PARTNERSHIP ASPECTS OF FINAL AND PROPOSED REGULATIONS ON BUSINESS INTEREST EXPENSE UNDER SECTION 163(J)

SUMMARY

On July 28, 2020, the U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) issued final regulations (T.D. 9905) about the limitation on the deduction for business interest expense under Section 163(j), as amended by the Tax Cuts and Jobs Act (TCJA), which was enacted on December 22, 2017, and the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), which was enacted on March 27, 2020. Along with the issuance of the final regulations, the government issued a new set of proposed regulations (REG-107911-18) (2020 proposed regulations) to address some complex issues that warrant additional study and comments from the public.

The final regulations largely adopt the Section 163(j) proposed regulations (REG-106089-18) published in the Federal Register on December 28, 2018 (2018 proposed regulations), with major revisions to certain controversial rules provided in the 2018 proposed regulations. Taxpayers, especially manufacturers and producers of property, may see a significant increase in their ability to deduct business interest expense under Section 163(j), because the final regulations now provide that depreciation, amortization and depletion capitalized into inventory under Section 263A can be added back for purposes of calculating adjusted taxable income (ATI).

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Additionally, the final regulations meaningfully narrow the definition of "interest" in the Section 163(j) context. As a result, commitment fees, debt issuance costs, guaranteed payments for the use of capital under Section 707(c), and hedging gains and losses are generally no longer considered interest to which Section 163(j) may apply. The final regulations also bring some good news for taxpayers that wish to make the real property trade or business election. Small business taxpayers and taxpayers that are unsure whether their rental real estate activities (such as triple net lease arrangements) rise to the level of a trade or business under Section 162 can now make an election to be treated as conducting electing real property trades or businesses. However, the regulations clarify that an election must be made for each of the taxpayer's eligible real property trades or businesses, and to be valid, the election must sufficiently describe the taxpayer's real property trades or businesses to demonstrate qualification for the election. Along with the issuance of the final regulations, the IRS issued Notice 2020-59 to provide a proposed safe harbor under which a taxpayer that operates residential living facilities (such as assisted living facilities) may elect to treat such trade or business as a real property trade or business.

Section 163(j) as amended by the TCJA, applies broadly to all business interest expense regardless of whether the related indebtedness is between related parties or incurred by a corporation, and regardless of the taxpayer's debt-to-equity ratio. Section 163(j) provides a new limitation on the deduction for "business interest expense" of all taxpayers, including, for example, individuals, C corporations, partnerships and S corporations, unless a specific exclusion applies under Section 163(j). Section 163(j) generally limits the amount of business interest expense that can be deducted in the current year. Under Section 163(j)(1), the amount allowed as a deduction for business interest expense is limited to the sum of (1) the taxpayer's business interest income for the taxable year; (2) 30% of the taxpayer's ATI for the taxable year; and (3) the taxpayer's floor plan financing interest expense for the taxable year.

The CARES Act further amended Section 163(j). Under the CARES Act, the amount of business interest that is deductible under Section 163(j)(1) for taxable years beginning in 2019 or 2020 is computed using 50%, rather than 30%, of the taxpayer's ATI for the taxable year. A taxpayer may elect not to apply the 50% ATI limitation to any taxable year beginning in 2019 or 2020, and instead apply the 30% ATI limitation. In the case of a partnership, the 50% ATI limitation does not apply for taxable years beginning in 2019, and the election not to apply the 50% ATI limitation may be made only for taxable years beginning in 2020. However, a partner treats 50% of its allocable share of a partnership's excess business interest expense for 2019 as a business interest expense in the partner's first taxable year beginning in 2020 that is not subject to the Section 163(j) limitation. The remaining 50% of the partner's allocable share of the partnership's excess business interest expense remains subject to the Section 163(j) limitation applicable to excess business interest expense carried forward at the partner level. Lastly, the CARES Act allows a taxpayer to elect to use its ATI for the last taxable year beginning in 2019 for the taxpayer's ATI in determining the taxpayer's Section 163(j) limitation for any taxable year beginning in 2020.

GUARANTEED PAYMENTS FOR THE USE OF CAPITAL

The 2018 proposed regulations contain a relatively broad definition of "interest" for purposes of Section 163(j), which included guaranteed payments for the use of capital as determined under Section 707(c). This definition was proposed to provide a complete definition of interest that addresses all transactions that are commonly understood to produce interest income and expense, including transactions that otherwise may have been entered into to avoid the application of Section 163(j).

In the final regulations, Treasury and the IRS appear to have scaled back on the inclusion of a certain amount within the definition of interest. While substitute interest payments (only if the payments relate to a sale-repurchase or securities lending transaction that is not entered into by the taxpayer in the ordinary course of its business) are still considered interest in the final regulations, guaranteed payments for the use of capital under Section 707(c) have been removed from the definition. Consequently, guaranteed payments for the use of capital under Section 707(c) are no longer subject to Section 163(j).

Notwithstanding the exclusion of guaranteed payments for the use of capital as interest, Treasury and the IRS modified the anti-avoidance rule in the final regulations by introducing "a principal purpose" standard. Under §1.163(j)-1(b)(22)(iv)(A)(1), any expense or loss economically equivalent to interest is treated as interest expense for purposes of Section 163(j) if a principal purpose of structuring the transaction(s) is to reduce an amount incurred by the taxpayer that otherwise would have been interest expense. Under §1.163(j)-1(b)(22)(iv)(B), any income realized by a taxpayer in a transaction or series of integrated or related transactions is not treated as interest income of the taxpayer for purposes of Section 163(j) if and to the extent a principal purpose for structuring the transaction(s) is to artificially increase the taxpayer's business interest income.

Consider the following example as included in the final regulations:

- Facts. A, B and C are equal partners in ABC partnership. ABC is considering acquiring an additional loan from a third-party lender to expand its business operations. However, ABC already has significant debt and interest expense. For the purpose of reducing the amount of additional interest expense ABC would have otherwise incurred by borrowing, A agrees to make an additional contribution to ABC for use in its business operations in exchange for a guaranteed payment for the use of capital under section 707(c).
- **Analysis.** The guaranteed payment is deductible by ABC, incurred by ABC in a transaction in which ABC secures the use of funds for a period of time, and is substantially incurred in consideration of the time value of money. As a result, the guaranteed payment to A is economically equivalent to the interest that ABC would have incurred on an additional loan from a third-party lender. A principal purpose of A making a contribution in exchange for a guaranteed payment for the use of capital was to reduce the amount incurred by ABC that otherwise would be interest expense. As a result, for purposes of section 163(j), the guaranteed payment is treated as interest expense of ABC for purposes of section 163(j). In addition, if A knows that the guaranteed payment is treated as interest expense of ABC, because A provides the use of funds for a period of time in a transaction subject to the anti-abuse rules, A earns income or gain with respect to the transaction, and that income or gain is substantially earned in consideration of the time value of money provided by A, the guaranteed payment is treated as interest income of A for purposes of section 163(j).

BDO Insight: The final regulations clarify that a purpose may be a principal purpose even though it is outweighed by other purposes (taken separately or together). In other words, the taxpayer's business purpose for acquiring the funds is not relevant to the principal purpose inquiry, nor is the fact that the taxpayer has obtained funds at a lower pre-tax cost based on the structure of the transaction. In the partnership context, there is concern of the potential application of this rule whereby guaranteed payments for the use of capital and certain preferred returns may be viewed as economically similar to interest. In the absence of additional guidance, it is likely that taxpayers with these arrangements will face some degree of uncertainty.

PARTNERSHIP-LEVEL CALCULATION AND ALLOCATION OF SECTION 163(J) EXCESS ITEMS

Section 163(j)(4) provides that a partner's excess taxable income (ETI) is determined in the same manner as the non-separately stated taxable income or loss of the partnership. Section 163(j)(4) further provides that excess business interest expense (EBIE) is allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership. Similarly, excess business interest income (EBII) is allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership.

As highlighted in the 2018 proposed regulations, the phrase "non-separately stated taxable income or loss of the partnership" is not defined in Section 163(j), and it has not previously been defined by statute or regulations. The phrase "in the same manner as" is also undefined. The 2018 proposed regulations established an 11-step process intended to create a system of allocating the appropriate Section 163(j) items.

While the proposed 11-step process created a workable system, commenters requested clarification and modification in several areas. In particular, the 2020 final regulations confirm the following:

- Any calculations performed under the 11-step process are solely for purposes of Section 163(j) and do not impact the partnership's allocations under Section 704(b).
- Reg. §1.704-1(b)(4)(xi) has been added as part of the final regulations to confirm that allocations made in accordance with the 11-step process will be deemed to be in accordance with the partners' interests in the partnership.
- The final regulations do not adopt the recommendation that the 11-step process take remedial allocations into consideration.
- The final regulations do not adopt the recommendation to allow remedial allocations of ETI to partners allocated greater taxable income than ETI.
- Treasury and the IRS received numerous comments with requests for possible exceptions and alternatives to the 11-step process described in the 2018 proposed regulations. For the most part, none of these suggestions were incorporated into the final regulations. Treasury and the IRS determined that the 11-step process produces results that are most consistent with the principle that the amount of business interest expense a taxpayer is capable of deducting should increase as its ATI and business interest income (BII) increase.
- Notwithstanding adoption of the 11-step process, the final regulations incorporate an exception to the general requirement that partnership taxpayers must apply the 11-step process. In particular, the final regulations establish a "pro rata" exception from steps three through 11.

BDO Insight: Many partnerships will need to continue applying the full 11-step process and will find themselves ineligible for the pro rata exception to steps three through 11. The inability to apply this exception will be primarily due to the extensive use of "targeted allocation agreements." Consequently, affected partnership taxpayers should consider developing standardized procedures for applying the 11-step process, which will help minimize the potential administrative burdens created by the Section 163(j) reporting requirement.

BASIS ADJUSTMENTS UPON DISPOSITION OF PARTNERSHIP INTERESTS

Under the 2018 proposed regulations, when a partner disposes of its interest in a partnership, any basis adjustments attributable to remaining allocations of EBIE are reversed. Consequently, the partner will increase the basis in its partnership interest immediately before the disposition. This treatment will effectively cause the previously suspended interest expense allocated to the disposing partner to recognize less capital gain (or more capital loss) on the disposition. Importantly, the 2018 proposed regulations provided that this rule applies only in situations involving the disposition of all or substantially all of the partner's interest in the partnership.

In response to numerous comments, Treasury and the IRS modified this rule in the final regulations to adopt a proportionate approach to partial dispositions of partnership interests. Under the adopted proportionate approach, Treasury and the IRS changed course and agreed that the basis add-back should be allocated to the disposed interest rather than the retained interest.

The 2020 proposed regulations would provide that if a partner (transferor) disposes of its partnership interest, the partnership will increase the adjusted basis of partnership property by an amount equal to the amount of the increase required under §1.163(j)-6(h)(3), if any, to the adjusted basis of the partnership interest being disposed of by the transferor. Such increase in the adjusted basis of partnership property (§1.163(j)-6(h)(5) basis adjustment) will be allocated among partnership properties in the same manner as a positive Section 734(b) adjustment. Because a §1.163(j)-6(h)(5) basis adjustment is taken into account when determining the gain or loss upon a sale of the asset, a §1.163(j)-6(h)(5) basis adjustment prevents the shifting of built-in gain to the remaining partners.

These proposed regulations would adopt an approach that treats the increase in the adjusted basis of any partnership property resulting from a §1.163(j)-6(h)(5) basis adjustment as not depreciable or amortizable under any section of the code, regardless of whether the partnership property allocated such §1.163(j)-6(h)(5) basis adjustment is otherwise generally depreciable or amortizable. This approach perceives EBIE as a deduction that was disallowed to the partnership (consistent with Section 163(j)(4)(B)(iii)(II)), and thus should not result in a depreciable Section 734(b) basis adjustment.

Consider the following example as included in the 2020 proposed regulations:

- In Year 1, A, B and C formed partnership PRS by each contributing $1,000 cash. PRS borrowed $900, causing each partner's basis in PRS to increase by $300 under Section 752. Also in Year 1, PRS purchased Capital Asset X for $200. In Year 2, PRS pays $300 of business interest expense, all of which is disallowed and treated as EBIE. PRS allocated the $300 of EBIE to its partners, $100 each. Each partner reduced its adjusted basis in its PRS interest by its $100 allocation of EBIE to $1,200. In Year 3, when the fair market value of Capital Asset X is $3,200 and no partner's basis in PRS has changed, PRS distributed $1,900 to C in complete liquidation of C's partnership interest in a distribution to which Section 737 does not apply. PRS had a Section 754 election in effect in Year 3.
- **Consequences to selling partner.** Pursuant to §1.163(j)-6(h)(3), C increases the adjusted basis of its interest in PRS by $100 immediately before the disposition. Thus, C's Section 731(a)(1) gain recognized on the disposition of its interest in PRS is $900 (($1,900 cash + $300 relief of liabilities) — ($1,200 outside basis + $100 EBIE add-back)).
- **Partnership basis.** Pursuant to §1.163(j)-6(h)(5), PRS has a $100 increase to the basis of its assets immediately before C's disposition. Under Section 755, the entire $100 adjustment is allocated to Capital Asset X. Pursuant to §1.163(j)-6(h)(5), regardless of whether Capital Asset X is a depreciable or amortizable asset, none of the $100 of basis increase allocated to Capital Asset X is depreciable or amortizable. PRS has a Section 734(b) increase to the basis of its assets of $900 (the amount of Section 731(a)(1) gain recognized by C). Under Section 755, the entire $900 adjustment is allocated to Capital Asset X. As a result, PRS's basis in Capital Asset X is $1,200 ($200 + $100 basis increase + $900 Section 734(b) adjustment). Following the liquidation of C, PRS's basis in its assets ($1,500 cash + $1,200 Capital Asset X – $900 liability) equals the aggregate adjusted tax basis capital of partners A and B in PRS ($1,800).

BDO Insight: Adoption of a proportionate approach to partial dispositions with basis add-back to the disposed interest will allow taxpayers to recoup suspended interest more quickly than under the 2018 proposed regulations. It is worth noting, however, that this approach also eliminates the ability to potentially utilize the suspended interest against ordinary income taxed at higher rates.

DEBT-FINANCED PARTNERSHIP DISTRIBUTIONS

In 1987, Treasury regulations were issued providing guidance to taxpayers about how to allocate interest expense among expenditures (see §1.163-8T). The guidance classified interest expense into five categories: trade or business, passive activity, investment, personal and portfolio. Notably, the regulations reserved guidance as to how debt was to be allocated to distributions by passthrough entities.

In a series of notices, Treasury and the IRS provided further guidance with respect to the allocation of interest expense in connection with certain transactions involving passthrough entities and owners of passthrough entities (see 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). Specifically, Notice 89-35 provides, in part, rules addressing the treatment of (1) passthrough entity debt allocated to distributions by the entity to its owners (debt-financed distributions), and (2) a passthrough entity owner's debt allocated to contributions to, or purchases of, interests in a passthrough entity (debt-financed contributions or acquisitions).

In the case of debt-financed distributions, Notice 89-35 provides a general allocation rule and an optional allocation rule. The optional allocation rule applicable to debt-financed distributions allows a passthrough entity to allocate distributed debt proceeds and the associated interest expense to one or more expenditures, other than distributions, of the entity that are made during the same taxable year of the entity as the distribution, to the extent that debt proceeds, including other distributed debt proceeds, are not otherwise allocated to such expenditures. Under the optional allocation rule, distributed debt proceeds are traced to the owner's use of the borrowed funds to the extent that such distributed debt proceeds exceed the entity's expenditures, not including distributions, for the taxable year to which debt proceeds are not otherwise allocated.

Treasury and the IRS have determined that additional rules, specific to passthrough entities and their owners, are needed to clarify how the rules under §1.163-8T work when applied to a passthrough entity and to account for the partnership entity-level limitation under Section 163(j).

To more accurately account for the types of expenditures made by passthrough entities, the 2020 proposed regulations would provide rules tailored to passthrough entities. The framework that the 2020 proposed regulations provides is needed for a passthrough entity to determine how much of its interest expense is allocable to a trade or business for purposes of applying Section 163(j). These 2020 proposed regulations would apply before a passthrough entity applies any of the rules in Section 163(j).

The 2020 proposed regulations would provide that when debt proceeds of a passthrough entity are allocated under §1.163-8T to distributions to owners of the entity, the debt proceeds distributed to any owner and the associated interest expense will be allocated under the newly proposed regulations. In general, the 2020 proposed regulations would adopt a rule similar to Notice 89-35, but with the following modifications. First, instead of providing that passthrough entities may use the optional allocation rule, the 2020 proposed regulations would generally provide that passthrough entities are required to apply a rule that is similar to the optional allocation rule. Second, instead of providing that the passthrough entity may allocate excess interest expense using any reasonable method, the 2020 proposed regulations would generally provide that the passthrough entity must allocate excess interest expense based on the adjusted tax basis of the passthrough entity's assets.

EXAMPLE 1:

Individuals A and B are partners in partnership PRS. PRS conducts two businesses; a manufacturing business, which is a trade or business within the meaning of Section 162 (manufacturing), and a separate commercial real estate leasing business (leasing). In Year 1, PRS borrowed $100,000 from an unrelated third-party lender (the loan). Other than the loan, PRS does not have any outstanding debt. During Year 1, PRS paid $80,000 in manufacturing expenses, $120,000 in leasing expenses and made a $100,000 distribution to A, the proceeds of which A used to make a personal expenditure. Under §1.163-8T, PRS treated the $100,000 of loan proceeds as having been distributed to A. As a result, in Year 1 PRS had $200,000 of available expenditures and $100,000 of distributed debt proceeds. PRS paid $10,000 in interest expense that accrued during Year 1 on the loan and allocated such interest expense under Section 704(b) equally to A and B ($5,000 each). Thus, A and B each had $5,000 of allocable interest expense.

Because PRS treated all $100,000 of the loan proceeds as having been distributed under §1.163-8T, PRS allocated all $10,000 of the interest expense associated with the loan to the distribution. Thus, PRS must determine the tax treatment of such $10,000 of interest expense. To the extent PRS has available expenditures, it must allocate any distributed debt proceeds to the available expenditures. Here, PRS has distributed debt proceeds of $100,000 and available expenditures of $200,000 (manufacturing expenditures of $80,000, plus leasing expenditures of $120,000). Thus, PRS allocates all $100,000 of the distributed debt proceeds to available expenditures as follows: $40,000 to manufacturing expenditures ($100,000 x ($80,000/$200,000)) and $60,000 to leasing expenditures ($100,000 x ($120,000/$200,000)). Because the amount of PRS's distributed debt proceeds is less than its available expenditures, none of the distributed debt proceeds are allocated to debt financed distributions.

Because PRS's distributed debt proceeds are allocated to available expenditures (pursuant to paragraph (d)(1)(i) of this section), A and B each treat all $5,000 of their allocable interest expense as expenditure interest expense.

Each partner treats its expenditure interest expense in the same manner as the distributed debt proceeds that were allocated to available expenditures. Thus, A's $5,000 of expenditure interest expense comprises of $2,000 of business interest expense ($5,000 x ($40,000/$100,000)) and $3,000 of interest expense allocated to rental expenditures ($5,000 x ($60,000/$100,000)). B's $5,000 of expenditure interest expense similarly comprises of $2,000 of business interest expense and $3,000 of interest expense allocated to rental expenditures. As a result, $4,000 of interest expense associated with the distributed debt proceeds (A's $2,000 plus B's $2,000 of expenditure interest expense treated as business interest expense) is business interest expense of PRS, subject to Section 163(j) at the PRS level.

EXAMPLE 2:

The facts are the same as in Example 1, except that PRS did not have any rental expenditures in Year 1. As a result, in Year 1 PRS had $80,000 of available expenditures and $100,000 of distributed debt proceeds.

Because PRS treated all $100,000 of the loan proceeds as having been distributed to A under §1.163-8T, PRS allocated all $10,000 of the interest expense associated with the loan to the distribution. Thus, PRS must determine the tax treatment of such $10,000 of interest expense.

To the extent PRS has available expenditures, it must allocate any distributed debt proceeds to such available expenditures. Here, PRS has distributed debt proceeds of $100,000 and available expenditures of $80,000. Thus, $80,000 of the distribute debt proceeds are allocated to such available expenditures. PRS allocates the remaining $20,000 of the distributed debt proceeds to debt financed distributions.

A treats $2,000 of its allocable interest expense as debt-financed distribution interest expense, which is the lesser of $5,000 or $2,000 ((A), the portion of debt proceeds distributed to A ($100,000), multiplied by (B) a fraction, the numerator of which is the portion of PRS's distributed debt proceeds allocated to debt-financed distributions ($20,000), and the denominator of which is PRS's total amount of distributed debt proceeds ($100,000), multiplied by (C) the distributed debt proceeds interest rate of 10% (the amount of interest expense associated with distributed debt proceeds ($10,000), divided by the amount of distributed debt proceeds ($100,000))) and B treats $0 of its allocable interest expense as debt-financed distribution interest expense, which is the lesser of $5,000 or $0 ((A) $0 x (B) 20% x (C) 10%).

Neither partner treats any of its allocable interest expense as excess interest expense.

Each partner determines the tax treatment of its debt-financed distribution interest expense based on its use of the distributed debt proceeds. Because A used its $100,000 of distributed debt proceeds on a personal expenditure, A's $2,000 of debt-financed distribution interest expense is personal interest subject to Section 163(h) at A's level. Each partner treats its expenditure interest expense in the same manner as the distributed debt proceeds that were allocated to available expenditures. Thus, all $3,000 of A's expenditure interest expense and all $5,000 of B's expenditure interest expense is business interest expense. As a result, $8,000 interest expense associated with the distributed debt proceeds (A's $3,000, plus B's $5,000 of expenditure interest expense treated as business interest expense) is business interest expense of PRS, subject to Section 163(j) at the PRS level.

SELF-CHARGED LENDING TRANSACTIONS

The 2018 proposed regulations reserved on the treatment of BII and BIE with respect to lending transactions between a partnership and a partner (self-charged lending transactions). The 2020 proposed regulations would add a rule to provide that, in the case of a lending transaction between a partner (lending partner) and partnership (borrowing partnership) in which the lending partner owns a direct interest (self-charged lending transaction), any BIE of the borrowing partnership attributable to the self-charged lending transaction is BIE of the borrowing partnership for purposes of §1.163(j)-6.

Further, if in a given taxable year the lending partner is allocated EBIE from the borrowing partnership and has interest income attributable to the self-charged lending transaction (interest income), the lending partner will treat such interest income as an allocation of EBII (EBII) from the borrowing partnership in such taxable year, but only to the extent of the lending partner's allocation of EBIE from the borrowing partnership in such taxable year. To prevent the double counting of BII, the lending partner includes interest income that was recharacterized as EBII pursuant to proposed §1.163(j)-6(n) only once when calculating the lending partner's own Section 163(j) limitation.

In cases where the lending partner is not a C corporation, to the extent that any interest income exceeds the lending partner's allocation of EBIE from the borrowing partnership for the taxable year, and such interest income otherwise would be properly treated as investment income of the lending partner for purposes of Section 163(d) for that year, such excess amount of interest income will continue to be treated as investment income of the lending partner for that year for purposes of Section 163(d).

PASSIVE INVESTORS IN TRADING PARTNERSHIPS

The preamble to the 2018 proposed regulations states that business interest expense of certain passthrough entities, including S corporations, allocable to trade or business activities that are per se passive under Section 469 and activities with respect to which the taxpayer does not materially participate, will be subject to Section 163(j) at the entity level even if the interest expense is later subject to limitation under Section 163(d) at the individual partner or shareholder level. To the extent that interest expense from a trading activity is limited under Section 163(j) and becomes a carryover item of partners who do not materially participate in the trading activity, the interest expense will be treated as investment interest in the hands of those partners for purposes of Section 163(d) once the interest expense is no longer limited under Section 163(j). This approach would effectively create a double-layered limitation for partners subject to the Section 163(d) limitation.

Commentators noted that creating a system whereby partners could see interest expense subject to both Section 163(j) and Section 163(d) was not consistent with rules under Section 163(j)(5). Pursuant to Section 163(j)(5), business interest expense does not include investment interest within the meaning of Section 163(d).

Under the 2020 proposed regulations, a trading partnership would be required to bifurcate its interest expense from a trading activity between partners that materially participate in the trading activity and partners that are passive investors. The Section 163(j) limitation would then be applied solely to the portion of the interest expense that is allocable to the materially participating partners. The portion of interest expense from a trading activity allocable to passive investors will be subject to limitation under Section 163(d) at the partner level, as provided in Section 163(d)(5)(A)(ii). In addition to the bifurcation of interest expense, the 2020 proposed regulations would also require the separate allocation of other items of income, gain, loss and deduction from trading activities to materially participating partners and passive partners.

BDO Insight: Under the 2020 proposed regulations, interest expense from trading partnerships may be subject to 163(j) or 163(d), but not both, with respect to a specific partner. While creating what appears to be an equitable result and one that is consistent with Section 163(j)(5), the 2020 proposed regulations may create significant administrative burden on trading partnerships. To comply with these rules, trading partnerships will be required to conclude on the passive vs. non-passive status of each partner and then specially allocate relevant items to each group of partners.

TREATMENT OF EXCESS BUSINESS INTEREST EXPENSE IN TIERED PARTNERSHIPS

General Rule

While Section 163(j) clearly applies at the partnership level, less clear is how the limitation should impact partners in a tiered partnership structure. The 2018 proposed regulations specifically reserved on providing guidance and instead the preamble requested comments regarding whether, in a tiered partnership arrangement, carryforwards should be allocated through upper-tier partnerships. Additionally, Treasury and the IRS requested comments regarding how and when an upper-tier partner's basis should be adjusted when a lower-tier partnership is subject to Section 163(j). Comments submitted generally described three approaches to resolving the issues surrounding the application of Section 163(j) in tiered partnership structures. These approaches are:

- **Entity Approach:** In applying the Entity Approach, Section 163(j) would be applied independently to each partnership. At each tier, EBIE that is not treated as paid or accrued or that has not given rise to a basis adjustment by a partnership would not be further allocated up the chain of ownership.
- **Aggregate Approach:** Under the Aggregate Approach, Section 163(j) would be applied only by the borrowing partnership. Partners in the borrowing partnership that are partnerships would pass through EBIE amounts and basis adjustments to their partners. Only direct and indirect partners that are not partnerships would apply the carryover rules in Section 163(j)(4) and would account for indirect shares of EBIE from a lower tier partnership or partnerships.
- **Blended Approach:** As a final option, a Blended Approach would require partners that are partnerships to apply the Section 163(j)(4) carryover rules but would also pass through EBIE amounts and basis adjustments to upper tier partners.

In the 2020 proposed regulations, Treasury and the IRS would adopt the Entity Approach in applying Section 163(j) in tiered partnership structures. Under these rules, if a lower-tier partnership allocates EBIE to an upper-tier partnership, then the upper-tier partnership reduces basis in its interest in the lower-tier partnership. However, partners of the upper-tier partnership do not reduce the bases of their upper-tier partnership interests until the upper-tier partnership treats such EBIE as business interest expense paid or accrued.

Notwithstanding the rule that partners of the upper-tier partnerships do not reduce tax basis by allocated EBIE, the expense does reflect an actual economic outlay and reduction in inherent partnership value. Consequently, the 2020 proposed regulations would provide that if the lower-tier partnership pays or accrues business interest expense and allocates such business interest expense to an upper-tier partnership, then both the upper-tier partnership and any direct or indirect partners of the upper-tier partnership treat such expense as a reduction to the partner's Section 704(b) capital account, i.e., the expense is treated as a Section 705(a)(2)(B) expenditure.

BDO Insight: While application of the Entity Approach should generally be administratively easier than the Aggregate or Blended Approaches, care will need to be taken to ensure accurate maintenance of Section 704(b) capital. Further, the 2020 proposed regulations do not appear to provide guidance on the implications of a partnership that may have previously applied the Aggregate or Blended Approaches.

BASIS AND CARRYFORWARD COMPONENT OF EBIE

A concern raised in connection with application of the Entity Approach is the apparent variance between inside and outside basis as it relates to the partners in the upper-tier partnership. Treasury and the IRS, however, explained in the preamble to the 2020 proposed regulations that there is no basis variance. While the upper-tier partnership reduces its basis in its interest in the lower-tier partnership, the reduction is not a permanent cost. Rather, the upper-tier partnership has basis in the EBIE.

Accordingly, the 2020 proposed regulations would provide that if the lower-tier partnership allocates EBIE to the upper-tier partnership and such EBIE is not suspended under Section 704(d), then the upper-tier partnership treats the EBIE (UTP EBIE) as a nondepreciable capital asset, with a fair market value of zero and basis equal to the amount by which upper-tier partnership reduced its basis in the lower-tier partnership. Further, the fair market value of UTP EBIE, described in the preceding sentence, is not adjusted by any Section 704(b) capital account revaluations.

The 2020 proposed regulations would provide that the upper-tier partnership treats the EBIE allocated from a lower-tier partnership as UTP EBIE until a “conversion event.” The 2020 proposed regulations describe two conversion events to include (1) when the EBIE is treated as business interest expense paid or accrued under the Section 163(j) regulations and (2) when there is a disposition of the interest in the lower-tier partnership.

ANTI-LOSS TRAFFICKING RULES

As described above, the Entity Approach relies on the creation of a built-in loss asset presumably under either Section 734(b) or Section 743(b). This approach is intended to prevent a partner from deducting business interest expense that was formerly a UTP EBIE if the partner did not bear the economic cost of the interest expense payment. The anti-loss trafficking rule under the 2020 proposed regulations would prohibit the trafficking of business interest expense by providing that no deduction is allowed to any transferee specified partner for any business interest expense derived from a transferor’s share of UTP EBIE.

PARTNERSHIP OR S CORPORATION NOT SUBJECT TO SECTION 163(J)

Under the 2018 proposed regulations, if a partner or S corporation shareholder is allocated business interest expense from an exempt entity, that allocated business interest expense will be subject to the partner’s or S corporation shareholder’s Section 163(j) limitations. After considering comments received, Treasury and the IRS decided to withdraw this rule and provide that business interest expense of an exempt partnership, or exempt S corporation, pursuant to Section 163(j)(3) does not retain its character as business interest expense and, as a result, is not subject to the Section 163(j) limitation at the partner or S corporation shareholder level.

Additionally, if a partner is allocated excess business interest expense from a partnership and, in a succeeding taxable year, the partnership engages in excepted trades or businesses, then the partner may not treat any of its excess business interest expense that was previously allocated from such partnership as business interest expense paid or accrued by the partner in such succeeding taxable year by reason of the partnership engaging in excepted trades or businesses. Rather, such excess business interest expense will remain as excess business interest expense until such time as it is treated as business interest expense paid or accrued by the partner pursuant to §1.163(j)-6(g)(2) or by reason of the partnership becoming an exempt entity (relating to the small business exemption). The final regulations provide a similar clarification for S corporations in §1.163(j)-6(m)(4).

EFFECTIVE DATES

With limited exceptions (affecting the interplay of Section 163(j) with Section 382 and Section 1502), the final regulations will take effect for taxable years beginning on or after November 13, 2020. However, taxpayers may apply the final regulations retroactively to taxable years beginning after December 31, 2017, and before November 13, 2020, provided the final regulations are consistently applied by the taxpayers and their related parties. As an alternative, taxpayers may apply the 2018 proposed regulations to taxable years beginning after December 31, 2017, and before the final regulations take effect, provided the 2018 proposed regulations are applied consistently by the taxpayers and their related parties.

The 2020 proposed regulations would take effect for taxable years beginning on or after 60 days after they have been adopted as final regulations and published in the Federal Register. However, taxpayers may apply the 2020 proposed regulations to any taxable year beginning after December 31, 2017, and before the date the regulations are published in the Federal Register, provided they are consistently applied by the taxpayers and their related parties during the taxable years, and for certain rules, each subsequent taxable year.

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