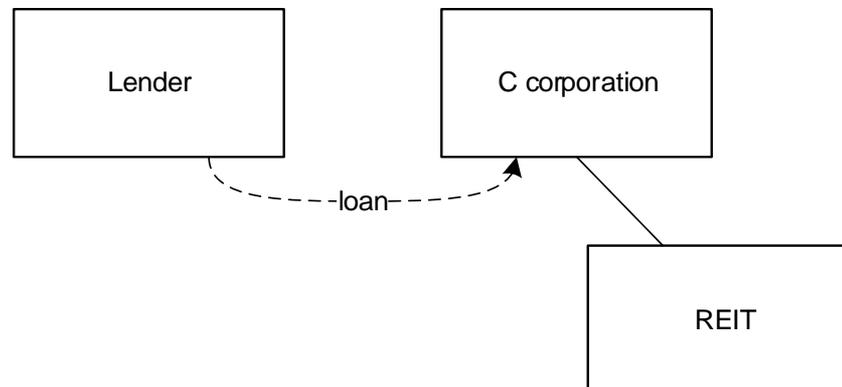
- Preamble to proposed regulations provides:
  - “Consistent with section 163(j)(3), these proposed regulations would provide that taxpayers that meet the gross receipts test of section 448(c) are not subject to the section 163(j) limitation. Eligible taxpayers are those, other than tax shelters under section 448(a)(3), with average annual gross receipts of \$25 million or less, tested for the three taxable years immediately preceding the current taxable year. **Such a taxpayer is not permitted to make an election under either section 163(j)(7)(B) or (C) because the taxpayer is already not subject to the section 163(j) limitation.”**

## Effect of RPTB election

- For a partnership or S corporation that makes the RPTB election, its items are effectively exempt from section 163(j) and do not pass through to the partner or shareholder
- For an S corporation, carryovers are allowed at the S corporation level
- Some lack of clarity in the section 163(j) regulations:
  - What happens to disallowed interest carryovers for an individual or a partnership that makes the RPTB election in later year?
  - How to apply look-through rules in Treas. Reg. 1.163(j)-10(c) for partner-level interest expense allocable to partnership interests?
  - If a partnership is a small business and allocates interest expense to a partner, can the partner then make the RPTB election?

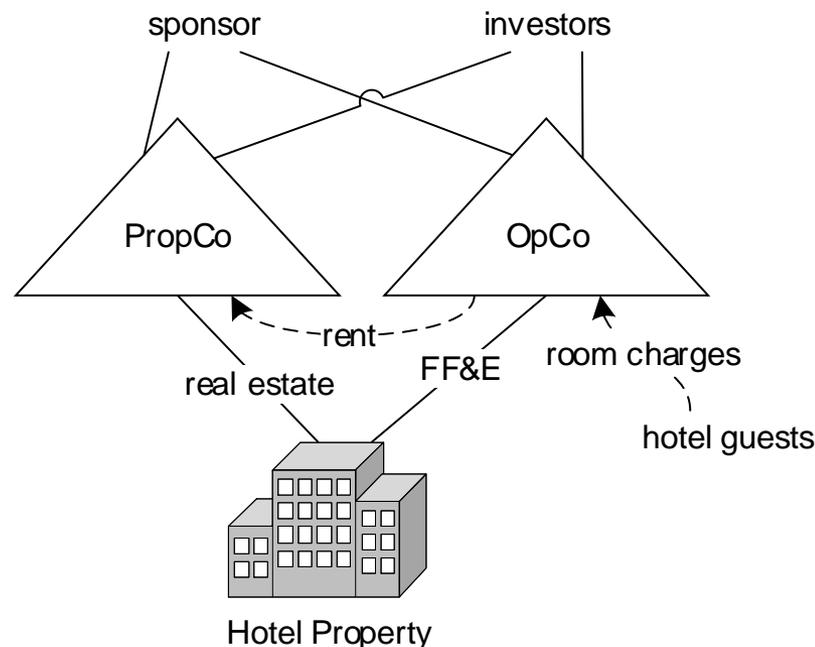
## RPTB Election for REITs

- REITs can make the RPTB election based on the broader definition of “real property” under section 856 and Treas. Reg. 1.856-10, which includes shares in other REITs that own real property
- A REIT that borrows money to acquire stock in a subsidiary REIT can therefore make the RPTB election in order to fully deduct interest expense against the subsidiary REIT’s dividends
- No relief for C corporation that borrows money to acquire REIT stock



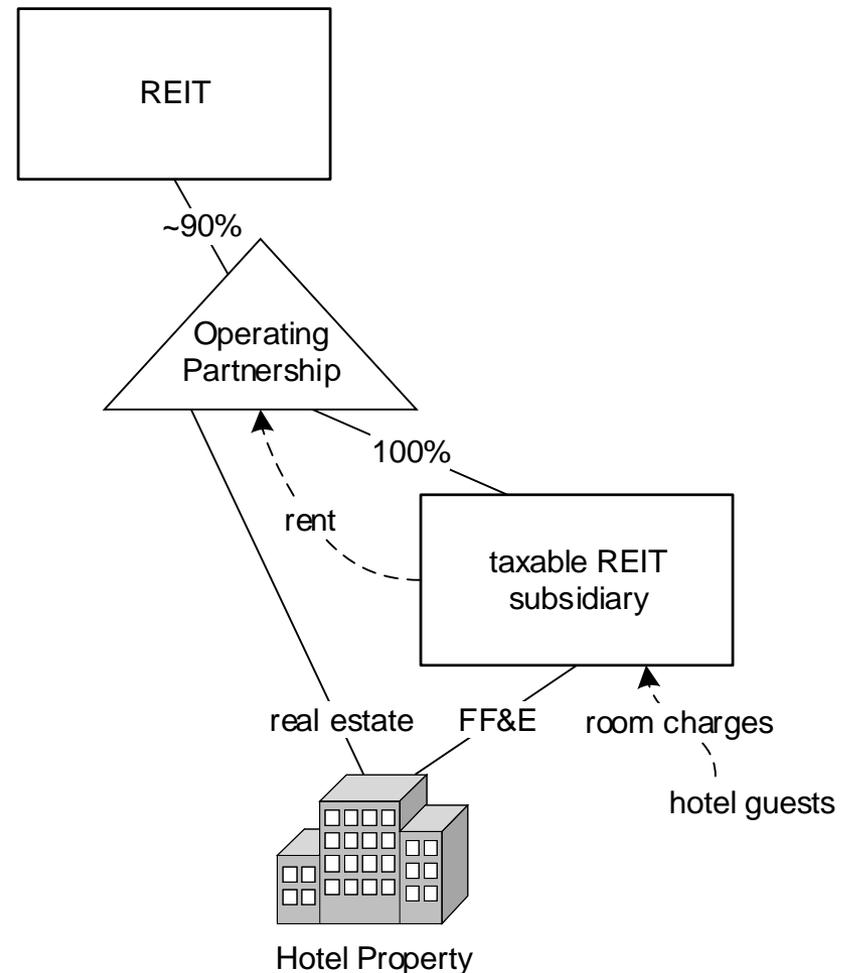
# RPTB election in OpCo-PropCo structure

- Anti-abuse rule disallows the RPTB election for a real property trade or business that leases at least 80% of its real property to a trade or business under 50% or more common control
- Applies even if the lessee is also a real property trade or business



# RPTB election in OpCo-PropCo structure (cont'd)

- Anti-abuse rule does not apply to a REIT that leases qualified lodging facilities and qualified healthcare facilities
- Less clear on whether anti-abuse rule does not apply to a REIT that is a partner in a partnership that owns the facilities



## Other Resources

- Legislative history:
  - Revenue Act of 1964 for section 1563
  - Tax Reform Act of 1969 for section 1563(a)(2)
  - Tax Reduction and Simplification Act of 1977 for section 52
  - Miscellaneous Changes in Tax Laws Act of 1980 for section 414(m)
  - Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982 for section 414(m)(5)
  - American Jobs Creation Act of 2004 for section 1563(f)(5)
  - Tax Cuts and Jobs Act of 2017 for section 163(j)
- Libin Zhang, *Links to the Past: Old Exceptions to New Interest Deduction Limitations*, Tax Notes (Jan. 21, 2019).

Questions?

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