The Real Estate Roundtable

February 26, 2019

The Honorable David J. Kautter
Assistant Secretary of Tax Policy
U.S. Department of Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable William M. Paul
Chief Counsel (Acting)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Limitation on Deduction for Business Interest Expense (REG-106089-18)

Dear Assistant Secretary Kautter and Chief Counsel Paul:

On behalf of The Real Estate Roundtable, I am pleased to provide comments regarding proposed regulations limiting the deductibility of business interest under section 163(j).

No issue in tax reform is more important to the health and stability of U.S. commercial real estate than the new rules related to the taxation of business-related borrowing. U.S. commercial real estate is leveraged conservatively with roughly $14 trillion of total property value[1] and $4 trillion of debt.[2] The economic consequences of changes to the deductibility of business interest expense, and particularly the potential impact on real estate, was a central focus of lawmakers during consideration of tax reform. The need to preserve the deduction for business interest expense for income-producing real estate was at the center of my testimony and my exchanges with Senate Finance Committee Chairman Orrin Hatch and other members of the committee at the last congressional hearing on business tax reform prior to votes on the *Tax Cuts and Jobs Act*.[3]

[1] NAREIT, *Estimating the Size of the U.S. Commercial Real Estate Market* (May 2018).

[2] Federal Reserve Board of Governors, *Financial Accounts of the United States: Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts, Third Quarter 2018* (Dec. 6, 2018).

[3] Business Tax Reform: Hearing Before the S. Comm. on Finance, 115th Cong. (Sept. 19, 2017), at 14-15.

In passing *TCJA* and the new limitation on the deductibility of business interest expense, Congress understood that debt is a fundamental part of the capital structure of a typical real estate business. Congress further understood that broad restrictions on the deductibility of interest expense would alter the underlying economics of commercial real estate. Taxpayers would shelve new projects otherwise economically feasible, along with the jobs and productive assets they would create. Lenders would not approve many real estate refinancing transactions. Applied retroactively to existing real estate debt, changes in the business interest deduction could have dramatic, severe, and unintended consequences for real estate markets and values—not unlike the overreaching changes in the *Tax Reform Act of 1986* that led to widespread real estate defaults. Other factors specific to real estate debt further mitigated the general policy concerns with the deductibility of borrowing costs. For example, real estate debt is related to a long-lived asset, which reduces economic risk. In addition, real estate is held predominantly in pass-through form, which reduces the tax distortion between equity-financed and debt-financed investment—a principal concern of lawmakers.

For these reasons and others, the final bill included a robust exception from the business interest limitation for electing real estate businesses. We commend Treasury for issuing proposed regulations that largely preserve the real estate exception that Congress intended. For example, the attribution rules for partner-level debt, and the clarification that an election by a partnership does not bind a partner with respect to any trade or business conducted by the partner outside of the partnership, were much-needed and welcome clarifications.

In light of the clear legislative intent to enact a broad real estate exception and its importance to the health and stability of real estate markets, the final Treasury regulations should build on the proposed rules and not limit unnecessarily the ability of a real property trade or business (RPTOB) to elect out of the provisions of section 163(j).

Specific Comments

I. Real Estate Exception in the Context of Tiered Structures

We commend Treasury for including provisions in the proposed regulations that treat interest on debt incurred by a partner to fund an investment in a partnership engaged in a real property trade or business as interest on debt allocable to that trade or business. The proposed regulations include other important attribution provisions in this area applicable to stock of S corporations and, in certain circumstances, stock of C corporations. For example, an S corporation shareholder may treat its interest expense on debt that is allocated to its shares in the S corporation as attributable to a real property trade or business to the extent the assets of the S corporation are attributable to a real property trade or business.

We recommend that final regulations clarify that interest may be treated as allocated to a real property trade or business to the extent the interest is attributable to an equity interest in an entity that is an electing real property trade or business. The final regulations should end the disparate treatment across structures and eliminate unnecessary complexity by providing a uniform "look-through" approach and by modifying the proposed rules that provide for attribution only if certain ownership thresholds are met. Expanded attribution rules would recognize the diversity of real estate ownership arrangements and ensure that taxpayers investing in a real property trade or business, directly or indirectly, qualify for the exception Congress intended to provide. In particular, we note that the inability of a REIT shareholder to allocate interest expense on debt incurred to acquire the stock of a REIT[4] that is engaged in a real property trade or business would cause adverse consequences that the real property trade or business exception was intended to avoid.

[4] A REIT is required to be taxed as a corporation for U.S. federal income tax purposes. As a result, the proposed regulations do not allow the debt incurred to acquire the stock of a REIT that is an electing RPTOB to be considered allocated to a RPTOB unless such stockholder owns at least 80% of such stock.

II. Non-Rental Activities and the Real Estate Exception

In contrast to the operative provisions of the proposed regulations, the preamble suggests that eligibility for the real estate exception will be limited to trades or businesses involved in rental real estate activities.[5] The only justification offered for such a limitation is an assertion in the preamble that Congress was focused on providing relief to entrepreneurs in businesses with some nexus to or involvement with rental real estate when section 469(c)(7) was enacted. If given effect in the operative provisions, the statement in the preamble could prevent businesses involved in non-rental activities, such as the development and construction of condominiums and other forms of non-rental real estate, from qualifying for the real estate exception.

The statute and legislative history do not support the preamble's assertion that a trade or business must relate to "rental real estate" in order to qualify as an electing real property trade or business. The new law defines an eligible trade or business as "any trade or business which is described in section 469(c)(7)(C) and which makes an election under this subparagraph." I.R.C. §163(j)(7)(B). Section 469 defines a real property trade or business as "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business." I.R.C. §469(c)(7)(C). Rather than referencing section 469, the statement of the conferees included the full text of the definition:

> [A]t the taxpayer's election, any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business is not treated as a trade or business for purposes of the limitation, and therefore the limitation does not apply to such trades or businesses.

Conf. Rpt. to H.R. 1, Tax Cuts and Jobs Act (Dec. 15, 2017), at 391 (hereinafter Conf. Rpt.).

There is no evidence that Congress intended to restrict the definition of a real property trade or business beyond the terms of the statute and conference report, which expressly references non-rental activities such as development and construction. The actual inclusion of the term "rental" in the list of covered activities in section 469(c)(7)(C) and the statement of the conferees suggests that rental real estate is just one of several activities covered under the definition, rather than an umbrella term that limits all others. Moreover, in a footnote accompanying the description of the provision, Congress clarified that it intended for the exception to cover activities that might otherwise be questioned under a strict reading of the definition, including a real property trade or business conducted by a corporation or a REIT, as well as a trade or business that operates or manages a lodging facility. Conf. Rpt. at Fn 697. The same footnote clarified that Congress did not intend to limit the real estate exception by applying other elements of section 469 to the definition. *Id*.

Where the terms of the statute and legislative history are clear, as they are here, Treasury should not read-in a restriction that relies on an interpretation of the intended beneficiaries of relief enacted over 25 years ago. The relief referenced in the preamble was part of a broader statutory change and relates to an entirely different tax issue—whether certain real estate losses are treated appropriately as passive or active.[6]

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[5] "Given Congress's focus in enacting section 469(c)(7) to provide relief to entrepreneurs in real property trades or businesses with some nexus to or involvement with rental real estate, these proposed regulations would not include trades or businesses that generally do not play a significant or substantial role in the creation, acquisition, or management of rental real estate in the definition of real property trade or business under section 469(c)(7)(C)." 83 Fed. Reg. 67490, 67524 (Dec. 28, 2018) (Preamble to Proposed Regulations for Limitation on Deduction for Business Interest Expense).

[6] As a separate and narrower issue, the proposed regulations indicate that only a "direct or indirect owner of the real property" can engage in "real estate operations", seemingly excluding operators with a leasehold interest in the real property. Prop. Treas.

III. Corporations and the Real Estate Exception

Under the proposed regulations, debt incurred directly or indirectly by a C corporation automatically is treated as trade or business debt subject to the business interest limitation in section 163(j). At the same time, real estate activity financed with the same debt may not constitute a trade or business for purposes of the real estate exception. Depending on how the rules are interpreted, this could lead to a "whipsaw" result unintended and unforeseen by Congress in which a taxpayer's interest deduction is limited because the debt is considered allocable to a trade or business, but the debt is not eligible for the real estate exception because the activity financed with the debt is not considered a trade or business.[7]

In contrast, in the case of an individual borrower, if a real estate activity does not rise to the level of a trade or business, then the debt allocable to that activity is not treated as business debt subject to the business interest limitation. Such interest expense is not considered investment interest expense under section 163(d), but it remains deductible by the individual borrower under section 62(a)(4) and subject to the passive loss rules of section 469.[8]

It is critical that the final regulations address this issue and avoid an unfair tax result that targets specific types of entities. The term "trade or business" should be defined consistently for purposes of section 163(j) and for purposes of the definition of a real property trade or business. If a taxpayer is treated as engaged in a "trade or business" for section 163(j) purposes generally, then the taxpayer also should be treated as engaged in a "trade or business" for purposes of the definition of a real property trade or business. A C corporation automatically is treated as engaged in a "trade or business" for purposes of determining whether its interest is business interest, and therefore, should always be eligible to make the RPTOB election with respect to debt allocable to its interest in an entity engaged, directly or indirectly, in one of the enumerated activities in the RPTOB definition, even if the activity does not give rise to a trade or business at the entity level.

IV. Anti-Abuse Rule for Certain Real Property Trades or Businesses

The proposed regulations contain a rule providing that a real property trade or business will not be eligible to make the real property trade or business election if at least 80 percent of the business's real property is leased to a trade or business that is under common control with the real property trade or business.[9] The proposed rules provide an exception for leases by a REIT of qualified lodging facilities or qualified healthcare properties to a taxable REIT subsidiary.

Reg. §1.469-9(b)(2)(ii)(H). A taxpayer who holds real property as a lessee should be able to engage in real property operations with respect to such leasehold interest.

[7] Prop. Treas. Reg. §1.163(j)-10(c)(5)(iii) provides that a C corporation partner's share of partnership assets that are not properly allocable to a trade or business will be treated as "properly allocable to an excepted or non-excepted trade or business with respect to such partner in the same manner that such assets would be treated if held directly by such partner." In many cases, this may address the concern by allowing a corporate taxpayer to treat a real estate activity that does not constitute a trade or business at the partnership level as a trade or business at the level of the corporate taxpayer. In such situations, the corporation would be subject to section 163(j), but could make the real estate election out of the limitation. Final regulations should clarify the scope and application of this provision.

[8] I.R.C. §163(d)(3)(B)(ii).

[9] Prop. Treas. Reg. §1.163(j)-9(h)(1).

We note that, in many situations, REITs own qualified lodging facilities and qualified healthcare properties through partnerships, and the exception in the regulations technically would not apply to such arrangements. More broadly, we question the need for an anti-abuse rule in situations where the separate real estate rental and operating businesses could qualify for the RPTOB exception on an aggregated basis. Lodging and assisted living facilities are prime examples of such situations. The anti-abuse rule should not apply to situations in which the entities, if combined and without a lease, would qualify as a RPTOB.

V. Small Business and Real Estate Exceptions

Generally, taxpayers with average annual gross receipts in the three prior years that do not exceed $25 million are exempt from the new limitation on the deductibility of business interest expense. The preamble to the proposed regulations indicates that a partnership that qualifies for the small business exception is ineligible to be an electing RPTOB, even if it is engaged in a real property trade or business. The proposed regulations do not allow interest to be allocated to an exempted business of a partnership that qualifies for the small business exception even if the business qualifies as a RPTOB. However, the tax attributes of an excepted small business that is organized as a partnership, including interest expense, flow up to the partners. The partners themselves may not qualify for the small business exception. At the same time, assuming the RPTOB election must be made at the partnership level, the partners are unable to elect out of the business interest limitation, even though the relevant debt is allocable to a RPTOB. The small business exception effectively preempts otherwise qualifying taxpayers from making the RPTOB election.

The final regulations should clarify that the small business exception does not prevent taxpayers from electing out of the business interest limitation under the real estate exception and that a small business may elect to allow its partners to "look through" the small business for purposes of interest allocation. This clarification would allow a partnership to ensure that all of its partners qualify for the relief Congress intended to provide under the rules for an electing RPTOB.

VI. Nonrecourse Debt and Basis Allocation

Final regulations should ensure that the basis allocation rules do not generate an uneconomic and unfair result in which a small amount of qualified nonrecourse debt results in an entire property being removed from a taxpayer's basis allocation computation. For example, assume a taxpayer has: (a) $500,000 of unsecured indebtedness; (b) a property in a RPTOB with a value and basis of $1 million and $100,000 of secured indebtedness that is qualified nonrecourse indebtedness (within the meaning of Treas. Reg. §1.861-10T); and (c) a non-RPTOB with a value and basis of $1 million. Under the proposed regulations, the entire $500,000 of unsecured debt is allocated to the non-RPTOB because the $100,000 of secured indebtedness means the $1 million RPTOB property is removed from the basis allocation computation.[10] The qualified nonrecourse debt should result only in the removal of basis up to the amount of the nonrecourse debt.

VII. Senior Housing and the Real Estate Exception

Consistent with Congressional intent, the final regulations should remove any uncertainty and clarify that the operation or management of residential rental property for the elderly is not excluded from the definition of a real property trade or business merely because the business provides necessary supplemental assistive services that meet the needs of seniors.[11] The purpose of seniors housing is to provide residences that meet the needs of our aging population. Services that are provided in senior living properties are a necessary part of the RPTOB of providing a

[10] Prop. Treas, Reg. §1.163(j)-10(d)(4) and (5), Example.

safe place for seniors to live. The final regulations should include a specific example addressing seniors housing under the real property trade or business definition along the lines recommended in the comments provided by the American Senior Housing Association.

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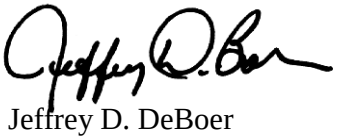
The Real Estate Roundtable is appreciative of your deliberate approach to tax reform and its implementation. We are grateful for the open dialogue on these issues with you and your staff. We look forward to continuing to work with you to accelerate economic growth, create jobs, and improve local communities.

Sincerely,



Jeffrey D. DeBoer
President and Chief Executive Officer

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[11] *See* Congressional Record (Dec. 19, 2017) at S8109 (transcript of colloquy between Senator James Lankford and Senate Finance Committee Chairman Orrin Hatch); Jt. Comm. on Tax'n, *General Explanation of Public Law 115-97* (Dec. 2018), at 178, n. 883 ("a real property operation or a real property management trade or business includes the operation or management of a lodging facility, *including a lodging facility that provides some supplemental services, such as an assisted living facility*") (emphasis added).