THIS ARTICLE WAS WRITTEN BY CHRISTOPHER HANEWALD WHILE HE WAS WORKING AT THE CBIZ ACCOUNTING FIRM.

Real Estate Partnerships and the Looming Tax Shelter Threat

By **CHRISTOPHER HANEWALD**

Many touted the tax reform legislation known as the TCJA as the most significant change to the Internal Revenue Code (IRC) since the Tax Reform Act of 1986. While those reactions are most assuredly true, the proclamations were made at a time when there was substantial uncertainty about the application and applicability of a number of new and revised IRC sections.

In the roughly 14 months since the passage of the TCJA, taxpayers have been eager to capitalize on the aforementioned tax cuts. The changes have left tax practitioners attempting to keep pace while trying to decipher hundreds of pages of proposed and final tax regulations. Certain gray areas have been clarified by subsequent regulations, sometimes at the expense of taxpayers' nefarious intentions, but other aspects of the new law have only become more confusing as regulations are issued and practitioners begin applying these provisions for the first time in the 2018 filing season.

Business Interest Changes under the Tax Reform Law

Perhaps the area most exemplary of such confusion concerns the newly imposed limit on the deductibility of business interest. The TCJA limits the interest expense deduction for any business to its interest income plus 30% of its adjusted taxable income (roughly equating to EBITDA for tax years prior to 2022 and EBIT thereafter).

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The application of the new limitation imposed on the deductibility of business interest under Section 163(j) applies to all business entities; however, there are two important exemptions from the application of this limitation, which taxpayers and their practitioners will be focusing on in the coming months.

First, if a business has average gross receipts for the prior three years of less than $25 million, that business is exempt from the limitation *unless that entity is considered a tax shelter* (Small Business Taxpayer Exemption). Second, any entity that qualifies as a real property trade or business (RPTB) has the ability to elect out of the interest limitation in exchange for a slower depreciation schedule on real property.

While the preceding exemptions are not exhaustive, those two alternatives will assuredly be the most highly utilized by taxpayers, particularly in the real estate sector, seeking to avoid any potential limit on the deductibility of their business interest. The release of 400-plus pages of proposed regulations concerning Section 163(j) in November 2018 brought little clarity and, in fact, has stoked a realization among practitioners that unintended consequences loom at every turn. In particular, how a "tax shelter" is defined has renewed importance for tax practitioners for the first time since the 1980s.

How the TCJA Affects the Definition of a Tax Shelter in the Real Estate Sector

The tax shelter caveat to the Small Business Taxpayer Exemption has garnered significant scrutiny in the wake of the proposed Section 163(j) regulations. A tax shelter, as cumulatively defined by IRC Sections 448, 1256 and 461, is any partnership or entity, other than a C corporation, that has more than 35% of losses in a tax year allocable to limited partners or limited entrepreneurs. A limited entrepreneur is considered any business owner who is not actively engaged in the operations or management of the business.

Thus, if we consider a routine example of a real estate partnership with four partners and only one of those partners manages day-to-day operations, an issue immediately arises. Assuming this partnership has a standard no-frills operating agreement, 75% of the profits and/or losses will be allocated to limited entrepreneurs according to the definition above. If the partnership keeps with operations of an average real estate partnership, it would operate at a loss in its early years.

Suddenly, that partnership operating a few single-family rentals made possible through debt financing will be faced with an expensive and irrevocable decision. Either:

a. Elect to be an RPTB and accept a costly and irrevocable depreciation result for assets placed in service prior to 2018; or

b. Accept the limitation of business interest because their investment has abruptly become a tax shelter.

Unfortunately, neither option presented is particularly palatable for a small business that may be squeezed for returns. Moreover, while a limitation of interest in one year is not permanently lost, partnerships holding assets for long-term investment will not recognize the timing difference for years until an ultimate disposition of the asset or partnership interest occurs.

Careful Analysis Required!

As the simple example above demonstrates, no single change stemming from the TCJA is occurring in a vacuum. These new or altered provisions are interacting with existing frameworks within the IRC to ensure that compliance is neither black nor white. This filing season it will be imperative for practitioners to communicate loudly and clearly with clients as difficult and potentially irreversible decisions must be contemplated.