The Real Estate Trade or Business Exception from IRC Section 163(j)

By Yoram Keinan

The scope of the exception for taxpayers engaged in a real estate trade or business from the harsh consequences of Internal Revenue Code (IRC) section 163(j) remains uncertain, even in the aftermath of the issuance of proposed regulations under that section. In particular, the scope and definition of what constitutes "real estate trade or business" remains unclear, and the reference to the same definition under IRC section 469 [which is unrelated to section 163(j)] is equally unhelpful. This article lists several activities that have been previously treated by courts and the IRS as "real estate trade or business" under section 469, and thus should equally apply to section 163(j).

The Proposed Regulations

Prior to the Tax Cuts and Jobs Act of 2017 (TCJA), IRC section 163(j), as amended, applied only to certain interest paid or accrued by corporations; the TCJA significantly changed this limitation. On November 26, 2018, Treasury and the IRS released proposed regulations (REG-106089-18) under section 163(j).

Under IRC section 163(j)(1) and Proposed Treasury Regulations section 1.163(j)-2, the amount of deductible business interest expense in a taxable year cannot exceed the sum of—

- the taxpayer's business interest income for the year,
- 30% of the taxpayer's adjusted taxable income (ATI) for the year, and
- the taxpayer's floor plan financing interest expense for the year.

Under IRC section 163(j)(8)(A), ATI is the taxable income of the taxpayer, computed without regard to—

- any item of income, gain, deduction, or loss not properly allocable to a trade or business;
- business interest expense and income;
- net operating loss deductions under IRC section 172;
- deductions for qualified business income under IRC section 199(A); and
- deductions for depreciation, amortization, or depletion for years beginning before January 1, 2022.

Interest that may not be deducted in the current year is carried forward to the following year and is treated as business interest expense for that subsequent year. [Proposed Treasury Regulations section 1.163(j)-5 provides rules for carrying forward interest expenses that are incurred by a corporation and disallowed under section 163(j)(1).] For this purpose, "business interest expense" is any interest expense that is properly allocable to a trade or business. "Business interest income" is interest income that is includable in gross income and properly allocable to a trade or business. The interest expense carried forward may be limited in the next taxable year if the section 163(j) limitation continues to apply.

The proposed regulations adopt an expansive definition of "interest" for this purpose, which includes amounts paid, received, or accrued as compensation for the use or forbearance of money under the terms of an instrument that is treated as a debt instrument for purposes of IRC section 1275. Such instruments include original issue discount (OID), qualified stated interest, acquisition discounts related to short-term debt instruments, accrued market discounts, repurchased premium deductibles by an issuer, imputed interest under IRC section 483 or 7872, amounts treated as interest under IRC section 467 rental agreements, section 163(c) redeemable ground rents, section 636 mineral production payments, and amounts treated as interest under section 988. Certain amounts predominantly associated with the time value of money may also be treated as interest expense for the purposes of section 163(j); Proposed Treasury Regulations section 1.163(j)-1(b)(20) provides additional information on what constitutes interest under section 163(j).

The proposed regulations also include in the definition of interest many items that are not treated as interest under general U.S. federal income tax principles, the IRC, or any regulations, but which the IRS and Department of the Treasury view as "closely related" to interest and that "affect the economic yield or cost of funds of a transaction involving interest." These include—

- income, deduction, gain, or loss from transactions used to hedge interest bearing assets or liabilities, or from other derivatives that alter a taxpayer's effective cost of borrowing;
- debt issuance costs;
- guaranteed payments for the use of capital under IRC section 707(c);
- income from factored receivables;
- commitment fees, to the extent that amounts have been borrowed;
- substitute interest payments on securities lending or sale-repurchase transactions;
- ordinary gain from IRC section 1258 conversion transactions;
- ordinary income from bond issuance premiums by an issuer or a bond premium deduction by a holder;
- ordinary income or loss arising from contingent payment debt instruments, including foreign currency contingent payment debt instruments; and
- interest on a notional principal contract's significant nonperiodic payments for noncleared swaps.

Consistent with section 163(j)(3), the proposed regulations would not subject taxpayers that meet the gross receipts test of section 448(c) to section 163(j). A business generally meets the gross receipts test of section 448(c) when it is not a "tax shelter" [as defined in section 448(a)(3)] and has had average annual gross receipts of $25 million or less in the previous three years.

IRC section 163(j)(7) and Proposed Treasury Regulations section 1.163(j)-2 exempt certain trades or businesses from the application of section 163(j). These include—

- providing services as an employee,
- certain real property trades or businesses,
- certain farming businesses, and
- certain regulated utility trades or businesses.

The proposed regulations provide that the term "trade or business" has the same meaning as under IRC section 162. Interest expense that is properly allocable to an exempted trade or business is not subject to the section 163(j) limitation. Similarly, items of income, gain, deduction, or loss, including interest income that is properly allocable to an exempted trade or business, are excluded in determining the section 163(j) limitation. The taxpayer must allocate tax items between exempted and nonexempted trades or businesses to determine the section 163(j) limitation.

Proposed Treasury Regulations section 1.163(j)-10 provides special rules for allocating tax items. The taxpayer must generally compare the basis in the assets used in exempted trades or businesses and the basis in the assets used in nonexempted trades or businesses to determine what portion of interest expense and interest income to allocate to the exempted trades or businesses.

The proposed regulations contain an anti-avoidance rule, which provides that any arrangement entered into with a principal purpose of avoiding the rules of section 163(j) or the proposed regulations may be disregarded or recharacterized by the IRS to the extent necessary to carry out the purposes of section 163(j).

> In particular, the scope and definition of "real estate trade or business" remains unclear, and the reference to the same definition under IRC section 469 is equally unhelpful.

Under section 163(j)(7)(B), a "real property trade or business," as defined in section 469(c)(7)(C), may elect not to be treated as a trade or business for purposes of section 163(j). The discussion immediately below details the scope of a "real property trade or business" in section 469(c)(7)(C).

IRC Section 469(c)(7)(C)

Taxpayers are allowed deductions for certain business and investment expenses under IRC sections 162 and 212. IRC section 469(a)(1) disallows deduction for passive activity losses and credits. A passive activity loss is the excess of the aggregate losses from all passive activities for a taxable year over the aggregate income from all passive activities for that year [section 469(d)(1)]. A passive activity always involves the conduct of a trade or business, or the expenses of which are deductible under section 212, in which the taxpayer does not materially participate [section 469(c)(1), (6)(B)].

A rental activity is treated as a per se passive activity, regardless of whether the taxpayer materially participates [section 469(c)(2), (4)]. Rental activity is defined as any activity where payments are principally for the use of tangible property [section 469(j)(8)]. Under section 469(c)(7)(B), rental activity of a taxpayer who qualifies as a real estate professional is not a per se passive activity under section 469(c)(2), but is treated as a passive activity unless the taxpayer materially participated in the activity [Treasury Regulations section 1.469-9(e)(1)].

A taxpayer qualifies as a real estate professional if the following conditions are met:

- More than one-half of personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates; and
- Such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.

The term "real property trade or business" means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business [IRC section 469(c)(7)(C)]. As the IRS noted in CCA 201504010, "these terms are not defined in section 469 or the regulations. Absent

further guidance, legislative history and principles of statutory construction apply to determine the meaning of 'real property brokerage' for purposes of section 469."

In CCA 201504010, the issues were whether a real estate agent is engaged in a real property brokerage trade or business, and whether a mortgage broker is engaged in a real property brokerage trade or business. The IRS ruled that a real estate agent who brings together buyers and sellers of real property may be engaged in a real property brokerage trade or business under section 469(c)(7)(C), but that a mortgage broker who is a broker of financial instruments is not engaged in a real property brokerage trade or business. The IRS reviewed the plain language of the term "brokerage" and stated that:

> Webster's Dictionary defines "real estate" as "property consisting of buildings and land; the business of selling land and buildings," and defines "brokerage" as "the business of a broker" or the "broker's fee or commission." … Webster's defines a "broker" as "a person who helps other people … to buy and sell property." … Accordingly, the common and ordinary construction of "real property brokerage" for purposes of section 469(c)(7)(C) involves bringing together buyers and sellers of real property.

In *Agarwal v. Comm'r* (T.C. Summ. 2009-29), the Tax Court held that a California real estate agent who was not a licensed broker under state law was engaged in a real property trade or business because she was engaged in the same activity—bringing together buyers and sellers of real property—as a fully licensed broker. Agarwal argued that real estate agents should be considered engaged in a real property trade or business; the IRS responded that she was a licensed real estate agent, but not a licensed real estate broker. Thus, under California law, according to the IRS, Agarwal could not be engaged in a brokerage trade or business, and therefore, she was not engaged in a real property trade or business under section 469(c)(7)(C).

The Tax Court reviewed Webster's definition for the term "brokerage" as "the business of a broker" or "the fee or commission for transacting business as a broker." The court outlined five activities indicative of the business of a real estate broker:

- Selling, exchanging, purchasing, renting, or leasing real property
- Offering to do those activities
- Negotiating the terms of a real estate contract
- Listing of real property for sale, lease, or exchange
- Procuring prospective sellers, purchasers, lessors, or lessees.

The Tax Court elaborated that:

> Whether Mrs. Agarwal is characterized as a broker or a salesperson for state law purposes is irrelevant for federal income tax purposes—the test is whether she was engaged in 'brokerage' within the meaning of section 469 … Consistent with her real estate salesman's license and pursuant to her contract with the brokerage firm, Mrs. Agarwal was engaged in 'brokerage'; i.e., she sold, exchanged, leased, or rented real property and solicited listings. Therefore, Mrs. Agarwal was engaged in a 'brokerage' trade or business within the meaning of §469(c)(7)(C).

In *Calvanico v. Comm'r* (T.C. Summ. 2015-64), the IRS and the Tax Court agreed that a licensed real estate appraiser who worked for a public accounting firm may be engaged in a real property trade or business ("Respondent does not dispute that petitioners' rental real estate activities constituted a trade or business during the year in issue"). In 2010, Calvanico worked full time as the director of real estate valuation and property tax at Grant Thornton, and later served as the director of national property tax and real estate valuation at Crowe Horwath. He did not own an equity interest in either business. While the court ended up holding that Calvanico was not a real estate professional because he held no ownership interest, the court and the IRS did not dispute that the services of appraising real estate should be treated as real estate trade or business.

In *Stanley v. United States* [W.D. Ark. No. 5:14-cv-5236 (2015)], the taxpayer owned and worked for a real estate management company that managed his rental properties; he also served as general counsel for the management company. The IRS argued that the taxpayer could not count the hours spent performing services as general counsel toward the real estate professional test because those hours were spent providing legal services, rather than providing services related to the management of the company's real estate business. The court held that the taxpayer's hours spent providing legal services counted toward satisfying the real estate professional test because "section 469 does not … require that the service performed in a real property trade or business be of any specific character or that all such services must be directly related to real estate. Rather, the services must simply be performed 'in real property trades or businesses in which the taxpayer materially participates.'" In AOA 2017-7, the IRS challenged the 5% ownership rule, but did not challenge the determination of what constitutes a real estate trade or business.

Evaluate Client Activities

A broad range of professional services that are provided in connection with the sale of real estate, including agents, brokers, appraisers, attorneys, accountants and more, should be treated as real estate trade or businesses for purposes of IRC section 163(j). Mortgage brokers, however, are not exempt. CPAs should advise their clients who provide such services accordingly. ❑

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