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Treasury Issues Final Regulations Under Section 163(j)

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In 2017, P.L. 115-97 was enacted, commonly known as the Tax Cuts and Jobs Act. Among other things, the Act amended Section 163(j) of the Internal Revenue Code to place a limit on deductions for business interest. As amended, Section 163(j) generally limits a taxpayer's deductions for business interest to the sum of (1) the taxpayer's business interest income and (2) 30% of the taxpayer's taxable income (with certain adjustments). Any interest deductions disallowed under Section 163(j) may be carried forward to future years. Section 163(j) applies to all types of taxpayers, including both corporations and partnerships. In the case of a partnership, the rules generally apply at the partnership level.

The statute contains two important exceptions to the application of Section 163(j). First, the interest limitation generally does not apply to "small businesses," which are defined as taxpayers whose average annual gross receipts over the previous three years are less than a specified threshold, which is currently \$26 million. While this may seem like a large number, there are very broad aggregation rules which may require gross receipts of related entities to be taken into account in determining whether a taxpayer is below this threshold.

Second, the interest limitation does not apply to a real property trade or business that makes an irrevocable election to be treated as an "electing real property trade or business." Although there are no negative tax consequences to qualifying under the small business exception, if a taxpayer makes an election to be treated as an electing real property trade or business, then the taxpayer must use the alternative depreciation system with respect to its real property.

Prior to the enactment of the CARES Act earlier this year, it was thought that the only consequences to this would be that the taxpayer would generally be required to depreciate commercial real estate over 40 years instead of 39 years and to depreciate residential real estate over 30 years instead of 27.5 years. However, the CARES Act made several technical changes to the Code, and it is now clear that a taxpayer that makes this election must depreciate qualified improvement property (i.e., certain improvements to the interior portion of existing buildings) over 20 years (instead of 15 years) and is ineligible to claim bonus depreciation with respect to qualified improvement property. Thus, there are now significant consequences to being treated as "real property trade or business" in certain circumstances.

On Nov. 26, 2018, the Treasury Department issued proposed regulations under Section 163(j), and on July 28, 2020, these regulations were finalized. The final regulations largely adopt the proposed regulations, but with some important modifications that are generally favorable to taxpayers.

The 2018 proposed regulations contained a very broad definition of interest, which included many items not traditionally considered interest, including guaranteed payments to partners of a partnership for the use of capital. If enacted, this provision would have treated many common economic arrangements as interest, such as a preferred return accrued by a partnership on a partner's preferred equity that is treated as a guaranteed payment. The proposed regulations also would have treated items such as debt issuance costs and commitment fees as interest. In response to comments, the final regulations significantly narrowed the definition of interest, such that guaranteed payments to partners for the use of capital, debt issuance costs, and commitment fees, among other things, are no longer treated as interest, and thus are not subject to limitation under Section 163(j).

Under the 2018 proposed regulations, if a taxpayer qualified as a small business, the taxpayer was not eligible to make the election to be treated as an electing real property trade or business, because Treasury thought such an election would not be necessary. In contrast, the final regulations permit a taxpayer to make a protective real property trade or business election, even if the taxpayer qualifies as a small business. The preamble states that this rule was enacted as a matter of administrative simplicity, so that a taxpayer need not test its gross receipts every year to determine whether it qualifies as a small business, particularly since the aggregation rules for related entities are complex.

In addition, this protective election may also be beneficial if a small business is a partnership and one of its partners has partner-level debt, as the election may permit the partner to allocate some or all of the interest expense on the partner-level debt to an electing real property trade or business, which could limit the application of Section 163(j) to the partner-level debt. However, if a small business makes this protective election, it must use the alternative depreciation system on its real estate and is ineligible to claim bonus depreciation on qualified improvement property, just like any other electing real property trade or business.

Section 163(j) by its terms applies only to "business interest," that is, interest on indebtedness that is allocable to a trade or business. If an activity does not rise to the level of a trade or business, then Section 163(j) is inapplicable. However, it may be unclear whether certain rental real estate activities, like triple net leases, would be considered trades or businesses.

To provide taxpayers engaged in these activities with more certainty, the final regulations now allow taxpayers to make a protective real property trade or business election with respect to any rental real estate activity, even if it does not rise to the level of a trade or business. Just like the small business protective election, a taxpayer making this protective election faces adverse depreciation consequences, and so the election should not be made without careful thought.

In sum, real estate businesses can often avoid the interest deduction limitations of Section 163(j), either through the small business exception or the real property trade or business election, and the final regulations that were recently released are generally favorable to taxpayers. Nevertheless, Section 163(j) and other provisions of the Tax Cuts and Jobs Act are relatively new to the Code, and these rules can interact

with changes made by the CARES Act and regulations in unexpected ways. In particular, taxpayers need to carefully evaluate the costs and benefits before making real property trade or business elections.

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