



February 26, 2019

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable William M. Paul
Chief Counsel (Acting)
Internal Revenue Service
1111 Constitutional Avenue, N.W.
Washington, D.C. 20224

RE: Comments to Proposed Regulations Concerning Section 163(j) of the Code (REG-106089-18).

Dear Assistant Secretary Kautter and Chief Counsel Paul:

The International Council of Shopping Centers (“ICSC”) appreciates the opportunity to provide comments on the proposed regulations titled “Limitation on Deduction for Business Interest Expense” under Section 163(j) of the Internal Revenue Code (hereinafter the “Proposed Regulations”).

Founded in 1957, ICSC is the global trade association of the shopping center industry. Our more than 70,000 members in over 100 countries include shopping center owners, developers, managers, investors, retailers, brokers, academics, and public officials. The shopping center industry is essential to economic development and opportunity. It is a significant job creator, driver of GDP, and critical revenue source for the communities it serves through the generation of sales taxes and the payment of property taxes. These taxes fund important municipal services like firefighters, police officers, teachers, and infrastructure such as roadways and parks. Shopping centers aren’t only fiscal engines—they are integral to the social fabric of our communities by providing a central place to congregate with friends and family, discuss community matters, and participate in and encourage philanthropic endeavors.

ICSC commends the Treasury and the IRS for the overall helpful and practical clarifications provided in the Proposed Regulations, including clarifications regarding (i) applying the real property trade or business exception at the operating entity level, (ii) the effect of capitalized interest, and (iii) the mechanical application of Section 163(j) in complex tiered structures.

As the Treasury and IRS finalize the Proposed Regulations we would request that the final regulations (“Final Regulations”) clarify the following additional items:

- I. Trade or business clarifications. Provide clarification with respect to the applicable interest deduction limitation regime in light of the common factual uncertainty as to what constitutes a Section 162 trade or business for rental real estate. Specifically clarify that the test for trade or business is the same for Section 163(j) generally as it is for the Section 163(j) Electing Real Property Trade or Business ("ERPTB") exception such that rental real estate is either eligible for making the ERPTB election or they are outside of Section 163(j) altogether because the interest is not business interest. This clarification should include corporate taxpayers owning rental real estate that are treated as being in a Section 163(j) business by virtue of being a corporation. We request that the clarification also allow taxpayers to make a protective ERPTB election if they consistently apply the conditions of that election.
- II. Real estate partnerships, the small taxpayer exception and the tax shelter rules. Narrowly define the tax shelter exception to the Section 163(j)(3) small taxpayer exception for taxpayers with average annual gross receipts of \$25 million or less so that real estate partnerships with net losses are not inadvertently excluded from the small taxpayer exception. Further, because of the factual uncertainty of this exception, we request that the clarification also allow taxpayers to make a protective ERPTB election if they consistently apply the conditions of that election. Finally, clarify that, if applicable, the small partnership exception exempts the partnership interest expense from the limitations of Section 163(j) at both the partnership and the partner level.
- III. Create a simplified version of the 11-step Section 163(j) calculation for simple partnerships. Provide a shortened version of the 11-step process (or examples of how the 11-step process applies in an abbreviated manner) for more simplified fact patterns that average taxpayers are able to understand and practically apply.
- IV. Guidance regarding Section 707(c) guaranteed payments for the use of capital. Remove the extension of the Section 163(j) regulatory scope to Section 707(c) guaranteed payments for the use of capital based on the statutory limitation to interest expense on indebtedness for which a guaranteed payment is neither and further given the material lack of guidance as to what is a guaranteed payment.
- V. Allow for the use of traditional Reg. §1.163-8T tracing principles. The Final Regulations should allow an alternative use of the more traditional Reg. §1.163-8T tracing rules commonly used for real estate partnerships for purposes of tracing interest expense to a trade or business.
- VI. Provide additional examples of the application of the ERPTB exception. Provide detailed examples of the mechanical application of the ERPTB exception, including the impact of an election (or lack of an election) at each tier of passthrough entity and the corresponding impact on depreciation.

I. Trade or Business Clarifications.

The Proposed Regulations apply the Section 162 definition of trade or business for purposes of Section 163(j). As has been discussed and commented on extensively in the Section 199A

area,¹ the vagaries in the application of Section 162 to rental real estate create material taxpayer uncertainty. The conclusion of whether rental real estate creates a trade or business has a two-fold application in Section 163(j). First and foremost, Section 163(j) does not apply unless the interest is trade or business interest. Thus, for a passive for-profit investment that is not a trade or business, the interest expense would instead be subject to the Section 163(d) investment interest limitations, which are less restrictive than Section 163(j). Second, to the extent that a taxpayer is under Section 163(j), one needs a trade or business to elect to apply the ERPTB exception.

We respectfully request that the Final Regulations provide needed clarity for rental real estate in the following manner.

(A) Either expand the Section 163(j) trade or business definition beyond traditional Section 162 principles to include all rental real estate or alternatively clarify that rental real estate that does not meet this standard does not create business interest subject to Section 163(j), which by its terms is limited to business interest expense.

(B) Clarify that corporate taxpayers that are deemed to be in a trade or business for Section 163(j) be consistently deemed to be in a trade or business for purposes of applying the ERPTB exception to passive real estate investments that may not otherwise meet the Section 162 standard of a trade or business.

(C) Allow taxpayers that are uncertain as to whether they meet the Section 162 standard of a trade or business to make a protective ERPTB election if they consistently apply the limitations that follow from such ERPTB election.

The above three clarifications avoid taxpayers being whipsawed by the legal uncertainty of what comprises a Section 162 trade or business while providing the IRS certainty that taxpayers electing into the ERPTB exception will consistently follow the related limitations of such election.

II. Real estate partnerships, the small taxpayer exception

The Syndicate Exception

Although section 163(j)(3) turns off Section 163(j) for taxpayers with average annual gross receipts of \$25 million or less, this small taxpayer exception does not apply to a "tax shelter" that is not permitted to use the cash method of accounting under Section 448(c). Section 448(d)(3) defines tax shelter for this purpose by reference to Section 461(i)(3), which in turn includes both Section 6662(d)(2)(C)(ii) tax shelters and "any syndicate (within the meaning of section 1256(e)(3)(B))." The definition of syndicate is extraordinarily broad and means any partnership or other entity if more than 35% of the losses of the entity during the tax year are allocable to limited partners or limited entrepreneurs. Because it is common for real estate partnerships to have at least 35% of the owners as either limited partners or limited entrepreneurs of a limited liability company, there is a material concern that net losses could have the unintended effect of disqualifying a large number of partnerships from the small business exception. The concern of syndicating losses to passive investors was removed by the Section 469 passive activity loss rules.

¹ See ICSC comment letter on Section 199A dated October 1, 2018 discussing the need for certainty for rental real estate and the definition of a trade or business.

We respectfully request that Final Regulations clarify that the term tax shelter for purposes of the Section 163(j)(3) exception be defined to either exclude or very narrowly limit a section 1256(e)(3)(B) syndicate from the tax shelter exclusion. At a minimum, the loss test in the syndicate rules should be limited to losses in the current year that are not otherwise limited under Section 469.

Protective ERPTB Election

Because of the factual uncertainty of the small partnership exception, some partnerships may wish to simply elect into the ERPTB exception as a protective matter, deciding that the tax detriment of depreciation limitations is worth the certainty that results as compared to being wrong about the application of the small partnership exception and later finding out that it was too late to make the ERPTB election. For this reason, we request that the Final Regulations allow taxpayers with rental real estate to make a protective ERPTB election if they consistently apply the conditions of that election.

Effect of Small Partnership Exception at Partner Level

Once the small taxpayer exception is applied at the partnership level, we request that the regulations clarify that the interest expense should not be tested again at the partner level. To do so would mean that the small partnership, which is supposed to be relieved of the burden of this complex rule, would essentially be thrown back into some of the complications of Section 163(j) in order to provide the required level of detail to its partners. Further, as the ERPTB exception is applied at the partnership level, applying the test again at the partner level would inappropriately deny the partners this exception because the small partnership would have been separately exempted and would have not made the election for the ERPTB exception.

III. Create a simplified version of the 11-step Section 163(j) calculation for simple partnerships.

The Proposed Regulations provide an extremely detailed and complex 11-step process for applying Section 163(j) to partnerships. We recognize that the complexity in the regulations stems from the statute itself and to factual variations implicating needed tracking of suspended losses, basis, and character in a hybrid entity-aggregate approach. However, for many partnerships this complexity is factually inapplicable, and yet they are only treated as being compliant after learning and applying this complex 11-step process.

We request that the Final Regulations include an alternate, simplified process for partnerships that lack the factual complexities that necessitate the 11-step "long form" process in the Proposed Regulations. For example, it may be possible to simplify by allowing certain partnerships to track suspended interest deductions at the partnership level and flow the deductions through in future years to the extent future partnership income allows the use of the prior interest expense. If it is not possible to create an alternative shortened process, we request that examples be added showing only the relevant steps applicable to certain simplified fact patterns so that taxpayers can look to those examples for their abbreviated step process.

IV. Guidance regarding Section 707(c) guaranteed payments for the use of capital.

Section 163(j) statutorily defines "business interest" subject to its limitations as "any interest paid or accrued on indebtedness properly allocable to a trade or business," which expressly

limits its scope to "interest" on "indebtedness." However, the Proposed Regulations extend the limitations to Section 707(c) guaranteed payments for the use of capital, which are neither interest nor do they relate to indebtedness. Further, because the current regulations under Section 707(c) are very unclear on exactly when a guaranteed payment occurs (particularly in the case of preferred returns on equity), this unauthorized extension creates material uncertainty in how taxpayers are to apply the law to partnerships. It is for these reasons that we respectfully request that the Final Regulations do not apply to Section 707(c) guaranteed payments, except possibly as an anti-abuse rule for taxpayers who have a principal purpose for the use of a Section 707(c) guaranteed payment as a substitute for true debt that would otherwise be subject to Section 163(j) limitations.

V. Allow for the use of traditional Reg. 1.163-8T tracing principles.

Prop. Reg. § 1.163(j)-10 provides 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 Section 163(j). Prop. Reg. § 1.163(j)-10(c) specifically allocates interest based upon the relative amounts of the taxpayer's adjusted basis in the assets as of a defined determination date based on certain alternative methodologies. Further Prop. Reg. § 1.163(j)-10(d) requires that a taxpayer with qualified nonrecourse indebtedness to directly allocate interest expense from such indebtedness to the taxpayer's assets, as provided in Reg. § 1.861-10T(b). The Preamble to the Proposed Regulations requests comments on what additional reasonable methods should be considered, specifically asking about the possible use of a tracing method similar to Reg. § 1.163-8T.

We respectfully request that taxpayers should be allowed to alternatively use the § 1.163-8T tracing method, as this is commonly used in real estate partnerships and would allow taxpayers to avoid a separate additional calculation. This change would also require a modification to the definition of qualified nonrecourse debt under Reg. § 1.861-10T(b)(2) for purposes of the direct tracing rule in Prop. Reg. § 1.163-10(d), to allow for Reg. § 1.163-8T tracing.

VI. Provide additional examples of the application of the ERPTB exception.

Real estate partnerships involve a variety of fact patterns, such as partnerships with additional mezzanine financing at the partner level, partnerships with real estate assets at both the partnership level and the partner level, and partnerships with different tax elections at the partnership and the partner levels. It would be helpful for the Final Regulations to include examples of the impact of the ERPTB exception particular to these various fact patterns, including the effect on depreciation lives. Examples showing the mechanical application of the ERPTB exception (or lack of an election) at each tier of ownership in the following fact patterns would be helpful:

(i) partnership owns real estate trade or business with ERPTB election but partner does not have ERPTB election.

(A) partner has no other real estate or debt;

(B) same as (i)(A) except that partner has additional mezzanine debt traceable to investment in the real estate partnership (with and without partner-level ERPTB election);

(ii) partnership owns real estate trade or business but partnership makes ERPTB election in a year after the taxpayer elected "bonus" depreciation under Section 168(k); and

(iii) application of Section 163(j) if partnership only owns rental real estate that does not rise to the level of a Section 162 trade or business (with and without protective ERPTB election requested above).

ICSC thanks you for considering the above comments. We welcome the opportunity to discuss these in more detail. For further questions, please contact Phillips Hinch, Vice President of Tax Policy, at phinch@icsc.org or (202) 626-1402.

Sincerely,

A handwritten signature in cursive script that reads "Tom McGee".

Tom McGee
President and Chief Executive Officer
International Council of Shopping Centers