Section 163(j) Update: Proposed Regulations - Selected Topics Relating to Real Estate

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Section 163(j): Background
Section 163(j): Limitation on deductibility of interest

- In general, a taxpayer is prohibited from deducting business interest expense in excess of the sum of: (1) business interest income, (2) floor plan financing interest, and (3) 30% of adjusted taxable income. I.R.C. §163(j)(1)
  - For tax years beginning after December 31, 2017, and before January 1, 2022, adjusted taxable income is taxable income other than: (1) items not allocable to a trade or business, (2) business interest income and expense, (3) depreciation, amortization, and depletion, (4) the 20% deduction for qualified business income, and (5) NOLs. I.R.C. §163(j)(8)
    - For tax years beginning after December 31, 2021, depreciation, amortization, and depletion would be deducted in calculating adjusted taxable income. I.R.C. §163(j)(8)(A)(v)
  - Applies to tax years beginning after December 31, 2017, and there is no grandfathering of existing debt. P.L. 115-97, §13301(c)
  - Any disallowed interest may be carried forward indefinitely. I.R.C. §163(j)(2)
Section 163(j): Exceptions

• Contains several exceptions
  • The limitation does not apply to certain “exempt” businesses (i.e., certain small businesses).
    • 25 million dollar gross receipts test
    • “Tax shelters” not eligible
  • The limitation does not apply to certain “excepted” businesses, including any electing real property trade or business (RPTB)
    • Code defines RPTB by cross-reference to Section 469(c)(7)(C).
      • Section 469(c)(7)(C): Any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business is a RPTB.
Section 163(j): Proposed Regulations
Proposed Regulations under Section 163(j): Overview


• The Proposed Regulations would generally apply to tax years ending after the date the Proposed Regulations are published as final regulations.
  • Pending the issuance of the final regulations, however, taxpayers may apply the Proposed Regulations to a tax year beginning after December 31, 2017, provided the taxpayers and their related parties consistently apply the Proposed Regulations to those tax years.
    • All or nothing?

• Comments are due by February 26, 2019.
Proposed Regulations under Section 163(j): Roadmap

- Definitions (Prop. Reg. § 1.163(j)-1)
- General rules on the computation of a taxpayer’s Section 163(j) limitation (Prop. Reg. § 1.163(j)-2)
- Ordering rules and other rules regarding the relationship of the Section 163(j) limitation and other provisions of the Code affecting the deduction of interest (Prop. Reg. § 1.163(j)-3)
- Rules applicable to C corporations (including REITs, RICs, and consolidated group members) (Prop. Reg. § 1.163(j)-4 and Prop. Reg. § 1.163(j)-5)
- Rules applicable to partnerships and their partners and S corporations and their shareholders (Prop. Reg. § 1.163(j)-6)
- Rules applicable to foreign corporations and their shareholders (Prop. Reg. § 1.163(j)-7)
- Rules applicable to foreign persons with effectively connected income (Prop. Reg. § 1.163(j)-8)
- Rules regarding elections for “excepted” trades or businesses (e.g., electing real property trades or businesses) as well as a safe harbor for certain REITs (Prop. Reg. § 1.163(j)-9)
- Rules to allocate expense and income between “non-excepted” and excepted trades or businesses (Prop. Reg. § 1.163(j)-10)
- Transition rules (Prop. Reg. § 1.163(j)-11)
Selected Defined Terms:

- **Business Interest Expense (BIE)**
  - Any “interest” expense that is properly allocable to a non-excepted trade or business (within the meaning of Section 162)
  - Excludes “investment interest” within the meaning of section 163(d) and personal interest within the meaning of section 163(h)

- **Business Interest Income (BII)**
  - The amount of “interest” includible in the gross income of the taxpayer for the taxable year properly allocable to a trade or business
  - Excludes “investment income” within the meaning of section 163(d)

- **Trade or Business**
  - A trade or business within the meaning of section 162. Excludes an excepted trade or business

- **Excepted Trade or Business**
  - An electing real property trade or business, electing farming business, and certain regulated utilities

- **Exempt Entity**
  - A trade or business that meets the small business exemption ($25M gross receipts test)

- **Excess Business Interest (EBI)**
  - The amount of any BIE not allowed as a deduction to the partnership for any taxable year by reason of the section 163(j) limitation

- **Excess Taxable Income (ETI)**
  - The amount of the partnership’s ATI that has not been applied to the partnership’s own section 163(j) limitation

- **Excess Business Interest Income (EBII)**
  - The amount of a partnership’s BII that exceeds the partnership’s BIE in a taxable year
ATI – Selected Issues

For tax years beginning after December 31, 2017, and before January 1, 2022, ATI does not take into account depreciation, amortization, and depletion

• Depreciation includes bonus depreciation

• Section 734(b) adjustments taken into account for purposes of calculating a partnership’s ATI

• Section 743(b) adjustments and 704(c) remedial allocations taken into account for purposes of calculating a partner’s ATI

New depreciation double-counting rule

• Under the proposed regulations, sale gain that is treated as ATI is reduced by any prior depreciation, amortization, and depletion deductions for taxable years beginning after December 31 2017, and before January 1, 2022
ATI – Selected Issues

New look-through rule for gain or loss on the sale of a partnership interest or S corporation stock

• Under the proposed regulations, gain or loss on the sale of a partnership interest (subject to the cost-recovery adjustment) or S corporation stock is included in the transferor’s ATI to the extent of the transferor’s allocable share of non-excepted assets held by the partnership or S corporation.

• If a partnership or S corporation has both excepted and non-excepted businesses, asset-basis allocation rules are used to determine the gain or loss attributable to the non-excepted business assets.

• What if one category is an overall gain and the overall is an overall loss?
What is “Interest”

• The proposed regulations provide an expansive definition of interest:
  • Amounts associated with conventional debt instruments and amounts already treated as interest for all purposes under existing statutory provisions or regulations (e.g., section 467)
  • Amounts that are functionally similar to interest
  • Other amounts treated as interest for purposes of section 163(j) (e.g., guaranteed payments for the use of capital under section 707(c) are treated as interest)
  • Anti-avoidance rule: generally, any deductible expense or loss predominately incurred in consideration of the time value of money
Application to Partnerships

• The section 163(j) limitation applies at the partnership level
  • Deductible BIE at the partnership level is included in the partnership’s non-separately stated taxable income or loss and is allocated to the partners
  • A partner generally is required to reduce its outside basis in its partnership interest by any allocated EBI
  • The basis reduction is reversed to the extent of EBI that has not been treated as “paid or accrued” by the partner (compare “allowed as a deduction”) at the time of a disposition of all or substantially all of the partnership interest
  • Under the statutory language and the proposed regulations, EBI is “freed up” for potential deduction in future years (i.e., treated as paid or accrued by the partner) only to the extent of the partner’s allocable share of ETI or EBII from the same partnership; the Conference Report and Bluebook describe a different approach

• ETI, EBII, and EBI (collectively, “section 163(j) excess items”) are allocated in the same manner as the non-separately stated taxable income or loss of the partnership
Exception for electing RPTBs: Prop. Reg. § 1.163(j)-9
Exception for Electing RPTBs: General requirements

• An Electing Real Property Trade or Business (an Electing RPTB) is not subject to the limitation of deductibility under section 163(j)
  • Only BIE is subject to the limitation on deductibility under section 163(j)
  • BIE is interest properly allocable to a non-excepted trade or business
  • An Electing RPTB is an excepted trade or business
  • Therefore, interest properly allocable to the electing RPTB is not BIE

• Requirements to become an Electing RPTB:
  • Trade or business is a RPTB (to be discussed in subsequent slides).
  • Trade or Business elects under Section 163(j)(7)(B).
  • Trade or Business must depreciate its nonresidential real property, residential real property and qualified improvement property (QIP) using the alternative depreciation system (ADS).
    • The change-in-use rules under Reg. §1.168(i)-4 should be used to compute depreciation for assets placed in service in prior years that would change from MACRS to ADS as a result of this election
    • These rules require use of ADS life as of the date the converted property was acquired
Prop. Reg. § 1.163(j)-9: Elections for Excepted Trade or Business

- Election is made for each trade or business.
  - Prop. Reg. § 1.163(j)-1(b)(38) defines trade or business for Section 163(j) purposes by reference to Section 162.
    - Section 162(a) “standard” is unclear and requires a fact and circumstance analysis.
      - *Triple-net lease?*
    - Section 162 focuses on whether there is a trade or business, not how many trades or businesses a taxpayer is engaged in.

- Time and manner of making election
  - Election is made by attaching a statement to original tax return.
  - Election applies for taxable year that the election is made and all subsequent years.
  - Election is irrevocable, but can terminate automatically if taxpayer ceases to exist or ceases the operation of the electing trade or business.
    - However, if taxpayer transfers all of the assets of an electing trade or business to a related party, election does not terminate.
Prop. Reg. § 1.163(j)-9's requirement that election is made for each trade or business

- Where a taxpayer has some activities that are RPTB activities and other “incidental activities” that are not RPTB activities, whether a taxpayer has one or more trades or business is meaningful.
  - If all activities are a single trade or business that is a RPTB, a taxpayer appears able to elect out of Section 163(j) in whole.
  - If the activities constitute one (or more than one) RPTB and one (or more than one) non-excepted trade or business, the taxpayer will need to apply Section 163(j)’s rules (including Prop. Reg. § 1.163(j)-10) and its deductible business interest expense is potentially limited.
REIT Safe Harbor
Prop. Reg. § 1.163(j)-9(g): REIT safe harbor

• REIT safe harbor:
  • If a REIT holds real property (generally as defined in Treas. Reg. § 1.856-10), interests in partnerships holding real property or shares in other REITs holding real property, the REIT is generally eligible to make the election to be an electing RPTB for “all or part of its assets.”
  • For purposes of the REIT safe harbor, real property does not include real property financing assets (defined to include interests in mortgages).
    • However, a REIT can own up to 10% financing assets and still be eligible for the REIT safe harbor.
    • If the value of the REIT’s real property financing assets is more than 10 percent of the value of the REIT’s total assets, a pro rata rule applies.
What is a Real Property Trade or Business
Prop. Reg. §1.469-9
What is an Electing Real Property Trade or Business?

• Definition of Electing Real Property Trade or Business (an “Electing RPTB”)
  • A trade or business
  • that makes an election as provided in Prop. Treas. Reg. § 1.163-9 or other published guidance
  • described in § 469(c)(7)(C) and Prop. Treas. Reg. § 1.469-9(b)(2)

• § 469(c)(7)(C):
  • any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.
What Activities Are Real Property Trades or Businesses under the Proposed Regs?

• Proposed Regulations define two of the terms listed in section 469(c)(7)(C)—”real property operation” and “real property management”—all others are reserved.
  
  • **Real Property Operation:**
    - handling, by a **direct or indirect owner** of the real property,
    - the day-to-day operations relating to the **maintenance and occupancy** of the real property that affect the availability and functionality of that real property used or held out for use by **customers**
    - **Of a trade or business as defined in 1.469-9(b)(1)**
      - Generally trade or business activities under section 162 and any interest in rental real estate, including any in rental real estate that gives rise to deductions under section 212.
    - Payments received from customers are **principally for the customers’ use** of the real property
    - **Principal purpose** of the business must be **provision of the use of the real property** or physical space accorded by or within the property to customers, **not provision of other significant or extraordinary personal services with incidental use of real property**.
    - **Incidental personal services** may be provided so long as **insubstantial in relation to the customer’s use of the real property** and receipt of the services **not a significant factor** in customer’s decision to use the real property.
What Activities Are Real Property Trades or Businesses under the Proposed Regs? (cont’d)

• Proposed Regulations define two terms listed in section 469(c)(7)(C)—real property operation and real property management—all others are reserved.

  • **Real Property Management:**
    • handling, by a **professional manager**
    • of the day-to-day operations of a trade or business relating to the **maintenance and occupancy** of the real property that affect the availability and functionality of that real property used or held out for use by **customers**
    • “**Of a trade or business**” as defined in 1.469-9(b)(1)
      • Generally trade or business activities under section 162 and any interest in rental real estate, including any in rental real estate that gives rise to deductions under section 212.
    • Payments received from customers are **principally for the customers’ use** of the real property
    • **Principal purpose** of the business must be **provision of the use of the real property** or physical space accorded by or within the property to customers, **not provision of other significant or extraordinary personal services with incidental use of real property**.
    • **Incidental personal services** may be provided so long as **insubstantial in relation to the customer’s use of the real property** and receipt of the services **not a significant factor** in customer’s decision to use the real property.
    • A **professional manager** is a person responsible, full-time, for overall management and oversight of the real property, **not a direct or indirect owner**
What Activities Are Real Property Trades or Businesses under the Proposed Regs? (cont’d)

- Preamble language places significance on nexus to “rental real estate”:
  - “Given Congress’s focus in enacting section 469(c)(7) to provide relief to entrepreneurs in real property trades or businesses with some nexus to or involvement with rental real estate, these proposed regulations would not include trades or businesses that generally do not play a significant or substantial role in the creation, acquisition, or management of rental real estate in the definition of real property trade or business under section 469(c)(7)(C). Therefore, taxpayers engaged in trades or businesses that are not directly or substantially involved in the creation, acquisition, or management of rental real estate, or that provide personal services which are merely ancillary to a real property trade or business, will generally not be treated as engaged in real property trades or businesses for this purpose.”
Anti-Abuse Rule and REIT Exception
Anti-abuse Rule

Can a real property trade or business be segregated in a partnership that is separate from the entity's other business activities in order to elect out of section 163(j)?

- If at least 80 percent of the business’s real property, determined by fair market value, is leased to a trade or business under common control with the real property trade or business, the trade or business will not be eligible for the election.

- Common control for this purpose means related parties within the meaning of sections 267(b) and 707(b) hold 50 percent of the direct and indirect ownership interests.
Exception for Certain REITs

Proposed regulations contain an exception for certain REITs:

- The anti-abuse rule *does not apply to REITs that lease qualified lodging facilities*, as defined in section 856(d)(9)(D), and qualified health care properties, as defined in section 856(e)(6)(D).

- What about a REIT that holds through an operating partnership that enters into the lease with the TRS or a joint venture owned by the TRS? Technically, the REIT exception to the anti-abuse rule does not seem to include this situation.
Prop. Reg. § 1.163(j)-6(m): Exempt entity with a RPTB business
Exempt entity with a RPTB business

• Preamble: “The Treasury Department and the IRS also have determined that small businesses that are exempt under section 163(j)(3) and proposed § 1.163(j)-2(d)(1) may not make an election under proposed § 1.163(j)-9.”

• Treatment of partnership business interest expense
  • Partners of an exempt entity (i.e., certain small business) include partnership-level business interest expense, business interest income and items of ATI in their partner-level section 163(j) calculations and allocated business interest expense is subject to the partner's section 163(j) limitation. Prop. Reg. § 1.163(j)-6(m)(1).
  • To the extent a partnership is not subject to section 163(j) because it has an excepted trade or business (e.g., electing RPTB), the partners do not include partnership-level business interest expense, business interest income and items of ATI allocable to any excepted trade or business (and thus partnership-level business interest expense is not subject to a partner's section 163(j) limitation). Prop. Reg. § 1.163(j)-6(m)(2).

• Thus, where an exempt partnership has a RPTB, business interest expense from the RPTB will be subject to Section 163(j) (at the partner level).
Allocating Between Excepted and Non-Excepted Businesses
Allocating interest

Is properly allocable to investment or trade or business activities?

• C corporations – business interest expense only
• Other taxpayers—first apply Temp. Treas. Reg. sec. 1.163-8T and notice 89-35 to determine interest that is traceable to investment activities
• Investment interest subject to section 163(d) generally is not subject to section 163(j)

If properly allocable to a trade or business, determine amount allocable to excepted or non-excepted trades or businesses

• If only excepted or only non-excepted, no further allocation required
• If some excepted and some non-excepted, use modified basis allocation rules in Prop. Treas. Reg. 1.163(j)-10 to allocate interest among them

If some excepted and some non-excepted, allocate using modified basis allocation rules in Prop. Treas. Reg. 1.163(j)-10

• Complex look-through rules allocate interest to assets held directly or indirectly by partnerships and corporations
• Special direct tracing rule for qualified non-recourse debt
Allocating interest – Look-through Rules

Where a taxpayer does not look through a partnership or an S corporation, the taxpayer treats its entire basis in the partnership or S corporation as allocable to an investment or a non-excepted trade or business, as applicable (determined under the tracing rules), unless the taxpayer is a C corporation or a tax-exempt corporation, in which case it is treated as allocable to a non-excepted trade or business.
Allocating interest – Look-through Rules

Where a taxpayer does not look through a corporation, the taxpayer treats its entire basis in the stock as allocable to an investment unless the taxpayer is a C corporation or a tax-exempt corporation, in which case it is treated as allocable to a non-excepted trade or business.

- Special rules for REITs
- Similar look-through rules apply for allocating business interest income
Allocating interest (cont’d)

- Look-through rules do NOT trump the application of section 163(d) – i.e., the interest allocation rules apply only to business interest after allocating between business, investment or personal interest under Temp. Treas. Reg. § 1.163-8T

- The look-through rules can lead to odd and counterintuitive results:

**Example 1**
- A owns 100% of Corp., a non-REIT C corporation.
- Corp. manufactures and sells widgets and is not a small business.
- A borrows $1M to carry his interest in Corp., which is allocable under -8T to the investment in Corp;
- A has no trade or business activity (including through partnerships).
- All of the interest on the $1M is investment interest

**Example 2**
- the facts are the same as in Example 1, but A also has an Electing RPTB that he operates through a disregarded entity.
- A borrows another $1M to use in that excepted business, none of which is allocable under -8T to the investment in Corp.
- All of the interest on the $1M borrowing used to carry Corp. is investment interest.
- The other $1M borrowing (used to finance the Electing RPTB) must be allocated under the relevant rules between A’s non-excepted business, looking through the C Corp, and the Electing RPTOB under the modified asset basis allocation rules.
Allocating interest – Debt-Financed Distributions

• What is the character of interest traced to a debt-financed distribution?
  • Treas. Reg. §163-8T provides rules for allocating interest expense for purposes of applying sections 163(d) and (h) and section 469.
    • Provides generally that debt is allocated by tracing disbursements of debt proceeds to specific expenditures and
    • Interest expense on such debt is allocated in the same manner as the debt to which such interest expense relates
    • Does not address treatment of debt allocated to expenditures for interests in passthrough entities and debt of passthrough entities allocated to distributions of such entities
Allocating interest – Debt-Financed Distributions (cont’d)

• What is the character of interest traced to a debt-financed distribution?
  • With regard to debt-financed distributions, Notice 88-20, 1988-1 C.B. 487 provides:
    • the debt proceeds and associated interest expense may, at the option of the entity, be allocated among
      the expenditures (other than distributions) of the entity during the taxable year, to the extent that debt
      proceeds have not otherwise been allocated to such expenditures. (optional allocation).
    • If partnership does not choose the optional allocation method, debt proceeds are allocated to
      distributions to owners of the entity, each owner’s share of the associated interest expense is allocated
      under the rules of section 1.163-8T in accordance with the use of the debt proceeds distributed to the
      owner.
  • Notice 89-35, 1989-1 C.B. 675 supplements Notice 88-20 – where optional allocation method not
    chosen:
    • Partnership includes interest on the line on Schedule K-1 for other deductions to the extent it does not
      exceed the entity's interest expense on the portion of the debt proceeds distributed to such owner,
      identified on an attached schedule as “Interest expense allocated to debt-financed distributions.”
    • Owner reports on Schedule A interest expense in the manner dependent upon the types of expenditures
      owner made with the distributed debt proceeds, e.g., personal expenditure (within the meaning of
      section 1.163-8T(b)(5)).

How does a partnership apply these rules and the section 163(j) rules?
Carryforwards
Carryforwards of Old Section 163(j) Disallowed Amounts

• “Old” section 163(j) disallowed disqualified interest expense
  • “Disallowed Disqualified Interest” (i.e., interest limited under pre-2018 section 163(j)) is carried forward to the taxpayer’s first taxable year beginning after December 31, 2017, and is subject to disallowance as a “disallowed business interest expense carryforward” under section 163(j) and Prop. Treas. Reg. §1.163(j)-2, except to the extent the interest is properly allocable to an excepted trade or business under Prop. Treas. Reg. § 1.163(j)-10.
  • However, Prop. Treas. Reg. § 1.163(j)-10(a)(6) reserves on the application of the Prop. Treas. Reg. § 1.163(j)-10 allocation rules to Disallowed Disqualified Interest.
    • Consider a real property trade or business that has Disallowed Disqualified Interest and becomes an excepted business (by making the election) for its 2018 taxable year
• Prop. Reg. §1.163(j)-6(m)(4) provides that, “[i]f a partnership allocates excess business interest expense to one or more partners, and in a succeeding taxable year becomes not subject to the requirements of section 163(j), the excess business interest expense from the prior taxable years is treated as paid or accrued by the partner in the succeeding taxable year.”

• Examples indicate that the interest is freed up to the extent that the business subsequently qualifies for the small business exemption. Prop. Reg. §1.163(j)-6(o), Ex. 6 and 7.

• What does “becomes not subject to the requirements of section 163(j)” mean – excepted trades or businesses also, or only exempt?
Thank You