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Complexity Cubed: Partnerships, Interest, and the Proposed Regs

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Complexity Cubed: Partnerships, Interest, and the Proposed Regs

by Walter D. Schwidetzky

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In this two-part report, Schwidetzky examines how section 163(j)'s limitation on the business interest expense deduction applies to partnerships. This first installment considers what prompted the enactment of section 163(j) and explains why the statute's operation in the partnership context is inherently complex. Part 2 will navigate the proposed regulations' complicated, 11-step system for partnerships and propose simpler ways to keep partnership and partner levels aligned for purposes of the deduction.

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I. Introduction

New section 163(j) strictly limits business interest expense (BIE) deductions to large (and possibly not-so-large) taxpayers. Generally, BIEs may only be deducted to the extent that they do not exceed 30 percent of adjusted taxable income plus business interest income. Section 163(j)(4) requires partnerships to calculate this limitation at the partnership level. In this report, I focus on how section 163(j) applies to partnerships. Given my focus, I leave to others a more comprehensive review of section 163(j) as a totality,[1] as well as the coverage of S corporations. I will tend to give fairly short shrift to the portions of the statute and proposed regulations (REG-106089-18) that do not primarily apply to partnerships. For the most part, I assume the reader is well-versed in subchapter K. I begin by laying out some background to the enactment of section 163(j) and its application to partnerships.

II. Why Section 163(j)?

Why, after allowing BIEs generally to be fully deductible for generations, did Congress feel the need to enact section 163(j)? Surprisingly, the Tax Cuts and Jobs Act conference report, as well as the Joint Committee on Taxation's explanation,[2] have little to say on the subject. But there are likely three — at times overlapping — motivations for its enactment: the need for revenue, concerns about excessive leverage in the economy, and the need to avoid the distortions that would be caused by

[1] *See* Fred Feingold and Yishaya Marks, "Interest Deduction Limitation: Matters of Principle or Principal?" *Tax Notes*, Mar. 18, 2019, p. 1295.

[2] JCT, "Technical Explanation of the Revenue Provisions of the House Amendment to the Senate Amendment to H.R. 1625 (Rules Committee Print 115-66)," JCX-6-18 (Mar. 22, 2018).

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keeping the old rules in light of new section 168(k). New section 168(k), through 2023, allows 100 percent of the cost of depreciable personal property to be deducted in the year of purchase if it has less than a 20-year recovery period (which pretty much covers the personal property waterfront). After 2023, the percentage of the cost that is deductible drops each year, from 100 percent to eventually 20 percent, depending on when the property was placed in service.[3] Section 168(k) expires at the end of 2026 or 2027, depending on the type of asset at issue,[4] but if history is any guide, it will not be allowed to fully expire.

The TCJA steeply cut some taxes, especially corporate taxes. Estimates vary as to the extent of the loss in revenue caused by reduction of the corporate tax rate in section 11 from a maximum of 35 percent to a flat rate of 21 percent. A common estimate is about $1.4 trillion in revenue losses.[5] Total revenue losses from the TCJA also vary, of course, but are often close to the same $1.4 trillion, suggesting that outside the corporate tax cut, the TCJA was close to revenue neutral.[6] Inasmuch as the TCJA also made other tax cuts, it needed to also raise revenue to keep the rest of the tax bill close to revenue neutral. One major revenue raiser is indeed section 163(j): According to the JCT, section 163(j) will generate about $253.4 billion in revenue between 2018 and 2027.[7] The House Ways and Means Committee, however, did not admit that the revenue need was a priority, and instead focused on the risk of excessive leverage in the economy:

> The Committee believes that the general deductibility of interest payments on debt may result in companies undertaking more leverage than they would in the absence of the tax system. The effective marginal tax rate on debt-financed investment is lower than that on equity-financed investment. Limiting the deductibility of interest along with reducing the corporate tax rate narrows the disparity in the effective marginal tax rates based on different sources of financing. This leads to a more efficient capital structure for firms. The Committee believes that it is necessary to apply the limitation on the deductibility of interest to businesses regardless of the form in which such businesses are organized so as not to create distortions in the choice of entity.
>
> The Committee believes that limitations on the deductibility of interest should be applied to those businesses with the greatest levels of leverage. Such firms may pose the greatest societal costs in times of financial distress. Smaller firms are likely to impose smaller costs on the economy than larger firms. Additionally, smaller firms have limited access to public equity capital markets as compared to larger firms. Thus, the Committee believes it is appropriate to limit the interest deductions of only the largest taxpayers.[8]

If excessive leverage is the concern, why enact section 163(j) now? When corporate tax rates were higher, the potential benefit of leverage was also higher. An interest deduction at a corporate rate of 35 percent is more valuable than at a corporate rate of 21 percent. Further, the House

[3] Section 168(k)(b)(A)(i)-(iv).

[4] *See* section 168(k)(6).

[5] *See* JCT, "Estimated Budget Effects of the Conference Agreement for H.R. 1, the 'Tax Cuts and Jobs Act' Fiscal Years 2018-2027," JCX-67-17 (Dec. 18, 2017) ($1.389 trillion); Penn Wharton Budget Model, "The Senate Tax Cuts and Jobs Act, as Passed by Senate (12/2/17): Static and Dynamic Effects on the Budget and the Economy," at 3 (2017) ($1.435 trillion); and Tax Foundation, "Preliminary Details and Analysis of the Tax Cuts and Jobs Act," at 9 (2017) (static, $1.42 trillion). Using dynamic forecasting, which tries to predict changes in the economy brought about by changes in fiscal policies, even the conservative Tax Foundation acknowledges that the corporate rate reduction will cost $668 billion between 2018 and 2027. On the other hand, the less-conservative Penn Wharton Budget Model predicts revenue losses between 2018 and 2040 of $4.185 trillion.

[6] *See supra* note 5. The JCT and the Tax Foundation were close to $1.4 trillion using a static model; the Penn Wharton Budget Model came in at about $2 trillion.

[7] JCT, "General Explanation of Public Law 115-97," JCS-1-18, at 437 (Dec. 20, 2018). *See also* KPMG LLP, "New Tax Law: Issues for Partnerships, S Corporations, and Their Owners," at 12-14 (Jan. 18, 2018).

[8] H.R. Rep. No. 115-409, at 247-248 (Nov. 2017) (House report).

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acknowledged that the reduced corporate rate "narrows the disparity in the effective marginal tax rates based on different sources of financing." To worry about excessive leverage under these circumstances is a bit of a non sequitur. If Congress was truly concerned about excessive leverage, one would have expected it to act long before now, when rates were higher.[9] Then again, this would not be the first problem that Congress was slow to address. In any event, if excess leverage has been a problem in the economy — and many think it has — the limitation is better late than never.[10] But one suspects that revenue needs also played a major, if unwritten, role.

One of the bigger revenue losers in the TCJA is new section 168(k).[11] The 2016 Republican "Better Way" plan, while again not directly addressing the revenue needs, did acknowledge an interrelationship between sections 168(j) and 163(k):

> The benefit of immediate expensing of business investment operates as a more beneficial and more neutral substitute for the deduction of interest expense associated with debt incurred to finance such investment. Allowing investments to be immediately written off provides a greater incentive to invest than is provided through interest deductions under current law; allowing both together would be distortive as it would result in a tax subsidy for debt-financed investment.[12]

[9]Some have suggested that new deduction rules for business interest were motivated by a desire to limit transfers to related foreign companies. By paying interest on debt to a foreign entity, income can be lodged offshore at presumably lower tax rates. The difficulty with this argument is the same as with the leverage argument: It made more sense when corporate tax rates were higher. Also, I'm unable to find any written evidence supporting that interpretation.

[10]*See* Mark P. Keightley and Molly F. Sherlock, "The Corporate Income Tax System: Overview and Options for Reform," Congressional Research Service report R42726 (Sept. 13, 2012); Sven Langedijk et al., "Debt Bias in Corporate Taxation and the Costs of Banking Crises in the EU," European Commission's Directorate-General for Taxation and Customs Union working paper 50 (2014); and Serena Fatica, Thomas Hemmelgarn, and Gaëtan Nicodème, "The Debt-Equity Tax Bias: Consequences and Solutions," European Commission's Directorate-General for Taxation and Customs Union working paper 33 (2012).

[11]JCX-67-17, *supra* note 5 (revenue loss estimated at $86.3 billion).

[12]Better.gop, "A Better Way: Our Vision for a Confident America," at 26 (June 24, 2016).

And indeed, the distortion could be substantial if the old rules on business interest deductions are coupled with new section 168(k). A simple example: Assume a taxpayer at a 30 percent marginal tax rate buys a $100,000 piece of new equipment for use in business. Under section 168(k), the entire cost is deductible, saving the taxpayer $30,000 in taxes, for a net cost of the equipment of $70,000. Now assume section 163(j) was never enacted, business interest remains fully deductible, and the taxpayer borrows the entire cost of the equipment. The taxpayer receives a $100,000 deduction and a $30,000 tax savings with zero equity outlay. For simplicity, assume the loan has an interest rate of 5 percent and is interest-only for five years when the principal becomes due. Each year the taxpayer pays $5,000 of (under the old rules) fully deductible interest, which saves taxes of $1,500, and thus has a net cost of $3,500 ($5,000 - $1,500).

In year 1, the taxpayer has total tax savings of $31,500 and $100,000 of equipment for use in its business, which cost it only $3,500 that year. Thus, the taxpayer has more in tax savings than its out-of-pocket cost for the equipment. This tax arbitrage continues until the loan becomes due, because four more years of net interest cost of $3,500 per year is $14,000 — still less than the tax savings in year 1 (ignoring time value of money considerations).

Of course, in year 5 it comes time to pay the piper. At this point the math can become complex, and I will not burden the reader with it. But depending on interest rates, the time value of money, the taxpayer's other investment opportunities, and tax rates, it is possible that even after paying back the $100,000 loan, the taxpayer is economically ahead on an after-tax basis because of the savings offered by section 168(k) and the old interest deduction rules. That in turn could mean that the taxpayer effectively is buying the property for free (or even for a negative amount).

Taxpayers with no skin in the game do not tend to make optimal business decisions. The combination of section 168(k) and the old business interest deduction rules could easily lead to poor business decisions, the purchase of business assets that might not be truly needed, and excessive leverage in the economy. Thus, the

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concerns about the distortive effects of section 168(k) are decidedly valid. The enactment of section 168(k) effectively forced Congress to address the BIE rules. Further, if the old rules caused the use of excessive leverage even without new section 168(k), one could argue that one benefit of section 168(k) (regardless of its other merits and demerits) is that it forced Congress to do what it should have done earlier.[13]

As I will discuss, section 163(j) contains an exception for small and medium-size businesses. The reason, according to the quoted language from the House report, is that small business has less of an impact, which is a doubtful assumption. Small businesses make up 99.9 percent of all companies and 97.6 percent of exporters.[14] Small business, in the aggregate, is thus a huge part of the economy, and excessive leverage there can certainly create economywide problems. That said, small businesses have less access to capital than large businesses, and individuals often have to borrow funds or personally guarantee them to get necessary capital. If the interest deduction were taken away from small business, it could mean that a business that operated at a loss in terms of cash flow would have taxable income because interest payments would no longer be counted. There is also some backstop to excessive leverage for small business, because lenders will look at the creditworthiness of individual borrowers, and those borrowers will have less access to borrowed capital generally. It is not as if they can issue junk bonds. Thus, perhaps retaining the full interest deduction for small business is easier to justify than for large business.

III. Partnerships and Section 163(j)

Section 163(j) is complex generally, but it saves its most sublime tortures for partnerships in section 163(j)(4). There are at least three reasons for this extra complexity.

A. Partnership-Level Calculation

The first reason is that under section 163(j)(4), for partnerships, the section 163(j) restriction on the deduction of interest must be calculated at the partnership level. Under subchapter K, partnerships are normally not taxable entities, with all income and expenses flowing through to the partners. For that reason, normally any limitation on deductions is calculated at the partner level.[15] For nontaxable entities, it is much easier to calculate deduction limitations at the owner level because that is the level at which income and expenses are taken into account and at which the tax is calculated. Applying a limitation at the partnership level essentially stands subchapter K on its head, treating the partnership as if it were a taxable entity for purposes of the limitation. But almost all of subchapter K assumes the opposite, and integrating the general rules of subchapter K with an entity-level tax rule is no small feat. Complex regulations were hard to avoid.

If it creates so much complexity, why did Congress enact section 163(j)(4), which has no real analog in subchapter K? Oddly, nowhere have I found a clear-cut explanation for why Congress enacted section 163(j)(4). Out of desperation, I even contacted someone in government with section 163(j) expertise, who could not give me a reason for section 163(j)(4). The answer may lie in section 704(b). If true, it provides a second reason for the complexity.

B. Section 704(b) Allocations

Section 704(b) permits disproportionate allocations of partnership items. For example, someone who contributed 10 percent of capital could be allocated 100 percent of depreciation deductions.[16] Could partners manipulate section 163(j) by how they allocate ATI and deduction items? This report is not the place for a deep dive into the section 704(b) regulations, but the answer is mostly no, assuming the partners play by the rules. As I tell my students, generally, for an allocation to be valid under section 704(b), on a present value, after-tax basis, at least one partner

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[13] Note that section 168(k) alone can distort business decisions, encouraging capital investments over labor investments in a way the economy might not do in a more neutral tax universe. But that is getting a bit far afield for this report, and I will leave these complex economics issue to the economists.

[14] *See* Mary Ellen Biery, "The Big Impact of Small Businesses: 9 Amazing Facts," *Forbes*, Oct. 22, 2017.

[15] *See*, *e.g.*, sections 465 and 469.

[16] *See* Richard Lipton et al., *Partnership Taxation*, ch. 5 (4th ed. 2017).

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must be better off, and at least one partner must be worse off. And under some circumstances, the regulations look not only at the tax year in question, but up to four future years as well.[17] If the partnership indefinitely allocates more ATI to one partner and more ATI deductions to other partners, the allocation likely will be valid under these standards — and also inoffensive.

If someone receives a valid allocation of ATI, why not give that person more BIE deductions? But why would the other partners allow one of their own to receive most or all ATI items? True, less income means fewer taxes in the short run, but it can also mean less money in a partner's pocket. More ATI may not only mean more taxable income, but it also may mean a larger capital account increase, larger distributions, and a bigger payout on liquidation (although liquidation that is far off in the future may be of limited relevance). So it might not be easy to get the other partners to play ball in many contexts, although hardly all contexts. In a family partnership, for example, the parents/general partners can typically arrange initial allocations any way they want. But those allocations would still have to pass muster under the section 704(b) regulations.

Thus, section 704(b) does not provide a satisfying explanation for section 163(j)(4), at least for partners playing by the rules. But, of course, partners do not always play by the rules. One can easily imagine a situation in which a partner is given a temporary increase in ATI to get a partner over some tax hurdle that arose outside the partnership. Temporary allocations designed to give partners short-term tax advantages typically do not pass muster under the section 704(b) regulations because they violate the substantiality rule or the rules for partners' interests in the partnership, but that does not mean that those allocations would not happen.

It is generally acknowledged that the IRS does not have the personnel to adequately audit partnerships, that partnership audits are relatively uncommon, and that IRS agents rarely have sufficient expertise in partnership tax law. Indeed, partners could be inclined to push the planning envelope and engage in the suggested temporary allocations, knowing that an audit is unlikely. The best argument for calculating section 163(j) at the partnership level is not its theoretical underpinnings, which are shaky at best, but rather pragmatism: It may make the law easier for the IRS to enforce. With the deductibility of BIE determined at the partnership level, on the other hand, there is not much to game. Under section 163(j)(4) and the proposed regulations, aggregate allowed and disallowed BIEs at the partnership level must be matched by the aggregate deductions and carryforwards at the partner level. As Part 2 of this report will show, if gaming the system was the concern, section 163(j)(4) provides an effective solution.

Further, I have no doubt that some gaming of the system would go on if section 163(j)(4) had not been enacted. Whether it would occur enough to justify the enactment of a code provision as complex as section 163(j)(4) and the associated regulations is dubious, however. To keep the partnership and partner levels aligned for BIE deduction purposes, the proposed regulations create a highly complex 11-step system. I view complexity as an evil that should be avoided whenever possible. Is there a simpler way of addressing the problem? I believe so, as I discuss in Part 2 of this report. In that final section I also give an example of the application of section 704(b) in the section 163(j) context.

C. Tax Shelter Carveout

The complexity added by the third reason is not that great, compared with the others, but in exchange it may end up being the most problematic. As noted, Congress did not feel that the new rules should apply to small business. In addition to the discussed economic problems, Congress may have appreciated that the complexities surrounding section 163(j) could overwhelm small business. Whatever the motivation, section 163(j)(3) contains a fairly generous exemption for small and medium-size businesses. Generally, a taxpayer is not subject to section 163(j) for a given tax year if its average

[17] *See id*. at sections 5.03 and 5.04.

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annual gross receipts for the three previous years do not exceed $25 million.[18]

But the $25 million exemption does not apply to tax shelters prohibited from using the cash method of accounting under section 448(a)(3). As I will discuss in more detail later, the definition of tax shelter is so broad that it potentially includes most sophisticated partnerships. Likely, most of these partnerships typically would not be thought of as traditional tax shelters, at least if a tax shelter is defined as an undertaking whose primary purpose is to reduce taxes as opposed to operating a legitimate business. Yet, many sophisticated cash-basis partnerships with gross receipts of less than $25 million could be fully subject to section 163(j) with all its complexities.

IV. The Non-Partnership Fundamentals

As noted, my focus is on how section 163(j) applies to partnerships. For the un- or under-initiated, I briefly review the fundamentals of section 163(j).

The House report as well as the proposed regulations provide that the section 163(j) limitation should be applied after other interest disallowance, deferral, capitalization, or limitation provisions apply.[19] Only interest that is still deductible after applying these provisions is subject to section 163(j). Interestingly, however, the proposed regulations provide that section 163(j) applies *before* sections 461(l), 465, and 469.[20] The preamble provides little in the way of justification for this. It notes that the pre-TCJA section 163(j)(7) provided for this treatment,[21] but there is no such language in the current version of section 163(j). Further, old section 163(j) was a very different code subsection, denying the deduction of BIEs on specific related-party debt of corporations with high debt-equity ratios. Relying on the old section 163(j) to provide the justification for this rule in the proposed regulations is — take your pick — inexplicable or specious. If the House report were legally binding (it is not), it seems that section 163(j) should be applied *after* sections 461(l), 465, and 469.

That said, there is little question that the IRS is right on the merits. The three code sections typically apply to net losses and thus would be awkward to apply before a code section like section 163(j) that limits a deduction used in computing net losses. Further, these three code sections apply at the partner level, whereas the initial section 163(j) calculation is made at the partnership level. It would be awkward, to say the least, to apply a partner-level limitation before a partnership-level limitation. The partnership would have to communicate with the partners, figure out which, if any, of the other three code sections apply, and somehow integrate it with the partnership's application of section 163(j).

Making the process even more complex is that the order in which these three code sections must be applied is section 465, section 469, and finally section 461(l).[22] One partner could be stopped at section 465, another at section 469, and still another at section 461(l). Also, all three code sections in some fashion allow the disallowed losses to be carried forward. Would section 163(j) be reapplied downstream to a previously disallowed loss that became deductible? All of this sounds like an even bigger nightmare in the making. Thus, although the proposed regulations seem to be at disjuncture with the House report, the reality is that the IRS may have had little choice, and it is hard to see who would want to challenge the IRS in this regard.

Other rules limiting the deduction of interest do not tend to carry as much baggage. For example, the capitalization rules of section 263A prevent the deduction of interest outright. It is not a problem to apply section 163(j) after code sections that take interest payments off the table. The proposed regulations note that section 163(e)(3) and (5)(A)(ii) (original issue discount rules), section 267(a)(2) and (3) (matching

[18] Note the difference between gross receipts and gross income. Gross receipts minus the cost of goods sold equals gross income. Generally, commonly controlled businesses must be aggregated when calculating gross receipts. *See* sections 163(j)(3), 448(c), and 52(b). *See also* preamble to REG-106089-18, 83 F.R. 67490, at 67509-67510 (Dec. 28, 2018).

[19] *See* H.R. Rep. No. 115-409, at 249; and prop. reg. section 1.163(j)-3(b).

[20] Prop. reg. section 1.163(j)-3(b). Section 461(l) provides an overall loss limitation rule for noncorporate taxpayers ($250,000 per year for single taxpayers and $500,000 per year for taxpayers filing jointly). It applies after the other two code sections. Section 465 contains the at-risk rules. Section 469 contains the passive loss rules.

[21] *See* preamble to REG-106089-18, 83 F.R. at 67503.

[22] *See* Lipton et al., *supra* note 16, at ch. 4.07.

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deduction and income between related parties), section 1277 (accrued market discount), and section 1282 (deferral of interest deduction on short-term obligations) all apply before section 163(j). But again, none of these has a meaningful partner-level interaction; they can all be resolved at the partnership level without ever speaking to a partner. That said, the IRS was not able to escape addressing all non-section 163(j) partner-level adjustments, as I discuss later.

Under section 163(j)(1), the amount allowed as a deduction for BIEs may not exceed the sum of:

A. the business interest income of the taxpayer for the tax year (gross of BIEs);
B. 30 percent of the ATI of the taxpayer for the tax year; and
C. the floor plan financing interest of the taxpayer for the tax year (which I will diligently ignore for the balance of the report).

The amount of any business interest not allowed as a deduction for any tax year because of section 163(j)(1) is treated under section 163(j)(2) as business interest paid or accrued in the succeeding tax year, subject to the same rules.

BIE means any interest paid or accrued on indebtedness properly allocable to a trade or business. The term does not include investment interest (within the meaning of section 163(d)).[23] Prop. reg. section 1.163(j)-1(b)(20)(iii)(I) provides that guaranteed returns on capital are treated as BIEs. If finalized, this regulation could cause allocations of preferred gross (or net) income and related distributions to receive greater scrutiny. Guaranteed payments are commonly deductible to the partnership in computing partnership taxable income (relevant, for example, in computing partners' outside bases under section 705). In response to how guaranteed payments on capital would be treated, partnerships may move to a system of non-guaranteed preferred returns, but the loss of the deduction would have to be assessed. Often it would be of little significance, but there is no substitute for running the numbers.

Business interest income means the amount of interest includable in the taxpayer's gross income for the tax year that is properly allocable to a trade or business. Logically, the term does not include investment income within the meaning of section 163(d).[24] The proposed regulations do not add much to this definition; they simply state that business interest income means interest income that is properly allocable to a non-excepted trade or business (defined later).[25] Does interest income on a business bank account constitute business interest income? Neither the statute nor the proposed regulations provide an answer.

Under section 163(j)(7), the term "trade or business" does not include:

i. the trade or business of performing services as an employee;
ii. any electing real property trade or business;
iii. any electing farming business;
iv. the trade or business of the furnishing or sale of electrical energy, water, sewage disposal services, gas, or steam through a local distribution system; or
v. transportation of gas or steam by pipeline, if (to be brief) rates are regulated by a state, the federal government, or other political body.

In the lingo of the proposed regulations, a business engaged in any of the activities listed in i-iv is called an "excepted trade or business" holding "excepted assets"; any other trade or business is, inescapably, a "non-excepted trade or business" holding "non-excepted assets."[26] Generally, in this report I assume that a partnership conducts only a non-excepted business and holds only non-excepted assets. If a partnership holds both, the proposed regulations generally require that a proportionate allocation be made between the excepted and non-excepted assets.[27]

[23] Section 163(j)(5). Notice 2018-28, 2018-16 IRB 492, stated that Treasury and the IRS intend to issue regulations clarifying that, solely for purposes of section 163(j), for a C corporation taxpayer, all interest paid or accrued by that C corporation on its indebtedness will be BIE within the meaning of section 163(j)(5), and all interest on indebtedness held by the C corporation that is includable in its gross income will be business interest income within the meaning of section 163(j)(6).

[24] Section 163(j)(6).

[25] Prop. reg. section 1.163(j)-1(b)(3).

[26] Prop. reg. section 1.163(j)-1(b)(7) and (8).

[27] Prop. reg. section 1.163(j)-10(b)(4)(ii).

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The exception for an "electing real property trade or business" is highly important. The term means any trade or business described in section 469(c)(7)(C) that makes the election.[28] Section 469(c)(7)(C) in turn states that a real property trade or business means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. This definition is broad so that one can say that real property businesses are generally exempt from section 163(j) if they make an election out. Once made, the election is irrevocable. To except real property business from the application of section 163(j) is to except a large segment of the economy.

Of course, the real estate industry can have excess leverage as much as any other economic industry. If, as the House report suggests, the reason for section 163(j) was to prevent excess leverage, why allow such a large segment of the economy to elect out — especially one that has major issues with excess leverage that helped create the Great Recession?

Note that many real property businesses have substantial personal property components (think hotels with furniture, TVs, etc.[29]), making section 168(k) far from irrelevant. Congress only partially addressed this concern through section 168(g)(8), which provides that real property businesses that elect out of section 163(j) must use the alternative depreciation system, but only for residential real property, nonresidential real property, and qualified improvement property (QIP). QIP is essentially the interior remodeling costs of real property. That system elongates the depreciation term for residential real property from 27½ years to 30 years, and for nonresidential real property from 39 years to 40 years. That cost is pennies in the bigger scheme of things. Section 168(k) continues to fully apply to personal property. One wonders why Congress even bothered.

Had Congress eliminated section 168(k) entirely for electing real property businesses, the choice of whether to make the election might have been challenging. But now it is hard to see why any real property business would not make the election, at least under the status quo. QIP, however, can throw a wrench into the works. Congress apparently intended to provide a 15-year recovery period for QIP, making it eligible for section 168(k), which applies to property with less than a 20-year recovery period. Congress failed to do that, apparently inadvertently, meaning that QIP costs would have to be depreciated over the relevant depreciation term for real property. But the plot thickens: There has been a (believe it or not, somewhat bipartisan) technical correction bill in the works that would give QIP the originally intended 15-year recovery period, retroactive to 2018. Given that the election out of section 163(j) for real property businesses is irrevocable, the possibility of using section 168(k) for QIP could make the election decision more than a little challenging for some real property businesses that plan to do significant remodeling.[30]

Under section 163(j)(8), ATI means the taxable income of the taxpayer, computed without regard to:

i. any item of income, gain, deduction, or loss that 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;[31] and
v. for tax years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion.

Saying the same thing in a different way, ATI is taxable income with the items listed in i-v added back in or subtracted.

[28] Section 163(j)(7)(B).

[29] I have been told that some taxpayers treat door locks as personal property.

[30] *See* Rev. Proc. 2019-8, 2019-3 IRB 347, for details on how to make the election. *See also* Tony Nitti, "A First Step: Senators Introduce Bill to Fix Costly Depreciation Mistake in GOP Tax Law," *Forbes*, Mar. 14, 2019. Thanks go to professor Deborah A. Geier, who brought me up to speed on this issue.

[31] Section 199A allows a below-the-line, non-itemized deduction for, commonly, 20 percent of specific net business income not earned through a C corporation. *See* Karen C. Burke, "Section 199A and Choice of Passthrough Entity," 72 *Tax Law*. 551 (2019).

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V. A Tax Shelter by Any Other Name

As noted earlier, the $25 million gross receipts exemption does not apply to tax shelters that may not use the cash method of accounting under section 448(a)(3). One might think one could look to section 448 to determine when one has a prohibited tax shelter. Indeed, section 448, while providing that a tax shelter may not use the cash method of accounting (making the statement in section 163(j) somewhat redundant), doesn't define a tax shelter at all. Instead, it refers the reader to section 461(i)(3), which defines a tax shelter as:

A. any enterprise (other than a C corporation) if at any time interests in that enterprise have been offered for sale in any offering required to be registered with any federal or state agency having the authority to regulate the offering of securities for sale;

B. any syndicate (within the meaning of section 1256(e)(3)(B)); and

C. any tax shelter (as defined in section 6662(d)(2)(C)(ii)).[32]

Most people, lay and professional, would define a tax shelter as a venture in which the primary objective of the investment is to save taxes as opposed to operating a business for profit. Registration with a governmental authority is irrelevant to this question. Further, the reach of this rule could be quite broad because, in the IRS's view, a taxpayer falls within the rule even if the securities are exempt from registration, for example, under regulation D, (which still requires a filing).[33] Although few smaller partnerships likely issue securities that need to be formally registered, issuing securities that are exempt from registration under an exception like regulation D is quite common.

Under section 1256(e)(3)(B), the term "syndicate" means any partnership or other entity (other than a corporation that is not an S corporation) if more than 35 percent of its losses during the tax year are allocable to limited partners or limited entrepreneurs (within the meaning of section 461(k)(4)). When investment capital is being raised from investors who are not expected to be active in the business, whether limited partners or non-managing members of a limited liability company, it is common to allocate all or most of the losses to them. As indicated earlier, section 704(b) permits this type of disproportionate allocation,[34] and usually it is anything but offensive. In the typical deal, the investors are putting up most of the money and taking most of the economic risk. Who else should be allocated the losses? If they were *not* allocated the early losses, it would be questionable. Why allocate losses to those who did not bear the economic burden of them? This factor alone would not distantly cause one to conclude that a tax shelter exists according to a common-sense definition of the term.

Many entirely legitimate partnerships will meet the section 461(i)(3) definition of a tax shelter and thus be unable to take advantage of the $25 million gross receipts exemption. That may make these partnerships less than fully competitive with businesses that don't have passive investors or that allocate losses in a manner that stays under the 35 percent threshold. One solution would be to never allocate passive investors more than 35 percent of losses, but that would likely be met with legitimate resistance from investors, and indeed might create an economic distortion if losses are allocated to parties who did not bear them. Here the tail often will be wagging the dog. Legitimate businesses should be allowed to negotiate with investors in any way that makes sense, and they should not have to factor in an irrational loss allocation threshold.

And it gets worse.

Section 6662(d)(2)(C)(ii) defines a tax shelter as:

A. a partnership or other entity;

B. any investment plan or arrangement; or

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

[32] The rules are somewhat less onerous for farmers. *See* section 461(i)(4).

[33] *See* reg. section 1.448-1T(b); and GCM 39781 (1989). Thanks to Alan Berkeley of K&L Gates for his words of wisdom in this regard.

[34] *See* Lipton et al., *supra* note 16, at ch. 5.

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If section 6662(d)(2)(C)(ii) just said "evasion," it would not be objectionable. Tax evasion usually is said to exist when a taxpayer deliberately avoids paying a true tax liability in a manner that constitutes a crime.[35] For example, section 7201 provides:

> Any person who willfully attempts in any manner to *evade* or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution. [Emphasis added.]

Tax avoidance, on the other hand, usually means the legal avoidance of a tax liability.[36] That legal avoidance might come about because the code intentionally gives the taxpayer a given tax benefit, or it might be an unintended benefit — that is, a tax loophole. As Judge Learned Hand famously observed:

> Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.[37]

To state the obvious, legally avoiding taxes should not prevent one from taking advantage of the $25 million exemption (or any other tax benefit).

For section 6662(d)(2)(C)(ii) to apply, the evasion or avoidance must be a "significant purpose." That term is not defined in the code or the section 6662 regulations, but arguably it is fairly common. For example, if investors put up the capital for a new enterprise, their long-term objectives may be to make a profit, but the near-term tax benefits likely will be highly relevant. Assuming sections 465 and 469 do not impose undue hurdles, the ability to deduct near-term losses will probably be important to investors and likely will be a significant purpose for the investment. And not many tax return preparers will be willing to advise investors that the tax benefits from the near-term were not a significant purpose for the investment and risk section 6694 penalties, even if they might have a valid argument.

Example: Assume the partnership agreement allocates losses 99 percent to the limited partners until partnership income equals partnership losses, and then "flips" the allocation to 50 percent to the limited partners and 50 percent to the general partners. Flips like this are very common and, as such, inoffensive. But the partnership likely will be seen as a tax shelter under section 6662. The ability to deduct near-term losses is almost certainly a significant factor for the limited partners. Thus, a perhaps entirely inoffensive partnership will fail to qualify for the $25 million exemption.

Also, unlike with a syndicate, section 6662(d)(2)(C)(ii) can apply when there are no passive investors. Even if all the owners of the business are active in the business, if they expect near-term losses, the ability to deduct those losses could be considered significant. The idea that persons investing in a business in which they are actively involved could be seen as investing in a tax shelter if the business loses money in the early going is silly on its face. There are countless other examples in which legitimate tax savings opportunities will at least arguably play a significant role. There is simply no logic to this fact preventing a taxpayer from using the $25 million exemption.

That this overbroad definition of tax shelters has survived scrutiny is perplexing. Being forced onto the accrual method of accounting is no small thing. The answer is likely a mundane one: Making the definition of a tax shelter more rational would probably be scored as a revenue loser, and given the large deficits that the federal government has been running, it is hard to get a revenue loser enacted, regardless of the logic, unless it has substantial public support. To date,

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[35] *See* Boris I. Bittker, Martin J. McMahon Jr., and Lawrence A. Zelenak, *Federal Income Taxation of Individuals*, para. 1.03[2] (3d ed. 2003).

[36] *Id. See also* Alan Gunn, "Tax Avoidance," 76 *Mich. L. Rev.* 733 (1978).

[37] *Commissioner v. Newman*, 159 F.2d 848, 850-851 (2d Cir. 1947) (dissenting opinion); *see also* Marvin Chirelstein, "Learned Hand's Contribution to the Law of Tax Avoidance," 77 *Yale L.J.* 440, 456 (1968).

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that has not been the case for the definition of tax shelter.[38] Perhaps this will change when section 163(j)'s potential problem for small business becomes clear.

VI. Kafka, Partnerships, and Section 163(j)

A. The Code

In this section, I focus on what new section 163(j) provides, although an occasional foray into the proposed regulations and subchapter K is unavoidable. Section 163(j) is a complicated section, and its most complicated provisions are perhaps those that apply to partnerships in section 163(j)(4). Before reviewing section 163(j)(4), a quick review of a subchapter K rule that plays a role in section 163 is in order.

Under section 702, partnerships have to separate income and expenses into two categories: one for items that can affect different partners differently (sometimes called "separately stated items"), and one for items that do not (commonly called "non-separately stated items"). An example of a separately stated item is long-term capital gains. Partnership long-term capital gains can affect different partners differently depending on what other capital gains and losses the partners have. Consequently, under section 702(a)(2), they must be stated separately on the Schedule K-1 given to the partners. Many items do not affect partners differently. Under section 702(a)(8), these non-separately stated items are netted and flow through to the partners as a single figure. Before the TCJA, a BIE usually would have been an example of a non-separately stated item because it typically was an ordinary expense item, fully deductible, and did not affect different partners differently.

Section 163(j)(4)(A)(i) provides that section 163(j) is to be applied at the partnership level, and that any deduction for a BIE will be taken into account in determining the non-separately stated taxable income or loss of the partnership. It is not clear what the purpose behind this non-separately stated provision is. The preamble notes that if a BIE that the partnership may deduct is taken into account as non-separately stated taxable income or loss, that item loses its character as a BIE at the partner's level for purposes of the partner's section 163(j) calculation.[39] It is combined with all the other non-separately stated items and is not subject to further limitations under section 163(j).[40]

Does that mean that the deductible BIE can just be ignored going forward? No — prop. reg. section 1.163(j)-6(c) provides that for purposes of the code other than section 163(j), BIEs retain their character as BIEs at the partner level. For example, for purposes of section 469, the interest retains its characterization as either passive or non-passive when allocated to the partner.[41] Accordingly, even though BIEs deductible by the partnership under section 163(j) are included with the partnership's non-separately stated taxable income and loss, the partnership will likely still have to keep track of them separately, making it a non-separately stated item that is actually separately stated.[42]

Apparently, there is no legal significance to requiring BIEs to be part of non-separately stated items. The motivation may have been pragmatic, albeit likely created by someone without a deep understanding of subchapter K. Calling it non-separately stated may have been seen as creating a sort of firewall to ensure that the section 163(j) calculation occurred at the partnership level. There were other ways to do that without creating a mostly incorrect use of the term "non-separately stated taxable income or loss"; but as defects in section 163(j) go, this one is fairly trivial.

Inasmuch as section 163(j) is applied at the partnership level, ATI must be computed at the partnership level. ATI is a term specific to section 163(j) and is not covered by the flow-through rules of section 702. Arguably, then, ATI as such cannot flow through to the partners, although its component parts certainly could. To the extent that the component parts flow through, it could permit the double counting of ATI by a partner in her own partnership-independent section 163(j) calculation if the flow through could increase the partner's ATI. Section 163(j)(4)(A)(ii) addresses

[38] Thanks to Shelly Banoff of Katten Muchin Rosenman LLP for his words of wisdom in this regard.

[39] *See* preamble to REG-106089-18, 83 F.R. at 67503.

[40] *See id*. and prop. reg. section 1.163(j)-6(c).

[41] *See* prop. reg. section 1.163(j)-6(c).

[42] *See* prop. reg. section 1.163(j)-3.

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this issue by providing that the ATI "of each partner of such partnership — shall be determined without regard to such partner's distributive[43] [that is, allocable] share of any items of income, gain, deduction, or loss of such partnership and shall be increased by such partner's distributive share of such partnership's excess taxable income." I discuss excess taxable income (ETI) later.

Calculating a partner's ATI amount is different from calculating his share of partnership income for non-section 163(j) purposes. The preamble states:

> No rule set forth in [the 11 steps] prohibits a partnership from making an allocation to a partner of any section 163(j) item that is otherwise permitted under section 704 and the regulations thereunder. Accordingly, any calculations in [the proposed 11 steps] are solely for the purpose of determining each partner's deductible BIE and section 163(j) excess items [excess BIEs, excess business interest income, and ETI — all discussed below] and do not otherwise affect any other provision under the Code, such as section 704(b).[44]

Thus, all items included in partnership ATI can be included in a partner's share of partnership income, gain, deduction, or loss for non-section 163 purposes and, for that matter, adjusted basis. In other words, the ATI rules for partners don't somehow trump the rules of subchapter K generally. The section 163(j) rules effectively overlay the section 704(b) rules to determine (among other things) if BIE allocated to a partner is deductible, but in no way do they change a valid section 704(b) allocation.

The amount of any BIE not allowed as a deduction to a partnership for any tax year is not treated as business interest paid or accrued by the partnership in the succeeding tax year (the general rule of section 163(j)(2) for non-partnership taxpayers). Instead, that amount is treated as "excess BIE," which is allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership — again with the non-separately stated piece having little meaning. Rather than have the partnership treat the disallowed BIE under the general rule of section 163(j)(2), that amount is allocated to the partners, who will need to keep track of it under section 163(j)(4)(B)(ii).

Why give the partnership a BIE deduction but effectively transfer any carryforwards to the partners? We are not told, but a possible answer is that the partners in a partnership can change. Optimally, the partners who were members of the partnership when the BIE was incurred, but that did not get the benefit of a deduction because of the section 163(j) limitations, should get the benefit of any carryforward. Again, optimally, new partners that enter later should not be able to benefit from a carryforward that did not arise on their watch, to the disadvantage of the continuing partners. And as I discuss later, if a partner transfers a partnership interest to another, the transferee does not get the benefit of a carryforward.

If a partner is allocated any excess BIE from a partnership, the excess BIE is treated as business interest paid or accrued *by the partner* in the next succeeding tax year in which the partner is allocated ETI or (in a nonstatutory, regulatory addition) "excess business interest income" (defined below) from the partnership, but only to the extent of those excess income items.[45]

One may question whether the IRS has the authority to allow excess BIEs to be deducted from excess business interest income when the statute provides only for the deduction from ETI. The addition, at least, makes sense: If in the current year a taxpayer can deduct BIEs from excess business interest income, it is not apparent why the taxpayer cannot deduct excess BIE in a future year from excess business interest income allocated to the partner from the same partnership.

Excess business interest income unsurprisingly means the amount by which a partnership's business interest income exceeds its

[43] As I tell my students, the term "distributive" is awkward because it suggests that distributions are involved. That is not the case in this context. In section 702, distributive is synonymous with allocable.

[44] *See* preamble to REG-106089-18, 83 F.R. at 67505.

[45] Prop. reg. section 1.163(j)-6(g)(2)(i).

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BIE in a tax year.[46] Somewhat confusingly, the proposed regulations have "excess business interest income" and also "business interest income excess." The two terms appear to be synonymous, but the former is calculated at the partnership level and the latter is calculated at the partner level.[47] Even though the meaning appears to be the same, the IRS apparently wanted to use different terms in different contexts. Perhaps nothing is more emblematic of the excessive complexity of the statute and the proposed regulations than the fact that the IRS felt the need to use different terms to say the same thing. Prop. reg. section 1.163(j)-6(e)(4) provides that, for section 163(j) purposes, a partner may count business interest income allocated to it from a partnership only to the extent of the partnership's excess business interest income allocated to it (plus a floor plan financing interest adjustment). This sensibly prevents a double counting of business interest income.

Notably, under section 163(j)(4)(b)(ii) and the proposed regulations, excess BIE allocated to a partner can become deductible only if ETI and excess business interest income are allocated to it by the same partnership that allocated the excess BIE.[48] Also, a taxpayer cannot choose the tax year in which the excess BIE becomes deductible. To the extent that excess BIEs become deductible in a given year, the taxpayer must deduct them in that year.[49] Any portion of that excess BIE remaining is treated as BIE paid or accrued by the partner in succeeding tax years.

To what extent must ETI be integrated with a partner's personal ATI before the partner can calculate the interest deduction? Can excess BIEs be deducted from ETI regardless of the other rules of section 163(j)? Or, alternatively, does a partner's share of the ETI increase its ATI, after which the partner runs through the regular section 163(j) rules (that is, deductible up to 30 percent of ATI, etc.)? The preamble acknowledges that both interpretations are possible, but it chose the latter view, arguing that it is more consistent with the statutory language.[50]

Accordingly, under the proposed regulations, excess BIE is treated as paid by a partner in the year in which the partner is allocated partnership ETI or excess business interest income (dollar for dollar), and it becomes, as it were, "regular" BIE to which section 163(j)(4) no longer applies. The ETI increases the partner's ATI. But the excess business interest expense that is now regular BIE is deductible only to the extent of 30 percent of the partner's ATI (plus the partner's business interest income — increased for the excess business interest income allocated to the partner), that is, the regular rule.

Thus, it is a two-track (almost stacking-rule-like) process. First, excess BIE in the hands of a partner is converted to regular BIE to the extent of the ETI or excess business interest income allocated to that partner. Second, if the now-regular BIE is not deductible because it exceeds 30 percent of the partner's ATI plus the partner's business interest income, it is subject to the regular section 163(j)(2) carryforward rules. It is carried forward at the partner level and is treated as paid in the subsequent year subject to the regular, non-partnership section 163(j) rules.[51]

Example 1: Assume a partner has $10 of excess BIE in year 1. In year 2 the partner is allocated $20 of ETI, which increases its 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 proposed regulations no longer limit the partner's ability to deduct the $10 of BIE, the regular rules do. Thirty percent 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).

The IRS's interpretation is not all that close of a call, at least if one focuses on the statute. The relevant language in section 163(j)(4)(B)(ii)(I) reads:

> If a partner is allocated excess business interest [expense] from a partnership . . .

[46] Prop. reg. section 1.163(j)-6(b)(4).

[47] For business interest income excess, see prop. reg. section 1.163(j)-6(f)(2)(iii).

[48] *See also* prop. reg. section 1.163(j)-6(g)(2).

[49] *See* prop. reg. section 1.163(j)-6(g)(3); and preamble to REG-106089-18, 83 F.R. at 67508.

[50] Preamble to REG-106089-18, 83 F.R. at 67508.

[51] Prop. reg. section 1.163(j)-6(g)(3); and preamble to REG-106089-18, 83 F.R. at 67508.

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> for any taxable year — such excess business interest [expense] shall be treated as business interest *paid or accrued* by the partner in the next succeeding taxable year in which the partner is allocated ETI from such partnership, but only to the extent of such ETI. [Emphasis in original.]

This language does not state that a partner receives a deduction to the extent of the ETI, but only that BIE is considered to be paid to that extent. There is some language in the legislative history, however, that could be interpreted to favor the other interpretation — that is, that a partner may deduct a dollar of excess BIE for each dollar of ETI allocated to the partner: "The partner may deduct its share of the partnership's excess business interest in any future year, but only against ETI attributed to the partner by the partnership the activities of which gave rise to the excess business interest carryforward."[52] This may be a case of sloppy drafting, because there is much logic to the IRS's approach, as I hope to explicate.

How is ETI defined? Section 163(j)(4)(C) defines it in a decidedly complex way. ETI means the amount that bears the same ratio to the partnership's ATI as (1) the excess (if any) of the 30 percent of ATI limit over; and (2) the amount (if any) by which the BIE of the partnership, reduced by the floor plan financing interest, exceeds the business interest income of the partnership bears to the 30 percent of ATI limit.[53] Putting this into an algebraic equation in which one solves for X, X/ATI = (0.3 ATI - (BIE - business interest income))/0.3 ATI. BIE - business interest income cannot be less than zero.

For example, assume in the current year that the partnership has ATI of $300,000. Thirty percent 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 because it is less than 30 percent of ATI plus the business interest income, which adds up to $100,000. The BIE of $50,000 exceeds the business interest income of $10,000 by $40,000. Do the latter half of the equation first: ($90,000 - ($50,000 - $10,000))/$90,000 = 0.555. ETI is thus ATI of $300,000 x 0.555 = $166,666. That amount increases the partners' ATI.

Assume further that the partnership in prior years had $200,000 of BIE disallowed, which it allocated to the partners as excess BIE under section 164(j)(4)(B), and that no ETI or excess business interest income has been allocated to the partners before the current year. The partners must treat $166,666 of the $200,000 of the excess BIE as currently paid, subject to the regular rules. Any amount they cannot deduct is now outside section 163(j)(4) and carried forward under 163(j)(2). It is no longer part of the ETI system. The remaining amount of $33,333 of excess BIE awaits further allocation of ETI or excess business interest income to the partners.

The ETI equation, in addition to being complex, seemingly can generate odd outcomes. The right side of the equation, with its focus on 30 percent of ATI, appears to be meant to capture how much unused ATI limit the partnership has. But at first blush, there appears to be something amiss. Under the equation, ATI equals ETI when the partnership does not incur a BIE. If a partnership has $100,000 of ATI, but no BIE, ETI will be $100,000. But if the partnership also incurs $10,000 of BIE and no business interest income, ETI dramatically drops to $66,666. It is hard to see why a BIE that is 10 percent of ATI should cause a one-third drop in ETI. The ETI of a partnership is presumably intended to represent the amount of ATI not needed to permit the partnership to deduct its BIE under the section 163(j) rules.[54] That being the case, why not simply have ETI equal to the amount by which ATI exceeds the allowed BIE deduction (net of business interest income)? Thus, if there is $100,000 of ATI and $10,000 of BIE, ETI would be $90,000, not just $66,666.

But if one looks at the partners and the partnership together, the equation holds up better.[55] For example, assume that in 2018 a partnership has $20,000 of BIE, no ATI, and no

[52] H.R. Rep. No. 115-466, at 391 (2017).

[53] The proposed regulations track this definition. *See* prop. reg. section 1.163(j)-1(b)(15).

[54] *See* Kevin Anderson et al., "Section 163(j) Proposed Regulations Applications for S Corporations Wednesday," ABA Webinar (July 24, 2019).

[55] Thanks go to professor Fred Brown, who originally developed a version of this example. Query why the IRS did not provide such an example.

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business interest income, and thus allocates $20,000 excess BIE to its partners. In 2019 the partnership has $10,000 of BIE, no business interest income, and $76,666 of ATI. All $10,000 of BIE would be deductible under section 163(j) and flow through to partners. The maximum amount of BIE that could have been deducted by the partnerships is 30 percent of $76,666 or about $23,000. But the partnership only deducted $10,000 of BIE, leaving, as it were, $13,000 of unused ATI.

If the system works properly, when ETI is allocated to the partners, it should permit them to deduct BIE up to $13,000 ($23,000 - $13,000). Under the statutory formula, assuming the partnership deducted only $10,000 of BIE, ETI is $43,332, which increases the partners' ATI. The partners could then deduct BIEs up to 30 percent of that, or — voilà — about $13,000. Thus, both the way ETI is calculated under the statute, and the IRS's interpretation of how it should operate at the partner-level, make good sense if the partnership and the partner are viewed together, as they should be in this context.

Although the IRS got the calculation of ETI right, it got the application of ETI wrong in the section 743(b) context. I discuss this issue in Part 2, in my examination of Example 8 of the proposed regulations.

Notably, how ETI is allocated to a partner is not truly optional, unlike the allocation of BIEs, a topic to which I return in Part 2 when I discuss the 11 steps. For now, note that the allocation of ETI generally tracks the allocation of positive ATI to partners.

The proposed regulations respect the partnership's allocation of BIEs as such; they never change the partnership's allocation of BIEs. If the partnership's BIE is not fully deductible, the partnership does not have unbridled discretion about which partner is allocated deductible BIE and which is allocated excess BIEs. I return to this topic in Part 2 when discussing the examples in the proposed regulations, but generally, to have a current deduction, the partner must also have been allocated positive ATI. Partners that were not allocated positive ATI are likely to have the allocated BIE classified as excess BIE, at least in part.

A remaining issue is 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 BIE allocated to the partner. This is fair enough if the partner is allowed to eventually deduct the excess BIE. The statute could have provided that the basis is reduced only when the interest is deductible by the partner, but that might have created tracking issues. Procedurally, it is easier to reduce the basis when the excess BIE is allocated to the partner rather than keep track of it over time and reduce basis down the road. Under the proposed regulations, gain or loss from the sale of the partnership interest adjusts ATI.[56]

What if the partner does not get to deduct all the excess BIE before disposing of the partnership interest? Section 163(j)(4)(iii) and prop. reg. section 1.163(j)-6(h)(3) come to the rescue, providing that if a partner disposes of its partnership interest in a taxable or nontaxable transaction (including death), its adjusted basis in the partnership interest (outside basis) is *increased* immediately before the disposition by any excess business interest that was allocated to that partner but not yet "converted" (that is, treated as paid by the partner).[57] Of course, no deduction is allowed to the transferor or transferee for any excess BIE that increased outside basis.

Example 2: Assume $20,000 of excess BIE is allocated to Partner A, who sells his partnership interest in a fully taxable transaction to new Partner X before any of the $20,000 is converted. A will have a $20,000 basis increase in his

[56] Prop. reg. section 1.163(j)-6(e)(3), assuming the partnership holds only non-excepted trade or business assets. If the partnership does hold excepted assets, prop. reg. section 1.163(j)-10(b)(4)(ii) generally provides for a proportionate apportionment of the gain or loss between excepted and non-excepted assets. The IRS also considered adopting a reasonable method standard by which a partnership could determine the amount properly allocable to a non-excepted trade or business and therefore properly includable in the partner's ATI. These provisions would have adopted tracing rules similar to those in reg. section 1.163-8T, as modified by Notice 88-20, 1988-1 C.B. 487; Notice 88-37, 1988-1 C.B. 522; and Notice 89-35, 1989-1 C.B. 675. The IRS has requested comments in this regard.

[57] Also, prop. reg. section 1.163(j)-6(h)(2) provides that any "negative section 163(j) expense" will remain negative section 163(j) expense of the transferor partner until the expense is no longer suspended under section 704(d). (*See* the discussion of prop. reg. section 1.163(j)-6(o), examples 9 and 10 in Part 2, Section VI.B.2, and accompanying note 18.) These rules are similar to the rules found under section 469 and its regulations concerning suspended passive activity loss deductions. *See* preamble to REG-106089-18, 83 F.R. at 67509.

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partnership interest, and the excess BIE will never be deductible. To that extent, A will have less gain or more loss on the sale. The character of A's gain or loss will depend on how sections 741 and 751(a) apply to the sale, but typically the basis increase will reduce capital gains or increase capital losses recognized by A on the sale of the partnership interest.[58]

Note that this does not make Partner A even, because a downstream deduction of the $20,000 would have reduced higher-taxed ordinary income. Does the entire partnership interest have to be transferred? The statute implies that, but it does not state it explicitly. But the adjustment does not make much sense (possibly even for the partner, who may be forgoing an ordinary income deduction) unless at least almost all the interest is transferred. The proposed regulations do not contain a formal de minimis rule, but they do provide that the adjustment occurs if a partner transfers "all or substantially all" of the interest. Thus, it appears that if a partner disposes of most of a partnership interest but retains a small portion — say, 1 percent — a basis adjustment should still occur. Caution should be exercised because we don't reliably know what the "substantially all" threshold is.

As indicated above, the ability to deduct the excess BIE is personal to the taxpayer and cannot be carried over to a transferee. But, for example, in a gift transfer, a donee can get the benefit of the basis increase provided by section 163(j)(4)(iii) and prop. reg. section 1.163(j)-6(h)(3).[59]

Of course, the first mode of defense is to avoid the section 163(j)/partnership mess entirely, if possible. More sophisticated businesses may seek to "place" debt in a way that takes it outside the partnership rules, particularly when a partnership acquires a portfolio company operating as a C corporation (an S corporation cannot have a partnership as a partner under section 1361(b)). Pre-TCJA businesses may have generally placed the debt with the operations, but now they should consider whether it's best to place it in the corporate entity if nontax considerations make it optional.[60] Avoiding all the partnership complications and possible compliance burdens would be a major incentive. ■

[58] Section 751(a) may cause the partner to recognize (typically) ordinary income on a disposition of a partnership interest to the extent of the partner's share of (typically) ordinary income inherent in accounts receivables, inventory, and some other ordinary income assets. Section 751(a) does not apply to interest deductions. The application of section 751(a) can be complex, but at a minimum it can be said that the basis increase provided by section 163(j)(4)(iii) will most likely affect section 741 gain or loss, *i.e.*, capital gain or loss.

[59] If there is a loss inherent in the interest at the time of the gift, its deductibility may be restricted. *See* section 1015.

[60] Emily L. Foster, "Business Interest Limitation Muddles Private Equity Investments," *Tax Notes Federal*, Aug. 19, 2019, p. 1293.

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