Understanding Section 163(j) Limitation at the Partnership Level (Real Estate – Project)

Summary: Section 163(j) of the Internal Revenue Code imposes limitations on the deductibility of business interest expenses. For partnerships, this limitation is applied at the partnership level, which can have significant implications for partners. Understanding and properly managing the Section 163(j) limitation is crucial for optimizing tax outcomes within real estate partnerships and other ventures.

Case Study:

Partnership Details:

- Partner A: 40% Profit Interest
- Partner B: 60% Profit Interest

Year 1 Activities:

- Partnership Income: $1,000,000 *on a $10M valued apartment building*
- Partnership Expenses (excluding interest): $300,000
- Interest Expenses: $150,000
- Depreciation: $200,000

Section 163(j) Calculation: The Section 163(j) limitation for partnerships is generally the sum of 30% of the partnership's adjusted taxable income (ATI) and the partner's share of business interest income. ATI is calculated by taking taxable income before interest expense, depreciation, and amortization, and then adding back depreciation and amortization. *Calculation Follows:*

1. **Partnership's ATI:**
   - Partnership Income: $1,000,000
   - Partnership Expenses (excluding interest): $300,000
   - Depreciation: $200,000
   - Taxable Income Before Interest and Depreciation: $1,000,000 - $300,000 - $200,000 = $500,000
   - ATI: $500,000 + $200,000 = $700,000
2. **30% of ATI:**
   - 30% * $700,000 = $210,000
3. **Partners' Share of Interest Expense:**
   - Partner A: 40% * $150,000 = $60,000
   - Partner B: 60% * $150,000 = $90,000
4. **Total Allowed Interest Deduction:**
   - Lesser of 30% of ATI or total interest expenses

Lessor Of → 30% *700,000 = 210,000

→ 60,000+90,000 = 150,000 ✓ (this goes on Form 8990)

- Total Interest Expenses: $150,000
- **Allowed Deduction: $150,000**

Form **8990**
(Rev. December 2022)
Department of the Treasury
Internal Revenue Service

Limitation on Business Interest Expense Under Section 163(j)

Attach to your tax return.

Go to *www.irs.gov/Form8990* for instructions and the latest information.

OMB No. 1545-0123

Taxpayer name(s) shown on tax return	**Identification number**

A If Form 8990 relates to an information return for a foreign entity (for example, Form 5471), enter:

Name of foreign entity

Employer identification number, if any

Reference ID number

B Is the foreign entity a CFC group member? See instructions . . . . ☐ **Yes** ☐ **No**

C Is this Form 8990 filed by the specified group parent for an entire CFC group? See instructions . . . . . . ☐ **Yes** ☐ **No**

D Has a CFC or a CFC group made a safe harbor election? If yes, see instructions for which lines of Form 8990 to complete . . . . ☐ **Yes** ☐ **No**

Part I Computation of Allowable Business Interest Expense

Part I is completed by all taxpayers subject to section 163(j). Schedule A and Schedule B need to be completed before Part I when the taxpayer is a partner or shareholder of a pass-through entity subject to section 163(j).

Section I—Business Interest Expense

1	Current year business interest expense (not including floor plan financing interest expense), before the section 163(j) limitation	1			
2	Disallowed business interest expense carryforwards from prior years. (Does not apply to a partnership)	2			
3	Partner's excess business interest expense treated as paid or accrued in current year (Schedule A, line 44, column (h))	3			
4	Floor plan financing interest expense. See instructions	4			
5	**Total business interest expense.** Add lines 1 through 4			5	

Section II—Adjusted Taxable Income

In Conclusion: Properly allocating this deduction can help partners maximize their deductible interest expenses while adhering to tax regulations.

Tax Journal Entries:

1. **Book to Tax Adjustments:**
   - Increase Interest Deduction for Partner A: Debit Partner A's Tax Basis account, Credit Partner A's Capital Account
   - Increase Interest Deduction for Partner B: Debit Partner B's Tax Basis account, Credit Partner B's Capital Account
2. **Allocate Allowed Interest Deduction to Partners:**
   - Debit Partnership Interest Expense Account, Credit Partner A's Tax Basis Account
   - Debit Partnership Interest Expense Account, Credit Partner B's Tax Basis Account
3. **Depreciation Adjustment:**
   - Reverse Book Depreciation: Debit Accumulated Depreciation Account, Credit Depreciation Expense Account
   - Apply Tax Depreciation: Debit Depreciation Expense Tax Account, Credit Accumulated Depreciation Account

Tax Trial Balance:

Account	**Debit ($)**	**Credit ($)**
Partner A Basis		$60,000
Partner B Basis		$90,000
Partnership Interest Expense	$150,000	
Depreciation Expense (Book)		$200,000
Depreciation Expense (Tax)	$200,000	

Conclusion: Section 163(j) limitation at the partnership level requires careful consideration of each partner's share of the allowed interest deduction based on their ownership percentages. Properly allocating this deduction can help partners maximize their deductible interest expenses while adhering to tax regulations. Implementing the necessary book-to-tax adjustments and maintaining clear tax records are essential components of successfully managing the Section 163(j) limitation within real estate partnerships or similar structures.