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The New Section 163(j): Partnerships Issues

September 24, 2018

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Tax reform created new rules that limit the deduction of business interest expense. With respect to interest incurred by a partnership, the drafters of new section 163(j) adopted a unique "entity approach," providing that the interest limitation is applied and limited at the partnership level. This article provides a detailed explanation of the new interest deduction rules and explains why using the entity approach added significant complexity and ambiguity to the rules for both partners and partnerships.

I. Introduction

On December 22, 2017, H.R. 1 (originally known as the Tax Cuts and Jobs Act of 2017)[1] was signed into law (the "Act"). As part of the Act, Code section[2] 163(j) was amended to create a broad deferral/disallowance regime with respect to the deductibility of "business interest expense." Judging by the numerous drafting mistakes that the IRS has all but acknowledged,[3] it appears that new section 163(j) was rushed into law without a full and careful review. This is particularly true in respect of the application of the provision to partnerships, when the drafters made the decision, perhaps driven by some unstated policy consideration that is difficult to divine, to craft a provision rife with contradictory and unprecedented features, without any attempt at maintaining a logical and theoretical consistency

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[1] Pub. L. No. 115-97, 115 Stat. 2054 (2017).

[2] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

[3] *See* Notice 2018-28 (issued Apr. 2, 2018), discussed below in the text.

with other similar tax provisions in similar contexts. As further discussed below in part III, the provision in this respect is a complex hodgepodge of contradictory rules with glaring errors because the drafters did not follow long understood principles as to how partnerships are taxed. And now that it has been enacted, it will be the job for years to come of the IRS, the courts, and tax practitioners to grapple with and work out the numerous problems and mistakes of the new statute.

II. Overview

A. General

Section 163(j) was amended by the Act to provide new rules limiting the deduction of "business interest expense" ("BIE") for tax years beginning after December 31, 2017. Section 163(j) now provides that a taxpayer (including individuals and corporations) generally will be prohibited from deducting BIE in excess of the sum of its:

- Business interest income ("BII"),
- 30 percent of "adjusted taxable income" ("ATI") from a trade or business, as further described below, and
- Floor plan financing interest[4] for the tax year.[5]

BIE is interest expense, and BII is interest income, that are properly allocable to a "trade or business, but not investment interest expense or income under section 163(d). A "trade or business" does not include:

- The trade or business of performing services as an employee
- Any electing real property trade or business
- Any electing farming business
- The trade or business of the furnishing or sale[6] of (1) electrical energy, water, or sewage disposal services, (2) gas or steam through a local distribution system, or (3) transportation of gas or steam by pipeline[7]

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[4] As floor plan financing interest applies to a very limited number of taxpayers, we will ignore this provision for purposes of this article.

[5] Section 163(j)(1).

[6] Provided that the rates for such furnishing or sale, as the case may be, have been established or approved by a state or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any state or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative

[7] Section 163(j)(7)(A).

For tax years beginning after December 31, 2017, and before January 1, 2022, ATI is defined as taxable income other than: (1) items not allocable to a "trade or business," (2) BIE and BII, (3) net operating losses under section 172, (4) the 20 percent deduction for qualified business income pursuant to section 199A; and (5) depreciation, amortization, and depletion.[8] For tax years beginning after December 31, 2021, depreciation, amortization, and depletion must be deducted in determining ATI.[9] The exclusion of depreciation, amortization and depletion from ATI until such date (i.e., thereby increasing ATI, and consequently the 30 percent bucket of allowable BIE) should have the effect of putting off the day of reckoning with the new section 163(j) for many taxpayers.

Any disallowed interest may be carried forward indefinitely.[10] However, unlike old section 163(j) (which allowed the carryforward of unused excess limitation, see below), unused ATI may not be carried forward to increase the ATI of the taxpayer in a subsequent tax year. For example, if a taxpayer has $200 of ATI and $30 of BIE in year 1, the taxpayer may use $100 out of the $200 of ATI to permit the deductibility of the BIE of $30. Nevertheless, the taxpayer may not carry forward the extra $100 of unused ATI to year 2 to permit the deductibility of another $30 of BIE in year 2. Section 163(j) applies after the rules for capitalizing interest under section 263A and after any other rules that otherwise disallow deductibility of interest, such as sections 265 and 279.[11] The limitation on deductibility of interest applies to tax years beginning after December 31, 2017, and interest on existing debt instruments is not grandfathered.[12]

III. Partnerships

A. Overview

With respect to interest incurred by a partnership, the drafters of new section 163(j) adopted a unique "entity approach," providing that the section 163(j) interest limitation is applied and limited at the partnership level.[13] As discussed in detail below, the decision to apply this approach has added significant complexity and ambiguity to the statute.

Mechanically, the statute provides that if a partnership incurs BIE, the interest limitation is applied by reference to the attributes of the partnership, i.e., the BII of the partnership and 30 percent of the partnership's ATI. Any BIE deductions that are allowed are taken into account in determining the nonseparately stated taxable income and loss of the partnership that is allocated to the partners.[14] Thus, the partner need not reapply section 163(j) at the partner level to the BIE allocated to it from the partnership, as the partnership BIE loses its character as "interest" at the partner level. Arguably, this

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8 Section 163(j)(8)(A).

9 Section 163(j)(8)(A)(v).

10 Section 163(j)(2).

11 H.R. Conf. Rep. No. 115-466, at 387.

12 Pub. L. No. 115-97, § 13301(c).

13 Section 163(j)(4)(A).

14 This amount is the "ordinary business income or loss" reflected on Form 1065, *U.S. Return of Partnership Income*. The partner's distributive share is reflected in box 1 of schedule K-1. H.R. Conf. Rep. No. 115-466, at 387 n.690.

should only be for purposes of section 163(j) but not for other purposes of the Code. To the extent that the partnership's BIE exceeds the BII of the partnership and 30 percent of the partnership's ATI, such excess business interest expense ("EBI") is disallowed and carried forward to future tax years. Each partner is allocated its share of the EBI and must reduce its basis in its partnership interest by that amount (despite being unable to currently deduct the EBI). Although a partner may have significant BII and ATI outside the partnership, that income may not be offset by partnership EBI. Rather, such EBI may only be used to offset excess ATI (so-called "excess taxable income," see below) generated by the partnership in future years, as described below. When a partner disposes of its partnership interest, it increases its basis by the amount by which its allocated EBI exceeds the EBI treated as paid or accrued by the partner.[15]

To illustrate these provisions, consider the following example. Partnership AB, a 50/50 partnership with partners A and B, earns $200 of ATI, and incurs $100 of BIE (and has zero BII). Applying section 163(j)(4), $60 of interest (30 percent of $200 ATI) will be allowed as a deduction which will reduce each partner's allocable share of the nonseparately stated taxable income of the partnership (by $30 each). The remaining $40 of interest will be disallowed and treated as EBI, with each partner being allocated $20 of such disallowed EBI and each partner's tax basis in its partnership interest is nevertheless reduced by $20. In addition, assume that outside the partnership, Partner A earns $500 of ATI and has zero BIE. Although Partner A earned $500 which would support an interest deduction of $150 (30 percent of $500 ATI), it may not deduct the $20 EBI, as such interest was incurred inside the partnership and may be only used to offset partnership excess ATI. Thus, the statute effectively segregates the interest deductions of a partnership from a taxpayer's income outside the partnership. This segregation approach prevents partners from utilizing their allocable share of partnership interest deductions to reduce non-partnership income.

In determining a partner's share of partnership ATI for use at the partner level (either against the partner's direct BIE or against the partner's carryforward of EBI from the partnership), to the extent partnership income was used to calculate the interest limitation at the partnership level for the current year, it may not then be used again in computing ATI at the partner level. To prevent such "double counting," the statute provides a complex series of rules. First, it states that in computing the ATI of each partner, the partner's distributive share of any items of income, gain, deduction or loss of the partnership are excluded.[16] However, to the extent that a partnership has "excess taxable income" i.e., excess capacity of the partnership to deduct interest ("ETI"), such "unneeded" ETI is allocated to the partners and may be used by the partners, first, against their share of carried forward EBI from the partnership[17] and, second, in calculating their ATI to determine their own section 163(j) limitation on BIE incurred outside the partnership. The statutory definition of ETI is rather obtuse. Section 163(j)(4)(C) defines ETI as the amount which bears the same ratio to the partnership's ATI as (1) the excess of (i) 30 percent of the partnership's ATI minus (ii) the partnership's net interest expense, bears to

15 This provision will be discussed in greater detail below in Part III.B.2(iv) below.

16 Section 163(j)(4)(A)(ii).

17 Section 163(j)(4)(B)(ii)(I). The flush language at the end of section 163(j)(4)(B)(ii) references "paragraph (1)(A)" and presumably should reference "paragraph (1)(B)"—a technical correction is needed.

(2) 30 percent of the partnership's ATI.[18] A simpler formula for ETI can be expressed as (30 percent of ATI minus net business interest expense)/(.3). Thus, although Congress did not allow non-partnership business income or business interest income to offset partnership BIE, partnership business income and business interest income may be used to offset non-partnership partner level BIE.

B. Partnership as an Aggregate or Entity

1. General

Section 163(j) in its application to partnerships represents a radical departure from the way partnerships are normally taxed under the tax law. Partnerships may be viewed as aggregates or entities for tax purposes, and subchapter K adopts each of these views in different contexts. Specifically, the entity approach predominates in the treatment of partnership interest transfers, the computation and character of taxable income, tax basis, the adoption of a separate tax year, and certain transactions between partners and their partnerships. But with respect to the *taxation* of partnership income, the aggregate view predominates. As the Supreme Court stated in *Bayse*: [19]

> There has been a great deal of discussion in the briefs and in the lower court opinions with respect to whether a partnership is to be viewed as an "entity" or as a "conduit." We find ourselves in agreement with the Solicitor General's remark during oral argument when he suggested "(i)t seems odd that we should still be discussing such things in 1972." Tr. Of Oral Arg. 14. The legislative history indicates, and the commentators agree, that partnerships are entities for purposes of calculating and filing informational returns but that they are conduits through which the taxpaying obligation passes to the individual partners in accord with their distributive shares. See, e.g., H.R.Rep.No.1337, 83d Cong., 2d Sess., 65-66 (1954); S.Rep.No.1622, 83d Cong., 2d Sess., 89-90 (1954).

Under this approach, although the *character* of partnership interest expense as, for example, BIE or section 163(d) investment interest would be determined at the partnership level, the interest expense would flow up to the partners and would be aggregated with the partners other income and deductions in order to compute the partners tax obligations. Indeed, this was the approach adopted by the proposed regulations under old section 163(j).[20] And yet for no discernable or obviously compelling policy reason, section 163(j) attempts rather sloppily and only partially successfully to treat the partnership as an entity even in this regard and to segregate the partnership business interest expense

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18 The definition can be expressed mathematically as (ETI/ATI) = (30% of ATI minus net business interest expense)/(30% of ATI).

19 United States v. Basye, 410 U.S. 441, 448, n.8 (1973).

20 Proposed sections 1.163(j)-3(b)(3), 1.163(j)-2(e)(4), and 1.163(j)-2(e)(5). These rules provided that partnership level debt (for purposes of determining a partner's debt–equity ratio under old section 163(j)(2)(A)(2)), interest expense and interest income all flow up to the partner level when old section 163(j) was applied. In the words of the Mckee treatise on partnerships, the proposed regulations "apply these rules to partnerships with corporate partners in a quite logical manner." *See* Mckee, Nelson & Whitmire, Federal Taxation of Partnerships and Partners ¶ 9.02[3][c][ii] (Thomson Reuters Tax & Accounting 4th ed. & Supp. 2018-3).

as if the partnership were akin to an unconsolidated corporate subsidiary. Such an approach represents a new and unprecedented understanding of how partnerships should be taxed as there is no comparable provision that restricts the deductibility of a partnership expense solely to partnership income.[21] Nevertheless, the statute paradoxically also adopts several features reflecting an aggregate approach, thereby creating a certain degree of incoherence and confusion in applying the statue to partnerships.

This is puzzling for many reasons. One might argue that the statute drafters viewed each partnership as a separate contained "activity,"[22] and despite the general flow-through nature of the taxation of partnerships, they applied section 163(j) to the partnership on a segregated basis in order to discourage each separate activity from borrowing excessively. But if this is the case, why wouldn't a business run out of a consolidated corporate subsidiary not be similarly restricted and discouraged on an entity basis from borrowing excessively? Indeed, the statute itself is not clear as to the application of section 163(j) to consolidated groups; Notice 2018-28 clarified that a consolidated group would be treated as one entity. Why for tax policy reasons would an activity contained in a "flow-through" consolidated subsidiary be more favored than an activity contained in a flow-through partnership? Although consolidated subsidiaries are by definition predominantly owned by one or a family of commonly owned corporations, it is not obvious why this should make a difference if the writers were attempting to apply section 163(j) on an "activity by activity" basis.[23] Indeed, to take the point to its logical conclusion, if the drafters were seeking to apply section 163(j) on an activity by activity basis, this approach should not have been restricted to activities run out of a partnership. Instead, section 163(j) should have been applied separately to each and every activity directly or indirectly engaged in by the taxpayer, similar to the activity by activity restrictions under the at-risk rules of section 465. And in addition, similar to the section 465 at-risk rules and the passive loss rules of section 469, it should have been possible to aggregate the BIE, BII, and ATI and so forth of several partnerships together if the partnerships were all engaged in one aggregate activity.[24]

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[21] Although there are many limitation provisions on deductions applied at the partnership level (e.g. section 163(e)(3)), there is no provision that limits a deduction to the income of the partnership on the basis that a partnership is an entity similar to a corporation. For example, under section 704(d), a partner's distributive share of partnership losses for a year is allowed to be taken by the partner only to the extent of the partner's adjusted basis in its partnership interest at the end of such year, and thus may only flow through if the partner has basis or increases its basis from allocations of income or contributions of property. The section 704(d) limitation is not based on available income, but rather based on basis, a different concept. See also below the discussion in the text regarding the at risk rules of section 465 which segregates income based on "activities" but not based on partnerships as an entity.

[22] Compare, e.g., to section 469, i.e., section 1.469-4(c) that permits the grouping of activities that are conducted through separate partnerships or S corporations, even though creditors of one entity usually cannot reach the assets of the other entities to satisfy legal claims. With respect to aggregating activities for purposes of section 465, see footnote 24 below.

[23] But see sections 1.469-1(h) and 1.469-1T(h), which provide that a consolidated group generally is treated as one corporation for purposes of the passive loss rules. Thus, passive losses of one member can be applied against passive income of another member. Similarly, passive losses of one member can be offset against active income of another member, but not against portfolio income.

[24] But see CCA 201805013, which discusses the aggregation of the activities of several S corporations for purposes of applying section 465. The CCA conceded that the legislative history to the 1986 Tax Reform Act indicates that, at least with respect

Set forth below is a discussion of various features of new section 163(j), which illustrates the incoherence that results from the chaotic alternating blending of extreme notions of the aggregate and entity theory of the taxation of partnerships.

2. Specific Issues

(i) No Flow Through from the Partnership.

As briefly discussed above in the overview, section 163(j) (4)(A)(i) provides that "[i]n the case of any partnership, this subsection shall be applied at the partnership level and any deduction for business interest expense shall be taken into account in determining the non-separately stated taxable income or loss of the partnership." If after applying these provisions there is disallowed business interest expense, the partnership will not be allowed a deduction for that excess interest and, instead, the carryforward rules of section 163(j)(4)(B) will apply to the excess, which subsequently permit such carryforwards to be treated as paid or accrued only to the extent of excess taxable income of the partnership. Here, the statute adopts the entity theory in an unprecedented departure in this context from the aggregate approach (i.e. the ordinary flow-through treatment of all partnership tax items subject to available basis.) That is, in contrast to ordinary partnership taxation, a partner's share of partnership BIE may only offset the partner's share of partnership ATI and BII, and it may not so offset the partner's directly accrued ATI and BII. And yet, paradoxically, a partner's share of partnership ATI and BII, subject to the complicated no-double counting calculations, may be used to offset the partners directly incurred BIE.

This leads to varying results depending on the structure adopted, for no apparent policy reason. For example, real estate partnerships typically refinance and distribute excess proceeds to the partners. Unless the partnership makes the real estate exception election (and is forced to extend the term for the tax depreciation of its assets), the partners may not be allowed under section 163(j) to deduct the full amount of their allocable shares of partnership interest expense (particularly after January 1, 2021, when amortization and depreciation reduce partnership ATI.) At the same time, if a real estate investment is held by a taxpayer directly (or, e.g., thorough a disregarded limited liability company), the taxpayer could use interest expense from such a real estate investment to offset income earned from its other investments and activities, including income from investments in partnerships. So if the policy was to limit interest expense to the "activity" incurring the interest expense, the rules clearly do not achieve this. Rather, the statute solely closes off the flow-through nature of partnerships in this respect.

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to real estate activities, activities from multiple entities are aggregated for purposes of section 465. Nevertheless, the CCA concludes that conducting activities through separate entities that limit the liability of their owners generally will be strong evidence indicating that the activities do not compose a single trade or business for purposes of section 465(c)(3)(B) ("While the conduct of the activities through separate legal entities might not be a dispositive factor that, in itself, would prohibit aggregation of those activities under [section] 465(c)(3)(B)(i) and (ii), we believe that conducting activities through separate legal entities that limit the liability of their owners is a probative factor that should weigh heavily against aggregation"). Under this formulation, several activities engaged in by one taxpayer through several limited liability entity disregarded entities should also be segregated. This indicates that the salient point isn't the existence of separate tax entities but rather whether the activities have segregated liabilities.

This will lead to needless distortions of the structures in which taxpayers hold their investments. No doubt, in certain cases, great effort will be made to borrow at the partner level with upstream guarantees from the partnership of the partner level debt, which itself may be subject to attack.[25] Moreover, as in the case with any badly thought-out statute, the new section 163(j) may provide opportunities for manipulation.

For example, suppose a taxpayer has a $100 net operating loss carryover ("NOL") that is scheduled to expire in a few years (as it arose in a pre-Act year and thus it is subject to the old rule that NOLs expire after 20 years.)[26] Taxpayer is purchasing a business that includes depreciable and amortizable assets for $1000, $200 financed by its own equity, and $800 from third party debt that accrues interest at a 10 percent per annum rate. Assume that if taxpayer buys the business, it can deduct the BIE accruing on the debt, as taxpayer has sufficient BII and/or ATI (due to the fact, for example, that the purchase is taking place before January 1, 2022, so that depreciation and amortization is added back to ATI). As a result of taking the permitted BIE deduction, assume that taxpayer has zero net income and it will not use its expiring NOL.

Instead, a taxpayer might consider forming a partnership, or using an existing partnership between two of its subsidiaries to buy the business and incur the debt. By using a partnership to make the purchase and operate the business, the goal would be to limit the amount of ATI and BII available to offset the BIE from the third-party debt to partnership level ATI and BII. Assuming for arguments sake that during the course of a few years there is disallowed partnership BIE of $100, this will result in a corresponding increase in the net income of taxpayer by the same amount, which taxpayer can use to utilize its expiring NOL. Thereafter, taxpayer can arrange for the liquidation of the partnership. As a result of the liquidation, the partner's partnership interests in the liquidating partnership should be viewed as being "disposed" and therefore the basis of those partnership interests will be stepped up under section 163(j)(4)(B)(iii) by the disallowed and carried forward BIE of $100. Upon the liquidation of the partnership, assuming the assets of liquidating partnership are depreciable or amortizable property, the assets in the hands of the partners will be allocated a basis under section 732 that reflects an additional $100 of basis added to the partnership interest immediately prior to the liquidation. As a result of the additional basis, Taxpayer will enjoy additional tax deductible depreciation or amortization over time of $100. Thus, taxpayer has refreshed its expiring NOL by effectively converting section 163(j) limited interest deductions into allowable tax depreciation or amortization. By pushing down or pushing up debt to and from captive partnerships, taxpayers may thereby manage their taxable income from period to period.

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[25] See *Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712 (5th Cir. 1965), which looks to the true credit of the loan as the borrower. Upstream guarantees also face enforceability hurdles in bankruptcy proceedings.

[26] *See* new section 172(a).

(ii) Partnership Investment Interest

(a) Corporate Partners

Notice 2018-28 provides that Treasury and the IRS intend to issue regulations clarifying that, solely for purposes of section 163(j), in the case of a taxpayer that is a C corporation, all interest paid or accrued by the C corporation on indebtedness of the C corporation will be BIE, and all interest on indebtedness held by the C corporation that is includible in gross income of the C corporation will be BII. This statement relates to a corporation that incurs interest expense directly. But what if a corporation is a partner in a partnership and the partnership incurs investment interest expense (or receives investment interest income), e.g., the partnership borrows money to fund an investment that does not qualify as a trade or business? It is not clear whether or not in this case too, the corporate partner must treat its share of such interest as BIE or not. If it did, it would create the paradoxical result that BIE generated by a partnership may only offset BII and ATI of the partnership, but investment interest generated by a partnership flows up as BIE to a corporate partner and it may offset such "deemed" BIE against its direct ATI and BII. For example, consider a corporate partner in a partnership that conducts a trade or business. Interest incurred by the partnership will be treated as BIE and, thus, the interest deductions are "trapped" at the partnership level (i.e., it may not offset the corporate partner's direct ATI and BII). By contrast, interest incurred by an "investment partnership" would not be so trapped with respect to a corporate partner and it would be available to offset the partner's direct ATI and BII. The notice punts on this question, stating, "[r]egulations also will address whether and to what extent interest paid, accrued, or includible in gross income by a non-corporate entity such as a partnership in which a C corporation holds an interest is properly characterized, to such C corporation, as business interest within the meaning of Section 163(j)(5) or business interest income within the meaning of Section 163(j)(6)." In the absence of any other current guidance, we present two approaches.

Under the first approach, we begin by first analyzing the character of the investment interest at the partnership level, pursuant to section 163(j)(4)(A): "[T]his subsection shall be applied at the partnership level." Accordingly, the interest is treated at the partnership level as "investment interest" and thus not subject to the limitation of section 163(j) at the partnership level, as it is not connected to a trade or business at the partnership level.[27] This is consistent with the rule throughout subchapter K that the character of an item of income or loss (e.g., capital versus ordinary and so forth) is determined at the partnership level as in this regard partnerships traditionally are viewed as entities.

Next, the investment interest flows up to the partners as a "separately stated item." This is based on section 703, which provides that the taxable income of a partnership shall be computed in the same manner as in the case of an individual, except that the items described in section 702 shall be separately stated. Section 702(a)(7) states that separately stated items include, "other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary." The regulations under section 702 provide that a partner shall take into account separately, his or her share

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[27] See also sections 1.58-2(b)(2)(i), (ii) and (iii), providing that the characterization of partnership level interest expense, interest income, and investment expense is made at the partnership level for purposes of section 163(d).

of nonbusiness expenses as described in section 212.[28] Regulations section 1.212-1(g) provides for the individual itemized deduction for investment interest expense. Moreover, section 1.702-1(a)(8)(ii) provides a "catch-all" rule that each partner must also take into account separately the partner's distributive share of any partnership item which, if separately taken into account by any partner, would result in an income tax liability for that partner, or for any other person, different from that which would result if that partner did not take the item into account separately. As the treatment of section 163(d) investment interest expense can vary depending on the identity of the partner (i.e., corporate partner versus individual), it should properly be treated as a separately stated partnership item and should be characterized as investment interest expense in the hands of the partner.

In other words, if the rules of section 163(j) are to be consistent, then the partnership should be treated as an entity, and the characterization of partnership level interest expense and income as investment interest expense and income should be made at the partnership level. And based on the above authorities, it would appear that when the investment interest expense flows up as a separately stated item to the partners, it would retain its character as investment interest, even at the partner level. Thus, section 163(j), which applies only with respect to business interest, should not apply with respect to such interest even in the case of a corporate partner. Therefore, non-corporate partners will be subject to the limitations of section 163(d) with respect to the interest, but corporate partners should not be subject to section 163(d) or section 163(j) on the interest.

Nevertheless, the notice reserves judgement on this issue and it seems questionable that the IRS will permit this result. Instead, here again, theoretical consistency will probably be thrown to the side to make way for the desired result. Instead of viewing the partnership as an entity as it is in general under section 163(j), the IRS may view the partnership as an aggregate for this purpose and treat the corporate partner as if it itself had incurred or received the interest expense or income. The IRS can use as support section 702(b), which provides that the character of a partnership item is determined "as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership."[29] If the partnership level interest expense and income are viewed as if each was directly incurred or received by the corporate partner, the IRS can then fall back on the footnote in the legislative history cited above that states "[s]ection 163(d) applies in the case of taxpayer other than a corporation. Thus, a corporation has neither investment interest nor investment income within the meaning of [s]ection 163(d)."[30] As such, a corporate partner's investment interest expense and income, per se, cannot be treated as such and thus it must treat its allocable share of all partnership interest as BIE or BII, regardless of how the interest expense and income is

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[28] Section 1.702-1(a)(8)(i). Section 212 allows, in the case of an individual, a deduction for all of the ordinary and necessary expenses paid or incurred during the tax year (1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income; or (3) in connection with the determination, collection, or refund of any tax.

[29] Section 702(b).

[30] *See also* Rev. Rul. 2008-12, 2008-1 C.B. 520 (finding that a non-corporate partner's share of partnership level trade or business interest expense was nevertheless treated as investment interest at the partner level pursuant to section 163(d)(5)(A)(ii)).

characterized at the partnership level. But unlike a corporate partner's share of partnership level BIE, one would expect that under this approach, this investment-interest-turning-into-BIE may offset all of the corporate partner's direct BII and ATI and not just the partnership's ATI and BII.

(b) Trader Hedge Funds

Aggregate-entity confusion reaches schizophrenic proportions when section 163(j) is applied to partnerships that are engaged in a trade or business that is not a passive activity, e.g., a trader hedge fund. In such case, section 163(d)(5)(A)(ii) provides that any non-corporate partner that does not materially participate in the partnership (e.g. a limited partner) is deemed to hold its partnership interest as "property held for investment" and any partnership level interest expense allocated to that partner will be investment interest under section 163(d).[31] This appears to conflict with section 163(j)(4)(A)(i), which states that section 163(j) is applied at the partnership level and not the partner level. As the trader partnership is engaged in a trade or business, this would lead to the conclusion that the partnership's interest expense is BIE at the partnership level and may not be deducted by the partners except to the extent of the BII and ATI of the partnership. Nevertheless, as sections 163(j)(5) and (6) state unequivocally that BIE and BII do not include investment interest expense and income within the meaning of section 163(d), it seems that in such case section 163(d)(5)(A)(ii) and the aggregate theory prevail and the non-corporate limited partners' share of the trader partnership's interest expense and income should be treated as investment interest expense and income and not subject to section 163(j).

So far so good. But what happens if in addition to the partners who do not materially participate, there are non-corporate partners (e.g. general partners) who do materially participate, or if there are corporate partners regardless of their level of participation? In these situations, section 163(j) does apply at the partnership level with respect to these partners, while at the same time the provision does not apply at the partnership level with respect to the non-corporate, non-materially participating partners. The partnership becomes a half aggregate-half entity for this purpose with no guidance other than taxpayer creativity to conjure the tax results and tax reporting.

(iii) EBI Issues

As discussed above, to the extent that a partnership's BIE exceeds its BII and 30 percent of its ATI, the excess business interest expense ("EBI") is disallowed and carried forward to future tax years. EBI may be deducted in future years to the extent of "excess taxable income" ("ETI") allocated by the partnership to the partner. Conceptually, ETI is fairly straightforward as it represents the "unused" portion of a partnership's income used in calculating the partnership's section 163(j) interest limitation. These complications are required because of the underlying principle adopted that a partnership should be taxed as an entity for these purposes.

If a partner who had previously been allocated EBI is allocated any ETI for any tax year, the EBI is treated as paid or accrued by the partner to the extent of its share of ETI. ETI in any year must first be used by a partner to offset all carried forward partnership EBI from all preceding tax years and only then

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[31] Rev. Rul. 2008-12, *amplified by* Rev. Rul. 2008-38, 2008-31 C.B. 249.

can it be added to a partner's ATI, to be used by the partner to offset its own BIE incurred outside the partnership.[32]

With respect to the above rule that ETI frees up carried forward EBI and thereby allows a partner to deduct that EBI, the wording of the statute is problematic and poorly drafted. Section 163(j)(4)(B)(ii)(I) provides that the carried forward EBI is treated as paid or accrued by the partner in the next succeeding tax year during which the partner is allocated ETI from the partnership, "*but only to the extent of such excess taxable income.*" Consider a partner who in year 1 is allocated $100 of EBI, carries forward the EBI to year 2, and in year 2 is allocated $100 of ETI. What amount of EBI can the partner deduct in year 2 and what amount should be carried forward to year 3? Presumably, based on the policy and legislative history underlying section 163(j), the answer should be that the partner may deduct EBI equal to 30 percent of ETI, i.e., $30, and the remaining $70 of EBI should be carried forward (and freed up in subsequent years only if and when the partnership has ETI.) However, the statute states that EBI is treated as paid "*to the extent of such excess taxable income,*" and, as ETI is $100 in our example, a possible reading of the statute (the "First Approach") would allow the partner to deduct the full $100 of EBI regardless of whether the partner itself has any other ATI or BII. This result would however be inconsistent with the overall section 163(j) limitation that only allows a taxpayer to deduct interest expense up to 30 percent of ATI. Furthermore, the statute does not say EBI may be *deducted* to the extent of ATI, but rather that it is treated as "*paid or accrued*" to the extent of ETI. Thus, the text does not appear to support a $100 deduction of EBI.

Another possibility (the "Second Approach") is that $100 of EBI is treated as paid or accrued *by the partner*, and then added to all the other BIE directly incurred by the partner. Next, the partner must determine to what extent the $100 EBI is deductible by calculating its general section 163(j) limitation. Thus, in our example, the partner could deduct $30 of EBI, as it is supported by the $100 of ETI. With respect to the remaining $70 of EBI, if the partner has $233 of non-partnership ATI (or $70 of its own BII), it would be able to deduct such $70 of EBI. This Second Approach is justified based on a literal reading of the statute, but contradicts the apparent congressional intent to treat a partnership as an entity under section 163(j). As discussed above, in enacting section 163(j)(4), Congress adopted an entity approach and effectively walled-off interest deductions incurred by a partnership, by only allowing a partner to deduct such interest in an amount equal to the partnership's BII and /or 30 percent of the partnership's ATI, regardless of the partner's overall ATI. Thus, in general, when a partner's share of partnership income is $100 and its share of current year partnership BIE is $100, the partner may deduct only $30 of the BIE and the remaining $70 is carried forward as EBI, even if the partner has $233 of ATI outside the partnership. Yet, under the Second Approach, in year 2, when the partnership has $100 EBI and $100 ETI, the partner would be allowed to deduct the full $100 of EBI if it has $233 of ATI outside the partnership. There seems to be no rational explanation why non-partnership ATI can offset a deduction of carried forward EBI, but cannot offset a partner's share of current year partnership level BIE.

[32] Section 163(j)(4)(B).

Rather, from a partnership as entity perspective, the "right result" (the "Third Approach") should be that EBI may be deducted to the extent of 30 percent of ETI and the remaining EBI continues to be carried forward, regardless of the amount of the partner's directly accrued ATI and BII. Thus, in our example, the partner may deduct $30 of EBI and the remaining $70 would be carried forward and deducted in future years to the extent of 30 percent of ETI generated by the partnership. This third approach would be consistent with the apparent intent of section 163(j)(4), as EBI would be treated in the same manner as all BIE incurred by a partnership. However, the current language in section 163(j)(4)((B)(ii)(I) doesn't appear to support the Third Approach and it is unclear if Treasury or the IRS could mandate the Third Approach by regulation or other guidance.

(iv) Basis and EBI Issues

Under the partnership EBI carryforward rules, the carried forward EBI is allocated to each partner and reduces each partner's basis in its partnership interest.[33] Here again, the statute departs from the theory and rules of partnership taxation in an unprecedented manner—while under section 705a)(2)(B), a partner's basis is reduced by its share of partnership expenditures "not deductible in computing its taxable income and not properly chargeable to capital account," expenses that are merely deferred only reduce the basis when allowed.[34] By reducing the basis, section 163(j) "penalizes" the partner by thereby limiting its ability to be allocated losses or receive distributions tax free from the partnership. In other words, after applying the entity theory to the partnership in limiting the availability of BIE solely to offset partnership income, the statute swivels and accords the partnership aggregate treatment by allocating out the deferred BIE for tax basis purposes.

After making this design choice, the statute writers no doubt realized that this would create an unfair result where the partner sells or otherwise disposes of the partnership interest—if the basis is reduced by the disallowed expense, it would unfairly increase gain (or decrease the loss) upon a sale. To remedy this problem, the statute adopts another questionable "entity" type result: Instead of simply freeing up the carried forward loss as an ordinary deduction for the partner upon the sale, it provides that the basis of the sold interest gets stepped up immediately before the sale by the amount of such carried forward unused BIE, thereby reducing what may be capital gain or increasing what may be a capital loss. It is not readily apparent why this should be the result and one strains to find an analog in

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[33] This is conceptually similar to the positon taken in Notice 2018-28 that section 163(j) disallowed business interest reduces corporate E&P currently even though the interest expense is carried forward to future years. See discussion above in section II.C.3.

[34] Rev. Rul. 96-10, 1996-1 C.B. 138 ("In determining whether a transaction results in exempt income within the meaning of [section] 705(a)(1)(B) or a nondeductible, noncapital expenditure within the meaning of [section] 705(a)(2)(B), the proper inquiry is whether the transaction has a permanent effect on the partnership's basis in its assets, without a corresponding current or future effect on its taxable income.") Section 163(j)(4)(B)(iii)(I), which states, "[t]he adjusted basis of a partner in a partnership interest shall be reduced (but not below zero) by the amount of excess business interest allocated to the partner," should have included a clause to the effect of "notwithstanding section 705(a)(1)(B)" or something similar. As it is, the two provisions arguably are in conflict as section 705(a) states, "[t]he adjusted basis of a partner's interest in a partnership shall, except as provided in subsection (b)," i.e., with the sole exception of subsection (b) and no other exception.

other provisions of the Code. [35] Instead, it appears to adopt an incoherent approach with the sole aim of picking the worse possible result for the taxpayer in each instance, regardless of the complexity and confusion that results. That is, on the one hand, the "disallowed" interest effectively flows through and reduces basis (thus limiting the taxpayer's ability to receive distributions tax free, or loss allocations), but upon a disposition the suspended deduction effectively flows back into the partnership so that the taxpayer receives only a stepped up basis and no ordinary deductions. It also creates differing results depending on whether the partnership sells assets or the partners sell their interests. In the former, if the sale generates sufficient excess taxable income, it results in the partners enjoying gain from the sale of the assets and an ordinary deduction for the carried forward interest expense.[36] In contrast, in the case of the latter, the result is the upward adjustment of basis and the decrease of capital gain or increase of capital loss as described above.

There are other issues with respect to the mechanics of the EBI rules and their effect on partnership interest basis. Under section 163(j)(4)(B)(iii)(I), if a partner disposes of its partnership interest, its adjusted basis is increased (immediately before the disposition) by the amount of the excess of (i) the basis reduction resulting from EBI under section 163(j)(4)(B)(iii)(I) minus (ii) the partner's EBI previously treated as "*paid or accrued by the partner*." As discussed above, the purpose of this basis add-back provision is to allow a partner to recover its basis reduction associated with its share of EBI, to the extent that it never deducted the EBI. However, the language in the statute which focuses on EBI "treated as paid or accrued," as opposed to deducted, may possibly lead to harsh results for a taxpayer.

Consider the example discussed in part (ii) above when, in year 1, a partner is allocated $100 of EBI. The partner must then reduce its basis by $100. In year 2, the partner is allocated $100 of ETI. Based on section 163(j)(4)(B)(ii) above, all $100 of EBI is treated as paid or accrued in year 2. However, under the Second Approach discussed above, the taxpayer is limited in the amount of EBI that it can deduct. For example, assuming that the partner has zero non-partnership ATI and BII, under the Second Approach, it can only deduct $30 of EBI even though all $100 of former EBI has been "released" and has been added to the general BIE of the partner. If the partner then disposes of its interest, in theory, it should be allowed to increase its basis by $70, i.e., the EBI it never deducted. However, under a literal reading of the statute, as $100 of EBI was treated as paid or accrued in year 2, the partner would arguably receive no basis increase, an unjustified result.

Such a result would be particularly onerous in the case of a corporation whose sole asset is an interest in the partnership described in the text (e.g., a "blocker" corporation). If the partner sells it partnership interest at the beginning of year 3 at a $70 gain and has no other income or loss for the year and has no other activities to apply the released $70 of EBI, it will (1) recognize $70 of gain from the sale from

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[35] *See, e.g.*, section 469(g) (permitting the deduction of previously deferred ordinary passive losses as an ordinary deduction upon the sale of the partnership interest).

[36] When EBI is "treated as business interest paid or accrued by the partner" to the extent there is partnership ETI, under a proper reading of the statute, the EBI should be taken as an ordinary tax deduction at the partner level, and should not become a nonseparately stated item together with the partner's share of any capital gain recognized from the sale of the assets at the partnership level.

the partnership interest and (2) 30 percent of the $70 of ATI so generated (i.e. $21) of the released $70 of BIE will be available to offset such gain, thereby resulting in net taxable income of $49 and a useless section 163(j) carryforward of $49 ($70- $21) of EBI. The equitable result would be to step up the basis by the full $70 so that no taxable gain should be artificially generated by the original step down in basis of the partnership interest by the disallowed EBI. It is unclear if this unequitable result can be corrected by regulation or whether the statutory language would need to be amended.

(v) Business Interest Income

Section 163(j) reaches its apogee of entity-aggregate incoherence in its treatment of the BII generated by the partnership. First, despite the rule that partnership BIE may only offset partnership ATI and BII under an entity theory, partnership BII allocated to a partner may be used to offset other directly incurred BIE of the partner pursuant to an aggregate theory.[37] Moreover, under a plain reading of the statute, BII used by the partnership to offset its BIE continues to be a separately stated item in the hands of the partner under section 702, and under a literal reading of the statute, would therefore be available to be double counted and offset the partner's direct BIE. (But, see below, how Notice 2018-26 addressed this "glitch.")

An example would be a lending fund "finance" partnership that has large amounts of business interest income, say $100, and $60 of interest deductions, and there is a 50 percent partner with its own BIE from its directly held businesses. Under the statute, the partner may use the $20 (50 percent of the $40) of the excess partnership level BII allocated to it to offset BIE incurred by it from its other businesses. But in addition, under the plain reading of the statute, the partner may also use its 50 percent share ($30) of the gross BII ($60) that was offset at the partnership level (by $60 of partnership BIE) to offset

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[37] The technical reading of the statute that supports this conclusion is as follows. BII flowing up from the partnership is separately stated and retains its character under section 703 as BII. This is because section 163(j)(4)(A)(i) states that "this subsection shall be applied at the partnership level…and any deduction for business interest shall be taken into account in determining the non-separately stated taxable income or loss of the partnership." The provision only treats the BIE "deduction" as non-separately stated income in the hands of the partners, so that at the partner level, such BIE doesn't get added back into that partner's BIE subject to the rule. But it implicitly treats partnership BII as separately stated taxable income, consistent with the normal rules of partnership taxation. Thus, the partnership's BII flows up and retains its character and should be available to offset partner level BIE. Further, section 163(j)(4)(A)(ii) states that in determining the amount of the ATI of the taxpayer partner under 163(j)(1)(B), the partner does not include partnership level items of income and expense, but rather, the partner only includes its share of excess taxable income. "Adjusted taxable income" and "excess taxable income" does not include BII, see section 163(j)(8)(A)(ii)), because ATI is a separate basket (section 163(j)(1)(B)) and only 30 percent of it is usable against the partner's BIE. Partnership BII is set forth in section 163(j)(1)(A), the first basket against which BIE may be offset, and there is no limitation that "partnership items" of such BII may not flow up to the partner. Only partnership items that would otherwise be includible in "adjusted taxable income" are being limited, and it would therefore make no sense to limit BII as such income could never be part of a partner's "adjusted taxable income." Under this reading, there is nothing in the statute to prevent double counting as literally under the statute, partnership BII would first offset partnership BIE, but then such BII would retain its character and could be used again by the partner to offset its BIE. However, as set forth in the notice, regulations will provide for no such double counting and only "excess" partnership level BII will be available to the partners to offset their BIE.

the partner's directly incurred BIE. This is because section 163(j)(4)(A)(ii) says that partnership BIE flows up as a non-separately stated item in the hands of the partner, but it does not say the same for the partnership BII allocated to the partner. Thus, as under section 703 tax items of a partnership may be separately stated and retain their character in the hands of the partner, the BII allocated would be double counted. This unintended bounty for taxpayers was fixed by Notice 2018-28, although it is not readily clear how the IRS can override a clearly written statute that as described above often incoherently harms the taxpayer.

The statute contains another flaw relating to BBI. Although BII of the partnership flows up to the partners and may be used to offset their other direct BIE, the BII may not offset the carried forward EBI of the partnership. A partner who has carried forward EBI allocated by a partnership in a prior year can only deduct such EBI in carryover years by reference to the partnership's ETI (as described in detail above), but not by partnership BII generated in future years (which under the statute is not includible in partnership ETI.) But the partner could use that available BII from the partnership in Year 2 to offset BIE incurred by the partner directly from some other source. Accordingly, a partnership's BII in a current year, even though available to offset BIE directly incurred by a partner in the current year, apparently is not available to offset EBI allocated by a partnership and carried over from a prior year.

For example, assume there is a partnership that only generates BIE and BII (e.g., a credit fund partnership.) The partnership has BIE of $100 in excess of BII in 2018. The partnership allocates the $100 of excess BIE to the partners, reduces the basis of the partners' partnership interests, and the $100 of BIE is carried forward as EBI and may only offset the ETI of the partnership in future years. The problem is that the partnership will never have any ETI as the sole income that it generates in its business is BII. Therefore, in 2019, if the partnership has BII of $100 in excess of BIE, because the $100 of excess BII does not factor into the calculation of the partnership's ETI, that amount is not available to offset the $100 of EBI carried over from 2018. This is completely incoherent as being that the partnership is viewed as a self-contained taxpayer for this purpose, why wouldn't future BII of the partnership be offset by the EBI carryforwards, just as future ETI of the partnership is so offset?

(vi) Partnerships and the Real Estate Exception

It is unclear how section 163(j) will apply for debt incurred by a partner to fund an investment in a partnership conducting a real property trade or business. First, can an investor that borrows money to invest, or to purchase from another partner an interest, in a partnership that is engaged in a real property trade or business elect out of the section 163(j) limitation rules based upon the underlying real property trade or business of the partnership? On one hand, as discussed above, pursuant to the entity theory of partnerships, the section 163(j) limitation applies at the partnership level. Nevertheless, it can be argued that the fact that the limitation applies at the partnership level should not influence whether the trade or business of a partnership can determine the deductibility of interest on debt incurred by a partner in that partnership. In other contexts, the aggregate theory has been adopted in this instance, with authority that has analyzed the attribution of a partnership's trade or business to a partner by reference to the participation of the partner in the partnership's business or the magnitude of the partner's interest in the partnership.[38] Closer to the point, there is authority in certain contexts that interest expense with respect to debt incurred by a partner to acquire a partnership interest is characterized based on the nature of the partnership's activities.[39]

The election to be excluded from section 163(j) as a real property trade or business requires that real property and qualified improvement property must be depreciated using ADS recovery periods. Accordingly, if a partner of a real estate partnership is permitted to make the election, some mechanism must be developed to provide that the partner indirectly invested in a real property trade or business must use the slower ADS recovery period with respect to property used in that business. One option would be to require that, in order for a partner to elect out of section 163(j), the partnership must have made a similar election. Alternatively, the rules under section 168(h)(6) relating to tax-exempt use property held by a partnership might serve as a model. Applying such rules, the electing partners' proportionate share of the property (determined by looking to the partnerships allocations and so forth) would be subject to ADS. An added feature would provide that such slower depreciation would be allocable to the electing partner.

[38] *See, e.g.,* Rev. Rul. 92-17, 1992-1 C.B. 142 (section 355 active trade or business); section 1.368-1-(d)(4)(ii) (continuity of business enterprise). And in other contexts, the trade or business of a partnership is attributed to the partners without limitation, see, for example, sections 512(c)(1), 875(a), and 1.856-3(g).

[39] As discussed above, if the partnership is engaged in a non-passive trade or business, the interest with respect to the partner's debt is treated as a passive loss expense if the partner does not materially participate in the partnership's business. Temporary sections 1.163-8T; 1.469-(2)T(d)(3). *See* Jt. Comm. on Tax'n, General Explanation of the Tax Reform Act of 1986, at 265 n. 57 (May 4, 1987); Notice 89-35, 1989-1 C.B. 675; TAM 8235004 (May 21, 1982).