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Partnership Tax *Matters*

The Tax Cuts and Jobs Act of 2017 (the "TCJA" or "Act")[1] made relatively few specific modifications to subchapter K of the Internal Revenue Code of 1986, as amended (the "Code"), but its myriad changes in other areas are having an extensive effect on the taxation of partnership items. In addition, ongoing developments in case law, administrative guidance, and legislative proposals will continue to have significant repercussions for the field of partnership taxation. This inaugural issue of **Partnership Tax *Matters*** is the first in a series of updates that we will distribute to help our clients keep abreast of the rapidly changing rules related to the taxation of partnerships and their partners.

Partnership Aspects of the Code Section 163(j) Business Interest Limitation

One area in which the TCJA's impact on partnership taxation is yet to be fully clarified is with respect to revised Code Section 163(j), which limits the deductibility of interest expense that is attributable to a trade or business. The Treasury Department has issued proposed regulations under Code Section 163(j) (the "Proposed Regulations"),[2] which provide much-needed guidance with respect to its application in the partnership context (as well as outside of it). However, there are several ways in which further elucidation is needed. Below, we provide general background with respect to Code Section 163(j) before discussing its application to partnerships. We then highlight several issues that remain unresolved regarding how the Code Section 163(j) limitation should apply where partnerships are involved.

Background

Code Section 163(j)(1) limits the deduction for "business interest" in any given taxable year to the sum of three amounts: the taxpayer's "business income," 30 percent of the taxpayer's positive "adjusted taxable income," and the taxpayer's floor plan financing interest (i.e., interest paid or accrued on debt used to finance the acquisition of certain motor vehicle inventory). Under Code Section 163(j)(2), all amounts whose current deductibility is so limited are carried forward indefinitely, as business interest, until they can be utilized.

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[1] P.L. 115-97, 131 Stat. 2054 (Dec. 22, 2017).

[2] 83 F.R. 67490 (Dec. 28, 2018). The Proposed Regulations are proposed to be effective upon finalization, but they can be relied upon by taxpayers (if consistently applied) for taxable years beginning after December 31, 2017.

Code Section 163(j)(5) and (6) provide that "business interest" and "business interest income" constitute interest expense and income, respectively, that are properly allocable to a trade or business. For these purposes, "trade or business" is defined by Code Section 163(j)(7) to exclude certain regulated public utilities and the trade or business of acting as an employee. In addition, some real property and farming businesses can make an irrevocable election out of "trade or business" status, but doing so has certain corollary consequences, such as required use of the alternative depreciation system and loss of Code Section 168(k) bonus depreciation. An exemption from the Code Section 163(j) limitation is provided for small businesses with average annual gross receipts of less than $25 million and that otherwise satisfy the gross receipts test of Code Section 448(c).

In computing the Code Section 163(j) limitation, "adjusted taxable income" is a taxpayer's taxable income figured without including (1) amounts not allocable to a trade or business, (2) business interest or business interest income, (3) net operating losses, (4) the deduction for "qualified business income" under new Code Section 199A, (5) for taxable years beginning before January 1, 2022, any deduction for depreciation, amortization, or depletion, and (6) certain other adjustments provided for under the Proposed Regulations, such as capital loss carryovers and certain depreciation recapture. Beginning in 2022, taxpayers will be required to subtract cost recovery deductions in computing their "adjusted taxable income."

The Proposed Regulations elaborate upon the foregoing rules in detail. For example, the Proposed Regulations adopt a broad definition of "interest" for purposes of Code Section 163(j),[3] and they provide ordering rules that generally apply the Code Section 163(j) limitation, with limited exceptions, after all other provisions that might subject interest expense to disallowance, deferral, capitalization, or other limitations.[4] In addition, the Proposed Regulations provide rules for computing and adjusting certain 163(j)-related items in the case of C corporations and tax-exempt entities, and they generally require that all members of a consolidated group be treated as a single taxpayer for purposes of applying Code Section 163(j).[5] Moreover, under the Proposed Regulations, broad anti-avoidance rules increase the scope of the "interest" definition and preclude arrangements that have a principal purpose of circumventing Code Section 163(j).[6] Finally, as if the above complexity is not enough, the application of Code Section 163(j) in the partnership context requires addressing a host of additional issues resulting from a blended use of aggregate and entity concepts, as discussed in more detail below.

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[3] Prop. Treas. Reg. Sec. 1.163(j)-1(b)(20).
[4] Prop. Treas. Reg. Sec. 1.163(j)-3(b)(1). Exceptions are provided for limitations based upon passive losses, material participation, and excess business losses of noncorporate taxpayers, which apply after the Code Section 163(j) limitation under Proposed Regulation Section 1.163(j)-3(b)(4).
[5] Prop. Treas. Reg. Sec. 1.163(j)-4.
[6] Prop. Treas. Reg. Secs. 1.163(j)-1(b)(20)(iv) and -2(h).

Application of Code Section 163(j) in the Partnership Context

The TCJA's modifications to Code Section 163(j) articulate specific rules for applying it to situations involving partnerships. In particular, the limitation on deducting a partnership's business interest is applied at the partnership level, with any allowable business interest deduction of a partnership taken into account in determining its non-separately stated taxable income or loss.[7] For purposes of the partnership-level limitation, the Proposed Regulations elaborate that a partnership's "adjusted taxable income" generally includes items described in Code Section 703(a) (to the extent consistent with the general definition of adjusted taxable income under the Proposed Regulations) and also includes basis adjustments to partnership property under Code Section 734(b).[8] In contrast, Section 743(b) basis adjustments to partnership property, Section 704(c)(1)(C) built-in loss amounts, and remedial allocations under Section 704(c) (collectively, "partner-level adjustments") are not incorporated into the partnership-level Code Section 163(j) limitation. The Proposed Regulations clarify that business interest determined to be deductible at the partnership level is not subject to further testing at the partner level, although such expense retains its character as business interest at the partner level for all other purposes of the Code.[9]

Consistent with the foregoing entity-focused approach to applying the Code Section 163(j) limitation to the business interest of partnerships, Code Section 163(j)(4)(A)(ii) provides that the adjusted taxable income of a partner (for purposes of computing the partner's own separate Code Section 163(j) limitation) generally is determined without regard to the partner's share of any partnership items, other than the partner's share of the partnership's "excess taxable income." Under Code Section 163(j)(4)(C), "excess taxable income" generally is the proportion of the partnership's adjusted taxable income that remains unused after applying the Section 163(j) limitation at the partnership level.[10] Although the TCJA's revisions to the Code did not explicitly provide for the pass-through of partnership "business interest income" to partners in computing the partner-level limitation, the Proposed Regulations extend this ability to partners, allowing them to utilize the partnership's "excess business interest income" (i.e., generally, the amount of business interest income that remains unused in computing the limitation at the partnership level) in computing the partner-level Code Section 163(j) limitation.[11] However, under the Proposed Regulations, use of a partnership's "excess taxable income" and "excess

[7] Code Section 163(j)(4)(A)(i).
[8] Prop. Treas. Reg. Sec. 1.163(j)-6(d).
[9] Prop. Treas. Reg. Sec. 1.163(j)-6(c).
[10] Code Section 163(j)(4)(C). As a technical matter, "excess taxable income" is defined as the amount that bears the same ratio to a partnership's "adjusted taxable income" as (i) the excess of 30 percent of the partnership's "adjusted taxable income" over the partnership's net business interest expense computed without regard to floor plan financing interest, bears to (ii) 30 percent of the partnership's "adjusted taxable income."
[11] Prop. Treas. Reg. Sec. 1.163(j)-6(b)(4).

business interest income" to compute the partner-level Section 163(j) limitation is subject to application of a labyrinthine 11-step procedure (the "11-step Process"), described in more detail below.[12]

Application of the Code Section 163(j) limitation in the partnership context is complicated by the fact that any business interest deductions which have been limited at the partnership level must be carried forward at the partner level, despite the general treatment of partnerships as entities for purposes of Code Section 163(j). In particular, Code Section 163(j)(4)(B) provides that such carryforwards are deductible at the partner level only to the extent of "excess taxable income" allocated to the partners from such partnership in later years. Again, under the Proposed Regulations, the pass-through of partnership attributes for purposes of computing the Code Section 163(j) limitation is applied by also allowing partners to use their share of a partnership's "excess business interest income" to absorb partnership carryforwards at the partner level, subject to application of the 11-Step Process referred to above.

Thus, the overall regime of the Code and Proposed Regulations suggests a blended application of entity and aggregate concepts in connection with implementing the Code Section 163(j) limitation in the partnership context, an approach that creates the potential for problems (e.g., double-counting, inconsistencies, etc.) in applying the Code Section 163(j) limitation at two levels, particularly given the flexibility afforded by the partnership form to use special allocations in structuring business arrangements. The Proposed Regulations attempt to guard against abuse by mandating the application of an 11-Step Process (referred to above) in determining the applicable Code Section 163(j) limitation at each of the partnership and partner levels. A detailed explanation of the 11-Step Process is beyond the scope of this article, but it generally involves the determination of a partnership's "163(j) excess items" (i.e., excess business interest expense, excess taxable income, and excess business interest income) and the allocation of such items among the partnership's partners (solely for purposes of applying Code Section 163(j)) in a manner that preserves parity between the partnership's total items and the aggregate of the partners' shares of such items.[13] In addition, the Treasury Department utilized the following two principles in designing the 11-Step Process, with a stated goal of recognizing the aggregate nature of partnerships under subchapter K of the Code while also preserving application of Code Section 163(j) at the partnership level: (1) a partnership having both excess business interest expense and deductible business interest expense in a given year should not allocate the excess amount to a partner to the extent that the partner is allocated the items that comprise the income amounts (i.e., adjusted taxable income or business interest income) that enable absorption of the partnership's deductible business interest expense, and (2) a partnership

[12] Prop. Treas. Reg. Sec. 1.163(j)-6(f)(1).
[13] 83 F.R. 67490 (Dec. 28, 2018).

having excess business interest income or excess taxable income in a given year should allocate such amounts to partners only to the extent such partners are allocated more of the items that make up adjusted taxable income and business interest income than needed to absorb the partnership's allocation to them of deductible business interest expense.[14] Notably, the preamble to the Proposed Regulations emphasizes that the allocations required by them are solely for purposes of applying Code Section 163(j) and, therefore, do not interfere with implementation of any special allocations by a partnership that conform to the requirements of Code Section 704(b). Nonetheless, implementation of the Proposed Regulations' 11-Step Process can become quite complex. Fortunately, the Proposed Regulations provide an extensive set of examples that illustrate their application in situations involving both "straight-up" allocations and special allocation provisions.[15]

Completing the integration of entity and aggregate treatment in applying Code Section 163(j), the Code and Proposed Regulations provide for adjustments to the basis of a partner's partnership interest that correspond to Code Section 163(j)-related allocations in a manner intended to ensure that a partner cannot take advantage of an artificially high basis in a partnership interest prior to the time that excess business interest with respect to the partnership interest can be deducted.[16] Corresponding basis adjustments are made if the partnership interest is disposed of prior to the time that a partner's share of excess business interest expense has been absorbed. Furthermore, the Proposed Regulations provide that any gain or loss recognized by partners from partnership interest dispositions that are attributable to non-excepted business assets is included in adjusted taxable income at the partner level.[17]

Key Open Issues with respect to Applying Code Section 163(j) to Partnerships

In the preamble to the Proposed Regulations, the Treasury Department reserved judgment with respect to the application of Code Section 163(j) to certain partnership-related issues, instead seeking comments from taxpayers as to their appropriate treatment.[18] In particular, guidance is yet to come with respect to applying Code Section 163(j) to "self-charged" interest between partners and partnerships, the extent to which carryforwards should flow through multiple levels of tiered partnership structures, and the impact of partnership mergers and divisions on the treatment of attributes that are relevant for purposes of Code Section 163(j).

In addition, additional guidance may be forthcoming with respect to certain other areas of intersection between the Code Section 163(j) limitation and partnership-related issues. For

[14] Id.
[15] Prop. Treas. Reg. Sec. 1.163(j)-6(o).
[16] Prop. Tres. Reg. Sec. 1.163(j)-6(h).
[17] Prop. Treas. Reg. Sec. 1.163(j)-6(e).
[18] 83 F.R. 67490 (Dec. 28, 2018).

example, under the Proposed Regulations, the entity treatment of partnerships applies even to partnerships that are wholly-owned within a consolidated group, despite the application of Code Section 163(j) to corporate members of such a group at the consolidated group level. Revisiting this discrepancy arguably would make sense in light of legislative history indicating Congressional intent that choice-of-entity decisions be Code Section 163(j)-neutral.[19] Another rule may be revised in connection with finalization of the Proposed Regulations relates to the scope of "interest" for purposes of applying Code Section 163(j) to partnership matters. In particular, in adopting a broad definition of "interest," the Proposed Regulations included a partnership's Section 707(c) guaranteed payments for use of capital as amounts whose deductibility can be limited under Code Section 163(j). However, this position is arguably inconsistent with Code Section 707(c), which distinguishes the tax treatment of payments for partnership equity from loans to a partnership. In addition, depending on the type of contributed capital underlying a Code Section 707(c) guaranteed payment, application of the Code Section 163(j) limitation to such guaranteed payments could result in its inappropriate application to amounts that substantively look more like rent than interest.

Conclusion

While the Treasury Department has provided extensive guidance (including a detailed, 11-Step Process) to help taxpayers navigate the hybrid entity-aggregate approach that Code Section 163(j) mandates in applying its business interest limitation to partnerships, significant open issues remain. Future regulations are anticipated to address complex issues, such as the application of the Code Section 163(j) limitation to self-charged interest, tiered partnerships, and partnership mergers and divisions.

Contacts

If you have questions regarding the subject matter herein, please feel free to contact Ken Harris (312-662-4620, kharris@hwhlegal.com), Andrea Despotes (312-662-4627, adespotes@hwhlegal.com), Matt Koenders (312-662-4626, mkoenders@hwhlegal.com), or Bob Bedore (312-662-4625, rbedore@hwhlegal.com) directly.

[19] H.R. Rep. 115-409, at 247.