KPMG report: Preliminary analysis and observations, JCT Bluebook description on application of section 163(j) to passthrough entities

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Introduction

The staff of the Joint Committee on Taxation (JCT) on December 20, 2018, issued the *General Explanation of Public Law 115-97*—the "Bluebook." This report provides initial impressions regarding the explanation of the application of section 163(j) to passthrough entities in the Bluebook (JCS-1-18).

The **Bluebook**—prepared in consultation with the staffs of the House Ways and Means Committee, the Senate Finance Committee, and the Treasury Department's Office of Tax Policy—provides an explanation of the federal tax provisions enacted in December 2017 as Pub. L. No. 115–97 (the law that is often referred to as the "Tax Cuts and Jobs Act" or the "Act").

The Bluebook contains an explanation of each provision in the Act—including the reason for change to existing law—and thus may provide insight regarding congressional intent underlying those provisions. Note that the Bluebook is technically not considered "legislative history" with regard to the Act. See *FPC v. Memphis Light, Gas & Water Div.*, 411 U.S. 458, 472 (1973). The courts have applied varying degrees of deference to Bluebooks on prior legislation.

Bluebook explanation of the application of section 163(j) to passthrough entities

Section 163(j) was amended by the Act to provide new rules limiting the deduction of business interest expense for tax years beginning after December 31, 2017. In general, section 163(j) provides that a taxpayer is prohibited from deducting business interest expense in excess of the sum of the taxpayer's (1) business interest income, (2) 30% of adjusted taxable income from a trade or business, and (3) floor plan financing interest for the tax year. In the case of a partnership, section 163(j) provides that the limitation is applied at the partnership level.

The Bluebook explanation of these rules is largely consistent with the Conference Report[1] description of the application of section 163(j) to passthrough entities under the Act. However, there are a number of significant discrepancies from the Bluebook explanation of the passthrough entity rules and the statute and recently issued section 163(j) proposed regulations (the "proposed regulations").[2] These discrepancies, as well as some other observations, are discussed below. The Bluebook notes—at the beginning of the discussion of how the new interest expense limitation applies to passthrough entities—that technical corrections may be necessary to achieve the application of section 163(j) to passthrough entities as described in the Bluebook.[3]

Excess business interest carryforward rule

The statute provides that the amount of any business interest expense not allowed as a deduction to a partnership for a tax year ("excess business interest") is allocated to the partners in the same manner as the nonseparately stated taxable income or loss of the partnership and reduces the partners' bases in their partnership interests. The excess business interest is "treated as paid or accrued" by a partner (as opposed to "deductible") in a subsequent tax year to the extent of any "excess taxable income"

[1] H.R. Conf. Rep. No. 115-466 (2017) (the "Conference Report").
[2] REG-106089-18 (November 26, 2018).
[3] See footnote 877 in the Bluebook.

allocated by such partnership to the partner.[4]

The proposed regulations provide that excess business interest allocated to a partner is also treated as paid or accrued by such partner to the extent of any "excess business interest income" allocated to the partner in a subsequent tax year by such partnership.[5]

Example

> If a partnership allocates $100 of excess business interest to a partner in Year 1 and then allocates $100 of excess taxable income to such partner in Year 2, based on a plain reading of the statute, all $100 of excess business interest allocated to the partner would be treated as paid or accrued by such partner in Year 2. This $100 of excess business interest treated as paid or accrued by the partner in Year 2 is not necessarily deductible. Rather, the $100 of excess business interest must be added to all of the business interest expense directly paid or accrued by the partner in Year 2 and the partner must calculate the partner's own section 163(j) limitation based upon the partner's business interest income (which includes the partner's allocable share of excess business interest income from the partnership) and 30% of the partner's adjusted taxable income (which includes the partner's allocable share of excess taxable income from the partnership) to determine the deductibility of the partner's business interest expense (which includes the partner's allocable share of excess business interest treated as paid or accrued).
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> In this example, if the partner has $233.33 of adjusted taxable income in Year 2 in addition to the partner's allocation of $100 of excess taxable income from the partnership, the partner's aggregate $333.33 of adjusted taxable income would support a deduction of all $100 of the excess business interest treated as paid or accrued by the partner.
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> To the extent the partner does not have sufficient business interest income or adjusted taxable income to support the deduction of all of the partner's paid or accrued excess business interest expense, such non-deductible amount would be carried forward as business interest expense paid or accrued by the partner in subsequent tax years and would no longer be siloed to the partnership. In this example, if the partner's adjusted taxable income in Year 2 consists only of the $100 of excess taxable income allocated from the partnership, only $30 of the paid or accrued excess business interest would be deductible by the partner in Year 2 and $70 of the paid or accrued excess business interest would be carried forward as business interest expense paid or accrued by the partner in subsequent years. The proposed regulations confirm this reading of the statute.

The Bluebook explanation of the excess business interest carryforward rule appears to differ significantly from the plain statutory language and the proposed regulations—perhaps reflecting that this is one of the areas in which technical corrections legislation might be needed. The Bluebook's description of the excess business interest carryforward rule suggests that excess business interest may be deducted by a partner (as opposed to "treated as paid or accrued") in a tax year to the extent of the excess business interest income and 30% of any excess taxable income allocated by the partnership to the partner. In addition, any excess business interest in excess of 30% of excess taxable income remains siloed to the partnership that allocated the excess business interest and may only be deducted by the partner when such partnership allocates sufficient excess taxable income to the partner in a later year to support the partner's deduction. As stated in the Bluebook,

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[4] Excess taxable income of a partnership is equal to the amount of the partnership's adjusted taxable income that was not used to generate a business interest deduction at the partnership level.

[5] Excess business interest income of a partnership is equal to the amount of the partnership's business interest income that was not used to generate a business interest deduction at the partnership level.

…each partner may deduct its share of the partnership's disallowed business interest in any future year, but only to the extent of the partner's distributive share of excess business interest income and 30 percent of the partner's distributive share of excess taxable income of the partnership.

Thus, in the example above, in Year 2 when the partnership allocates $100 of excess taxable income to the partner, under the Bluebook explanation, the partner may deduct $30 of the excess business interest, and the remaining $70 would continue to be siloed to the partnership until the partnership allocates sufficient excess business interest income or excess taxable income to the partner to support a deduction of the remaining $70 of excess business interest.

The Bluebook provides a similar example that demonstrates this approach.

Basis adjustment rule

The statute provides that if a partner has been allocated excess business interest from a partnership (resulting in a decrease in the partner's basis in the partnership) and subsequently disposes of the partnership interest, the partner's basis in the partnership is increased immediately before such disposition by the amount of any excess business interest that has not been treated as paid or accrued by the partner.

The proposed regulations contain the same basis increase rule, but only to the extent that a partner disposes of "all or substantially all" of the partnership interest.

Therefore, in the example above, if all $100 of the partner's excess business interest had been treated as paid or accrued, but only $30 was deductible by the partner based on the partner's own section 163(j) limitation, the partner would not be entitled to a $70 basis increase immediately before the disposition of the partnership interest. Instead, the $70 of remaining business interest expense would continue to be carried forward by the partner.

Notwithstanding the "paid or accrued" language in the statute, the Bluebook explanation looks to whether the interest was "deducted" rather than whether it was treated as "paid or accrued." The Bluebook states:

…in the event the partner disposes of a partnership interest the basis of which has been so reduced, the partner's basis in such interest shall be increased, immediately before such disposition, by the amount that any such basis reductions exceed any amount of disallowed business interest that has been ***deducted*** *by the partner against excess business interest income or excess taxable income of the same partnership." [Emphasis added].*

Thus, in the example above, if all $100 of the partner's excess business interest had been treated as paid or accrued by the partner, but only $30 was deductible by the partner, the partner would still be entitled to a $70 increase to the partner's basis in the partnership immediately prior to a disposition of the partnership interest, and the $70 of remaining business interest expense would no longer be carried forward.

Definition of interest

The proposed regulations provide an expansive definition of interest that includes guaranteed payments for the use of capital. The Bluebook (consistent with the Conference Report) appears to define interest in a more limited manner, stating that "[b]usiness interest means any interest paid or accrued on indebtedness properly allocable to a trade or business" and that "[a]ny amount treated as interest for purposes of the Code is interest for purposes of the provision."

Electing real property trade or business

Section 163(j) provides that a real property trade or business may make an irrevocable election to not be subject to the business interest expense limitation.[6] A real property trade or business is defined by reference to section 469(c)(7)(C), which includes any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

For purposes of the electing real property trade or business exception, the Bluebook states that it is intended that a real property operation or a real property management trade or business includes the operation or management of a lodging facility, including a lodging facility that provides some supplemental services, such as an assisted living facility. The Conference Report also suggested that operation or management of a lodging facility is intended to be included as a real property trade or business, but did not mention an assisted living facility. In connection with the passage of the Act, a colloquy between Senator Lankford (R-OK) and Senate Finance Committee Chairman Hatch (R-UT) entered into the Congressional Record on December 19, 2017, implied an intention for the operation and management of residential rental property housing the elderly, such as an assisted living residential living facility, memory care residence, or a continuing care retirement community, to qualify as a real property trade or business, but this was not included in the Conference Report.[7]

Accordingly, the Bluebook may provide further support for including the operation or management of an assisted living facility within the definition of a real property trade or business.

[6] An electing real property trade or business must depreciate nonresidential real property, residential rental property, and qualified improvement property using the ADS recovery period. The Act eliminated the separate definitions of qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property and the Bluebook states that "a technical correction may be necessary to reflect that an electing real property trade or business is also required to use ADS to depreciate its qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property (as defined under prior law) that was placed in service prior to 2018 and is owned by the taxpayer as of the beginning of the year of the election out of the interest limitation."

[7] See Congressional Record – Senate, at S8109-S8110 (December 19, 2017).

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