



# ASSET MANAGEMENT **INSIGHTS**

INSIGHTS FROM THE BDO FINANCIAL SERVICES PRACTICE

## **RECENT IRS GUIDANCE ON BUSINESS INTEREST EXPENSE INCLUDES NEW RULES FOR HEDGE FUNDS**

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On July 28, 2020, the U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) issued long-awaited final regulations (T.D. 9905, Final Regulations) 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. Concurrent with the issuance of the final regulations, Treasury and the IRS also issued a new set of proposed regulations (REG-107911-18) to address certain complex issues that warrant additional study and comments from the public.

Certain aspects of the 2020 proposed regulations merit special consideration by hedge fund managers. As discussed in more detail below, the 2020 proposed regulations effectively reverse the proposed rules published in 2018 that have the potential to subject interest expense to limitation at both the fund and passive investor level. The 2020 proposed regulations provide welcome relief to hedge funds and their passive investors. However, as noted below, the 2020 proposed regulations may increase the administrative burden and reporting requirements on hedge fund managers.

### **BACKGROUND AND THE 2020 PROPOSED REGULATIONS**

Prior to the enactment of the TCJA, business interest expense incurred at trader funds, e.g., hedge funds engaged in a trade or business activity, would generally be subject to limitation under Section 163(d) solely with respect to non-materially participating passive investors (most limited partners). The TCJA amended Section 163(j) in such a way that business interest expense incurred by trader funds may be subject to limitation at the fund level. Importantly, Section 163(j)(5) provides that business interest expense does not include investment interest within the meaning of Section 163(d).

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Notwithstanding the Section 163(j)(5) language, the preamble to the 2018 proposed regulations states that business interest expense of certain passthrough entities 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 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). Under the 2020 proposed regulations, trading funds would be required to bifurcate their 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.

The 2020 proposed regulations are proposed to 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 taxable years beginning after December 31, 2017, so long as the 2020 proposed regulations are consistently applied by the taxpayers and their related parties.

**BDO INSIGHTS:** Under the 2020 proposed regulations, interest expense incurred by trader funds 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 a significant administrative burden on trading partnerships. To comply with these rules, trading partnerships will be required to conclude on passive vs. non-passive status of each partner and then specially allocate relevant items to each group of partners.

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