March 7, 2019

Hon. Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on the Impact of the Proposed Regulations under Section 163(j) on Passthrough Entities and their Owners

Dear Commissioner Rettig:

Enclosed please find comments on the impact of the proposed regulations under section 163(j) on passthrough entities and their owners. These comments are submitted on behalf of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

Eric Solomon
Chair, Section of Taxation

Enclosure

cc: Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury
William M. Paul, Acting Chief Counsel and Deputy Chief Counsel (Technical), Internal Revenue Service
Lafayette G. "Chip" Harter III, Deputy Assistant Secretary (International Tax Affairs), Department of the Treasury
Krishna P. Vallabhaneni, Acting Tax Legislative Counsel, Department of the Treasury
Doug Poms, International Tax Counsel, Department of the Treasury
Brett York, Associate International Tax Counsel, Department of the Treasury
Colin Campbell, Attorney-Advisor, Department of the Treasury
Ellen Martin, Tax Policy Advisor, Department of the Treasury
Bryan A. Rimmke, Attorney-Advisor, Department of the Treasury
Brenda Zent, Special Advisor, Office of International Tax Counsel, Department of Treasury
Scott K. Dinwiddie, Associate Chief Counsel (ITA), Internal Revenue Service
Helen M. Hubbard, Associate Chief Counsel (Financial Institutions & Products), Internal Revenue Service
Daniel M. McCall, Deputy Associate Chief Counsel (International), Internal Revenue Service
Holly Porter, Associate Chief Counsel (PSI), Internal Revenue Service
Robert Wellen, Associate Chief Counsel (Corporate), Internal Revenue Service
These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Kevin Anderson, Jason Dexter, Katie Fuehrmeyer, Craig Gerson, Erich Hahn, Daniel Hudson, Dustin Janes, Teka Jarmon, Thomas Phillips, Jennifer Ray, Monisha Santamaria, and Joshua Tompkins. Substantial contributions were made by Jennifer H. Alexander. These comments have been reviewed by Adam Cohen, Council Director for the Partnerships & LLCs Committee, Gary Huffman of the Committee on Government Submissions, and Eric B. Sloan, Vice-Chair for Government Relations for the Section.

Although members of the Section may have clients who might be affected by the federal tax principles addressed by these Comments, no member who has been engaged by a client (or who is a member of a firm or other organization that has been engaged by a client) to make a government submission with respect to, or otherwise to influence the development or outcome of one or more specific issues addressed by, these Comments has participated in the preparation of the portion (or portions) of these Comments addressing those issues. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

Contacts:

Erich Hahn
(202) 758-1360
ehahn@deloitte.com

Craig Gerson
(202) 253-5698
craig.gerson@pwc.com

Katie Fuehrmeyer
(415) 783-5442
kfuehrmeyer@deloitte.com

Date: March 7, 2019
EXECUTIVE SUMMARY

Section 163(j) limits a taxpayer’s deduction for business interest expense (“BIE”) each taxable year.¹ Section 163(j) applies to both corporate and noncorporate taxpayers, including partnerships and their partners. To apply section 163(j) to partnerships, the Act adopted special rules differentiating partnerships from other taxpayers.² In particular, section 163(j)(4) provides that the section 163(j) limitation is applied at the partnership or S corporation level. The partnership or S corporation determines its own “adjusted taxable income” (“ATI”), BIE, and “business interest income” (“BII”) and calculates its own section 163(j) limitation. To the extent that a partnership has disallowed BIE in a tax year, such amount, referred to as “excess business interest expense” (“EBIE”), is allocated among the partners and treated as a carryforward at the partner level. EBIE of an S corporation is an S corporation attribute that is carried forward to succeeding taxable years of the S corporation.

On November 26, 2018, the Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) published proposed regulations under section 163(j) (the “Proposed Regulations”).³ The Proposed Regulations provide definitions and detailed application rules under section 163(j). The Proposed Regulations also add and amend Regulations under certain other provisions of the Code where necessary to provide conformity across the Regulations. The preamble to the Proposed Regulations (the “Preamble”) invites comments on the Proposed Regulations.

We commend Treasury and the Service for their commitment to provide expedited guidance, and we respectfully request that Treasury and the Service consider the following recommendations in finalizing the Proposed Regulations (the “Final Regulations”):

1. Remove guaranteed payments for the use of capital from the definition of interest in the Final Regulations.

2. Provide that if section 448(c) does not apply to aggregate the gross receipts of a partner and a partnership, the partner should not be required to include any share of partnership gross receipts when determining its partner-level eligibility for the small business exemption.

¹ Section 163(j) was amended by An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, commonly referred to as the Tax Cuts and Jobs Act. P.L. 115-97, 131 Stat. 2054 (Dec. 22, 2017) (hereinafter, the “Act”). Unless otherwise indicated, all “section” references are to the Internal Revenue Code of 1986, as amended (the “Code”), and all “Regulation section” references are to the Treasury Regulations promulgated under the Code, all as in effect on the date of these Comments.

² I.R.C. § 163(j)(4).

3. Clarify when a partner must include a share of partnership gross receipts when determining partner-level eligibility for the small business exemption.

4. Provide that BIE incurred by an exempt partnership (i.e., a partnership qualifying for the small business exemption) is not subject to section 163(j) at the partner level.

5. Provide, for purposes of the small business exemption of section 163(j), a definition of tax shelter based on methodological application of cross-referenced Code sections, existing Regulations, and guidance under such sections.

6. Provide that a transfer of a partnership interest in an intercompany transaction that does not result in the termination of the partnership is not treated as a disposition solely for purposes of the basis adjustment rule in section 163(j)(4)(B)(iii)(II), but only to the extent the transferee is treated as a successor to the transferor.

7. Provide that excess business interest expense (“EBIE”) carries over to the transferee upon a transfer of a partnership interest in an intercompany transaction to the extent the transferee is treated as a successor to the transferor.

8. Provide that on the termination of a partnership as a result of the transfer of a partnership interest, both the transferor and the transferee are treated as having disposed of their respective partnership interests, resulting in the basis increase immediately before the transfer under section 163(j)(4)(B)(iii)(II).

9. Provide in the Final Regulations rules akin to the Self-Charged Interest Rules (as defined below) in order to identify self-charged interest income and expense and further allow such self-charged interest income or expense to be excluded from the definition of business interest and BII under sections 163(j)(5) and (6), respectively.

10. Provide that EBIE carryforward amounts allocated to and maintained as EBIE pursuant to section 163(j)(4)(B)(i)(II) by a partner that is itself a partnership (“Upper Tier Partnership” or “UTP”), and any corresponding reductions pursuant to section 163(j)(4)(B)(iii)(I) in the adjusted basis of a UTP’s interest in lower tier source partnership (“LTP”), not be immediately allocated to and taken into account by the partners of UTP.

11. Provide that only EBIE that is treated as “paid or accrued” by UTP and that is determined either to be deductible or nondeductible by UTP (EBIE from LTP that has become EBIE at UTP) should be allocated by UTP to UTP’s partners, including any UTP partners that are partnerships. Once UTP has treated the EBIE as paid or accrued, the tax basis of the interests
and the capital accounts of the UTP partners, including any UTP partners that are partnerships, may then be adjusted.

12. Clarify that the carryforward rule in Proposed Regulation section 1.163(j)-6(g) applies to partners of a partnership treated as a continuing partnership in a partnership merger or division.

13. Clarify that the disposition rule of Proposed Regulation section 1.163(j)-6(h)(3)(i) applies to a partnership interest that is treated as liquidated in a partnership merger or division.

14. Clarify that the disposition rule of Proposed Regulation section 1.163(j)-6(h)(3)(i) applies to a partnership interest that is treated as liquidated in a partnership merger or division.

15. Provide that a taxpayer may adopt any reasonable method to allocate deductible BIE, excess taxable income (“ETI”), excess business interest income (“EBII”), and EBIE among the partners, provided the method does not produce results inconsistent with the application of section 163(j) at the partnership level as articulated by the goals in the Preamble.

16. Provide that the 11-step calculation to allocate deductible BIE, ETI, EBII, and EBIE among the partners constitutes a reasonable method.

17. Allow a partner that is allocated ETI to treat the portion of its negative section 163(j) expense attributable to EBIE as EBIE in a year in which it is allocated ETI to the extent the partner cannot utilize the ATI to deduct BIE at the partner level.

18. Require a partner to increase its basis in the portion of the partnership interest that is sold by an amount of the EBIE that bears the same relation to the partner’s total EBIE as the fair market value of the interest sold bears to the total fair market value of the partner’s interest (“Sold Basis Approach”).

19. Retain the treatment of disallowed BIE as a corporate attribute at the S corporation level.

20. Provide that section 382 (and the comparable provisions of section 382) be applied only to those attributes that are carried forward and taken into account at the corporate level and not be applied to any item of deduction, loss, or credit that is allocated to shareholders on a current basis and taken into account at the shareholder level.

21. Provide that that section 163(j) be applied separately to each of the short periods when an S corporation is required to determine its taxable income or loss for an actual or hypothetical short taxable year.
22. Provide that a distributive share of partnership deductions capitalized by a corporate partner under section 59(e) or section 291(b) will increase the ATI of the partner.
# TABLE OF CONTENTS

## BACKGROUND

DISCUSSION

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Section 707(c) Guaranteed Payments for the Use of Capital</td>
<td>13</td>
</tr>
<tr>
<td>II. Gross Receipts Test in the Partnership Context</td>
<td>15</td>
</tr>
<tr>
<td>III. Tax Shelter Definition in the Partnership Context</td>
<td>23</td>
</tr>
<tr>
<td>IV. Treatment of Intercompany Transfers of Partnership Interests</td>
<td>29</td>
</tr>
<tr>
<td>V. Self-Charged Lending Transactions</td>
<td>37</td>
</tr>
<tr>
<td>VI. Application of Section 163(j) to Tiered Partnerships</td>
<td>43</td>
</tr>
<tr>
<td>VII. Partnership Mergers and Divisions</td>
<td>51</td>
</tr>
<tr>
<td>VIII. Methods of Allocating Partnership Section 163(j) Items to the Partners</td>
<td>54</td>
</tr>
<tr>
<td>IX. Competing Deduction Limitations Under Sections 704(d) and 163(j)</td>
<td>59</td>
</tr>
<tr>
<td>X. The Effect of a Partial Disposition on a Partner’s Basis</td>
<td>61</td>
</tr>
<tr>
<td>XI. Treatment of Disallowed BIE as Corporate Attribute/Section 382</td>
<td>65</td>
</tr>
<tr>
<td>XII. Alternative Treatment as Shareholder Attribute</td>
<td>67</td>
</tr>
<tr>
<td>XIII. Subchapter S and Section 382 (Beyond Section 163(j))</td>
<td>68</td>
</tr>
<tr>
<td>XIV. Partnership Deductions Capitalized by a Corporate Partner</td>
<td>71</td>
</tr>
</tbody>
</table>

## APPENDICES

APPENDICES

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>APPENDICES</td>
<td>73</td>
</tr>
</tbody>
</table>
BACKGROUND

Section 163(j)\(^4\) limits a taxpayer’s deduction for BIE\(^5\) each taxable year to an amount equal to the sum of (i) the BII of the taxpayer for the taxable year; (ii) 30 percent of the ATI of the taxpayer for the taxable year; and (iii) the “floor plan financing interest” of the taxpayer for the taxable year.\(^6\)

The Proposed Regulations provide definitions and detailed application rules under section 163(j).\(^7\) Notably, the Proposed Regulations broadly define interest to include interest equivalents. As it relates to partnerships, the Proposed Regulations define interest expansively and include as interest items not traditionally considered interest, such as guaranteed payments for the use of capital.\(^8\)

Certain taxpayers are outside the scope of section 163(j). First, under the small business exemption, the section 163(j) limitation does not apply if the taxpayer, other than a tax shelter (within the meaning of section 448(d)(3)), meets the gross receipts test of section 448(c) and the section 448(c) Regulations (applied as if the taxpayer were a corporation or partnership) (an “exempt entity”).\(^9\) An entity meets the gross receipts test if its annual average gross receipts over the preceding three years does not exceed $25

\(^4\) In these Comments, we refer to section 163(j) as amended by the Act as “section 163(j),” and we refer to section 163(j) as it existed prior to amendment by the Act as “former section 163(j).” Former section 163(j) primarily prevented the erosion of the U.S. tax base by limiting the deductibility of interest that a corporate taxpayer paid to a related foreign person, if such interest was exempt (in whole or in part) from U.S. tax. It did not apply to partnerships but was relevant to partnerships with corporate partners. If a corporate taxpayer owned an interest in a partnership, (i) that corporation’s distributive share of interest income paid or accrued to the partnership was treated as interest income paid or accrued to the corporation; (ii) the corporation’s distributive share of interest paid or accrued by the partnership was treated as interest paid or accrued by the corporation; and (iii) the corporation’s share of the liabilities of the partnership were treated as liabilities of the corporation.

\(^5\) BIE does not include investment interest expense (within the meaning of section 163(d)). I.R.C. § 163(j)(5). The Proposed Regulations provide that a C corporation can have only BIE and BII (and not investment income or expense). Prop. Reg. § 1.163(j)-4(b). That treatment extends to items allocated to a corporate partner from a partnership, even if the items constitute investment items at the partnership level. Thus, a partnership’s allocation of investment interest expense (within the meaning of section 163(d)) to a C corporation partner is treated as BIE at the partner level. Prop. Reg. § 1.163(j)-6(b).

\(^6\) I.R.C. § 163(j)(1). The amount determined under section 163(j)(1)(B) cannot be less than zero. Id. (flush language).

\(^7\) Except as otherwise provided in the Proposed Regulations, the Proposed Regulations are generally proposed to be effective for taxable years ending after the date the Treasury decision adopting the Proposed Regulations as final is published in the Federal Register. However, taxpayers and their related parties generally may apply rules in the Proposed Regulations to a taxable year beginning after December 31, 2017, provided that the taxpayer and related parties consistently apply all rules of the Proposed Regulations and related provisions, as applicable, to those taxable years. Prop. Reg. § 1.163(j)-1(c).

\(^8\) Prop. Reg. § 1.163(j)-1(b)(20)(I). Prop. Reg. § 1.163(j)-1(b)(20) contains an expansive list of items defined as interest for purposes of the Proposed Regulations.

\(^9\) I.R.C. § 163(j)(3); Prop. Reg. § 1.163(j)-1(b)(2)(i).
BIE of a partnership or S corporation that qualifies for the small business exemption is subject to the section 163(j) limitation at the partner or S corporation shareholder level. A partner or S corporation shareholder includes items of income, gain, loss, or deduction from the exempt entity when calculating its ATI and also includes its share of BII from the entity.11

Second, if taxpayer, including a partnership, is an “excepted entity” because it operates an “excepted trade or business” (i.e., the trade or business of performing services as an employee, an electing real property trade or business, an electing farming business, or an excepted regulated utility trade or business), the excepted entity does not calculate a section 163(j) limitation.12 Any section 163(j) item that is allocable to the partnership’s excepted trade or business are excluded from the partner’s section 163(j) deduction calculation.13 Proposed Regulation section 1.163(j)-10(c) provides rules for the allocation between excepted trades or businesses and non-excepted trades or businesses.

Section 163(j) is applied at the partnership level, and any deduction for BIE is taken into account in determining the non-separately stated taxable income or loss of the partnership.14 The definition of ATI in the Proposed Regulations generally tracks the statute with certain clarifications and additional adjustments.15 For purposes of computing ATI of a partnership, taxable income of the partnership is determined under section 703(a).16 Section 734(b) adjustments are taken into account for purposes of calculating partnership ATI. Section 743(b) and section 704(c)(1)(C)(i) items and any allocation to a partner of remedial items of income, gain, loss, or deduction pursuant to section 704(c) and Regulation section 1.704-3(d) are not taken into account in determining partnership’s ATI.17

To the extent a partnership has deductible BIE (i.e., BIE that is less than or equal to the section 163(j) limitation), a partner’s allocable share of the deductible BIE is not again subject to section 163(j) at the partner level.18 To the extent that a partnership has

10 An individual’s gross receipts generally include all items except for “inherently personal amounts.” Prop. Reg. § 1.163(j)-1(b)(2)(ii). Generally, each partner in a partnership includes a share of partnership gross receipts in proportion to the partner’s distributive share of items of gross income that were taken into account by the partnership. Prop. Reg. § 1.163(j)-1(b)(2)(iii).
11 Prop. Reg. § 1.163(j)-6(m)(1). See Prop. Reg. § 1.163(j)-6(o), Ex.(6) and Ex. (7).
12 Prop. Reg. § 1.163(j)-6(m)(2).
13 Prop. Reg. § 1.163(j)-6(m)(2).
14 Prop. Reg. § 1.163(j)-6(b).
15 Prop. Reg. § 1.163(j)-1(l(b).
16 Prop. Reg. § 1.163(j)-6(d)(1).
17 Prop. Reg. § 1.163(j)-6(d)(2).
18 Prop. Reg. § 1.163(j)-6(c). For all other purposes of the Code, deductible BIE and EBIE retain their character as BIE at the partnership level. For example, for purposes of section 469, the deductible BIE (i) retains its character as either passive or non-passive in the hands of the shareholder, and (ii) remains
disallowed business interest expense in a tax year, such amount (i.e., EBIE) is allocated among the partners and treated as a carryforward at the partner level. The adjusted basis of a partner in the partnership is reduced, but not below zero, for EBIE allocated to the partner. As noted above, EBIE of an S corporation is an S corporation attribute that is carried forward to succeeding taxable years of the S corporation. The EBIE is subject to the same ordering rules as a C corporation that is not a member of a consolidated group, as well as the limitation under section 382. Accordingly, an S corporation shareholder’s basis and accumulated adjustment account is not reduced until the EBIE is deductible at the S corporation level.

Section 163(j)(4) provides that a partner’s ATI is determined in accordance with the general definition of ATI and without regard to the partner’s distributive share of any items of income, gain, deduction, or loss of the partnership. Each partner’s own ATI is increased, however, by the partner’s share of the partnership’s ETI and EBII. ETI is generally the amount that bears the same ratio to the partnership’s ATI as (i) the excess (if any) of (I) 30 percent of ATI, over (II) the amount (if any) by which the BIE of the partnership exceeds the BII of the partnership, bears to (ii) 30 percent of ATI. EBII is generally the excess of the partnership’s BII over the partnership’s BIE in a taxable year. Each partner’s share of partnership ETI and EBII is determined in the same manner as the partner’s distributive share of non-separately stated taxable income or loss of the partnership. Section 743(b) and section 704(c)(1)(C)(i) items and any allocation to a partner of remedial items of income, gain, loss, or deduction pursuant to section 704(c) and Regulation section 1.704-3(d) are taken into account as items derived directly by the partner.

The Proposed Regulations provide an 11-step calculation to determine and allocate section 163(j) items. If determinations and allocations are made in accordance with the 11-step calculation in Proposed Regulation section 1.163(j)-6(f), the determinations and allocations of deductible BIE and of EBIE, ETI, and EBII (“section 163(j) excess items”) are considered made in the same manner as the non-separately stated taxable income or loss of the partnership. These rules are only applicable for interest derived from a trade or business in the hands of a shareholder even if the shareholder does not materially participate in the S corporation’s trade or business activity.

---

20 Prop. Reg. § 1.163(j)-6(e)(1).
24 Prop. Reg. § 1.163(j)-6(e)(2).
purposes of determining the allocation of section 163(j) items and do not change the partnership’s section 704(b) allocations.26

Deductible BIE and EBIE are subject to section 704(d).27 If a partner is allocated BIE or EBIE that is limited under section 704(d), that loss is suspended as a “negative section 163(j) expense.”28 For purposes of determining which interest expense is limited by section 704(d), deductible BIE is taken into account before EBIE. If a partner has a negative section 163(j) expense, that amount is not affected by an allocation of ETI and is not treated as EBIE in a subsequent year until the negative 163(j) expense is no longer suspended under section 704(d) (i.e., the partner is allocated sufficient items of income or gain to increase its outside basis to allow the trapped EBIE).29 If a partner is allocated ETI and has a negative section 163(j) expense, that ETI is included in the partner’s ATI until the negative section 163(j) expense is no longer suspended.30

To the extent that a partner is allocated ETI or EBII from the same partnership, that previously allocated EBIE is treated as BIE paid or accrued by the partner in that taxable year in which the ETI or EBII is allocated.31 The amount treated as paid or accrued is then combined with the partner’s other items of BII and BIE and subject to the section 163(j) limitation at the partner level.32

Section 163(j)(4)(B)(iii)(II) provides that if a partner disposes of a partnership interest, the adjusted basis of the partner’s interest in the partnership is increased immediately before disposition by (i) the amount of any basis reduction for EBIE allocated to the partner, less (ii) any amount of EBIE that has been treated as interest paid or accrued by the partner in any year due to an allocation of ETI or EBII. This rule applies to both taxable and non-taxable dispositions. The Proposed Regulations modify the statute to provide that the increase in the partner’s adjusted basis in the partnership occurs if a partner disposes of all or substantially all of a partnership interest (whether by sale, exchange, or redemption).33 If, however, a partner disposes of less than substantially all of its interest in a partnership (whether by sale, exchange, or redemption), a partner does not increase its basis in its partnership interest.34 No basis

---

27 Section 704(d) limits a partner’s ability to deduct its distributive share of partnership loss to the partner’s adjusted basis in its partnership interest, because the partner’s basis cannot be reduced below zero. Section 704(d) losses are suspended until the partner has sufficient additional adjusted basis in its partnership interest.
28 Prop. Reg. § 1.163(j)-6(h)(1).
29 Prop. Reg. § 1.163(j)-6(h)(2).
30 Prop. Reg. § 1.163(j)-6(h)(2).
31 Prop. Reg. § 1.163(j)-6(g)(2).
increase is allowed for any negative section 163(j) expense (because the partner’s basis was never decreased by that amount).\footnote{Prop. Reg. § 1.163(j)-6(h)(3)(i).}
DISCUSSION

I. Section 707(c) Guaranteed Payments for the Use of Capital

A. Summary

Section 163(a) provides a deduction for “all interest paid or accrued within the taxable year on indebtedness.” Notwithstanding the fact that section 163(j) provides a limit on the deduction otherwise permitted by section 163(a) in the case of “business interest,” the Proposed Regulations treat as interest certain amounts that are “closely related to interest and that affect the economic yield or cost of funds of a transaction involving interest, but that may not be compensation for the use or forbearance of money on a stand-alone basis.” As noted by the Preamble, “[a]s a consequence of these rules, however, in some cases certain items could be tested under section 163(j) that are not treated as interest under other Code provisions that interpret the definition of interest more narrowly. Thus, for example, in certain cases, an amount that was previously deductible under section 162 without limitation could now be tested as business interest expense under section 163(j).” Proposed Regulation section 1.163(j)-1(b)(20)(iii)(I) includes guaranteed payments for the use of capital (“GPUCs”) in the definition of “interest” for purposes of section 163(j).

B. Recommendation

While the Section understands the policy rationale for including GPUCs in the list of items treated as interest, we believe that doing so is inconsistent with the statutory language of section 707(c), its implementing Regulations, and with case law and administrative authority interpreting the statute. As a result, we recommend that GPUCs be removed from the definition of interest in the Final Regulations.

C. Explanation

A partner may supply capital to a partnership by making an equity contribution in exchange for a partnership interest or by lending funds to the partnership. Section 707 draws a sharp distinction between the federal income tax rules applicable to payments by the partnership to a partner depending upon whether the payments relate to contributed equity or loans to the partnership. Under section 707(a), interest paid by a partnership to a partner with respect to a loan by the partner is deductible under section 163. By

37 83 Fed. Reg. at 67,493 (2018). The general approach of the Proposed Regulations to defining interest for purposes of section 163(j) is beyond the scope of these Comments. For a general discussion of the definition of interest under the Proposed Regulations, please see Comm. on Partnerships & LLCs, ABA Tax Sec., Comments on the Definition of Interest in the Proposed Regulations under Section 163(j) (2019).
38 See Reg. § 1.707-1(a) (providing that a loan of money from a partner to a partnership is treated as a transaction between the partnership and a person that is not a member of the partnership); PLR 8304059 (Oct. 25, 1982).
contrast, if a partner makes an equity contribution to the partnership and receives payments from the partnership for the use of the capital contributed, section 707(c) provides that, from the perspective of the partnership, such payments are deductible under section 162, not section 163. The dichotomy is reflected in Form 1065; guaranteed payments are deducted by a partnership on line 10, while interest is generally deducted on line 15.

The fact that section 162, not section 163, governs the deductibility of a GPUC made by a partnership is confirmed by Regulation section 1.707-3(c), which provides, in relevant part, that “[f]or a guaranteed payment to be a partnership deduction, it must meet the same tests under section 162 as it would if the payment had been made to a person who is not a member of the partnership, and the rules of section 263 (relating to capital expenditures) must be taken into account.” Case law and administrative authority confirm that section 707(c) permits deductibility of a GPUC if it meets the requirements of section 162. We are not aware of any authority holding that a partnership’s deduction of a GPUC is subject to the requirements of section 163.

That GPUCs are statutorily deductible under section 162 is confirmed in Notice 2004-31, in which the Service targeted certain transactions that were intended to “convert interest payments that would not be currently deductible under [former] section 163(j) into deductible payments” through the use of GPUCs. In contrast with the inappropriate transactions covered by the notice, the Service acknowledged that bona fide guaranteed payments did not constitute debt, and that a partnership would not be subject

---

39 Section 707(c) was enacted in 1954 to provide certainty with respect to the treatment of circumstances in which “payments” to partners for services, or for the use of capital, might exceed income of the partnership. See S. Rep. No. 1622, 83rd Cong., 2d Sess. at 22 (1954). Prior to the enactment of section 707(c), if a payment made to a partner acting in a partner capacity exceeded the income of the partnership in the year of payment, the tax treatment of the payment amount in excess of partnership income depended upon whether the capital account of the partner receiving the payment or the capital accounts of other partners was charged with the excess. See Augustine Lloyd, 15 BTA 82 (1929); Rev. Rul. 55-30, 1955-1 C.B. 430. Section 707(c) brought clarity to the treatment of such payments by providing that the full amount of the payment (not just the amount in excess of partnership income) was deductible by the partnership and includible in income by the partner.

In its current form, section 707(c) provides that “[t]o the extent determined without regard to the income of the partnership, payments to a partner for the use of capital shall be considered as made to one who is not a member of the partnership, but only for purposes of section 61(a) (relating to gross income) and, subject to section 263, for purposes of section 162(a) relating to trade or business expenses.”

40 See Cagle v. Commissioner, 63 T.C. 86 (1974), aff’d, 539 F.2d 409 (5th Cir. 1976); Mallary v. United States, 238 F. Supp. 87 (M.D. Ga. 1965). Notably, The legislative history of the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1525, approves the Cagle decision and states that for a section 707(c) payment to be deductible by a partnership, the payment must meet the same tests under section 162(a) as if it had been made to a person who was not a member of the partnership, and the normal rules of section 263 (relating to capital expenditures) must be taken into account. Staff of Joint Committee on Taxation, 94th Cong., 2d Sess., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, 90 (Comm. Print 1976).


42 Id. As noted above, “former section 163(j)” refers to section 163(j) as it existed prior to the Act.
to an interest limitation under [former] section 163(j): “If the guaranteed payment right … were instead debt [payments to a partner], then interest on such indebtedness would be subject to the limitations imposed by section 163(j).” Other administrative guidance is consistent with this position.\(^{43}\) Additionally, we note that if Treasury and the Service believe that treating GPUCs as interest for purposes of section 163(j) is crucial to the proper operation of section 163(j), then we recommend that legislation be sought that would achieve that result. Section 163(j)(4) quite arguably indicates that Congress considered the statute’s application to partnerships and, if Congress had wanted to treat GPUCs as interest, it could have drafted a provision to override the plain language of section 707(c).

In summary, GPUCs are deductible, under the literal terms of section 707(c), its implementing Regulations, case law and administrative authority, if the requirements of section 162 are met. Subjecting GPUCs to an additional deductibility hurdle under section 163(j) is inconsistent with those authorities and with Congressional policy underlying the enactment of section 707(c). As a result, we recommend that GPUCs be removed from the list of items treated as interest in the Final Regulations.

II. Gross Receipts Test in the Partnership Context

A. Summary

Section 163(j)(3) provides for a small business exemption. The small business exemption of section 163(j)(3) applies to “taxpayers,” and it is clear that the small business exemption may apply to both partnerships\(^ {44}\) and to their partners, provided that the provision’s requirements are satisfied. Taxpayers, including partnerships and partners, seeking to utilize the small business exemption must (i) meet the gross receipts test of section 448(c) for the taxable year and (ii) not be classified as a tax shelter within

\(^{43}\) See GCM 36702 (Apr. 12, 1976) (“Concededly, in a sense section 707(c) creates a fictional indebtedness by allowing partnerships to deduct guaranteed payments for the use of capital as if such payments were made to a creditor rather than a partner. However, the language of section 707(c) indicates that deductions for these fictitious interest payments are to be limited to situations in which the payments would qualify as trade or business expenses under Section 162”). See also GCM 37512 (Apr. 26, 1978) (“The legislative history of the Tax Reform Act of 1976 approves the Cagle decision and states directly that, for a section 707(c) payment to be deductible by a partnership, the payment must meet the same tests under section 162(a) as if it had been made to a person who was not a member of the partnership, and the normal rules of section 263 . . . must be taken into account”), and GCM 38133 (Oct. 10, 1979) (“Although the [guaranteed] payments are made for the use of capital and are interest payments under section 61(a)(4), they are not interest payments within the meaning of section 163”).

\(^{44}\) The language of section 163(j)(3) language – in particular, the reference to “any taxpayer which is not a corporation or a partnership” – indicates a clear legislative intent to treat a partnership as a taxpayer for section 163(j)(3) purposes. The phrase uses “which” to introduce a nonrestrictive clause (as opposed to “that” to introduce a restrictive clause). Moreover, section 163(j)(4) treats a partnership as a taxpayer, applying section 163(j) at the partnership level. Furthermore, a partnership is a taxpayer under general tax principles.
the meaning of section 448(d)(3).\textsuperscript{45} Both requirements raise special considerations in the partnership context. The gross receipts requirement is discussed first.

In general, a taxpayer meets the gross receipts test of section 448(c) for a taxable year if its average annual gross receipts for the three-taxable-year period ending with the taxable year which precedes the determination year does not exceed $25 million.\textsuperscript{46}

Section 448(c) contains certain aggregation rules, which, in broad terms, apply to aggregate certain entities that are connected to one another through greater than 50 percent ownership and certain entities that are functionally connected by conducting integrated activities. Specifically, under the aggregation provision of section 448(c)(2), all persons treated as a single employer under section 52(a) or (b) or section 414(m) or (o) are treated as a single taxpayer. With respect to partnerships and their partners, section 52(b) describes employees of trades or businesses (whether or not incorporated) that are under common control as employed by a single employer, and section 414(m) treats all employees of the members of an “affiliated service group” as employed by a single employer.\textsuperscript{47}

Under these rules, a partner and a partnership may be treated as a single employer and, consequently, as a single taxpayer, if the partner and the partnership are each engaged in businesses that are under common control or if the partner and partnership are each members of an affiliated service group.\textsuperscript{48} In such a case, the partner and the partnership are each treated as having the gross receipts of the (single) taxpayer as so defined (i.e., the group). If the aggregate gross receipts of the (single) taxpayer as so defined (i.e., the group) exceed $25 million, the both partner and the partnership are ineligible for the small business exemption. If the gross receipts of the (single) taxpayer as so defined (i.e., the group) equal or are less than $25 million, however, both the partner and the partnership are eligible for the small business exemption. It is unnecessary in either case to determine whether a partner includes a share of partnership gross receipts (and, if so, the partner’s share of partnership gross receipts) as the partner and the partnership are treated as a single taxpayer and each is treated as having the total


\textsuperscript{46} I.R.C. § 448(c)(1).

\textsuperscript{47} The application of section 52 and section 414 in the section 163(j) context appears to raise a number of general questions. Those issues are beyond the scope of these Comments. However, we recommend that Treasury and the Service provide guidance on the application of sections 52 and 414 in the section 163(j) context.

\textsuperscript{48} It is unclear whether partners not directly engaged in a trade or business would be included in a group treated as a single employer under section 52 or section 414, because those sections aggregate only entities engaged in a trade or business. Prop. Reg. § 1.469-9(b)(2)(iii)(E), published in conjunction with the Proposed Regulations under section 163(j), contains an example in which a partnership’s luxury hotel business is attributed to a partner “for purposes of section 469(c)(7)(C) and [Prop. Reg. § 1.469-9(1)].” This example suggests that a partnership’s trade or business may be attributed to a partner for certain purposes and may be viewed as creating uncertainty regarding whether or not the gross receipts of a partner not directly engaged in a trade or business may be aggregated under section 448(c).
gross receipts of the group (i.e., in effect, gross receipts are determined on an aggregate basis). Furthermore, in such an instance, requiring the partner to include a share of partnership gross receipts would appear to result in double-counting those gross receipts.

Proposed Regulation section 1.163(j)-2(d)(1) repeats the statutory rule in section 163(j)(3). Proposed Regulation section 1.163(j)-2(d)(2)(iii) provides that except when the aggregation rules of section 448(c) apply, each partner in a partnership includes a share of partnership gross receipts in proportion to such partner’s distributive share (as determined under section 704) of items of gross income that were taken into account by the partnership under section 703. Thus, even where a partnership is exempt from section 163(j) by virtue of the small business exemption (i.e., is an “exempt entity”) and the aggregation rules of section 448 do not apply, partner-level gross income is increased by a share of partnership gross receipts for purposes of determining partner-level eligibility for the small business exemption. The amount is “in proportion to such partner’s distributive share (as determined under section 704) of items of gross income that were taken into account by the partnership under section 703.” Neither Proposed Regulation section 1.163(j)-2 nor any other provision of the Proposed Regulations provides guidance as to when a partner and a partnership may be treated as a single taxpayer under section 448(c).

Under Proposed Regulation section 1.163(j)-6(m)(1), partners in an exempt entity include partnership-level BIE, BII, and items of ATI in their partner-level section 163(j) calculations, and allocated BIE is subject to the partner’s section 163(j) limitation.

As discussed in greater detail below, we recommend that Treasury and the Service revise Proposed Regulation section 1.163(j)-2(d)(2)(iii) to narrow the circumstances in which a partner includes a share of partnership gross receipts for

---

49 Prop. Reg. § 1.163(j)-2(d)(1) provides that the general rule in [Prop. Reg. § 1.163(j)-2(b)] does not apply to any taxpayer, other than a tax shelter as defined in section 448(d)(3), in any taxable year if the taxpayer meets the gross receipts test of section 448(c) and the Regulations thereunder for the taxable year.


51 Prop. Reg. § 1.163(j)-6(m)(1) defines an exempt entity as “a partnership or S corporation [that] is not subject to section 163(j) by reason of [Prop. Reg.] § 1.163(j)-2(d).”

52 Thus, for example, neither Prop. Reg. § 1.163(j)-2 nor any other provision of the Proposed Regulations addresses whether the gross receipts of a partner not directly engaged in a trade or business may be aggregated under section 448(c).

53 Prop. Reg. § 1.163(j)-6(m)(1) provides that if a partnership or S corporation is not subject to section 163(j) by reason of Prop. Reg. § 1.163(j)-2(i)(i.e., is an exempt entity), the exempt entity does not calculate the section 163(j) limitation under Prop. Reg. § 1.163(j)-2 and the Proposed Regulations. Because an exempt entity is not subject to section 163(j)(4), it does not take its deduction for BIE into account in determining its non-separately stated taxable income or loss within the meaning of section 163(j)(4)(A)(i) and retains its character as BIE. Thus, if a partner or S corporation shareholder is allocated BIE from an exempt entity, that allocated BIE will be subject to the partner’s or S corporation shareholder’s section 163(j) limitation. Additionally, contrary to the general rule in Prop. Reg. § 1.163(j)-6(e)(1), a partner or S corporation shareholder includes items of income, gain, loss, or deduction of such exempt entity when calculating its ATI. Finally, BII of such exempt entity is included in the partner’s or S corporation shareholder’s section 163(j) limitation regardless of the exempt entity’s BIE amount.
purposes of determining the partner’s eligibility for the small business exemption. However, to the extent the approach of Proposed Regulation section 1.163(j)-2(d)(2)(iii) is retained, we recommend that Treasury and the Service clarify when a partner includes a share of partnership gross receipts to determine partner-level eligibility. Moreover, whether or not the approach of Proposed Regulation section 1.163(j)-2(d)(2)(iii) is retained, we recommend that Proposed Regulation section 1.163(j)-6(m)(1) be modified so that BIE incurred by an exempt partnership is not subject to section 163(j) at the partner level.

B. Attribution of Partnership Gross Receipts to a Partner in the Absence of Section 448(c) Aggregation

1. Recommendation

We recommend that where section 448(c) does not apply to aggregate a partner and partnership’s gross receipts, the partner should not be required to include any share of partnership gross receipts when determining its partner-level eligibility for the small business exemption. Accordingly, we recommend that Proposed Regulation section 1.163(j)-2(d)(2)(iii), which takes a contrary position, be amended.

2. Explanation

Proposed Regulation section 1.163(j)-2(d)(2)(iii) provides that except when the aggregation rules of section 448(c) apply, each partner in a partnership includes a share of partnership gross receipts for purposes of determining its eligibility for the small business exemption. The aggregate approach of Proposed Regulation section 1.163(j)-2(d)(2)(iii) does not appear to align with key aspects of the statutory scheme. In particular, the approach appears to be inconsistent with the fact that section 163(j)(4) takes an entity approach. Moreover, the approach does not align with the fact that, for purposes of determining eligibility for the small business exemption, section 448(c) appears to provide the exclusive circumstances as to when a partner’s gross receipts and a partnership’s gross receipts are combined.54 Furthermore, as a practical matter, the approach may discourage taxpayers who operate small businesses from investing in entities classified as partnerships. Each of these points is discussed below.

First, we believe that in determining partner-level eligibility for the small business exemption, a partner not subject to section 448(c) aggregation should not be required to include gross receipts from a partnership that may be independently subject to section 163(j), as the same gross receipts would potentially disqualify two different taxpayers (i.e., both the partner and the partnership). Because section 163(j) is applied at the partnership level and takes an entity view of partnerships, it seems inconsistent to take an aggregate view of partnerships for purposes of the small business exemption and attribute

---

54 We note that partners generally include items listed in section 702(a) (“distributive share items”) in partner-level computations. However, gross receipts are not a distributive share item.
partnership gross receipts to a partner in the absence of specific statutory attribution rule.55

Second, and relatedly, the plain language of section 163(j) appears to indicate that section 448(c) provides the exclusive attribution rule (i.e., a partnership’s gross receipts should not be attributed to a partner when section 448(c) does not apply). Stated differently, as section 163(j)(3) provides that the limitation in section 163(j)(1) “shall not apply” to a taxpayer (e.g., a partnership56 or a partner) who (1) is not a “tax shelter” and (2) meets the gross receipts test of section 448(c), section 448(c) appears to provide the exclusive circumstances as to when gross receipts are aggregated or attributed.57

Furthermore, requiring a partner not subject to section 448(c) aggregation to include partnership gross receipts for purposes of determining partner-level eligibility for the small business exemption appears to discourage taxpayers who operate small businesses from investing in entities classified as partnerships. Assume that a sole proprietor operates a plumbing business that generates $20 million in average annual gross receipts. In that case, the sole proprietor would qualify for the small business exemption, and the interest expense properly allocable to its business would not be subject to section 163(j). If the sole proprietor invests in an entity classified as a corporation, the sole proprietor would still qualify for the small business exemption if the corporation pays the sole proprietor dividends of $5 million or less annually.58 In such a situation, the sole proprietor’s interest expense would not be subject to section 163(j). If, however, the sole proprietor invests in an exempt or nonexempt partnership (including a publicly traded partnership), the sole proprietor would fail to qualify for the small business exemption if the sole proprietor’s share of the partnership’s gross receipts exceeds $5 million (i.e., even if the partner and its partnership are not aggregated under section 448(c)). In that case, the sole proprietor’s interest deductions with respect to its plumbing business would no longer be exempt from section 163(j). There does not appear to be any compelling policy reason why section 163(j) should encourage small businesses to organize as corporations, rather than partnerships. As a result, there exists a strong policy reason for amending the general approach of Proposed Regulation section 1.163(j)-2(d)(2)(iii).

We acknowledge that the approach in Proposed Regulation section 1.163(j)-2(d)(2)(iii) may be intended to discourage taxpayers from establishing partnerships in order to qualify for the small business exemption (e.g., by splitting one or more

55 It is worth noting that the gross receipts test of section 448(c) is applied independently to a partnership and its partners. See Temp. Reg. § 1.448-1T(f)(2)(i) (“The gross receipts of the corporate partner are not taken into account in determining whether the partnership meets the $5,000,000 gross receipts test”).

56 See supra note 44.

57 Note, however, that the gross receipts test of section 448(c) is applied to a taxpayer who is neither a corporation nor a partnership (e.g., an individual) in the section 163(j) context. Prop. Reg. § 1.163(j)-2(d)(2)(i). The limitation in section 448(c) is only applicable to a C corporation, a partnership with a C corporation as a partner or a tax shelter (within the meaning of section 446(d)).

58 The sole proprietor would include dividend income from the corporation in its gross receipts. See Prop. Reg. § 1.163(j)-2(d)(2)(ii); Temp. Reg. § 1.448-1T(f)(2)(v).
businesses into multiple separate partnerships). However, the carve out for tax shelters (within the meaning of section 448(d)(3)) and the aggregation rules of section 448(c) aggregation rules should generally prevent any abusive structures whereby business activity is split between multiple entities.

In sum, we believe that the approach of Proposed Regulation section 1.163(j)-2(d)(2)(iii) diverges from key aspects of the statutory scheme. We also believe policy concerns, on balance, favor amending the provision. Accordingly, we recommend that the approach of Proposed Regulation section 1.163(j)-2(d)(2)(iii) be changed so that, unless a partner is required to aggregate with its partnership pursuant to section 448(c), a partner does not include any share of the partnership’s gross receipts when determining the partner’s eligibility for the small business exemption.

C. Circumstances in Which Partnership Gross Receipts Should Be Attributed to Partners

1. Recommendation

To the extent the approach of Proposed Regulation section 1.163(j)-2(d)(2)(iii) is retained, we recommend that Treasury and the Service clarify when a partner must include a share of partnership gross receipts when determining partner-level eligibility for the small business exception. Specifically, we recommend that the language of Proposed Regulation section 1.163(j)-2(d)(2)(iii) be modified as follows:

Except when the aggregation rules of section 448(c) apply, each partner in a partnership includes a share of partnership gross receipts in proportion to such partner’s distributive share (as determined under section 704) of items of gross income that were taken into account by the partnership under section 703 unless the partner is required to aggregate its gross receipts with the partnership’s gross receipts under the aggregation rules of section 448(c).

2. Explanation

Proposed Regulation section 1.163(j)-2(d)(2)(iii) begins “except when the aggregation rules of section 448(c) apply, each partner in a partnership includes.” The scope of this language is unclear. For example, does the language of the Proposed Regulation turn off the general rule of Proposed Regulation section 1.163(j)-2(d)(2)(iii) with respect to all partners when one partner’s gross receipts and the partnership’s gross receipts are aggregated under section 448(c)? Similarly, does the language of the Proposed Regulation turn off the general rule of Proposed Regulation section 1.163(j)-2(d)(2)(iii) when a partnership’s gross receipts are aggregated with another person who is not a partner (e.g., a lower-tier corporation)? Presumably, Treasury and the Service meant to include only situations in which section 448(c) applies to aggregate a partner and partnership’s gross receipts and cover only the partner (or the partners) whose gross
receipts are aggregated under section 448(c). Thus, to the extent the approach of Proposed Regulation section 1.163(j)-2(d)(2)(iii) is retained, we recommend that the language of Proposed Regulation section 1.163(j)-2(d)(2)(iii) be modified as described above.

D. Treatment of BIE, BII, and ATI from an Exempt Partnership

1. Recommendation

Regardless of whether the approach of Proposed Regulation section 1.163(j)-2(d)(2)(iii) is retained, we do not believe that BIE incurred by an exempt partnership should be subject to section 163(j) at the partner level. This result could be achieved by modifying Proposed Regulation section 1.163(j)-6(m)(1) to track the treatment of “excepted entities” under Proposed Regulation section 1.163(j)-6(m)(2).

2. Explanation

Under Proposed Regulation section 1.163(j)-6(m)(1), partners in an exempt entity include partnership-level BIE, BII, and items of ATI in their partner-level section 163(j) calculations, and allocated BIE is subject to the partner’s section 163(j) limitation. In essence, under the Proposed Regulations, an exempt partnership’s BIE is not entirely exempt from the section 163(j) limitation. Rather, such BIE is merely tested at the partner level, and a deduction for such BIE may be supported by items of the exempt partnership.

We believe that a partner’s distributive share of BIE from an exempt partnership should not be subject to section 163(j) in the hands of the partner for the same reason that BIE subjected to section 163(j) in the hands of a nonexempt partnership should not be subjected to a second application of section 163(j) in the hands of the partner. Section 163(j)(4)(A)(i) makes it clear that partnership-level BIE is taken into account by the partner as a part of non-separately stated taxable income or loss. This is the case when the BIE has been subjected to section 163(j) or is exempt from section 163(j) by virtue of the small business exemption. The statutory designation of such BIE as a part of non-separately stated taxable income or loss would indicate that the BIE loses its character as BIE, and thus should not be retested at the partner level.

---

59 In such situations, the statutory scheme suggests that if aggregate gross receipts exceed the threshold, neither the partner nor the partnership is exempt, and if aggregate gross receipts equal or are less than the threshold, neither the partner nor the partnership should be subject to section 163(j).

60 Prop. Reg. § 1.163(j)-6(m)(2) defines an excepted entity as “a partnership or S corporation [that] is not subject to section 163(j) because it has an excepted trade or business as defined in [Prop. Reg.] § 1.163(j)-1(b)(38)(ii).” Excepted trades or businesses include electing real property trades or businesses, electing farming businesses, and utility trades or businesses meeting enumerated criteria. Prop. Reg. § 1.163(j)-1(b)(38)(ii). Interest expense allocable to an excepted trade or business is not subject to the section 163(j) limitation as such interest expense is not BIE (as an excepted trade or business is not a trade or business for section 163(j) purposes). See I.R.C. § 163(j)(7).

61 See supra note 53.
Proposed Regulation section 1.163(j)-6(m)(1) may be seen as conforming to an entity view of partnerships in that, under it, the small business exemption provides relief only to the partnership, not the partners. Using an entity approach is logical: section 163(j) generally, and the small business exemption specifically, adopt an entity view of partnerships. However, we believe that Proposed Regulation section 1.163(j)-6(m)(1) does not adopt an entity view of partnerships in that it tests partnership-level BIE at the partner level, which, we believe, is inconsistent with section 163(j)(4) which requires the testing of partnership-level BIE at the partnership level, not the partner level.

Moreover, if Proposed Regulation section 1.163(j)-6(m)(1) was motivated by a concern that a partnership could be used to isolate gross receipts with respect to a non-excepted business, we believe the carve-out for tax shelters and the aggregation rules of section 448(c) should generally apply to prevent abusive structures.

In addition, Proposed Regulation section 1.163(j)-6(m)(1) stands in contrast to Proposed Regulation section 1.163(j)-6(m)(2), which provides a rule for excepted entities. Under the rule for excepted entities, when a partnership is not subject to section 163(j) because it has an excepted trade or business, the partners do not take into account BIE, BII, or items of ATI attributable to an excepted trade or business (and thus partnership-level BIE is not subject to a partner’s section 163(j) limitation). The disparate approaches taken by Proposed Regulation section 1.163(j)-6(m)(1) and Proposed Regulation section 1.163(j)-6(m)(2) raise concerns when an exempt partnership has an excepted trade or business. Under Proposed Regulation section 1.163(j)-6(m)(1), an exempt partnership “is not subject to section 163(j).” Proposed Regulation section 1.163(j)-6(m)(2) applies only “[t]o the extent a partnership or S corporation is not subject to section 163(j) because it has an excepted trade or business.” Furthermore, the Preamble to the Proposed Regulations provides, “[t]he Treasury Department and the Service also have determined that small businesses that are exempt under section 163(j)(3) and [Proposed Regulation section] 1.163(j)-2(d)(1) may not make an election under [Proposed Regulation section] 1.163(j)-9.” As such, the Proposed Regulations subject partnership-level BIE arising from an excepted trade or business to a partner’s section 163(j) limitation if incurred by an exempt partnership. This appears to contravene any policy rationale (and the statutory scheme).

Accordingly, we believe that BIE incurred by an exempt partnership should not be subject to section 163(j) at the partner level. Our recommended approach could be achieved by modifying Proposed Regulation section 1.163(j)-6(m)(1) to resemble Proposed Regulation section 1.163(j)-6(m)(2). This would mean that partners of an exempt partnership would not include BIE, BII, or items of ATI from the exempt partnership. We, however, believe that items of ATI (equal to the exempt partnership’s

---

62 The rule for excepted entities in Proposed Regulation section 1.163(j)-6(m)(1) may be merely viewed as a rule of administrative convenience as items attributed to an excepted trade or business do not generate BIE, BII or items of ATI.
ETI) should be available to an exempt partnership’s partners to offset partner-level BIE.\(^{63}\) Should Treasury and the Service agree that that BIE incurred by an exempt partnership should not be subject to section 163(j) at the partner level and that items of ATI from an exempt partnership should be available to offset partner-level BIE, we would be happy to explore options and provide more detailed comments.\(^{64}\)

III. Tax Shelter Definition in the Partnership Context

A. Summary

The small business exemption of section 163(j)(3) does not apply to a “tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3).” Section 448(d)(3) defines a tax shelter for purposes of section 448(a)(3). Proposed Regulation section 1.163(j)-2(d)(1) similarly states that the small business exemption does not apply to a tax shelter as defined in section 448(d)(3). The definition of a tax shelter in section 448(d)(3) in turn is extremely complicated because it relies on a number of cross-references to various provisions in the Code and only limited interpretive guidance has been provided in Regulations. We are concerned that taxpayers may misapply the definition. Thus, we recommend that Treasury and the Service clarify and simplify the definition of tax shelter for section 163(j) purposes to ensure its proper application by taxpayers seeking to determine whether they qualify for the small business exemption.

B. Recommendation

As a preliminary matter, we recommend that Final Regulations provide a definition that clearly articulates the meaning of tax shelter for purposes of section 163(j). Specifically, we recommend that Treasury and the Service provide a definition based on methodological application of cross-referenced Code sections, existing Regulations, and guidance under those sections. Consistent with Temporary Regulation section 1.448-1T(b)(3) and informal guidance, this definition should provide that an entity is not a syndicate in a given year unless more than 35 percent of net losses in such year are allocated to partners or members treated as limited partners or limited entrepreneurs. Implicit in this formulation is that an entity’s syndicate status is (1) determined on a year-

---

\(^{63}\) Prop. Reg. § 1.163(j)-6(m)(1) is consistent with this view and our reading of section 163(j)(4). Section 163(j)(4) indicates that a partner in an exempt partnership should be entitled to offset BIE incurred at the partner level with the partner’s distributive share of ETI from the exempt partnership. Section 163(j)(4) applies “in the case of any partnership,” which language is broad enough to include both partnerships subject to section 163(j) and those that are exempt. I.R.C. § 163(j)(4)(A). ETI is defined similarly as an amount with respect to “any partnership.” I.R.C. § 163(j)(4)(C). The flush language of section 163(j)(4)(B)(ii) indicates a partner in a partnership (i.e., “any partnership”) may be entitled to offset BIE incurred at the partner level with the partner’s distributive share of ETI.

\(^{64}\) For example, should Treasury and the Service provide a rule whereby BIE from an exempt partnership is not tested at the partner level and ETI from an exempt partnership is available to offset partner-level BIE, it may be necessary to clarify whether the BIE of the exempt partnership should be treated as zero, which would result in the partners treating the entire amount of ATI from the exempt partnership as ETI or should be determined under the normal rules.
by-year basis and (2) requires net losses in a given year. Furthermore, this definition should provide guidance as to when a tax partner or member will be treated as a limited partner or limited entrepreneur. Under current law, certain persons are not treated as limited partners or limited entrepreneurs if such persons actively participate in the management of the entity. We recommend that guidance explicitly incorporate such a rule and enumerate factors to be considered when determining whether interests are held (or treated as held) by a person who actively participates in the management of the entity. We believe the factors should be based on current guidance and, as such, should include: (1) ongoing participation in day-to-day operations; (2) the ability to hire or discharge employees (other than the business manager); (3) having professional certification, training, or licenses pertinent to the operation of the business (e.g., a CPA for an accounting business); and (4) the ability to vote on matters beyond the selection of the business manager.

C. Explanation

1. General Statutory Scheme: Three Types of Tax Shelters

The statutory language of section 163(j)(3) makes ineligible for the small business exemption a “tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3).” Based on the statutory cross-references to section 448(a)(3), section 448(d)(3), section 461(i)(3) and section 6662(d)(2)(C)(ii), a tax shelter for section 163(j)(3) purposes includes three types of entities:

1. Any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any federal or state agency having the authority to regulate the offering of securities for sale. However, an S corporation shall not be treated as a tax shelter for purposes of this section merely by reason of being required to file a notice of exemption from registration with a state agency described in section 461(i)(3)(A), but only if there is a requirement applicable to all corporations offering securities for sale in the state that to be exempt from such registration the corporation must file such a notice.

2. A syndicate (within the meaning of section 1256(e)(3)(B)).

3. A partnership or other entity, any investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of federal income tax.

Thus, a partnership is a tax shelter for section 163(j) purposes if: (1) at any time interests in such partnership have been offered for sale in any offering required to be

66 I.R.C. § 448(d)(3).
registered with any federal or state agency having the authority to regulate the offering of securities for sale; (2) it is a syndicate (within the meaning of section 1256(e)(3)(B)); or (3) a significant purpose of such partnership is the avoidance or evasion of federal income tax. The definition of syndicate in section 1256(e)(3)(B) requires that a taxpayer consult a number of Code provisions and Regulations and may encompass a large number of partnership structures. Thus, the definition of syndicate (within the meaning of section 1256(e)(3)(B)) is key and is discussed, in detail, immediately below.

2. Syndicate

A taxpayer seeking to understand whether a partnership is a syndicate (within the meaning of section 1256(e)(3)(B)) and thus for purposes of section 448 (and section 163(j)) must consult each of section 1256(e)(3)(B) and Temporary Regulation section 1.448-1T(b)(3) for a definition of syndicate. The taxpayer must also look to each of section 461(k)(4) and section 1256(e)(3)(C) to understand key terms used in each of section 1256(e)(3)(B) and Temporary Regulation section 1.448-1T(b)(3).

Tracing through the provisions leads to the following simplified definition under current law: a syndicate (and, thus, a tax shelter for section 163(j)(3) purposes) generally includes an entity if more than 35 percent of the losses of the entity during the taxable year are allocated to (i) in the case of a limited partnership, to limited partners other than (a) individuals who actively participate at all times during such taxable year in the management of such entity, or (b) individuals who actively participated in the management of such entity for a period of not less than five years, and (ii) in the case of an entity other than a limited partnership (e.g., a limited liability company), persons other than persons (whether individuals or entities) who actively participate in the management of such entity.69

The relevant provisions—and simplified definition—raise two questions: (1) whether an entity is a syndicate if and only if it has current year losses and (2) when a person is considered to actively participate in the management of an entity.

a. Allocable versus Allocated

In defining the term “syndicate,” section 1256(e)(3)(B) requires that losses be allocable to limited partners or limited entrepreneurs during the taxable year. In contrast, Temporary Regulation section 1.448-1T requires that such losses be allocated to limited partners or limited entrepreneurs during the taxable year.

As to whether actual losses are required, the section 1256 definition is arguably ambiguous. The use of the term “allocable” may suggest that an entity may be a syndicate in the absence of losses in a given year. However, the phrase “during the

69 It appears that whether a partnership is a syndicate depends, in some cases, on the entity’s state law classification. An entity organized as limited partnership, as opposed to another type of legal entity (e.g., LLC), appears more likely to be classified as a syndicate. Whether the disparate treatment is intended and whether policy goals are served by the disparate treatment is outside the scope of these Comments.
taxable year” indicates that the syndicate determination is made on a year-by-year basis (and thus may imply losses must exist in a given year).

The definition of syndicate in Temporary Regulation section 1.448-1T clearly requires net losses at the entity-level in a given year in order for an entity to be considered a syndicate: The first sentence of the provision uses the terms “allocated” and “during the taxable year.” The second to last sentence of the provision indicates that (1) a syndicate must have net losses and (2) that determination is made at the entity level.

Requiring net losses at the entity level in a given year is also the position the government has taken in informal guidance. For example, in PLR 8753032,70 the Service concluded that a limited partnership was not a “tax shelter for purposes of section 448 of the Code to the extent defined in section 461(i)(3)(B) as modified by section 1.448-1T(b)(3) of the [T]emporary [R]egulations, provided that M [the limited partnership] does not report total deductions in excess of total income for any tax year.” Likewise, in PLR 8911011,71 the Service applied the tax shelter definition of section 448 on a year-by-year basis and the determination turned on whether the partnership actually had losses. PLR 8911011 states, “With respect to profit years, M will not be a ‘syndicate’ within the meaning of section 1256(e)(3)(B) of the Code because there will be no losses allocable to partners, whether treated as limited partners or otherwise.” 72

We believe that the definition of a syndicate provided under Temporary Regulation section 1.448-1T and interpreted by the Service in the informal guidance described above (i.e., requiring actual losses allocated to, and not merely hypothetical losses allocable to) also should be applied in the context of section 163(j). Accordingly, we recommend that, consistent with existing law, Final Regulations clarify that: (1) whether an entity is a syndicate is determined on a year-by-year basis;73 and (2) an entity will only be a syndicate in a given year if it has net losses (determined under the rules of Temporary Regulation section 1.448-1T(b)(3)) in the given year and more than 35 percent of those net losses are allocated to partners or members treated as limited partners or limited entrepreneurs.

b. Active Participation

Section 1256(e)(3)(C) provides that an interest in an entity is not treated as held by a limited partner or a limited entrepreneur if the limited partner or limited entrepreneur meets certain active-participation-in-management requirements (the “active participation

70 PLR 8753032 (Oct. 5, 1987).
72 See also PLR 9602018 (Jan. 12, 1996); PLR 9535036 (Sept. 1, 1995).
73 A year-by-year approach is consistent with the statutory scheme. As discussed above, whether an entity meets the gross receipts test of section 448(c) is a year-by-year determination and thus whether an entity is eligible for the small business exemption of section 163(j)(3) is a year-by-year determination under the Code.
However, no definition of active participation in management is provided in the statute.

Section 1256 in its original form was intended to combat abusive commodity straddle transactions by requiring taxpayers to mark to market their regulated commodity futures positions. However, many taxpayers entered into regulated commodities futures to hedge business risks in transactions that were not targeted by the straddle rules. To preserve the efficiency of the commodities futures markets, Congress provided an exemption from the section 1256 character and recognition rules for hedging transactions (the “hedging exemption”). Syndicates were excluded from the hedging exemption to “prevent possible manipulation of the hedging exemption by tax shelters structured as limited partnerships.”

When viewed in the context of this legislative history, we believe that the active participation exception can be construed broadly without undermining the purpose of the syndicate rules (for section 1256 purposes or otherwise). The purpose of the active participation exception was to prevent tax-shelter investors from availing themselves of the hedging exemption. Tax-shelter investors do not typically participate in the activities of the entity in which they invest in any meaningful sense, and a broad construction of the active participation exception would not allow tax-shelter investors to qualify for the hedging exemption.

74 The degree of “active participation in management” that is required to fall within the active participation exception may depend on whether a person is a limited partner or a limited entrepreneur. See supra notes 70 and 71 and accompanying text.

75 In the prototypical straddle transaction, a taxpayer would enter into two offsetting positions with respect to the same property, with one position generating an unrealized loss and another an unrealized gain. At year-end, the taxpayer would dispose of the position with the built-in loss, recognize a tax loss in the current taxable year, and then immediately reacquire a position identical to the position disposed of. At no point would the taxpayer bear any economic risk of loss because the positions were offsetting, but a tax loss would nonetheless be triggered. Moreover, if the unrealized gain position was later sold, the gain realized would generally be long-term, thereby providing a favorable character benefit. Section 1256 addressed these perceived abuses by requiring section 1256 contracts to be marked to market (thereby requiring the recognition of the unrealized gain in the example above) and providing that gain or loss would be 60/40 long-term/short-term (thereby eliminating the ability to “age” a gain position on a risk-free basis).


The committee believes that commodity futures markets play an important role in the economy. These markets provide a valuable means for farmers to reduce their risks in the production of crops and for bulk consumers to hedge their risks of price shifts. There has been explosive growth in the futures market over the past decade, and, there is good evidence that such growth will continue. Because of the importance of the commodities markets, particularly in the agricultural and commercial sectors, it is critical that the efficiency of these markets be preserved. The liquidity of these markets must be maintained. Thus, for example, the committee has included an exception to the rules for hedging transactions.

77 Id. at 160.
A broad construction of the active participation exception is also consistent with previous informal guidance, which indicates that practitioners in various professional services firms meet the active participation requirement if they have voting rights, have limited voting rights (e.g., the ability to approve major decisions), or simply engage in the practice of the professional activities (e.g., law, medicine, management consulting, or accounting). In other words, direct participation in the overall management of a business (e.g., officer positions or board representation) is not required, as long as other managerial tasks (e.g., supervising subordinates) are performed.

It also bears mentioning that the general structure of the syndicate rule (and the definition of active participation in management in particular) was borrowed from the definition of a farming syndicate in section 461(k). The legislative history and judicial interpretations of that provision are therefore instructive in analyzing the active participation exception in the context of section 1256(e). The legislative history to section 461(k) states:

The determination whether a person actively participates in the operation or management of a farm depends upon the facts and circumstances. Factors which tend to indicate active participation include participation in the day-to-day decisions in the operation or management of the farm, actually working on the farm, living on the farm, and engaging in the hiring and discharging of employees as compared to only the farm manager. Factors which tend to indicate a passive person similar to a limited partner include lack of control of the management and operations of the farm, having authority only to discharge the farm manager, having a farm manager who is an independent contractor rather than an employee, not owning the farm land in fee, and having limited liability for farm losses.

---

78 PLR 9426030 (July 1, 1994) (“Since less than 35 percent of any losses of Company would be allocated to the nonequity members, who have no vote in the management of Company, Company is not a syndicate described in section 1256(e)(3)(B) and is not a tax shelter under section 448(a)(3) by reason of being a syndicate.”); PLR 9421025 (May 27, 1994) (“[A]ll equity members will participate in the management activities (i.e., voting on all formal decisions).”).

79 PLR 9321047 (Feb. 25, 1993) (LLC members had ability to vote on major decisions); PLR 9350013 (Sept. 15, 1993) (similar); see also PLR 9434027 (Aug. 26, 1994) (management consulting; similar); PLR 9412030 (Dec. 22, 1993) (accounting firm; similar).

80 PLR 9452024 (Dec. 30, 1994) (implied medical professionals without voting rights or general business management responsibilities satisfied active participation in management requirement); PLR 9501033 (Oct. 5, 1994) (new members were only able to vote on executive committee members, but nonetheless fulfilled the active management requirement, all members were engaged in the practice of law); PLR 9407030 (Nov. 24, 1993) (similar);

81 The other provisions of the Code that employ an “active participation” standard (e.g., section 469) were enacted after section 1256(e) and for different purposes; therefore, the interpretation of active participation as used in these other provisions would not appear appropriate in the context of section 1256(e) (and section 163(j)).

This legislative history indicates that the ability to select a manager in itself is not sufficient to meet the active participation exception. Instead, a taxpayer must as be able to exert influence over the manager’s decisions or the overall operation of the business.\footnote{See also Estate of Wallace v. Commissioner, 95 T.C. 525 (1990) (the taxpayer did not actively participate in the management of a cattle-feeding business because the taxpayer only controlled the selection of the business manager, not the operation of the business itself).} This is consistent with the informal guidance described above, in which taxpayers participating in day-to-day operations met the requirements of the active participation exception.

Under current law, the determination of whether a limited partner or limited entrepreneur actively participates in management is a facts and circumstances determination. However, Final Regulations could provide useful guidance by explicitly listing the various factors that should be relevant in making this determination and by providing examples of taxpayers who actively participate in management under common fact patterns. We recommend that the following factors be enumerated in Final Regulations: (1) ongoing participation in day-to-day operations; (2) the ability to hire or discharge employees (other than the business manager); (3) having professional certification, training, or licenses pertinent to the operation of the business (e.g., a CPA for an accounting business); and (4) the ability to vote on matters beyond the selection of the business manager.

IV. Treatment of Intercompany Transfers of Partnership Interests

A. Summary

As discussed above, section 163(j)(4)(B)(i) provides that EBIE is allocated by the partnership to the partners and carried forward at the partner level. Section 163(j)(4)(B)(iii)(I) generally provides that a partner’s adjusted basis in its partnership interest is reduced (but not below zero) by the amount of EBIE allocated to that partner. Section 163(j)(4)(B)(iii)(II) further provides that if a partner disposes of its partnership interest, the adjusted basis of the partner’s interest is increased, immediately before the disposition, by the amount of the excess (if any) of the basis reduction described in the immediately preceding sentence over the amount of any excess interest expense that has been treated as paid or accrued by the partner. By its terms, section 163(j)(4)(B)(iii)(II) also applies to the transfer of a partnership interest in a transaction “in which gain is not recognized in whole or in part.”

Proposed Regulation section 1.163(j)-6(h)(3) clarifies and modifies the statutory provision by requiring, before permitting a basis adjustment, that the partner dispose of “all or substantially all of a partnership interest (whether by sale, exchange, or redemption).” Under section 163(j)(4)(B)(iii)(II), no deduction under section 163(j) is allowed to the transferor or transferee for any EBIE resulting in a basis increase.

Proposed Regulation section 1.163(j)-4(d)(4)(i) provides that the transfer of a partnership interest in an intercompany transaction that does not result in the termination
of the partnership is treated as a disposition for purposes of the basis adjustment rule in section 163(j)(4)(B)(iii)(II), regardless of whether the transfer is one in which gain or loss is recognized. The Proposed Regulations also add several examples to Regulation section 1.1502-13(c)(7)(ii) to illustrate the application of these rules. The Preamble explains that Treasury and the Service have determined that intercompany transfers of partnership interests should be treated as dispositions for purposes of section 163(j)(4) because (1) dispositions are broadly defined in section 163(j)(4)(B)(iii)(II), and (2) ignoring intercompany transfers of partnership interests as dispositions for purposes of section 163(j)(4) would be inconsistent with the view that an entity whose owners are all members of the same consolidated group can be a partnership.84

Treasury and the Service request comments on two specific issues related to the transfer of partnership interests in intercompany transactions. First, whether the intercompany transfer of a partnership interest in a nonrecognition transaction should constitute a disposition for purposes of section 163(j)(4)(B)(iii)(II) and, if so, how Regulation section 1.1502-13(c) should apply to such a transfer if there is ETI in a succeeding taxable year.85 Second, what is the treatment of the transfer of a partnership interest in an intercompany transaction that results in the termination of the partnership.86 Each request for comments is addressed in more detail below.

B. Recommendations

With respect to transfers of partnership interests in intercompany nonrecognition transactions, we recommend that the Final Regulations provide that a transfer of a partnership interest in an intercompany transaction that does not result in the termination of the partnership is not treated as a disposition solely for purposes of the basis adjustment rule in section 163(j)(4)(B)(iii)(II), but only to the extent the transferee is treated as a successor to the transferor. We also recommend the Final Regulations provide that EBIE carries over to the transferee upon a transfer of a partnership interest in an intercompany transaction in which the transferee is treated as a successor to the transferor.87

84 See 83 Fed. Reg. at 67,500 (2018). The Preamble further explains: “Additionally, partnerships that are wholly owned by members of a consolidated group would not be aggregated with the consolidated group for purposes of applying the section 163(j) limitation. The Treasury Department and the IRS have determined that non-consolidated entities should not be aggregated for purposes of applying the section 163(j) limitation because, whereas old section 163(j)(6)(C) expressly provided that “[a]ll members of the same affiliated group (within the meaning of section 1504(a)) shall be treated as 1 taxpayer,” section 163(j) no longer contains such language, and nothing in the legislative history of section 163(j) suggests that Congress intended non-consolidated entities to be treated as a single taxpayer for purposes of section 163(j).” See also 83 Fed. Reg. at 67,499 (2018).
86 Id.
87 For further discussion on transfers within a consolidated group, please see Comm. on Corporate Tax, ABA Tax Sec., Comments on Proposed Guidance under Section 163(j) Regarding Issues Affecting Corporate Taxpayers and Consolidated Groups (2019) (the “Corporate 163(j) Comments”).
With respect to transfers of partnership interests in intercompany transactions that terminate the partnership, we recommend that Final Regulations provide that, on the termination of a partnership through transfer of a partnership interest, both the transferor and the transferee be treated as having disposed of the respective partnership interest, resulting in the basis increase immediately before the transfer under section 163(j)(4)(B)(iii)(II).88

C. Explanations

1. Transfers of Partnership Interests in Intercompany Nonrecognition Transactions

As mentioned above, section 163(j)(4)(B)(iii)(II) clearly contemplates that a disposition of a partnership interest includes a transaction “in which gain is not recognized in whole or in part.”89 The legislative history, moreover, provides no indication otherwise but instead specifically provides that nonrecognition transfers are dispositions.90 Accordingly, based on the plain language of the statute, we believe that the transfer of a partnership interest in a nonrecognition transaction should be treated as a disposition for purposes of section 163(j)(4)(B)(iii)(II).91 Moreover, we agree with the

---

88 We note that the Corporate 163(j) Comments also recommend that the intercompany transfer be treated as a disposition of the partnership interest by the transferor for purposes of the basis adjustment rule in section 163(j)(4)(B)(iii)(II). With respect to the transferee, the Corporate 163(j) Comments offer two alternatives, one of which also treats the transferee as disposing of its partnership interest for purposes of the basis adjustment rule in section 163(j)(4)(B)(iii)(II), provided the transferee also is a partner in the partnership before the intercompany transaction. The other alternative would permit the transferee to take into account the EBIE that had previously been allocated by the partnership as BIE paid or accrued by the transferee in the taxable year in which the partnership terminates. As discussed in more detail below, we think both alternatives have merit and recommend adoption of the first alternative.

89 (Emphasis added.)

90 See Staff of the Joint Committee on Taxation, General Explanation of Public Law 115-97, JCS-1-1, n.880 (“The special rule for dispositions also applies to transfers of a partnership interest (including by reason of death) in transactions in which gain is not recognized in whole or in part”).

91 This conclusion is also consistent with the canon of statutory construction that a term appearing in several places in a statute should be treated the same way each time it appears. See, e.g., Ratzlaf v. United States, 510 U.S. 135, 143 (1994). In drafting the Code, Congress generally has used the term “disposition” to refer to any transaction that satisfies the realization requirement. For instance, section 1001(b) defines “amount realized” in terms of the amount that is received “from the sale or other disposition of property.” See also Reg. § 1.1001-1(a). Once a transaction satisfies the realization requirement, various recognition and nonrecognition provisions of the Code provide whether the taxpayer is required to recognize gain or loss on the transaction. The disposition of a partnership interest therefore includes the transfer of a partnership interest in a nonrecognition transaction.

Section 7701(a)(45) supports this conclusion as well. In relevant part, this provision defines the term “nonrecognition transaction” as any “‘disposition’ of property in a transaction in which gain or loss is not recognized in whole or in part for purposes of subtitle A.” Emphasis added. This is also consistent with the Supreme Court’s decision in Cottage Savings Inc. v. Commissioner, 499 U.S. 554, 559 (1991), where it observed that “the parties agree that the exchange of participation interests in this case cannot be characterized as a ‘sale’ under § 1001(a); the issue before us is whether the transaction constitutes a
statement in the Preamble that transfers of a partnership interest among consolidated group members is a disposition for U.S. federal income tax purposes and that partnerships among consolidated group members should be given effect.

While we agree that the transfer of a partnership interest in an intercompany transaction should be a “disposition” of the partnership interest for U.S. federal income tax purposes, we believe that maintaining the EBIE attribute of the consolidated group by not converting the EBIE amount to a basis adjustment upon such a transfer is more consistent with the interaction of section 163(j)(4)(B)(i) (which provides that the EBIE is an attribute of the consolidated group member partner, not the partnership) and Proposed Regulation section 1.163(j)-5(b)(3) (which provides that the disallowed BIE is the consolidated group’s disallowed BIE). 92 As stated above, EBIE is not an attribute of the partnership. Rather, it is an attribute of the partner. Because EBIE is an attribute of the partner, and not the partnership, we do not believe maintaining the EBIE attribute upon a disposition in a transfer among consolidated group members is inconsistent with respecting and giving effect to partnerships among consolidated group members. Instead, we believe maintaining the EBIE attribute (which is now an attribute of a consolidated group member) upon a transfer in an intercompany transaction is more consistent with the legislative history providing that section 163(j) apply at the consolidated group level.93

Accordingly, we recommend that the Final Regulations amend Proposed Regulation section 1.163(j)-4(d)(4)(i) to provide that a transfer of interest in an intercompany transaction that does not result in the termination of the partnership is not treated as a disposition solely for purposes of the basis adjustment rule in section 163(j)(B)(iii)(II), but only to the extent the transferee is treated as a successor to the transferor. We also recommend the Final Regulations clarify that EBIE carries over to the transferee upon a transfer of a partnership interest in an intercompany transaction in which the transferee is treated as a successor to the transferor.

2. Transfers of Partnership Interests In Intercompany Transactions that Terminate the Partnership

Treasury and the Service also request comments on the proper treatment of an intercompany transfer of a partnership interest that results in the termination of the

---

92 The Preamble recognizes the board authority of Treasury under section 1502. “Section 1502 provides broad authority for the Secretary of the Treasury to prescribe such regulations as are necessary in order that the tax liability of any affiliated group of corporations filing a consolidated return may be returned, determined, computed, assessed, collected, and adjusted, in order to clearly reflect the income tax liability of the consolidated group and to prevent the avoidance of such tax liability.” See also 83 Fed. Reg. at 67,499 (2018).

93 See H.R. REP. NO. 115-466, at 228 (2017). (“In the case of a group of affiliated corporations that file a consolidated return, the limitation applies at the consolidated tax return filing level.”)
partnership. \footnote{See 83 Fed. Reg. at 67,500 (2018).} Section 708(b)(1) \footnote{The Act amended section 708 to remove section 708(b)(1)(B) and redesignate section 708(b)(1)(A) and section 708(b)(1). Act, § 13504. The amendments apply to partnership taxable years beginning after December 31, 2017.} provides that a partnership is considered terminated only if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership. As a result, a partnership will terminate under section 708(b)(1) if either (i) the partnership no longer carries on any business, financial operation, or venture or (ii) the partnership is no longer classified as a partnership for U.S. federal income tax purposes. An eligible entity\footnote{Reg. § 301.7701-3(a) (defining an eligible entity).} classified as a partnership for U.S. federal income tax purposes will no longer be classified as a partnership if the partnership has only one owner for U.S. federal income tax purposes.\footnote{Reg. § 301.7701-3(b)(2) provides that a foreign eligible entity under the default provision is treated as (1) a partnership if it has two or more members and at least one member does not have limited liability; (2) an association taxable as a corporation if all members have limited liability; or (3) a disregarded entity if it has a single owner that does not have limited liability.} A partnership that has only one owner is considered terminated under section 708(b)(1) and is classified as a disregarded entity unless an election is made to be classified as a corporation.\footnote{Reg. § 301.7701-3(f)(2).}

As a general matter, Treasury and the Service have provided guidance on the tax consequences that result from the transfer of partnership interests that results in the termination of the partnership. This guidance is summarized below. Moreover, Treasury and the Service have also provided guidance on the tax consequences that result from a partnership termination in an intercompany transaction.\footnote{See, e.g., PLR 200334037 (Aug. 22, 2003) (sale of group member partner’s entire interest in an intercompany partnership to another group member partner treated as a termination of the partnership pursuant to Rev. Rul. 99-6 and an intercompany transaction described Reg. § 1.1502-13(b), with the selling partner’s intercompany items treated as with respect to the disposition of its partnership interest); and PLR 200737006 (Sep. 14, 2007) (group member partners’ sale of their interests in intercompany partnership to another group member treated as a termination of the partnership pursuant to Rev. Rul. 99-6 and intercompany transactions described Reg. § 1.1502-13(b), with the selling partners’ intercompany items treated as with respect to the disposition of their partnership interest).}

In Revenue Ruling 99-6,\footnote{Rev. Rul. 99-6, 1999-1 C.B. 432.} Situation 1, A and B were equal members in AB, a limited liability company classified as a partnership. A sold its entire interest in AB to B. After the sale, the limited liability company continued its business with B as the sole owner. The ruling concludes that A must treat the transaction as the sale of a partnership interest. For purposes of determining the tax treatment of B, however, the ruling concludes that the AB partnership terminates and is deemed to make a liquidating distribution of all of its assets to A and B. Following this distribution, B is treated as
acquiring, from A, the assets deemed to have been distributed to A in liquidation of A’s partnership interest.

In Situation 2 of Revenue Ruling 99-6, C and D are equal members in CD, a limited liability company classified as a partnership. Both C and D sell their entire interests in CD to E, an unrelated person for cash. After the sale, the limited liability company continued its business with E as the sole owner. Similar to the treatment of A in Situation 1, the ruling concludes that C and D must report gain or loss, if any, resulting from the transaction as a sale of their partnerships interests. For purposes of determining the federal income tax consequences of the acquisition of the CD interests by E, the ruling holds that the CD partnership terminates under section 708(b)(1)(A) and is deemed to make a liquidating distribution of its assets to C and D. Immediately following this distribution, E is deemed to acquire, from C and D by purchase, all of the former CD partnership’s assets.

Revenue Ruling 84-111 addresses partnership incorporation transactions, with Situation 3 addressing the incorporation of a partnership by transfer of the partnership interests. In Situation 3, the partners in a three-member partnership transferred their partnership interests to a newly formed corporation in exchange for all of its outstanding stock, causing the partnership to terminate. Upon termination of the partnership, all of the partnership’s assets and liabilities became assets and liabilities of the corporation. The transfer of partnership interests is analyzed under section 351.

Although Revenue Ruling 99-6 and Revenue Ruling 84-111 provide for different deemed transactions, under those revenue rulings, in both recognition and nonrecognition transfers, the transferor is treated as transferring its partnership interest. The transferee, in each construct where the transferee is also a partner, is treated as receiving a deemed distribution of assets in liquidation of the partnership interest held. As discussed above, Proposed Regulation section 1.163(j)-6(h)(3) provides that a partner must dispose of substantially all of the partnership interest (whether by sale, exchange, or redemption). Because the definition of “disposition” includes a redemption of a partnership interest, the transferee should also be treated as having disposed of its partnership interest when it is deemed to receive the partnership assets in liquidation of its partnership interest.

We recommend that Final Regulations provide that because both the transferor and the transferee dispose of their respective partnership interests (either by selling the interest or by receiving a deemed distribution in liquidation of the interest), each should


102 In Rev. Rul. 99-6, Situation 1, B, the transferee, is treated as receiving a deemed distribution from AB of its share of assets and liabilities of partnership and purchasing the share of assets and liabilities treated as distributed to the transferor. In Rev. Rul. 84-111, Situation 3, the newly formed corporation is treated as receiving partnership interests and holding those interests as single partner for a moment in time.

103 Although section 731(b) refers to “a distribution in liquidation” and not a “redemption” of a partnership interest. We believe that the term “redemption” is commonly understood to mean a distribution in liquidation.
increase its outside basis by the amount of its share of EBIE not treated as paid or accrued in accordance with section 163(j)(4)(B)(iii)(II) and Proposed Regulation section 1.163(j)-6(h)(3). Section 163(j)(4)(B)(iii)(II) provides that the basis increase happens immediately before the transfer. Accordingly, both the transferor and the transferee should increase their respective outside basis immediately before the transfer of the partnership interest by the transferor that terminates the partnership. When the transferee receives the partnership assets, including the deemed distribution of assets in liquidation of its partnership interest, the transferee’s basis in the assets deemed distributed will be determined under section 732(b), taking into account the increase for the unused EBIE. The transferee’s basis in the assets deemed acquired from the transferor will be determined based on the construct of the transaction. For example, if the transferee purchased the transferor’s interest for cash, the transferee will take a basis in the assets deemed distributed to the transferor equal to the amount of cash.

We acknowledge that there are alternative regimes to account for EBIE on the termination of a partnership. For example, principles similar to Proposed Regulation section 1.163(j)-6(m)(3) could apply under the theory that because the partnership terminates, the partnership is no longer subject to section 163(j). If a partnership allocates EBIE to one or more of its partners and, in a succeeding taxable year, becomes not subject to the requirements of section 163(j) (e.g., because the partnership makes a real property trade or business election), the EBIE from the prior taxable years is treated as paid or accrued by the partner in the succeeding taxable year. Because the partners are not allocated any ETI or EBII from the partnership, the partners are dependent upon

---

104 If the construct of Rev. Rul. 99-6, Situation 1 applies and the transferor sells its interest, the transferor will increase its basis in its partnership interest immediately before the transfer by the amount of EBIE in accordance with section 163(j)(4)(B)(iii)(II). The transferor will recognize less gain (or an increased loss) on the disposition. With respect to the transferee, both the transferor and transferee will increase its basis in its partnership interest immediately before the transfer by the amount of EBIE in accordance with section 163(j)(4)(B)(iii)(II). Thus, the transferee will be deemed to receive its share of the assets as a liquidating distribution from the partnership, and the transferee’s basis in those assets will include its increased basis in its partnership interest. From the transferee’s perspective, the transferor will also be deemed to receive a liquidating distribution from the partnership, and the transferor’s basis in those assets will include its increased basis in its partnership interest. That increased basis will then carry over to the transferee if the partnership interest is transferred in a nonrecognition transaction.

If Rev. Rul. 84-111, Situation 3 applies, both the transferor and the transferee (if the transferee also transfers its interest to a corporation) will increase their outside basis in their partnership interests immediately before the transfer by the amount of EBIE in accordance with section 163(j)(4)(B)(iii)(II). Each of the transferor and the transferee will receive stock with a substituted basis equal to the increased basis in its partnership interest. The corporation will take a carryover basis in its single, unitary partnership interest equal to the increased basis in the hands of both the transferor and the transferee. The corporation will receive the former partnership assets with basis equal to the increased outside basis of the partnership interest under section 732(b).

105 See Rev. Rul. 99-6, Situation 1 (“B’s basis in the assets attributable to A’s one-half interest in the partnership is $10,000, the purchase price for A’s partnership interest.”)

106 Prop. Reg. § 1.163(j)-6(m)(3). See also Prop. Reg. §§ 1.163(j)-6(o)(6) and (7) (providing examples illustrating the application of this rule).
Applying these principles, the EBIE from the prior taxable years of both the transferor and transferee would be treated as paid or accrued in the taxable year following termination of the partnership, and the combined amount would be treated as BIE of the transferee. Because section 163(j) applies at the consolidated group level, the consolidated group would take that BIE and the ATI generated by the assets of the former partnership into account when computing the consolidated section 163(j) limitation. This approach permits the consolidated group to deduct the BIE of the transferee much sooner and use ATI generated by other consolidated group members to offset the transferee’s BIE, a result that would likely not occur if the partnership did not terminate.

Alternatively, the transferee could continue to track the EBIE amount. The tracked EBIE could be treated as paid or accrued in the year in which the assets of the former partnership, now held directly by the transferee, generate income. The transferee would then apply section 163(j) to the BIE treated as paid or accrued to determine if the BIE is deductible or carried forward. This construct may produce the correct result if the transferee owns no other assets. Rules could be implemented to attempt to track the newly paid or accrued BIE by former partnership assets; however, such a regime would be difficult to administer and could lead to inequitable results.

An additional alternative could treat the transferor as disposing of its interest and increasing its basis by the unused EBIE while the EBIE of the transferee is treated as paid or accrued in the year of the partnership termination. The transferee would use ATI generated from the former partnership assets to take the EBIE into account in a later year. This alternative poses two concerns. First, this alternative ignores the transferee’s disposition of its partnership interest in the deemed liquidation. Second, if the transferor increases its basis in its partnership interest immediately before the transfer, Proposed Regulation section 1.163(j)-6(h)(3) denies any deduction for the EBIE. It logically follows that the transferee should not benefit from the ATI generated by those assets to cause the EBIE to be treated as paid or accrued. Again, rules could be implemented to track only the transferee ATI, but such a regime would be difficult to administer, in particular in situations where the partnership historically had special allocations.

---

107 An excepted business, such as a real property trade or business, does not report section 163(j) items to its partners, and all excepted section 163(j) items are not included in the partner’s computation of its own section 163(j) limitation. Prop. Reg. § 1.163(j)-6(m)(2).

108 Because a partner is dependent upon an allocation of ETI or EBII from the same partnership that allocated the EBIE, a partner cannot use allocations of section 163(j) items from other partnerships in which it is a partner. Similarly, if two members of a consolidated group are partners in a partnership, an allocation of ETI to one partner cannot be used to cause EBIE of the other to be treated as paid or accrued. See Prop. Reg. § 1.163(j)-6(g)(2)(i).

109 As discussed above in Part IV.C.2, we recommend that EBIE carries over to the transferee in an intercompany transaction in a transfer that does not terminate the partnership provided the intercompany transfer is a successor transaction. In that situation, if the transferee owns other assets in addition to the partnership interest, the transferee still has the ability to receive an allocation of ETI or EBII from the partnership to cause EBIE to be treated as paid or accrued in a subsequent year. Once the partnership has terminated, that same tracking is not available.
After consideration of the alternative constructs summarized above, we recommend that Final Regulations provide that, on the termination of a partnership through transfer of a partnership interest, both the transferor and the transferee be treated as having disposed of the respective partnership interests, resulting in the basis increase immediately before the transfer under section 163(j)(4)(B)(iii)(II).

V. Self-Charged Lending Transactions

A. Summary

The Preamble to the Proposed Regulations invites comments on the proper treatment of BII and BIE with respect to lending transactions between a passthrough entity and an owner of the entity (self-charged lending transactions). Further, the Preamble notes that Treasury and the Service intend “to adopt certain rules to re-characterize, for both the lender and the borrower, the BIE and corresponding BII arising from a self-charged lending transaction that may be allocable to the owner, to prevent such BII and expense from entering or affecting the section 163(j) limitation calculations for both the lender and the borrower in such situations.” In that regard, Treasury and the Service expressed that one possible approach is “to adopt rules similar in scope as those contained in Treas. Reg. 1.469-7, dealing with the treatment of self charged lending transactions for purposes of section 469.”

We generally agree with the approach described in the Preamble, and the following discussion illustrates the potential application of such approach, which should apply to both partnerships and S corporations (even though the discussion focuses on S corporations).

An S corporation may issue stock or debt in exchange for property received from the shareholder(s) upon incorporation. Under the tracing rules of Temporary Regulation section 1.163-8T, the character of the corporation’s interest expense depends on the corporation’s use of the debt. If the corporation issuing the debt to the shareholder(s) then acquires assets to be used solely in a trade or business, the interest expense could constitute business interest and may be subject to the new business interest limitation of section 163(j).

When a shareholder lends money to an S corporation, the interest received by the shareholder generally is portfolio income. If the corporation’s interest deduction is part of a loss from a passive activity, the loss is considered passive in the hands of the shareholder.

---

112 See Temp. Reg. §§ 1.163-8T(a)(4)(i)(A) and (b)(7); see also I.R.C. §§ 163(h)(2)(A) and 163(j)(7) (for exceptions from the definition of “trade or business” for purposes of the new business interest limitation).
113 See id.; see also I.R.C. § 163(j)(5).
shareholder under the passthrough rules of section 1366(b). Accordingly, the shareholder could not use the interest deduction to offset the interest income (self-charged interest), absent a special rule.

Example 1: A lends $1,000 to S, his newly formed wholly owned calendar-year S corporation. S is engaged in a single non-real property rental activity, and uses the loan proceeds for such rental activity. S pays $100 of interest to A for the taxable year. Under the general application of the passive loss rules of section 469, A might be viewed as incurring $100 of passive activity expense (passed through by S), and having $100 of portfolio interest income which could not be offset by the passive activity interest expense deduction. As a result, A could end up with $100 of taxable income from the transaction, although in economic substance he has paid himself the interest.116

In the context of the passive activity loss rules of section 469, the “Self-Charged Interest Rules” contained within such Regulations address this issue for passthrough entities and generally provide that a taxpayer may offset non-passive interest income and passive interest deductions that arise from the same loan.117

More specifically, the Self-Charged Interest Rules: (i) recharacterize certain interest income resulting from these lending transactions as passive activity gross income; (ii) recharacterize certain deductions for interest expense that is properly allocable to the interest income as passive activity deductions; and (iii) allocate the passive activity gross income and passive activity deductions resulting from this treatment among the taxpayer’s activities.118

1. Taxpayer Lends to Passthrough Entity

If a taxpayer lends to a passthrough entity (borrowing entity), the Self-Charged Interest Rules apply to the lender’s interest in the passthrough entity for any tax year during which:


117 See generally Reg. § 1.469-7; see also Reg. §§ 1.469-7(a)(1) and (b)(1) (Self-Charged Interest Rules apply to passthrough entities, defined as a partnership or S corporation). Under Reg. § 1.469-7, self-charged interest income is interest income derived by a taxpayer from lending transactions between the taxpayer and a partnership or S corporation in which the taxpayer has a direct or indirect interest, or between two identically owned partnerships or S corporations in which the taxpayer has a direct or indirect interest.

118 See Reg. § 1.469-7(a)(1)(i)-(iii).
1. The borrowing entity has deductions for interest charged by a lender who holds a direct or indirect interest in the passthrough entity (the “self-charged interest deductions”);

2. The lender owns a direct (or indirect) interest in the borrowing entity at any time during the entity’s taxable year and has gross income for the taxable year from interest charged to the borrowing entity by the lender (the lender’s income from interest charged to the borrowing entity); and

3. The lender’s share of the borrowing entity’s self-charged interest deductions includes passive activity deductions.119

Under these circumstances, the Self-Charged Interest Rules provide that (1) the applicable percentage of each item of the lender’s income for the taxable year from interest charged to the passthrough entity is treated as passive activity gross income from the activity; and (2) the applicable percentage of each deduction for the taxable year for interest expense that is properly allocable (under Temporary Regulation section 1.163-8T) to the lender’s income from interest charged to the passthrough entity is treated as a passive activity deduction from the activity.120

The applicable percentage is obtained by dividing the lender’s share for the taxable year of the passthrough entity’s self-charged interest deductions that are treated as passive activity deductions from the activity by the greater of (1) the lender’s share for the taxable year of the passthrough entity’s self-charged interest deductions (regardless of whether these deductions are treated as passive activity deductions), or (2) the lender’s income for the taxable year from interest charged to the passthrough entity.121 The general application of the above Self-Charged Interest Rules to a loan from a lender to its passthrough entity can be illustrated as follows:

Example 2: A and B each own one-half of the shares of S, a calendar-year partnership. S is engaged in a single non-real property rental activity.122 S borrows $50,000 from A and uses the loan proceeds in such rental activity. S pays $5,000 of interest to A for the taxable year. A and B each incur $2,500 of interest expense as their pro rata share of S’s interest expense.123

Since all the conditions of Regulation section 1.469-7(c)(1) are met, the Self-Charged Interest Rules apply in determining A’s passive activity gross income,124 and the

---

119 Reg. §§ 1.469-7(c)(1)(i)-(iii).
120 Reg. § 1.469-7(c)(2).
121 Reg. § 1.469-7(c)(3).
122 A rental activity within the meaning of Reg. § 1.469-1T(e)(3).
123 See Reg. § 1.469-7(h), Ex. (1).
124 Id.; see also Reg. § 1.469-7(c)(1) ((i) S has self-charged interest deductions for the taxable year (i.e., the deductions for interest charged to S by A); (ii) A owns a direct interest in S during S’s taxable year and has
The applicable percentage is obtained by dividing A’s share for the taxable year of S’s self-charged interest deductions that are treated as passive activity deductions from the activity ($2,500) by the greater of (i) A’s share for the taxable year of S’s self-charged interest deductions ($2,500), or (ii) A’s income for the taxable year from interest charged to S ($5,000). Thus, A’s applicable percentage is 50 percent ($2,500/$5,000), and $2,500 (50 percent × $5,000) of A’s income from interest charged to S is treated as passive activity gross income from the passive activity A conducts through S. Since B does not have any gross income for the year from interest charged to S, the above rules do not apply to B.  

2. Passthrough Entity Lends to Taxpayer

If a passthrough entity is the lender (lending entity), the Self-Charged Interest Rules apply to the borrower’s interest in the partnership for any tax year during which:

1. The lending entity has interest income (lending entity’s self-charged interest income) from loans to borrowers who own direct or indirect interests in the partnership;

2. The borrower holds a direct or indirect interest in the lending entity and has interest deductions with respect to borrowings from the lending entity; and

3. The borrower’s interest deductions with respect to such borrowings include passive activity deductions.

Under these circumstances, the Self-Charged Interest Rules provide that the applicable percentage of the borrower’s share of each item of the lending entity’s self-charged interest income is treated as passive activity gross income from the activity, and the same portion of the borrower’s share of the interest expense deduction that is properly allocable to the lending entity’s self-charged interest income is treated as a passive activity deduction from the activity. The applicable percentage for an activity is determined by dividing the borrower’s interest deductions with respect to such borrowings (to the extent treated as passive activity deductions from the activity) by the greater of (1) the borrower’s total interest deductions or (2) the borrower’s share of the lending entity’s self-charged interest income. The general application of the above can be illustrated as follows:

---

income for A’s taxable year from interest charged to S; and (iii) A’s share of S’s self-charged interest deductions includes passive activity deductions).

125 Reg. § 1.469-7(h), Ex. (1).
126 See Reg. § 1.469-7(h), Ex. (1).
127 Reg. § 1.469-7(d)(1)(i)-(iii).
128 Reg. § 1.469-7(d)(2).
Example 3: E and F each own 50 percent of the stock of X, a calendar year S corporation. E borrows $30,000 from X, and pays X $3,000 of interest for the taxable year. E uses $15,000 of the loan proceeds to make a personal expenditure, and uses $15,000 of loan proceeds to purchase a trade or business activity in which E does not materially participate for the taxable year. E and F each receive $1,500 as their pro rata share of X’s interest income from the loan for the taxable year. Since the conditions of Regulation section 1.469-7(d)(1) are met, the Self-Charged Interest Rules apply in determining E’s passive activity gross income, and the applicable percentage of E’s share of X’s self-charged interest income is recharacterized as passive activity gross income from the activity. The applicable percentage is obtained by dividing E’s deductions for the taxable year for interest charged by X, to the extent treated as passive activity deductions from the activity ($1,500), by the greater of E’s deductions for the taxable year for interest charged by X, regardless of whether those deductions are treated as passive activity deductions ($3,000), or E’s share for the taxable year of X’s self-charged interest income ($1,500). As a result, E’s applicable percentage is 50 percent ($1,500/$3,000), and $750 (50 percent x $1,500) of E’s share of X’s self-charged interest income is treated as passive activity gross income.

3. Overlay of Section 163(j)

While the potentially inequitable treatment of self-charged interest income and expense is addressed for purposes of the passive activity loss rules of section 469 by the Self-Charged Interest Rules discussed above, the application of section 163(j) could produce inappropriate results in the passthrough context that might be best illustrated by this simple example:

Example 4: Expanding on Example 1 (above): By year X, A has lent a total of $5 million to S, all of which was used for its single trade or business activity. As detailed below, in year X, S has $30 million of gross income and total deductions of $27.5 million, which includes $1.5 million in BIE. This BIE includes the $250,000 of interest S paid to A for the taxable year on the aforementioned shareholder loan.

---

129 Reg. § 1.469-7(h), Ex. (3).
130 Reg. § 1.469-7(h), Ex. (3) (X has gross income for X’s taxable year from interest charged to E (X’s self-charged interest income); E owns a direct interest in X during X’s taxable year and has deductions for the taxable year for interest charged by X; and E’s deductions for interest charged by X include passive activity deductions).
131 Id.
132 This example assumes that S does not qualify for the small business exemption under section 163(j)(3), or an exception from the definition of “trade or business” under section 163(j)(7)(A).
<table>
<thead>
<tr>
<th>Year X Income Statement for S (in thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>INCOME</strong></td>
</tr>
<tr>
<td>BII</td>
</tr>
<tr>
<td>Non-T/B Income or Gain</td>
</tr>
<tr>
<td>Other Income</td>
</tr>
<tr>
<td><strong>Total Gross Income</strong></td>
</tr>
<tr>
<td><strong>DEDUCTIONS</strong></td>
</tr>
<tr>
<td>COGS</td>
</tr>
<tr>
<td>BIE Self Charged Interest Expense Portion:</td>
</tr>
<tr>
<td>Depreciation</td>
</tr>
<tr>
<td>Other Deductions (SG&amp;A)</td>
</tr>
<tr>
<td><strong>Total Deductions</strong></td>
</tr>
<tr>
<td><strong>Net Taxable Income</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ATI Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Taxable Income</td>
</tr>
<tr>
<td>(Non-T/B Income, Gain) + Deduction, Loss</td>
</tr>
<tr>
<td>(BII)</td>
</tr>
<tr>
<td>BIE</td>
</tr>
<tr>
<td>Section 172 – NOLs</td>
</tr>
<tr>
<td>Section 199A – Passthrough Deduction</td>
</tr>
<tr>
<td>(Until 2022), Depreciation, Amort., Depletion</td>
</tr>
<tr>
<td><strong>ATI for Section 163(j) Purposes</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Business Interest Limitation</th>
</tr>
</thead>
<tbody>
<tr>
<td>BII</td>
</tr>
<tr>
<td>30 percent of ATI</td>
</tr>
<tr>
<td>Floor Plan Financing</td>
</tr>
<tr>
<td><strong>Section 163(j) Business Interest Limitation</strong></td>
</tr>
</tbody>
</table>

| Amount of disallowed Interest Expense: $150 |

As shown above, in applying the statutory language, S will have $150,000 of business interest that will not be allowed as a deduction by reason of section 163(j). Accordingly, S would have a net taxable income of $2.65 million, instead of $2.5 million. Moreover, A will have $250,000 of interest income which could not be offset by $150,000 of disallowed business interest since, in accordance with the language of sections 163(j)(4)(D) and 163(j)(2), the disallowed business interest is kept at the level of S (as an

---

133 I.R.C. § 163(j)(8).
134 I.R.C. § 163(j)(1).
S corporation) and treated as business interest paid or accrued in the succeeding taxable year. 135

B. Recommendation

We recommend that Treasury and the Service promulgate rules in the Final Regulations under Proposed Regulation section 163(j)-6(n) akin to the Self-Charged Interest Rules in order to identify self-charged interest income and expense and further allow such self-charged interest income/expense to be excluded from the definition of BIE and BII under sections 163(j)(5) and (6), respectively. Further, as suggested in Proposed Regulation section 1.163(j)-3(b)(4), we recommend the Service retain the rule applying the limitation under section 163(j) prior to the application of the passive activity loss rules of section 469 (and the Regulations thereunder which include the Self-Charged Interest Rules) in the Final Regulations. The adoption of such rules should apply the same policies behind the Self-Charged Interest Rules to help avoid the inequitable treatment of such otherwise counterbalanced transactions. 136

C. Explanation

The above recommended rules could closely follow the language used within the Self-Charged Interest Rules under Regulation section 1.469-7, including the rules relating to applicability and the applicable percentage (which will be of particular importance in the non-solely owned S corporation and partnership context). 137 The envisioned application of the above recommended rule (in combination with the Self-Charged Interest Rules under section 469) to Example 1 above would allow A to deduct the self-charged interest expense of S against A’s self-charged interest income, thereby eliminating the additional phantom income that the limitation would otherwise produce.

VI. Application of Section 163(j) to Tiered Partnerships

A. Summary

The Preamble notes that guidance on the treatment of EBIE in tiered partnerships has been reserved in the Proposed Regulations. 138 Treasury and the Service requested comments regarding whether, in a tiered partnership arrangement, carryforwards should be allocated through upper-tier partnerships. 139 Additionally, Treasury and the Service requested comments regarding how and when an upper-tier partner’s basis should be adjusted when a lower-tier partnership is subject to a section 163(j) limitation. 140

---

135 See I.R.C. §§ 163(j)(2) and (4)(D).
137 See Reg. §§ 1.469-7(c)(1), (3) and (d)(1), (3).
139 Id.
140 Id.
B. Recommendation

We considered three approaches that Treasury and the Service could take: (i) an Entity Approach, (ii) an Aggregate Approach, and (iii) a Blended Approach that incorporates aspects of both the Entity Approach and the Aggregate Approach.

Under an Entity Approach, section 163(j) would be applied independently to each partnership. At each tier, EBIE that is not treated as paid or accrued or that has not given rise to a basis adjustment by a partnership would not be further allocated up the chain of ownership.

Under an Aggregate Approach, section 163(j) would be applied only by the borrowing partnership. Partners in the borrowing partnership that are partnerships would pass through EBIE amounts and basis adjustments to their partners. Only direct and indirect partners that are not partnerships would apply the carryover rules in section 163(j)(4) and would account for indirect shares of EBIE from a lower tier partnership or partnerships.

Finally, under a Blended Approach, partners that are partnerships would apply the section 163(j)(4) carryover rules but would also pass through EBIE amounts and basis adjustments to upper tier partners.

We believe both the Entity Approach and the Aggregate Approach are administrable and reasonably implement Congressional intent to apply section 163(j) at the partnership level. Both approaches require the allocation of section 163(j) items by all partnerships in a tiered structure. On balance, the Entity Approach reflects the stronger allegiance to the entity treatment of partnerships for purposes of section 163(j), and because the approach centers a significant portion of the compliance effort with partnerships rather than partners, the Entity Approach may increase compliance and simplify Service review. While the Aggregate Approach avoids certain temporary basis disparities, it also requires meaningful compliance efforts be undertaken by the ultimate partners. For these reasons, although we believe that both approaches are reasonable, we slightly favor the Entity Approach and recommend that EBIE carryforward amounts allocated to and maintained as EBIE pursuant to section 163(j)(4)(B)(i)(II) by a partner that is a UTP, and any corresponding reductions pursuant to section 163(j)(4)(B)(iii)(I) in the adjusted basis of a UTP’s interest in an LTP, not be immediately allocated to and taken into account by the partners of UTP. Only EBIE that is treated as “paid or accrued” by UTP and that is determined either to be deductible or nondeductible by UTP (EBIE from LTP that has become EBIE at UTP) should be allocated by UTP to UTP’s partners, including any UTP partners that are partnerships. Similarly, the tax basis of the interests and the capital accounts of the UTP partners in their UTP interests should not be adjusted for amounts of EBIE allocated to UTP. Once UTP has treated the EBIE as paid or accrued, the tax basis of the interests and the capital accounts of the UTP partners, including any UTP partners that are partnerships, may then be adjusted.
C. Explanation

1. Background

Under section 163(j)(4)(A), the section 163(j) limitation on the deduction of BIE is applied by any partnership. Section 163(j)(4)(A) also describes the impact of the limitation: (i) any amount of BIE that is deductible is taken into account as a part of partnership non-separately stated taxable income, and (ii) any amount for which a deduction is not allowed is treated as EBIE that is allocated to the partners in the same manner as non-separately stated taxable income. Under section 163(j)(4)(B)(ii)(I), EBIE is treated as business interest paid or accrued by the partner in the next succeeding taxable year in which the partner is allocated ETI (or EBII) from such partnership, but only to the extent of such ETI or EBII. Finally, section 163(j)(4)(B)(iii)(I) provides that the adjusted basis of a partner’s partnership interest is reduced (but not below zero) by the amount of EBIE allocated to the partner under section 163(j)(4)(B)(ii)(I).

Section 163(j)(4) does not appear to rely upon existing rules in subchapter K to address the allocation of EBIE or the impact of EBIE on outside basis; rather, section 163(j)(4) appears to provide separate rules for the allocation of EBIE and for a corresponding basis reduction that operate independently of the existing rules of subchapter K, as well as special rules that a partner that is allocated EBIE must apply to determine its deductibility. Under this view, EBIE at LTP may be treated by LTP as “an expenditure not deductible in computing its taxable income and not properly chargeable to a capital account” under section 705(a)(2)(B), but EBIE allocated to a partner may nonetheless be deductible by the partner. For this reason, the existing rules in subchapter K governing distributive share items do not apply in a traditional manner to EBIE. Stated differently, an allocated EBIE amount seems to be held in suspense by the partner, awaiting to be treated as paid or accrued or to be added to basis by the partner on a disposition of the partner’s interest. The Preamble’s discussion of EBIE allocated to a consolidated group member seems to confirm this unique aspect of EBIE.

Additionally, proposed §1.163(j)-4(d) would provide that a member’s allocation of excess business interest expense from a partnership and the resulting decrease in basis in the partnership interest under section 163(j)(4)(B) is not a noncapital, nondeductible expense for purposes of §1.1502-32(b)(3)(iii). Similarly, an increase in a member’s basis in a partnership interest under section 163(j)(4)(B)(iii)(II) because of a disposition of a partnership interest with respect to which there is an EBIE amount] to reflect excess business interest expense not deducted by the consolidated group is not tax-exempt income for purposes of §1.1502-32(b)(3)(ii). These special rules are intended to ensure that the allocations

143 Prop. Reg. § 1.163(j)-6(g)(2)(i) mirrors the statutory provision.
144 Section 163(j)(4)(B)(iii)(I) may have been needed to provide a basis adjustment for the amount of BIE at a time its deductibility or nondeductibility cannot be definitively determined.
and basis adjustments under proposed §1.163(j)-6 do not result in investment adjustments within the consolidated group. This result is appropriate because the application of the proposed §1.163(j)-6 rules does not result in a net reduction in the tax attributes of the member partner; rather, there is an exchange of one type of attribute for another (excess business interest expense allocated from the partnership vs. basis in the partnership interest). 145

Applied to tiered partnerships, this last sentence would provide that the partner in LTP is properly viewed as exchanging, at least temporarily, one attribute (tax basis in the partnership interest) for a different attribute (an EBIE amount, which, in the future, could support either a deduction or a basis adjustment). If this interpretation is correct, EBIE allocated to a partner in LTP may not be definitively a non-deductible, noncapitalizable expense of LTP for which a basis adjustment is required under section 705.

Arguably, to the extent EBIE allocated to UTP has not yet been treated as paid or accrued by UTP, it is not definitively an item of deduction in the hands of UTP subject to further allocation by UTP. The language of the Preamble seems to support the view that EBIE and any corresponding basis adjustments are not controlled by the existing rules of subchapter K. If this support was intended, further confirmation would be helpful.

2. The Entity Approach

As stated above, section 163(j)(4)(A) states, that in the case of any partnership, section 163(j) applies at the partnership level. Under the Entity Approach, EBIE amounts would be maintained only by the direct partners of a partnership, including any partners that are partnerships, and would not be further allocated by UTP to UTP’s partners. Similarly, any corresponding basis reduction that UTP partners might make with respect to their interests in UTP would await a “paid or accrued” determination by UTP.146

Example 5: X and Y are equal partners in UTP, and each has a $50 basis in its UTP interest. UTP and Z are equal partners in LTP, and each has a $100 basis in its LTP interest. In Year 1, LTP has $60 of BIE, $0 of BII, 145 83 Fed. Reg. at 67,500 (2018) (Emphasis added).

146 The Entity Approach is in some tension with the general principle that the presence of additional partnerships in a chain of ownership ought not change the tax consequences to the partners. For example, if the Entity Approach is adopted, a corporate partner in UTP would not have a corresponding earnings and profits (“E&P”) adjustment until the EBIE of LTP is treated as paid or accrued at UTP and allocated to the UTP partners, including the corporate partner, as deductible BIE or EBIE. Prop. Reg. § 1.163(j)-4(c)(1) provides that a disallowance and carryforward of a deduction for the taxpayer’s BIE will not affect whether or when the taxpayer reduces its E&P for the BIE, whether deductible BIE or EBIE. Similarly, Prop. Reg. § 1.163(j)-4(c)(3) provides that if a corporate partner has been allocated EBIE from a partnership and that EBIE has not been treated as BIE by the corporate partner at the time the corporate partner disposes of its interest, the corporate partner will increase its E&P by the EBIE. Under the Entity Approach, a direct corporate partner in LTP would reduce its E&P by the EBIE amount; however, because UTP does not allocate EBIE to its partners, an indirect corporate partner in LTP, i.e., a corporate partner in UTP, would not reduce its E&P by any portion of the EBIE amount. Although we recognize that this result may be in some tension with the Proposed Regulations, we believe this result is not inconsistent with the Proposed Regulations, as under the Entity Approach, a corporate partner in UTP has yet to be allocated either deductible BIE or EBIE from UTP to cause a reduction in E&P under Prop. Reg. § 1.163(j)-4(c).
and $0 of ATI. LTP’s section 163(j) limitation is $0, and all of LTP’s $60
of BIE is EBIE that is allocated equally to its partners, UTP and Z. UTP
carries forward the $30 of EBIE and reduces its basis in its LTP interest by
$30. At the end of Year 1, UTP has an EBIE amount of $30 and a $70
basis in its LTP interest. UTP has no other items of income or deduction.
Under the Entity Approach, UTP would not allocate its EBIE to its
partners, and neither X nor Y would account for an indirect share of
LTP’s EBIE amount and would not reduce its basis in its UTP interest in
Year 1.

Under section 163(j)(4)(B)(iii)(I), a UTP partner may only reduce its basis by
the amount of EBIE that is allocated to the partner under section 163(j)(4)(B)(i)(II). The
amount of EBIE allocated to a partner under section 163(j)(4)(B)(i)(II) is equal to the
amount of business interest not allowed as a deduction to a partnership for any taxable
year by reason of the limitation in section 163(j)(1). Under the Entity Approach, because
EBIE has not been treated as paid or accrued by UTP, it cannot have not been determined
to be nondeductible by UTP, and because a partner is only entitled to a basis adjustment
for an allocable share of an EBIE amount determined to be nondeductible, a UTP partner
may not reduce its UTP basis.

As the facts of Example 5 illustrate, the Entity Approach results in a temporary
basis disparity between UTP’s basis in its LTP interest ($70) and the aggregate basis that
UTP partners have in their UTP interests ($100). The basis disparity arises because, as to
UTP, the EBIE amount is held in suspense because it is not yet treated as paid or accrued
by UTP. The basis disparity will be resolved in one of two ways. First, in a later year, if
UTP is allocated sufficient ETI or EBII from LTP, UTP will be able to treat the EBIE as
paid or accrued. UTP would allocate the deductible BIE to the UTP partners, and the
UTP partners would reduce their basis in UTP by the deductible BIE and the
nondeductible amount (i.e., EBIE at the UTP level) at that time under the existing rules of
subchapter K. As shown by Example 6, the basis disparity has been eliminated.

**Example 6:** Assume the same facts as Example 5, but in Year 2, LTP has
$0 of BIE, $0 of BII, and $160 of ATI. The $160 of LTP ATI becomes
ETI of LTP, and LTP allocates $80 of ETI to each of UTP and Z. UTP’s
basis in LTP is increased by the $80 allocation from $70 to $150. The
$80 of ETI allocated to UTP causes the $30 of EBIE carried forward by
UTP from Year 1 to be treated as paid or accrued by UTP. UTP has no
standalone items to include it its ATI. Thus, UTP’s section 163(j)
limitation in Year 2 equals $24 ($80 * 30 percent), and UTP treats $24 of
the BIE as deductible BIE and includes the amount in non-separately
stated taxable income. UTP allocates its Year 2 distributive share of
taxable income of $56 ($80 of distributive share from LTP, reduced by

---

147 As noted above, the normal basis adjustment rules of section 705 apply except, perhaps, for allocations
of EBIE, which might be governed by section 163(j)(4)(B)(iii)(I). For ease of discussion, however, the
examples in this Part VI.C. refer to adjustments to the partners’ basis as a result of allocations by the
allocating partnership.


$24 of deductible BIE) equally between X and Y ($28 each). The remaining nondeductible business interest of $6 becomes EBIE at UTP in Year 2, and UTP allocates $3 of EBIE to each of X and Y. In Year 2, X’s and Y’s aggregate basis in UTP is increased by $50 (from $100 to $150). That increase reflects the $80 of income from LTP and $30 of reduction (i.e., $24 of deductible BIE and $6 of EBIE). The aggregate outside basis of X and Y now equals UTP’s basis in its LTP interest ($150).

Second, the basis disparity can be resolved in connection with UTP’s disposition of its LTP interest. Thus, if UTP were to dispose of its LTP interest on day 1 of Year 2, before being allocated sufficient ETI or EBII from LTP to permit UTP to treat the EBIE as paid or accrued, UTP would, in effect, exchange EBIE for an increase in the tax basis of its LTP interest immediately before the disposition pursuant to section 163(j)(4)(B)(iii)(II). This basis increase would reduce UTP’s gain (or increase its loss) from the sale of the interest. UTP’s allocation of the gain or loss to X and Y would eliminate the disparity between UTP’s basis in its LTP interest and the aggregate basis that X and Y have in their UTP interests. For example, if UTP sold its LTP interest on the first day of Year 2 for $70, UTP would increase its basis in LTP from $70 to $100 immediately before the sale and would recognize a $30 loss on the sale of the interest. X’s and Y’s distributive share of that loss would reduce their aggregate outside basis to $70, causing the aggregate amount of X’s and Y’s basis in their UTP interests to equal the amount of cash UTP has after the sale.

The basis disparity between UTP’s basis in its LTP interest and the aggregate of the UTP partners’ bases in their UTP interests will be eliminated by an allocation of deductible interest, an allocation of EBIE, or an allocation of reduced gain (or increased loss). The preservation of outside basis by X and Y in their UTP interests until such time is consistent with the conclusion that the amount has not yet been treated as paid or accrued by UTP.

It should be noted that not reducing X’s and Y’s bases in their UTP interests for their indirect shares of an EBIE amount at UTP under the Entity Approach means that the basis of X’s and Y’s interest in UTP should not be increased in the event of a sale by X or Y of their interest in UTP. To achieve a result for a sale of an interest by a partner of UTP consistent with the result that arises where UTP sells its interest in LTP, Final Regulations under the Entity Approach (under which the UTP partners do not increase or decrease their basis) could adopt a rule requiring that a portion of a transferring partner’s outside basis equal to the amount by which the partner’s basis would have been increased had the partner been treated as receiving an allocation of EBIE and been eligible to increase its basis treated as “a basis increase” within the meaning of section 163(j)(4)(B)(iii)(II). The transferor of an interest in UTP and the transferee would then be denied a deduction for BIE to that extent. Under the Entity Approach, as of the time of the sale, a final determination of the deductibility of the EBIE amount to UTP has not yet occurred, and subsequent to the sale, LTP may generate ETI or EBII resulting in a deduction to UTP that would be allocated to a buyer of a UTP interest. That future deduction may not be addressed by existing provisions in subchapter K that police loss duplication, such as section 743(b) or (d).
3. Aggregate Approach

As noted above, we also considered an Aggregate Approach, under which an EBIE amount originating at LTP would pass through an intermediate partnership or partnerships and would be taken into account only by the first non-partnership taxpayer. That taxpayer would determine whether the EBIE amount was properly treated as paid or accrued, as deductible or nondeductible, or whether the amount should be added to the taxpayer’s basis by reference to amounts of ETI or EBII allocated to it indirectly from the originating partnership (i.e., LTP). The ultimate partner would base its determination whether the EBIE amount is properly treated as paid or accrued solely upon allocations of ETI or EBII that are passed through from that same partnership.

Example 7: Assume the same facts as Example 5 for Year 1. Under the Aggregate Approach, UTP allocates the $30 of EBIE equally to X and Y, and X and Y each reduce the basis of their interests in UTP by $15. At the end of Year 1, UTP maintains no EBIE amount and has a $70 outside basis in its LTP interest. X and Y each maintain a $15 EBIE amount, and each has a $35 basis in its interest in UTP.

In Year 2, LTP has $120 of ATI. The $120 of LTP ATI becomes ETI of LTP, and LTP allocates $60 of ETI to each of UTP and Z. UTP’s basis in LTP is increased by the $60 allocation from $70 to $130. Assume, unlike the case in Example 5, that UTP has $40 of standalone ATI. The $60 of ETI allocated to UTP does not become ATI at UTP. UTP allocates $60 of ETI from LTP, and $40 of standalone ATI from UTP, which became ETI of UTP, equally to X and Y. That is, UTP allocates $30 of the LTP ETI and $20 of UTP ETI to each of X and Y.

The $30 of LTP ETI allocated to each of X and Y causes the $15 of EBIE carried forward from Year 1 to be treated as paid or accrued by X and Y. X and Y are also each allocated $20 of ETI from UTP. That ETI becomes ATI to X and Y. X and Y’s section 163(j) limitation with respect to LTP BIE of $15 is $15 ($50 * 30 percent), and X and Y each treat all of the $15 of BIE treated as paid or accrued as deductible BIE.

In Year 2, the aggregate of X’s and Y’s basis in UTP is increased by $160 (from $70 to $230). That increase reflects the $120 of ETI from LTP and $40 of ETI from UTP. The aggregate outside basis of X and Y now equals UTP’s basis in its LTP partnership interest ($190), plus $40, reflecting the earnings of $40 at UTP.

148 We note that allocating ETI directly from LTP to the ultimate partners in UTP may be interpreted as conflicting with Prop. Reg. § 1.163(j)-6(e)(1) that defines ATI of a partner to include ETI allocated from the partnership. Accordingly, we note that if the Final Regulations adopt the Aggregate Approach, either Prop. Reg. § 1.163(j)-6(e)(1) should be modified and/or separate rules for non-tiered and tiered partnership structures should be provided, though separate regimes also may lead to inadvertent noncompliance.
To apply section 163(j)(4) properly, the partners are entirely dependent upon receiving timely and accurate detailed information from every direct and indirect partnership in which it has an interest.149

Further, as stated above, under section 163(j)(4)(B)(iii)(I), a disposing partner that previously reduced its basis in its partnership interest is entitled to increase the basis of the interest sold by the cumulative EBIE allocated to it that has not been previously treated as paid or accrued. As a result, either the intervening partnerships would be required to track and maintain records of such amounts from each LTP in which it held a direct or indirect interest or the ultimate partners would have to adjust any gain or loss allocated to them by such EBIE (i) to determine gain or loss on the sale of the interest, and (ii) to determine the appropriate deduction disallowance. This information would also need to be provided to the transferee. We are concerned that this may lead to inadvertent noncompliance or errors, especially in complex partnership structures or structures with multiple borrowing partnerships.

4. Blended Approach

We believe either the Entity Approach or the Aggregate Approach is superior to the Blended Approach that would both apply section 163(j) at the partnership level and would pass EBIE amounts and basis adjustments through to UTP partners, primarily because of the need to make correcting adjustments that the Blended Approach would create.

Correcting adjustments would be needed under the Blended Approach because downward basis adjustments arising from tiering up EBIE amounts would, if not reversed, be duplicated later when an EBIE amount is treated as paid or accrued by UTP or UTP disposes of its interest, and an actual allocation of the deduction or loss is made. Absent a correction, X’s and Y’s outside basis would reflect two reductions, one for the allocable share of EBIE and a second reflecting any allocation of (i) BIE determined to be deductible, (ii) LTP allocated EBIE that has become nondeductible EBIE at UTP, or (iii) a distributive share of decreased gain or increased loss. The need for additional adjustments strongly suggests that the Blended Approach is inferior and significantly more complex.

5. Conclusion

We believe either an Entity Approach or an Aggregate Approach can achieve Congressional intent to apply limit interest deductibility through the application of section 163(j) to partnerships. The ultimate determination of which approach is more appropriate rests, in large part, on one’s view of whether partners are better able to

---

149 The Aggregate Approach is in some tension with the express application of 163(j)(4)(A) to any partnerships and existing subchapter K rules requiring partnerships to compute taxable income in the same manner as individuals and providing conduit treatment for items the deductibility of which is determined by the partner.
comply with the provision. The Entity Approach places more of that burden on partnerships, and the Aggregate Approach places more of the burden on partners.

VII. Partnership Mergers and Divisions

A. Summary

The Proposed Regulations provide no guidance relating to the application of section 163(j) in the context of partnership mergers and divisions.\(^{150}\) Because the partnership merger and division rules under section 708 may treat a partnership as terminating or continuing, clarifying rules in the Final Regulations are necessary to address EBIE carryforwards and excepted trade or business elections under section 163(j).

B. Recommendation

We recommend that the Final Regulations clarify that: (i) the carryforward rule in Proposed Regulation section 1.163(j)-6(g) applies to partners of partnerships treated as a continuing partnership in a partnership merger or division; (ii) the disposition rule of Proposed Regulation section 1.163(j)-6(h)(3)(i) applies to partnership interests that are treated as liquidated in a partnership merger or division; and (iii) confirm, perhaps through examples, the application of the excepted trade or business election and termination rules in Proposed Regulation section 1.163(j)-9 in the context of a partnership merger or division.

C. Explanation

1. Partnership Mergers

With respect to a carryforward of EBIE of a partner of a partnership treated as continuing under the partnership merger rules, the Final Regulations should clarify a clarification should be added in the Final Regulations. Such EBIE carryforward will generally remain subject to the carryforward rule in Proposed Regulation section 1.163(j)-6(g). Thus, the EBIE carryforward will be treated as paid or incurred in a succeeding taxable year when ETI or EBII is allocated from that same continuing partnership to the partner. A clarification to Proposed Regulation section 1.163(j)-6(g) should be included in the Final Regulations to provide that the carryforward rules apply to a partnership treated as continuing after a partnership merger.

However, if a partner of a terminated partnership has an unused carryforward of EBIE at the time of termination, it is not clear under the Proposed Regulations what happens to the partner’s unused carryforward. In the absence of a special rule, it would seem that the partner is treated as disposing of its interest under Proposed Regulation section 1.163(j)-6(h)(3)(i) because the partnership is treated as terminating for federal income tax purposes, making a liquidating distribution to the partner under either an

\(^{150}\) See Prop. Reg. § 1.163(j)-6(k). The Service and Treasury state that comments are requested.
assets-over or assets-up form. We believe that this is a reasonable result, but we believe that a more appropriate result would require the partner of a terminated partnership to carry forward the amount to its interest in the continuing partnership, providing parity between the terminated and continuing partnerships. In either case, we recommend that the Final Regulations clarify the treatment of a partner’s EBIE carryforward with respect to a partnership that terminates in a merger or consolidation.

With respect to a partnership’s excepted trade or business election, no additional rules are needed in connection with a partnership merger or consolidation. Where a partnership is treated as continuing in a partnership merger, the trade or business for which the partnership made an election to treat as an excepted trade or business is also continuing. Thus, the election should remain in place. Where a partnership is treated as terminating in a merger, for federal income tax purposes (and thus for purposes of section 163(j)), the terminated partnership’s excepted trade or business election should terminate.\footnote{See Prop. Reg. § 1.163(j)-9(d)(1).} An example illustrating the application of the excepted trade or business election rules to a partnership or merger or consolidation would be helpful.

2. Partnership Divisions

The Final Regulations should clarify how the carryforward rule of Proposed Regulation section 1.163(j)-6(g) applies where a resulting partnership is treated as a continuation of the prior partnership in a partnership division. Under this recommendation, where a partner in any resulting partnership was a partner in the prior partnership and had an unused carryforward of EBIE with respect to the prior partnership, the partner should treat its carryforward of EBIE as paid or accrued when allocated ETI or EBII from the resulting partnership. (While a rule apportioning the carryforward amount only among continuing partnerships could also be reasonable, we believe that a rule providing parity between continuing partnerships and new partnerships will be more often equitable.) Absent such clarification, it is arguable that the resulting partnership could be viewed as not being the same partnership as the prior partnership for purposes of Proposed Regulation section 1.163(j)-6(g)(2)(i).

Additional clarifications in the Final Regulations would be helpful to address a partner’s carryforward of EBIE with respect to a prior partnership, where, after a partnership division, the partner is a partner in a resulting partnership that is not a continuation of the prior partnership. Where a resulting partnership is not a continuation of the prior partnership, the resulting partnership cannot be the divided partnership. If the resulting partnership is not the divided partnership, under the division rules, the partnership is treated as a new partnership. As such, under either an assets-over or assets-up division, the partner is treated as partially or completely liquidating its interest in the prior partnership, either in exchange for interests in the resulting partnership (in an assets-over division) or in exchange for certain assets followed by a contribution by the partner

\footnote{See Prop. Reg. § 1.163(j)-9(d)(1).}
of such distributed assets to the new partnership (in an assets-up divisions). In the absence of a special rule, it would seem that a partner who is fully redeemed from the divided partnership is treated as disposing of its interest under Proposed Regulation section 1.163(j)-6(h)(3)(i) because that partner’s interest has been fully liquidated for federal income tax purposes, while a partner who receives a distribution from the divided partnership, but continues as a partner in the divided partnership would continue to have a carryforward of EBIE with respect to the divided partnership. As with partnership mergers, we believe that this is a reasonable result, but we believe that a more appropriate result would require the partner who is fully redeemed from a divided partnership to carry forward the amount to its interest in the resulting partnership, providing parity between the divided and resulting partnerships. If the partner retains an interest in the divided partnership, we recommend that the partner be permitted to apportion the carryforward amount between the divided partnership and any other resulting partnership using any reasonable method. Alternatively, the Final Regulations could provide that the carryforward amount is apportioned based either on tracing principles or on relative fair market value of the retained partnership interests; however, we believe that requiring tracing or valuation would be difficult to administer and could frequently lead to inequitable results. In either case, we recommend that the Final Regulations clarify the treatment of a partner’s EBIE carryforward with respect to a partnership that divides under section 708(b)(2)(B).

With respect to a partnership’s excepted trade or business election, no additional rules are needed in connection with a partnership division. Regulation section 1.708-1(d)(2)(ii) provides that all resulting partnerships regarded as a continuation are subject to preexisting elections made by the prior partnership. Thus, a prior partnership’s election with respect to an excepted trade or business should continue to apply to any resulting partnership that is considered a continuation of the prior partnership. However, where the resulting partnership in a division is not treated as a continuation of the prior partnership, the partnership should be treated as a new partnership eligible to make its own elections, including the election to treat a trade or business as an excepted trade or business under the Proposed Regulations, if applicable. An example illustrating the

See Reg. § 1.708-1(d)(3). Under an assets-over division, where at least one resulting partnership is a continuation of the prior partnership, the “divided partnership distributes the interests in such recipient partnership or partnerships to some or all of its partners in partial or liquidation of the partners’ interests in the divided partnership.” Reg. § 1.708-1(d)(3)(i)(A). Where no resulting partnership is a continuation of the prior partnership in an assets-over division, the “prior partnership will be treated as liquidating by distributing the interests in the new resulting partnerships to the prior partnership’s partners.” Reg. § 1.708-1(d)(3)(i)(B). Under an assets-up division, where at least one resulting partnership is a continuation of the prior partnership, the divided partnership “distributes certain assets . . . to some or all of its partners in partial or complete liquidation of the partners’ interests in the divided partnership, and immediately thereafter, such partners contribute the distributed assets to a recipient partnership or partnership in exchange for interests in such recipient partnership or partnerships.” Reg. § 1.708-1(d)(3)(ii)(A). Where no resulting partnership is a continuation of the prior partnership in an assets-up division, in general, the prior partnership is treated as “distributing certain assets . . . to some or all of its partners in partial or complete liquidation of the partners’ interests in the prior partnership, and immediately thereafter, such partners contribute the distributed assets to a resulting partnership or partnerships in exchange for interests in such resulting partnership or partnerships.” Reg. § 1.708-1(d)(3)(ii)(B).
application of the excepted trade or business election rules to a partnership division would be helpful.

VIII. Methods of Allocating Partnership Section 163(j) Items to the Partners

A. Summary

As stated above, section 163(j)(4)(A)(ii)(II) provides that a partner’s ETI is determined in the same manner as the non-separately stated taxable income or loss of the partnership. Similarly, section 163(j)(4)(B)(i)(II) provides that EBIE and EBII are also allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership. As the Preamble notes, the phrase “non-separately stated taxable income or loss of the partnership” is not defined in section 163(j) and has not previously been defined by statute or regulations. Moreover, the Preamble notes that the phrase “in the same manner as” is also undefined.

For purposes of allocating deductible BIE and section 163(j) excess items, the Proposed Regulations provide an 11-step calculation to implement the five considerations outlined by Treasury and the Service in the Preamble. The five issues that Treasury and the Service attempted to address with the 11-step calculation are:

1. section 163(j) is applied at the partnership level;
2. a partnership cannot have both ETI (or EBII) and EBIE in the same taxable year;
3. parity must be preserved between a partnership’s deductible BIE and section 163(j) excess items and the aggregate of each partner’s share of deductible BIE and section 163(j) excess items from such partnership;
4. if in a given year a partnership has both deductible BIE and EBIE, a partnership should not allocate EBIE to a partner to the extent such partner was allocated the items comprising ATI (or BII) that supported the partnership’s deductible BIE; and
5. if in a given year a partnership has ETI (or EBII), only partners allocated more items comprising ATI (or BII) than necessary to support their allocation of BIE should be allocated a share of ETI (or EBII).

According to the Preamble, the 11-step calculation “preserves requirement set forth in section 163(j)(4), while also preserving the economics of the partnership and respecting any special allocations made by the partnership in accordance with section 704 and the [R]egulations thereunder.”

---

155 Id.
The 11-step calculation provides a framework for a partnership to allocate section 163(j) items to its partners that takes into account the varying economic arrangements, including special allocations. At the conclusion of the 11-step calculation, the total amount of deductible BIE and section 163(j) excess items allocated to each partner will equal the partnership’s total deductible BIE and section 163(j) excess items. Generally, under the 11-step calculation the partnership first requires a partnership-level calculation of its section 163(j) limitation and then determines how the items comprising ATI, BIE, and EBII are allocated to the partners for section 704(b) purposes. The partnership then determines which partners are deemed to receive allocations of EBIE, ETI, or BII, as the case may be, through a series of calculations that are intended to allocate items among partners and correct distortions that may otherwise arise as a result of differing allocations of section 704(b) items among the partners.

Treasury and the Service requested comments on the 11-step calculation. Specifically, Treasury and the Service requested comments regarding other reasonable methods to allocate deductible BIE, ETI, and EBIE in a manner that permits partners that bear the taxable income supporting the deductible BIE to be allocated a disproportionate share of deductible BIE and ETI.

B. **Recommendation**

We recommend that the Final Regulations provide that a taxpayer may adopt any reasonable method to allocate deductible BIE, ETI, EBII, and EBIE among the partners, provided the method does not produce results inconsistent with the application of section 163(j) at the partnership level as articulated by the goals in the Preamble. We also recommend that the Final Regulations provide that the use of the 11-step calculation to allocate deductible BIE, ETI, EBII, and EBIE among the partners constitutes a reasonable method.

C. **Explanation**

In considering potential approaches to implement the policy goals of section 163(j), the Preamble notes that a commentator proposed a manner for allocating section 163(j) excess items that would require a partnership to allocate each section 163(j) excess item (for example, EBIE) in the same proportion as its underlying section 163(j) item (BIE).

The Preamble specifically discusses the application of the 11-step calculation and notes that “[i]n situations where the partnership does not allocate all of its section 163(j) items pro rata, such as this example, [allocating section 163(j) excess items in proportion]

---

156 Prop. Reg. § 1.163(j)-6(f)(2). See also Prop. Reg. § 1.163(j)-6(o), Ex. (11) through Ex. (15).


to the underlying section 163(j) item] could require a partnership to allocate its section 163(j) excess items in a manner inconsistent with the Treasury Department and the Service’s resolution of issues four and five. Because this approach could require a partnership to arguably allocate inappropriate amounts of section 163(j) excess items to its partners, it is not adopted in these [P]roposed [R]egulations.” The Preamble highlights two of its five policy goals in implementing the 11-step calculation: allocating deductible BIE (rather than EBIE) to a partner who was allocated items comprising ATI that supported the partnership’s deductible BIE and allocating ETI (or EBII) to a partner who was allocated more items comprising ATI (or BII) than necessary to support the partner’s allocation of deductible BIE.

A similar issue arises in the context of allocations of items of income, gain, deduction, and loss under section 704(c).

Example 8: Partnership AB allocates items equally to A and B, subject to the application of section 704(c). Partnership AB has $100 of ATI comprised of gain on the sale of an asset. Because A contributed the asset to Partnership AB and the asset had a remaining section 704(c) amount of $60 at the time of sale, $60 of gain is specially allocated to A, and the remaining $40 of gain is allocated equally to A and B. Thus, A is allocated a total of $80 of ATI, and B is allocated a total of $20 of ATI. Partnership AB also has $50 of BIE that it allocates $25 each to A and B. Partnership AB’s section 163(j) limit is $30, resulting in $30 of deductible BIE and $20 of EBIE. If the deductible BIE and the EBIE are allocated based on the economic sharing percentages of Partnership AB, A and B would each be allocated $15 of deductible BIE and $10 of EBIE even though A is allocated a disproportionately high amount of ATI due to the application of section 704(c).

Applying the 11-step calculation, however, A is allocated $24 of deductible BIE and $1 of EBIE while B is allocated $6 of deductible BIE and $19 of EBIE. Because A is allocated 80 percent of the ATI, it is consistent with the policy goals that A is also allocated 80 percent of deductible BIE.

This result is consistent with the goal of “preserving the economics of the partnership and respecting any special allocations made by the partnership in accordance with section 704 and the [R]egulations thereunder.” Although a reasonable method of allocating A deductible BIE based on A’s share of ATI would have produced the same result, a similar result may not occur in all scenarios. Thus, the 11-step calculation, though meaningfully more complex for some taxpayers, is an appropriate method to ensure that the policy goals outlined by Treasury and the Service in situations in which special allocations and/or section 704(c) allocations are present.

---


160 See Appendix A, for a detailed summary of the calculation.

Although the use of the 11-step calculation may properly implement the underlying policy of section 163(j), it is extremely complex, and its application may not be necessary to achieve appropriate results in all cases.\textsuperscript{162} Congress acknowledged this possibility in the Tax Technical and Clerical Corrections Act Discussion Draft (the “Technical Corrections Draft”) that provides allocation rules for allocating a partner’s distributive share of such partnership’s disallowed business interest, EBII, and ETI to the partner.\textsuperscript{163} This proposed amendment would provide that disallowed business interest is allocated in the same manner as the items of interest expense of the partnership.\textsuperscript{164} EBII is allocated in the same manner as the items of interest income of the partnership.\textsuperscript{165} ETI is allocated in the same manner as the items that comprise taxable income or loss of the partnership (taken together, the “Proportionate Allocation Method”).\textsuperscript{166} For certain taxpayers, the Proportionate Allocation Method arrives at the same result as the 11-step calculation without the additional complexity.

**Example 9:** Partnership AB allocates items equally to A and B, subject to the application of section 704(c). Partnership AB has $100 of ATI comprised of gain on the sale of an asset. Because the asset was not section 704(c) property, the $100 of gain is allocated equally to A and B. Partnership AB also has $50 of BIE that it also allocates $25 each. Partnership AB’s section 163(j) limit is $30, resulting in $30 of deductible BIE and $20 of EBIE. If the deductible BIE and the EBIE are allocated based on the underlying sharing percentage of Partnership AB, each of A and B is allocated $15 of deductible BIE and $10 of EBIE.

Applying the 11-step calculation, the same result occurs.\textsuperscript{167}

Accordingly, for those taxpayers, a different method, such as the Proportionate Allocation Method, may be more appropriate. Although the Preamble notes that, in certain situations, Proportionate Allocation Method may be incompatible with the underlying goals of the Proposed Regulations, the Preamble does not state that in all cases the Proportionate Allocation Method would be incompatible. Thus, the Proportionate Allocation Method may qualify as a reasonable method in certain situations.

Moreover, as Treasury and the Service indicate, a variety of other allocation methods may be more reasonable in certain situations. For example, the Final Regulations could adopt an approach that permits the partnership to allocate deductible BIE and EBIE in a manner that is reasonably consistent with the underlying section

\textsuperscript{162} We have some concern that the complexity of the 11-step calculation may lead to noncompliance if its application is mandatory.

\textsuperscript{163} Technical Corrections Draft, section 163(j)(4)(H).

\textsuperscript{164} Technical Corrections Draft, section 163(j)(4)(H)(i).

\textsuperscript{165} Technical Corrections Draft, section 163(j)(4)(H)(ii).

\textsuperscript{166} Technical Corrections Draft, section 163(j)(4)(H)(iii).

\textsuperscript{167} See Appendix B, for a detailed summary of the calculation.
704(b) items. Thus, a partnership could allocate the section 163(j) based on the allocation of the underlying interest expense, notwithstanding that the partner may be allocated a disproportionately high amount of ATI due to the application of section 704(c) or other special allocations. Alternatively, in the case of nonrecourse debt, the section 163(j) items could be allocated in a manner that is reasonably consistent with some other significant item of partnership income or gain that has substantial economic effect, provided those allocations are related to allocations with respect to the property securing the debt.168 Although we note that prescribing one or a few methods may not appropriately address all situations, no matter what method is chosen, the allocations must be respected under section 704(b).

Thus, we recommend that Treasury and the Service permit taxpayers to choose and implement a reasonable method that is most appropriate to the taxpayer’s specific situation in “preserving the economics of the partnership and respecting any special allocations made by the partnership in accordance with section 704 and the [R]egulations thereunder.”169 Use of a reasonable method, with certain methods prescribed as presumed reasonable, is consistent with other allocation provisions in Subchapter K.170 In addition, allowing taxpayers to choose a reasonable method in consistent with the purposes of Subchapter K of permitting taxpayers to conduct joint business activities through a flexible economic arrangement, including one in which the partnership incurs debt and allocates the debt, and underlying items of income, gain, deduction, or loss, in a manner that reflects the economic arrangement of the parties. Regardless of the method chosen, the Final Regulations should make clear that the method will not be reasonable if it produces results inconsistent with the application of section 163(j) at the partnership level as articulated by the goals in the Preamble. For example, the method will not be


170 See, e.g., Reg. § 1.704-2(h) (“A partnership may use any reasonable method to determine whether a distribution by the partnership to one or more partners is allocable to proceeds of a nonrecourse liability. The rules prescribed under § 1.163-8T for allocating debt proceeds among expenditures (applying those rules to the partnership as if it were an individual) constitute a reasonable method for determining whether the nonrecourse liability proceeds are distributed to the partners and the partners to whom the proceeds are distributed.”); Reg. § 1.704-3(a)(1) (“Notwithstanding any other provision of this section, the allocations must be made using a reasonable method that is consistent with the purpose of section 704(c). For this purpose, an allocation method includes the application of all of the rules of this section (e.g., aggregation rules). An allocation method is not necessarily unreasonable merely because another allocation method would result in a higher aggregate tax liability. [Reg. §§ 1.704-3(b), -3(c), and -3(d)] describe allocation methods that are generally reasonable. Other methods may be reasonable in appropriate circumstances. Nevertheless, in the absence of specific published guidance, it is not reasonable to use an allocation method in which the basis of property contributed to the partnership is increased (or decreased) to reflect built-in gain (or loss), or a method under which the partnership creates tax allocations of income, gain, loss, or deduction independent of allocations affecting book capital accounts.”); Reg. § 1.752-3(b) (“[I]f a partnership holds multiple properties subject to a single nonrecourse liability, the partnership may allocate the liability among the multiple properties under any reasonable method. A method is not reasonable if it allocates to any item of property an amount of the liability that, when combined with any other liabilities allocated to the property, is in excess of the fair market value of the property at the time the liability is incurred.”)
reasonable if it results in the partnership allocating both ETI (or EBII) and EBIE in the same taxable year or if it results in a the amount of the partnership’s deductible BIE and section 163(j) excess items being different from the aggregate amount of each partner’s share of deductible BIE and section 163(j) excess items from such partnership.

Therefore, we recommend that the Final Regulations provide that a taxpayer may adopt any reasonable method to allocate section 163(j) items among the partners, provided the method does not produce results inconsistent with the application of section 163(j) at the partnership level as articulated by the goals in the Preamble. We also recommend that the Final Regulations provide that the application of the 11-step calculation constitutes a reasonable method.

IX. Competing Deduction Limitations under Sections 704(d) and 163(j)

A. Summary

Generally, a partner’s adjusted basis in its partnership interest is reduced by allocated items of partnership loss or deduction. A partner’s basis in its interest, however, cannot be reduced below zero. The Proposed Regulations provide coordination rules for the application of this limitation to deductible BIE and EBIE.

As described above, the adjusted basis of a partner in a partnership interest is reduced, but not below zero, by the amount of EBIE allocated to the partner pursuant to Proposed Regulation section 1.163(j)-6(f)(2). If a partner is subject to a loss limitation under section 704(d) and a partner is allocated losses from a partnership in a taxable year, the limited losses are grouped based on the character of each loss (each grouping of losses based on character being a “section 704(d) loss class”). If there are multiple section 704(d) loss classes in a given year, the partner apportions the limitation to each section 704(d) loss class proportionately. For purposes of applying this proportionate rule, any deductible BIE (whether allocated to the partner in the current taxable year or suspended under section 704(d) in a prior taxable year), any EBIE allocated to the partner in the current taxable year, and any EBIE from a prior taxable year that was suspended under section 704(d) (“negative section 163(j) expense”) makes up the same section 704(d) loss class (the “section 163(j) loss class”). Importantly, once the partner determines the amount of limitation on losses apportioned to the section 163(j) loss class, any deductible BIE is taken into account before any EBIE or negative section 163(j) expense.

Proposed Regulation section 1.163(j)-6(h)(2) provides that negative section 163(j) expense is not treated as EBIE in any subsequent year until such negative section 163(j) expense is no longer suspended under section 704(d). Consequently, an allocation of ETI

171 I.R.C. § 704(d)(1); Reg. § 1.704-1(d)(2).
172 Reg. § 1.704-1(d)(2).
173 Id.
or EBII does not result in the negative section 163(j) expense being treated as BIE paid or accrued by the partner. Further, unlike EBIE preventing a partner from including ETI in its ATI as described in section 163(j)(4)(B)(ii) (flush language), negative section 163(j) expense does not affect, and is not affected by, any allocation of ETI to the partner.\textsuperscript{174} Accordingly, any ETI allocated to a partner from a partnership while the partner still has a negative section 163(j) expense will be included in the partner’s ATI.\textsuperscript{175} However, once the negative section 163(j) expense is no longer suspended under section 704(d), it becomes EBIE, which is subject to the general rules in Proposed Regulation section 1.163(j)-6(g).\textsuperscript{176}

The rules of Proposed Regulation section 1.163(j)-6(h)(2) are intended to address situations in which a partner is subject to a limitation under section 704(d) and is also allocated ETI. Pursuant to Proposed Regulation section 1.163(j)-6(g), EBIE would otherwise be treated as paid or accrued by the partner in an amount equal to the ETI, but the partner’s basis in the partnership does not increase in an amount equal to the allocated ETI and, therefore, remains subject to the loss limitation in section 704(d). The approach taken in Proposed Regulation section 1.163(j)-6(h)(2) described above attempts to reconcile the competing deduction limitations imposed by sections 704(d) and 163(j) along with section 163(j) treating EBIE as paid or accrued by the partner when the partner is allocated ETI.

**B. Recommendation**

We recommend that the Final Regulations allow a partner that is allocated ETI to treat the portion of its negative section 163(j) expense attributable to EBIE as EBIE in a year in which it is allocated ETI to the extent the partner cannot utilize the ATI to deduct BIE at the partner level.

**C. Explanation**

In situations in which freeing EBIE would be unhelpful because of a section 704(d) limitation, the rules of Proposed Regulation section 1.163(j)-6(h)(2) treat ETI as ATI at the partner level. We believe this rule is helpful and should be included in the Final Regulations.

Some partners, however, may not have BIE from other sources. In those cases, ATI is not useful to the partner. Those partners would generally prefer to treat their negative section 163(j) expense as EBIE and utilize ETI in the current year even if the EBIE treated as paid or accrued in that year would continue to be not deductible because of a section 704(d) limit. Consider the following example.

\textsuperscript{174} Prop. Reg. § 1.163(j)-6(h)(2).
\textsuperscript{175} Id.
\textsuperscript{176} Id.
Example 10: X is a partner in PRS. At the beginning of Year 1, X has a zero basis in its interest in PRS.

In Year 1, PRS allocates to X $30 of loss, all of which is BIE. PRS has no other items. Since PRS does not have ATI, the BIE becomes EBIE. Because X has a zero basis, the EBIE is limited under section 704(d) and is treated as negative section 163(j) expense.

In Year 2, PRS allocates to X $1 of net loss, which consists of $100 of gross income and $101 of depreciation. The $100 of gross income is ETI. X does not have enough basis, however, for the Year 1 EBIE that was treated as negative section 163(j) expense to be EBIE in Year 2. Therefore, the ETI is treated as ATI in the partner’s hands. X has no BIE from other sources and the ATI is not used.

In Year 3, PRS allocates no items to X, but X contributes $31 to PRS. The contribution increases X’s basis in its PRS interest to $31, causing $31 of its negative section 163(j) expense to become EBIE in Year 3. X is not allocated any ETI in Year 3, however, and is not able to use any of its EBIE.

If our recommendation is adopted, however, in Year 2 X would have treated the negative section 163(j) attributable to its suspended EBIE as EBIE. This would have caused the EBIE to be treated as paid or accrued in Year 2 and all $30 would have become deductible under section 163(j). The deductible BIE, however, would still have been suspended under 704(d). In Year 3 when X contributed $31, the deductible BIE would have no longer been suspended by section 704(d).

X. The Effect of a Partial Disposition on a Partner’s Basis

A. Summary

Under section 163(j)(4)(B)(ii), if a partner is allocated EBIE from a partnership, the EBIE is treated as BIE paid or accrued by the partner in the next succeeding taxable year in which the partner is allocated ETI or EBII from the same partnership. In addition, section 163(j)(4)(B)(iii)(I) requires a partner to reduce its basis, but not below zero, by its share of EBIE. Under section 163(j)(4)(B)(iii)(II), when a partner disposes of a partnership interest, the adjusted basis of the partner’s interest is to be increased immediately before the disposition by the amount of remaining EBIE, that is, the excess (if any) of EBIE allocated to the partner that has not yet been treated as business interest paid or accrued by the partner. The statute does not address a disposition of a portion of a partner’s partnership interest (a “partial disposition”).

177 See also Prop. Reg. § 1.163(j)-6(g)(2)(i).
178 See also Prop. Reg. § 1.163(j)-6(h)(2).
Under the Proposed Regulations, if a partner disposes of all or substantially all of its partnership interest, the adjusted basis of the partnership interest is increased immediately before the disposition by the entire amount of remaining EBIE. If a partner disposes of less than substantially all of its interest in a partnership, the partner cannot increase its basis by any portion of the remaining EBIE (i.e., the No Basis Approach that is discussed in detail below). The Preamble states that Treasury and the Service considered alternative approaches and request comments to address the effect of partial dispositions on a partner’s basis.

B. Recommendation

We believe there are three approaches that Treasury and the Service could consider with respect to this issue: (i) the Sold Basis Approach, (ii) the No Basis Approach, and (iii) the Retained Basis Approach.

Under the Sold Basis Approach, a partner would increase its basis in the partnership interest sold by an amount of EBIE attributable to the interest sold.

Under the No Basis Approach of the Proposed Regulations, a partner would defer the basis increase for EBIE until a disposition of all or substantially all of its partnership interest.

Finally, under the Retained Approach, a partner would increase its basis in the partnership interest retained by an amount of EBIE attributable to the interest sold.

We recommend that the Final Regulations require a partner to increase its basis in the portion of the partnership interest that is sold by an amount of the EBIE that bears the same relation to the partner’s total EBIE as the fair market value of the interest sold bears to the total fair market value of the partner’s interest using the Sold Basis Approach, which is described below. The last sentence of section 163(j)(4)(B)(iii)(II), disallowing a deduction to the transferor or transferee with respect to EBIE for which a basis adjustment is allowed, would apply to the transferee to the extent of the transferor’s basis increase.

C. Explanation

Although we recommend that Final Regulations adopt the Sold Basis Approach, we have considered alternative approaches to address the effect of partial dispositions on a partner’s basis. In Part X.C.1., we discuss the Sold Basis Approach and why we

---

179 We note that the Treasury and the Service do not define “substantially all” for purposes of the Proposed Regulations.


believe it is the best approach. In Part X.C.2. and Part X.C.3. we discuss the alternative approaches and the potential concerns they raise.

1. **Sold Basis Approach**

The Sold Basis Approach is not mentioned in the Preamble or the Proposed Regulations; however, it applies the equitable apportionment principles of Regulation section 1.61-6 (referenced in Revenue Ruling 84-53) to determine the amount of EBIE attributable to the partner’s interest sold.\(^{182}\) In example 1 of Regulation section 1.61-6, basis is apportioned among properties based on the fair market value of the property and is treated as equitably apportioned. Similarly, in Situations 1 and 3 of Revenue Ruling 84-53, Service ruled that a selling partner’s basis in the transferred portion of the interest generally equals an amount that bears the same relation to the partner’s basis in the partner’s entire interest as the fair market value of the transferred portion of the interest bears to the fair market value of the entire interest (\(i.e.,\) the pro rata approach to equitable apportionment).\(^{183}\) If a partnership has liabilities, however, special adjustments must be made to take into account the effect of the liabilities on the basis of the partner’s interest.\(^{184}\) Accordingly, the Sold Basis Approach adopts the pro rata approach to equitable apportionment and increases a partner’s basis by an amount of the EBIE that bears the same relation to the partner’s total EBIE as the fair market value of the interest sold bears to the total fair market value of the partner’s interest, taking into account partnership liabilities allocated to the partner.

**Example 11:** X is a 50 percent partner in partnership PRS. In Year 1, PRS allocates $20 of EBIE to X. The $20 of EBIE allocated to X reduces X’s basis from $120 to $100. After the allocation of EBIE, in Year 2, X sells 80 percent of its interest to Y for $150, retaining a 10 percent interest.

Eighty percent of X’s $20 EBIE will increase in its basis in the interest sold by $16. Therefore, X’s basis in the portion of its interest sold would be $96 ($80 + $16), and X’s gain would be $54 ($150 - $96). X would have remaining basis of $20 and remaining EBIE of $4.

The Sold Basis Approach is consistent with the economics of the partial disposition and resolves a concern with the No Basis Approach of the Proposed Regulations which, as illustrated below, distorts the after-tax economics of the partial disposition. At the time of the partial disposition, X would recognize a $54 of gain as opposed to the $70 gain from the other approaches. The Sold Basis Approach would equitably apportion the EBIE to the interest sold to determine the partner’s basis in the

\(^{182}\) Reg. § 1.61-6(a) provides that when a part of a larger property is sold, the basis of the entire property must be equitably apportioned among the several parts for purposes of determining gain or loss on the part sold.

\(^{183}\) 1984-1 C.B. 159. In Situations 2 and 4, however, basis is allocated differently due to the presence of liabilities. For simplicity in our examples, we have assumed that the partners do not have any basis resulting from the allocation of partnership liabilities.

\(^{184}\) See also Reg. § 1.161-6(a).
interest sold. In addition, the Sold Basis Approach would allow a partner to recover that portion of its remaining EBIE with the same portion of allocations of ETI and EBII.

2. **No Basis Approach**

As discussed above, the No Basis Approach is the approach under the Proposed Regulations. The effects of the No Basis Approach on a partner’s basis are best illustrated with an example.

**Example 12.** As in Example 11, X sells 80 percent of its interest to Y for $150, retaining a 10 percent interest when X has a basis in its PRS interest of $100, reflecting the Year 1 allocation of $20 of EBIE.

X determines its gain or loss on the sale by taking into account 80 percent of its $100 basis. Therefore, X would recognize $70 of gain ($150 – $80), hold its 10 percent interest with a $20 basis and have $20 of EBIE.

There are several concerns with the No Basis Approach. First, if a partner could not increase its basis for EBIE until a complete disposition, the absence of an adjustment for the partial disposition likely would create tax gain in excess of economic gain in connection with the sale of the partial interest, while the addition to basis of the entire adjustment in connection with the complete disposition likely would create economic gain in excess of tax gain. This timing difference between economic gain and tax gain disconnects taxable income from economic income.

Second, after a sale, the partner would hold a smaller interest than it held before the sale, with the result that the partner would receive smaller allocations of ETI and EBII in subsequent years than the original allocation of EBIE (i.e., 10 percent allocations of ETI and EBII in subsequent years as opposed to the 50 percent allocation of EBIE in Year 1). This would extend the amount of time needed for a partner to convert the EBIE to business interest paid or accrued.

3. **Retained Basis Approach**

In the Preamble, Treasury and the Service describe the Retained Basis Approach as one that “would increase the partner’s remaining basis in the partnership interest by the amount of [EBIE] that is proportionate to the amount of the partner’s adjusted basis in the partnership interest that was transferred or redeemed.” The Preamble states that the Retained Basis Approach would require a partner to track its basis in the partnership interest in a manner similar to that set forth in Revenue Ruling 84-53.

---


186 In addition, because the partner would have a lower basis in its partnership interest with the same amount of EBIE, the partner would have less capacity to receive allocations of loss by the partnership or distributions from the partnership.

Example 13: As in Example 11, X is a 50 percent partner in partnership PRS. PRS allocates $20 of EBIE to X. The $20 of EBIE allocated to X reduces X’s basis from $120 to $100. After the allocation of EBIE, X sells 80 percent of the fair market value of its interest to Y for $150.

X would recognize the same gain of $70 ($150 – $80) as the No Basis Approach. However, X would have a remaining EBIE of $4 ($20 x 20 percent). X’s remaining basis of $20 ($100 x 20 percent) would be increased by $16 of EBIE ($20 x 80 percent).

The Retained Basis Approach would not resolve the first concern with the No Basis Approach because it continues to distort the after-tax economics of the partial disposition. X would recognize the same increased tax gain as the No Basis Approach because the Retained Basis Approach does not apportion any portion of the EBIE to increase the basis in the interest sold. Instead, the Retained Basis Approach apportions a portion of the EBIE to the retained interest. Although, in a sense, the Retained Basis Approach equitably apportions EBIE among the interest sold and the interest retained, in our view, the approach apportions EBIE to increase the incorrect portion of the taxpayer’s partnership interest (i.e., to the interest retained rather than the interest sold).

Second, the Retained Basis Approach would also resolve the concern of the extended timing for allocation of ETI and EBII to a partner with the No Basis Approach because it would allow a partner to recover its remaining EBIE with an economically equivalent portion of allocations of ETI and EBII.188

XI. Treatment of Disallowed BIE as Corporate Attribute under Section 382

A. Summary

The Proposed Regulations provide that business interest is disallowed and carried forward as an attribute at the S corporation level.189 Any disallowed interest is not allocated to the shareholders until such interest is allowed under section 163(j).190 Similarly, the shareholders’ stock basis and the corporation’s accumulated adjustments account (“AAA”) balance are not reduced until such interest is allowed under section 163(j).191 Because disallowed interest is carried forward as an attribute of the corporation, a disallowed business expense carryforward is subject to the limitations on pre-change losses under section 382.

The Preamble specifically requested comments regarding the treatment of disallowed BIE carryforwards as an attribute of the S corporation, subject to section 382,

---

188 In addition, the Retained Basis Approach results in an increase to the partner’s basis in its retained interest by a portion of the EBIE, permitting the partner to utilize that increased basis for loss allocations and distributions.

189 Prop. Reg. § 1.163(j)-6(l)(5).

190 Prop. Reg. § 1.163(j)-6(l)(1).

191 Prop. Reg. § 1.163(j)-6(l)(6) and (7).
as opposed to the shareholders, and the timing for any adjustments to shareholder basis and the corporation’s AAA.

A. Recommendation

We recommend that the Regulations, when finalized, retain the treatment of these items as set forth in the Proposed Regulations.

B. Explanation

Section 163(j)(4) contains three separate provisions for the application of section 163(j) to partnerships and their partners.\(^{192}\) Section 163(j)(4)(D) provides that rules similar to the rules of section 163(j)(4)(A) and (C) apply with respect to any S corporation and its shareholders. The partnership provision that does not apply to an S corporation and its shareholders, section 164(j)(4)(B), provides that the amount of any disallowed business expense carryforward is not treated as business interest paid or accrued by the partnership in the succeeding taxable year, and is treated as excess business interest which is allocated to each partner in the same manner as non-separately stated taxable income or loss of the partnership. BIE allocated to a partner of a partnership reduces the partner’s basis in the partnership interest\(^{193}\) and is generally deductible only as the result of the partnership’s allocation of ETI to the partner in a succeeding taxable year.\(^{194}\)

The treatment in the Proposed Regulations of disallowed BIE as an attribute of the S corporation is arguably inconsistent with the provisions of section 1371(b)(2). That section provides that no carryforward, and no carryback, shall arise at the corporate level for a taxable year for which a corporation is an S corporation. Until the enactment of section 163(j)(4), all items of income, deduction, loss, and credit of an S corporation were allocated to its shareholders on a current basis. Any applicable limitations, e.g., for capital losses, charitable contributions, stock and debt basis, at-risk, and passive activity losses, were applied at the shareholder level. To the extent that any of these items were allocated to a shareholder but limited in their current use, they were carried forward at the shareholder level to succeeding taxable years.

Nevertheless, we believe that the specific manner in which section 163(j)(4) was drafted suggests that Congress intended to create an exception to section 1371(b)(2), even though not explicitly stated.\(^{195}\) On balance, we believe that disallowed BIE should be carried forward as an attribute of the S corporation.

\(^{195}\) Section 1374(b)(2) is an example of an explicit reference to section 1371(b)(1), which generally precludes carryforwards and carrybacks from a C corporation taxable year to an S corporation taxable year.
This treatment causes an S corporation with disallowed BIE to be treated as a “loss corporation” within the meaning of section 382(k)(1). We believe that the provisions of section 382 should be applied to any attribute of an S corporation that is carried forward at the corporate level. The “anti-trafficking” policies underlying section 382 could apply to the disallowed BIE of an S corporation even though this item might be the corporation’s only entity-level tax attribute.

Finally, we agree that the BIE of an S corporation should be reflected in a shareholder’s stock or debt basis, and in the corporation’s AAA balance, only when the interest expense is deducted. Stock basis and AAA are closely correlated to each other, with certain exceptions. With certain limitations, stock basis is adjusted to reflect the cumulative results, using tax basis principles, of the corporation’s operations as an S corporation. In general, the AAA balance of an S corporation reflects many of the same adjustments as are made to stock basis.

Because adjustments to stock basis and AAA generally follow the S corporation’s computation of its taxable income and separately stated items, we believe it is appropriate for disallowed BIE carryforwards to be reflected in stock basis and AAA only when allowed as a deduction. This treatment is consistent with a number of other S corporation items, including, for example, the deferral of deductions because the corporation uses the cash receipts and disbursements method of accounting, the deferral of deductions by reason of section 267(a)(2), and the non-recognition of gains and losses under a number of deferral provisions in the Code. Each of these items is reflected in stock basis and the corporation’s AAA balance only when they are deductible or includible in gross income, as the case may be.

The proposed treatment of disallowed BIE is also consistent with the investment adjustment rules under the consolidated return regulations. A net operating loss sustained by a member does not reduce the stock basis of that member until the taxable year in which the loss is absorbed by the group.196

XII. Alternative Treatment as Shareholder Attribute

A. Summary

The Preamble states that Treasury and the Service have considered an alternative to the rules described in the preceding section of these Comments. The alternative would allocate carryforwards from an S corporation to its shareholders in a manner similar to the rules proposed for partnerships and their partners. This option would require shareholders to receive ETI or EBII from the S corporation to treat the disallowed business interest carryforwards as paid or accrued by the shareholder. The shareholder’s basis and the corporation’s AAA would be reduced upon an allocation of EBIE to the shareholders. The Preamble invited comments on this alternative approach and the authoritative support for adopting it.

196 Reg. § 1.1502-32(b)(3)(i).
B. Recommendation

We do not believe that the alternative approach should be adopted in the Final Regulations.

C. Explanation

As indicated above, section 1371(b)(2) represents some authority for the alternative approach. If this provision is applied to preclude the carryforward of disallowed BIE at the corporate level, the alternative is to allocate EBIE from an S corporation to its shareholders on a current basis.

Section 163(j)(4) represents a combination of “aggregate” and “entity” theories for the application of section 163(j)(4) to partnerships and S corporations. The entity theory is more predominant in the case of an S corporation, because disallowed BIE is both limited and carried forward at the corporate level, whereas the same attribute of a partnership is allocated to partners currently and carried forward at that level.

We believe that the specific, more recently enacted, provisions of section 163(j)(4) should be applied notwithstanding the more generally applicable (and older) provisions of section 1371(b)(2). We agree with the manner in which the Proposed Regulations implicitly resolved this apparent conflict between these two provisions.

XIII. Subchapter S and Section 382 (Beyond Section 163(j))

A. Summary

The Proposed Regulations provide that sections 381(c)(20) and 382(d)(3) and (k)(1) apply to S corporations with respect to disallowed business expense carryforwards. The Preamble noted that Treasury and the Service continue to consider the extent to which section 382 should apply to S corporations for purposes other than section 163(j). Further, the Preamble specifically requested comments regarding the proper integration of these two Code sections and subchapter S (for example, comments regarding the interaction of between sections 382 and 1362(e)(6)(D)).

B. Recommendation

We recommend that section 382 (and the comparable provisions of section 382) be applied only to those attributes that are carried forward and taken into account at the corporate level. We recommend that section 382 not be applied to any item of deduction, loss, or credit that is allocated to shareholders on a current basis and taken into account at the shareholder level.

Regarding the proper integration of sections 381(c)(20) and 382(d)(3) and (k)(1) with subchapter S, we will address the circumstances in which an S corporation is

---

197 Section 1371(b) was enacted by the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669, effective, generally, for taxable years beginning after December 31, 1982.
required to determine its taxable income or loss for an actual or hypothetical short taxable year. We recommend that section 163(j) be applied separately to each of these short periods.

C. Explanation

1. Limited Application of Section 382

As noted above, we believe it is appropriate to treat disallowed BIE of an S corporation as a “pre-change loss” such that the corporation would be a loss corporation pursuant to section 382(k)(1). This approach is consistent with the treatment in the Proposed Regulations of interest expense as an attribute of the corporation to be carried forward and limited at the corporate level.

In limited cases, tax attributes may also be carried from a C corporation taxable year to an S corporation taxable year for use at the corporate level. For the purpose of determining an S corporation’s liability for the tax under section 1374 on net recognized built-in gain, an S corporation may apply its net operating losses and capital losses from C corporation taxable years, as well as its business credit carryforwards from such years.

In each of these cases, inasmuch as these attributes may be carried forward and used by an S corporation at the corporate level, we believe it is appropriate to apply the rules of section 382 (and so much of section 383 as would apply to these attributes) to limit an S corporation in its use of these attributes.

Beyond these two limited instances, we do not believe that Treasury and the Service should seek to apply section 382 to any other item of an S corporation. All other items of deduction, loss, and credit are allocated by an S corporation to its shareholders on a current basis and either taken into account or carried forward by the shareholders themselves. Because section 382 limits the ability of a loss corporation to use pre-change losses to offset post-change taxable income, we do not believe that this offset can occur outside of the two limited circumstances described in the preceding paragraphs.

2. Application of Section 163(j) to Short Periods

An S corporation is permitted to make a “closing of the books” determination of its taxable income in two cases where it will nevertheless file an income tax return for a full taxable year of 12 months. First, it may make an election under section 1377(a)(2) if

198 I.R.C. § 1374(b)(2).
200 As an example, an S corporation may have a net unrealized built-in loss, within the meaning of section 382(h)(3)(A), at the time of an ownership change. If the corporation has a recognized built-in loss sustained during the recognition period, such loss will be allocated to its shareholders on a current basis and deducted (or carried forward) at the shareholder level.
a shareholder has a complete termination of the shareholder’s interest in the corporation.\textsuperscript{201} Second, it may make an election where a shareholder has a “qualifying disposition.”\textsuperscript{202} In both cases, the corporation treats the taxable year as if it consisted of separate taxable years.

An S corporation is also permitted to make a “closing of the books” election in any case where it has an S termination year, as defined in section 1362(e)(4), with one exception. If there is a sale or exchange of at least 50 percent of the corporation’s stock during the S termination year, the corporation must determine its taxable income or loss on the basis of a closing of the books.\textsuperscript{203} A daily allocation of income or loss is not permitted in this latter case. Whether a closing of the books is permitted or required, the corporation will file two separate returns, one for the short S year and one for the short C year. Although these short years are treated as one taxable year for certain carryover purposes,\textsuperscript{204} they are treated as separate taxable years for all other purposes of the Code.\textsuperscript{205}

Finally, an S corporation is required to file a return for a short taxable year if it has been the “old target” in a qualified stock purchase for which a section 338(h)(10) election is made or a qualified stock disposition for which a section 336(e) election is made. In each case, the corporation is treated as if it sold its assets to a “new target” and then liquidated.

In any case where an S corporation has an actual short taxable year, or determines its taxable income or loss as if its taxable year consisted of separate taxable years, we believe it is appropriate for the Final Regulations to provide for a separate calculation of the section 163(j) limitation for each of the actual or hypothetical taxable years. We recognize that the Proposed Regulations use a different approach where a corporation is called upon to determine its pre-change income or loss and its post-change income or loss. Under the Proposed Regulations, the loss corporation’s deduction for current-year BIE is calculated based on a single taxable year and is allocated between the pre-change period and the post-change period by ratably allocating an equal portion to each day in the year.\textsuperscript{206} This rule applies even if the loss corporation makes an election to close the books for purposes of determining its pre-change income or loss and its post-change income or loss.

We do not believe that this rule should be applied to the S corporation area, in those cases where an actual or hypothetical short taxable year forms the basis for determining its taxable income or loss. There are sound policy reasons for permitting or

\textsuperscript{201} Reg. § 1.1377-1(b).
\textsuperscript{202} Reg. § 1.1368-1(g)(2).
\textsuperscript{203} I.R.C. § 1362(e)(6)(D).
\textsuperscript{204} I.R.C. § 1362(e)(6)(A).
\textsuperscript{205} Reg. § 1.1362-3(c)(3).
\textsuperscript{206} Prop. Reg. § 1.382-6(b)(4)(i).
requiring a closing of the books for the purpose of determining taxable income or loss for the two periods. Whether a closing of the books is permitted or required, the owners of the entity during the first short period should not be affected by any of the results of the entity for the second short period, and vice versa. This policy can only be carried out by not adopting a rule similar to the rule set forth in the Proposed Regulations for other loss corporations.

XIV. Partnership Deductions Capitalized by a Corporate Partner

A. Summary

The ATI of a partnership is generally determined in accordance with Proposed Regulation section 1.163(j)-1(b)(1).\(^\text{207}\) Partnership ATI is therefore reduced by deductions claimed under sections 173 (relating to circulation expenditures), 174(a) (relating to research and experimental expenditures), 263(c) (relating to intangible drilling and development expenditures), 616(a) (relating to mine development expenditures), and 617(a) (relating to mining exploration expenditures) (collectively “qualified expenditures”).\(^\text{208}\) As a result, deductions for qualified expenditures will reduce a partnership’s section 163(j) limitation pursuant to Proposed Regulation section 1.163(j)-2(b). Deductions for those items will also reduce the amount of ETI that may be allocated to the partners and thus reduce the amount by which partner-level ATI may be increased under Proposed Regulation section 1.163(j)-6(e)(1).

B. Recommendation

We recommend that the Final Regulations provide that a distributive share of partnership deductions capitalized by a corporate partner under section 59(e) or section 291(b) increase the ATI of the partner.

C. Explanation

A corporate partner may elect to capitalize its distributive share of any qualified expenditures of a partnership under section 59(e)(4)(C) or may be required to capitalize a portion of its distributive share of certain qualified expenditures of a partnership under section 291(b).\(^\text{209}\) As a result, the taxable income reported by a corporate partner in a taxable year attributable to the ownership of a partnership interest may exceed the amount of taxable income reported to the partner on a Schedule K-1. Because qualified expenditures reduce both partnership ATI and ETI, but may not reduce the taxable

\(^{207}\) Prop. Reg. § 1.163(j)-6(d)(1).

\(^{208}\) None of those deductions may be added back to partnership ATI for taxable years beginning before January 1, 2022 under section 163(j)(8) or Prop. Reg. § 1.163(j)-1(b)(1)(i). Notably, amounts deductible under those provisions are not subject to capitalization under section 263A. See I.R.C. § 263A(c).

\(^{209}\) Section 291(b) does not address whether a corporate partner must capitalize a portion of its distributive share of deductions under sections 263(e), 616, or 617. Reg. § 1.702-1(a)(8), however, requires each partner to take into account separately its distributive share of such items, and it is generally understood that a corporate partner must capitalize a portion of its distributive share of such items.
income of a corporate partner, we recommend that Final Regulations provide that a
distributive share of partnership deductions capitalized by a corporate partner under
section 59(e) or section 291(b) increase the ATI of the partner.
### APPENDICES

**Appendix A – Example 8 - 11-Step Calculation**

Step 1: Partnership level section 163(j) calculation

<table>
<thead>
<tr>
<th>163j Limitation:</th>
<th>$ 30</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBII</td>
<td>$ 0</td>
</tr>
<tr>
<td>ETI</td>
<td>$ 0</td>
</tr>
<tr>
<td>Deductible BIE</td>
<td>$ 30</td>
</tr>
<tr>
<td>EBIE</td>
<td>$ 20</td>
</tr>
</tbody>
</table>

Step 2: Partnership determines each partner’s allocable share of section 163(j) items

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocable ATI</td>
<td>$ 80</td>
<td>$ 20</td>
<td>$ 100</td>
</tr>
<tr>
<td>Allocable BII</td>
<td>$ 0</td>
<td>$ 20</td>
<td>$ 0</td>
</tr>
<tr>
<td>Allocable BIE</td>
<td>$ 25</td>
<td>$ 25</td>
<td>$ 50</td>
</tr>
</tbody>
</table>

Step 3: Partnership compares each partner’s allocable BII to allocable BIE

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocable BII</td>
<td>$ 0</td>
<td>$ 0</td>
<td>N/A</td>
</tr>
<tr>
<td>Allocable BIE</td>
<td>$ 25</td>
<td>$ 25</td>
<td>N/A</td>
</tr>
<tr>
<td>Allocable BII Excess</td>
<td>$ 0</td>
<td>$ 0</td>
<td>$ 0</td>
</tr>
<tr>
<td>Allocable BII Deficit</td>
<td>$ 25</td>
<td>$ 25</td>
<td>$ 50</td>
</tr>
</tbody>
</table>

Step 4: Partnership determines each partner’s final allocable BII excess

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocable BII Excess</td>
<td>$ 0</td>
<td>$ 0</td>
<td>N/A</td>
</tr>
<tr>
<td>Less: (Total Allocable BII Deficit) * (Allocable BII Excess / Total Allocable BII Excess)</td>
<td>$ 0</td>
<td>$ 0</td>
<td>N/A</td>
</tr>
<tr>
<td>= Final Allocable BII Excess</td>
<td>$ 0</td>
<td>$ 0</td>
<td>$ 0</td>
</tr>
</tbody>
</table>

Step 5: Partnership determines each partner’s remaining BIE

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocable BII Deficit</td>
<td>$ 25</td>
<td>$ 25</td>
<td>$ 50</td>
</tr>
<tr>
<td>Less: (Total Allocable BII Excess) * (Allocable BII Deficit / Total Allocable BII Deficit)</td>
<td>$ 0</td>
<td>$ 0</td>
<td>N/A</td>
</tr>
<tr>
<td>= Remaining BIE</td>
<td>$ 25</td>
<td>$ 25</td>
<td>N/A</td>
</tr>
</tbody>
</table>
Appendix A cont’d – Example 8 - 11-Step Calculation

Step 6: Partnership determines each partner’s final allocable ATI

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocable ATI</td>
<td>$80</td>
<td>$20</td>
<td>$100</td>
</tr>
<tr>
<td>Negative Allocable ATI</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Positive Allocable ATI</td>
<td>$80</td>
<td>$20</td>
<td>$100</td>
</tr>
</tbody>
</table>

| Positive Allocable ATI | $80| $20| $100 |

Less: (Total Negative Allocable ATI) *  
(Positive Allocable ATI / Total Positive Allocable ATI) | $0 | $0 | $0

= Final Allocable ATI | $80| $20| $100 |

Step 7: Partnership compares each partner’s ATI capacity (ATIC) amount to such partner’s remaining BIE

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>ATIC (Final allocable ATI * 30 percent)</td>
<td>$24</td>
<td>$6</td>
<td>N/A</td>
</tr>
<tr>
<td>Remaining BIE</td>
<td>$25</td>
<td>$25</td>
<td>N/A</td>
</tr>
<tr>
<td>ATIC Excess</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>ATIC Deficit</td>
<td>$1</td>
<td>$19</td>
<td>$20</td>
</tr>
</tbody>
</table>

Step 8: Partnership determines each partner’s priority amount and usable priority amount

Not needed.

Step 9: Partnership determines each partner’s final ATIC excess amount

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>ATIC Excess</td>
<td>$0</td>
<td>$0</td>
<td>N/A</td>
</tr>
</tbody>
</table>

Less: (Total ATIC deficit) *  
(ATIC excess/Total ATIC excess) | $0 | $0 | N/A

= Final ATIC excess | $0 | $0 | $0
Appendix A cont’d – Example 8 - 11-Step Calculation

Step 10: Partnership determines each partner’s final ATIC deficit amount

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>ATIC Deficit</td>
<td>$ 1</td>
<td>$ 19</td>
<td>N/A</td>
</tr>
<tr>
<td>Less: (Total ATIC Excess) * (ATIC Deficit / Total ATIC Deficit)</td>
<td>$ 0</td>
<td>$ 0</td>
<td>N/A</td>
</tr>
<tr>
<td>= Final ATIC Deficit</td>
<td>$ 1</td>
<td>$ 19</td>
<td>$ 20</td>
</tr>
</tbody>
</table>

Step 11: Partnership allocates deductible BIE, EBIE, ETI, and EBII to the partners

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deductible BIE</td>
<td>$ 24</td>
<td>$ 6</td>
<td>$ 30</td>
</tr>
<tr>
<td>EBIE Allocated</td>
<td>$ 1</td>
<td>$ 19</td>
<td>$ 20</td>
</tr>
<tr>
<td>ETI Allocated</td>
<td>$ 0</td>
<td>$ 0</td>
<td>$ 0</td>
</tr>
<tr>
<td>EBII Allocated</td>
<td>$ 0</td>
<td>$ 0</td>
<td>$ 0</td>
</tr>
</tbody>
</table>
Appendix B – Example 9 - 11-Step Calculation

Step 1: Partnership level section 163(j) calculation

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>163j Limitation</td>
<td>$ 30</td>
<td></td>
</tr>
<tr>
<td>EBII</td>
<td>$ 0</td>
<td></td>
</tr>
<tr>
<td>ETI</td>
<td>$ 0</td>
<td></td>
</tr>
<tr>
<td>Deductible BIE</td>
<td>$ 30</td>
<td></td>
</tr>
<tr>
<td>EBIE</td>
<td>$ 20</td>
<td></td>
</tr>
</tbody>
</table>

Step 2: Partnership determines each partner’s allocable share of section 163(j) items

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocable ATI</td>
<td>$ 60</td>
<td>$ 40</td>
<td>$ 100</td>
</tr>
<tr>
<td>Allocable BII</td>
<td>$ 0</td>
<td>$ 0</td>
<td>$ 0</td>
</tr>
<tr>
<td>Allocable BIE</td>
<td>$ 30</td>
<td>$ 20</td>
<td>$ 50</td>
</tr>
</tbody>
</table>

Step 3: Partnership compares each partner’s allocable BII to allocable BIE

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocable BII</td>
<td>$ 0</td>
<td>$ 0</td>
<td>N/A</td>
</tr>
<tr>
<td>Allocable BIE</td>
<td>$ 30</td>
<td>$ 20</td>
<td>N/A</td>
</tr>
<tr>
<td>Allocable BII excess</td>
<td>$ 0</td>
<td>$ 0</td>
<td>$ 0</td>
</tr>
<tr>
<td>Allocable BII deficit</td>
<td>$ 30</td>
<td>$ 20</td>
<td>$ 50</td>
</tr>
</tbody>
</table>

Step 4: Partnership determines each partner’s final allocable BII excess

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocable BII Excess</td>
<td>$ 0</td>
<td>$ 0</td>
<td>N/A</td>
</tr>
<tr>
<td>Less: (Total Allocable BII Deficit) * (Allocable BII Excess / Total Allocable BII Excess)</td>
<td>$ 0</td>
<td>$ 0</td>
<td>N/A</td>
</tr>
<tr>
<td>= Final Allocable BII Excess</td>
<td>$ 0</td>
<td>$ 0</td>
<td>$ 0</td>
</tr>
</tbody>
</table>

Step 5: Partnership determines each partner’s remaining BIE

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocable BII Deficit</td>
<td>$ 30</td>
<td>$ 20</td>
<td>$ 50</td>
</tr>
<tr>
<td>Less: (Total Allocable BII Excess) * (Allocable BII Deficit / Total Allocable BII Deficit)</td>
<td>$ 0</td>
<td>$ 0</td>
<td>N/A</td>
</tr>
<tr>
<td>= Remaining BIE</td>
<td>$ 30</td>
<td>$ 20</td>
<td>N/A</td>
</tr>
</tbody>
</table>
Appendix B cont’d – Example 9 - 11-Step Calculation

Step 6: Partnership determines each partner’s final allocable ATI

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocable ATI</td>
<td>$60</td>
<td>$40</td>
<td>$100</td>
</tr>
<tr>
<td>Negative Allocable ATI</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Positive Allocable ATI</td>
<td>$60</td>
<td>$40</td>
<td>$100</td>
</tr>
<tr>
<td>Positive Allocable ATI</td>
<td>$60</td>
<td>$40</td>
<td>$100</td>
</tr>
<tr>
<td>Less: (Total Negative Allocable ATI) * (Positive Allocable ATI / Total Positive Allocable ATI)</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>= Final Allocable ATI</td>
<td>$60</td>
<td>$40</td>
<td>$100</td>
</tr>
</tbody>
</table>

Step 7: Partnership compares each partner’s ATI capacity (ATIC) amount to such partner’s remaining BIE

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>ATIC (Final allocable ATI * 30 percent)</td>
<td>$18</td>
<td>$12</td>
<td>N/A</td>
</tr>
<tr>
<td>Remaining BIE</td>
<td>$30</td>
<td>$20</td>
<td>N/A</td>
</tr>
<tr>
<td>ATIC Excess</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>ATIC Deficit</td>
<td>$12</td>
<td>$8</td>
<td>$20</td>
</tr>
</tbody>
</table>

Step 8: Partnership determines each partner’s priority amount and usable priority amount

Not needed.

Step 9: Partnership determines each partner’s final ATIC excess amount

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>ATIC Excess</td>
<td>$0</td>
<td>$0</td>
<td>N/A</td>
</tr>
<tr>
<td>Less: (Total ATIC Deficit) * (ATIC Excess / Total ATIC Excess)</td>
<td>$0</td>
<td>$0</td>
<td>N/A</td>
</tr>
<tr>
<td>= Final ATIC Excess</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
</tbody>
</table>
Appendix B cont’d – Example 9 - 11-Step Calculation

Step 10: Partnership determines each partner’s final ATIC deficit amount

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>ATIC Deficit</td>
<td>$12</td>
<td>$8</td>
<td>N/A</td>
</tr>
<tr>
<td>Less: (Total ATIC Excess) * (ATIC Deficit / Total ATIC Deficit)</td>
<td>$0</td>
<td>$0</td>
<td>N/A</td>
</tr>
<tr>
<td>= Final ATIC Deficit</td>
<td>$12</td>
<td>$8</td>
<td>$20</td>
</tr>
</tbody>
</table>

Step 11: Partnership allocates deductible BIE, EBIE, ETI, and EBII to the partners

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deductible BIE</td>
<td>$18</td>
<td>$12</td>
<td>$30</td>
</tr>
<tr>
<td>EBIE Allocated</td>
<td>$12</td>
<td>$8</td>
<td>$20</td>
</tr>
<tr>
<td>ETI Allocated</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>EBII Allocated</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
</tbody>
</table>