AICPA

December 21, 2020

The Honorable David J. Kautter
Assistant Secretary for Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Notice of Proposed Rulemaking [REG-107911-18] and Notice of Final Regulations [T.D. 9905] Regarding the Limitation on Deduction for Business Interest Expense under Section 163(j)

Dear Messrs. Kautter and Rettig:

The American Institute of CPAs (AICPA) appreciates the efforts of the Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS) to address the need for guidance related to the changes to section 163(j)[1] as enacted under Pub. L. No. 115-97, commonly referred to as the Tax Cuts and Jobs Act (TCJA).

The AICPA respectfully submits the following recommendations to improve the administrability and practicality of the section 163(j) regulations as they apply to partnerships and their partners and S corporations.[2]

Our comments, if adopted in final regulations, would decrease the complexity in applying the proposed regulations and specifically cover the following:

I. Allocation of Debt-Financed Distribution Interest Expense Between Excepted, Non-excepted, and Investment Activities

II. Guaranteed Payments for Use of Capital

III. Self-Charged Lending Transactions
1. Application to Partnerships
2. Application to S corporations

IV. Adjusted Basis Attributed to Partnership Interests, Treas. Reg. § 1.163(j)-10(c)

[1] Unless otherwise indicated, hereinafter, all section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations promulgated thereunder.
[2] A separate forthcoming AICPA comment letter addresses international and tax-exempt organization issues.

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V. Partnership Basis Adjustments, 2020 Proposed Regulations
1. Partnership Basis Adjustments upon Partner Dispositions
2. Partnership Basis Adjustments upon Current Distributions
3. Treatment of Excess Business Interest Expense in Tiered Partnerships

VI. Partnership Mergers and Divisions

VII. Partnership Trade(s) or Business(es) Becoming an Excepted Trade(s) or Business(es) in Succeeding Tax Year

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We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. If you have any questions, please contact Sarah Allen-Anthony, Chair, AICPA Partnership Taxation Technical Resource Panel, at (574) 235-6818, or Sarah.Allen-Anthony@crowe.com; Alexander Scott, AICPA Senior Manager – Tax Policy & Advocacy, at (202) 434-9204, or Alexander.Scott@aicpa-cima.com; or me at (612) 397-3071 or Chris.Hesse@CLAconnect.com.

Sincerely,

Christopher W. Hesse, CPA
Chair, AICPA Tax Executive Committee

cc: The Hon. Michael J. Desmond, Chief Counsel, Internal Revenue Service
Roger Pillow, Attorney-Advisor, Office of Tax Legislative Counsel, Dept. of the Treasury
Bryan Rimmke, Attorney-Advisor, Office of Tax Legislative Counsel, Dept. of the Treasury
Holly Porter, Associate Chief Counsel (Passthroughs & Special Industries), IRS

AMERICAN INSTITUTE OF CPAs

Notice of Proposed Rulemaking [REG-107911-18] and Notice of Final Regulations [T.D. 9905] Regarding the Limitation on Deduction for Business Interest Expense under Section 163(j)

December 21, 2020

BACKGROUND

The section 163(j) business interest expense (BIE) limitation is equal to the sum of (1) 30% of taxpayer's adjusted taxable income (ATI), (2) taxpayer's business interest income (BII), and (3) taxpayer's floor plan financing interest. This limitation applies at both the partnership and partner levels. It does not apply to any taxpayer, other than a tax shelter, which meets a $25 million rolling three-year average gross receipts test. It also does not apply to certain excepted trades or businesses.

In general, partnership BIE that is less than or equal to the section 163(j) limitation computed at the partnership level is deductible and flows up to the partners, where it is not subject to a second partner-level limitation. However, excess business interest expense (EBIE), BIE in excess of the limitation, is not deductible and cannot be carried forward by the partnership, but is instead allocated to the partners and carried forward at that level.

A partner's share of that partnership EBIE is carried forward by the partner to a year in which the partner is allocated partnership excess business interest income (EBII) (BII in excess of BIE) or excess taxable income (ETI). The partner's share of EBIE is treated as paid or incurred by the partner in a subsequent year to the extent it does not exceed the sum of partner's share of EBII and ETI for the year ("freed up EBIE"). Any remaining EBIE allocated from the partnership is carried forward by the partner to a later taxable year at the partner level. The freed up EBIE is added to partner BIE, where it is subject to a partner-level section 163(j) limitation.

The partner-level limitation generally follows the general rule, but the partner increases its ATI by the partner's share of partnership ETI, and partner BII is increased by the partner's share of partnership EBII for the year, for limitation purposes.

Section 163(j) as enacted by the TCJA, is effective for tax years beginning after December 31, 2017. However, section 163(j) was amended by the Coronavirus Aid, Relief, and Economic Security Act (CARES Act). The effective date of the amendment is for tax years beginning after December 31, 2018.

Regulations were proposed in December 2018 (2018 proposed regulations) and finalized in September 2020 (2020 final regulations). New proposed regulations were issued in September 2020 (2020 proposed regulations). Both the final regulations and the 2020 proposed regulations are voluminous and complex. The cause of much of the complexity is the inherent subchapter K tension between the aggregate and entity theories.

I. Allocation of Debt-Financed Distribution Interest Expense Between Excepted, Non-excepted, and Investment Activities

Overview

Under the 2020 proposed regulations, partnerships that make a debt-financed distribution must follow an interest tracing approach to determine which portion of the interest expense is subject to section 163(j) at the partnership level and which portion is subject to the limitation at the partner level. A partnership would classify the interest expense associated with a debt-financed distribution into the following categories:

1. Expenditure interest expense;
2. Debt-financed distribution interest expense; and
3. Excess interest expense.

The tax treatment of the interest expense for each of the above categories depends on the type of assets to which the interest expense is allocated. The allocation of expenditure interest expense as investment or business interest for section 163(j) purposes depends on the type of partnership expenditures to which the debt proceeds are allocated. The tax treatment of the debt-financed distribution interest expense is determined based on the distributee partner's use of the funds. The tax treatment of the excess interest expense is based on the character of the partnership's assets to which the excess interest expense is allocated (e.g., trade or business or investment).

Under the 2020 proposed regulations, a partnership includes the sum of its partners' share of business expenditure interest expense and business excess interest expense in the computation of its section 163(j) limitation for the tax year. A partner's share of business debt-financed distribution interest expense is tested at the partner level for section 163(j) purposes. Investment interest expense attributable to each of the three categories (expenditure interest expense, debt-financed distribution interest expense, and excess interest expense) is subject to limitation under section 163(d). Excess interest expense allocated to trade or business assets is tested at the partnership level under section 163(j).

Recommendations

The AICPA recommends that Treasury and the IRS issue final regulations clarifying how a partnership should coordinate the expenditure interest expense allocation under the 2020 proposed regulations with the interest allocation rules under Treas. Reg. § 1.163(j)-10(c).

We also recommend that the final regulations provide additional examples on how to coordinate the expenditure interest expense allocation with the interest allocation rules.

Analysis

The 2020 proposed regulations provide examples for how a partnership should allocate interest expense between its trade or business and non-trade or business expenditures (e.g., section 469 passive rental activities that don't rise to the level of a trade or business). The 2020 proposed regulations do not provide examples on how a partnership with both excepted and non-excepted trades or businesses should allocate its expenditure interest expense among such trades or businesses. Under Treas. Reg. § 1.163(j)-10(c), proceeds from debt are treated as fungible and thus interest expense must be allocated based on the taxpayer's relative adjusted basis in its assets used in excepted versus non-excepted trades or businesses each year. However, Prop. Reg. § 1.163-14 requires the interest expense associated with a debt-financed distribution to be allocated among the available expenditures in proportion to the amount of each expenditure.[3] Thus, it appears that expenditure interest expense that is treated as allocable to an expenditure incurred in an excepted trade or business is treated as interest expense incurred in an excepted trade or business, and accordingly is not subject to section 163(j) at the partnership level.

This result contradicts the concept of the cash fungibility introduced with the interest allocation rules under Treas. Reg. § 1.163(j)-10(c). To be consistent with the concept that cash used in a trade or business is fungible, expenditure interest expense that is allocated to a trade or business (rather than a non-business passive section 469 activity or investment activity)[4] should be subject to the business interest expense allocation rules under Treas. Reg. § 1.163(j)-10(c). Examples clarifying and providing how a partnership first determines the total amount of business expenditure interest expense under Prop. Reg. § 1.163-14, and the determination of current year BIE that is then allocated between excepted and non-excepted trades or businesses based on relative adjusted basis used in such trades or businesses under Treas. Reg. § 1.163(j)-10(c), would alleviate confusion and additional complexity for both practitioners and taxpayers in practical application of the rules.

II. Guaranteed Payments for Use of Capital

Overview

The 2020 final regulations do not explicitly include guaranteed payments for the use of capital under section 707(c) in the definition of interest under section 163(j). Instead, the anti-avoidance rules in Treas. Reg. § 1.163(j)-1(b)(22)(iv) include an example in which a guaranteed payment for the use of capital is treated as interest expense and interest income for purposes of section 163(j).

Recommendation

The AICPA requests that Treasury and the IRS issue final regulations clarifying that arrangements entered into before September 14, 2020 that would generate a guaranteed payment for the use of capital are not subject to the anti-avoidance rules.

Analysis

The 2018 proposed regulations provided that any guaranteed payments for the use of capital under section 707(c) are treated as interest. In response to comments to the 2018 proposed regulations, the IRS and Treasury changed course in the final regulations. Instead of guaranteed payments for the use of capital *per se* treated as interest for section 163(j) purposes, the final regulations include

[3] Prop. Reg. § 1.163-14(d)(1).
[4] Under Prop. Reg. § 1.163-14.

an example in the anti-avoidance rules within the definition of interest that illustrates a situation in which a guaranteed payment for the use of capital is treated as interest expense and interest income.

In the example, a partner of a three-person partnership agrees to make a contribution to the partnership for use in its business operations in exchange for a guaranteed payment for the use of capital. The partnership had considered acquiring an additional loan from a third-party lender to expand its business operations. The partner made the contribution for the purpose of reducing the amount of additional interest expense that the partnership would have incurred. The regulations explain that a principal purpose of the arrangement between the partner and partnership was to reduce the amount incurred by the partnership that would be treated as interest expense. Thus, the guaranteed payment is treated as interest expense under the anti-avoidance rule.

Treasury Reg. § 1.163(j)-1(c)(2) states that the anti-avoidance rules in Treas. Reg. § 1.163(j)-1(b)(22)(iv) apply to transactions entered into on or after September 14, 2020. Arrangements entered into before September 14, 2020 could cause a guaranteed payment for the use of capital to be generated in more than one succeeding tax year. Such arrangements may have been entered into without the consideration of the application of section 163(j). These legal and business arrangements should not be covered by regulations that did not apply before the agreement was entered into.

III. Self-Charged Lending Transactions

1. Application to Partnerships

<u>Overview</u>

Generally, if a partner owns a direct interest in a partnership and provides a loan to that partnership, any BIE of the partnership attributable to the loan is BIE for section 163(j) purposes. Partner interest income attributable to the loan is transmuted into allocated EBII to the extent of the EBIE (if any) allocated to the partner by the partnership. This self-charged lending rule is designed to prevent a mismatching of investment interest income of the lender and BIE of the partnership that may potentially be limited as EBIE at the partner level by section 163(j). Uncertainty exists as to whether the transmutation is a partnership- or partner-level event. Uncertainty also exists as to whether indirect lending by the partner through a disregarded entity (such as a single-member LLC) also qualifies under the proposed regulations. Furthermore, the proposed rules do not address brother-sister partnership lending transactions.

<u>Recommendations</u>

The AICPA recommends that Treasury and the IRS clarify that the transmutation of interest income by the lending partner into allocated EBII is strictly a partner-level determination as it occurs even though the partnership has no EBII.

The AICPA also recommends that Treasury and the IRS clarify that the self-charged lending rule applies to indirect lending by a lender partner made through its wholly-owned disregarded entity (DRE).

Additionally, the AICPA recommends that Treasury and the IRS provide a special rule for partners that have the same proportional interests in both the lending and borrowing partnerships collectively owning 100% of both partnerships, and those partnerships engage in a lending transaction between them, that those partners may net EBII (or deemed allocated EBII) and EBIE from those entities at the partner level.

Analysis

A partnership cannot have both (positive) EBII and EBIE. Therefore, if the lending partner is allocated EBIE, the partnership would have no EBII. It follows that the transmutation of lender-partner's interest income into EBII is strictly a partner-level event and in no way implicates, or is implicated by, the partnership. As a result, there should be no reporting mechanism by the partnership for this partner-level determination and reporting by the partner.

It is unclear if a partner that lends to the partnership through a disregarded entity, such as a single-member LLC, qualifies under the self-charged lending rules. Under Treas. Reg. § 301.7701-2(c)(2) the DRE is disregarded as an entity separate from its owner for federal tax purposes.[5] There is no legal or policy reason to treat a DRE other than as disregarded for purposes of the Prop. Reg. § 1.163(j)-6(n) self-charged lending rules. There are also various non-tax business reasons for a partner to lend through a DRE. A lending partner should not be precluded from the self-charged lending rules due to the partner using common business structures and agreements.

Additionally, partners that own the same proportional interests in both the lending and borrowing partnerships collectively owning 100% of both partnerships should not be precluded from offsetting EBII and EBIE from those partnerships as a partner-level determination if there is a lending transaction between those partnerships. A similar regime exists in the passive loss limitation rules under section 469 that serves as a policy "blueprint" for such an exception in the self-charged lending rules.[6] The proposed brother-sister exception should also specify that deemed allocated EBII from one or more lending-partnerships in the transaction(s) may be used to offset the EBIE from the partnership(s) as generally EBIE may only be offset by EBII (or ETI) from the same entity. This brother-sister lending is not uncommon in business transactions and engaged in for non-tax reasons, and a similar exception should be provided for under these specific facts.

2. Application to S corporations

Overview

An S corporation may borrow from one or more of its shareholders in lieu of financing its operations from capital contributions or third-party lenders. Because an S corporation is a separate

[5] There are exceptions to this general rule that are not relevant to this letter. We note that similar application may be appropriate to grantor trusts as grantor trusts have the same effect as a DRE but are not classified as such.
[6] *See* Treas. Reg. § 1.469-7.

taxpayer from its shareholders, albeit a pass-through entity, the corporation is required to treat its interest expense in accordance with general federal income tax principles (e.g., as business interest and thus part of its non-separately stated taxable income or loss, as investment interest expense, or as personal interest). In turn, the shareholders take into account their share of the S corporation's items of income or loss, as well as the interest income derived from the loans to the corporation. Absent any special rules or circumstances, the shareholder's interest income from the loan is treated as investment interest income.

Since the section 163(j) limitation is applied at the entity level in the case of an S corporation, and any EBIE is carried forward as an entity-level attribute, an S corporation and its shareholders may be subject to unexpected tax consequences from these shareholder loans. Section 163(j)(4) applies similar rules to S corporations and partnerships, with one important exception. While both types of pass-through entities apply the limitation at the entity level, the treatment of EBIE differs significantly. A partnership allocates its EBIE to its partners on a current basis, and such amounts are carried forward at the partner level.[7] In contrast, an S corporation carries forward its EBIE at the entity level, and the interest is not allocated to shareholders until the entity-level limitation in a subsequent year allows the deduction.[8]

Assume that A is the sole shareholder of X Corp., an S corporation that uses the calendar year as its taxable year. A makes a loan to X Corp. and the corporation pays $100 of BIE on the loan for 2020. X Corp. has $150 of ATI for the year. Absent any special rules, X Corp. can deduct $75 of the BIE[9] and will be required to carry forward the remaining $25 as EBIE to 2021.[10] However, A will be required to include the entire $100 of interest income in A's gross income. If A made a capital contribution to the S corporation in lieu of extending a loan, X Corp. would not have any BIE to account for, and A would not have any interest income from the loan. While the overall economic arrangement is the same in both cases, the federal income tax consequences are different.

An S corporation carries forward its EBIE at the entity level, therefore, the treatment of partnership self-charged lending transactions in the proposed regulations cannot be applied to S corporations. However, no special rules for S corporations were provided in the proposed regulations. The preamble to the proposed regulations recognized that "issues analogous to the issues faced by partnerships in self-charged lending transactions exist between S corporations and their shareholders," and invited comments on whether a similar rule is appropriate for S corporations in light of section 163(j)(4)(B) not applying to such taxpayers.

There are other statutory constraints that may preclude the use of a similar rule for S corporations and their shareholders (e.g., the requirement to apply the limitation and carry forward any EBIE at the entity level). Conversely, there is no clear statutory authority to allocate the EBIE of an S corporation to its shareholders on a current basis. Moreover, section 1377(a)(1) precludes special allocations of items to S corporation shareholders. Each shareholder is allocated a share of each S corporation item on a per-share, per-day basis unless a closing-of-the-books election is made

[7] Section 163(j)(4)(B).
[8] Treas. Reg. § 1.163(j)-6(l)(1)(i), -6(l)(5).
[9] Section 163(j)(10)(A)(i) (temporary increase in the section 163(j) limitation for 2019 and 2020 taxable years).
[10] Section 163(j)(4)(D).

under section 1377(a)(2).[11] Section 1366(b) provides that the character of an S corporation item is determined at the entity level.

A rule similar to the proposed rule for partnership self-charged lending transactions would not achieve the desired result if all of these constraints are faithfully observed. Because EBIE is not allocated to shareholders on a current basis, a hypothetical allocation of EBII to the lending shareholder (even if otherwise permitted) would not increase the parties' ability to deduct any additional interest expense from the lending transaction, and it may be necessary to consider other means of achieving similar results within the applicable constraints.

Recommendations

The AICPA recommends to Treasury and the IRS three alternative applications of the section 163(j) regulations self-charged lending rules specifically to S corporations for consideration. The three proposed alternatives are:

1. Current allocations to shareholders;
2. An entity-level recharacterization; or
3. A consolidated group model.

Analysis

1. Current Allocation to Shareholders

Under the current allocation to shareholders approach, an S corporation would, notwithstanding section 163(j)(4)(D), allocate all BIE from shareholder loans to all shareholders, on a current basis, to the extent of the lesser of (1) the EBIE of the corporation, or (2) the corporation's BIE from the shareholder loans. The lending shareholder would begin by treating interest income from the loan as BII (rather than investment income) of the shareholder. The lending shareholder could use the BII to offset EBIE allocated from the S corporation. Any non-lending shareholder would need ETI from a subsequent taxable year, and from the same S corporation, to be able to deduct shareholder-level EBIE carried forward at that level. This approach appears to be the most effective to accomplish the policy objective of section 163(j) while respecting the per-share, per-day rules in subchapter S.

Example 1 – Current Allocation to Shareholders

S corporation has two equal shareholders. One shareholder loaned money to S corporation. The lending transaction gives rise to $50 of interest expense to the corporation and $50 of interest income to the lending shareholder. If the corporation's section 163(j) limitation is $20, its EBIE (without regard to any special treatment for self-charged interest) is $30.

[11] Even in the case of a closing-of-the-books election, each shareholder's share of each S corporation item is still determined on a per-share, per-day basis within each hypothetical short taxable year.

> Under the current allocation to shareholders approach, each shareholder would be allocated one-half of the corporation's EBIE from the lending transaction, or $15, inasmuch as that amount is less than the corporation's BIE from the shareholder loan. The lending shareholder would have $50 of BII from the loan and would be permitted to currently deduct the entire amount of the allocated EBIE, or $15. The non-lending shareholder would be allocated the remaining EBIE ($15) that is nondeductible. The non-lending shareholder's allocation of EBIE would be deductible to the extent the corporation generates ETI in a subsequent taxable year. The non-lending shareholder would bear the appropriate share of the burden of the section 163(j) limitation, while the lending shareholder would realize the full benefit of the BIE from the self-charged lending transaction.

As part of this proposal, the determination of the corporation's accumulated adjustments account ("AAA") and the adjustments to the basis of the stock of the corporation would be altered in the case of BIE from a self-charged lending transaction. Because all shareholders are currently allocated their respective shares of the interest expense, whether or not the expense is immediately deductible, the corporation's AAA should be adjusted currently.[12] Similarly, the shareholders should be required to currently reduce the basis of their stock (and loans to the corporation, as appropriate) under general principles of subchapter S.[13]

Although this proposal is inconsistent with section 163(j)(4)(D), it is consistent with section 1371(b)(2), which provides that no carryforward, and no carryback, shall arise at the corporate level for a taxable year for which a corporation is an S corporation. Section 1371(b)(2) provides the statutory basis for much of the treatment of S corporation items, for which all such items are allocated to shareholders currently, and taken into account by the shareholders subject to limitations applied at the shareholder level (including through carryforward provisions). By allocating the EBIE from a self-charged lending transaction to shareholders on a current basis, this proposal ensures that this item will not be carried forward at the corporate level.

2. Entity-Level Recharacterization

Under this approach, the corporation would recharacterize its BIE from its self-charged lending transaction as interest expense not subject to a section 163(j) limitation. Consistent with the proposed rules for partnerships, the amount of BIE that could be recharacterized would be limited to the lesser of (1) the lending shareholder's share of the EBIE of the corporation, or (2) the corporation's BIE from the shareholder loans. Such amount would be taken into account in determining the corporation's non-separately computed taxable income or loss, however, it would not be subject to a section 163(j) limitation.

If the proposed rule is not accompanied by a special allocation of the recharacterized interest expense to the lending shareholders, both lending shareholders and non-lending shareholders would bear the burden of the entity-level section 163(j) limitation and realize the benefits of exempting a portion of the interest expense from the limitation.

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[12] In general, the AAA of an S corporation is adjusted to take into account BIE in the year in which the corporation is permitted to deduct the expense pursuant to the section 163(j) limitation. Treas. Reg. § 1.163(j)-6(l)(7).
[13] *See* Treas. Reg. § 1.163(j)-6(l)(6).

Example 2 – Entity-Level Recharacterization

> Same facts as *Example* 1, above. Under the entity-level recharacterization recommendation, the lesser of the lending shareholder's share of the corporation's EBIE of $15 or the shareholder's income from the lending transaction of $50, or $15, would be recharacterized as interest not subject to the section 163(j) limitation. Thus, $35 of the corporation's interest expense would be deductible by the corporation ($20 under the regular limitation plus $15 under the proposed recharacterization rule). The non-lending shareholder would realize the benefit of one-half of the $15 of the recharacterized interest expense, or $7.50, in addition to one-half of the amount allowable under the regular limitation, or $10. Conversely, the lending shareholder would only realize the benefit of one-half of the recharacterized interest expense.

If the proposed rule is accompanied by a special allocation of the recharacterized expense to the lending shareholders, only the lending shareholders will realize the benefits of exempting a portion of the interest expense from the entity-level section 163(j) limitation, and the non-lending shareholders will primarily bear the burden of the limitation.

Special allocations are inconsistent with the mandate of section 1377(a). However, if this recommendation is adopted, the IRS has instances of reconciling two different statutory provisions—apparently in conflict with each other—by permitting special allocations. It is arguable that special allocations are already in effect. Under section 179, an S corporation is permitted to deduct the cost of qualifying property acquired by the corporation, subject to limitations. These limitations are applied first at the entity level and then again at the shareholder level. However, an estate or trust is not eligible for the benefits of section 179.[14] If an S corporation has an estate or trust as a shareholder, the S corporation's basis in section 179 property is not reduced by the *portion* of the expense allocable to the trust or estate.[15] The corporation continues to depreciate the portion of the cost of the property that is not eligible for section 179 expensing. In order to disallow the benefits of section 179 to trust and estate shareholders while permitting such benefits to other shareholders, the section 179 regulations seem to suggest that shareholders that are trusts or estates are allocated depreciation over the requisite recovery period while other shareholders are allocated potential section 179 expense on a current basis. In contrast, if special allocations are not permitted in this case, a shareholder that is not a trust or estate could bear a portion of the burden of disallowing the benefits of section 179 to shareholders that are trusts or estates. Although not clear under current law, it appears that non-pro-rata allocations would be required in this case in order to carry out the purposes of section 179(d)(4).

3. Consolidated Group Model

The consolidated group approach would use a model similar to that for BII and BIE on intercompany loans between members of a consolidated group. In this case, such items are disregarded for purposes of computing a member's BII and BIE and computing the group's ATI.[16]

[14] Section 179(d)(4).
[15] Treas. Reg. § 1.179-1(f)(3).
[16] Treas. Reg. § 1.163(j)-4(d)(2)(v)(A).

The lending member's interest income from the transaction is not treated as BII and the borrowing member's interest expense from the transaction is not treated as BIE. In the case of an S corporation, the shareholder's interest income from the lending transaction would not be treated as BII or as investment interest income, and the corporation's interest expense from the same transaction would not be treated as BIE or as investment interest expense.

> <u>*Example 3 – Consolidated Group Model*</u>
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> Same facts as *Example 1*, above. Under the consolidated group model, the corporation has $0 BIE and the lending shareholder has $0 BII and investment income. The full amount of the corporation's interest expense would be allowed without regard to section 163(j). Each shareholder would be allocated one-half of the corporation's interest expense, or $25. The non-lending shareholder would realize a portion of the benefit of this proposal, and the lending shareholder would not be subject to a section 163(j) limitation from the lending transaction.

We recognize that the consolidated return model may not be an appropriate model for self-charged lending transactions between an S corporation and its shareholders. In order to be eligible to file a consolidated federal income tax return, each corporation must be a member of an affiliated group, (as defined in section 1504(a)). In general, the term "affiliated group" means one or more chains of includible corporations if the common parent owns the requisite amount of stock[17] in at least one other includible corporation, and the requisite amount of stock of each other includible corporation is owned by one or more of the other includible corporations.[18]

The predominant policy of the consolidated return regulations is that transactions among members of the group should be treated in the same manner as if the members were divisions of a single corporation for purposes of timing, and character, source, and other attributes of the intercompany items.[19] The high threshold of requisite stock ownership of the members makes it appropriate to treat the subsidiary members of the group as if they were wholly owned, directly or indirectly, by the common parent.

In the case of an S corporation, a loan could be made by a shareholder without regard to any threshold level of ownership. If the consolidated return model were to be adopted for use in connection with loans made by a shareholder to an S corporation, it may be appropriate to impose a requisite level of stock ownership comparable to that of section 1504(a)(2).

IV. Adjusted Basis Attributed to Partnership Interests, Treas. Reg. § 1.163(j)-10(c)

<u>Overview</u>

Treasury Reg. § 1.163(j)-10 provides rules for allocating tax items between excepted and non-excepted trades or businesses. The 2020 final regulations retain the asset-based allocation approach for interest expense and interest income contained in the 2018 proposed regulations of

[17] Under section 1504(a)(2), (a)(5).
[18] *See* section 1504(b).
[19] Treas. Reg. § 1.1502-13(a)(2).

allocating those items between a taxpayer's excepted and non-excepted trades or businesses based upon the taxpayer's relative adjusted basis in the assets used in its trades or businesses. For purposes of allocating interest expense and interest income under Treas. Reg. § 1.163(j)-10(c), a partner's interest in a partnership is treated as an asset of the partner. A partner may generally allocate its adjusted basis in its partnership interest between excepted and non-excepted trades or businesses by looking through the partnership to the partner's share of the inside basis in the partnership assets (the "look-through rule").

The final regulations clarify in an example that under the look-through rule, a partner allocates its adjusted basis in its partnership interest between excepted and non-excepted trades or businesses calculated from the ratio of the partner's share of partnership adjusted tax basis in assets used in excepted versus non-excepted trades or businesses. Partners may look-through its partnership interest in certain cases and must look-through in others. Partners that do not look-through or are otherwise not required to look-through must treat the partnership interest as a non-excepted asset.

Furthermore, the final regulations require that a partner applying the look-through rule must also adjust its basis in the partnership interest by the partner's share of certain adjustments. In particular, the partner must adjust its basis in the partnership interest by its share of any adjustments to the basis of the partnership's assets required under Treas. Reg. § 1.163(j)-10(c)(5)(i) (e.g., reducing basis attributable to cash and cash equivalents) (the "Look-through Adjustments").[20] For the reasons described below, it is administratively burdensome to comply with this requirement and it is not clear how a partner should adjust the basis in its partnership interest by these adjustments.

Recommendations

The AICPA recommends that Treasury and the IRS remove the requirement that a partner must make the Look-through Adjustments for purposes of determining its adjusted basis in the partnership interest under Treas. Reg. § 1.163(j)-10(c).

If Treasury and the IRS retain the requirement, the AICPA recommends providing an exception to the requirement to make the Look-through Adjustments for partners that look through an interest in a partnership that engages solely in an excepted trade or business.

The AICPA also recommends that the final regulations clarify how a partner should determine its share of partnership adjustments under Treas. Reg. § 1.163(j)-10(c)(5)(i) and provide additional examples to illustrate how a partner should adjust its basis by those adjustments, if the rule is retained.

Analysis

Partnerships that engage solely in an excepted trade or business generally do not need to make an allocation of interest expense under Treas. Reg. § 1.163(j)-10(c). Often, partners that want to look through those partnerships are unable to obtain the proper information in order to adjust their basis in the partnership interest by the Look-through Adjustments, which include, among other items,

[20] Treas. Reg. § 1.163(j)-10(c)(5)(ii)(A)(1).

their share of the unadjusted cost basis of any real property, alternative depreciation system adjustments to certain depreciable property, and cash and cash equivalent items. Treasury Reg. § 1.163(j)-10(e)(3) provides an example on how a corporate partner can look-through its interest in a partnership. However, the example does not contemplate how the corporate partner should adjust its basis in its partnership interest by its share of any of the items under Treas. Reg. § 1.163(j)-10(c)(5)(i) that are required to be made by the partnership. Without clarification and additional examples, it is unclear as to how a partner should determine its share of Look-through Adjustments (e.g., how to determine a partner's share of the adjustments by taking into account section 704(b) and (c) allocations).

Example

Corp A and Corp B, each own a pro-rata 50% interest in partnership PRS. PRS has made a real property trade or business election with respect to its sole trade or business. For Treas. Reg. § 1.163(j)-10(c) purposes, PRS has $100 of cash, $200 of adjusted tax basis, and $500 of original cost basis in the building. PRS also has liability of $50, which is allocated pro-rata to each of Corp A and Corp B under section 752. Assume Corp A and Corp B, each have an adjusted outside basis in PRS of $150 ($125 of tax capital plus $25 of liabilities).

For section 163(j) purposes, Corp A has an adjusted basis in PRS of $125 ($150 outside basis reduced by $25 of liabilities allocable to Corp A under section 752).

Asset	PRS's Tax Basis	Treas. Reg. § 1.163(j)-10(c)(5)(i) adjustments	PRS' adjusted basis for Treas. Reg. § 1.163(j)-10(c) purposes	Corp A's share of Look-through Adjustments
Cash	$100	$(100)	$0	$(50)
Building	$200	$300	$500	$150
Total	**$300**	**$200**	**$500**	**$100**

If Corp A would like to look through its partnership interest in PRS and treat its adjusted basis in PRS as an asset used in an excepted trade or business, Corp A must make Look-through Adjustments. Under the final regulations, it appears that Corp A should increase its $125 adjusted basis in PRS by its share of the Look-through Adjustment with respect to the building of $150 (50% of the $300 PRS adjustment to arrive at the unadjusted basis for the building). Corp A should also reduce its adjusted basis by its share of cash or cash equivalents excluded for this purpose of $50 (50% of the $100 of cash). Thus, Corp A appears to have an adjusted basis in PRS of $225 (compared to its initial adjusted basis of $125) for purposes of Corp A's Treas. Reg. § 1.163(j)-10(c) allocation.

The example above does not contemplate section 704(c) allocations. If Corp A is a contributing partner with respect to the building it is unclear how Corp A should determine its share of the Look-through Adjustments to the building to take into account section 704(c). A seemingly logical application of the rules would require Corp A to compute its cumulative historical share of tax depreciation deductions taken with respect to the building in order to determine its share of the

Look-through Adjustments. However, this computation would require a partnership to track the allocation of the cumulative historical deductions on an asset-by-asset and partner-by-partner basis for this purpose, which is prohibitively burdensome for taxpayers.

Additionally, further difficulties arise in applying these rules if Corp A is allocated a disproportionate share of partnership debt under section 752 (e.g., the debt is treated as partner nonrecourse debt allocable solely to Corp A). While it may be appropriate to allocate a disproportionate share of the Look-through Adjustments to Corp A in order to arrive at a tax basis that more closely resembles Corp A's initial adjusted basis in PRS, there is significant uncertainty in this application.

Partnerships are subject to numerous cumulative reporting burdens, including requirements to report unrealized section 704(c) amounts by partner, at-risk activity on an activity-by-activity basis, section 163(j) items (e.g., allocating section 163(j) attributes under the 11-step process, determining relative adjusted basis in their assets for Treas. Reg. § 1.163(j)-10(c) purposes), and tax basis capital accounts. In connection with the look-through rules, partnerships would be required to prepare separate computations in order to provide partners with their share of the Look-through Adjustments. Furthermore, due to this additional complexity, partners often find it administratively burdensome to obtain all the necessary information to apply the rules under Treas. Reg. § 1.163(j)-10(c). Under the final regulations, shareholders use their stock adjusted tax basis for purposes of the look-through rules under Treas. Reg. § 1.163(j)-10(c), without the need to make additional adjustments similar to the Look-through Adjustments.[21] Other than the debt allocation reduction requirement, an interest in a partnership should be treated the same as an interest in a corporation for Treas. Reg. § 1.163(j)-10(c) purposes.

Additionally, most partnerships that engage in excepted trades or businesses have favorable Look-through Adjustments with respect to inherently permanent structures or other depreciable property under the alternative depreciation method. A partner required to make Look-through Adjustments may generally receive a favorable increase to its adjusted basis allocable to excepted assets. Thus, removing the requirement to make Look-through Adjustments will not distort a taxpayers' adjusted basis toward excepted assets and may prove to be unfavorable for some taxpayers. Removing the requirement for a partner to make Look-through Adjustments with respect to its partnership interest and adopting the same approach allowable to a shareholder that looks through its stock will significantly simplify the reporting requirements and reduce complexity.

Alternatively, an exemption from the Look-through Adjustments should be provided to certain partners and partnerships that look-through a partnership that engages solely in an excepted trade or business to ease the administrative burden on compliance. Often, a partnership with solely an excepted trade or business would alert its partners that it engages solely in an excepted trade or business without providing the partner with its share of the partnership adjusted basis information. Partnerships that solely engage in excepted trades or businesses largely have favorable Look-through Adjustments with respect to inherently permanent structures or other depreciable property under the alternative depreciation method; partners that are required to make the Look-through Adjustments would be able to increase their adjusted basis in the partnership interest under Treas. Reg. § 1.163(j)-10(c)(5)(i)(C). Taxpayers that want to look-through a partnership with an excepted

[21] Treas. Reg. § 1.163(j)-10(c)(5)(ii)(B)(2)(i).

trade or business that otherwise find it administratively difficult to comply should be provided with an option to "opt out" of this requirement.

Additionally, the final regulations currently do not provide an example that illustrates how a partner should adjust its basis by the Look-through Adjustments. It is unclear whether taxpayers should apply the methodology presented in the above *Example* without additional guidance. Thus, if the requirement to make Look-through Adjustments is retained, we suggest providing additional examples in the final regulations to clarify how a partnership should determine if a partner's share of Look-through Adjustments is necessary and how to make those adjustments.

V. Partnership Basis Adjustments, 2020 Proposed Regulations

1. Partnership Basis Adjustments upon Partner Dispositions

Overview

Under section 163(j)(4)(B)(ii), if a partner is allocated EBIE from a partnership, the EBIE is treated as BIE paid or accrued by the partner in the next succeeding taxable year in which the partner is allocated ETI or EBII from the same partnership.[22] Section 163(j)(4)(B)(iii)(I) requires a partner to reduce its basis, but not below zero, by its share of EBIE.[23] When a partner disposes of a partnership interest, the adjusted basis of the partner's interest in the partnership is increased immediately before the disposition ("Basis Addback Rule") by the amount of the excess (if any) EBIE allocated to the partner that has not yet been treated as business interest paid or accrued by the partner ("Remaining EBIE"). If the Basis Addback Rule applies, section 163(j)(4)(B)(iii)(II) provides that no deduction shall be allowed to the transferor or transferee for any excess business interest resulting in a basis increase.

The 2020 proposed regulations provide that if a partner disposes of a partnership interest and increases the basis of its partnership interest by an amount of Remaining EBIE, the partnership would correspondingly increase the adjusted basis of partnership property by the same amount.[24] This increase in partnership basis would be allocated among capital gain property of the partnership in the same manner as a positive section 734(b) adjustment but would not be depreciable or amortizable, regardless of the property to which it is allocated. Generally, the partnership would allocate this basis increase immediately before the partner's disposition of the interest. However, if the disposition results from a distribution in complete liquidation of a partner, the partnership would allocate the additional basis adjustment only after it has allocated its section 734(b) adjustment (if any, and the amount of which is determined taking into account the Basis Addback Rule) among its properties.

The preamble to the 2020 proposed regulations indicates that the purpose of the Prop. Reg. § 1.163(j)-6(h)(5) basis adjustment is to prevent disparities between the partnership's basis in its assets ("inside basis") and the partners' aggregate basis in their partnership interests ("outside basis") resulting from a partner's addition of EBIE to its basis upon disposition of a partnership

[22] *See also* 2018 Prop. Reg. § 1.163(j)-6(g)(2)(i).
[23] *See also* 2018 Prop. Reg. § 1.163(j)-6(h)(2).
[24] Prop. Reg. § 1.163(j)-6(h)(5).

interest.[25] The preamble to the 2020 proposed regulations also notes that such disparities may occur when a partner is redeemed from the partnership and increases its basis in its partnership interest by its Remaining EBIE. In that case, the partner will recognize less gain or more loss as a result of the EBIE addback than it would have recognized if the interest expense had been deductible. As a result, the partnership's section 734(b) adjustment (if any) will be correspondingly smaller than it would have been without the EBIE addback compared to a situation in which the interest had been deductible.

Recommendation

The AICPA recommends that Treasury and the IRS issue final regulations stating that the Basis Addback Rule does not apply to disposition (e.g. sale or exchange) of partnership interests to which section 743(b) may otherwise apply.

Analysis

The Basis Addback Rule prevents inside-outside basis disparities in the case of a redemption of a partner. However, in the case of a sale or exchange of a partnership interest to which section 743(b) may otherwise apply, the rule creates inside-outside basis disparities. The Basis Addback Rule would also cause economically similar transactions to be taxed differently, unnecessarily distort the fungibility of partnership interests, and does not further the policy intent of section 163(j)(4)(B)(iii)(II), which is to allow a partner to recover its Remaining EBIE as a basis addback. Section 743(b) adequately addresses the difference between an acquirer's outside basis and its share of inside basis, negating the need for duplicative regulatory complexity.

Recommendations

The AICPA recommends that Treasury and the IRS issue final regulations stating that in the case of distributions characterized as redemptions, the partnership does not take into account any EBIE added back by the partner as a result of the distribution[26] when calculating a partnership's section 734(b) adjustment resulting from a distribution to a partner.

Additionally, the AICPA recommends depreciable or amortizable treatment for any section 734(b) adjustment resulting from a distribution characterized as a redemption if it is allocated to depreciable or amortizable assets.

Analysis

Excluding the EBIE addback prevents creation of an inside-outside basis disparity in a redemptive distribution without causing distortions in sale or exchange transactions. Additionally, this simplified calculation and approach lends itself to eliminating the basis disparities if the 734(b) adjustment is depreciable or amortizable if it is allocated to an appropriate asset. These simplified

[25] 85 Fed. Reg. at 56,856.

[26] The same "section 734(b) glitch" exists when a partner has losses limited by section 704(d) at the time the partner is redeemed. In that situation, the partner's basis was not reduced by the section 704(d) losses, so the partnership's section 734(b) adjustment is correspondingly lower than the parties might expect.

methods provide benefits to both the IRS and taxpayers in tracking these adjustments to ensure proper, and continuing compliance.

2. Partnership Basis Adjustments upon Current Distributions

Overview

The Basis Addback Rule of section 163(j)(4)(B)(iii)(II) requires that a partner's Remaining EBIE must be added to basis when a partner disposes of a partnership interest. The statute does not address a disposition of a portion of a partner's partnership interest (a "partial disposition") or whether a disposition includes a distribution that disproportionately reduces the distributee partner's capital account.

Under the 2018 proposed regulations, if a partner disposed of all or substantially all of its partnership interest,[27] the adjusted basis of the partnership interest would have been increased immediately before the disposition by the entire amount of Remaining EBIE.[28] If a partner disposed of less than substantially all of its interest in a partnership, the partner would not have increased its basis by any portion of the Remaining EBIE. Any Remaining EBIE would remain EBIE of the transferor partner until the transferor partner was allocated ETI or EBII from the partnership or the transferor partner disposed of all or substantially all of its remaining partnership interest.

The 2020 final regulations modify the rule for partial dispositions. Specifically, Treas. Reg. § 1.163(j)-6(h)(3) provides that if a transferor partner disposes of an interest in a partnership, the adjusted basis of the partnership interest disposed of (i.e., the transferred interest) is increased immediately before the disposition by an amount equal to the Remaining EBIE (if any) multiplied by the ratio of the fair market value of the transferred interest to the total fair market value of the transferor's partnership interest immediately before the disposition. No deduction is allowed to the transferor or the transferee partner for any amount of Remaining EBIE proportionate to the transferred partnership interest. The amount of Remaining EBIE proportionate to the partnership interest retained by the transferor partner remains EBIE until the transferor partner is allocated ETI or EBII from the partnerships or disposes of all or an additional portion of its partnership interest.

The preamble to the 2020 final regulations notes three concerns cited by commenters to the "all or substantially all" approach of the 2018 proposed regulations. First, commenters noted that the absence of a rule addressing partial dispositions could result in tax gain in excess of economic gain in connection with a partial disposition, while the addition of the entire adjustment to outside basis in connection with a complete disposition could result in economic gain in excess of tax gain, inappropriately disconnecting economic income from taxable income. Second, commenters expressed concern that because a partial disposition results in a partner holding a smaller interest in the partnership, the partner could receive smaller allocations of ETI or EBII in subsequent years, prolonging the amount of time a partner needs to convert its EBIE to be paid or accrued for purposes of section 163(j). Third, commenters noted that the 2018 proposed regulations could

[27] The 2018 proposed regulations did not define the phrase "substantially all."

[28] 2018 Prop. Reg. § 1.163(j)-6(h)(3)(i).

cause a discrepancy between the capital accounts of the transferor and transferee and the EBIE associated with each interest.[29]

The 2020 final regulations also provide additional guidance on the treatment of distributions by the partnership to the partner for purposes of the "disposition" requirement of the Basis Addback Rule. Treasury Reg. § 1.163(j)-6(h)(3) provides that a disposition includes a distribution of money or other property by the partnership to a partner in complete liquidation of its interest in the partnership. The 2020 proposed regulations address distributions that are not in complete liquidation of a partner's interest in the partnership (i.e., a current distribution). Proposed Reg. § 1.163(j)-6(h)(4) provides that a current distribution of money or other property by the partnership to a continuing partner is not a disposition for purposes of the Basis Addback Rule.

The preamble to the 2020 proposed regulations requests comments "on whether a current distribution of money or other property by the partnership to a continuing partner as consideration for an interest in the partnership should also trigger an addback and, if so, how to determine the appropriate amount of the addback."[30]

Recommendation

The AICPA recommends that Treasury and the IRS issue final regulations specifying that a current (i.e., nonliquidating) distribution should not be a "disposition" for purposes of the Basis Addback Rule under section 163(j)(4)(B)(iii)(II).

Analysis

Since the Basis Addback Rule increases the partner's basis by all of the EBIE previously allocated to that partner, the statute appears to contemplate a transaction in which a partner disposes of its entire interest.[31] Absent additional guidance from Treasury and the IRS, under the statute, a partner would have to dispose of its entire interest before the Basis Addback Rule could apply.

If the partner receives a current distribution (including a distribution in partial redemption of its interest in the partner), the partner presumably retains the entire EBIE previously allocated to its partner. Thus, if the partnership later allocates ETI or EBII to the partner, it can potentially treat that amount of EBIE (even the amount attributable to its interest in the partnership that has been partially redeemed) as paid or accrued and potentially deductible by the partner. This result is appropriate; the Basis Addback Rule should not be applied in this situation.

[29] 85 Fed. Reg. 56,721.
[30] 85 Fed. Reg. 56,861.
[31] As confirmed in the final regulations, a distribution in complete liquidation of a partner's interest in the partnership qualifies as a disposition for purposes of the Basis Addback Rule. Treas. Reg. § 1.163(j)-6(h)(3).

3. Treatment of Excess of Business Interest Expense in Tiered Partnerships

Overview

The 2020 proposed regulations provide a complex new regime to track an upper-tier partnership's (UTP) EBIE in tiered partnership structures. The preamble to the 2020 proposed regulations notes that the new regime would be implemented "in order to prevent a partner from deducting BIE that was formerly UTP EBIE if such partner did not bear the economic cost of such business interest expense payment."[32] To implement this policy, the 2020 proposed regulations require an allocation of a section 705(a)(2)(B) expenditure solely for purposes of section 704(b) equal to a UTP partner's share of UTP EBIE.[33] The partner that reduces its section 704(b) capital account would become the "specified partner" with respect to that EBIE.[34] To the extent a direct, or indirect, partner disposes of its partnership interest, the proposed regulations generally rely on negative sections 734(b) and 743(b) adjustments ("Negative Basis Adjustment") to prevent a "transferee specified partner" from receiving the tax benefit of that decrease in the form of a future deduction or basis increase under the Basis Addback Rule.[35]

The proposed regulations also provide anti-loss trafficking rules as a backstop in the event the Negative Basis Adjustment fails to offset a deduction or basis increase of a transferee specified partner.[36] Treasury and the IRS requested comments on the approach taken, and specifically whether further guidance on the treatment of UTP EBIE under the rules of subchapter K of the Code is necessary.[37]

Recommendation

The AICPA recommends that Treasury and the IRS in the final regulations discard the approach set forth in Prop. Reg. §§ 1.163(j)-6(j)(1)-(8) and adopt a simplified entity approach with respect to all aspects of UTP EBIE. The simplified entity approach would include the section 704(b) capital account rules that would treat UTP EBIE as a nondepreciable capital asset with a section 704(b) basis and tax basis equal to the amount by which UTP reduced its basis in lower-tier partnership (LTP) on account of the allocation of UTP EBIE.

Analysis

Under our simplified entity approach, a disparity between a UTP partner's basis in its partnership interest and the partner's share of the adjusted basis of UTP's property is not created upon the allocation of EBIE by LTP to UTP. When EBIE is allocated by LTP to UTP, UTP's basis in its LTP interest is reduced in accordance with section 163(j)(4)(B)(iii). However, the UTP partners' bases and section 704(b) capital accounts in UTP would not be reduced until the UTP EBIE is treated as paid or accrued by UTP. UTP would treat the UTP EBIE as a nondepreciable capital

[32] 85 Fed. Reg. at 56,859.
[33] Prop. Reg. § 1.163(j)-6(j)(2).
[34] *See* Prop. Reg. § 1.163(j)-6(j)(5)(i)(B).
[35] 85 Fed. Reg. at 56,859.
[36] *id*.
[37] 85 Fed. Reg. at 56,860.

asset with a section 704(b) value and basis equal to the amount by which UTP reduced its basis in LTP on account of the allocation of UTP EBIE. The fact pattern from the proposed regulations[38] can be used to illustrate the application of this approach.

> <u>*Example 1*</u>
>
> A, B, and C form partnership UTP in Year 1, each contributing $1,000 cash in exchange for a one third interest. Also, in Year 1, UTP, D, and E formed partnership LTP, each contributing $1,200 cash in exchange for a one-third interest. LTP borrowed $9,000, resulting in each of its partners increasing its basis in LTP by $3,000. Further, the partners of UTP each increase their basis in UTP by $1,000 as a result of the LTP borrowing.
>
> In Year 1, LTP's only item of income, gain, loss, or deduction was $900 of BIE. As a result, LTP had $900 of EBIE. Pursuant to Prop. Reg. § 1.163(j)-6(f)(2), LTP allocated $300 of EBIE to each of its partners.

Under our recommended approach, the section 704(b) capital accounts of UTP's partners would not be reduced as the result of an allocation of EBIE from LTP, because UTP EBIE has not yet been treated as paid or accrued. Because no item has been paid or accrued by UTP, there is no item of loss or deduction for UTP to allocate to its partners. UTP would treat its allocation of EBIE as a nondepreciable capital asset and there would be parity between the tax basis and section 704(b) basis:

UTP Balance Sheet at End of Year 1			
	Section 704(b)	**Tax**	**Outside Basis**
Cash	$1,800	$1,800	
LTP	$3,900	$3,900	
UTP EBIE	$300	$300	
Total Assets	**$6,000**	**$6,000**	
Liability	$3,000	$3,000	
Total Liabilities	$3,000	$3,000	
A	$1,000	$1,000	$2,000
B	$1,000	$1,000	$2,000
C	$1,000	$1,000	$2,000
Total Capital	$3,000	$3,000	$6,000
Total Liabilities and Capital	**$6,000**	**$6,000**	

To the extent UTP is subsequently allocated ETI or EBII from LTP, UTP would treat the vintage year(s) of UTP EBIE as paid or accrued by UTP using any reasonable method (e.g., on a FIFO or LIFO basis). UTP's BIE for the year, prior to the application of section 163(j), would include the

[38] *See* Prop. Reg. § 1.163(j)-6(o) *Ex*. 27, *et seq.*

amount of EBIE from LTP treated as paid or accrued, its own current year BIE, and any EBIE treated as paid or accrued from other LTPs. UTP would then allocate the BIE using its allocation methodology to determine each UTP partner's distributive share of UTP's BIE (prior to the application of section 163(j)). Each UTP partner would be allocated deductible BIE or EBIE using the 11-step calculation.

> In Year 2, if LTP allocated $240 of ETI to UTP, UTP would treat $240 of prior year EBIE as paid or accrued and add it to UTP's own BIE and perform the section 163(j) calculation at the UTP level. Assuming that UTP's distributive share of section 704(b) and taxable income is also $240, LTP would increase UTP's section 704(b) and tax capital accounts by $240. Assuming UTP has no other activity, UTP's taxable income (prior to the application of section 163(j)) would be comprised of the $240 of income from LTP and $240 of deductions related to the amount of UTP EBIE treated as paid or accrued, for a net taxable income of $0. Section 704(b) income would be equal to taxable income because there is no disparity in the UTP EBIE asset. UTP would increase A, B, and C's section 704(b) and tax capital accounts by $80 each related to UTP's distributive share of income from LTP, and decrease A, B, and C's section 704(b) and tax capital accounts by $80 each for the EBIE treated as paid or accrued.

UTP's section 163(j) limitation would equal $72. $72 of BIE would be deductible by UTP with the remaining $168 disallowed at the UTP level. UTP would allocate $24 of deductible BIE and $56 of EBIE to A, B, and C. UTP would have $60 of UTP EBIE remaining on its balance sheet:

UTP Balance Sheet at End of Year 2			
	Section 704(b)	**Tax**	**Outside Basis**
Cash	$1,800	$1,800	
LTP	$4,140	$4,140	
UTP EBIE	$60	$60	
Total Assets	**$6,000**	**$6,000**	
Liability	$3,000	$3,000	
Total Liabilities	$3,000	$3,000	
A	$1,000	$1,000	$2,000
B	$1,000	$1,000	$2,000
C	$1,000	$1,000	$2,000
Total Capital	$3,000	$3,000	$6,000
Total Liabilities and Capital	**$6,000**	**$6,000**	

If a UTP partner disposes of all or a portion of a UTP partnership interest, the principles of sections 734 and 743 apply. If either a section 754 election is in effect at UTP or UTP has a substantial built-in-loss (as defined under sections 734(d) or 743(d), as applicable), the UTP EBIE asset would be treated as any other asset of UTP to which a basis adjustment can be allocated. UTP would treat UTP EBIE as an ordinary asset solely for purposes of Treas. Reg. § 1.755-1(b), resulting in a negative adjustment to UTP EBIE. When UTP EBIE to which a section 734(b) or section 743(b) adjustment has been allocated is treated as paid or accrued, a corresponding amount of the section 734(b) or section 743(b) basis adjustment would reduce the amount of UTP EBIE treated as BIE, thus preventing a transferee UTP partner from benefiting from the deduction.

However, if UTP does not a have a section 754 election in effect and the substantial built-in-loss rules are not implicated, a transferee UTP partner may be allocated a future deduction of BIE when the UTP EBIE is treated as paid or accrued, as UTP EBIE is treated like any other built-in-loss asset.

Example 2

Same facts as *Example 1*. However, instead of LTP allocating UTP ETI in Year 2, C sold its UTP interest to D for $900,[39] C would recognize a loss of $100 on the sale ($900 of cash + $1,000 assumption of liabilities less $2,000 of basis in C's interest in UTP). Assuming that UTP has a section 754 election in effect, UTP would calculate a section 743(b) adjustment with respect to D and allocate it to its assets. D's negative $100 section 743(b) adjustment is allocated among UTP's assets under section 755. Solely for purposes of Treas. Reg. § 1.755-1(b), any UTP EBIE is treated as ordinary income property. Thus, D's negative $100 section 743(b) basis adjustment is allocated to UTP EBIE:

UTP Balance Sheet Post-Sale to D			
	Section 704(b)	**Tax**	**Outside Basis**
Cash	$1,800	$1,800	
LTP	$3,900	$3,900	
UTP EBIE	$300	$300	
Total Assets	**$6,000**	**$6,000**	
Liability	$3,000	$3,000	
Total Liabilities	$3,000	$3,000	
A	$1,000	$1,000	$2,000
B	$1,000	$1,000	$2,000
D	$1,000	$1,000	$1,900
Total Capital	$3,000	$3,000	$5,900
Total Liabilities and Capital	**$6,000**	**$6,000**	

If the UTP EBIE is treated as paid or accrued in a later year, D's section 743(b) adjustment would offset the allocation of BIE that was previously EBIE to D. D's section 704(b) and tax capital accounts would be reduced by the allocation at that time. However, D's outside tax basis would

[39] Although C's section 704(b) capital account is equal to $1,000, the fair market value of C's interest remains $900. D is valuing the potential future deduction of EBIE when treated as paid or accrued.

not be adjusted as D's distributive share of the deduction (i.e., the deductible BIE and/or EBIE) would be offset under Treas. Reg. § 1.743-1(j)(2) as illustrated in the following example:

UTP Balance Sheet Post-Sale to D			
	Section 704(b)	**Tax**	**Outside Basis**
Cash	$1,800	$1,800	
LTP	$4,140	$4,140	
UTP EBIE	$60	$60	
Total Assets	**$6,000**	**$6,000**	
Liability	$3,000	$3,000	
Total Liabilities	$3,000	$3,000	
A	$1,000	$1,000	$1,900
B	$1,000	$1,000	$1,900
D	$1,000	$1,000	$1,900
Total Capital	$3,000	$3,000	$5,700
Total Liabilities and Capital	**$6,000**	**$6,000**	

If UTP did not have a section 754 election in effect or a substantial built-in loss,[40] D would not calculate a section 743(b) adjustment. When LTP allocates ETI to UTP and UTP treats the EBIE as paid or accrued, D would be allocated deductible BIE or EBIE from UTP. Because C never decreased its basis in its UTP interest by an allocation of EBIE from UTP, the Basis Addback Rule did not apply to cause C to increase its basis in its UTP interest. Thus, under our recommended approach and section 163(j)(4)(B)(iii)(II), D (a UTP transferee partner) is not prohibited from deducting any portion of the UTP EBIE when that amount becomes paid or accrued and potentially deductible in a subsequent year.

Finally, if UTP disposes of its interest in LTP, UTP's basis in its LTP interest will be increased under the Basis Addback Rule by the amount of any Remaining UTP EBIE. If UTP disposes of a portion of its LTP interest, UTP would determine the vintage years of UTP EBIE subject to the Basis Addback Rule using any reasonable method. Additionally, UTP would take into account any basis adjustments under sections 734(b) and 743(b) with respect to the LTP interest in determining or adjusting the total gain or (loss) amount.

> _Example 3_
>
> Same facts as *Example 1*. However, instead of allocating ETI to UTP following the sale by C to D, UTP disposed of its LTP interest for $900 plus the assumption of $3,000 of liabilities. UTP would increase its basis in its LTP interest by $300 under the Basis Addback Rule, resulting in UTP recognizing a loss of $300 that would be allocated to A, B, and D reducing their section 704(b) and tax capital

[40] As defined in section 743(d).

accounts by $100 each.[41] A and B would both reduce their outside basis by the $100 of loss. D's section 743(b) adjustment, however, would offset D's distributive share of $100 under Treas. Reg. § 1.743-1(j)(2) as illustrated in the following example:

UTP Balance Sheet Post-Sale of LTP			
	Section 704(b)	**Tax**	**Outside Basis**
Cash	$2,700	$2,700	
LTP	$0	$0	
UTP EBIE	$0	$0	
Total Assets	**$2,700**	**$2,700**	
Liability	$0	$0	
Total Liabilities	$0	$0	
A	$900	$900	$900
B	$900	$900	$900
D	$900	$900	$900
Total Capital	$2,700	$2,700	$2,700
Total Liabilities and Capital	**$2,700**	**$2,700**	

VI. Partnership Mergers and Divisions

Overview

The preamble to the final regulations provides that, in most cases, the partnership merger and divisions rules in section 708 and the regulations thereunder provide sufficient guidance to analyze the effect on section 163(j) attributes of merger or division transactions. However, there are cases in which the intent and policy behind the section 163(j) rules may not be accomplished by stringently following the mechanics of the merger and division regulations under Treas. Reg. § 1.708-1(c) and (d).

Recommendation

The AICPA recommends that Treasury and the IRS clarify in the final regulations, that in the case of a partnership merger or division, the section 163(j) attributes that are properly allocable to a trade or business continue to be allocable to that trade or business after the merger or division, notwithstanding any transfer of that trade or business into a new (or different) tax partnership.

[41] We note that under Prop. Reg. § 1.163(j)-6(j)(5), the gain or loss computed on the sale of an LTP interest by UTP is adjusted by any section 743(b) basis adjustment with respect to UTP EBIE. This result appears to cause any section 743(b) basis adjustment with respect to UTP EBIE to effectively become a common basis item shared by all partners of UTP.

Analysis

The regulations under section 708 provide strict rules for determining, in a partnership merger or division, whether a partnership is considered as a continuing partnership, a terminated partnership, or a newly formed partnership. In the case of a division, any resulting partnership whose partners held an interest in more than 50% of the profits and capital of the prior partnership will be considered a continuing partnership, with any other resulting partnership being a newly formed partnership. If no resulting partnership had members that held more than 50% of the capital and profits of the prior partnership, the prior partnership is deemed terminated and each resulting partnership is considered newly formed.[42] Often, the tax determination between which of the resulting partnerships is deemed a continuation of the prior partnership may differ from the legal structuring that occurs.

As a result of this formulaic approach to determining the tax status of a partnership in a division, a partnership with multiple trades or businesses with differing section 163(j) profiles that undergoes a division may inappropriately disassociate their section 163(j) attributes from the debt and the trade or business to which the debt is allocable.

> *Example*
>
> Partnership PRS is owned 70% by Partner A, and 15% each by Partners B and C. Partners share in capital and profits based on these ratios. Partnership PRS operates two unrelated trades or businesses, AB and BC. Business AB is generating taxable losses and has no properly allocable business debt. Business BC is generating significant taxable income and has properly allocable business debt. Partnership PRS has historically had EBIE that it allocated to its partners.
>
> If Partnership PRS divides into Partnership AB and Partnership BC, taking an assets-over form (with those respective partners taking interest in the divided partnerships), the rules of Treas. Reg. § 1.708-1(d)(1) dictate that: (1) as Partners A and B collectively hold greater than 50% of the capital and profits of Partnership PRS, Partnership AB will be a continuing partnership; and (2) as Partners B and C collectively hold less than 50% of the capital and profits of Partnership PRS, Partnership BC will be a newly formed partnership.
>
> Under Treas. Reg. § 1.708-1(d)(3)(i)(A), Partnership PRS is deemed to contribute the BC assets and liabilities to a newly formed Partnership BC and subsequently distributes BC interests to Partners B and C. Note that B's distribution is in partial liquidation of its interest in PRS, as it will remain a partner in Partnership AB going forward. Partner C will receive an increase in basis for its share of any EBIE previously allocated to it,[43] while Partners A and B will retain their EBIE in the continuing Partnership AB (formerly PRS).

[42] Treas. Reg. § 1.708-1(d)(1).

[43] Treas. Reg. § 1.163(j)-6(h)(3) and Prop. Reg. § 1.163(j)-6(h)(4). Note that, under Prop. Reg. § 1.163(j)-6(h)(5), Partnership PRS receives a basis adjustment for the amount of EBIE that was previously allocated but unutilized by

Once the partnership division is complete, the partners have the following attributes:

- Partner A has a partnership interest in Partnership AB and EBIE from AB that was originally attributable to the BC trade or business that can only be released by EBII or ETI from AB.

- Partner B has a partnership interest in Partnership AB, with EBIE from AB that was originally attributable to the BC trade or business that can only be released by EBII or ETI from AB. Even though Partner B has an interest in Partnership BC and that the EBIE is properly allocable to Partnership BC's trade or business, EBII or ETI from Partnership BC cannot be used to release this historical EBIE.

- Partner C's prior EBIE resulted in an increase to the outside basis in its interest in Partnership BC as a result of the Basis Addback Rule. Even though it holds a continued interest in the trade or business generating the interest expense, C no longer has EBIE and, thus, cannot treat any of it as paid or accrued (and potentially deduct such an amount) in the first year in which there is sufficient EBII or ETI in Partnership BC.

If, instead of following the tax construct of the continuing partnership, the EBIE followed the BC business, the basis adjustment under Prop. Reg. § 1.163(j)-6(h)(5) could instead be applied to Partner A, who has no continuing interest in the trade or business that caused the EBIE. Partners B and C could continue to hold EBIE in Partnership BC that could be used in the future, when there is sufficient EBII or ETI to release the EBIE.

Similar concerns exist in certain partnership mergers. If two partnerships merge, and the terminating partnership has allocated EBIE to its partners, the rules as written appear to require that any EBIE of the terminated partnership would be capitalized into the outside basis of the partners' interest in the continuing partnership. This mechanism is a result of the deemed distribution of the continuing partnership interest to the partners of the terminating partnership,[44] which would be considered a complete disposition of the partners' interest in the terminating partnership, and would result in an increase to partner basis immediately prior to the distribution.[45] This situation creates a result in which a partner's EBIE becomes unable to be utilized, although the partner continues to hold an interest in the trade or business, and the debt, to which the interest expense relates.

Accordingly, while the partnership merger and division regulations provide mechanisms that can be used to apply the section 163(j) regulations, those mechanisms do not, in all cases, arrive at an appropriate result, based on the policy and intent of section 163(j). Therefore, special rules are appropriate to align interest expense attributes with the trade or business to which the attributes are properly allocable, in order to more equitably reflect the economic effect of a partnership merger or division.

Partner C. Accordingly, Partner C will have outside basis in new partnership BC that includes the increase from the EBIE. Partnership PRS increases its inside basis as well. See Part V of this letter for additional commentary on the basis adjustment under Prop. Reg. § 1.163(j)-6(h)(5).

[44] *See* Treas. Reg. § 1.708-1(c)(3)(i).

[45] Treas. Reg. § 1.163(j)-6(h)(3).

VII. Partnership Trade(s) or Business(es) Becoming an Excepted Trade(s) or Business(es) in Succeeding Tax Year

Overview

The 2018 proposed regulations provided[46] that if a partnership allocates EBIE to one or more of its partners, and in a succeeding taxable year becomes excepted to section 163(j), the EBIE from the prior taxable years is treated as paid or accrued by the partner in the succeeding taxable year. The final regulations change this rule which may unfairly disadvantage partners of partnerships that have changed to excepted entities. The final regulations treat EBIE as continuing EBIE until the time that the partnership allocates ETI and/or EBII such that the EBIE is treated as BIE paid or accrued by the partner under Treas. Reg. § 1.163(j)-6(g)(2) or if the partnership becomes an exempt entity.

Recommendations

The AICPA recommends that Treasury and the IRS allow a partnership that allocates EBIE to one or more of its partners, and in a succeeding taxable year becomes an excepted entity (i.e., an entity that becomes an electing real property trade or business or an electing farming business), to treat the EBIE from the prior taxable years as paid or accrued by the partner in the succeeding taxable year.

Alternatively, the AICPA recommends that Treasury and the IRS permit the partners to treat the EBIE as paid or accrued in the year that the election was made for those taxpayers who allocated EBIE to partners and in a subsequent year before the final regulations became applicable made either a real property trade or business election or a farming business election.

Analysis

Many taxpayers and tax practitioners interpreted the 2018 proposed regulations to mean that if a partnership allocates EBIE to one or more of its partners, and in a succeeding taxable year becomes either an exempt entity (i.e., subject to the small business exemption) or an excepted entity, the EBIE from the prior taxable years is treated as paid or accrued by the partner in the succeeding taxable year. These partners are unfairly disadvantaged by the application of the final regulations to their transactions that occurred prior to publication.

The final regulations clarify that the 2018 proposed rule does not apply when a partnership engages in excepted trades or businesses. More precisely, under Treas. Reg. § 1.163(j)-6(m)(3), if a partner is allocated EBIE from a partnership and, in a succeeding taxable year, that partnership makes a real property trade or business or farming business election, there is no mechanism that allows the partner to treat any of its EBIE previously allocated from the partnership as paid or accrued in the year the election is made. Rather, the EBIE remains as EBIE until the partnership allocates ETI and/or EBII to the partners for that EBIE to be treated as BIE of the partner, or if the partnership becomes an exempt entity. A partnership that engages solely in a single trade or business generally would not have other sources of ETI or EBII once it has made a real property trade or business

[46] 2018 Prop. Reg. § 1.163(j)-6(m)(3).

election with respect to its sole trade or business. Therefore, EBIE would be suspended indefinitely until disposition of that interest. The partners of these partnerships are disadvantaged. A taxpayer that operates a single trade or business applying these rules generally may not realize the implication of this election -- and that the EBIE for tax years prior to making the election will be suspended at the partner level indefinitely.