



Section of Taxation

Suite 400
1050 Connecticut Avenue, NW
Washington, DC 20036
202-662-8670
FAX: 202-662-8682
E-mail: tax@americanbar.org

February 28, 2019

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

Re: Comments on the Impact of the Proposed Regulations under Section 163(j) on Real Estate

Dear Commissioner Rettig:

Enclosed please find comments on the impact of the proposed regulations under section 163(j) on real estate. These comments are submitted on behalf of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

Eric Solomon
Chair, Section of Taxation

Enclosure

cc: Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury
William M. Paul, Acting Chief Counsel and Deputy Chief Counsel (Technical),
Internal Revenue Service
Lafayette G. "Chip" Harter III, Deputy Assistant Secretary (International Tax Affairs), Department of the Treasury
Krishna P. Vallabhaneni, Acting Tax Legislative Counsel, Department of the Treasury
Doug Poms, International Tax Counsel, Department of the Treasury
Brett York, Associate International Tax Counsel, Department of the Treasury
Colin Campbell, Attorney-Advisor, Department of the Treasury
Ellen Martin, Tax Policy Advisor, Department of the Treasury
Bryan A. Rimmke, Attorney-Advisor, Department of the Treasury
Brenda Zent, Special Advisor, Office of International Tax Counsel, Department of Treasury
Scott K. Dinwiddie, Associate Chief Counsel (ITA), Internal Revenue Service
Helen M. Hubbard, Associate Chief Counsel (Financial Institutions & Products), Internal Revenue Service
Daniel M. McCall, Deputy Associate Chief Counsel (International), Internal Revenue Service
Holly Porter, Associate Chief Counsel (PSI), Internal Revenue Service
Robert Wellen, Associate Chief Counsel (Corporate), Internal Revenue Service

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AMERICAN BAR ASSOCIATION SECTION OF TAXATION

Comments on Proposed Regulations under Section 163(j) Regarding Issues Affecting Real Estate

These comments (the “Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Kimberly Arndt, Ossie Borosh, Mark Van Deusen, Jason Dexter, Adam Feuerstein, Katie Fuehrmeyer, Michael Humphrey, and Sanjeev Magoon. The Comments have been reviewed by Todd Keator of the Real Estate Committee, Adam M. Cohen, Council Director for the Partnerships and LLCs and Real Estate Committees, Jeanne Sullivan and Lisa Zarlenga of the Section’s Committee on Government Submissions, and Eric Sloan, Vice-Chair of Government Relations for the Tax Section.

Although members of the Section may have clients who might be affected by the federal tax principles addressed by these Comments, no member who has been engaged by a client (or who is a member of a firm or other organization that has been engaged by a client) to make a government submission with respect to, or otherwise to influence the development or outcome of one or more specific issues addressed by, these Comments has participated in the preparation of the portion (or portions) of these Comments addressing those issues. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

Contact: Ossie Borosh
 (202) 533-5648
 oborosh@kpmg.com

 Mark Van Deusen
 (804) 697-1509
 mvandeusen@deloitte.com

 Adam S. Feuerstein
 (240) 476-2647
 adam.s.feuerstein@pwc.com

Date: February 28, 2019

EXECUTIVE SUMMARY

Section 163(j),¹ as amended by Pub. L. No. 115-97 (the “Act”),² generally limits a taxpayer’s deduction for business interest expense for any taxable year to the sum of (i) the taxpayer’s business interest income for the taxable year, (ii) 30% of the taxpayer’s adjusted taxable income (“ATI”) for the taxable year, plus (iii) the taxpayer’s floor plan financing interest expense for the taxable year.³ The section 163(j) limitation applies to both corporate and noncorporate taxpayers, including partnerships, but, under a special exemption, section 163(j) does not apply to certain small businesses (the “Small Business Exemption”).⁴

Section 163(j)(5) defines the term “business interest [expense]” as any interest paid or accrued on indebtedness properly allocable to a trade or business.⁵ Although section 163(j) does not affirmatively define the term “trade or business,” section 163(j)(7)(A)(A)(ii) expressly excludes from the definition any real property trade or business (“RPTOB”) that elects to be excepted from the section 163(j) limitation (an “Electing RPTOB”).⁶ As a result, the deductibility of interest expense on indebtedness properly allocable to an Electing RPTOB is not limited by section 163(j). Section 163(j)(7)(B) defines an Electing RPTOB as any trade or business described in section 469(c)(7)(C) that makes an election under section 163(j)(7)(B) (a “RPTOB Election”).

On November 26, 2018, the Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) issued proposed regulations under section 163(j) (the “Proposed Regulations”). The Proposed Regulations were published in the Federal Register on December 28, 2018.⁷ Among other things, the Proposed Regulations prescribe rules relating to the exception for Electing RPTOBs and the Small Business Exemption. In addition, the Proposed Regulations provide a new safe harbor, which allows a real estate investment trust (a “REIT”) that holds real property, interests in partnerships holding real property, or shares in other REITs holding real property to make the RPTOB Election (the “REIT Safe Harbor Election”). Pertinent aspects of these rules are discussed in the discussion section below.

¹ References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), and the Treasury Regulations promulgated thereunder, unless otherwise indicated.

² Pub. L. No. 115-97, § 13301, 131 Stat. 2054, 2117–21 (Dec. 22, 2017).

³ I.R.C. § 163(j)(1).

⁴ I.R.C. § 163(j)(3).

⁵ Business interest expense, business interest income, and ATI each requires a determination of whether an item is properly allocable to a trade or business. I.R.C. § 163(j)(5), (6), (8).

⁶ Similarly, the term “trade or business” for purposes of section 163(j) does not include a farming business, as defined in section 263A(e)(4), or any trade or business of a specified agricultural or horticultural cooperative, as defined in section 199A(g)(2), that elects to be excepted from the section 163(j) limitation (“Electing Farming Business”). I.R.C. § 163(j)(7)(C).

⁷ *Limitation on Deduction for Business Interest Expense*, REG-106089-18, 83 Fed. Reg. 67,490 (Dec. 28, 2018).

We commend Treasury and the Service for their commitment to provide expedited guidance, and we ask that Treasury and the Service consider the following recommendations in finalizing the Proposed Regulations:

1. We recommend that Treasury and the Service revise Proposed Regulation section 1.163(j)-9(g)(1) to clarify that the REIT Safe Harbor Election can be made if the electing REIT owns an interest in one or more partnerships or stock in one or more REITs.
2. We also recommend that the final Regulations clarify that the REIT Safe Harbor Election can be made if the electing REIT owns a direct interest in a partnership or lower-tier REIT that does not directly hold “real property,” as defined in Regulation section 1.856-10, but indirectly holds such real property through the ownership of an interest in another partnership or lower-tier REIT that directly holds such real property.
3. We recommend that the final Regulations allow a partnership or S corporation that qualifies for the Small Business Exemption to elect to be an Electing RPTOB or Electing Farming Business.
4. We also recommend that if the final Regulations allow entities that qualify for the Small Business Exemption to elect to be an Electing RPTOB or Electing Farming Business, the final Regulations also allow partners and shareholders in these entities to apply the look-through rules of Proposed Regulation section 1.163(j)-10(b)(3) and (c)(5)(ii)(A)–(C) (the “Look-Through Rules”).
5. If the final Regulations prohibit entities that qualify for the Small Business Exemption from also electing to be an Electing RPTOB or Electing Farming Business, we recommend that the final Regulations address whether a previously made RPTOB Election or an election to be an Electing Farming Business (a “Farming Election”) would be invalidated if the taxpayer qualifies for the Small Business Exemption in a taxable year after the taxable year in which the election to be an Electing RPTOB or Electing Farming Business was made.
6. To provide certainty to taxpayers, we recommend that the term “trade or business” be defined consistently for purposes of all of section 163(j), including for purposes of the definition of a RPTOB. Thus, if a taxpayer is treated as engaged in a trade or business for purposes of section 163(j), it also generally should be treated as engaged in a trade or business for purposes of the definition of a RPTOB.
7. We recommend that the final Regulations provide that any interest expense be treated as allocated to a RPTOB to the extent the interest expense is attributable to an equity interest in an entity that is treated as engaged in a RPTOB. To implement this recommendation, we recommend that the Look-Through Rules for excepted trades or businesses of partnerships, S corporations, and C corporations be harmonized and the ownership threshold for non-consolidated domestic C corporations and

CFCs in Proposed Regulation section 1.163(j)-10(c)(7)(i)(A) be eliminated.

8. We recommend that, in providing definitions for the other terms enumerated in section 469(c)(7)(C), Treasury and the Service not adopt a restrictive view of real estate activities defined in section 469(c)(7) that requires either a nexus to, involvement with, or significant or substantial role in, the creation, acquisition, or management of rental real estate.
9. We recommend that Treasury and the Service clarify that the terms “operation” and “management” encompass the operation and management of real property, even if the income from the business does not produce rental income.
10. We recommend that the definition of the terms “real property operation” and “real property management” in Proposed regulation section 1.469-9(b)(2)(ii)(H) and (I), respectively, each be revised by deleting the following sentence:

However, other incidental personal services may be provided to the customer in conjunction with the use of real property or physical space, as long as such services are insubstantial in relation to the customer’s use of the real property or physical space and the receipt of such services is not a significant factor in the customer’s decision to use the real property or physical space.
11. We recommend that the terms “rental” and “leasing” be defined to include payments derived from the use of real property and all associated services, even if the services are significant. Moreover, we recommend confirming that the provision of significant services in connection with rental activities does not create two separate businesses: a rental business and a services business.
12. We recommend that guidance clarify that for a taxpayer to be engaged in a RPTOB involving the “acquisition” of real property, the taxpayer must be either selling and disposing of real property or engaging in one of the other ten qualifying activities in section 469(c)(7)(C).
13. We recommend that guidance confirm that a taxpayer may be engaged in a RPTOB even if all or substantially all of its activities are conducted by one or more independent contractors.
14. We recommend that the final Regulations revise the example in Proposed Regulation section 1.163(j)-10(d)(5) to clarify that, where a direct allocation of interest expense related to qualified nonrecourse indebtedness is required, the basis of the related asset should be reduced, but not below zero, only by an amount equal to the qualified nonrecourse indebtedness and not be completely excluded for purposes of allocating interest expense based on the adjusted basis of assets.
15. We recommend that Treasury and the Service clarify that if all of a taxpayer’s disallowed disqualified interest under old section 163(j) is

properly allocable to a RPTOB that is permitted to, and does, elect out of new section 163(j) in its first taxable year beginning after December 31, 2017, then not only does all of that disallowed disqualified interest still carry over into that first year, but also all of that disallowed disqualified interest may be deductible fully in that first year under section 163(a) (*i.e.*, without regard to the limitation under new section 163(j)) unless another disallowance, deferral, capitalization, or other limitation provision prevents the otherwise allowable deduction for that interest expense.

16. We recommend that Treasury and the Service clarify whether Proposed Regulation section 1.163(j)-6(m)(3) applies only to exempt small businesses or also could apply to a trade or business that becomes not subject to the requirements of section 163(j) by reason of making a RPTOB Election.

BACKGROUND

Section 163(j)(5) defines the term “business interest [expense]” as any interest paid or accrued on indebtedness properly allocable to a trade or business. Although section 163(j) does not affirmatively define the term “trade or business,” section 163(j)(7)(A) expressly excludes from the definition any Electing RPTOB.⁸ As a result, interest on indebtedness properly allocable to an Electing RPTOB is not limited by section 163(j).

Section 163(j)(7)(B) defines an Electing RPTOB as any trade or business described in section 469(c)(7)(C) that makes a RPTOB Election. Section 469(c)(7)(C) defines a RPTOB as any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.⁹ The legislative history of section 163(j) provides further explanation:

It is intended that any such real property trade or business, including such a trade or business conducted by a corporation or real estate investment trust, be included. Because this description of a real property trade or business refers only to the section 469(c)(7)(C) description, and not to other rules of section 469 (such as the rule of section 469(c)(2) that passive activities include rental activities or the rule of section 469(a) that a passive activity loss is limited under section 469), the other rules of section 469 are not made applicable by this reference. It is further intended that a real property operation or a real property management trade or business includes the operation or management of a lodging facility.¹⁰

As noted in the statute and the legislative history of section 163(j), the definition of a RPTOB is derived from the passive loss rules in section 469. Those rules incorporate the definition of a RPTOB in a set of rules that effectuate Congress’s intention to provide special treatment to “real estate professionals.”

The Proposed Regulations prescribe rules relating to, among many other aspects of newly enacted section 163(j), the exception for Electing RPTOBs and the Small Business Exemption. In addition, the Proposed Regulations provide a REIT Safe Harbor Election under which a REIT that holds real property, interests in partnerships holding real property, or shares in other REITs holding real property, is eligible to make the RPTOB Election. The Proposed Regulations also prescribe new rules under section 469 relating to whether a trade or business is a real property trade or business for purposes of section 469(c)(7)(C) and, by extension, section 163(j). Pertinent aspects of these rules are discussed below in the Discussion.

⁸ I.R.C. § 163(j)(7)(A)(ii).

⁹ See also H.R. Rep. No. 115-466, at 391–92 (2017) (Conf. Rep.) (“CONFERENCE REPORT”) (“In the Senate amendment, at the taxpayer’s election, any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business is not treated as a trade or business for purposes of the limitation, and therefore the limitation does not apply to such trades or businesses.”).

¹⁰ CONFERENCE REPORT, at 392 n. 697.

DISCUSSION

I. Recommendations Relating to the REIT Safe Harbor

A. Ability to Make a REIT Safe Harbor Election Even When a REIT Owns an Interest in Only One Partnership or Lower-tier REIT, or Owns an Interest in a Partnership or Lower-tier REIT That Indirectly Owns Real Property

1. Recommendations

We recommend that the final Regulations provide that a REIT Safe Harbor Election can be made even if the electing REIT owns an interest in only one partnership or lower-tier REIT.

We also recommend clarifying that the REIT Safe Harbor Election can be made if an electing REIT owns an interest in a partnership or lower-tier REIT that does not directly hold “real property,” as defined in Regulation section 1.856-10, but indirectly holds such real property through the ownership of an interest in another partnership or lower-tier REIT that directly holds such real property.

2. Explanation

Proposed Regulation section 1.163(j)-9(g)(1) provides that a REIT can make a REIT Safe Harbor Election if it “holds real property, as defined in § 1.856-10, *interests in partnerships* holding real property, as defined in § 1.856-10, or *shares in other REITs* holding real property, as defined in § 1.856-10.”¹¹ The use of the plural “*interests in partnerships*” and “*shares in other REITs*” may imply that a REIT cannot make a REIT Safe Harbor Election if it owns an interest in only “*a*” partnership or stock in only “*a*” REIT. Yet, such a rule seems inconsistent with the provisions under Proposed Regulation section 1.163(j)-9(g)(4)(ii) and (iii), which address the application of various look-through rules for purposes of allocating a REIT’s interest expense between excepted and non-excepted businesses.

More specifically, Proposed Regulation section 1.163(j)-9(g)(4)(ii) states that if a REIT described in Proposed Regulation section 1.163(j)-9(g)(3) holds “*an interest in a partnership*, in applying the partnership look-through rule described in § 1.163(j)-10(c)(5)(ii)(A)(2), the REIT treats assets of the partnership that meet the definition of real property under § 1.856-10 as assets of an excepted trade or business.”¹² Proposed Regulation section 1.163(j)-9(g)(4)(iii) similarly provides:

[i]f a REIT (the shareholder REIT) described in [§ 1.163(j)-9(g)(3)] holds *an interest in another REIT*, then for purposes of applying the allocation rules in § 1.163(j)-10, the partnership look-through rule described in § 1.163(j)-

¹¹ (Emphasis added).

¹² (Emphasis added).

10(c)(5)(ii)(A)(2) applies to the assets of the other REIT (as if the other REIT were a partnership) in determining the extent to which the shareholder REIT's adjusted basis in the shares of the other REIT is allocable to an excepted or non-excepted trade or business of the shareholder REIT.¹³

The foregoing language suggests that it was intended for the REIT Safe Harbor Election to be available even if the REIT does not hold interests in multiple partnerships or stock in multiple REITs. Moreover, there appears to be no policy reason to deny the REIT Safe Harbor Election to a REIT that owns an interest in only one partnership or lower-tier REIT. Indeed, such a rule would make the REIT Safe Harbor Election of no value to the numerous publicly traded REITs that are organized as "UPREITs," a structure in which the REIT is a holding company and owns only equity in a single operating partnership.¹⁴ Accordingly, we recommend that the final Regulations revise Proposed Regulation section 1.163(j)-9(g)(1) to include the ownership of an interest in one or more partnerships or stock in one or more REITs.

In addition, we recommend that the final Regulations clarify that a REIT can make the REIT Safe Harbor Election if the partnership or lower-tier REIT in which the REIT has a direct interest does not directly hold "real property," as defined in Regulation section 1.856-10, but holds an interest in another partnership or lower-tier REIT that holds such real property. Based on the flush language of the Proposed Regulations, it is unclear whether the REIT Safe Harbor Election is available when the partnership or lower-tier REIT in which the electing REIT owns a direct interest is itself a holding company.¹⁵ For example, consider a REIT that owns only an interest in a fund organized as a partnership that holds only interests in numerous joint venture partnerships that in turn hold significant real property investments. Under a narrow construction of the Proposed Regulations, it would appear that the REIT would not be able to make the REIT Safe Harbor Election because the fund does not directly hold real property, even though the REIT would have a significant indirect ownership interest in the real property held by the lower-tier joint venture partnership.

Similarly, consider a REIT that owns stock in another public REIT that is organized as an UPREIT, in which the REIT owns only partnership interests in an operating partnership that owns significant real property. Once again, under a narrow construction of the Proposed Regulations, it would appear that the shareholder REIT in the public REIT also would not be able to make the REIT Safe Harbor Election because the public REIT does not directly hold real property. There appears to be no policy reason to deny the REIT Safe Harbor Election when a REIT indirectly owns an interest in real

¹³ (Emphasis added).

¹⁴ The UPREIT structure was specifically addressed and approved in the partnership anti-abuse regulation. *See* Reg. § 1.701-2(d), Ex. (4).

¹⁵ *See* Prop. Reg. § 1.163(j)-9(g)(1) ("If a REIT holds real property, as defined in § 1.856-10, interests in partnerships *holding* real property, as defined in § 1.856-10, or shares in other REITS *holding* real property, as defined in § 1.856-10, the REIT is eligible to make the [REIT Safe Harbor Election] for all or part of its assets.") (emphasis added).

property through several intervening entities rather than through only one intervening entity.

The REIT Safe Harbor Election generally does not apply to real property financing assets (“Real Property Financing Assets”) of a REIT.¹⁶ However, the Proposed Regulations contain a de minimis rule—if 10% or less of the value of the REIT’s assets consist of Real Property Financing Assets at the close of the taxable year, then all of the REIT’s assets will be treated as an excepted trade or business.¹⁷ If the Real Property Financing Assets are greater than 10% of the value of the REIT’s assets, then the REIT must allocate interest expense and income and other items of expense and income between excepted and non-excepted trades or businesses.¹⁸ Proposed Regulation section 1.163(j)-9(g)(2) and (3) indicates that the determination of whether more than 10% of the REIT’s assets are Real Property Financing Assets is made at the close of the taxable year as determined under section 856(c)(4)(A). The reference to the REIT 75% asset test in section 856(c)(4)(A) presumably incorporates all of the rules that apply to a REIT in determining compliance with that test. Accordingly, Regulation section 1.856-3(g), which treats a REIT as owning its proportionate share of the assets of a partnership based on its capital interest,¹⁹ presumably would apply to determine ownership of Real Property Financing Assets, and Regulation section 1.856-3(g) would apply through multiple tiers of partnerships.²⁰

Similarly, Proposed Regulation section 1.163(j)-(g)(5) requires a REIT (a shareholder REIT) owning stock in another REIT to include in the value of the shareholder REIT’s Real Property Financing Assets the portion of the value of the shareholder REIT’s shares in the other REIT that are attributable to the other REIT’s investments in Real Property Financing Assets. There is no indication that this rule would

¹⁶ Real Property Financing Assets include mortgages, deeds of trust, and installment land contracts; mortgage pass-thru certificates guaranteed by Government National Mortgage Association, Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, or Canada Mortgage and Housing Corporation; real estate mortgage investment conduit (“REMIC”) regular interests; other interests in investment trusts classified as trusts under Regulation section 301.7701-4(c) that represent undivided beneficial ownership in a pool of obligations principally secured by interests in real property and related assets that would be permitted investments if the investment trust were a REMIC; obligations secured by manufactured housing treated as single family residences under section 25(e)(10), without regard to the treatment of the obligations or the properties under state law; and debt instruments issued by publicly offered REITs. Prop. Reg. § 1.163(j)-9(g)(6).

¹⁷ Prop. Reg. § 1.163(j)-9(g)(2).

¹⁸ Prop. Reg. § 1.163(j)-9(g)(3).

¹⁹ Reg. § 1.856-3(g) (“In the case of a real estate investment trust which is a partner in a partnership, as defined in section 7701(a)(2) and the regulations thereunder, the trust will be deemed to own its proportionate share of each of the assets of the partnership and will be deemed to be entitled to the income of the partnership attributable to such share. For purposes of section 856, the interest of a partner in the partnership’s assets shall be determined in accordance with his capital interest in the partnership. The character of the various assets in the hands of the partnership and items of gross income of the partnership shall retain the same character in the hands of the partners for all purposes of section 856.”).

²⁰ See, e.g., PLR 200310014 (Mar. 7, 2003) (applying Regulation section 1.856-3(g) to a REIT’s operating partnership that owned an interest in a lower-tier partnership).

not apply to a shareholder REIT that owns shares in another REIT that is itself a shareholder REIT.

Based on the foregoing, we recommend that the same look-through rules that Proposed Regulation section 1.163(j)-9(g) generally uses for determining the ownership of Real Property Financing Assets be applied in making the threshold determination of whether the REIT (directly or indirectly) holds real property and thus is eligible to make the REIT Safe Harbor Election in Proposed Regulation section 1.163(j)-9(g)(1).

II. Interaction of the Small Business Exemption with Electing RPTOBs and Electing Farming Businesses, and the Look-Through Rules

A. Background

As noted above, section 163(j) does not apply to an Electing RPTOB or Electing Farming Business. Section 163(j) provides a further carve-out for certain trades or businesses that qualify for the Small Business Exemption.²¹ A taxpayer will qualify for the Small Business Exemption for any taxable year if it satisfies the gross receipts test of section 448(c) for that taxable year.²²

A corporation or partnership satisfies the gross receipts test of section 448(c) if the average annual gross receipts of that entity for the three-year period ending with the immediately prior taxable year does not exceed \$25 million.²³ If the taxpayer is not a corporation or partnership, the gross receipts test of section 448(c) is applied in the same manner as if such taxpayer were a corporation or partnership.²⁴ Even if the gross receipts test is met, however, the Small Business Exemption does not apply to a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3).²⁵

The Preamble to the Proposed Regulations (the “Preamble”) provides that a taxpayer that qualifies for the Small Business Exemption is *not permitted* to make the RPTOB Election because the taxpayer is already not subject to the section 163(j) limitation.²⁶ Although this prohibition is stated in the Preamble, we have not identified a rule in the Proposed Regulations that memorializes it.

Unlike the RPTOB Election, which requires an Electing RPTOB to use the alternative depreciation system (“ADS”) to slow down its depreciation on existing and new residential real property, non-residential real property, and qualified improvement

²¹ I.R.C. § 163(j)(3).

²² *Id.*

²³ Section 448(c)(2) provides that all persons treated as a single employer under section 52(a) or (b) or section 414(m) or (o) are treated as one person for purposes of the gross receipts test.

²⁴ I.R.C. § 163(j)(3).

²⁵ *Id.*

²⁶ 83 Fed. Reg., at 67,496 (“Such a taxpayer is not permitted to make an election under either section 163(j)(7)(B) or (C) because the taxpayer is already not subject to the section 163(j) limitation.”).

property,²⁷ no such requirement exists for a taxpayer that qualifies for the Small Business Exemption. Thus, it is possible that some taxpayers whose activities constitute a RPTOB but who also qualify for the Small Business Exemption may favor the Small Business Exemption and may not want to make the RPTOB Election, even if they were permitted to do so. If these taxpayers were interested in making the RPTOB Election, however, the Preamble states that the RPTOB Election is not available.²⁸

Additionally, the Proposed Regulations provide that a taxpayer may not apply the Look-Through Rules of Proposed Regulation section 1.163(j)-10(b)(3) and (c)(5)(ii)(A)–(C) to a partnership, S corporation, or non-consolidated C corporation (including a controlled foreign corporation (“CFC”)) that qualifies for the Small Business Exemption.²⁹ Proposed Regulations section 1.163(j)-10(c)(5)(ii)(A)–(C) provides rules allowing, and, in certain instances, requiring, shareholders of S corporations, partners in partnerships, and shareholders in non-consolidated C corporations (including CFCs) to allocate their tax basis in their equity interests in those entities between excepted and non-excepted trades or businesses based on the proportion of assets held by those entities in excepted and non-excepted trades or businesses for purposes of allocating the shareholder’s or partner’s interest expense between excepted and non-excepted trades or businesses. When the Look-Through Rules apply to a corporation, Proposed Regulation section 1.163(j)-10(b)(3) allocates dividend income received by shareholders between excepted and non-excepted trades or businesses based on the relative amounts of the payor-corporation’s adjusted basis in its assets used in those trades or businesses.

B. Recommendations

We recommend that the final Regulations allow a partnership or S corporation that qualifies for the Small Business Exemption to elect to be an Electing RPTOB or Electing Farming Business. If the partnership or S corporation makes a RPTOB Election or Farming Election, then the provisions of the Proposed Regulations applicable to the Small Business Exemption would not apply.

We also recommend that if the final Regulations allow entities that qualify for the Small Business Exemption to elect to be an Electing RPTOB or Electing Farming Business, the final Regulations also allow partners and shareholders in these entities to apply the Look-Through Rules.

Alternatively, if the final Regulations prohibit entities that qualify for the Small Business Exemption from electing to be an Electing RPTOB or Electing Farming Business, we recommend that the final Regulations address whether a previously made election to be an Electing RPTOB or Electing Farming Business would be invalidated if the taxpayer qualifies for the Small Business Exemption in a taxable year after the

²⁷ I.R.C. § 168(g)(1)(F).

²⁸ 83 Fed. Reg., at 67,496 (“Such a taxpayer is not permitted to make an election under either section 163(j)(7)(B) or (C) because the taxpayer is already not subject to the section 163(j) limitation.”).

²⁹ Prop. Reg. § 1.163(j)-10(c)(5)(ii)(D).

taxable year in which the election to be an Electing RPTOB or Electing Farming Business was made.

C. Explanation

1. Ability of Those Qualifying for the Small Business Exemption to Make a RPTOB Election or Farming Election

As noted above, the Preamble states that a taxpayer that qualifies for the Small Business Exemption is not permitted to make either a RPTOB Election under section 163(j)(7)(B) or a Farming Election under section 163(j)(7)(C). We believe that such a rule is not necessary, results in inequitable outcomes for partners in partnerships and shareholders in S corporations that otherwise would qualify to make a RPTOB Election or Farming Election, and is contrary to Congressional intent.

Proposed Regulation section 1.163(j)-6(m)(1) provides that a partnership or S corporation that qualifies for the Small Business Exemption does not calculate the section 163(j) limitation, and any business interest expense allocated to a partner or S corporation shareholder is subject to the section 163(j) limitation at the partner or S corporation shareholder level. Further, the partner or S corporation shareholder must include in its ATI, the items of income, gain, loss, or deduction from the exempt partnership or S corporation.³⁰ Consequently, the business interest expense of the exempt partnership or S corporation is not completely exempt from the section 163(j) limitation; rather, the section 163(j) limitation is applied to the interest expense at the partner or S corporation shareholder level. We refer to this as the “Partner-Level Testing Rule.”

The inequitable result for partners in partnerships and shareholders in S corporations that otherwise qualify for the RPTOB Election or Farming Election occurs in part because of the Partner-Level Testing Rule. The Preamble’s prohibition of a RPTOB Election or Farming Election by entities that qualify for the Small Business Exemption, when combined with the Partner-Level Testing Rule for partnerships and S corporations, causes the partners and S corporation shareholders in those partnerships or S corporations that could otherwise make a RPTOB Election or Farming Election but that qualify for the Small Business Exemption to be in a *worse* position than if the partnership or S corporation did not qualify for the Small Business Exemption.³¹ If a RPTOB Election or Farming Election is made at either the partnership or S corporation level or the partner or S corporation shareholder level and that same partnership or S corporation qualifies for the Small Business Exemption, the interest expense attributable to the RPTOB or farming business is subject to the section 163(j) limitation at the partner or S corporation shareholder level. Thus, the interest properly allocable to a RPTOB or farming business may be limited by section 163(j) solely because the business is conducted in a partnership or S corporation that qualifies for the Small Business Exemption. We see no policy reason why partners and S corporation shareholders should

³⁰ Prop. Reg. § 1.163(j)-6(m)(1).

³¹ Cf. Prop. Reg. § 1.163(j)-6(m)(2).

be in a worse position because their partnerships or S corporations qualify for the Small Business Exemption.

Moreover, we believe that this result is contrary to Congressional intent. The Small Business Exemption was intended by Congress to exempt small businesses from the section 163(j) interest limitation, presumably to allow those businesses the full benefit of the deduction for business interest expense until such time as those businesses grow and no longer qualify for the exemption. Thus, the Small Business Exemption is intended to be a taxpayer-favorable rule. Similarly, Congress recognized that real estate and farming were capital-intensive businesses that are typically debt-financed, and Congress determined not to apply the section 163(j) limitation to those businesses.³² The exceptions for Electing RPTOBs and Electing Farming Businesses are intended to be taxpayer-favorable rules. We therefore suggest that Congress did not intend that partners in a partnership or shareholders in an S corporation that qualified for *both* of these taxpayer-favorable rules should be in a worse position than if the partnership or S corporation qualified for only the exception for Electing RPTOBs or Electing Farming Businesses.

Further, the rule in the Preamble would impose unnecessary administrative burdens on taxpayers conducting RPTOBs and farming businesses. Before making a RPTOB Election or Farming Election, every taxpayer would need to determine whether the Small Business Exemption applies. This will often require taxpayers to apply the complicated aggregation rules in sections 52(a)–(b) and 414(m)–(o).³³ We do not believe that a taxpayer should be required to incur the administrative burden necessary to determine precisely what provision of section 163(j) will allow its interest expense to be excluded from the section 163(j) limitation when Congress intended that this interest expense be excluded regardless of which exemption or exception applies. Allowing businesses that qualify for the RPTOB Election or Farming Election to make those elections regardless of whether they qualify for the Small Business Exemption will eliminate that unnecessary administrative burden, and, as noted above, we believe is consistent with Congressional intent. Accordingly, we recommend that the final Regulations provide that taxpayers can make a RPTOB Election or Farming Election, regardless of whether they otherwise qualify for the Small Business Exemption. If the taxpayer makes a RPTOB Election or Farming Election, then the provisions of the Proposed Regulations applicable to the Small Business Exemption would not apply.

³² The legislative history of section 163(j) suggests that “any” RPTOB should be eligible to make the RPTOB Election. CONFERENCE REPORT, at 391-92 (“In the Senate amendment, *at the taxpayer’s election, any* real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business *is not treated as a trade or business for purposes of the limitation*, and therefore *the limitation does not apply to such trades or businesses.*”) (emphasis added).

³³ I.R.C. §§ 163(j)(3), 448(c)(2).

2. Application of the Look-Through Rules

We further recommend that the final Regulations allow partners in partnerships and shareholders in S corporations that qualify for the Small Business Exemption but also make a RPTOB Election or Farming Election to apply the Look-Through Rules. The inability of these partners and shareholders to look through their investments appears to be contrary to Congressional intent in that it would cause taxpayers that conduct a RPTOB or farming business that qualifies for the Small Business Exemption to be *worse off* than taxpayers that conduct a RPTOB or farming business that does not qualify for the Small Business Exemption.³⁴

Consider a partner that does not qualify for the Small Business Exemption itself and incurs debt to acquire an interest in a partnership. If that partnership qualifies for the Small Business Exemption and conducts only a qualifying RPTOB, then that partner would *not* be able to apply the Look-Through Rules to treat its adjusted basis in its partnership interest as an asset used in an excepted trade or business. Accordingly, the partner may have partner-level interest expense that is limited by section 163(j) because the partnership qualified for the Small Business Exemption. Conversely, if that partnership did *not* qualify for the Small Business Exemption but made a RPTOB Election, the partner would be permitted to apply the Look-Through Rules and treat all of its basis in its partnership interest as allocable to an excepted trade or business. In that case, the partner would be able to allocate some or all of its interest expense to an excepted trade or business.

The rationale stated in the Preamble for not applying the Look-Through Rules to taxpayers that qualify for the Small Business Exemption appears to be easing the administrative burdens of such businesses:

The Treasury Department and the IRS have determined that the look-through rules should not be available [where the Small Business Exemption applies] because of the administrative burden that would be imposed on small businesses from collecting and providing information to their shareholders or partners regarding inside asset basis when those small businesses are themselves exempt from the application of section 163(j).³⁵

³⁴ A similar issue appears to occur when a REIT invests through a partnership or subsidiary REIT that qualifies as a small business. Specifically, Proposed Regulation section 1.163(j)-9(g)(4)(ii) and (iii) direct REITs to apply the Look-Through Rules; however, as discussed above, the Look-Through Rules do not apply to partnerships that are small businesses, even though Congress intended REITs conducting RPTOBs to be excluded from the section 163(j) limitation. CONFERENCE REPORT, at 392 n. 697 (“It is intended that any such real property trade or business, including such a trade or business conducted by a corporation or real estate investment trust, be included.”); Joint Committee on Taxation, *General Explanation of Public Law 115-97* (JCS-1-18), Dec. 2018, at 178 n. 883 (the “Bluebook”) (“Congress intends that any such real property trade or business, including such a trade or business conducted by a corporation or REIT, be included [as a RPTOB].”).

³⁵ 83 Fed. Reg., at 67,520.

While we understand this rationale, we nevertheless recommend that the final Regulations provide investors in businesses qualifying for the Small Business Exemption with the flexibility to apply the Look-Through Rules.

Because of the Proposed Regulations' treatment of businesses qualifying for the Small Business Exemption, we are concerned that some taxpayers may be less inclined to invest in businesses that conduct RPTOBs *and* qualify for the Small Business Exemption. Specifically, certain small businesses may have, or be looking to attract, investors who would themselves be ineligible for the Small Business Exemption and thus limited under section 163(j) in the absence of a RPTOB Election or Farming Election by the small businesses. These investors may thus be less inclined to invest in such small businesses.

Conversely, the Proposed Regulations could encourage those taxpayers to invest in businesses conducting RPTOBs and farming businesses that do not qualify for the Small Business Exemption because those investments would be able to benefit from the Look-Through Rules. However, we suggest that Congress did not intend that businesses that qualify for the Small Business Exemption and conduct eligible RPTOBs or farming businesses to be put at a competitive disadvantage to larger businesses as a result of the interest allocation rules under section 163(j).

By providing small businesses with the choice of making the RPTOB Election or the Farming Election, these small businesses can independently weigh the costs—administrative as well as tax (*e.g.*, the requirement to use ADS)—versus the benefits of making the election (*e.g.*, the ability to attract more investors). Accordingly, we believe that providing taxpayers that qualify for the Small Business Exemption with the option of making these elections and permitting partners and shareholders in such entities the ability to apply the Look-Through Rules would be consistent with Congressional intent.

3. Consequences of Failure to Continue to Qualify for Small Business Exemption

If, contrary to our recommendation above, the final Regulations prohibit a taxpayer qualifying for the Small Business Exemption from making a RPTOB Election or Farming Election, then we recommend that the final Regulations address the consequence of qualifying for the Small Business Exemption after a prior RPTOB Election or Farming Election has been made. Below is an example that illustrates the issue that may occur for taxpayers.

Example: A taxpayer makes a valid RPTOB Election in Year 1 when it does not qualify for the Small Business Exemption. In Year 2, the taxpayer qualifies for the Small Business Exemption. In Year 3 the taxpayer does not qualify for the Small Business Exemption.

The Proposed Regulations do not address whether that taxpayer is required to make a new RPTOB Election in Year 3 or whether the RPTOB Election made in Year 1 applies to any year in which the Small Business Exemption does not apply.

We note that the statement in the Preamble regarding the interaction of the Small Business Exemption and a RPTOB Election or Farming Election could be interpreted to mean that the qualification for the Small Business Exemption prevents only a new election, but does not prevent a taxpayer that previously made a valid RPTOB Election or Farming Election from having its interest excepted in a subsequent year under section 163(j)(7), rather than exempted under section 163(j)(3), even if the taxpayer qualified for the Small Business Exemption in the subsequent year.³⁶ This interpretation would appear to be supported by the fact that the qualification for the Small Business Exemption is not listed in Proposed Regulation section 1.163(j)-9(d) as one of the events that causes a termination of the RPTOB Election.

If the intended result is that qualification for the Small Business Exemption only prevents a later election, but a taxpayer is not subject to the provisions applicable to the Small Business Exemption if it previously made a valid RPTOB Election or Farming Election, we recommend stating that explicitly in the final Regulations. Alternatively, if the intended result is that a taxpayer's interest expense is exempted under the Small Business Exemption in any year in which the taxpayer qualifies for that exemption—regardless of whether the taxpayer previously made a valid RPTOB Election or Farming Election—we recommend that the final Regulations provide that a valid RPTOB Election or Farming Election applies to any year in which the taxpayer does not qualify for the Small Business Exemption. We see no policy for a contrary rule, and we believe it would create unnecessary administrative burden on taxpayers conducting RPTOBs and farming businesses to be required to make multiple elections solely due to falling in and out of the Small Business Exemption.

III. Recommendations Relating to RPTOBs

A. Consistent Definitions of “Trade or Business” for Purposes of the Section 163(j) Limitation and the Exception for Electing RPTOBs

1. Background

Section 163(j)(5) provides that business interest expense means interest on indebtedness properly allocable to a trade or business. Section 163(j)(7) excludes any Electing RPTOB from the definition of the term “trade or business” for purposes of section 163(j).³⁷ As a result, interest expense on indebtedness properly allocable to an Electing RPTOB is not limited by section 163(j).

Section 163(j)(7)(B) defines an Electing RPTOB as any trade or business that is described in section 469(c)(7)(C) and that makes an election under section 163(j)(7)(B). Section 469(c)(7)(C) defines a RPTOB as any real property development, redevelopment,

³⁶ 83 Fed. Reg., at 67,496 (“Such a taxpayer is not permitted to *make* an election under either section 163(j)(7)(B) or (C) because the taxpayer is *already* not subject to the section 163(j) limitation.”) (emphasis added).

³⁷ I.R.C. § 163(j)(7)(A)(ii).

construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.³⁸

In summary, to qualify as a RPTOB, it appears that (i) the taxpayer must be in a trade or business, (ii) that trade or business involves “real property,” and (iii) that trade or business involves one of the specified activities listed in section 469(c)(7)(C). The discussion below relates to what activities should constitute a trade or business for purposes of the RPTOB Election.

Our recommendations are intended to avoid situations in which a taxpayer is treated inconsistently by being treated as engaged in a trade or business for purposes of determining if the taxpayer has business interest expense subject to the section 163(j) limitation, but then is treated as not being in a trade or business for purposes of the exception from that limitation for Electing RPTOBs. This is particularly important in the case of a C corporation, as the Proposed Regulations provide that a C corporation is treated as engaged in a trade or business for purposes of determining whether its interest expense is subject to the section 163(j) limitation without regard to whether the activities undertaken by the C corporation would be treated as a trade or business in other contexts.³⁹

In particular, we recommend that the final Regulations adopt rules that would:

- explicitly provide that a taxpayer engaged in activities identified in section 469(c)(7)(C) be treated as engaged in a trade or business for purposes of the Electing RPTOB exception if the taxpayer would be treated as engaged in a trade or business with respect to interest expense incurred with respect to those activities for purposes of section 163(j) generally; and
- provide that any interest expense incurred by a taxpayer on indebtedness attributable to equity in an entity be treated as interest attributable to a RPTOB to the extent both (i) the interest expense incurred by the taxpayer is treated as business interest expense under section 163(j) and (ii) the entity is treated as an Electing RPTOB.

³⁸ See also CONFERENCE REPORT, at 391–92 (“In the Senate amendment, at the taxpayer’s election, any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business is not treated as a trade or business for purposes of the limitation, and therefore the limitation does not apply to such trades or businesses.”).

³⁹ Prop. Reg. § 1.163(j)-4(b)(1), (3)(i); 83 Fed. Reg., at 67,497 (“*all* interest paid or accrued by a taxpayer that is a C corporation is treated as business interest expense”) (emphasis added); see also CONFERENCE REPORT, at 386 n. 688 (“[A] corporation has neither investment interest nor investment income within the meaning of section 163(d). Thus, interest income and interest expense of a corporation is properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of the provision.”).

2. Definition of “Trade or Business” in the Context of a RPTOB

a. Recommendation

To provide certainty to taxpayers, we recommend that the term “trade or business” be defined consistently for purposes of section 163(j), including for purposes of the definition of a RPTOB. Thus, if a taxpayer is treated as engaged in a trade or business for purposes of section 163(j) generally, then it should also be treated as engaged in a trade or business for purposes of the definition of a RPTOB.

b. Explanation

As discussed above, section 163(j)(7)(A) provides a list of activities excluded from the definition of trade or business but does not include a definition of trade or business. Section 163(j)(5) and (6) define the terms “business interest [expense]” and “business interest income” as interest expense and interest income “properly allocable to a trade or business,” excluding investment interest expense and investment interest income within the meaning of section 163(d).

The legislative history of section 163(j) notes that:

Section 163(d) applies in the case of a taxpayer other than a corporation. Thus, a corporation has neither investment interest nor investment income within the meaning of section 163(d). Thus, interest income and interest expense of a corporation is properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of the provision.⁴⁰

Based on this statement, it appears that Congress intended that all interest income and interest expenses of a C corporation would be treated as business interest expense and business interest income, unless explicitly excluded from the application of section 163(j), such as in the case of a C corporation that is an Electing RPTOB.⁴¹ The Proposed Regulations adopt this approach and provide that “[s]olely for purposes of section 163(j), all interest expense of a taxpayer that is a C corporation is treated as properly allocable to a trade or business. Similarly, solely for purposes of section 163(j), all interest income of a taxpayer that is a C corporation is treated as properly allocable to a trade or business.”⁴²

An Electing RPTOB is defined in the Proposed Regulations as a trade or business that (i) is described in section 469(c)(7)(C) and Proposed Regulation section 1.469-9(b)(2) (which contains the general rules related to a RPTOB) and Proposed Regulation section 1.163(j)-9(g) (which contains special rules related to REITs) and (ii) makes an

⁴⁰ CONFERENCE REPORT, at 386 n. 688.

⁴¹ See 83 Fed. Reg., at 67,497 (“Although the [language in the legislative history] could be read to apply to both C corporations and S corporations, it is clear that an S corporation can have investment income and investment expenses within the meaning of section 163(d).”).

⁴² Prop. Reg. § 1.163(j)-4(b)(1).

election to be excepted from the section 163(j) limitation.⁴³ As a general matter, the term “trade or business” is defined in the Proposed Regulations as a trade or business within the meaning of section 162.⁴⁴

Although there is no explicit indication in the legislative history of section 163(j) regarding what might constitute a trade or business in the context of an Electing RPTOB, it seems reasonable to assume that Congress would have made an explicit note if it intended that the trade or business prong for the Electing RPTOB exception be treated differently than a trade or business for purposes of the 163(j) limitation.

Thus, for example, assume that a corporate taxpayer purchases land on which it plans to construct a residential apartment building that it plans to operate, manage, and lease to tenants. Although the interest expense would be capitalized once construction begins,⁴⁵ the capitalization provisions do not apply to interest expense incurred prior to the beginning of construction.⁴⁶ The interest expense incurred in connection with pre-construction activities seems to fit the type that Congress intended to allow to be eligible for the Electing RPTOB exception from section 163(j), as it is incurred in connection with real property acquisition, development, construction, rental, operation, and leasing, all of which are explicitly listed as eligible activities of a RPTOB.⁴⁷ However, the taxpayer may not be treated as engaged in a trade or business under section 162 until the building is ready for rental.⁴⁸

Although the definition of a RPTOB was incorporated by reference from section 469, we see no policy reason why there should be a different definition of trade or business for purposes of section 163(j) generally and the definition of a RPTOB specifically. In fact, to achieve the policy goal of exempting the real estate activities identified in section 469(c)(7)(C) it would seem necessary to have the same definition of a trade or business apply to both section 163(j) generally and the definition of a RPTOB. Accordingly, we recommend that guidance clarify that if a corporation is per se treated as engaged in a trade or business for purposes of determining that the corporation has business interest expense subject to the section 163(j) limitation, then the corporation is also treated as engaged in a trade or business for purposes of determining whether it is a RPTOB that is eligible to make the RPTOB Election. Said another way, if a corporation is engaged in one of the enumerated activities in the definition of RPTOB, it will *always* be eligible to make the RPTOB Election.

⁴³ Prop. Reg. § 1.163(j)-1(b)(12).

⁴⁴ Prop. Reg. § 1.163(j)-1(b)(38)(i).

⁴⁵ I.R.C. § 263A(b)(1), (g)(1).

⁴⁶ I.R.C. § 263A(f)(1)(A), (5)(B). Further, the interest deduction is not limited under section 195 as a start-up expenditure, even though the trade or business may not have commenced. *See* I.R.C. § 195(c)(1).

⁴⁷ I.R.C. § 469(c)(7)(C); Prop. Reg. § 1.163(j)-1(b)(12).

⁴⁸ *See Aboussie v. United States*, 779 F.2d 424 (8th Cir. 1985).

B. Business Interest Expense Incurred to Acquire Interests in Entities That Make a RPTOB Election

1. Recommendations

We recommend that final Regulations provide that any interest expense be treated as allocated to a RPTOB to the extent the interest expense is attributable to an equity interest in an entity that is treated as engaged in a RPTOB. To implement this recommendation, we recommend that the Look-Through Rules for excepted trades or businesses of partnerships, S corporations, and C corporations be harmonized and the ownership threshold for non-consolidated domestic C corporations and CFCs in Proposed Regulation section 1.163(j)-10(c)(7)(i)(A) be eliminated.

2. Explanation

As noted above, a C corporation is treated as being engaged in a trade or business for purposes of determining whether it has business interest expense subject to the section 163(j) limitation without regard to its actual activities.⁴⁹ Thus, a corporation will be treated as being engaged in a trade or business for this purpose even if it engages in no activities other than the ownership of a minority interest in another corporation.

Although there is no specific legislative history regarding the intent of the Electing RPTOB exception, presumably this exception was intended to allow borrowing incurred to finance the acquisition of a real estate business to be exempt from the business interest expense limitation in section 163(j)⁵⁰ *provided* the business makes the appropriate election⁵¹ and depreciates its property in the manner required.⁵² There is no indication that Congress intended this exception to apply only to financing by the entity that owns the real property.⁵³

Further, there is no indication that Congress intended the concept of a trade or business in the context of the Electing RPTOB exception to be defined more narrowly than the manner in which a trade or business is defined for purposes of determining what constitutes business interest expense subject to the section 163(j) limitation. Since, as discussed above, a corporation is in a trade or business for purposes of the section 163(j) limitation even if it merely owns a minority interest in another entity, a corollary rule is

⁴⁹ Prop. Reg. § 1.163(j)-4(b)(1), (3)(i); 83 Fed. Reg., at 67,497 (“*all* interest paid or accrued by a taxpayer that is a C corporation is treated as business interest expense”) (emphasis added); *see also* CONFERENCE REPORT, at 386 n. 688 (“[A] corporation has neither investment interest nor investment income within the meaning of section 163(d). Thus, interest income and interest expense of a corporation is properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of the provision.”).

⁵⁰ I.R.C. § 163(j)(7)(A)(ii).

⁵¹ I.R.C. § 163(j)(7)(B).

⁵² I.R.C. §§ 163(j)(10)(A), 168(g)(1)(F), 168(g)(8).

⁵³ As a practical matter, we often see many real estate ventures that are formed as joint ventures and borrowing may occur above the property owning entity. This may be because the owners have varied access to credit (or varied cost of credit) or because the owners have different views regarding the proper level of indebtedness for the investment.

needed whereby the corporation is also in a RPTOB to the extent the entity in which it owns an interest is in a RPTOB. Otherwise, taxpayers that borrow to acquire or finance a RPTOB conducted through another entity may not get the benefit of a RPTOB Election at that entity, even though the taxpayer's capital was used to finance that RPTOB.

The Proposed Regulations incorporate a variety of provisions that allow interest attributable to an equity interest in an entity to be treated as interest attributable to a RPTOB to the extent the entity is engaged in a RPTOB. In particular, the Proposed Regulations provide that:

- a partner may treat its interest expense that is allocated to its partnership interest as attributable to a RPTOB to the extent the assets of the partnership are attributable to a RPTOB;⁵⁴
- an S corporation shareholder may treat its interest expense that is allocated to its shares in the S corporation as attributable to a RPTOB to the extent the assets of the S corporation are attributable to a RPTOB;⁵⁵ and
- a C corporation shareholder whose interest in a C corporation satisfies the ownership requirements of section 1504(a)(2) must treat its interest expense that is allocated to its shares in the C corporation as attributable to a RPTOB to the extent the assets of the C corporation are attributable to a RPTOB.⁵⁶

We believe the provisions of the Proposed Regulations noted above are appropriate as they allow partners and shareholders to avail themselves of the RPTOB Election when the entities in which they own an interest have made a RPTOB Election. This is in accord with the discussion above related to maintaining parity in the definition of a trade or business for purposes of both the interest deductibility limits and the Electing RPTOB exception, as it allows a borrower that is deemed to have a business interest expense (even though the borrower merely has equity in another entity) to get the benefit of a RPTOB conducted by that entity.

However, one circumstance in which the Proposed Regulations provide a disparate treatment between the general business interest expense limitation and the Electing RPTOB exception relates to a shareholder of a C corporation in which the shareholder does not satisfy the ownership thresholds in section 1504(a)(2).

For example, assume that REIT A is formed to engage in a RPTOB. One of its initial members is Corporation B, which is formed by its shareholders to invest in REIT A. Corporation B expects to own 30% of REIT A. Corporation B borrows to acquire its interest in REIT A.

In other contexts, one might conclude that Corporation B's investment is not sufficient to constitute a trade or business at all and, therefore, cannot constitute a

⁵⁴ Prop. Reg. § 1.163(j)-10(c)(7)(ii).

⁵⁵ Prop. Reg. § 1.163(j)-10(c)(7)(i)(A).

⁵⁶ *Id.*

RPTOB. However, as noted above, in the context of section 163(j), the interest expense incurred by Corporation B will be treated as incurred in a trade or business and thus the interest will be treated as business interest expense subject to limitation under section 163(j) even though Corporation B's only activity is ownership of an interest in REIT A.

If Corporation B is treated as having business interest expense subject to the section 163(j) limitation when its only activity is investing in REIT A, it would seem appropriate to treat Corporation B as being in a RPTOB for this purpose to the extent REIT A is in a RPTOB. Such a result would maintain consistency between the rules for determining when a shareholder of a corporation is in a trade or business for purposes of the interest deductibility limits under section 163(j) and when the shareholder is eligible for the RPTOB Election to be excepted from those limits.

We note that we do not know the reason that the section 1504(a)(2) ownership requirement was included in the Proposed Regulations, so it is difficult to comment with regard to its intended purpose. As noted above, however, we believe that the policy that should drive the rule should be to connect borrowing related to a RPTOB to that trade or business, without regard to whether that borrowing and business are in the same entity.⁵⁷ Accordingly, the section 1504(a)(2) limitation in the Proposed Regulations seems inappropriate because it creates a disconnect between the rules regarding when borrowing for real property activities listed in section 469(c)(7)(C) is subject to the section 163(j) limitation and when the Electing RPTOB exception to that limitation is available. In other words, to the extent the business interest expense limitation can apply to the ownership of a minority interest in stock, it would seem that the RPTOB Election should be equally available to the owner of that stock.

C. Definition of a RPTOB under Section 469(c)(7)(C)

1. Background

As noted above, section 469(c)(7)(C) defines a RPTOB as any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.⁵⁸ In enacting section 469(c)(7), Congress intended to rectify what it viewed as unfair treatment for persons involved in real estate trades or businesses. The legislative history of section 469(c)(7) states:

The committee considers it unfair that a person who performs personal services in a real estate trade or business in which he materially participates may not offset

⁵⁷ If the rule was put in place to prevent complicated reporting to small shareholders, it would be possible to permit, rather than require, a corporation to allow its less than 80% shareholders to look through the corporation for this purpose.

⁵⁸ See also CONFERENCE REPORT, at 391–92 (“In the Senate amendment, at the taxpayer’s election, any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business is not treated as a trade or business for purposes of the limitation, and therefore the limitation does not apply to such trades or businesses.”).

losses from rental real estate activities against income from nonrental real estate activities or against other types of income such as portfolio investment income. The committee bill modifies the passive loss rule to alleviate this unfairness.⁵⁹

The Proposed Regulations define two of the terms enumerated in section 469(c)(7): “real property operation” and “real property management.”⁶⁰ These definitions are nearly identical, except that real property operations are handled by a *direct or indirect owner* of the real property, whereas real property management is handled by a professional manager, who is a person responsible, on a full-time basis, for the overall management and oversight of the real property or properties and who is not a direct or indirect owner of the real property or properties.⁶¹

Real property operations and real property management are defined under the Proposed Regulations as the handling (by a direct or indirect owner, in the case of real property operations, or a professional manager, in the case of real property management) of the day-to-day operations of a trade or business, within the meaning of Regulation section 1.469-9(b)(1), relating to the maintenance and occupancy of the real property that affect the availability and functionality of that real property used, or held out for use, by customers where payments received from customers are *principally* for the customers’ use of the real property.⁶²

The Proposed Regulations require that the “principal purpose” of the business operations is “the provision of the use of the real property, or physical space accorded by or within the real property, to one or more customers, and not the provision of other significant or extraordinary personal services, within the meaning of Temporary Regulation section 1.469-1T(e)(3)(iv) and (v), to customers in conjunction with the customers’ incidental use of the real property or physical space.”⁶³ The Proposed Regulations further require:

If the real property or physical space is provided to a customer to be used to carry on the customer’s trade or business, the *principal purpose* of the business operations must be to provide the customer with exclusive use of the real property or physical space in furtherance of the customer’s trade or business, and not to provide other significant or extraordinary personal services to the customer in addition to or in conjunction with the use of the real property or physical space, regardless of whether the customer pays for the services separately.⁶⁴

The two “principal purpose” requirements quoted above are then followed by a sentence that appears to create an allowance for some degree of personal services despite the “principal purpose” requirements, but goes on to apply a more restrictive standard

⁵⁹ H.R. REP. NO. 103-11, at 613–14 (1993).

⁶⁰ Prop. Reg. § 1.469-9(b)(2)(ii)(H), (I).

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Id.* (emphasis added).

than the two preceding sentences and to add another subjective test. The definition continues:

However, other incidental personal services may be provided to the customer in conjunction with the use of real property or physical space, as long as such services are *insubstantial* in relation to the customer's use of the real property or physical space and the receipt of such services is not a significant factor in the customer's decision to use the real property or physical space.⁶⁵

The Proposed Regulations do not define the other terms included in section 469(c)(7)(C), instead reserving these definitions for future guidance.⁶⁶ The Preamble quotes the legislative history of section 469(c)(7) and notes that neither section 469 nor the legislative history defines any of the terms contained in section 469(c)(7)(C).⁶⁷ Although the other terms in section 469(c)(7)(C) are reserved, the Preamble suggests that Treasury and the Service view these activities as limited to those activities connected with rental activities:

Given Congress's focus in enacting section 469(c)(7) to provide relief to entrepreneurs in real property trades or businesses with some *nexus to or involvement with rental* real estate, these proposed regulations would not include trades or businesses that generally *do not play a significant or substantial role in the creation, acquisition, or management of rental real estate in the definition of real property trade or business under section 469(c)(7)(C)*. Therefore, taxpayers engaged in trades or businesses that are not directly or substantially involved in the creation, acquisition, or management of *rental* real estate, or that provide personal services which are merely ancillary to a real property trade or business, will generally not be treated as engaged in real property trades or businesses for this purpose.⁶⁸

2. Section 469(c)(7)(C) Activities Should Not Be Limited to Rental Activities

a. Recommendation

We recommend that, in providing definitions for the other terms enumerated in section 469(c)(7)(C), Treasury and the Service not adopt a restrictive view of real estate activities defined in section 469(c)(7) that requires either a nexus to, involvement with, or significant or substantial role in, the creation, acquisition, or management of *rental* real estate. Section 469(c)(7)(C) itself, in addition to the legislative history underlying it and case law interpreting it, suggests that the definition of qualifying real estate activities under section 469(c)(7)(C) should not be restricted to *rental* real estate activities.

⁶⁵ *Id.* (emphasis added).

⁶⁶ See generally Prop. Reg. § 1.469(b)(2)(ii).

⁶⁷ 83 Fed. Reg., at 67,524.

⁶⁸ *Id.* (emphasis added).

b. Explanation

The definition of RPTOB provided in section 469(c)(7)(C) is intended to include a broad range of activities related to real estate.⁶⁹ The legislative history of section 469 does not indicate that the activities constituting a RPTOB are limited to rental activities. In fact, Congress's stated intent in the legislative history of section 469 to allow *nonrental* real estate activities to be offset against rental real estate activities necessitates the opposite conclusion; specifically, that the activities of a real estate professional under section 469(c)(7) were not intended to be limited to rental activities.⁷⁰

The language of section 469(c)(7) further supports the view that real estate activities should not be limited to rental real property activities. The section 469(c)(7)(C) definition of RPTOB separately lists rental as a type of RPTOB qualifying within the definition among other types of RPTOBs. By including rental in this list of activities that are not necessarily performed in conjunction with renting real property, such as construction and development, section 469(c)(7)(C) by its terms acknowledges that the definition of RPTOB encompasses activities performed in connection with real property but not necessarily in connection with the *rental* of real property. Indeed, Treasury and the Service have previously acknowledged the broad nature of the activities listed in section 469(c)(7)(C) in regulations under section 1411.⁷¹

Further, the other enumerated activities in the statute are not modified by the word "rental." This evidences that rental real property trades or businesses were intended merely as one type of RPTOB within the meaning of section 469(c)(7)(C), and that the definition was intended to encompass trades or businesses not involving the rental of real property. Finally, case law and other administrative guidance also supports the view that activities other than rental activities can constitute a RPTOB activity.⁷²

⁶⁹ See *Stanley v. United States*, No. 5:14-CV-05236, 2015 U.S. Dist. LEXIS 153166 (W.D. Ark. Nov. 12, 2015) (noting that section 469 does not require that the services performed in a real property trade or business be of any specific character or that all such services must be directly related to real estate; rather, the services must simply be performed in real property trades or businesses in which the taxpayer materially participates); CONFERENCE REPORT, at 353 n. 487, 367 n. 569.

⁷⁰ H.R. REP. NO. 103-11, at 613-14 (1993).

⁷¹ T.D. 9644, 2013-2 C.B. 676 ("Section 469(c)(7)(C) provides 11 types of activities that constitute a real property trade or business. Only a few of the 11 enumerated activities may be relevant in determining whether rents are derived in the ordinary course of a trade or business, such as the activities of "rental" and "leasing." Some of the other enumerated items have little, if any, relation to rental activities. For example, an individual engaged in real property construction could satisfy the two tests enumerated in section 469(c)(7)(B) to qualify as a real estate professional, but the construction activities may not have any relation to whether the individual's rental income is derived in the ordinary course of a trade or business.").

⁷² See, e.g., *Coastal Heart Med. Group, Inc. v. Commissioner*, T.C. Memo. 2015-84 (concluding that a hospital acquisition and operation constituted a RPTOB, notwithstanding that the majority of the business activities likely involve patient care and services and not merely provision of hospital rooms); *Pungot v. Commissioner*, T.C. Memo. 2000-60 (stating that a RPTOB is "defined broadly" in section 469(c)(7)(C)); *Simmons-Brown v. Commissioner*, T.C. Summ. Op. 2015-62 (finding that a taxpayer engaged in a construction and reconstruction business met the definition in section 469(c)(7)(C)); CCA 201504010 (Jan. 23, 2015) (defining a real property brokerage trade or business as "[involving] bringing together buyers and sellers of real property"; there was no indication that the property involved needed to have been rental real property).

D. Recommendations Regarding the Definitions of “Real Property Operation” and “Real Property Management”

1. Clarify That Real Property Operations and Real Property Management Do Not Require Rental Income

a. Recommendation

We recommend that the definitions of both real property operation and real property management be revised in several respects. First, we recommend that Treasury and the Service clarify that the terms “operation” and “management” encompass the operation and management of real property, even if the income from the business does not produce rental income.

b. Explanation

As discussed above, because neither the language nor the legislative history of section 469(c)(7)(C) limit its application to rental real property, it follows that the terms “operation” and “management” likewise should not be limited to the operation and management of rental real property. Further, the legislative history of section 163(j) supports including operation and management of real property that is not limited to rental real property within the scope of permissible activities. As noted above, the Conference Report specifically states that “a real property operation or a real property management trade or business includes the operation and management of a lodging facility.”⁷³ Similarly, the colloquy on the Senate floor between Senators Hatch and Lankford made clear Congressional intent that the operation and management of senior living facilities was not excluded from the definition of a RPTOB “merely because [senior living facilities] provide necessary supplemental assistive services that meet the needs of aging services.”⁷⁴ This intent was further memorialized in the Bluebook prepared by the staff of the Joint Committee on Taxation.⁷⁵

2. Principal Purpose Test

a. Recommendation

We recommend that the definition of real property operation and real property management each be revised by deleting the following sentence:

However, other incidental personal services may be provided to the customer in conjunction with the use of real property or physical space, as long as such services are insubstantial in relation to the customer’s use of the real property or

⁷³ CONFERENCE REPORT, at 392 n. 697.

⁷⁴ 163 CONG. REC. S8109–S8110 (Dec. 19, 2017) (statements of Sens. Hatch and Lankford).

⁷⁵ Bluebook, at 178 n. 883 (“It is further 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.”)

physical space and the receipt of such services is not a significant factor in the customer's decision to use the real property or physical space.⁷⁶

b. Explanation

The above-quoted sentence is problematic in several regards. First, it is unclear whether this sentence is intended to provide further clarification only with respect to the sentence that immediately precedes it, pertaining to provision of space for a customer's trade or business, or, instead, is intended to apply with respect to the entire definition. If the sentence is intended to apply only with respect to the provision of space for a customer's trade or business, we are not aware of any policy basis for this distinction. Specifically, we believe that the standard for qualification of a trade or business under section 469(c)(7) should not vary based upon whether a third party used the real property in furtherance of its own trade or business, or for other purposes.

If, on the other hand, the sentence is intended to apply to the entire definition, it appears to be inconsistent with the first two sentences of the definition, which require only that the "*principal* purpose" of the business must be the provision of the use of real property or physical space and payments received from customers *principally* for the customers' use of real property.⁷⁷ Those sentences also require that the principal purpose of the business cannot be the provision of significant or extraordinary personal services as defined in Temporary Regulation section 1.469-1T(e)(3)(iv) and (v).⁷⁸ These requirements, however, do not preclude the business from providing significant personal services so long as the principal purpose of the business is the provision of the use of the real property, or physical space accorded by or within the real property, to one or more customers.

In fact, Example 5 in Proposed Regulation section 1.469-9(b)(2)(iii)(E) illustrates that even in a situation in which seemingly significant services are provided, an operator may be treated as engaged in a RPTOB under section 469(c)(7). The example explains that even though a luxury hotel provides significant personal services within the meaning of Temporary Regulation section 1.469-1T(e)(3)(iv), the *principal purpose* of the hotel operator's business is the hotel's provision of rooms and suites to customers. The example further states that the provision of personal services is incidental to the customers' use of the hotel's real property.⁷⁹ This example confirms that even if the provision of significant personal services within the meaning of Temporary Regulation section 1.469-1T(e)(3)(iv) is a purpose of the trade or business, it does not prevent a trade or business from qualifying under section 469(c)(7)(C), even where the provided services are not insubstantial, so long as the provision of significant services is not the *principal* purpose.

In addition, the above-cited sentence's directive that the personal services must be "insubstantial" in relation to the customer's use of the real property or physical space

⁷⁶ Prop. Reg. § 1.469-9(b)(2)(ii)(H), (I).

⁷⁷ *Id.* (emphasis added).

⁷⁸ *Id.*

⁷⁹ Prop. Reg. § 1.469-9(b)(2)(iii)(E).

imposes a new restrictive, quantitative standard. This quantitative restriction creates uncertainty in administering the definition, as it is unclear what quantum of services would run afoul of this limitation. Further, as demonstrated in the discussion of the example in the Proposed Regulations, it is possible to provide significant services that are more than insubstantial and still have a principal purpose of the provision of physical space. The legislative history's inclusion of both lodging facilities and assisted living facilities that include supplemental services further confirms that the "insubstantial" services restriction is in conflict with Congress's intent with respect to what business operations constitute a real property operation and real property management business.

Even if, as discussed above, the sentence is intended to apply solely with respect to situations in which the taxpayer has provided physical space or real property to a customer in furtherance of the customer's trade or business, we see no policy basis to impose this more restrictive "insubstantial services" standard simply based upon the customer's use of the property.

Finally, we believe that the subjective standard looking to whether the customer's receipt of services is a significant factor in the customer's decision to use the real property should be eliminated, as it introduces uncertainty in the determination. Specifically, this standard would be difficult to administer since neither the real estate professional, nor the Service, would have any visibility into the customer's subjective motivation for the use of the space.⁸⁰

3. Summary of Recommendations Regarding Real Property Operations and Management

In sum, we believe that the definitions of both "real property operations" and "real property management" should be revised from that provided in the Proposed Regulations to make clear that such activities are not limited to activities that give rise to rental income, and that operations and management business operations may qualify even if significant personal services are provided, so long as the provision of such services is not the principal purpose of the business operations. Further, we believe that neither the customer's use of the property nor the customer's subjective determination regarding the decision to use the property should be relevant in determining whether a business operation qualifies as a real property operation or real property management business under section 469(c)(7)(C).

E. Definitions of "Rental" and "Leasing"

1. Recommendation

We recommend that the terms "rental" and "leasing" be defined to include payments derived from the use of real property and all associated services, even if the services are significant. In addition, we recommend confirming that the provision of

⁸⁰ It also appears to be inconsistent with the inclusion of an example involving a luxury hotel, the operation of which would seemingly involve some level of differentiation with respect to competitors based on the composition of services provided to customers.

significant services in connection with rental activities does not create two separate businesses, *i.e.*, a rental business and a services business.

2. Explanation

As threshold matter, we recommend that the definition of “rental activity” under the passive loss rules should not be used for purposes of section 163(j). Although, as noted above, the definition of RPTOB is incorporated by reference from section 469(c)(7)(C), the Conference Report notes that “the other rules of section 469 are not made applicable by this reference.”⁸¹ Thus, although section 469 and the regulations thereunder use the term “rental activity,” that definition is not controlling for purposes of the definition of RPTOB.

Moreover, because of the different policy goals underlying the passive loss rules and section 163(j), the definition of “rental activity” in the passive loss rules is not instructive in defining “rental” for purposes of section 163(j). Section 469(j)(8) defines “rental activity” as an activity where payments are principally for the use of tangible property. The accompanying regulations define a “rental activity” as an activity if (i) tangible property held in connection with the activity is used by, or held for use by, customers; and (ii) the gross income from the activity represents amounts paid, or to be paid, principally for the use of such property.⁸² Notably, the definition does not encompass the provision of services in connection with the rental activity but instead defines the term “rental activity” narrowly. It is important, however, to keep in mind the narrow context in which section 469 uses the term “rental activity.” The narrow definition of “rental activity” is aimed, in part, at limiting the types of activities that can be grouped together with rental activities for purposes netting gains and losses from those various activities.⁸³ Classification of an activity as a rental activity determines whether an activity is treated as a passive activity without regard to material participation by the taxpayer in the activity (*i.e.*, rental activities are *per se* passive).⁸⁴ This classification is similar to the classification of a “rental” activity for purposes of the rules related to tax-exempt organizations and REITs.

In that regard, in the context of the unrelated business income tax, section 512(b)(3) generally excludes from the computation of unrelated business taxable income (“UBTI”) (i) all rents from real property and (ii) all rents from personal property leased with such real property, if the rents attributable to such personal property are an incidental amount of the total rents received or accrued under the lease, determined at the time the personal property is placed in service. However, the UBTI rules limit the services that can be rendered in connection with rental activities that are exempt from the definition of UBTI.⁸⁵ Thus, notwithstanding that income from the property might qualify

⁸¹ CONFERENCE REPORT, at 392 n. 697.

⁸² Temp. Reg. § 1.469-1T(e)(3)(i).

⁸³ See Reg. § 1.469-4(d)(1).

⁸⁴ I.R.C. § 469(c)(2).

⁸⁵ See Reg. § 1.512(b)-1(c)(5).

as rental income, the provision of services can taint the income and cause it to be subject to UBTI. These strict restrictions on the types of services that can be provided in connection with rental activities are consistent with Congress's policy goal of ensuring that only limited, specified sources of income are excluded from UBTI.

The REIT rules reflect similar policy considerations. Specifically, the REIT rules were generally intended to ensure that REITs are passive investors in real estate.⁸⁶ For purposes of the income tests applicable to REITs, "rents from real property" are treated as qualifying income.⁸⁷ In the REIT context, rents from real property include charges for services customarily furnished or rendered in connection with the rental of real property, whether or not separately stated.⁸⁸ If more than one percent of the income from a property constitutes "impermissible tenant services income," however, then none of the income is treated as rents from real property for the REIT rules.⁸⁹

Significantly, the fact that rental income does not meet the definition of what is qualifying income for a REIT does not suggest that such income is not rent in the more general sense. Although the Conference Report clarifies that the RPTOB of a REIT is included in the definition of RPTOB, the Conference Report suggests that rental activity is not limited to "rents from real property" under the REIT rules, stating, "[i]t is intended

[P]ayments for the use or occupancy of rooms and other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor courts or motels, or for the use or occupancy of space in parking lots, warehouses, or storage garages, do not constitute rent from real property. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways, and lobbies, the collection of trash, etc., are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, of offices in any office building, etc., are generally rent from real property.

⁸⁶ See H.R. REP. NO. 86-2020 (1960), *reprinted at* 1960-2 C.B. 819.

One of the principal purposes of your committee in imposing restrictions on types of income of a qualifying real estate investment trust is to be sure that the bulk of its income is from passive income sources and not from the active conduct of a trade or business. ... A second restriction, intended to limit the definition of rents from real property to those of a passive nature, excludes from the definition amounts where the trust directly furnishes or renders services to the tenants or manages or operates the property. However, the bill permits these services, or management or operation of the property to be provided through an independent contractor.

Id. at 822-23. In 1986, Congress amended these provisions to allow REITs to directly render services and management functions provided those services and management functions could be conducted by a tax-exempt organization without being subject to UBTI. I.R.C. § 856(d)(7)(C)(ii).

⁸⁷ I.R.C. § 856(c)(2)(c), (3)(A).

⁸⁸ I.R.C. § 856(d)(1)(B). The regulations provide that services furnished to the tenants of a particular building will be considered as customary if, in the geographic market in which the building is located, tenants in buildings which are of a similar class (such as luxury apartment buildings) are customarily provided with the service.

⁸⁹ I.R.C. § 856(d)(7)(B).

that any such real property trade or business, including such a trade or business conducted by a corporation or real estate investment trust, be included.”⁹⁰ Thus, a trade or business conducted by a REIT is only one of many businesses included in the RPTOB definition.

In contrast to the provisions in the UBTI and REIT rules, provisions in the S corporation context provide helpful guidance for defining rental activity. Specifically, section 1362(d) provides that an election to be taxed as an S corporation shall be terminated whenever the corporation (i) has accumulated earnings and profits at the close of each of three consecutive taxable years and (ii) has gross receipts for each of such taxable years more than 25% of which are passive investment income. Section 1362(d)(3)(C)(i) defines the term “passive investment income” as gross receipts derived from, among other passive sources, rents. The regulations under section 1362 provide that the term “rents” means amounts received for the use of, or the right to use, property (whether real or personal) of the corporation.⁹¹ These regulations further provide that the term “rents” does not include rents derived in the “active trade or business of renting property.”⁹² Rents received by a corporation are derived in an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business.⁹³ Thus, if rents are not characterized as “passive investment income” for purposes of section 1362(d), it must be the case that they are derived in the active trade or business of renting property. Regulation section 1.1362-2(c)(6) does not provide an example involving a rent payment; however, in revenue rulings and private letters rulings, the Service has generally taken a fairly broad approach in defining the active trade or business of renting property to include associated services.

For example, Revenue Ruling 65-83⁹⁴ addressed whether payments received by a corporation for the use of personal property in various scenarios constitute rents within the meaning of the predecessor to section 1362(d)(3) (*i.e.*, rents not derived in the active conduct of a trade or business).⁹⁵ In one scenario, the S corporation derived all of its income from leasing barricades for use around areas of construction and danger areas and for traffic control purposes. The corporation delivered the barricades to the job site and serviced them twice weekly, replacing batteries, bulbs, and lenses as well as parts stolen or broken, and picking up the barricades upon completion of the project. In another scenario, an S corporation leased golf carts at various golf courses at a charge based on the number of rounds of golf for which they were used. Payments for use of the golf carts were divided with the owner of the course involved, whose employees handled the actual rental of the carts to the golfers. The costs of maintaining and servicing the carts, including the wages of a full-time mechanic, were paid by the S corporation. The ruling

⁹⁰ CONFERENCE REPORT, at 392 n. 697.

⁹¹ Reg. § 1.1362-2(c)(5)(ii)(B)(1).

⁹² Reg. § 1.1362-2(c)(5)(ii)(B)(2).

⁹³ *Id.*

⁹⁴ 1965-1 C.B. 430.

⁹⁵ The predecessor provision section 1372(e)(5) of the Internal Revenue Code of 1954 was amended and redesignated as section 1362 as a result of the Subchapter S Revision Act of 1982 (P.L. 97-354).

holds that “the payments received by the corporations for the use of personal property in each of the above situations do not constitute rents within the meaning of section 1372(e)(5) of the Code since, in each instance, significant services are performed by the corporation in connection with such payments.”

The Service applied Revenue Ruling 65-83 to an analogous situation in Revenue Ruling 76-48.⁹⁶ In that ruling, a corporation operated tennis and handball courts and charged an hourly rate for the use of a court regardless of the number of players using it, with employees of the corporation handling the rental of the courts. Players who used the courts were provided with a locker room, lockers, saunas, showers, hair dryers, and parking facilities. The ruling holds that:

[T]he gross receipts for the use of the tennis and handball courts are not passive investment income for purposes of section 1372(e)(5) of the Code since, in connection with the provision of the locker room, lockers, saunas, showers, hair dryers, and parking facilities, significant services are performed by the corporation in connection with such gross receipts.

Notably, the ruling treated the entire property as a single “active trade or business of renting property” and did not bifurcate the activities.⁹⁷

This S corporation guidance provides a helpful framework for defining “rental” and “leasing” for purposes of the RPTOB exception to section 163(j). First and foremost, the Service’s rulings generally recognize that income from rental activities with significant services is still rental income and is not passive rents. Second, the Service analyzed rental businesses with significant service components as being part of a single active business and did not attempt to bifurcate the activities or the payments received.⁹⁸ The provision of the activities ancillary to renting the real property, as well as the bearing of the expenses associated with these activities, made the income from renting the real property active income and not passive investment income. Although the income was

⁹⁶ 1976-1 C.B. 265.

⁹⁷ See also Rev. Rul. 76-469, 1976-2 C.B. 252 (ruling that amounts received as part of a business of leasing motor vehicles under long-term leases were not rents when maintenance, repair, and other services were provided); Rev. Rul. 65-40, 1965-1 C.B. 429 (ruling that amounts received for the short-term leasing of motor vehicles were not rents when maintenance services such as gas and oil, tire repair and changing, cleaning, oil changing, and engine and body repair were provided); Rev. Rul. 64-232, 1964-2 C.B. 334 (ruling that amounts received from leasing glassware, silverware, tables, chairs, and electronic equipment when delivery and pickup functions were performed to wash, polish, repair, and store the items prior to lease to a customer).

⁹⁸ The Service has issued numerous private letter rulings that look to the activities of the business as a whole. See, e.g., PLR 200335018 (Aug. 29, 2003) (concluding that a taxpayer providing various services to the tenants of numerous properties as part of its real estate leasing and management business in which not all services are applicable to all of the properties generated income from the active trade or business of renting property); PLR 200328025 (July 11, 2003) (concluding that income from properties that were commercial, industrial, and residential real estate is income from the active trade or business of renting property); PLR 200310022 (Mar. 7, 2002) (concluding that rental income received under separate leases is income from the active trade or business of renting property); PLR 9839006 (Sept. 25, 1998) (concluding that the provision of services not ordinarily provided by commercial lessors were included in determining that the rental income was not passive investment income).

active and not passive, that classification did not disqualify the income from being rental income (albeit not qualifying for the definition of passive “rents” under section 1362(d)(3)(C)), recognizing that a rental business can involve significant services. Similarly, in the context of section 163(j), we recommend that payments received for the use of the real property and for all associated services, be considered one business that constitutes a single RPTOB, even if the associated services are significant.

Although the guidance addressed above treats the real property and related activities as constituting a single trade or business, there is some precedent for treating them separately. Lodging facilities often generate income from activities other than the rental of rooms, such as restaurants, spas, and gift shops. Certain tax provisions differentiate between property that is used predominantly in the operation of a lodging facility and property used in nonlodging commercial facilities. Under the regulations under section 48, property that is used predominantly in the operation of a lodging facility or in serving tenants is considered used in connection with the furnishing of lodging, whether furnished by the owner of the lodging facility or another person.⁹⁹ These regulations state that lobby furniture, office equipment, and laundry and swimming pool facilities used in the operation of an apartment house or in serving tenants are examples of property considered used predominantly in connection with the furnishing of lodging.¹⁰⁰ Nonlodging commercial facilities are those that are available to persons not using the lodging facility on the same basis as it is available to the tenants of the lodging facility such as restaurants, drug stores, grocery stores, and vending machines located in a lodging facility.

A similar distinction is made in section 897, which governs whether foreign persons are taxed on the sale of U.S. real property interests. A lodging facility is a U.S. real property interest, but the regulations under section 897 parallel those under section 48, noting that the term “lodging facility” does not include any portion of a facility that constitutes a nonlodging commercial facility and that is available to persons not using the lodging facility on the same basis that it is available to tenants of the lodging facility, such as restaurants, drug stores, and grocery stores located in a lodging facility.¹⁰¹

Although certain provisions have bifurcated rental activities from services, those provisions have done so to implement the underlying policy of the provisions. As a general matter, however, the tax law does not bifurcate rental activities from any services, and there is no underlying policy reason to do so for purposes of section 163(j).¹⁰² Unlike

⁹⁹ Reg. § 1.48-1(h)(1)(ii).

¹⁰⁰ The regulations under section 48 distinguish the property described in the sentence above from property that is used in furnishing, to the management of a lodging facility or its tenants, electrical energy, water, sewage disposal services, gas, telephone service, or other similar services, stating that those services are not treated as property used in connection with the furnishing of lodging, and further providing, by way of example, that items such as gas and electric meters, telephone poles and lines, telephone station and switchboard equipment, and water and gas mains furnished by a public utility would not be considered as property used in connection with the furnishing of a lodging.

¹⁰¹ Reg. § 1.897-1(b)(4)(i)(C).

¹⁰² See Rev. Rul. 2011-24, 2011-41 I.R.B. 485 (“Although authorities on Federal income tax principles such as those summarized above demonstrate that Federal income tax principles are generally used to determine

in the UBTI and REIT context, there is no indication in either section 469(c)(7)(C) or in section 163(j) that the terms “rental” or “leasing” are intended to be limited to passive arrangements.¹⁰³ Indeed, many of the other activities listed in the definition of RPTOB, such as brokerage, management, operations, and development, involve active businesses, the income from which would be UBTI for a tax-exempt entity or non-qualifying income for a REIT. Thus, we see no reason to define the terms “rental” or “leasing” in the definition of RPTOB to be limited to the types of passive rental activities permissible by the UBTI and REIT rules. Rather, we believe that the active rental trade or business concept from the S corporation rules acknowledges that a unitary active rental business can involve the provision of significant services.¹⁰⁴ Applying similar principles, we recommend that Treasury and the Service clarify that the definition of RPTOB is intended to be broad and that rental and leasing RPTOBs include all rentals of real property and all associated services, even if the services are significant. In addition, we recommend confirming that the provision of significant services as part of a rental business does not create a separate real property business and a separate services business.¹⁰⁵

F. Clarification of “Acquisition”

1. Recommendation

We recommend that guidance clarify that for a taxpayer to be engaged in a RPTOB involving the “acquisition” of real property, it either must be selling and

a single character for a given transaction, § 1.199-3(i)(1) provides that, solely for purposes of § 199, a single transaction may, depending on applicable Federal income tax principles, have both a services element and a lease element.”).

¹⁰³ We note that it is not entirely clear whether there is a distinction between a “rental” business and a “leasing” business. Although the rationale for including both “rental” and “leasing” in the definition of RPTOB may not be readily apparent, we do not believe the policy behind section 163(j) suggests that either term should be restricted to strictly passive-type income.

¹⁰⁴ We acknowledge that the services provided must be related to the rental business and cannot be a separate and distinct business apart from rental activity. In discussing the scope of rental activity, the legislative history of the S corporation rules illustrates a distinction between two businesses operated by the same taxpayer.

[S]uppose a travel agency operated in the form of a general partnership has its offices on three floors of a ten-story building that it owns. The remainder of the space in the building is rented out to tenants. The travel agency expects to take over another floor for its own use in a year. The partnership is treated as being engaged in two separate activities: a travel agency activity and a rental real estate activity.

S. REP. NO 99-313, at 743 (1986). Notably, this example differentiates between activities of the business (travel agency) and activities of owning rental real estate. Thus, the services provided must be related to the rental activity.

¹⁰⁵ As discussed above, we believe the better view is to not follow the UBTI and REIT rules that narrowly define the term “rental” and separate the services from the rental activities. We note, however, that if “rental” were defined not to include significant services provided in the production of rental income, then presumably a taxpayer providing such services would have two trades or businesses (i) a “rental” business and (ii) a business of “management”/“operation” of real property (*i.e.*, the services business). Under that analysis, the “rental” activities would qualify a RPTOB and the activities constituting the “management”/“operation” of real property would also qualify as a RPTOB.

disposing of real property or engaging in one of the other ten qualifying activities described in section 469(c)(7)(C).

2. Explanation

As noted above, section 469(c)(7)(C) contains a list of eleven qualifying activities that constitute a RPTOB. The list of activities is stated in the disjunctive.¹⁰⁶ As a result, it would appear that a taxpayer need only engage in one of the enumerated list of activities to be in a RPTOB.

Included in the enumerated list of activities is “acquisition.” It is not entirely clear how the activity of acquiring real property on its own would rise to the level of a trade or business. The Supreme Court has held that to be engaged in a trade or business, the taxpayer’s “primary purpose for engaging in the activity must be for income or profit.”¹⁰⁷ If a taxpayer merely acquires real property and does nothing else, it is unclear how the acquisition of real property would create income or profit.

Section 469(c)(7)(C) does not include in the list of qualifying activities the sale or disposition of real property. It would seem that Congress may have assumed that a business involving the “acquisition” of real property would necessarily involve the sale or disposition of real property. Otherwise, it would appear that the “acquisition” of real property by itself would not be a RPTOB. To avoid uncertainty, we recommend that Treasury and the Service issue guidance confirming that a taxpayer that engages in the business of acquiring and disposing of real property (*e.g.*, a dealer of undeveloped land, or a taxpayer that buys and sells hotels without operating them) is in a RPTOB, even if the taxpayer does not engage in any of the ten other qualifying activities in section 469(c)(7)(C).¹⁰⁸

G. Activities of Independent Contractors

1. Recommendation

We recommend that guidance confirm that a taxpayer may be engaged in a RPTOB even if all or substantially all of its activities are conducted by one or more independent contractors.

2. Explanation

The definition of RPTOB is used in the passive loss rules to identify those persons who are sufficiently engaged personally in activities relating to real estate such that any rental real estate activities they have also undertaken are not automatically considered to

¹⁰⁶ I.R.C. § 469(c)(7)(C) (“[T]he term ‘real property trade or business’ means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, *or* brokerage trade or business.” (emphasis added)).

¹⁰⁷ *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987).

¹⁰⁸ For this purpose, we believe there should be no requirement regarding the timing of sale of the property. A property that was held for long-term appreciation could still be treated as held for sale.

constitute passive activities.¹⁰⁹ However, the requirements related to personal services by a taxpayer are included – not in the definition of RPTOB itself – but in the other provisions of section 469 related to determining whether a taxpayer is a real estate professional.¹¹⁰ The legislative history of section 163(j) indicates that because the reference in section 163(j) is only to the definition of RPTOB in section 469(c)(7)(C), “the other rules of section 469 are not made applicable by this reference.”¹¹¹ Although the definition of RPTOB is derived from the passive loss rules that look to activities actually conducted by the taxpayer, we do not believe that the general rules in section 469 related to personal services in any way prevent a taxpayer for purposes of section 163(j) from conducting a RPTOB mainly or solely through independent contractors.¹¹²

Such a restrictive interpretation would be particularly inappropriate given the context in which the RPTOB Election will apply under section 163(j). For section 163(j) purposes, the RPTOB exception will apply only to taxpayers with larger-scale business operations. As discussed above, section 163(j)(3) exempts small businesses with gross receipts of not more than \$25 million (based on a three-year average) from section 163(j).¹¹³

Moreover, we believe it would be consistent with the treatment of the term “active trade or business” in section 355 to include in a RPTOB a business conducted only through independent contractors. Regulations under section 355 specify that for purposes of determining whether a corporation engages in “active conduct” or a trade or business, a corporation is required “itself to perform active and substantial management and operational functions” and “[g]enerally, activities performed by the corporation itself do not include activities performed by persons outside the corporation including independent contractors.”¹¹⁴ The specific exclusion from the “active” component of the definition of “active trade or business” in section 355 of activities of independent contractors implies that the activities of independent contractors would generally be included in determining whether a taxpayer is conducting a “trade or business.” If activities of independent contractors were not included in determining whether a “trade or business” existed, there would be no need to exclude them from the “active” component of “active trade or

¹⁰⁹ Participation by the taxpayer personally was a vital part in implementing the purposes of the passive loss rules. S. REP. NO 99-313, at 716 (1986) (“A taxpayer who materially participates in an activity is more likely than a passive investor to approach the activity with a significant non-tax economic profit motive, and to form a sound judgment as to whether the activity has genuine economic significance and value.”).

¹¹⁰ *E.g.*, I.R.C. § 469(c)(7)(B) (addressing the requirement either (i) one-half of the taxpayer’s personal services be performed in trades or business are for RPTOBs during the year in which the taxpayer material participates or (ii) the taxpayer performs more than 750 hours of services during the taxable year in RPTOBs in which the taxpayer materially participates).

¹¹¹ CONFERENCE REPORT, at 392 n. 697.

¹¹² We note that Treasury and the Service recently issued guidance consistent with this approach. Specifically, the rental safe harbor in the proposed Revenue Procedure of Notice 2019-07 provides that, for purposes of section 199A, which looks to whether there is a trade or business under section 162, “[r]ental services for purpose of this revenue procedure include: . . . (viii) supervision of employees and independent contractors. Rental services may be performed by owners or by employees, agents, and/or independent contractors of the owners.” Notice 2019-07, 2019-09 I.R.B. 740.

¹¹³ I.R.C. § 163(j)(3).

¹¹⁴ Reg. § 1.355-3(b)(2)(iii).

business.” Unlike section 355, the definition of RPTOB requires only that there is a “trade or business,” not an “active trade or business.” Based on the statutory language used in the definition of RPTOB, we believe activities of independent contractors should be taken into account in determining whether a trade or business existed.¹¹⁵

A contrary position would appear to frustrate Congressional intent. As noted above, legislative history indicates that operating and managing lodging and senior living facilities is to be treated as a RPTOB. Although some lodging and senior living facilities are operated by their owner or by a lessee-operator, a common – if not predominant – structure is for an owner of a lodging or senior living facility to engage a third-party manager to operate the facility. For example, many REITs that own and operate hotel properties lease those properties to a “taxable REIT subsidiary” which engages an “eligible independent contractor” to operate the property on behalf of the taxable REIT subsidiary.¹¹⁶ Other non-REIT owners of lodging and senior living facilities often engage third-party operators to manage their properties. If the activities of independent contractors were excluded in determining whether a taxpayer was engaged in a RPTOB, then the owner of a lodging or senior living facility that engaged a hotel or senior living manager to operate their facility might *not* be treated as being engaged in a RPTOB, but the manager would be treated as engaged in a RPTOB. The owner is the party that likely has incurred significant debt to construct, acquire, or carry the lodging or senior living facility, but, under this interpretation, the owner would not be able to make a RPTOB Election. We believe it would be inconsistent with Congressional intent to treat only owner-operators or owner-lessors of lodging and senior living facilities as being engaged in a RPTOB and not to accord similar RPTOB status to owners of those facilities that engage independent contractors to operate the facilities.

IV. Treatment of Certain Qualified Nonrecourse Indebtedness

A. Background

The Proposed Regulations provide rules for allocating tax items that are properly allocable to a trade or business between excepted and non-excepted trades or businesses for purposes of the section 163(j) limitation.¹¹⁷ Interest expense allocable to an excepted trade or business is generally excluded from a taxpayer’s section 163(j) limitation.¹¹⁸ This allocation is based upon the relative amounts of the taxpayer’s adjusted basis in the assets used in the excepted or non-excepted trades or businesses.¹¹⁹

¹¹⁵ We note that the courts have consistently looked to the activities of agents in determining whether a taxpayer was engaged in a U.S. trade or business, generally attributing the actions of agents to principals. *See, e.g., Gilford v. Commissioner*, 201 F.2d 735 (2d Cir. 1953); *Pinchot v. Commissioner*, 113 F.2d 718 (2d Cir. 1940); *D’Amodio v. Commissioner*, 34 T.C. 894 (1960); *Lewenhaupt v. Commissioner*, 20 T.C. 151 (1953). Thus, it follows that if the principal is attributed the activities of the agent, and the agent is involved in a RPTOB, the principal is also involved in a RPTOB.

¹¹⁶ I.R.C. § 856(d)(8)(B).

¹¹⁷ Prop. Reg. § 1.163(j)-10(a)(1)(i).

¹¹⁸ *Id.*

¹¹⁹ Prop. Reg. § 1.163(j)-10(c)(1)(i).

The Proposed Regulations provide that a taxpayer with qualified nonrecourse indebtedness (“QNI”) is required to directly allocate interest expense from that debt to the taxpayer’s assets.¹²⁰ When determining the amount of adjusted basis in assets used in each excepted or non-excepted trade or business, where a taxpayer has nonrecourse debt, the taxpayer is first required to reduce the amount of the taxpayer’s basis in its assets to reflect assets to which interest expense is directly allocable as a result of QNI.¹²¹ The Proposed Regulations include the following as Example 5:

Direct allocation of interest expense—(i) Facts. T conducts an electing real property trade or business (Business X) and operates a retail store that is a non-excepted trade or business (Business Y). In Year 1, T issues Note A to a third party in exchange for \$1,000x for the purpose of acquiring Building B. Note A is qualified nonrecourse indebtedness (within the meaning of §1.861-10T(b)) secured by Building B. T then uses those funds to acquire Building B for \$1,200x, and T uses Building B in Business X. During Year 1, T pays \$500x of interest, of which \$100x is interest payments on Note A. For Year 1, T’s basis in its assets used in Business X (as determined under paragraph (c) of this section) is \$3,600x (excluding cash and cash equivalents), and T’s basis in its assets used in Business Y (as determined under paragraph (c) of this section) is \$800x (excluding cash and cash equivalents). Each of Business X and Business Y also has \$100x of cash and cash equivalents.

(ii) Analysis. Because Note A is qualified nonrecourse indebtedness that is secured by Building B, in allocating interest expense between Businesses X and Y, T first must directly allocate the \$100x of interest expense it paid with respect to Note A to Business X in accordance with paragraph (d)(1) of this section. Thereafter, T must allocate the remaining \$400x of interest expense between Businesses X and Y under paragraph (c) of this section. After excluding T’s \$1,200x cost basis in Building B (see paragraph (d)(4) of this section), and without regard to T’s \$200x of cash and cash equivalents (see paragraph (c)(5)(iv) of this section), T’s basis in assets used in Businesses X and Y is \$2,400x and \$800x (75 percent and 25 percent), respectively. Thus, \$300x of the remaining \$400x of interest expense would be allocated to Business X, and \$100x would be allocated to Business Y.¹²²

B. Recommendation

We recommend that the final Regulations revise Example (5) to clarify that where a direct allocation of interest expense related to QNI is required, the basis of the related asset should be reduced, but not below zero, only by an amount equal to the amount of the QNI, and not be completely excluded for purposes of allocating interest expense based on the adjusted basis of assets. Specifically, we recommend the example be revised as follows (see *italics* below):

Direct allocation of interest expense—(i) Facts. T conducts an electing real property trade or business (Business X) and operates a retail store that is a non-excepted trade or business (Business Y). In Year 1, T issues Note A to a third party

¹²⁰ Prop. Reg. § 1.163(j)-10(d)(1).

¹²¹ Prop. Reg. § 1.163(j)-10(d)(4).

¹²² Prop. Reg. § 1.163(j)-10(d)(5).

in exchange for \$1,000x for the purpose of acquiring Building B. Note A is qualified nonrecourse indebtedness (within the meaning of §1.861-10T(b)) secured by Building B. T then uses those funds to acquire Building B for \$1,200x, and T uses Building B in Business X. During Year 1, T pays \$500x of interest, of which \$100x is interest payments on Note A. For Year 1, T's basis in its assets used in Business X (as determined under paragraph (c) of this section) is \$3,600x (excluding cash and cash equivalents), and T's basis in its assets used in Business Y (as determined under paragraph (c) of this section) is \$800x (excluding cash and cash equivalents). Each of Business X and Business Y also has \$100x of cash and cash equivalents.

(ii) Analysis. Because Note A is qualified nonrecourse indebtedness that is secured by Building B, in allocating interest expense between Businesses X and Y, T first must directly allocate the \$100x of interest expense it paid with respect to Note A to Business X in accordance with paragraph (d)(1) of this section. Thereafter, T must allocate the remaining \$400x of interest expense between Businesses X and Y under paragraph (c) of this section. After excluding T's *\$1,000x related to the amount of Note A secured by Building B* (see paragraph (d)(4) of this section), and without regard to T's \$200x of cash and cash equivalents (see paragraph (c)(5)(iv) of this section), T's basis in assets used in Businesses X and Y is \$2,600x and \$800x (76.5 percent and 23.5 percent), respectively. Thus, \$306x of the remaining \$400x of interest expense would be allocated to Business X, and \$94x would be allocated to Business Y.

C. Explanation

The current example provides that if QNI is directly allocable to an asset, the basis of that asset is completely excluded when allocating the interest expense from unsecured debt. Eliminating all of the basis of the asset could lead to economic distortions, particularly when the basis of the asset is well in excess of the qualified secured indebtedness.

For illustrative purposes, T conducts an Electing RPTOB (Business X) and operates a retail store that is a non-excepted trade or business (Business Y). In Year 2, Business X purchases Building C for \$800 million with \$20 million of QNI received in exchange for Note B, secured by Building C. Business Y, a non-excepted trade or business, has adjusted basis in assets of \$100 million. T has \$300 million of unsecured indebtedness. During Year 2, T pays \$30 million of interest, of which \$2 million is interest payments on Note B. T has no other assets, except as listed above.

Because Note B is QNI that is secured by Building C, in allocating interest expense between Businesses X and Y, T must first directly allocate the \$2 million interest expense paid on Note B to Business X. T must then allocate the remaining \$28 million of interest expense between Businesses X and Y. After excluding T's \$800 million basis in Building C, T's basis in assets used in Businesses X and Y is \$0 and \$100 million, respectively. Thus, the remaining \$28 million of interest expense is allocated to Business Y, a non-excepted business and subject to the section 163(j) limitation solely because the \$800 million basis in Building C is excluded from the calculation.

In this example, Building C is encumbered by only \$20 million of debt with respect to the \$800 million basis (or 2.5% of the basis) and much of the \$300 million unsecured debt may have been used to finance the purchase or improvements related to Building C. This seems to be an inappropriate result as it takes basis out of the calculation that the QNI was not used to finance. To avoid this noneconomic result, we recommend that, for purposes of allocating debt other than QNI, it would seem appropriate for the basis of a property subject to QNI to be reduced only by the amount of the nonrecourse indebtedness attributable to that property.

V. Treatment of Carried Forward Interest Upon RPTOB Election

A. Treatment of Disallowed Business Interest Expense Carried Forward under Former Section 163(j) Upon Subsequent RPTOB Election

1. Background

Prior to the enactment of the Act, a different interest disallowance regime existed under former section 163(j). Similar to new section 163(j), those rules contained a carryforward provision that treated disallowed interest expense as paid or accrued in a succeeding taxable year. Thus, it is possible that a RPTOB could have disallowed interest expense before January 1, 2018, that was carried forward under former section 163(j) to a taxable year beginning after the effective date of the new section 163(j) regime.

Notice 2018-28¹²³ noted this possibility and indicated:

Consistent with the approach of section 163(j)(1)(B) prior to the [Act] and section 163(j)(2), as amended by the [Act], the Treasury Department and the IRS intend to issue regulations clarifying that taxpayers with disqualified interest disallowed under prior section 163(j)(1)(A) for the last taxable year beginning before January 1, 2018, may carry such interest forward as business interest to the taxpayer's first taxable year beginning after December 31, 2017.¹²⁴

The Notice further states that “[t]he regulations will also clarify that business interest carried forward will be subject to potential disallowance under section 163(j), as amended by the [Act], in the same manner as any other business interest otherwise paid or accrued in a taxable year beginning after December 31, 2017.”¹²⁵ The Notice does not, however, address the treatment of these former section 163(j) carryforwards to the extent they are properly allocable to a RPTOB that elects in its first taxable year beginning after December 31, 2017, to be an Electing RPTOB excepted from the application of new section 163(j).

The Proposed Regulations define the term “disallowed disqualified interest” as “interest expense, including carryforwards, for which a deduction was disallowed under old section 163(j) in the taxpayer's last taxable year beginning before January 1, 2018,

¹²³ 2018-16 I.R.B. 492.

¹²⁴ *Id.*

¹²⁵ *Id.*

and that was carried forward pursuant to old section 163(j).”¹²⁶ Proposed Regulation section 1.163(j)-11(b)(1) provides:

Disallowed disqualified interest is carried forward to the taxpayer’s first taxable year beginning after December 31, 2017, and is subject to disallowance as a disallowed business interest expense carryforward under [new] section 163(j) and § 1.163(j)-2, *except to the extent* the interest is properly allocable to an excepted trade or business under § 1.163(j)-10. See § 1.163(j)-10(a)(6).¹²⁷

However, Proposed Regulation section 1.163(j)-10(a)(6) reserves on the allocation of disallowed disqualified interest to an excepted trade or business.

2. Recommendation

We recommend that Treasury and the Service clarify that if all of a taxpayer’s disallowed disqualified interest is properly allocable to a RPTOB that is permitted to, and does, elect out of new section 163(j) in its first taxable year beginning after December 31, 2017, then not only does all of that disallowed disqualified interest still carry over into that first year, but also all of that disallowed disqualified interest is fully deductible in that first year (*i.e.*, it is not subject to the limitation under new section 163(j)) unless another disallowance, deferral, capitalization, or other limitation provision prevents the otherwise allowable deduction for that interest expense.¹²⁸

3. Explanation

Proposed Regulation section 1.163(j)-11(b)(1) provides that disallowed disqualified interest carried forward from former section 163(j) *is subject to* disallowance under new section 163(j) *except to the extent* the interest is properly allocable to an excepted trade or business. Thus, if the carried forward disqualified interest is 100% allocable to a RPTOB that makes an election to be an Electing RPTOB in its first taxable year beginning after December 31, 2017, such interest ought to be deductible in full without regard to the limitation under section 163(j). However, because Proposed Regulation section 163(j)-11(b)(1) references Proposed Regulation section 1.163(j)-10(a)(6), and subparagraph (a)(6) is reserved, there may be a concern that the treatment of excepted trades or businesses under Proposed Regulation section 163(j)-11(b)(1) is itself reserved and therefore uncertain.

We believe that the reference to Proposed Regulation section 1.163(j)-10(a)(6) should be read in a more limited manner, relating solely to the way in which disallowed

¹²⁶ Prop. Reg. § 1.163(j)-1(b)(9).

¹²⁷ Prop. Reg. § 1.163(j)-11(b)(1) (emphasis added).

¹²⁸ In addition, we note that the way the language in Proposed Regulation section 1.163(j)-11(b)(1) is drafted may be ambiguous. That is, it is not clear whether the “exception” applies to the disallowance (*i.e.*, it effectively provides that carried forward interest allocated to a RPTOB is not subject to the business interest expense limitation under new section 163(j) after being carried over) or if it applies to the carrying forward of the interest in the first place. Given the context, the former appears to us to be the better reading. However, clarity on this point would be helpful.

disqualified interest is allocated between excepted and non-excepted trades or businesses where less than all of the disallowed disqualified interest relates to a RPTOB (*e.g.*, the disallowed disqualified interest relates to both a RPTOB, which is eligible to be an excepted trade or business, and another trade or business, which is not). That is, we believe that the reserved reference to the allocation provision of Proposed Regulation section 1.163(j)-10(a)(6) should be relevant only if the taxpayer had been, in years prior to the effective date of new section 163(j), engaged in one or more trades or businesses that would not qualify as a RPTOB in addition to being engaged in one or more trades or businesses that would qualify as a RPTOB. In that case, it seems it would be necessary to determine the amount of the disallowed disqualified interest properly allocable to the Electing RPTOB. No such uncertainty exists where 100% of the disallowed disqualified interest is properly allocable to a RPTOB that elects to be an Electing RPTOB in its first taxable year beginning after December 31, 2017. In that case, it seems the carried forward interest would not be subject to disallowance under section new 163(j) because it would be 100% allocable to an excepted trade or business as provided by Proposed Regulation section 1.163(j)-11(b)(1). We respectfully ask for clarification and confirmation of this point.

B. Treatment of Business Interest Expense Carried Forward under New Section 163(j) Prior to an Election to Be an Excepted Trade or Business

1. Background

The intended treatment under the Proposed Regulations with regard to a post-2017 disallowed business interest expense carryforward from a business that subsequently elects to become an Electing RPTOB or Electing Farming Business is unclear. Proposed Regulation section 1.163(j)-2(c)(1) provides that “any business interest expense disallowed under paragraph (b) of this section, or any disallowed disqualified interest that is properly allocable to a non-excepted trade or business under §1.163(j)-10, is carried forward to the succeeding taxable year as business interest expense that is subject to” limitation under section 163(j) in a succeeding taxable year. Proposed Regulation section 1.163(j)-2(c)(2) provides that disallowed business interest expense carried forward to a taxable year in which the Small Business Exemption applies to a taxpayer is not subject to the section 163(j) limitation in that taxable year.¹²⁹ Proposed Regulation section 1.163(j)-6(m)(3) provides that, “[i]f a partnership allocates excess business interest expense to one or more partners, and in a succeeding taxable year becomes not subject to the requirements of section 163(j), the excess business interest expense from the prior taxable years is treated as paid or accrued by the partner in the succeeding taxable year.” Examples illustrating these rules indicate that the interest is no longer subject to the section 163(j) limitation if the business subsequently qualifies for the Small Business Exemption; however, they do not address what happens if the trade or business becomes not subject to section 163(j) due to making a RPTOB Election.¹³⁰ Thus, it is not clear whether Proposed Regulation section 1.163(j)-6(m)(3) applies only to exempt small

¹²⁹ Prop. Reg. § 1.163(j)-2(c)(2).

¹³⁰ Prop. Reg. § 1.163(j)-6(o)(6), (7).

businesses or also could apply to a trade or business that becomes not subject to the requirements of section 163(j) by reason of making a RPTOB Election.

2. Recommendation

We recommend that Treasury and the Service clarify whether Proposed Regulation section 1.163(j)-6(m)(3) applies only to exempt small businesses or also applies to a trade or business that becomes not subject to the requirements of section 163(j) by reason of making a RPTOB Election.

3. Explanation

To provide certainty to Electing RPTOBs, we believe that Treasury and the Service should clarify whether it is intended that Proposed Regulations 1.163(j)-6(m)(3) apply with respect to a trade or business that elects to become an Electing RPTOB upon its becoming not subject to the requirements of section 163(j).