March 18, 2019

The Honorable David Kautter
Assistant Secretary of the Treasury (Tax Policy)
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

The Honorable Michael Desmond
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

CC:PA:LPD:PR (REG-106089-18)
Room 5203
Internal Revenue Service
P.O. Box 7604
Washington, D.C. 20224

Re: Comments on Proposed Regulations Regarding the Limitation on Deduction for Business Interest Expense (REG-106089-18)

Dear Sirs,

We are writing to provide comments on proposed regulations under Internal Revenue Code Section 163(j) on behalf of the members of the National Multifamily Housing Council (NMHC) and the National Apartment Association (NAA) who represent the $1.3 trillion apartment industry and its nearly 39 million residents. We would like to take this opportunity to discuss a few issues that affect the real estate industry that should be addressed so that the final regulations reflect Congressional intent. Specifically, we would like to discuss the interaction between: (1) the small business exception and the real estate trade or business election; and (2) the application of the REIT safe harbor to certain controlled partnerships.

For more than 20 years, NMHC and NAA have partnered to provide a single voice for America's apartment industry. Our combined memberships are engaged in all aspects of the apartment industry, including ownership, development, management and finance. NMHC represents the principal officers of the apartment industry's largest and most prominent firms. As a federation of 160 state and local affiliates, NAA encompasses over 75,000 members representing 9.25 million rental housing units globally.

Treatment of small real estate trades or businesses

Section 163(j), as modified by the Tax Cuts and Jobs Act ("TCJA"), limits a taxpayer's deduction for business interest expense to 30 percent of adjusted taxable income (ATI). TCJA provided exceptions from the limitation for various trades and businesses, including small businesses (as defined in Section 163(j)(3)) and any electing real property trade or business (as defined in Section 163(j)(7)(B)). We are writing to discuss the interaction between the rules for small businesses and an electing real property trade or business.

The proposed regulations provide that a business that meets the definition of a small business cannot elect to be treated as an electing real property trade or business. The proposed regulations further provide that a small business is not subject to Section 163(j) limitations at the entity level. However, if such small business is a partnership or an S corporation, business interest expense flows through to the partners or shareholders as a separately stated item for purposes of determining whether they are

subject to Section 163(j) at the partner or shareholder level. Thus, a partner or shareholder who does not itself meet the small business definition may be subject to interest disallowance from interest flowing from an interest in a small business (even if that business could otherwise be an electing real property trade or business).

The proposed regulations provide different results for a partnership or an S corporation that otherwise could be an electing real property trade or business, depending on whether the entity is a small business. If the electing real property trade or business is not a small business, the Section 163(j) limitation does not apply at the entity level (similar to the treatment of a small business). However, the business interest expense does not flow through to the partners or shareholders as a separately stated item for purposes of their Section 163(j) determinations. As a result, partners or S shareholders of real estate businesses generally are treated better if their partnership or S corporation does not qualify as a small business than if it did qualify (ignoring the depreciation adjustment).

It is difficult to believe that Congress intended that: (1) small businesses should be treated worse than large businesses; and (2) entities that qualify for two exemptions (as small businesses and as electing real property trades or businesses) should be treated worse than entities that qualify for one exemption (as an electing real property trade or business).

We believe that the treatment of a flow-through entity that qualifies as both a small business and an electing real property trade or business under the proposed regulations is inappropriate, conflicts with Congressional intent, and is not required under the statute. We respectfully request that Treasury modify the proposed regulations in one of the following ways: (1) provide that business interest expense of a partnership or S corporation that qualifies as a small business does not flow-through to partners or shareholders for purposes of determining any Section 163(j) limitation of the partners or shareholders; (2) allow a small business to elect to be an electing real property trade or business if it so qualifies, and apply the look-through rules to the partners or shareholders of such small business partnership or S corporation; or (3) allow partners and shareholders who receive Section 163(j) flow-through items from a small business to make the real estate trade or business election for such items at the partner or shareholder level.[1]

Section 163(j)(3) exempts a small business from the application of the business interest limitation of Section 163(j)(1). Neither the Internal Revenue Code nor the legislative history indicate that the Section 163(j) attributes of an exempt flow-through small business are revived and taken into account by the owners of the business. In fact, the statutory scheme would seem to indicate the opposite. Section 163(j)(4) provides rules applicable to partnerships and S corporations. Section 163(j)(4) provides that "subsection [j] shall be applied at the partnership level and any deduction for business interest shall be taken into account in determining the non-separately stated taxable income or loss of the partnership." Section 163(j)(4) is not limited to partnerships that do not qualify as small businesses.

Section 163(j)(4) indicates Congress' preference to apply an entity, rather than an aggregate, approach to applying the business interest limitation rules. The exemption for a small business at the entity level should end the inquiry. Business interest of a small business is fully deductible at the entity level and is to be taken into account in determining a partner's non-separately stated taxable income or loss from the partnership. Nowhere in the statute or the legislative history is there a suggestion that the business interest of a small business should become a separately stated item that is tested at the partner level.

[1] Under the third option, the partnership or S corporation would make a determination whether it could be an electing real estate trade or business but for its status as a small business. If it is eligible, it would provide such information (along with any necessary depreciation adjustments) to its partners or shareholders for purposes of their potential election.

The proposed regulations create situations where the business interest expense of a small business partnership or S corporation becomes limited at the partner or shareholder level, contrary to this statutory scheme and Congress' intent to exempt small businesses.

Further, there is nothing in the statute or the legislative history to indicate that a small business is precluded from making an election to be an electing real property trade or business. The Secretary has the authority to prescribe the timing and manner of the election, but not to provide any additional conditions relating to size, as prescribed by the proposed regulations. The election comes with a cost (i.e., the required use of the alternative depreciation system) and is irrevocable. Because status as an electing real property trade or business can be more restrictive than status as a small business for purposes of Section 163(j), Treasury and IRS should not be concerned if small businesses are allowed to make the election. In addition, the real estate trade or business election provides taxpayers with certainty. A taxpayer generally can control whether it is engaged in a particular trade or business. It cannot as accurately control the amount of its gross receipts on an annual basis.

The preamble to the proposed regulations does not explain the rationale for precluding small businesses from making the real estate trade or business election. The Section 448 aggregation rules do not allow a taxpayer that does not qualify as a small business to divert assets to a flow-through entity so that both the entity and the taxpayer qualify for the small business exception. If Treasury and IRS are concerned about some other abuse, perhaps it is better addressed specifically, or through the anti-avoidance rules.

Partnership interests of certain REITs

A significant amount of residential real property is held by REITs. REITs allow for the general public to invest in real estate and should be encouraged both as a source of investment capital and as a means of investment diversity.

REITs must distribute most of their taxable earnings to retain their status. Interest expense disallowance can present a significant concern if the effect of the disallowance requires REITs to distribute taxable income that does not correlate with economic income or cash flow. In that regard, we appreciate that the proposed regulations provide a safe harbor that treats a REIT as qualified to be an electing real property trade or business.[2]

A significant number of REITs are structured as "UPREITS," whereby the REITs hold significant interests in partnerships as both a general and limited partner. The partnerships themselves hold most of the actual real property interests, and most of the interest expense in the UPREIT structure is at the partnership level. It does not appear that the proposed regulations apply the REIT safe harbor to a partnership controlled by a REIT.

We request that the REIT safe harbor be made available to any partnership where the REIT owns a significant interest in the partnership (say, more than 50 percent). This would provide similar treatment between REITs that own real property directly and REITs that own real property indirectly through a partnership, as well as reduce the administrative burden on UPREIT structures.

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[2] Prop. Treas. reg. sec. 1.163-9(g)(2).

NMHC and NAA thank you for considering our views. Please feel free to contact Cindy Chetti, NMHC's Senior Vice President of Government Affairs, at 202-974-2300 or Greg Brown, NAA's Senior Vice President of Government Affairs, at 703-518-6141, should you have any questions.

Sincerely,

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National Multifamily Housing Council

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