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CARES Act Changes to Section 163(j) for Partnerships

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The Coronavirus Aid, Relief, and Economic Security Act ("CARES Act") makes significant changes to the section 163(j) business interest expense limitation rules. Partnerships and partners should take these changes into consideration when formulating cash retention and transaction structure planning, as well as organizing compliance efforts.

On March 27, 2020, President Trump signed into law the CARES Act, which includes significant temporary changes to section 163(j).¹ These changes apply to tax years beginning after December 31, 2018.

Prior to the CARES Act, section 163(j) limited, in any given tax year, the amount a taxpayer could deduct for business interest to the sum of:

- The taxpayer's business interest income for the tax year,
- 30 percent of the taxpayer's adjusted taxable income ("ATI") for the tax year (the "30 percent ATI Rule"), and
- The taxpayer's floor plan financing interest for the tax year.²

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¹ Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

² Although all taxpayers with business interest expense are generally subject to the section 163(j) limitation, a real property trade or business (within the meaning of section 469(c)(7)(C)) owned by a taxpayer is not subject to the section 163(j)

The CARES Act replaces the 30 percent ATI Rule for tax years beginning in 2019 and 2020 by allowing non-partnership taxpayers (including S corporations) to deduct up to 50 percent of the taxpayer's ATI (the "50 percent ATI Rule"). Taxpayers can elect to not apply the 50 percent ATI rule.³

For any tax year beginning in 2020, taxpayers (including partnerships) can elect to compute their section 163(j) limitations based on ATI from the taxpayer's last tax year beginning in 2019 rather than the taxpayer's ATI from the 2020 tax year. If this election is made for a short 2020 tax year, the taxpayer's 2019 ATI will be prorated. For taxpayers with reduced taxable income in 2020 (e.g., caused by COVID-19), computing their section 163(j) limitations based on their 2019 tax year ATI will likely further increase the amount of deductible business interest.

Partnership-Specific Changes and Considerations

The CARES Act includes certain partnership-specific changes to section 163(j). The 50 percent ATI Rule does not apply to a partnership's tax year beginning in 2019, but it does apply to a partnership's tax year beginning in 2020. A partnership can elect not to apply the 50 percent ATI Rule for its 2020 tax year.

As noted above, for tax years beginning in 2020, a partnership can elect to apply its 2019 ATI to compute its section 163(j) limitation. However, this raises an issue as to how the 2019 ATI should affect the allocation among the partners in 2020 of the partnership's deductible business interest expense, as well as the partnership's excess business interest expense ("EBIE") or excess taxable income ("ETI") (ETI together with EBIE, the "Excess Items"). The partnership's 2019 ATI will not correspond to any of the partnership's 2020 tax year items of income, gain, loss, or deduction. The section 163(j) proposed regulations' 11-step method for allocating a partnership's deductible business interest expense and Excess Items looks to the allocation of the partnership's actual items composing ATI for the applicable tax year. This 11-step method will not function properly when the amount of the partnership's deductible business interest expense and Excess Items is determined based on the partnership's 2019 ATI rather than 2020 ATI. In particular, there may be differences in the amount of partnership items and the manner in which these items are allocated among the partners in the partnership's 2019 and 2020 tax years. We understand that Treasury is developing guidance in this area; however, when this guidance will be released is uncertain. Pending the receipt of guidance from Treasury, there may be multiple

limitation to the extent the taxpayer makes an election under section 163(j)(7)(B) (an "Excepted Business Election"). Under section 163(j)(7)(B), as well as the proposed regulations under section 163(j) issued on December 28, 2018, an Excepted Business Election is irrevocable. The IRS recently released Revenue Procedure 2020-22, 2020-18 I.R.B. 745, to provide guidance under section 163(j) to taxpayers who may be affected by the changes made in the CARES Act. Importantly, the revenue procedure allows an automatic extension of time for certain taxpayers to make an Excepted Business Election or to retroactively withdraw a timely filed Excepted Business Election for 2018, 2019, or 2020 tax years.

³ The new section 163(j) elections described in this article are intended to provide taxpayers with flexibility. If an increase to a taxpayer's deduction for business interest expense would result in negative tax consequences under another tax provision, such as section 59A (the base erosion and anti-abuse tax), a taxpayer may choose not to apply one or more of the CARES Act section 163(j) changes.

reasonable methods to consider that could be applied for purposes of modeling the impact of these provisions or for determining estimated taxes for 2020.

The CARES Act provides another potentially beneficial rule for partners: Unless a partner elects otherwise, for tax years beginning in 2020, the partner is allowed to treat 50 percent of the partner's 2019 EBIE as business interest that is "paid or accrued" by the partner (regardless of any ETI or excess business interest income ("EBII") allocation). Furthermore, this amount is not subject to any section 163(j) limitation in 2020 that otherwise may have applied at the partner level. Thus, partners will generally be able to deduct 50 percent of 2019 EBIE in 2020 (subject to any other limitations in the Code, such as the basis limitations under section 704(d), the at-risk rules under section 465, and the passive activity loss rules under section 469). In addition, this deductible amount of a partner's 2019 EBIE currently appears to be added back to compute the partner's 2020 ATI, giving the partner an additional increase to its 2020 ATI and section 163(j) limitation amount (provided the partner does not elect to apply the partner's 2019 ATI to compute the partner's 2020 section 163(j) limitation). It is possible that Treasury could limit the add-back of this amount in subsequent regulations. The remaining 50 percent of a partner's 2019 EBIE will be subject to the limitations of section 163(j) in the same manner as any other EBIE (i.e., not treated as paid or accrued by the partner until the partner is allocated ETI or EBII from the same partnership, and thereafter subject to limitation under section 163(j) at the partner level).

Taxpayers should note that certain partnership restructuring transactions, such as the taxable or nontaxable disposition of a partnership interest with respect to which the partner had EBIE in 2019, may preclude a partner from taking advantage of the treatment of 50 percent of 2019 EBIE as paid or accrued and deductible in 2020. For example, if a partner disposed of substantially all of its partnership interest in 2019, the partner would generally increase the partner's basis in the partnership interest immediately before the disposition by an amount equal to the partner's EBIE and would be unable to deduct that amount in 2020.

The tax results are less clear if a partner disposes of substantially all of its partnership interest during 2020. That is the case because section 163(j)(4)(B)(iii) precludes a partner from deducting any EBIE that results in an increase to the partner's basis in the partnership interest. The CARES Act change to section 163(j) appears to not prevent the partner from obtaining a basis increase attributable to 2019 EBIE for a disposition of substantially all the partner's interest in the partnership at any time during 2020, thus precluding a deduction of 50 percent of the partner's 2019 EBIE. While we believe the intent of the CARES Act was to allow the partner to deduct 50 percent of the partner's 2019 EBIE and reduce any basis increase resulting from a 2020 partnership interest disposition by this amount, the current statutory language presents uncertainty. Treasury is aware of this issue and may address it in future guidance.

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