SECTION 163(j) AND PARTNERSHIPS: A NIGHTMARE IN THE MAKING

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163(j), The Nonpartnership Fundamentals

- 163(j) probably unavoidable in light of 168(k).

- Conference Report: Applies after other deduction restrictions, though Prop. Reg. 1.163(j)-3(b)(3) would apply 465, 469, and 461(l) after 163(j).
Basic rule of 163(j): Business interest expense (BIE) may only be deducted from the sum of:

- Business interest income (little definition, allocable to trade or business; not investment income).
- 30% of “Adjusted Taxable Income.”
- The floor plan financing interest.
Any amount disallowed is carried forward and treated as paid in next year, 163(j)(2).

Subject to same rules.
Business Interest Expense

- Prop. Reg. 1.163(j)-1(b)(2)(i): BIE means interest expense that is properly allocable to a non-excepted trade or business (or that is floor plan financing interest expense).

- BIE also includes disallowed BIE carryforwards.

- BIE does not include investment interest expenses.
Adjusted Tax Income (ATI)

- The taxable income of the taxpayer, computed without regard to
  - (i) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business,
  - (ii) any BIE or business interest income,
(iii) the amount of any net operating loss deduction under section 172,
(iv) the amount of any deduction allowed under section 199A, and
(v) in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion.
Excepted Trades or Businesses

- The trade or business of performing services as an employee,
- Any electing real property trade or business described in section 469(c)(7)(C),
- Any electing farming trade or business, or
- Regulated utility trade or business.
Businesses within these exceptions are sometimes called “excepted trades or businesses.”

Businesses outside these exceptions are sometimes called, wait for it, “nonexcepted trades or businesses.”
Small business exception.

- There is also a separate exception for small businesses, defined as those with average annual gross receipts of under $25 million for the 3 prior tax years (or all tax years if < 3 years).

- Gross receipts ≠ gross income.
- Commonly controlled businesses are aggregated. See 448(c).
$25 million exception and tax shelters

- Exception does not apply to tax shelters required to use accrual accounting under 448(a)(3). For definition of tax shelter, see 461(i)(3), 1256(e)(3)(B), and 6662(d)(2)(C)(ii).

- Includes (via 1256) any partnership if more than 35 percent of the losses during the taxable year are allocable to limited partners or limited entrepreneurs.
Includes (via 6662) any partnership if a **significant** purpose of partnership is tax **avoidance** or evasion.

Sophisticated partnerships may run afoul of tax shelter rule, e.g. if a flip is involved, making the $25 million exception unavailable for many small and medium businesses.
Who is the relevant taxpayer?

- For C corporations and sole proprietorships (including SMLLCs under default rule), 163(j) applies to C corporation or sole proprietor (SMLLC under default rule).

- 163(j) applies at the entity level for partnerships and S corporations, with the consequences of that determination passed through to the entity’s owners.
163(j)(4) and partnerships

- 163(j)(4) applies 163(j) at partnership level, but carryforwards (including for nondeductible interest) apply at partner level.

- Applying 163(j) at partnership level complicates matters.

- But also could be complicated at partner level unless address ATI allocations.
163(j) has no effect on, and does not change, 704(b) allocations or capital account adjustments.

163(j) effectively operates in a parallel universe and overlays 704(b).

163(j) exceptions apply to covered partnerships at the partnership level. In the slides I assume 163(j) applies, and exceptions to its application do not.
Allocations of business interest income

- A partner may increase her personal business interest income only with partnership “excess business interest income,” i.e., excess of partnership business interest income over partnership BIE.

- Prevents double counting.

- Note business interest income not part of ATI.
If 163(j) does not apply to partnership

- If due to one of the exceptions, 163(j) does not apply to the partnership,

- Partnership must give partners information they need to calculate own 163(j) limitation, as the partners may be subject to 163(j) even if the partnership is not. (Prop. Reg. § 1.163(j)-6(m) and Explanation.)
Partner’s ATI

- A partner’s personal ATI is computed without the allocation of items of partnership income and expense from partnership, except that,

- A partner’s share of excess taxable income (defined below) increases the partner’s personal ATI.

- Again, avoids double counting.
Guaranteed Payments on Capital

- Guaranteed returns on capital are treated as BIEs. Prop. Reg. § 1.163(j)–1(b)(20)(iii)(I)

- Thus cannot avoid 163(j) through preferred returns.

- Could cause allocations of preferred gross (or net) income and related distributions to receive greater scrutiny.
Nonseparately computed taxable income or loss

- Deductible BIE is taken into account in computing partnership “nonseparately stated taxable income or loss.”
  - May be of little practical significance.
  - Business interest income and expenses retain character at partner level and can be specially allocated. Prop. Reg. § 1.163(j)-6(c).
  - BIE should now have to be separately stated for non-163(j) purposes.
Excess business interest expense

- Any BIE not deductible by the partnership is carried forward by the partners as “excess business interest expense.”

- A partner’s share of excess business interest expense is treated as paid to the extent that the partner is allocated “excess taxable income” (ETI) and (say regs) “excess business interest income” from same partnership.
Simple example

- ABC partnership, 3 equal partners, has net ATI of $100,000, no business interest income, and a BIE of $40,000.

- ABC’s 163(j) limit is 30% $100,000 = $30,000.

- $30,000 BIE deductible by ABC, flows through with nonseparately stated item.
$10,000 disallowed BIE carried forward, i.e. as excess business interest expense, by partners.

But the BIE does not have to be allocated proportionately to the partners, though if it is not, life gets complicated. In all events, partners will have $30,000 of deductible BIE.

- If it is proportionately allocated, can mostly ignore “11 steps.”
If partnership no longer subject to 163(j)

- In the event a partnership allocates excess business interest expense to one or more of its partners, and in a later taxable year becomes exempt from the requirements of 163(j)(4), Prop. Reg. § 1.163(j)-6(m) provides that the excess business interest expense from the prior taxable years is treated as paid or accrued by the partner in the taxable year in which the partnership became exempt.
Excess Taxable Income

- ETI Formula: \( \frac{X}{ATI} = \frac{(.3ATI - BIE-BII)}{.3ATI} \)

- BII is business interest income, BIE-BII cannot be less than 0.

- Solve for X.
Prop. Regs: Do not get dollar for dollar BIE deduction for ETI, rather partners are considered to have paid the BIE to the extent of ETI.

ETI increases partners’ personal ATI (for all purposes).

Partners then go through regular 30% ATI, etc. rules to determine partners’ deductions.
ETI Example #1

- Example: Assume a partner has $10 of excess business interest expense from ABC in Year 1.

- In Year 2 the partner is allocated $20 of ETI by ABC, which increases the partner’s personal ATI by $20.
Assume the partner has no other items of ATI and no business interest income.

Even though the partnership rules of the regs no longer limit the partner’s ability to deduct the $10 of excess business interest expense, the “regular rules” do.
30% of $20 is $6, so only that amount is currently deductible by the partner.

The remaining $4 must be carried forward by the partner under section 163(j)(2), not under partnership rules.
But......

- Do get dollar for dollar liberation from ETI system. In Example 1, all $10 is no longer excess business interest expense.

- Excess business interest expenses equal to ETI that cannot be deducted by partner currently are carried forward by partner under nonpartnership rules of 163(j)(2).
ETI Example #2

- Assume in the current year that the partnership has ATI of $300,000. 30% of ATI is $90,000.

- The partnership incurs $50,000 of BIE, $10,000 of business interest income, and zero of floor financing interest.
The $50,000 of the BIE is currently deductible by the partnership as it is less than 30% of ATI plus the business interest income, which adds up to $100,000.

(30% 300,000) + $10,000
ETI Formula: \[ \frac{X}{ATI} = \frac{0.3ATI - (BIE-BII)}{0.3ATI} \]

Do the latter half of the equation first.
\[ \frac{90,000 - (50,000-10,000)}{90,000} = 0.555. \]

\[ \frac{X}{300,000} = 0.555 \]

Partnership ETI is thus ATI of \( 300,000 \times 0.555 = 166,666. \)
Assume further that the partnership in prior years had $200,000 of BIE disallowed which the partnership allocated to the partners as excess business interest expense under section 164(j)(4)(B), none of which was deductible by the partners prior to the current year.
The partners may treat $166,666 of the $200,000 of the excess business interest expense as currently paid and $166,666 is removed from ETI system.

The remaining amount of $33,333 awaits further allocation of ETI to the partners.
Note a partnership may limit BIE deduction when would not be limited if incurred by partner.

- Example: Partnership has ATI of $30,000,000, no business interest income.
- 163(j) limit of $900,000.
- BIE of $1,000,000.
- $100,000 of BIE not deductible. Would be deductible if incurred by partners directly with enough extra ATI.
Query whether partnerships and partners will attempt to spread their debt and interest expenses among multiple partnerships to limit application of 163(j)(4).

Or use partnerships less.
As noted, to the extent the partner does not have sufficient ATI, BIE deduction may be carried forward indefinitely by the partner under section 163(j)(2).

What might cause the partner to have insufficient ATI? Possibly 743(b).
743(b) and ATI

- Under Prop. Reg. § 1.163(j)-6(e)(2), a section 743(b) adjustment can offset both ETI allocated to the partner and any ATI a partner has personally. The latter seems dubious.
Basis adjustments

- Under Section 163(j)(4)(B)(iii), the adjusted basis of a partner in a partnership interest is reduced (but not below zero)

- not just by the currently deductible BIEs,

- but also by the amount of excess business interest expense allocated to the partner.
Sale of partnership interest

- What to do if sell partnership interest before allocated sufficient ETI to cover allocation of excess business interest expense?
Section 163(j)(4)(B)(iii)(II) provides that if a partner disposes of her entire partnership interest in a taxable or nontaxable transaction (including death),

Partner’s outside basis is increased immediately before the disposition by the amount of any allocated excess business interest expenses that were not treated as paid due to prior allocations of ETI.
Likely will not make partner even as basis increase likely will change partner’s capital gain or loss.

Whereas BIE would have reduced ordinary income.
Proposed Regulations

- On my computer, over 250 pages (and 84,000 words) long. Table of Contents over 30 pages long.

- Part that applies to partnerships and S corporations over 70 pages (and 20,000 words) long (and mostly discusses partnerships).
About 30 words of regulation for each of the 687 words of 163(j)(4).

Contain, by my count, 32 new terms. My two favorites:

- Excess business interest income.
- Business interest income excess.
Most Frustrating

- Is that the regs don’t usually show the math or, often, adequately explain their reasoning.

- It can often be very time consuming to figure out how the regs got from point A to point B.
Why is there 163(j)(4)?

- Not clearly explained.

- But a core problem, and presumably what lead to 163(j) applying at the partnership level,

- Is how to prevent partnerships from making allocations of ATI or business interest income that game 163(j).
For example, if there were no restrictions, a partnership could artificially inflate a partner’s ATI by allocating income items to him,

And allocating deduction items to others.

To be sure, could be real downstream economic impacts, but present value of money could trump.
11 Steps

- Regs apply to, and may reallocate for 163(j) purposes, “section 163(j) excess items.”

  i.e. the partnership’s excess business interest expense, ETI, and excess business interest income.

- May be the most important aspect of regs.
Regs can also adjust how ATI income and expense items are allocated for 163(j) purposes.

None of 11 steps change how BIEs are allocated, but can determine who receives an allocation of currently deductible BIE and who gets the carryforward.
Theoretical purity trumped simplicity. IRS wanted to maximally respect aggregate nature of partnerships and 704(b) allocations.

Best Example: Step 8, the most complex step, only exists to fix the fact that the other 10 steps do not always work (at least in IRS’s view).
If partnership’s allocations of ATI and BII and BIE are all “straight up” (i.e. all items are allocated the same way),

11 steps likely will not change any allocation. May lay out mechanics of allocating deductible BIE and section 163(j) excess items.
Recall that small business exception may not apply to sophisticated partnerships, meaning may apply to businesses that may not be able to afford sophisticated tax counsel.

And even for larger businesses, 163(j) significantly increases compliance costs which can lead to distorted business decisions and economic inefficiency.
I chose this example, because it is the simplest of the complicated examples. (No step 8.)

Spoiler alert: All of the BIEs are deductible, making the stakes lower.

As noted, the regs don’t change how BIEs are allocated. Note in example how ETI is allocated.
A, B, and C own all of the interests in partnership PRS. In Year 1, PRS has

- $150 of ATI,
- $10 of business interest income, and
- $40 of BIE.

PRS’s ATI consists of $200 of gross income and $50 of gross deductions.
PRS allocates its items comprising ATI:
- $50 of deductions to A,
- $200 income to B, and $0 to C.

PRS allocates its business interest income:
- $0 to A, $0 to B, and $10 to C.

PRS allocates its BIEs:
- $30 to A, $10 to B, and $0 to C.
Step 1

- PRS’s section 163(j) limit is 30 percent of its ATI plus its business interest income, or $55 (($200-$50) x 30 percent) + $10).

- Thus, PRS has $0 of excess business interest income, $50 of ETI, $40 of deductible BIE (i.e. all deductible), and $0 of excess business interest expense.
Step 2

- PRS determines each partner’s allocable share of section 163(j) items.

- These are simply the shares listed in the facts.
Steps 3-5

- Third, PRS compares each partner’s allocable business interest income to such partner’s “allocable business interest expense.”

- Because A’s allocable business interest expense exceeds its allocable business interest income by $30 ($30-$0), A has an allocable business interest income deficit of $30.
Because B’s allocable business interest expense exceeds its allocable business interest income by $10 ($10-$0), B has an allocable business interest income deficit of $10.

C does not have any allocable business interest income deficit.

Thus, the total allocable business interest income deficit is $40 ($30 + $10 + $0).
A and B, of course, do not have any allocable business interest income excess.

Because C’s allocable business interest income exceeds its allocable business interest expense by $10 ($10-$0), C has an allocable business interest income excess of $10.
Thus, the total allocable business interest income excess is $10 ($0 for A + $0 for B + $10 for C).

PRS determines each partner’s final allocable business interest income excess.

Because A and B do not have any allocable business interest income excess, each partner has final allocable business interest income excess of $0.
PRS determines C’s final allocable business interest income excess by reducing, but not below $0, C’s allocable business interest income excess ($10) by the product of the total allocable business interest income deficit ($40) and the ratio of C’s allocable business interest income excess to the total allocable business interest income excess ($10/$10).
Therefore, C’s allocable business interest income excess of $10 is reduced by $40, and ends up at zero as it cannot go below zero.

As a result, C’s allocable business interest income excess is $0 for section 163(j) purposes.
PRS determines each partner’s oddly named “remaining business interest expense.”

Step 5 involves the calculation of an intermediate number that is then used later, but ultimately step 5 does not define what a partner may or may not deduct.
PRS determines A’s remaining business interest expense by reducing, but not below $0, A’s allocable business interest income deficit ($30) by the product of the total allocable business interest income excess ($10) and the ratio of A’s allocable business interest income deficit to the total business interest income deficit ($30/$40).
Therefore, A’s allocable business interest income deficit of $30 is reduced by $7.50 ($10 x 75 percent).

As a result, A’s remaining business interest expense is $22.50 (BIE $30-$7.50). Does that mean that A may only deduct $22.50? No. Stay tuned.
- Same calculation is made for B.

- B’s allocable business income deficit of $10 is reduced by the product of the total allocable business interest income excess ($10) and the ratio of B’s allocable business interest income deficit to the total business interest income deficit ($10/$40).
B allocable business interest income deficit of $10 is reduced by $2.50 ($10 x 25 percent).

As a result, B’s remaining business interest expense is $7.50 (BIE $10-$2.50).

Does that mean that B may only deduct $7.50? No. Stay tuned.
Because C does not have any allocable business interest income deficit, C’s remaining BIE is $0.
Step 6 and “final allocable ATI.”

- Because A’s allocable ATI is comprised of $50 of items of deduction and loss and $0 of income and gain, A has negative allocable ATI of $50.

- A is the only partner with negative allocable ATI. Thus, the total negative allocable ATI amount is $50.
Any partner with a negative allocable ATI, or an allocable ATI of $0, has a positive allocable ATI of $0. Therefore, A has a positive allocable ATI of $0.

C also has a positive allocable ATI of $0, as C was allocated no ATI items.
Because B’s allocable ATI is comprised of $200 of items of income and gain and $0 of deduction and loss, B has positive allocable ATI of $200.

Thus, the total positive allocable ATI is $200 ($0 for A + $200 for B + $0 for C).
PRS determines B’s final allocable ATI by reducing, but not below $0, B’s positive allocable ATI ($200) by the product of total negative allocable ATI ($50) and the ratio of B’s positive allocable ATI to the total positive allocable ATI ($200/$200).

Therefore, B’s positive allocable ATI is reduced by $50 ($50 x 100 percent). As a result, B’s final allocable ATI is $150 (i.e. same as that of PRS).
In principle, if no partner received an allocation of negative ATI, step 6 should not apply, but it does anyway.

Apparently, this is just for nomenclature reasons. Step 7 keyed to the outcome of step 6, which is “final allocable ATI.” So, apparently, the outcome of step 5 would just be renamed.
Step 7

- PRS compares each partner’s ATI capacity (ATIC) amount.

- A partner’s ATIC amount is the amount that is 30% of such partner’s final allocable ATI as determined under step 6.

- A’s ATIC amount is $0 ($0 x 30%), B’s ATIC amount is $45 ($150 x 30%), and C’s ATIC amount is $0 ($0 x 30%).
A obviously does not have any ATIC excess.

Because B’s ATIC amount exceeds its remaining business interest expense by $37.50 ($45-$7.50), B has an ATIC excess amount of $37.50.

C does not have any ATIC excess.
Thus, the total ATIC excess amount is $37.50 ($0 for A + $37.50 for B + $0 for C).

Because A’s remaining business interest expense exceeds its ATIC amount by $22.50 ($22.50-$0), A has an ATIC deficit of $22.50.

B and C do not have any ATIC deficit.
Thus, the total ATIC deficit is $22.50 ($22.50 for A + $0 for B + $0 for C).

But where is this leading. It does not restrict what each partner may deduct, so what is the point? Stay tuned.
Step 9

- What happened to step 8? It did not apply. Be grateful.

- PRS must determine each partner’s “final ATI capacity excess.”

- A partner’s final ATI capacity excess amount is determined by reducing, but not below zero, such partner’s ATI capacity excess (if any) by the partner’s “step nine adjustment amount.”
A partner’s step nine adjustment amount is the product of the total ATI capacity deficit and the ratio of such partner’s ATI capacity excess to the total ATI capacity excess.
The rules of step 9 ensure that, following the application of step 11, the aggregate of all the partners’ allocations of ETI equals the total amount of the partnership’s ETI as determined in step 1.
Because B has ATIC excess, PRS must determine B’s final ATIC excess amount.

B’s final ATIC excess amount is B’s ATIC excess ($37.50), reduced, but not below $0, by the product of the total ATIC deficit ($22.50) and the ratio of B’s ATIC excess to the total ATIC excess ($37.50/$37.50).
Therefore, B has $15 of final ATIC excess ($37.50-($22.50 \times 100\%)).
Step 10

- PRS determines each partner’s “final ATIC deficit amount.”

- Because A has an ATIC deficit, PRS must determine A’s final ATIC deficit amount.
A’s final ATIC deficit amount is A’s ATIC deficit ($22.50), reduced, but not below $0, by the product of the total ATIC excess ($37.50) and the ratio of A’s ATIC deficit to the total ATIC deficit ($22.50/$22.50).

Therefore, A has $0 of final ATIC deficit ($22.50 - ($37.50 x 100 percent)).
Does that seem odd? A was allocated only ATI deductions, is going to be allowed the full BIE deduction, but still has an ATIC deficit of $0. Shouldn’t it be a negative number?

It might seem that way at first blush, but recall that the focus here is just on section 163(j). The Proposed Regulations are not making a capital account calculation. Thus, it does not make sense to go below zero.
Step 11

- Pay dirt. PRS allocates deductible BIE and section 163(j) excess items to the partners.

- Excess business interest income calculated under step 1, if any, is allocated dollar for dollar by the partnership to its partners with final allocable business interest income excess amounts. There were no such excess amounts in the problem.
Excess business interest expense calculated under step 1, if any, is allocated dollar for dollar to partners with final ATI capacity deficit amounts.

There was no excess business interest expense in the problem because all of the BIE was deductible.
Finally, after grossing up each partner’s final ATI capacity excess from step 9 by ten-thirds, ETI calculated under step 1, if any, is allocated dollar for dollar to partners with final ATI capacity excess amounts.
Step 7 calculated partners’ ATI capacity, which was 30% of partners’ final allocable ATI. That is obviously relevant for restricting a business interest deduction allocable to a partner.

But it is not relevant for the allocation of ETI which is based on ATI, not 30% of ATI.
- PRS has $50 of ETI and $40 of deductible BIE.

- After grossing up each partner’s final ATIC excess amounts by ten-thirds (0 for A, $50 for B, and 0 for C), ETI is allocated dollar for dollar to partners with final ATIC excess amounts.
Thus, PRS allocates its ETI of $50 to B.

It is clear from the regs if not the statute that ETI first offsets any excess business expense allocated to B in prior years. (See 163(j)(4)(B)(ii), Explanation at 67509, and Prop. Reg. § 1.163(j)-6(g)(3).)
Beyond that, ETI increases B’s personal ATI and can be used to deduct BIEs incurred outside the partnership.
A partner’s allocable “gross” BIE is deductible business interest expense to the extent it exceeds such partner’s share of excess business interest expense.

This would be obvious in any other context.

There was no excess business interest expense in this problem. So all allocable interest is deductible by the partners to whom it was allocated.
Better Solutions?

- The definition of tax shelter needs to be dramatically narrowed.

- One way to simplify 163(j) is to restrict a partnership’s ability to specially allocate ATI under 704(b).

- If elements cannot be specially allocated, no need to have partnership level calculation.
- Partnership would need to allocate net ATI to partners identified as such.

- If partnership not under exceptions, must tell partners ATI is tainted, i.e. subject to 163(j) rules.

- What to do with depreciation? Commonly specially allocated. Not currently part of ATI. Keep it that way?
A still more aggressive approach would be to disallow deductions of BIEs.

Query whether defensible in light of 168(k).

- But 168(k) percentage deduction drops staring in 2023.

- Better to have full 168(k) or full BIE deduction?