SAVING CLEMENTINE: IMPROVING THE CODE §163(J) DEDUCTION

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> Oh my darling, oh my darling, oh my darling, Clementine,
> You are lost and gone forever, dreadful sorrow, Clementine.
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> Drove the horses to the water, every morning just at nine.
> Hit her foot against a splinter, fell into the foaming brine.
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> – Popular American folk ballad[1]

The 2017 Tax Cuts and Jobs Act ("T.C.J.A.") amended subsection (j) of Code §163 to enact a brand-new version of the U.S. tax law's limitation on deductions claimed for business interest expense. The new version provides that a taxpayer's deduction is capped at 30% of its adjusted taxable income ("A.T.I.").[2] This represents a radical departure from old Code §163(j), as it shifts the focus from preventing earnings stripping transactions to a hard cap on the income tax benefit arising from debt placed in a taxpayer's capital structure.

The old Code §163(j) evaluated deductibility based on two thresholds: a debt-to-equity ratio and a 50% expense-to-A.T.I. ratio. Where the thresholds were exceeded, it disqualified interest expense deductions for related-party debt not subject to 30% Federal withholding tax, as well as third-party debt supported by related-party guarantees and certain R.E.I.T.-to-taxable-R.E.I.T.-subsidiary loans.[3]

It is worth noting that, in the Preamble to the new final Code §385 regulations, the I.R.S. cited to four aspects of the new-and-improved Code §163(j) as reducing the benefit of earnings stripping transactions, including its (i) elimination of the debt-equity ratio safe harbor; (ii) reduction to net interest deductions' maximum share of A.T.I. from 50% to 30%; (iii) extension of the interest expense limitation to all interest, not just related-party; and (iv) elimination of excess limitation carryforwards under old the Code §163(j).[4]

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1. Attributed to Percy Montrose in 1884, though sometimes also to Barker Bradford; it is commonly performed in the key of F major. A popular alternative version references ducklings instead of horses.

2. Pub. L. 115-97, §13301(a) (the 30% limitation is increased by taxpayer's business interest and floor plan financing interest income). Beginning in 2022, A.T.I. is computed without taking into account depreciation, amortization, and depletion, meaning that the effect of missing out on the exemption to the 30% limitation discussed herein will become more pronounced.

3. Regulations were proposed, but never finalized, under the prior Code §163(j) in 1991. See 56 Fed. Reg. 27907 (June 18, 1991). These are now withdrawn. New Code §163(j) is one aspect of U.S. tax reform that is consistent with broader efforts undertaken by many other countries pursuant to B.E.P.S. Action 4.

4. See T.D. 9880, 84 Fed. Reg. 59297-59302 (effective November 4, 2019, removing final Code §385 regulations enacted in October 2016).

Notably, the new Code §163(j) disallowance rule exempts from its purview taxpayers meeting Code §448(c)'s $25,000,000 gross receipts test and also allows certain trades or businesses (most notably for this article, a qualifying real property trade or business, or "R.P.T.O.B.") to elect out of the 30% limitation entirely. The election is irrevocable once made, until the taxpayer ceases to conduct the trade or business.

On August 8, 2018, the I.R.S. issued proposed regulations addressing the new Code §163(j), including mechanics by which R.P.T.O.B.'s could elect to be excepted from the 30% limitation.[5] Unfortunately, there are certain financing structures that, while somewhat common in the real estate industry, fall outside the conceptual rubric of the I.R.S.'s proposed regulations.

"Notably, the new disallowance rule exempts from its purview taxpayers meeting Code §448(c)'s $25,000,000 gross receipts test."

Similar to Clementine from the popular folk ballad, who falls in the river after her foot strikes a sharp splinter, certain taxpayers making leveraged investments in real estate through partnerships may accidentally trip into a "bad" outcome and thereafter have no recourse to the I.R.S. to cure the misstep – short of renegotiating the entire business deal.

This article identifies affected structures, explains why the proposed regulations appear not to reach them, and suggests that the I.R.S. may wish to revisit this matter as part of final regulations, which the I.R.S. has promised to issue by as early as the end of 2019, so as to enable ill-starred investors in U.S. real estate to have the benefit of the R.P.T.O.B. election.

As the U.S. real estate sector continues to be attractive,[6] for now (and until the I.R.S. acts to correct the matter), we would advise anyone considering a real estate investment to keep this "trap for the unwary" in mind – surely as dangerous for the unwary investor as the splinter that cost poor Clementine her life.

THE STATUTE

In Code §163(j)(7), Congress created a special definition of "trade or business" specifically for Code §163(j) purposes. The definition is framed in the negative, stating that a "trade or business" (subject to the 30% limitation) shall not include:[7]

- Any electing R.P.T.O.B.
- Any electing farming business

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5 REG-104397-18, 83 Fed. Reg. 39292.

6 See, *e.g.*, Harriet Torry and Kate Davidson, "U.S. Housing Starts Dropped 9.4% in September," *Wall Street Journal*, October 17, 2019 (noting that housing starts fell in September 2019 but recently "the National Association of Home Builders reported . . . that builder confidence in the market for new single-family homes climbed in October to its highest level since February 2018").

7 This is reminiscent of the T.C.J.A. drafters' approach in devising the deduction for "qualified business income," wherein they first crafted the definition of a "qualified trade or business" and then provided that it includes any trade or business "other than" a specified service trade or business or a trade or business of performing services as an employee (Code §199A(d)(1)). While there may be some superficial resemblance in terminology and concepts, under the Code §199A rules taxpayers are provided with a safe harbor for treating a "rental real estate enterprise" as a trade or business for Code §199A purposes. (See Rev. Proc. 2019-38). Thus, in the end, the approach is rather unlike the rules discussed herein.

- Some electricity, water, sewage disposal, gas or steam utility businesses, to extent that the rates they charge are established or regulated by certain arms of government

In a roundabout way, Congress thus tells us that the above businesses can enter a paradisiacal land where no Code §163(j) limitation applies! (Though note, in the first two cases, an election is required and certain costs may apply, such as a longer life for depreciable business assets.)

But what is an R.P.T.O.B.? And who exactly may make this election?

Code §163(j)(7)(B) clarifies that to understand this special election, we must first look to Code §469(c)(7)(C)'s definition of "real property," which is incorporated by reference.

CODE §469 "REAL PROPERTY" DEFINITION

As background to understanding Code §469(c)(7)(C), Congress enacted Code §469 to address a spate of tax-shelter activities as part of the Tax Reform Act of 1986 (the "1986 Act").[8] Congress defined a "tax shelter" as any investment in which a significant portion of the taxpayer's return comes from realizing tax savings, as shelters were organized to maximize certain taxpayers' losses and other tax attributes that could offset positive income.[9] In enacting Code §469, Congress placed substantial limits on taxpayers' ability to use deductions from one activity to offset income from other activities. In particular, the rule limited use of "bad" losses and excess credits from certain categories of suspicious activities (identified as "passive") so that tax attributes generated by those passive activities could not be used to reduce or avoid tax on income earned from other "active" sources. However, C-corporations, other than closely held corporations, were exempted from these rules.[10]

To start, in the 1986 Act, Congress erred on the side of treating all income from real estate activities as passive income. However, in 1993, Congress decided such treatment was unfair when applied to certain rental real estate businesses, in which the owners are heavily and actively involved.

Accordingly, it enacted Code §469(c)(7) to enable these ill-fated taxpayers to escape Code §469 if they could prove active management of their rental properties.[11] In this context, Code §469(c)(7)(C) was enacted, to define an R.P.T.O.B. as "any

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[8] Pub. L. No. 99-514.

[9] See Joint Committee on Taxation, Tax Reform Proposals: Tax Shelters and Minimum Tax (JCS–39–85), August 7, 1985, at 2.

[10] See Code §469(a)(2)(C).

[11] Omnibus Budget Reconciliation Act of 1993, Pub. L. 103-66, §13143(a) (adding Code §469(c)(7) to the Code effective for years after December 31, 1993) stating:

> The committee considers it unfair that a person who performs personal services in a real estate trade or business in which he materially participates may not offset losses from rental real estate activities against income from nonrental real estate activities or against other types of income such as portfolio investment income.

real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business." This tended to expand the class of persons who could benefit from the exception for active real estate businesses.

One might reasonably ask whether Code §163(j)(7)(B)'s cross-reference to Code §469(c)(7)(C) thus implicates other Code §469 rules and requirements for purposes of making the new Code §163(j)(7) R.P.T.O.B. election. For example, would the taxpayer need to meet the Code §469 requirement in order to actively manage property or materially participate in such management as a condition to benefit from Code §163(j)(7)(B)'s exemption? Fortunately, the answer is a clear no! The legislative history of the T.C.J.A. clarifies that the Senate's amendment to the House version of Code §163(j) introducing the Code §469 cross-reference, was intended to apply very broadly. Specifically, the Senate amendment indicated that the bill intended that:

> Any such real property trade or business, including such a trade or business conducted by a corporation or real estate investment trust, be included. Because this description of a real property trade or business refers only to the section 469(c)(7)(C) description, and not to other rules of section 469 (such as the rule of section 469(c)(2) that passive activities include rental activities or the rule of section 469(a) that a passive activity loss is limited under section 469), the other rules of section 469 are not made applicable by this reference.[12]

Thus, the owner of a qualifying R.P.T.O.B. should be able to benefit by making the election so long as the trade or business meets the very broad definition of an R.P.T.O.B. included in Code §469(c)(7)(C).

CERTAIN LEVERAGED FINANCING TRANSACTIONS INVOLVING PARTNERSHIPS

This brings us to identifying the taxpayers that may make (or have already made) the election and to discussing a relatively common leveraged financing deal structure that causes so much headache to investors who may have tripped into it prior to the T.C.J.A.'s enactment or issuance of proposed regulations by the I.R.S.

In the proposed regulations, the I.R.S. provided guidance on a variety of topics. However, the language that was adopted to provide election mechanics for R.P.T.O.B.'s in Prop. Treas. Reg. §1.163(j)-9(c) seemingly does not permit a corporate partner to make an election for the R.P.T.O.B. in which the corporate partner is engaged through owning a partnership interest, as in the chart below.[13]

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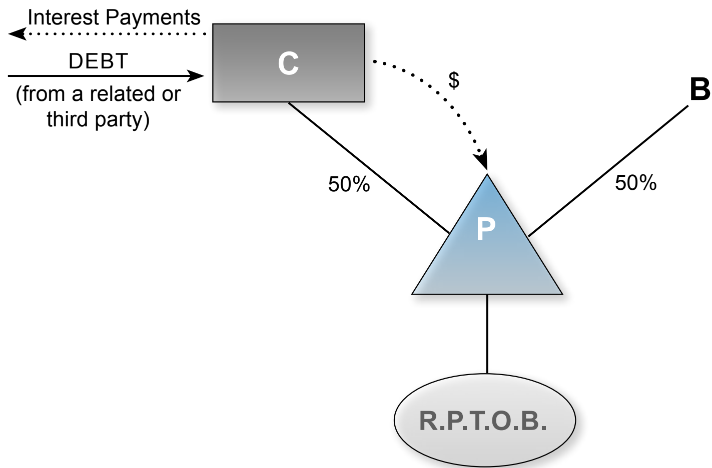
[12] Joint Committee on Taxation, General Explanation of Public Law 115-97, December 2018, at note 883 and accompanying text.

[13] The inability to elect under Prop. Treas. Reg. §1.163(j)-9 would extend to any partner, not just a corporate partner, but individuals do face other requirements before they can deduct business interest, including the rules contained in Code §163(d) regarding investment interest and the passive loss rules of Code §469.



As an example of this issue, as shown on the previous page, suppose that C (who happens to be a corporate partner), previously took out debt from a related or third-party lender and then invested it in a partnership, which conducts the relevant R.P.T.O.B.

Assume that P's sole source of revenue comes from the R.P.T.O.B. and that C and P have no income from any other sources. Based on the proposed regulations, while it appears P could make the R.P.T.O.B. election, if it does not do so C will likely not be qualified to make a Code §163(j)(7) R.P.T.O.B. election by itself on its corporate Form 1120 U.S. Federal income tax return vis-à-vis its flow-thru partnership income from P.[14] Thus, C's hands are tied based on what C and the remaining partners are able to agree. In particular, Prop. Treas. Reg. §1.163(j)-9(c)(4), which provides R.P.T.O.B. election mechanics, states in relevant part:

> An election for a partnership must be made on the partnership's return with respect to any trade or business that the partnership conducts. An election by a partnership does not apply to a trade or business conducted by a partner outside the partnership.

The second sentence does not address the converse fact pattern, *i.e.*, where a partner wishes to make an election with respect to a trade or business conducted through a partnership; though, perhaps the I.R.S. views that issue as disposed of in the first sentence. Thus, the proposed regulations provide little clear authority for a taxpayer who is a partner in an otherwise-eligible R.P.T.O.B. like C to make an independent, irrevocable partner-level Code §163(j)(7) election for the R.P.T.O.B., leaving such taxpayers drowning.[15] The result would be different if instead each partner directly owns an interest in a tenancy-in-common or a joint tenancy.[16]

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14 Note if C's payment is to a related foreign party then such foreign party may be ineligible for the exemption to withholding for U.S.-source portfolio interest under Code §1441(c)(9) (although the relevant double income tax treaty may provide for some relief), and Code §267(a)(3) may also apply to defer C's deduction until the interest is paid.

15 However, see **Conclusion** below addressing what C should do, if it took a position on its return that it was eligible to make the election for the portion of the R.P.T.O.B. that it owned via its partnership interest in P.

16 In this case, each partner would be the sole person capable of making the R.P.T.O.B. election with regard to their separate shares of the T.I.C. or their

Confusingly, as part of the same regulatory package, the proposed regulations also include some examples under Code §469 fleshing out the R.P.T.O.B. definition. One of the examples suggests that a partner would be treated as directly engaged in an R.P.T.O.B. if the partnership was so engaged.[17] The I.R.S.'s purpose in including this example in the regulatory package adopting the R.P.T.O.B. election without clarifying that it carried no significance for the Code §163(j)(7) partnership election mechanics is perplexing. At the same time, the Preamble to the proposed regulations does contain a somewhat cryptic statement about "real estate" definitions, which may have been the I.R.S.'s way of dispelling an undue inference based on the example's language for partnership election mechanics under Prop. Treas. Reg. §1.163(j)-9(c)(4).[18]

Another way C might claim that it is engaged in the R.P.T.O.B. for purposes of making an election at the partner level (rather than via reference to the misleading example under Code §469), would be by applying the "look-thru" rules of Prop. Treas. Reg. §1.163(j)-10. Those rules permit partners to elect to look through to the underlying business of a partnership for purposes of allocating their partner-level interest expense to excepted trades or businesses. Unfortunately, there is no basis for concluding that the -10 look-thru provision also enables the partner to look

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respective portions of the joint tenancy. As a broader matter, for Code §163(j) purposes, C should be able to treat its flow-through partnership income as increasing its A.T.I. for purposes of computing its partner-level Code §163(j) limitation. However, that may be cold comfort to a taxpayer when they would otherwise qualify for the R.P.T.O.B. election and other partnership structures that differ little in any meaningful respects are able to completely escape the 30% limitation. If C is foreign, query whether it can include C-level interest expense as a deduction against effectively connected earnings and profits in computing branch profits tax, which would may make incurring debt at C's level even more costly.

[17] Prop. Treas. Reg. §1.469-9(b)(2)(iii), ex. 5, describing a fact pattern where F owns and operates a luxury hotel through its interest in the limited partnership P, which provides significant personal services to hotel guests. The example concludes that "under these facts, F and P are treated as engaged in a real property trade or business for purposes of section 469(c)(7)(C) and this section."

[18] In particular, the I.R.S. stated in the Preamble:

> As the Treasury Department and the IRS have previously recognized (see Notice of Proposed Rulemaking, 'Definition of Real Estate Investment Trust Real Property,' published in the Federal Register (79 FR 27508, 27510) on May 14, 2014), the term 'real property' appears in numerous Code provisions, which could ordinarily imply that . . . the term 'real property' should have the same meaning throughout the Code. However, the context and legislative purpose underlying a specific Code provision may necessitate a broader or narrower definition of the term 'real property' than may be applied for other Code provisions. These proposed regulations under section 469 provide a definition of real property that is, for example, narrower than the one provided in the REIT context. The definition provided in these proposed regulations would apply solely for purposes of section 469(c)(7), and these regulations should not be construed in any way as applying to, or changing, the definitions in other Code provisions.

through for purposes of stepping into the partnership's shoes to make the election under -9 with respect to its own R.P.T.O.B.[19]

PRACTITIONER COMMENTARY

Both prior to and after the I.R.S.'s issuance of the proposed regulations, practitioners flagged this specific fact pattern and also addressed Code §163(j) issues arising when leverage is introduced to partnerships more generally.[20] Some concluded that the proposed regulations' approach does not make for good tax policy because what occurs at the partnership level should not influence deductibility of interest at the partner level.[21] One firm suggested that the new misleading example (discussed above) might "further suggest" the partner in an R.P.T.O.B. partnership "may elect to treat its partnership interest as an electing [R.P.T.O.B.]."[22]

Congress's infelicitous entity approach to partnerships was further taken up in the New York State Bar Association's report, which proposed that "consideration should be given to seeking a statutory amendment of Section 163(j) to apply the limitation on deductibility of interest . . . at the partner level."[23] More insightfully (but still not

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19 If, on different facts, P invested in a partnership conducting a utility business subject to rates approved by a public body then, because under Code §163(j)(7) no election is required, the look-thru rules may be sufficient for P to treat its partnership interest as an excepted trade or business, without needing to file an election to benefit, though the possibility of inconsistent treatment would need to be addressed in such case also.

20 On the precise facts discussed herein, one practitioner questioned whether Code §163(j)'s limitation would even apply to debt "incurred by a C corporation to fund an investment in a partnership conducting a real property trade or business," noting that "[t]here would seem to be greater barriers to applying the [R.P.T.O.B.] exception with respect to debt incurred by a C corporation that funds an investment in REIT or C corporation stock." See Jim Sowell, "Tax Reform and Partnerships" (PowerPoint presentation, Alabama Federal Tax Clinic, November 14, 2018), at p. 67.

21 See Hershel Wein and Charles Kaufman, "The New Section 163(j): Partnerships Issues," *What's News in Tax, September 24, 2018, at pp. 16–17:*

> Pursuant to the entity theory of partnerships, the section 163(j) limitation applies at the partnership level. Nevertheless, it can be argued that the fact that the limitation applies at the partnership level should not influence whether the trade or business of a partnership can determine the deductibility of interest on debt incurred by a partner.

22 "Proposed Section Section [sic] 163(j) Regulations Have Implications for Real Estate Industry," EY, November 28, 2018. However, in a longer tax alert on Code §163(j) published just two days later, the example was omitted ("US Proposed Regulations Offer Much-Needed Guidance on Section 163(j) Business Interest Expense Limitation," EY, November 30, 2018).

23 See New York State Bar Association Tax Section, Report No. 1412: Report on Proposed Section 163(j) Regulations (February 26, 2019), at pp. 35, 37-39 (finding that as an overall matter, the proposed regulations' approach produced reasonable results, but sometimes at the cost of undue complexity such as with regard to the 11-step process for determining each partner's items of deductible business interest expense, carryforwards, and other items under §163(j)). Somewhat confusingly, N.Y.S.B.A. also suggested that Code §163(d) should be applied on an aggregate basis and §163(j) on an entity basis. See id. at p. 35.

helpful to C), one law firm commentator noted that Prop. Treas. Reg. Code §1.163(j)-9(c)(4) reserved the election at the "trade-or-business level, not necessarily for a particular entity."[24] This trade or business orientation, combined with Congress's entity approach to partnerships for Code §163(j), is the genesis of C's issue.

For now, those taxpayers who have not yet made an investment and are properly advised can get the benefit of learning from C's example and avoid falling into the river. However, in agreement with the broad sweep of the foregoing commentators' statements, we would respectfully request the I.R.S. to consider appropriate ways of rectifying this unjustified disparity in the final regulations in order to remove the troublesome splinter and save Clementine.

"Different challenges may arise if there is uncertainty around the level at which any given rule is to be applied, since taxpayers may cherry-pick and alter their view depending on which rules are at stake, potentially subverting the intent of the rules."

CONCLUSION

Some might cynically protest that the R.P.T.O.B. election's very existence is another unprincipled "giveaway" to the real estate industry; however, it is worse to make defective gifts that sometimes explode (and sometimes don't) and more unprincipled to treat otherwise identical taxpayers in markedly different ways.

In this article, we have explored one challenge with applying one rule exclusively at the partnership level. Different challenges may arise if there is uncertainty around the level at which any given rule is to be applied, since taxpayers may cherry-pick and alter their view depending on which rules are at stake, potentially subverting the intent of the rules.

Certain practitioners may suggest that, barring further clarification, there is nevertheless sufficient basis for a return position that the R.P.T.O.B. election is permissible at the partner level. However, it would appear that if a taxpayer took such an inconsistent position, it may be required to include the Form 8082, *Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)*, together with the election statement that is attached to the partner's tax return, forego bonus depreciation to which it would otherwise be entitled, and make appropriate adjustments.[25] Also, in the authors' experience, many partnership and limited liability company operating agreements prohibit a partner from filing an inconsistent position without obtaining their partners' consent. This could present a stumbling block to the election.

It is possible that unless Congress repeals Code §163(j)(4), which provides that partnerships are to be treated as entities for Code §163(j) purposes, the I.R.S. will not be able to independently alter the election mechanics adopted in the proposed regulations.

However, to address C's specific issue, the I.R.S. could harness the proposed -9 and -10 regulations, whenever finally adopted, to permit a clear election for partners in C's position, providing that, in limited circumstances where the partnership would otherwise qualify, partners may step into the entity's shoes to make the R.P.T.O.B. election. Presumably, the I.R.S. could thus rectify this unfair disparity, subject to the taxpayer making appropriate adjustments. While introducing further complexity to

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[24] Peter M. Fass, "Real Estate Under §163(j) Interest Deduction Limitation," *New York Law Journal*, June 14, 2019.

[25] This disclosure would help to forestall penalties for underpayment under Code §6662, and for the tax return preparer under Code §6694.

the -9 and -10 rules, this would ensure taxpayers like C are not unfairly deprived of a beneficial election available to similarly situated taxpayers who happen to have a slightly different financing structure.

By making this small fix, the I.R.S. will ensure that taxpayers investing in real estate through leveraged partnerships will not stub their toes and plunge into the "foaming brine" that awaits them under the current language in Prop. Treas. Reg. §1.163(j)-9, in response to which the I.R.S.'s only refrain will be to echo the old folk ballad – "dreadful sorry, Clementine!"

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