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Time to Pay the Piper: Section 163(j) Considerations on the Disposition of Partnership Property and Partnership Interests

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Transactions that involve the disposition of partnership property or partnership interests may trigger rules that limit business interest expense deductions.

Section 163(j)[1] generally limits the deductibility of a partnership's business interest expense ("BIE") to an amount equal to its business interest income and 30 percent of its adjusted taxable income ("ATI"). Many taxpayers may be familiar with the timing provision that allowed a beneficial addback (the "Add Back") to ATI for depreciation, depletion, and amortization ("DD&A") during the 2018 through 2021 tax years (the "EBITDA period").[2] However, taxpayers may be less familiar with the requirement to reduce ATI by the Add Back if the partnership disposes of its property or a partner disposes of its partnership interest. Further, the reversal of the Add Back may be even more unexpected if the disposition is part of a nonrecognition transaction.

There are three main rules that govern the amount of the subtraction of DD&A from ATI—the General Rule, the Alternative Method, and the Cap on Negative Adjustment Rule.[3] For taxpayers that have any DD&A, these rules must be taken into account to determine their section 163(j) limitation. This article

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1 Section 163(j), in its current form, was enacted as part of the Tax Cuts and Jobs Act, Public Law 115-97 (2017). 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 It is unclear whether Congress will extend the Add Back rule to later years. However, if the Add Back rule is extended as part of future legislation, the discussion of the rules described below will have continued significance.

3 As defined below.

addresses the effect of these three rules that govern the amount of the subtraction of DD&A from ATI for partnerships and partners.

General Rule

The section 163(j) regulations generally require a partnership to reduce its ATI in the year of sale or other disposition of property by the greater of the allowed or allowable DD&A during the EBITDA period with respect to such property (the "General Rule").[4] Similarly, the section 163(j) regulations require a partner to reduce its ATI for its distributive share of DD&A during the EBITDA period upon the sale or other disposition of a partnership interest, but *only* with respect to property held by the partnership at the time of the sale or other disposition and only to the extent the deductions were allowable under section 704(d).[5]

Trap for the Unwary: Except when specifically excluded,[6] a "sale or other disposition" is not limited to taxable transactions and includes non-recognition transactions (e.g., transactions to which sections 351 or 721 apply). Taxpayers and their advisors should be aware that any transaction involving the transfer of assets by, or equity in, a partnership could cause the General Rule to apply.

Example 1

In 2022, partnership AB sells Property X, a property used in its trade or business, to an unrelated third-party for a gain of $1,500. Assume AB has no other items of taxable income except for the disposition gain. AB previously took depreciation deductions with respect to the disposed property in the amount of $1,200. Of the $1,200 depreciation deductions, $1,000 was incurred during 2018-2021 (the EBITDA period). In determining its ATI for section 163(j) purposes, AB starts with its disposition gain of $1,500, and then reduces its ATI by $1,000 for its DD&A incurred during the EBIDTA period.

Alternative Method

The section 163(j) regulations provide an elective alternative rule (the "Alternative Method") that limits the reduction to the partnership's ATI to the lesser of the gain recognized on the disposition of the property or the amount of the reduction required under the General Rule.[7] Similarly, on the sale or other disposition of a partnership interest, the ATI of a partner that elects to apply the Alternative Rule would be reduced by the lesser of the gain on sale or other disposition of the partnership interest or the reduction required under the General Rule.[8] Thus, when gain on sale is less than the DD&A (or when there is a loss on the sale), the Alternative Method may be beneficial. If a taxpayer applies this method

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4 Section 1.163(j)-1(b)(1)(ii)(C).

5 Section 1.163(j)-1(b)(1)(ii)(E).

6 Sections 1.163(j)-1(b)(1)(iv)(A)(1)-(3) provide specific exclusions for transfers of assets to an acquiring corporation when section 381(a) applies, all intercompany transactions within the meaning of section 1.1502-13(b)(1)(i), and de-consolidations described in section 1.502-13(j)(5)(i)(A).

7 Section 1.163(j)-1(b)(1)(iv)(E)(1). Versions of the Alternative Method were included in proposed section 163(j) regulations issued in 2018 and 2020. *See* proposed section 1.163(j)-1(b)(1)(ii)(C)-(E), 83 Fed. Reg. 67490 (Dec. 28, 2018); proposed section 1.163(j)-1(b)(1)(iv)(E), 85 Fed. Reg. 56846 (Sept. 14, 2020).

8 Section 1.163(j)-1(b)(1)(iv)(E)(3).

to any sale or other disposition, it must do so for all sales or dispositions for which an adjustment is required.[9] No election or disclosure is required to apply the Alternative Method.

Trap for the Unwary: The section 163(j) regulations expand the Alternative Method from proposed versions of the rule[10] to generally treat nonrecognition transactions as taxable dispositions when calculating the amount of gain recognized ("Taxable Nonrecognition Rule").[11] For example, a contribution of property to a partnership in a section 721 transaction may result in a reduction to the taxpayer's ATI even though no gain is actually recognized.

Example 2

Assume the same facts as Example 1, except that AB's disposition gain is $900 and AB uses the Alternative Method. In determining its ATI, AB's ATI would be reduced by $900 (i.e., the lesser of the disposition gain ($900) or the DD&A with respect to the disposed property during the EBITDA period ($1,000)). If AB had contributed the property to a lower-tier partnership instead of selling it to a third party, the result would be the same because the Taxable Nonrecognition Rule would apply in 2022.

Cap on Negative Adjustment

Lastly, the section 163(j) regulations limit the reduction to ATI of DD&A (determined under the General Rule or the Alternative Method) to the extent the "taxpayer" (the partnership or partner) establishes that the Add Back during the EBITDA period did not result in an increase in the amount of deductible BIE for that year (the "Cap on Negative Adjustment").[12] The Cap on Negative Adjustment is tracked cumulatively and is reduced in subsequent years to the extent it is taken into account by reducing ATI (i.e., effectively the benefit is recaptured as the taxpayer has dispositions). This rule was adopted in response to a comment suggesting that the reduction to ATI for DD&A is inappropriate if the taxpayer derived no benefit from the Add Back in prior years.[13]

The application of the Cap on Negative Adjustment rule to partnerships is not entirely clear and could be read to require partnerships to take into account all benefits from the Add Back, including the benefits that resulted to direct and indirect partners. For example, a partner may benefit from the partnership's Add Back if the partner is able to deduct additional BIE as a result of an allocation of excess taxable income ("ETI") generated by the partnership's Add Back. Section 163(j), however, generally applies at the entity level. Accordingly, the better view appears to be that the Cap on Negative Adjustment rule is intended to take into account only benefits to the direct taxpayer (i.e., the partnership). Moreover, because a partnership likely won't have information regarding its partners' other income or expense items, it generally would be impossible for a partnership to establish that none of its direct or indirect partners independently benefited from the Add Back.

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[9] Section 1.163(j)-1(b)(1)(iv)(E)(1).

[10] *See* note 7, *supra.*

[11] Section 1.163(j)-1(b)(1)(iv)(A)(4).

[12] Section 1.163(j)-1(b)(1)(iv)(F)

[13] T.D. 9943, 86 Fed. Reg. 5496, 5500 (Jan. 19, 2021).

The application of the Cap on Negative Adjustments rule for a taxpayer that sells or disposes of its partnership interest is also unclear. With respect to a partnership subject to section 163(j), a partner may receive an allocable share of deductible BIE and excess section 163(j) items from the partnership (i.e., excess business interest expense ("EBIE") or ETI and/or excess business interest income ("EBII")). In a tax year where a partner receives an allocable share of EBIE, the EBIE is not treated as paid or accrued until a succeeding tax year in which the partner is allocated ETI and/or EBII from the same partnership. However, in a tax year in which a partner receives an allocable share of ETI, the partner could benefit from the Add Back to the extent the ETI is attributable to the Add Back and results in deductible BIE at the partner level. Under those circumstances, if a partner sells or disposes of its partnership interest, the partner's Cap on Negative Adjustment should start with its share of the partnership's Cap on Negative Adjustment and be further adjusted to the extent its share of any excess section 163(j) capacity attributable to the Add Back results in an increase to the partner's deductible BIE.

In certain circumstances, the calculation of the benefit of the Add Back may be difficult to determine and track. Interestingly, the preamble to the final section 163(j) regulations issued in 2020 indicates that a Cap on Negative Adjustment rule was not adopted due to the "significant additional complexity" that would result. [14] Treasury and the IRS, however, reversed course with the final section 163(j) regulations issued in 2021.[15] Nevertheless, it appears that partnerships that fail to "establish" the lack of a benefit are not able to apply the Cap on Negative Adjustment rule. Advisors should have discussions with their clients regarding the complexity and cost required to calculate and track the Cap on Negative Adjustment.

Example 3

In 2021, partnership CD purchases a depreciable asset (Asset Y) for $30 and fully depreciates it under section 168(k). CD determines that its ATI before adding back the depreciation with respect to Asset Y is $30. After adding back its DD&A, CD's ATI is $60. CD incurs $12 of BIE in 2021. In 2023, CD sells Asset Y to an unrelated third-party for $40, recognizing $40 of gain.

CD's section 163(j) limitation for 2021 is $18 ($60 x 30%), so its entire $12 BIE is deductible. Without the Add Back, CD would only be able to deduct $9 ($30 x 30%) of BIE. The remaining deductible BIE of $3 is supported by a portion of the Addback. Therefore, CD benefits from the Add Back, but only to the extent of $10 of depreciation. That is, $10 of the $30 Add Back supports the remaining deductible BIE ($10 x 30%). Thus, the Cap on Negative Adjustment is $10, as CD does not benefit from the remaining $20 Add Back.

In computing its ATI for 2023, under the General Rule, CD would subtract $30 (the DD&A with respect to Asset Y for the EBITDA period). Use of the Alternative Method results in the same $30 reduction (i.e., the lesser of CD's $40 gain or $30 of DD&A). However, the Cap on Negative Adjustment limits CD's ATI reduction to $10.

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[14] T.D. 9905, 85 Fed. Reg. 56686, 56695 (Sept. 14, 2020).

[15] T.D. 9943, 86 Fed. Reg. 5496 (Jan. 5, 2021).

Allocation of Partnership Subtraction

There is no guidance as to how a partnership's subtraction for DD&A (as calculated under the General Rule, Alternative Method, or Cap on Negative Adjustment) should affect the partners' shares of partnership ATI under the 11-step process outlined in the section 163(j) regulations for allocating section 163(j) items (deductible BIE, EBIE, ETI, and EBII) among partners.[16] If the partners have the same percentage interest in profits, loss, and capital, then the determination of the impact may be straightforward. However, most partnerships today are not simple "straight up" partnerships. If the partnership agreement contains a complex distribution waterfall, special allocations of tax items, or section 704(c) allocations, for example, the partners' distributive shares of DD&A and gains on disposition of partnership property may vary. Depending on the facts and circumstances, there may be more than one reasonable approach to compute the partners' allocable shares of the DD&A subtraction. For example, it may be reasonable to allocate to a partner a portion of the partnership's DD&A subtraction amount equal to the partner's relative accumulated distributive share of DD&A for the EBITDA period. Other reasonable approaches might include allocating the subtraction amount in proportion to the partners' allocable share of pre-reduction ATI or the gain on the sale of the relevant property.

Example 4

In 2021, A contributes cash and B contributes section 704(c) property (Asset X) to partnership AB. The partnership chooses the traditional section 704(c) method with respect to Asset X. All section 704(b) and tax items are allocated equally except that the application of section 704(c) causes $1,000 of tax depreciation from Asset X to be allocated solely to A.

[see table on following page]

16 Section 1.163(j)-6(f)(2).

	Total	A	B
Gross income	$5,000	$2,500	$2,500
Depreciation	(1,000)	(1,000)	
BIE	(2,000)	(1,000)	(1,000)
Tentative taxable income	2,000	500	1,500
Addback depreciation	1,000	1,000	
Addback BIE	2,000	1,000	1,000
Partner's allocable ATI	5,000	2,500	2,500
Partner's allocable BIE	2,000	1,000	1,000
Partner's deductible BIE	1,500	750	750
Partner's EBIE	500	250	250

In 2022, AB sells Asset X for a gain of $1,500. All section 704(b) and tax items are allocated equally except that section 704(c) allocations cause the $1,500 of tax gain to be allocated solely to B. If AB allocates the DD&A subtraction based on relative accumulated DD&A relating to the EBITDA period, the entire subtraction is allocated to A and only A's allocable BIE is characterized, in part, as EBIE. If, instead, AB applies the DD&A subtraction in proportion to the relative gain on the disposed property, B is allocated all of the DD&A subtraction and A's and B's allocable BIE are characterized, in part, as EBIE.

[see tables on following page]

DD&A Subtraction Determined by Reference to Accumulated DD&A Relating to EBITDA Period

	Total	A	B
Gross income	$5,000	$2,500	$2,500
Gain	1,500		1,500
BIE	(2,000)	(1,000)	(1,000)
Tentative taxable income	4,500	1,500	3,000
Addback BIE	2,000	1,000	1,000
DD&A Subtraction	(1,000)	(1,000)	
Partner’s allocable ATI	5,500	1,500	4,000
Partner’s allocable BIE	2,000	1,000	1,000
Partner’s deductible BIE	1,650	650	1,000
Partner’s EBIE	350	350	

DD&A Subtraction Determined by Reference to Relative Gain of Disposed Property

	Total	A	B
Gross income	$5,000	$2,500	$2,500
Gain	1,500		1,500
BIE	(2,000)	(1,000)	(1,000)
Tentative taxable income	4,500	1,500	3,000
Addback BIE	2,000	1,000	1,000
DD&A Subtraction	(1,000)		(1,000)
Partner’s allocable ATI	5,500	2,500	3,000
Partner’s allocable BIE	2,000	1,000	1,000
Partner’s deductible BIE	1,650	750	900
Partner’s EBIE	350	250	100

Without any guidance with respect to the allocation of the DD&A subtraction among partners, it appears that taxpayers have flexibility to choose a reasonable method. Depending on the facts and circumstances, including whether there are varying interests among partners, special allocations or section 704(c) allocations, an approach for allocating the DD&A subtraction may be more favorable to certain partners than others. However, it seems that once an approach to allocating the DD&A subtraction is implemented, the partnership should consistently apply it going forward.

Section 743(b) Anomaly

The rules as written appear to contain a notable anomaly with respect to section 743(b) basis adjustments.

First, there is no guidance as to how the DD&A with respect to a partner's section 743(b) basis adjustment should impact the partnership's DD&A subtraction amount in the event the partnership sells or disposes of its assets. Generally, a partner's section 743(b) basis adjustment and section 704(c) remedial items are not taken into account by the partnership for section 163(j) purposes.[17] Here, the reduction in ATI is caused by the disposition of property by the taxpayer. Since there is no disposition of property by the partner, it does not appear that the DD&A associated with the partner's section 743(b) basis adjustment would be included in the partnership's DD&A subtraction.[18]

The General Rule, the Alternative Method, and Cap on Negative Adjustment also apply to the sale or other disposition of a partnership interest by a partner.[19] When a partner disposes of an interest in a partnership, the partner must reduce its ATI by its distributive share of the Add Back with respect to property held by the partnership at the time of the partner's sale or other disposition to the extent such amounts were allowable under section 704(d). Again, the rule does not appear to address the effect of section 743(b) basis adjustments. In addition to the partner's distributive share of the partnership Add Back, if a partner had a positive section 743(b) adjustment, the partner would have had DD&A deductions associated with the adjustment. While the additional deduction amounts were likely intended to reduce the partner's ATI, the DD&A associated with the partner's section 743(b) adjustment is not technically part of the partner's distributive share and, thus, the rule as written does not appear to require these amounts to be subtracted.

Potential Double Counting of DD&A Subtraction

As discussed above, when a partner sells a partnership interest, the partner is required to subtract the partner's distributive share of the Add Back from the partner's ATI. If the partnership subsequently sells the underlying property, the partnership also is required to reduce its ATI by the Add Back, thus resulting in at least a partial double counting of the Add Back. As written, the Cap on Negative Adjustment focuses on whether the Add Back, during the EBITDA period, benefited the taxpayer (i.e.,

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17 Section 1.163(j)-6(d)(2).

18 Further, partner basis items are taken into account as items derived directly by the partner in determining the partner's ATI for purposes of the partner's section 163(j) limitation. In other words, a partner's section 743(b) basis adjustment generally is not taken into account at the partnership level for section 163(j) purposes. Section 1.163(j)-6(e)(2).

19 Section 1.163(j)-1(b)(1)(ii)(E) (General Rule); section 1.163(j)-1(b)(1)(iv)(E) (Alternative Method); section 1.163(j)-1(b(1))(iv)(F) (Cap on Negative Adjustment).

the partnership). It does not consider whether the amount of the benefit to the partnership was subsequently recouped in whole or in part by a reduction to ATI by a partner. Without a regulatory fix, this rule can result in a reduction to ATI for the same DD&A twice, once by the partner and a second time by the partnership.[20] Moreover, if the historical partner has previously disposed of its interest, questions arise as to how the later subtraction by the partnership should be allocated among the existing partners. No rule addresses this fact pattern. It seems reasonable, however, for the transferee partner to step into the shoes of the transferor partner. Similarly, when a partner is redeemed by a partnership, it seems that the remaining partners would be allocated the DD&A reduction that would otherwise have been allocated to the redeemed partner.

Effective Date

These rules generally apply to partnerships for tax years beginning in 2022 and beyond.

Considerations

As a general matter, if partnerships do not already do so, they should track DD&A and consider the Cap on Negative Adjustment for the EBITDA Period (2018-2021 tax years) in order to determine the reversal amount when the partnership disposes of its property or to be in a position to provide this information to the partner at the time of the sale or disposition of the partner's interest. Sections 1245, 1254, and 1250 already require the tracking of each partner's accumulated distributive share of partnership DD&A by property in order for a partnership to properly determine the character of any gain on the disposition of its property. Similarly, sections 751(a), 751(b), 864(c)(8), and 1446(f) also require similar information in certain circumstances if a partner disposes of its partnership interest.

To the extent the partnership operates in multiple states,[21] it may need to consider state conformity to section 163(j) and federal DD&A methods (e.g., bonus depreciation and depletion) which may affect adjustments to ATI, if any.

Finally, and importantly, the administrative effort to comply with these rules likely may be significant and should be considered by taxpayers and their advisors.

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[20] If the rule is changed to allow the partnership to reduce its subtraction for DD&A by the amount previously subtracted by the transferor partner, query whether the rule could be similar to the section 1245 regulations, which generally allow a transferee partner to treat its share of depreciation adjustments prior the transfer date as zero. *See* section 1.1245-1(e)(3).

[21] For example, California does not conform to the federal special or bonus depreciation for qualified property acquired and placed in service.

