

Links to the Past: Old Exceptions to New Interest Deduction Limitations

by Libin Zhang

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Libin Zhang is a partner at Roberts & Holland LLP in New York. He thanks Benny Morgenstern and Lary S. Wolf for their helpful comments.

In this report, Zhang describes new interest limitations and some of the exceptions under section 163(j).

Libin Zhang

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I. Introduction

The Tax Cuts and Jobs Act (P.L. 115-97) enacted new rules that can severely limit taxpayers’ ability to deduct some business interest expenses. This limitation, in new section 163(j), has both substantive tax effects and significant implementation costs, especially after 439 pages of proposed regulations were released on November 26, 2018.¹ For example, a partnership must use an 11-step process to allocate deductible business interest expense and other section 163(j) items to its partners in some cases.

The section 163(j) business interest limitation applies to all taxpayers, including individuals, partnerships, domestic corporations, and some foreign corporations. As described later, there are three important exceptions for investment interest, small businesses, and real property businesses. The exceptions are based on existing tax provisions, which already have helpful

¹REG-106089-18.

guidance and should be relatively simple to apply.

This report concludes with a simplified example of the business interest limitation for an affected partnership.

II. General Rules

Section 163(j)(1) generally provides that a taxpayer may deduct its net business interest expense up to 30 percent of its adjusted taxable income (ATI).² In 2018 through 2021, ATI is similar to earnings before interest, taxes, depreciation, and amortization, being generally equal to the taxpayer's business taxable income plus business interest expense, depreciation, depletion, and amortization. Beginning in 2022, ATI is similar to earnings before interest and taxes, being generally equal to the taxpayer's business taxable income plus business interest expense. Any disallowed business interest expense is carried over to the next year.

For a partnership, the business interest limitation is generally applied at the partnership level, with the partnership's deductible net business interest expense limited to 30 percent of the partnership's ATI. Special carryover rules apply to disallowed partnership business interest expense, which are the subject of some interpretive disagreement between Treasury and Congress.³ Conversely, a less leveraged partnership may allocate excess taxable income to its partners, which may allow the partners to deduct more business interest expense from other sources.

The section 163(j) proposed regulations define interest broadly.⁴ It includes stated interest,

imputed interest (such as original issue discount and section 483 interest on some deferred payments), and other amounts treated as interest for tax purposes, including accrued market discount and the implicit interest factor in some leases with prepaid rent or uneven rent. Interest also includes substituted interest payments in securities lending transactions and sale repurchase transactions, debt issuance costs, loan commitment fees (if any portion of the loan is actually provided), parts of swaps with significant nonperiodic payments, and guaranteed payments to a partner for the use of capital.⁵

Example 1: Arie, Becca, and Colton form Partnership ABC. Colton contributes capital to ABC and is entitled to receive 30 percent of partnership income (before any guaranteed payments), but not less than \$10,000. If the partnership's income is \$20,000, Colton receives \$10,000, of which \$6,000 (30 percent of \$20,000) is a distributive share. The remaining \$4,000 is a guaranteed payment that is subject to a partnership-level business interest limitation. In contrast, if the partnership's income is \$60,000, Colton's entire distributive share of \$18,000 (30 percent of \$60,000) is not a guaranteed payment and therefore not subject to any business interest limitation.

The above example is found in reg. section 1.707-1(c), Example 2, which dates from 1956.⁶ Treasury issued proposed regulations in 2015 that when finalized would treat Colton as receiving a \$10,000 guaranteed payment in all cases, which would be subject to the business interest limitation.⁷

An antiabuse rule provides that interest expense includes any otherwise deductible expense or loss from transaction(s) in which the taxpayer secures the use of funds for a period, if that expense or loss is predominantly incurred in consideration of the time value of money. There is

²The business interest limitation doesn't apply to floor plan financing, which generally involves debt used to acquire motor vehicles (including boats and farm machinery or equipment) held for sale or lease and is secured by that motor vehicle inventory. Recent congressional bills contain a TCJA technical correction to provide that floor plan financing also covers any trailer or camper, with temporary living quarters, that may be towed by or affixed to a motor vehicle. See Rules Comm. Pr. 115-87, Text of the House Amendment to the Senate Amendment to H.R. 88, section 504 (Dec. 17, 2018).

³Compare prop. reg. section 1.163(j)-6(g), with H.R. Rep. No. 115-466, at 391 (2017) (conference report); and Joint Committee on Taxation, "General Explanation of Public Law 115-97," JCS-1-18, at 177-178 (Dec. 20, 2018) (blue book). See Tax Technical and Clerical Corrections Act, section 4(o) (Jan. 2, 2019) (discussion draft).

⁴Prop. reg. section 1.163(j)-1(b)(20). For a similar broad definition of interest under another TCJA provision, see prop. reg. section 1.267A-5(a)(12).

⁵See also Notice 2004-31, 2004-1 C.B. 830 (limitations on the use of guaranteed payments under now-repealed section 163(j), which generally applied to a corporation's interest expense with some foreign related parties and real estate investment trust shareholders).

⁶See T.D. 6175.

⁷See REG-115452-14.

no corresponding rule that creates interest income for the counterparty.

The proposed regulations provide that interest income includes factoring income from short-term receivables. There is no explicit rule that treats factoring expense as interest expense, although it may be interest expense under the antiabuse rule.

III. Investment Interest

The section 163(j) limitation applies to business interest, which is defined as any interest paid or accrued on debt properly allocable to a trade or business.⁸ Business interest does not include investment interest under section 163(d), which is any noncorporate taxpayer's interest generally paid or accrued on debt properly allocable to property held for investment, such as stocks, securities, and commodities.

Section 163(d) was originally enacted by the Tax Reform Act of 1969 to limit a noncorporate taxpayer's investment interest deduction to its net investment income for the year. Any disallowed investment interest is carried over to the next year.

Because an individual's investment interest deduction is allowed for up to 100 percent of NII whereas section 163(j) limits his business interest deduction to only 30 percent of ATI, an individual may be better off with investment interest expense (and investment income) in some circumstances.

Example 2: A taxpayer engages in the business of trading stocks and securities, with \$400 of short-term capital gain, \$600 of long-term capital gain,⁹ and \$500 of interest expense. The taxpayer's ATI is \$1,000, which allows only \$300 of deductible business interest. The remaining \$200 of disallowed business interest expense is carried to the next year.

Example 3: Same as the above example, except that the taxpayer incurs the capital gain and interest expense from holding stocks and securities for investment. The taxpayer can deduct \$400 of interest expense (up to the \$400 of short-term capital gain). The taxpayer may deduct

its remaining \$100 of interest expense by electing to treat \$100 of the long-term capital gain as ordinary income.¹⁰

Status as an investor, trader, or dealer in stocks, securities, and commodities has generated a long line of case law ever since the Revenue Act of 1934 created the (previously favored) class of traders.¹¹ Investor status for an individual may have various collateral tax consequences in 2018 through 2025, including the section 67(g) disallowance of non-interest investment expenses and the section 461(l) excess business loss limitation, which generally provides that net business losses can offset only up to \$500,000 of investment income and possibly wages.¹² Moreover, investor status may have adverse consequences for state income taxes, such as New York generally disallowing investment interest expense and most other itemized deductions for higher-income taxpayers.

The section 163(d) investment interest limitation can apply to activity involving a trade or business that is not a passive activity and in which the taxpayer does not materially participate.¹³ In Rev. Rul. 2008-12, 2008-1 C.B. 520, a partnership was engaged in the business of trading securities, and the IRS concluded that its partner, who did not materially participate in the trading business, was subject to the section 163(d) investment interest limitation at the partner level. The preamble to the proposed regulations confirms that it's possible for a partnership engaged in the trading business to be subject to the section 163(j) business interest limitation at the partnership level, while its partner is subject to the section 163(d) investment interest limitation at the partner level for the same interest expense.

Example 4: Two individuals, Link and Zelda, and a domestic C corporation (Salvage Corp.) are equal partners in Triforce Partners LP, which is engaged in the trade or business of trading stocks, securities, rupees, and other foreign currencies.

¹⁰ Section 163(d)(4)(B)(iii); section 1(h)(2).

¹¹ See, e.g., *Wood v. Commissioner*, 16 T.C. 213 (1951); and *King v. Commissioner*, 89 T.C. 445 (1987).

¹² See blue book, *supra* note 3, at 40. The remaining net business losses are treated as net operating losses in the next year, which effectively defers their deduction for a year. *Id.* at 39-40. See Tax Technical and Clerical Corrections Act, section 4(c) (discussion draft).

¹³ Section 163(d)(5)(A)(ii).

⁸ Section 163(j)(5).

⁹ See also section 475(f) (optional mark-to-market election for traders with ordinary income or ordinary loss annually).

Link materially participates in the trading activities, while Zelda does not participate at all. The partnership has \$1,200 of short-term capital gain, \$1,800 of long-term capital gain, and \$1,500 of interest expense. Zelda has \$850 of individual long-term capital losses and no other investment items.

The partnership's deductible business interest expense is limited to 30 percent of its \$3,000 ATI, or \$900. The remaining \$600 of disallowed interest expense is allocated to the partners, \$200 each, and carried to the next year.

Link materially participates in the trading activities and is not subject to a further interest limitation at the partner level. He is allocated \$400 of short-term capital gain, \$600 of long-term capital gain, and \$300 of deductible interest expense.

Zelda is also allocated \$400 of short-term capital gain, \$600 of long-term capital gain, and \$300 of deductible interest expense. But because she is not materially participating in the trading activity, she is subject to the section 163(d) investment interest limitation at the partner level. Her capital losses reduce her NII to \$150, so that only \$150 of her interest expense is deductible. The remaining \$150 interest expense becomes an investment interest carryover.

For C corporations (including a regulated investment company or a real estate investment trust), all interest expense or interest income is business interest expense or business interest income.¹⁴ If a C corporation is a partner in a partnership that has investment interest expense or income, the C corporation's allocable share of those items is recharacterized at the partner level as business interest expense or income. In the above example, Salvage Corp. has \$200 of business interest expense that is disallowed because of the partnership's ATI. If the corporation has ATI from other sources, it may be better off with the partnership's interest expense being investment interest expense, so that the business interest limitation is applied at the corporate partner level instead of the partnership level.

¹⁴ Prop. reg. section 1.163(j)-4(b)(1).

IV. Small Business Exception

Section 163(j)(3) generally provides that the business interest limitation does not apply to a taxpayer whose average annual gross receipts for the three prior tax years are \$25 million or less.¹⁵ This small business exception is less available than it may initially appear, because some persons and entities are aggregated in counting gross receipts, and the exception is unavailable for a broadly defined group of tax shelters.

The \$25 million gross receipts test is determined by reference to section 448(c), under which entities with more receipts are generally prohibited from using the cash method of accounting. The cash method's small business exception has been around since TRA 1986 and should be familiar to many small taxpayers, although the TCJA favorably increased the gross receipts threshold from \$5 million to \$25 million.

The section 448 regulations provide some general rules for computing gross receipts, which includes all sales and all amounts received for services, without any reduction for costs of goods sold.¹⁶ It also includes interest, dividends, rents, and royalties, even if not derived in the ordinary course of the taxpayer's trade or business. For sales of capital assets or business assets, only the gain is part of the gross receipts. If a taxpayer has a capital gain and a capital loss, the capital loss does not reduce gross receipts.¹⁷

An individual is treated as an entity in determining whether she qualifies for the section 163(j) small business exception. The proposed regulations provide that an individual's gross receipts include all business and nonbusiness receipts, other than inherently personal items, such as Form W-2 wages and disability benefits.¹⁸

A. Aggregation Rules

Some persons and entities are aggregated under section 448(c)(2) in measuring gross

¹⁵ The threshold is adjusted annually for inflation and increases to \$26 million in 2019. Rev. Proc. 2018-57, 2018-49 IRB 827, section 3.31. Section 448(c)(3) provides additional rules for entities that have been in existence for less than three years or have short tax years.

¹⁶ Reg. section 1.448-1T(f)(2)(iv).

¹⁷ Cf. reg. section 1.856-2(c)(1) (capital losses don't reduce REIT gross income).

¹⁸ Prop. reg. section 1.163(j)-2(d)(2)(ii).

receipts. The aggregate group must have \$25 million or less of total gross receipts for a group member to qualify for the small business exception, although payments between members are disregarded.

The aggregation rules, parts of which date back to the Revenue Act of 1964 (for section 1563), the Tax Reduction and Simplification Act of 1977 (for section 52), and the Miscellaneous Changes in Tax Laws Act of 1980 (for section 414(m)), generally apply to:

- all corporations, partnerships, and other persons that are members of the same parent-subsidiary controlled group through a chain of ownership of more than 50 percent (by vote or value) of the stock or interests in each entity;
- all corporations, partnerships, and other persons that are members of the same brother-sister controlled group, for which five or fewer individuals own 80 percent or more (by vote or value) of the stock or interests in each entity (and more than 50 percent when taking into account the direct or indirect ownership of each individual only to the extent that such direct or indirect ownership is identical for each entity);¹⁹
- three or more entities that are in both a parent-subsidiary controlled group and a brother-sister controlled group;
- a corporation, partnership, or other organization whose principal business is the performance of services, and members of its affiliated service group, which generally consists of related organizations that provide services; and
- specified aggregated organizations under section 414(m)(5) and section 414(o), which generally covers situations with management companies and other matters.²⁰

Complex constructive ownership rules apply in determining the ownership of each entity, such as family attribution that sometimes treats an individual as owning the interests owned by a

spouse, children, grandchildren, parents, and grandparents.

The TCJA enacted the section 59A base erosion and antiabuse tax, which generally imposes a 5 percent to 13.5 percent minimum tax rate on a C corporation's taxable income as modified with some addbacks of interest paid to foreign related parties and other base erosion payments.²¹ The BEAT has its own small business exception for C corporations with less than \$500 million of gross receipts, defined also by reference to section 448(c). Treasury has issued proposed regulations under section 59A that provide additional aggregation rules for computing gross receipts, which may be helpful guidance for section 163(j). For example, prop. reg. section 1.59A-2(d)(2)(ii) provides that each member must compute the aggregate group's gross receipts based on the member's own tax year and based on the members of the aggregate group at the end of that tax year. Therefore, members with different tax years may have different gross receipts.

For purposes of the BEAT's \$500 million gross receipts threshold, section 59A(e)(3) provides that a foreign corporation is included in the aggregate group, but only to the extent of its gross receipts that are effectively connected with a U.S. trade or business.²² For other tax purposes, in contrast, foreign corporations are generally excluded from the aggregate group.²³ Because the section 163(j) business limitation applies to controlled foreign corporations and other foreign persons, as described later, the application of the small business exception to foreign persons is not entirely clear.

²¹ See prop. reg. sections 1.59A-3(c)(4) and 1.1502-59A(c) for coordination rules between sections 163(j) and 59A.

²² Section 59A(e)(2); prop. reg. section 1.59A-1(b)(1) and -2(c).

²³ Section 1563(b)(2)(C) provides that a controlled group of corporations does not include any foreign corporation subject to tax under section 881 (for interest, dividends, and other FDAP income) for the year. When section 1563 was first enacted in 1964, section 881 applied only to corporations not engaged in a U.S. trade or business, and reg. section 1.1563-1(b)(2)(ii)(B) (issued by T.D. 6845) consistently provided that a foreign corporation is included in the controlled group if it is engaged in a U.S. trade or business. The Foreign Investors Tax Act of 1966 (P.L. 89-809) amended section 881 so that a foreign corporation can be subject to tax under section 881 for its FDAP income even if it is also engaged in a U.S. trade or business; reg. section 1.1563-1(b)(2)(ii)(B) was however never updated to reflect the statutory change.

¹⁹ See *Complete Finance Corp. v. Commissioner*, 80 T.C. 1062 (1983), *aff'd*, 766 F.2d 436 (10th Cir. 1985).

²⁰ Prop. reg. section 1.414(o)-1.

B. Tax Shelter

Section 163(j)(3) provides that the small business exception does not apply to a tax shelter, which is broadly defined in various code sections to include:

- any enterprise (other than a C corporation) if interests in that enterprise have ever been offered for sale in any offering that has to be registered with any federal or state agency (that regulates the offering of securities for sale);²⁴
- any syndicate, which is a partnership or other entity (other than a C corporation) if more than 35 percent of the losses of that entity during the tax year are allocable to limited partners or limited entrepreneurs (generally persons who do not actively participate in the management of the entity); and
- any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if its significant purpose is the avoidance or evasion of federal income tax.

The most prevalent and unobvious type of tax shelter is likely the syndicate, which includes any partnership or limited liability company that allocates more than 35 percent of its losses to limited partners or non-managing members.²⁵ In other words, an LLC must allocate 65 percent or more of its losses to members who actively participate in LLC management in order to not be a tax shelter and to be eligible for the small business exception.

The syndicate rule was created by the Economic Recovery Tax Act of 1981, but it is substantially similar to the farming syndicate provisions in section 461(k) (formerly section 464(c)) as enacted by TRA 1976. Withdrawn proposed regulations for farming syndicates once

indicated that active participation means either participation in the entity's operation and management decisions or participation in actual farming operations.²⁶ Former prop. reg. section 1.464-2(a)(3) helpfully explained:

Factors which tend to indicate active participation include participating in the decisions involving the operation or management of the farm, actually working on the farm, living on the farm, or hiring and discharging employees (as compared to only the farm manager). Factors which tend to indicate a lack of active participation include lack of control of the management and operation of the farm, having authority only to discharge the farm manager, having a farm manager who is an independent contractor rather than an employee, and having limited liability for farm losses. . . . [L]ack of fee ownership of the farm land shall not be a factor indicating a lack of active participation.

Similar factors can apply by analogy to non-farming businesses.

It is unclear how the active participation rules apply to owners that are entities, such as a corporate partner. In *Burnett Ranches*,²⁷ the Fifth Circuit rejected the IRS's argument that only an individual limited partner can actively participate in the management of a farming syndicate. Despite the decision, the IRS continues to believe that a separate legal entity, such as an S corporation, cannot actively participate in management.²⁸

Fortunately, for most partnerships and LLCs, several letter rulings have clarified that an entity is a tax shelter (under the syndicate rule) only if it in fact has tax losses.²⁹ An entity is not a tax shelter if it has net taxable income for the year, because no losses are being allocated to limited partners or limited entrepreneurs. LTR 8911011 and LTR

²⁴ An S corporation is not a tax shelter merely by reason of being required to file a notice of exemption from registration with a state agency (that regulates the offering of securities for sale), but only if there is a requirement, applicable to all corporations offering securities for sale in the state, that the corporation must file the notice to be exempt from registration.

²⁵ Active participation is deemed to occur if the owner has actively participated in the entity's management for five prior years or if the owner's spouse, children, grandchildren, or parents actively participate in the management of the entity.

²⁶ See 48 F.R. 51936 (Nov. 15, 1983) (notice of proposed rulemaking) and 63 F.R. 71047 (Dec. 23, 1998) (withdrawing the 1983 proposed regulations).

²⁷ *Burnett Ranches Ltd. v. United States*, 753 F.3d 143 (5th Cir. 2014).

²⁸ See AOD 2017-01 and ILM 200840042.

²⁹ LTR 9335041, LTR 9407030, LTR 9415005, and LTR 9535036.

9535036 noted that the tax shelter determination is made on a year-by-year basis.

Example 5: A new partnership is owned 20 percent by a general partner and 80 percent by various limited partners. In 2018 the partnership purchases a \$250 million residential rental property, of which \$20 million is allocated to personal property and immediately deducted using section 168(k) bonus depreciation. The remaining tax basis is allocated \$120 million to land and \$110 million to building, of which the latter is depreciated over 27.5 years (\$4 million annually). The partnership has \$10 million of net operating income (from \$20 million of gross rental receipts), \$4 million of regular depreciation, and \$5 million of interest expense each year.

In 2018 the partnership has \$10 million net operating income, \$5 million interest expense, and \$24 million depreciation (including \$20 million bonus depreciation), which results in a potential \$19 million net loss. The loss is allocated 80 percent to limited partners, which causes the partnership to be a tax shelter and therefore subject to the section 163(j) business interest limitation. Accordingly, the partnership's deductible business interest is limited to 30 percent of its \$10 million ATI, or \$3 million. The partnership allocates a net taxable loss of \$17 million to its partners, while \$2 million of disallowed interest expense is allocated to the partners and carried to the next year.

In 2019 the partnership has \$10 million net operating income, \$5 million interest expense, and \$4 million depreciation, which results in net taxable income of \$1 million. Because no losses are being allocated to any limited partners, the partnership is not a tax shelter and is eligible for the small business exception as a result of its \$20 million of gross receipts for the prior year. The \$5 million of 2019 interest expense is not limited by section 163(j) at the partnership level. Furthermore, the partners' \$2 million of interest expense carryforward (from 2018) is treated as paid or accrued by the partners in 2019.³⁰ The partners' \$10 million of partnership-allocated net operating income is added to the partners' ATI, which can help any partner who is subject to the

³⁰ Prop. reg. section 1.163(j)-6(m)(3).

business interest limitation at the partner level, for its share of the \$7 million interest expense.³¹

In late 2020 the partnership sells the building for \$350 million and recognizes \$132 million of taxable gain. Although the 2020 gross receipts are more than \$350 million, the partnership's \$5 million of interest expense in 2020 is not subject to the business interest limitation. The partnership qualifies for the small business exception in 2020 based on its \$20 million of average gross receipts for the two prior years (2018 and 2019). The partners' 2020 ATI is increased by \$100 million of gain, which is the taxable gain adjusted for recapture of 2018-2021 depreciation.³²

In some cases, a partnership may have a net taxable loss if section 163(j) were not to apply, which causes the partnership to be a tax shelter subject to the section 163(j) interest limitation. But when section 163(j) does limit the partnership's interest expense, the partnership has net taxable income and therefore may not be a tax shelter in the first place. In the context of the section 448 limitation on using the cash method of accounting, this circular loop was resolved by providing that the initial computation of net taxable income or loss is determined without regard to section 448.³³ A similar section 163(j) tax shelter analysis would be to determine whether the partnership has a net taxable loss if all of its interest expense were allowed.

Example 6: Same as Example 5, except that the partnership does not claim bonus depreciation in the first year and has \$6 million of regular depreciation annually instead.

In 2018 the partnership has \$10 million net operating income, \$5 million interest expense, and \$6 million depreciation, which results in a potential \$1 million net taxable loss. The loss is allocated 80 percent to the limited partners, which causes the partnership to be a tax shelter and therefore subject to the business interest limitation. The partnership's deductible interest is limited to 30 percent of its \$10 million ATI, or \$3 million. The partnership allocates \$3 million net taxable income to its partners, while \$2 million of

³¹ Prop. reg. section 1.163(j)-6(m)(1).

³² Prop. reg. section 1.163(j)-1(b)(ii)(C).

³³ Reg. section 1.448-1T(b)(3).

disallowed interest expense is carried by the partners to the next year.

Although capital gains are included in gross receipts and are sometimes included in ATI, gains and losses from the sales of capital assets and section 1231 assets (that is, trade or business assets) are disregarded in computing tax losses for tax shelter purposes.³⁴ The treatment of gains and losses from other dispositions, such as abandonment losses, is not specified.

V. Real Property Trade or Business Election

The small business exception applies to the taxpayer and all its trades or businesses. Section 163(j)(7)(A) contains further exceptions to the section 163(j) business interest limitation for some specific trades or businesses:

- being an employee;
- an electing real property trade or business;
- an electing farming business; or
- specified regulated utilities.

A real property trade or business is defined by reference to section 469(c)(7)(C), as enacted by the Revenue Reconciliation Act of 1993 for passive activity loss purposes, to mean any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.³⁵ Generally, under the passive loss rules, a person who spends at least 750 hours a year in real property trades or businesses (in which he materially participates), which constitutes more than 50 percent of his time spent on personal services performed in trades or businesses, is a real estate professional who may treat rental real estate activities as not per se passive activities.

The real property trade or business definitions have existing guidance. In ILM 201504010, the IRS concluded that a mortgage broker is not in a real property trade or business.³⁶ The IRS noted that

section 469(c)(7)(C) does not mention “finance operations,” whereas that clause was present in earlier, unenacted legislation. A real property brokerage trade or business consists only of real estate brokers and real estate salespersons.³⁷

The prior legislation also included “appraisal” as a real property trade or business, which was removed from the enacted section 467(c)(7)(C) and therefore may not be a real property trade or business, either.³⁸

In the landmark case of *Stanley*,³⁹ an Arkansas district court held that an in-house lawyer at a real estate management company can be engaged in a real property trade or business. His time spent in providing legal services may count toward his 750-hour qualification as a real estate professional.

A real property trade or business includes any real property management company. New proposed regulations define real property operation and management to cover hotels and other lodging facilities,⁴⁰ which is consistent with the TCJA’s legislative history.⁴¹ A lodging facility can provide some supplemental services, such as an assisted living facility,⁴² memory care residence, or continuing care retirement community.⁴³ In contrast, real property operation and management does not include business operations in which the principal purpose is the provision of significant or extraordinary personal services, which may include a hospital’s boarding facilities or a boarding school’s dormitories.⁴⁴

The election to be an electing real property trade or business is irrevocable. The trade-off for making the election is that the electing real property trade or business must claim depreciation deductions for some real property

³⁴ Reg. section 1.448-1T(b)(3).

³⁵ Rev. Proc. 2018-59, 2018-50 IRB 1018, provides that a real property trade or business generally includes specified infrastructure property that is (or will be) available for use by the public and is subject to contracts of more than five years between a government and a private trade or business.

³⁶ See also *Guarino v. Commissioner*, T.C. Summ. Op. 2016-12; and *Hickam v. Commissioner*, T.C. Summ. Op. 2017-66.

³⁷ See *Agarwal v. Commissioner*, T.C. Summ. Op. 2009-29. But see prop. reg. section 1.199A-5(b)(2)(X) (“brokerage” for section 199A purposes means stock brokers and similar financial professionals, but not real estate agents and brokers or insurance agents and brokers).

³⁸ H.R. 3732, 101st Cong., 2d Sess. 1989; S. 2384, 101st Cong. 1989-1990.

³⁹ *Stanley v. United States*, No. 5:14-cv-05236 (W.D. Ark. 2015), *nonacq.*, AOD-2017-07 (on other grounds).

⁴⁰ Prop. reg. section 1.469-9(b)(2).

⁴¹ Conference report, *supra* note 3, at 392 n.697.

⁴² Blue book, *supra* note 3, at 178 n.883.

⁴³ See *Cong. Rec.* at S8109-S8110 (Dec. 19, 2017).

⁴⁴ Reg. section 1.469-1T(e)(3)(iv) and (v).

under the alternative depreciation system (ADS), which has longer recovery periods and no bonus depreciation.⁴⁵ The electing real property trade or business may claim any allowable bonus depreciation and continue to use the general depreciation system for all its personal property and other classes of real properties (that are not qualified improvement property, residential rental property, or nonresidential real property), such as depreciable land improvements, solar or wind energy property, retail motor fuel outlets, motorsport entertainment complexes placed in service in late 2004 through 2017, and single-purpose agricultural or horticultural structures for livestock, plants, and mushrooms.

Example 7: In 2018 an S corporation purchases a \$230 million commercial rental property. The tax basis is allocated \$74 million to land and \$156 million to building, which is depreciated over 39 years (\$4 million per year). The S corporation spends an additional \$20 million on qualified improvement property, which is immediately deducted using bonus depreciation.⁴⁶ The S corporation has \$10 million of net operating income and \$5 million of interest expense each year.

In 2018 the S corporation's deductible interest is limited to 30 percent of its \$10 million ATI, or \$3 million. The S corporation therefore has \$10 million net operating income, \$3 million deductible business interest expense, and \$24 million depreciation (including \$20 million bonus depreciation), which results in a \$17 million net taxable loss for its shareholder. The remaining \$2 million of interest expense is carried to the next year at the S corporation level.⁴⁷

In 2019 the S corporation elects to be a real property trade or business. Its \$5 million of 2019 interest expense is not subject to the business interest limitation. The S corporation's \$2 million

of interest expense carryforward (from 2018) is no longer subject to the business interest limitation, either.⁴⁸

The building's remaining \$152 million adjusted tax basis is depreciated in 2019 over 39 years, as if the building were originally placed in service in 2018 using the longer ADS period of 40 years.⁴⁹ The 2018 bonus depreciation is not recaptured in 2019 with the switch to ADS.⁵⁰ The S corporation has \$10 million net operating income, \$7 million interest expense (including \$2 million carryforward), and \$3.9 million depreciation, which means a net \$900,000 tax loss for its shareholder in 2019.

The shareholder's allocated income or losses from the electing real property trade or business do not affect the shareholder's ATI for purposes of determining any shareholder-level business interest limitations.⁵¹

The switch to ADS for an electing real property trade or business's existing property may significantly lengthen the remaining recovery periods of residential rental property placed in service in 2017 and earlier. The TCJA enacted section 168(g)(2)(C), which provides that the ADS recovery period of residential rental property is reduced from 40 years to 30 years, but only for properties placed in service in 2018 and later. In contrast, the ADS recovery period of residential rental properties placed in service in 2017 and earlier would start at 40 years, which is significantly longer than the usual 27.5 years.⁵² For nonresidential real property, the switch to ADS increases the recovery period by one year, from 39 years to 40 years, which may result in more tax compliance costs than the actual incremental tax costs from less depreciation.

⁴⁵ Section 168(g)(1)(F).

⁴⁶ The TCJA has a drafting error in section 168(e)(3)(E) and section 168(g)(3)(B) concerning missing depreciation recovery periods for qualified improvement property. It is assumed in this example that the drafting error has been corrected to provide that qualified improvement property is 15-year property eligible for bonus depreciation. See Tax Technical and Clerical Corrections Act, section 4(m) (discussion draft) (fixing the depreciation recovery periods and also providing that qualified improvement property must be improvements made by the taxpayer).

⁴⁷ Reg. section 1.163(j)-6(l)(5).

⁴⁸ Prop. reg. section 1.163(j)-6(m)(4).

⁴⁹ Rev. Proc. 2019-8, 2019-3 IRB 347, section 4.02(2); reg. section 1.168(i)-4(d)(4); reg. section 1.168(i)-4(d)(6), Example 3.

⁵⁰ Rev. Proc. 2019-8, section 4.02(2); reg. section 1.168(k)-1(f)(6)(iv)(A); reg. section 1.168(k)-1(f)(6)(v), Example 2.

⁵¹ Prop. reg. section 1.163(j)-6(m)(2).

⁵² Rev. Proc. 2019-8, section 4.01.

Some taxpayers may have real estate activities that don't constitute a trade or business, as determined under section 162 and its case law.⁵³ In those cases, like with some ground-leased land or net-leased buildings, the nonbusiness activity is not subject to the business interest limitation. A more difficult factual question may be whether a taxpayer has one or more real property trades or businesses, because the irrevocable election must be made separately for each one.

A. Real Property Election by REIT

Under a safe harbor for REITs that make the electing real property trade or business election, a REIT's real property is defined consistently with the broader definition of real property under section 856 and reg. section 1.856-10 (finalized on August 30, 2016).⁵⁴ Importantly, a REIT's real property generally includes shares in other REITs that own real property.⁵⁵ Further, the REIT may have up to 10 percent of its assets consist of real property financing assets (such as mortgage loans and shares of mortgage REITs) and still make a real property trade or business election that applies to all the REIT's assets.⁵⁶

Example 8: An individual, a C corporation, and a private REIT each borrows money to acquire stock of a publicly traded REIT, which owns real property. The publicly traded REIT pays a \$100 REIT ordinary dividend to each shareholder, who has \$80 of interest expense allocated to the dividend.

The individual is not subject to the business interest limitation and is instead subject to the section 163(d) investment interest limitation. The individual has \$100 of NII (the REIT ordinary dividend) and therefore can deduct the \$80 investment interest expense. The investment interest is an ordinary deduction that can offset ordinary income subject to 37 percent tax rates, even though the REIT ordinary dividend is effectively taxed at only up to 29.6 percent

⁵³ See, e.g., *Pinchot v. Commissioner*, 113 F.2d 718 (2d Cir. 1940); *Lewenhaupt v. Commissioner*, 20 T.C. 151 (1953), *aff'd*, 221 F.2d 227 (9th Cir. 1955); and *Herbert v. Commissioner*, 30 T.C. 26 (1958).

⁵⁴ Prop. reg. section 1.163(j)-9(g).

⁵⁵ Prop. reg. section 1.163(j)-9(g)(4)(iii).

⁵⁶ Prop. reg. section 1.163(j)-9(g)(2).

because of the 20 percent section 199A passthrough business income deduction.⁵⁷

The C corporation is subject to the business interest limitation because a C corporation has neither investment interest nor investment income. The interest expense is allowed for 30 percent of the \$100 ATI, which results in only \$30 of deductible interest expense. The corporation likely cannot make an electing real property trade or business election, as holding REIT stock is not a real property trade or business.

The private REIT is treated similarly to the C corporation in the absence of an electing real property trade or business election, with only \$30 of deductible interest expense. The privately held REIT may be able to make the election because the publicly traded REIT stock is considered real property under the REIT safe harbor, although the exact real property trade or business is unclear. With the election, the private REIT can deduct all \$80 interest expense allocable to the publicly traded REIT stock.

Similar results apply if the publicly traded REIT's stock is owned through a partnership. The partnership allocates its investment interest and investment income to its C corporation and REIT partners, which take those items into account as business interest and business income at the partner level.⁵⁸ The partnership allocation may occur in umbrella partnership (UPREIT) structures, in which a REIT owns an operating partnership that owns stock of a subsidiary REIT. Although the partnership, not the partners, normally makes the electing real property trade or business election for any partnership business,⁵⁹ a REIT partner should be able to make its safe harbor REIT election at the partner level for allocable partnership investment items.

VI. Partnership Subject to Section 163(j) Example

For a partnership and its partners that find themselves unable or unwilling to use one of the section 163(j) exceptions, prop. reg. section

⁵⁷ *But see* Tax Technical and Clerical Corrections Act, section 4(b) (discussion draft) (REIT ordinary dividends cannot be allowed the section 199A deduction and also be allowed a deductible investment interest expense).

⁵⁸ Prop. reg. section 1.163(j)-4(b)(3).

⁵⁹ Prop. reg. section 1.163(j)-9(c)(4).

1.163(j)-6(f)(2) provides a few rules on how to determine and allocate the different partnership-level section 163(j) items. A brief overview of the 11-step process, based on prop. reg. section 1.163(j)-6(o), Example 13, and the addition of some business interest income, is provided in the following pages. The proposed regulations' preamble notes that the steps are intended to recognize the aggregate nature of partnerships to the greatest extent possible while remaining consistent with applying section 163(j) at the partnership level. They do not reallocate tax items between the partners but rather characterize the extent to which each partner's allocable items are affected by section 163(j).

For simplicity, the example does not address all partnership-level issues, such as guaranteed payments, preferred returns, section 704(c) built-in gain, excess taxable income, section 704(c) remedial allocations, section 743(b) adjustments at the partner level, investment income and interest, interest expense apportionment between excepted and non-excepted trades or businesses, floor plan financing, and the centralized partnership audit rules as enacted by the Bipartisan Budget Act of 2015.

Example 9: A, B, and C are equal partners in a partnership, which has \$100 of total ATI, \$10 of business interest income, and \$50 of business interest expense. Each of A, B, and C is a CFC owned 100 percent by a separate, unrelated domestic C corporation. The partnership's income gives rise solely to tested income under the global intangible low-taxed income regime for its CFC partners and their domestic shareholders.

Step 1: Partnership-Level Calculation of Section 163(j) Items

The partnership's section 163(j) limitation is \$40, equal to its \$10 business interest income plus 30 percent of its \$100 of total ATI. The partnership therefore has \$40 of deductible business interest expense and \$10 of excess business interest expense.

Step 2: Determination of Each Partner's Section 163(j) Items

Under section 704(b), the partnership's \$100 of total ATI is allocated \$100 to A, \$100 to B, and negative \$100 to C. The partnership's \$10 of

business interest income is allocated all to A. The partnership's \$50 of business interest expense is allocated \$0 to A, \$25 to B, and \$25 to C:

Table 1

	A	B	C	Total
ATI	\$100	\$100	(\$100)	\$100
Business interest income	\$10	\$0	\$0	\$10
Business interest expense	\$0	\$25	\$25	\$50

Step 3: Partner-Level Comparison of Business Interest Income and Business Interest Expense

The partnership must generally compare each partner's allocable business interest income with its allocable business interest expense to determine the partner's allocable business interest income excess (or allocable business interest income deficit):

Table 2

	A	B	C	Total
Business interest income	\$10	\$0	\$0	\$10
Business interest expense	\$0	\$25	\$25	\$50
Business interest income excess (any excess of business interest income over business interest expense)	\$10	\$0	\$0	\$10
Business interest income deficit (any excess of business interest expense over business interest income)	\$0	\$25	\$25	\$50

Step 4: Match Partnership and Aggregate Partner Excess Business Interest Income

A partner's final allocable business interest income excess is determined by reducing (but not below zero) its allocable business interest income excess by its pro rata share of the aggregate business interest income deficit (allocated based

on the partners' allocable business interest income excess):

Table 3

	A	B	C	Total
Business interest income excess	\$10	\$0	\$0	\$10
Adjustment based on business interest income deficit	(\$50)	\$0	\$0	(\$50)
Final allocable business interest income excess	\$0	\$0	\$0	\$0

Step 5: Determine Remaining Business Interest Expense

A converse computation is done for a partner's remaining business interest expense, which is determined by reducing (but not below zero) its allocable business interest income deficit by its pro rata share of the aggregate business interest income excess (allocated based on the partners' allocable business interest income deficit):

Table 4

	A	B	C	Total
Business interest income deficit	\$0	\$25	\$25	\$50
Adjustment based on business interest income excess	\$0	(\$5)	(\$5)	(\$10)
Remaining business interest expense	\$0	\$20	\$20	\$40

Step 6: Determine Final Allocable ATI

The partnership determines each partner's final allocable ATI in a two-step process. First, if a partner is allocated a positive ATI, the partner has a positive allocable ATI and a \$0 negative allocable ATI. Similarly, if a partner is allocated a negative ATI, the partner has a negative allocable ATI and a \$0 positive allocable ATI:

Table 5

	A	B	C	Total
ATI	\$100	\$100	(\$100)	\$100
Positive allocable ATI	\$100	\$100	\$0	\$200
Negative allocable ATI	\$0	\$0	\$100	\$100

Next, each partner's final allocable ATI is determined by reducing (but not below zero) its positive allocable ATI by its pro rata share of the aggregate negative allocable ATI (allocated based on the partners' positive allocable ATI):

Table 6

	A	B	C	Total
Positive allocable ATI	\$100	\$100	\$0	\$200
Adjustment based on negative allocable ATI	(\$50)	(\$50)	\$0	\$0
Final allocable ATI	\$50	\$50	\$0	\$100

Step 7: Partner-Level Comparison of 30 Percent Of ATI and Remaining Business Interest Expense

The partnership compares each partner's remaining business interest expense (from step 5) with the partner's ATI capacity, which is 30 percent of its final allocable ATI from step 6. A partner may have an ATI capacity excess or an ATI capacity deficit:

Table 7

	A	B	C	Total
ATI capacity (30 percent of final allocable ATI)	\$15	\$15	\$0	\$30
Remaining business interest expense	\$0	\$20	\$20	\$40
ATI capacity excess (any excess of ATI capacity over remaining business interest expense)	\$15	\$0	\$0	\$15
ATI capacity deficit (any excess of remaining business interest expense over ATI capacity)	\$0	\$5	\$20	\$25

Step 8: Determination of Partner Priority Right to ATI Capacity Excess Determination

To ensure that the partners with negative allocable ATI (from step 6) do not inappropriately benefit under the next steps to the detriment of partners with positive allocable ATI, this step 8 is necessary when:

- there is an excess business interest expense of more than \$0 under step 1;
- there is a total negative allocable ATI amount of more than \$0 under step 6; and
- the total ATI capacity excess amount is more than \$0 under step 7.

The above three conditions are met by the example's partnership as a result of its excess business interest expense of \$10, its total negative allocable ATI amount of \$100, and its total ATI capacity excess amount of \$15.

For each partner with an ATI capacity deficit, the partnership determines the partner's priority amount, which is 30 percent of the partner's positive allocable ATI minus its final allocable ATI:

Table 8

	A	B	C
Has ATI capacity deficit	No	Yes	Yes
Positive allocable ATI	N/A	\$100	\$0
Final allocable ATI	N/A	\$50	\$0
Excess of positive allocable ATI over final allocable ATI	\$0	\$50	\$0
Priority amount (30 percent of excess)	\$0	\$15	\$0

The partnership next determines the partner's usable priority amount, which is the lesser of the priority amount or the ATI capacity deficit from step 7:

Table 9

	A	B	C
Priority amount	\$0	\$15	\$0
ATI capacity deficit	\$0	\$5	\$20
Usable priority amount (lesser of the two above)	\$0	\$5	\$0

When the total ATI capacity excess amount is more than the total usable priority amount, the partnership reduces the ATI capacity deficits by the usable priority amounts.

The total ATI capacity excess of \$15 is also reduced by the usable priority amount to an adjusted total ATI capacity excess of \$10:

Table 10

	A	B	C	Total
ATI capacity deficit	\$0	\$5	\$20	\$25
Usable priority amount	\$0	(\$5)	\$0	(\$5)
ATI capacity deficit (adjusted)	\$0	\$0	\$20	\$20
ATI capacity excess	\$15	\$0	\$0	\$15
Usable priority amount	(\$5)	\$0	\$0	(\$5)
ATI capacity excess (adjusted)	\$10	\$0	\$0	\$10

A different and more complicated computation is required under prop. reg. section 1.163(j)-6(f)(2)(vii)(D) if the total ATI excess capacity amount is less than the total usable priority amount. Prop. reg. section 1.163(j)-6(o), examples 13 and 14, contain helpful illustrations.⁶⁰

Step 9: Match Partnership and Partner Excess Taxable Income

The partnership computes each partner's final ATI capacity excess by reducing (but not below zero) the partner's ATI capacity excess by its pro rata share of the aggregate ATI capacity deficit, which is allocated based on the partners' ATI capacity excess. This ensures that the aggregate final ATI capacity excess equals the partnership's excess taxable income from step 1:

⁶⁰ See Instructions for Form 990 Worksheet B.

Table 11

	A	B	C	Total
ATI capacity excess (adjusted)	\$10	\$0	\$0	\$10
Adjustment based on ATI capacity deficit (adjusted)	(\$20)	\$0	\$0	(\$20)
Final ATI capacity excess	\$0	\$0	\$0	\$0

Step 10: Match Partnership and Partner Excess Business Interest Expense

The partnership computes each partner's final ATI capacity deficit by reducing (but not below zero) the partner's ATI capacity deficit by its pro rata share of the aggregate ATI capacity excess, which is allocated based on the partners' ATI capacity deficits. This ensures that the aggregate final ATI capacity deficit equals the partnership's excess business interest expense from step 1:

Table 12

	A	B	C	Total
ATI capacity deficit (adjusted)	\$0	\$0	\$20	\$20
Adjustment based on ATI capacity excess (adjusted)	\$0	\$0	(\$10)	(\$10)
Final ATI capacity deficit	\$0	\$0	\$10	\$10

Step 11: Final Section 163(j) Allocations

The final allocations are done in several steps. First, the partnership allocates its excess business income from step 1 to the partners with final allocable business interest income excess from step 4. Both amounts are \$0 in this example.

Second, the partnership allocates its excess taxable income from step 1 to the partners with final ATI capacity excess amounts, grossed up by ten-thirds. Both amounts are \$0 in this example.

Third, the partnership allocates its excess business interest expense from step 1 to the partners with final ATI capacity deficits. A partner's allocable business interest expense is deductible business interest expense to the extent

that it exceeds the partner's allocable excess business interest expense:

Table 13

	A	B	C	Total
Business interest expense	\$0	\$25	\$25	\$50
Excess business interest expense (allocated based on final ATI capacity deficit)	\$0	\$0	\$10	\$10
Deductible business interest expense	\$0	\$25	\$15	\$40

The final allocations to the three partners are:

Table 14

	A	B	C	Total
ATI	\$100	\$100	(\$100)	\$100
Business interest income	\$10	\$0	\$0	\$10
Deductible business interest expense	\$0	(\$25)	(\$15)	(\$40)
Net taxable income	\$110	\$75	(\$115)	(\$60)

As noted in Table 14, each of A, B, and C is a CFC that is owned 100 percent by a separate domestic C corporation. Section 163(j) applies to any CFC with a direct or indirect 10 percent U.S. shareholder, as well as any partnership with a partner that is such a CFC, in the same manner as if the CFC were a C domestic corporation.⁶¹

A, B, and C therefore have GILTI tested income (or tested loss) of \$110, \$75, and (\$115), respectively. Their domestic corporate shareholders may claim up to a 50 percent section 250 deduction based on their GILTI income to generally arrive at shareholder-level net taxable income of \$55, \$37.50, and zero, respectively.

The domestic corporate shareholders may have shareholder-level interest expense that is allocated to the GILTI income, as provided by proposed regulations for foreign tax credits.⁶² A

⁶¹ Prop. reg. section 1.163(j)-7(b)(2).

⁶² See prop. reg. section 1.861-8(d)(2)(ii)(C).

shareholder's interest expense is subject to the section 163(j) business interest limitation, but a "double counting" rule provides that shareholder's ATI generally does not include any GILTI inclusions.⁶³ As a result, none of the GILTI-allocated interest expense is deductible by the shareholder in the absence of other sources of shareholder ATI. The result may be particularly unfair for situations like the corporate shareholder of A. Even though the CFC has no interest expense and is therefore not limited by section 163(j) at the CFC level, the whole GILTI inclusion is effectively disregarded at the shareholder level in deducting the shareholder's own interest expenses. In contrast, a domestic C corporation that receives a taxable dividend from another domestic corporation may sometimes include that taxable dividend in ATI.

Alternatively, a U.S. shareholder and its CFCs may make a "CFC grouping election,"⁶⁴ which provides some additional steps for treating some of the CFCs' subpart F income and GILTI tested income as increasing the shareholder's ATI. The CFC grouping election requires that the shareholder (with specified related parties) own 80 percent or more of all classes of the stock of two or more CFCs. The CFC grouping election is therefore unavailable for a shareholder that owns 100 percent of only one CFC, absent any regulatory relief to the contrary.

VII. Conclusion

The above description of the section 163(j) business interest limitation and its exceptions is not intended to be a comprehensive overview of all the interest limitation rules. The proposed regulations provide additional guidance on many other topics, such as how to compute ATI, consolidated groups, effects on corporate earnings and profits, interactions with other deduction limitations like the section 465 at-risk rules and the section 469 passive activity loss rules, and the proper allocations of interest expense. Treasury also reserved on some areas to be addressed in future regulations, such as the interaction of the section 163(j) limitation with

taxable-income-based limitations in section 246(b) and other code sections.

Likely less imminent are rules that apply section 163(j) for state and local corporate and personal income tax purposes. States differ in their level of conformity to the TCJA, with some states continuing to apply old section 163(j) (repealed by the TCJA) instead of new section 163(j). Even for conforming states, states generally don't follow federal consolidated group regulations and may require separate entity determinations of the section 163(j) limits, which may not interact perfectly with the states' expense apportionment rules and addbacks of related-party indebtedness. States can also differ in their taxation of partnerships and S corporations and how to apply section 163(j) to those entities. Further complications can arise with interest carryovers, which can vary in their apportionment from year to year and may be subject to limitations under section 382 and its state counterparts for a C or S corporation that undergoes a change in control.

Given the complexities in applying the business interest limitation rules at many levels, eligible taxpayers may find it beneficial to use one of the exceptions to section 163(j). Congress has thoughtfully chosen to use frameworks from decades-old tax provisions to make the exceptions easier to use by taxpayers and tax practitioners, such as the 1976 definition of tax shelters and other remembrances of things past. ■

⁶³ Prop. reg. section 1.163(j)-7(d)(1).

⁶⁴ Prop. reg. section 1.163(j)-7(b)(5).