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Anything But Simple Interest: Proposed Regulations Under §163(j)

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As part of the Tax Cuts and Jobs Act (P.L. 115-97) enacted in 2017, Section 163(j) of the Internal Revenue Code was amended to generally place a limit on business interest deductions, and on Nov. 26, 2018, the Treasury Department issued proposed regulations implementing this section. Although the statute contains two important exceptions that could help real estate businesses to continue to deduct interest expense, the rules are very complex and there are a number of potential pitfalls.

In general, new Section 163(j) limits a taxpayer's business interest deductions to the sum of its business interest income and 30 percent of its adjusted taxable income. Interest deductions that are disallowed under this rule may be carried forward indefinitely to future years. The section 163(j) limitation applies to all types of taxpayers, including both corporations and pass-through entities. In the case of a partnership, the rules generally apply at the partnership level.

Any real property trade or business can choose to not have the interest deduction limitation apply by making an election to be treated as an "electing real property trade or business." Once made, the election cannot be undone. The term "real property trade or business" is broadly defined to include many real estate businesses, such as those engaged in rental, development, or brokerage activities. However, some real estate activities, such as triple net leases, may not rise to the level of a "trade or business." In those cases, section 163(j) would not apply (although other provisions of the Code, such as the investment interest limitation, may instead be applicable).

Assuming a real property trade or business makes this election, it must depreciate commercial real property over 40 years instead of 39 years and residential real property over 30 years instead of 27.5 years. However, if residential real property was placed in service before 2018, the IRS has taken the position that the property must be depreciated over 40 years instead of 27.5 years if the election is made.

In addition, under the new law, a new category of depreciable property called qualified improvement property was created, which consists of certain types of improvements to commercial real property made after a building was placed in service. The intent of the law as indicated in the legislative history was (i) to allow 100 percent bonus depreciation for qualified improvement property and (ii) for an electing real property trade or business to have to depreciate qualified improvement property over a 20-year period.

However, due to a drafting error in the law, this category of property is depreciated over 39 years (or 40 years if the taxpayer makes the election) and is not eligible for bonus depreciation. Thus, under current law, the cost of making the election may be small for many taxpayers, but if Congress ever fixes this mistake, certain taxpayers that elected out of the interest limitation may forfeit a significant benefit.

Section 163(j) also contains a so-called small business exception, which provides that the interest limitation does not apply to a taxpayer whose average annual gross receipts over the previous three years are less than a certain threshold, which in the case of partnerships and corporations is currently $25 million. Unlike the electing real property trade or business exception, this exception is not elective and does not carry with it any negative tax consequences. Solely for purposes of determining qualification under this exception, an entity's gross receipts are aggregated with those of any other trade or business under common control. Although the attribution rules are highly complex, trades or businesses may have to be aggregated if they have at least 80 percent common ownership.

However, even if a business satisfies the gross receipts test, it does not qualify for the small business exception if it is considered a tax shelter. Through a series of cross-references (which it is unlikely Congress understood when drafting the law), a "tax shelter" includes a "syndicate," which is defined to include any partnership if more than 35 percent of its losses during the taxable

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year are allocated to limited partners. It is unclear exactly how this rule applies in the context of a limited liability company. However, it appears that this rule should not apply to an entity that does not have a loss for income tax purposes during a given taxable year (regardless of whether losses may have been allocated in previous years).

The new Section 163(j) limitation on deductions for interest expense introduced significant additional complexity to the tax law and has the potential to adversely affect real estate businesses, which tend to be highly leveraged. Real estate businesses should first consider whether they may qualify for the small business exception, and if not, then whether the benefits of electing the real property trade or business exception warrant its potential costs.