Novogradac
Journal of Tax Credits
News, Analysis and Commentary On Affordable Housing, Community Development and Renewable Energy Tax Credits
March 2018 • Volume IX • Issue III
Published by Novogradac & Company LLP

The Business Interest Limitation–Amended IRC Section 163(j)

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The recently enacted H.R. 1 includes a complex limitation on the deductibility of business interest.

The discussion below focuses on those aspects of the limitation relevant to partnerships that own properties qualifying for the federal low-income housing tax credit (LIHTC).

Calculation of the Limitation

Section 13301 of H.R. 1 limits the amount of "business interest" that may be deducted in any taxable year. "Business interest" is defined as interest paid or accrued on indebtedness "properly allocable" to the taxpayer's trade or business (excluding investment interest expense). The limitation (ignoring floor-plan financing interest, which is irrelevant to LIHTC partnerships) is an amount of business interest equal to the sum of the business interest income of the taxpayer for the taxable year plus 30 percent of the "adjusted taxable income" of the taxpayer (but not less than zero) for such taxable year.

For taxable years beginning before Jan. 1, 2022, "adjusted taxable income" is defined in relevant part as the taxable income from the taxpayer's trade or business (a) determined without regard to business interest or business interest income and (b) increased by depreciation, depletion and amortization. "Adjusted taxable income" is determined for later taxable years without adding back depreciation, depletion or amortization, the likely result of which would be a very low limit indeed.

Priority of Limitation

The Joint Explanatory Statement of the Committee of Conference of H.R. 1 states that the business interest limitation is subordinate to other Internal Revenue Code (IRC) provisions that may require deferral or capitalization of interest. For example, if accrued interest expense of a LIHTC partnership is subject to capitalization under IRC Section 263A, this capitalization requirement would take precedence over the limitation.

Partnership-Level Limitation

The business interest limitation of a partnership is calculated at the partnership level, such that the

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allowable business interest deduction is included in each partner's share of the partnership's nonseparately stated income or loss. Accordingly, the business interest limitation of each partner with respect to its other trades or businesses is generally determined without regard to its share of the partnership's income or loss (to avoid double-counting such income). Business interest of the partnership in excess of the limitation is not carried forward by the partnership–instead, it is allocated to each partner (expressly reducing basis and, by implication, capital account) and is thereafter carried forward by each such partner individually.

Such carried-forward business interest may only be offset by each such partner's share of the partnership's "excess taxable income." "Excess taxable income" of a LIHTC partnership is the amount bearing the same ratio to such partnership's adjusted taxable income as:

A. the excess of
   a. 30 percent of the partnership's adjusted taxable income over
   b. the amount by which the business interest of the partnership exceeds the business interest income of the partnership bears to
B. 30 percent of the partnership's adjusted taxable income.

Thus, if we assume A and B are equal partners in AB partnership and AB partnership has adjusted taxable income of $10,000 and business interest of $1,200 (net of business interest income), AB partnership's excess taxable income is as follows: 30 percent of $10,000 exceeds $1,200 of business interest by $1,800, yielding a ratio of 1,800/3,000 = 0.6. Multiplying adjusted taxable income of $10,000 by 0.6 yields excess taxable income of $6,000, which would be allocated $3,000 each to A and to B and can be offset by carried-forward business interest from the AB partnership by A and B. Excess taxable income allocated to a partner may only be used in calculating the business interest limitation of the partner's other trades or businesses if all excess business interest previously allocated to the partner from such partnership has been fully offset by the excess taxable income allocated to such partner (but such excess taxable income may not be used to offset excess business interest carryforwards derived from other partnerships).

If a partner disposes of its interest in a partnership at a time when it has an excess business interest carryforward, IRC Section 163(j)(4)(B)(iii)(II) provides that the amount of such carryforward is restored to the partner's basis in its partnership interest immediately before the disposition and the carryforward is thereupon terminated.

Election Out

A taxpayer that operates a "real property trade or business" as defined in IRC Section 469(c)(7)(C) (which would include a typical LIHTC partnership) may elect to opt out of the business interest limitation. Once made, the election is irrevocable, although there appears to be no restriction on when the election may be made. The consequence of such an election is that the taxpayer's residential rental property, nonresidential real property and qualified improvement property used in such real property trade or business must be depreciated using the alternative depreciation system (ADS). This ADS requirement does not extend to the taxpayer's other property, such that bonus depreciation may be claimed by the taxpayer for its qualified property that is not qualified improvement property (subject to the applicable phase-out of bonus depreciation).

ADS Recovery Period

For buildings placed in service after Dec. 31, 2017, H.R. 1 reduces the recovery period for residential rental property from 40 years to 30 years. Accordingly, given the immaterial difference between 27.5-year and 30-year recovery periods, it is likely that most LIHTC

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partnerships placing projects in service after Dec. 31, 2017 will benefit from electing out.

For existing developments, the analysis is more complex. It is unlikely the election out made by a partnership with an existing project would cause a new placement in service. For example, Treasury Regulation Section 1.168(i)-4(d)(4)(i) addresses the circumstance in which the cost recovery period of an existing asset must be extended due to a change in use of the asset. The regulation does not suggest that the change in use is a new placement in service–it simply prescribes a methodology for calculating the remaining depreciation. By analogy, the election out of the business interest limitation should not cause a new placement in service, such that an existing project would have to utilize the prior law 40-year ADS recovery period.

Thus, in determining whether a LIHTC partnership with an existing project should make the election out, the partnership must weigh the yield impact of the business interest limitation against changing depreciation from a 27.5-year to a 40-year cost recovery period.

One could reasonably argue that, if an election out is made, there is no valid policy reason for arbitrarily permitting a 30-year recovery period for new buildings while subjecting existing buildings to a 40-year recovery period. Unfortunately, the IRC includes no "good policy" exception to "arbitrary law," so while Treasury may have the authority to issue regulations that would permit existing projects owned by partnerships making the election out to use the new 30-year recovery period, in the absence of such regulations, H.R. 1 specifies a bright line placed-in-service date restriction that appears to preclude this result.

Equity Funds

In the case of an equity fund that invests in LIHTC partnerships, the business interest limitation, if applicable, would only apply only to interest on its own indebtedness, such as bridge financing to meet operating-tier capital contribution obligations. However, it is not clear whether such indebtedness is incurred in connection with a real estate trade or business or in connection with an investment activity that is not subject to the business interest limitation.

IRC Section 469(c)(7)(C) defines a real property trade or business as "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business." An equity fund does not own direct interests in a LIHTC development and typically is not actively involved in the development or management of such a project. If the IRS were to interpret "real estate trade or business" narrowly without tracing through the operating tiers, it could conclude that an equity fund is involved solely in investment activities. For example, in CCA 201504010 (Jan. 23, 2015), the IRS's chief counsel concluded that a mortgage broker was involved in a financing business, not a real property trade or business.

On the other hand, tracing has long been employed in classifying interest expense. In classifying interest expense as allocable to a trade or business, a passive activity, an investment expenditure, a personal expenditure or a portfolio expenditure, Treasury Regulation Section 1.163-8T(a)(3) provides that interest expense is allocated in the same manner as the debt to which it is attributable. It further states: "Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures." This would suggest that if an equity fund borrows money and contributes it to a LIHTC partnership and that LIHTC partnership uses the funds to cover construction costs of the project, the debt should be allocated to the LIHTC partnership's real estate business and the resulting interest incurred by the equity fund should retain that classification.

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This latter approach also seems less prone to circumventing the business interest limitation rules. For example, if an equity fund's interest expense is treated as investment interest that is not subject to the business interest limitation, one could envision structuring LIHTC project financing by using multiple tiers of partnerships incurring upper-tier mezzanine financing to minimize the business interest of the LIHTC partnership. Accordingly, it would seem that using a tracing concept would not only be consistent with Treasury Regulation Section 1.163-8T, it would also be less prone to manipulation. H.R. 1 does not clearly compel either interpretation and, accordingly, it falls to Treasury to provide guidance.❖

This article first appeared in the March 2018 issue of the Novogradac Journal of Tax Credits.

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ISSN 2152-646X

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