It’s Dealer’s Choice With 163(j) for Filing Season

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By Eric Yauch

As the current tax filing season heats up, practitioners should be modeling the consequences of using the proposed business interest limitation regulations because they again have the option to apply them.

The same was true for the previous filing season, and it boils down to inputting the proposed regulations’ (REG-106089-18) interest allocation rules for partnerships — referred to as the 11-step process — into an Excel spreadsheet to see if they produce a more favorable result than using a different, but reasonable, method.

According to Glenn Dance of Holthouse Carlin & Van Trigt LLP, that doesn’t necessarily mean taxpayers that want to use the 11-step process have to adopt the proposed regulations in full. It can be more of an a la carte approach of picking and choosing which portions of the proposed regulations to use, he added.

“It’s not like we’re ‘electing’ to apply the proposed regs — we’re just using a methodology sanctioned by the IRS in those regs,” Dance said. “Sort of like assembling a [Beatles’] greatest hits collection by taking all of *Abbey Road* without ‘Octopus’s Garden,’” Dance said.

However, one could argue that approach appears to be in contrast to the effective date language in the proposed rules that states taxpayers “may apply the rules of these regulations to a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules,” which then reference the definition of interest and partnership sections.

Dance said he can see how the IRS would assert that the effective date language means taxpayers would have to take the good with the bad when using the proposed regulations, and he added that it would likely be the safest way to proceed. However, taking the “greatest hits” approach would be grounded in a procedural argument that the IRS can’t take a position contrary to their own proposed regs.

“To be honest, if that’s how they wanted it to work, I would have thought they would have needed to use more substantive language like ‘taxpayers may elect to apply’ rather than ‘taxpayers may apply these rules,’” Dance said.

Congress amended the business interest deduction in the Tax Cuts and Jobs Act so that it is limited to interest income and 30 percent of adjusted taxable income, generally. The limitation under the statute applies to taxpayers with an average of less than $25 million of gross receipts over the preceding three-year period, and the limit applies at the partnership level — an odd result because the partners pay the tax. Excess business interest income or expense items not usable in the tax year are carried forward at the partner level.

The partner-level allocation of interest and expense items was accomplished in the proposed regulations by the creation of the 11-step process that can be put into Excel and allocates the items of business interest income and expense to the partners. Dance said the process is a nod by regulation writers to the aggregate nature of partnerships, even though Congress decided to apply the limit at the entity level.

An Imperfect Workaround

According to Dance, some taxpayers have called the 11-step process an imperfect workaround that adds unnecessary complexity without providing relief to partners with less than $25 million of gross receipts. Those partners wouldn't be subject to the limit had the statute been drafted using aggregate principles, he added.

When the process came to light shortly after the rules were released, practitioners weren't particularly fond of it — one referred to it publicly as "an abomination."

Jon Finkelstein of KPMG LLP agreed there was some initial concern about the complexity of the 11-step process, but he said some of the concern has been alleviated after many taxpayers developed spreadsheets to apply it.

"However, application of the 11-step process as a safe harbor methodology in the final regulations would still be welcomed," Finkelstein added.

Finkelstein said he generally believes the process produces a result that would also align with a reasonable interpretation of the section 163(j) statutory provisions.

"As such, it does not seem that allocating deductible business interest expense and section 163(j) excess items in a manner that is consistent with the result of the application of the 11-step process would constitute an election to adopt the proposed regulations," Finkelstein added.

Practitioners may soon have another round of section 163(j) regs to work with. Final regulations are at the Office of Management and Budget for review, which means they could be released publicly within weeks. Government officials recently discussed possibly scaling back the broad definition of interest, which in the proposed regulations included partnership guaranteed payments for the use of capital.

If the final regulations are released with a narrow definition of interest but with tweaks to the 11-step process, practitioners will again have to model that out to see which sets of rules to use when preparing 2019 tax returns.

Finkelstein said a lot would depend on the applicability language in the final regulations. But, he added, it seems that if final rules scaling back the definition of interest to exclude guaranteed payments for the use of capital and changing the 11-step process were released within weeks, taxpayers would likely be in a similar position to the one they were in with just the proposed regulations.

In other words, taxpayers would likely be allowed to apply a reasonable interpretation of the statute, which might include a determination that guaranteed payments for the use of capital are inconsistent with the definition of interest. Finkelstein said the taxpayer could also just apply a reasonable allocation method that could comply with what Treasury ultimately decides in final regulations but wouldn't necessarily have to.

It Makes Sense

Stefan Gottschalk of RSM US LLP said his firm follows the 11-step process mostly because once it's plugged into Excel, it makes sense.

"I haven't heard anybody say it doesn't make sense," Gottschalk said.

Gottschalk added that if taxpayers don't necessarily want to strictly follow the 11-step process in the proposed regs, they are likely going to analogize and look to other rules under section 704 for allocating interest and section 163(j) items. One set of rules that could be helpful in the allocation of interest process is section 704(c), which he said could be used if practitioners wanted to "recreate the wheel" and come up with their own interest allocation method.

But Gottschalk said it's uncommon for clients to go outside the proposed section 163(j) regulations because the 11-step process is an efficient method of doing tax compliance that's hard to beat.

However, there could be partnerships with unusual circumstances that make following the proposed regulations difficult, and Monte Jackel of Jackel Tax Law said what can be done in that scenario would depend on how the final regulations are written.

One common scenario would be if a taxpayer has guaranteed payments for the use of capital, which means the taxpayer must include them as interest to rely on the proposed 11-step process if it's different from the allocation process in the final regs.

"If the final regs say you must apply the proposed regulations in their entirety, that is even clearer," according to Jackel. The same goes for if the final regulations say taxpayers must use either the proposed regs or final regs in their entirety, he said, adding that even a reasonable position type of approach wouldn't work — absent challenging the validity of the final regulations and filing a Form 8275-R, "Regulation Disclosure Statement."