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Proposed Regulations on the Interest Deduction Limitation Under Section 163(j) of the Internal Revenue Code

On Nov. 26, 2018, the IRS issued proposed regulations under the Internal Revenue Code (IRC) § 163(j) enacted by the Tax Cuts and Jobs Act of 2017 (the Proposed Regulations). Generally, IRC § 163(j) limits certain taxpayers' business interest expense deduction to the sum of (i) the taxpayer's current year business interest income, (ii) 30 percent of the taxpayer's adjusted taxable income (ATI) from a trade or business, and (iii) certain floor plan financing interest expense. Any disallowed business interest expense (i.e., excess business interest expense) can be carried forward indefinitely and treated as business interest expense in future years. Taxpayers with average annual gross receipts of 25 million or less, tested for the three taxable years immediately preceding the current taxable year, are not subject to the above limitations. In addition, certain activities (referred to as "excepted trades or businesses") are excluded from the definition of a trade or business for purposes of IRC § 163(j). Such activities include (i) the trade or business of providing services as an employee; (ii) certain electing real property businesses; (iii) certain farming businesses; and (iv) certain regulated utility businesses.[1]

The Proposed Regulations are 439 pages long and are divided into eleven sections. Below is a high-level summary of key provisions of the proposed regulations.

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[1] IRC § 163(j)(7).

Computation of ATI

The Proposed Regulations define ATI as taxable income adjusted as specified in IRC § 163(j)(8).[2] IRC § 163(j)(8) provides that ATI is taxable income computed without regard to

(i) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business;

(ii) any business interest expense or business interest income;

(iii) any net operating loss deduction;

(iv) any deduction allowed under section 199A (the pass-through deduction allowed to owners of tax transparent entities); or

(v) in the case of taxable years beginning before Jan. 1, 2022, any deduction allowable for depreciation, amortization, or depletion.

In addition to the above statutory adjustments, the Proposed Regulations provide additional adjustments to prevent double counting in certain situations, e.g., ATI will not include any gain on the sale or disposition of property to the extent deductions for depreciation, amortization, or depletion with respect to such property were excluded from the computation of ATI.[3] Similar adjustments are required with respect to depreciable property held by either a partnership or a consolidated group if the partnership interest or the stock of the member is sold or disposed of. There are special ATI rules provided in the Proposed Regulations for partnerships, regulated investment companies (RIC), and real estate investment trusts (REIT).

Definition of Interest[4]

The Proposed Regulations have significantly expanded the definition of interest to include (i) any amount paid or accrued on conventional debt instruments (including original issue discount (OID), accrued market discount that is includible in the income of a holder, and amounts with respect to an integrated transaction), as well as transactions that are indebtedness in substance (e.g., a substitute interest payment made on a debt instrument under the terms of a securities lending or a sale-repurchase transaction, certain commitment fees in connection with a lending transaction, and certain debt issuance costs). In addition, the term interest also includes the time value component associated with a swap with significant nonperiodic payments. Further, the Proposed Regulations would treat a guaranteed payment for the use of capital under IRC § 707(c) as interest.

Definition of Trade or Business[5]

For purposes of IRC § 163(j) business interest income and business interest expense are taken into account in computing ATI only if such items are properly allocable to a trade or business. The Proposed Regulations adopt the rules under IRC § 162 to determine the existence of a trade or business. Generally,

[2] The deduction for depreciation, amortization, and depletion would lapse for taxable years beginning on or after Jan. 1, 2022.
[3] This adjustment is required because ATI is to be calculated without regard to deductions for depreciation, amortization, or depletion. Accordingly, in the years in which such deductions were claimed for purposes of calculating taxable income they would have reduced the basis in the associated assets. Therefore, the amount of gain for purposes of the ATI on such disposition must be calculated without regard to such reduction in basis.
[4] *See* Prop. Reg. 1.163(j)-1(b)(20).
[5] *See* Prop. Reg. 1.163(j)-1(b)(38).

the courts have interpreted the term "trade or business" for purposes of IRC § 162 to include any activity conducted with continuity and regularity with the principal purpose of earning income and making profits.

Floor Plan Financing Interest Expense

Certain interest expense paid or accrued on indebtedness used to acquire an inventory of motor vehicles (i.e., floor plan financing interest expense) is deductible without regard to the IRC § 163(j) limitation. The deduction with respect to floor plan financing interest expense will be allowed regardless of whether such expense would be considered as properly allocable to a trade or business.[6]

Carry Forward of Business Interest Expense[7]

As mentioned earlier, excess business interest expense can be carried forward indefinitely and treated as business interest expense in future years. The Proposed Regulations provide that the limitation under IRC § 163(j) and the disallowed business interest expense carryforward do not directly trace interest expense attributable to any specific debt obligation. Instead, the limitation and the carryforward applies to the total amount of business interest expense of a taxpayer and the disallowed portion thereof.

The Proposed Regulations also provide that if a taxpayer who is subject to the IRC § 163(j) limitation carries forward the disallowed business interest expense to a taxable year in which the taxpayer qualifies for the "small business exemption,"[8] the amount of the carryforward will generally be exempt from the application of IRC § 163(j) limitation and, thus, will be deductible in such year.

Ordering and Operating Rules with Respect to Business Interest Deduction Limitation and Other Provisions of IRC Affecting Interest[9]

The Proposed Regulations provide that the IRC § 163(j) limitation will generally not apply to an interest expense that either has been disallowed, deferred, or capitalized in the current taxable year under other provisions of the IRC or has not yet been accrued for tax purposes. However, under the Proposed Regulations, IRC § 163(j) would apply before the operation of the loss limitation rules in IRC §§ 465 (the "at risk" rules) and 469 (relating to passive activity losses) and before the application of the new rules under IRC § 461(l) (the limitation on excess trade or business losses of individual taxpayers).

The Proposed Regulations are reserved on the interaction of IRC §163(j) and the new base erosion and anti-abuse tax (BEAT) rules provided in IRC § 59A.

Application to Corporations[10]

Generally, for purposes of IRC § 163(j), business interest income and business interest expense do not include "investment income"[11] or deductions for "investment interest,"[12] respectively, as defined in IRC § 163(d). The Proposed Regulations provide that, solely for purposes of IRC § 163(j), all interest paid or

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[6] *See* Prop. Reg. 1.163(j)-1(b)(17).
[7] *See* Prop. Reg. 1.163(j)-2(c)
[8] The exemption from the application of IRC § 163(j) for the taxpayers with average annual gross receipts of 25 million or less, tested for the three taxable years immediately preceding the current taxable year.
[9] *See* Prop. Reg. 163(j)-3.
[10] *See* Prop. Reg. 163(j)-4 and -5.
[11] Generally, income or gain from property held for investment purposes.
[12] Generally, any interest allowable as a deduction which is paid or accrued on indebtedness properly allocable to property held for investment.

accrued and all interest received by a C corporation will be treated as business interest expense and business interest income, respectively, allocable to a trade or business.[13] In the case of a partnership in which a C corporation is a partner, the Proposed Regulations will recharacterize investment income and expense of the partnership that is allocable to the C corporation as business income and expense of the C corporation. However, this recharacterization rule will not apply to the extent a C corporation partner is allocated a domestic partnership's IRC § 951(a) (Subpart F) or IRC § 951(A)(a) (GILTI) income that is treated as investment income at the partnership level.

Generally, the forgoing rules would also apply to RICs and REITs.

Computation of E&P

The Proposed Regulations provide that the computation of a C corporation's earnings and profits (E&P) for a taxable year will not be affected by the disallowance of interest expense under IRC § 163(j). Thus, a C corporation's current E&P would be calculated by reducing the amount of E&P by the amount of business interest expense for the year, including the disallowed portion. Specific rules apply for computing the E&P of RICs, REITs, and C corporations that are allocated excess business interest expense from a partnership.

Application to Consolidated Groups

A consolidated group is generally treated as a single entity for purposes of IRC § 163(j) limitation and the computation of ATI. Any members of an affiliated group that do not file a consolidated return and partnerships that are wholly owned by members of a consolidated group will not be aggregated for purposes of applying the IRC § 163(j) limitation and the computation of ATI. However, any obligations between the members of the same consolidated group will be disregarded to determine business interest expense, business interest income, and ATI. Further, offsetting intercompany items will also be disregarded for purposes of computing the group's ATI. If a member has current year interest expense for which a deduction is disallowed under IRC § 163(j), the basis in the member's stock will not be adjusted until the year when the disallowed interest expense is absorbed by the group.

The Proposed Regulations provide special rules with respect to "separate return limitation year" (SRLY) limitations and net operating loss (NOL) carryforwards under IRC § 382. Special rules are also provided with respect to disallowed interest expense carryforwards in transactions to which IRC § 381(a) applies, which require an acquiring corporation to succeed to and take into account any disallowed business interest expense carryforwards.

Application to Partnerships and Subchapter S Corporations[14]

The application of the rules under IRC § 163(j) to passthrough entities are extremely complex and requires a deep understanding of several defined terms. Generally, for passthrough entities (partnerships and S corporations), the limitation under IRC § 163(j) is applied and the ATI is computed at the passthrough entity level.

In the case of a partnership, any interest expense that is disallowed at the partnership level is allocated to its partners. The ATI of each partner initially is determined without regard to such partner's distributive share of any items of income, gain, deduction, or loss of such partnership, but is then increased by such partner's distributive share of the partnership's "excess taxable income," which is generally the ATI of the

[13] Certain excepted trade or businesses will be excluded from the application of IRC § 163(j) limitation.
[14] *See* Prop. Reg. 1.163(j)-6.

partnership in excess of its interest expense that is deductible after computing its own limitation under IRC § 163(j). A partner's distributive share of the partnership's "excess taxable income" is determined in the same manner as the partner's share of "non-separately stated income or loss of the partnership," which is generally the ordinary business income or loss reflected in Form 1065. As these rules are very opaque, the Proposed Regulations provide a complex eleven-step computation to determine a partner's share of a partnership's excess business interest expense, excess business interest income, and excess taxable income for a taxable year. Under these rules, a partner is also allowed to use its share of the partnership's excess business interest income in the current taxable year to absorb the partner's excess business interest expense allocated from the same partnership in prior taxable years. The Proposed Regulations also provide basis and capital account adjustment for excess business interest expense allocations to its partners and upon disposition of partnership interests.

In the case of an S corporation, allocations of excess taxable income and excess business interest income are to be made in accordance with its shareholders' respective interests in the S corporation in accordance with IRC § 1366(a). Such allocation is made after the S corporation determines its IRC § 163(j) deduction limitation under the Proposed Regulations. The Proposed Regulations also provide guidance with respect to the inclusion of the proceeds from the disposition of the S corporation stock in the selling shareholder's ATI. Generally, gain or loss would be included in the selling shareholder's ATI only to the extent the S corporation's assets are not related to an excepted trade or business. In addition, the Proposed Regulations also provide certain rules to prevent double counting of business interest income and floor plan financing interest expense for purposes of calculating an S corporation shareholder's IRC § 163(j) limitation.

Application to Controlled Foreign Corporations[15]

The Proposed Regulations provide that a CFC with business interest expense must apply IRC § 163(j) to determine the extent to which such expense is deductible for purposes of computing its Subpart F income, tested income for GILTI purposes, and income that is effectively connected with the conduct of a trade or business. The Proposed Regulations provide two methods for computing IRC 163(j) at the CFC level: (i) CFC-by-CFC method (the "Default Method"), and (ii) an elective method for a group of highly-related CFCs (the "CFC Group Method").

Under the Default Method, the amount of business interest expense and business interest income is computed on a CFC-by-CFC basis. Under this method, the intercompany business interest income and business interest expense could result in an increase in GILTI inclusion at the U.S. shareholder level. This is because if CFC 1 lends money to CFC 2, any disallowed interest expense at the CFC 2 level would increase CFC 2's tested income, while at the same time interest income of CFC 1 will also increase CFC 1's tested income, thus, resulting in an overall increase in the U.S. shareholder's GILTI inclusion. If the intercompany business interest income and business interest expense were to fully offset one another, the U.S. shareholder's GILTI inclusion will not be impacted.

Under the Group Method, the Proposed Regulations permit CFCs to net intercompany interest income and interest expense within a group of highly-related CFCs. Any third-party interest expense that remains after such netting would be subject to the IRC § 163(j) limitation at the separate CFC level (determined by allocating the group's net interest expense to the individual members based on the ratio of the individual CFCs' net interest expense to the total net interest expense of the group). Generally, for purposes of the Proposed Regulations, a highly-related CFC group would include two or more CFCs if at least 80 percent of the stock by value of each CFC is owned, directly or indirectly, by a single U.S. shareholder or, in

[15] *See* Prop. Reg. 1.163(j)-7.

aggregate, by related U.S. shareholders that own stock of each member in the same proportion. However, any CFC that has effectively connected income (ECI) will be excluded from the definition of a CFC group member. Thus, a CFC with ECI is not eligible to compute its IRC § 163(j) limitation under the CFC Group Method. Further, if one or more CFCs conduct a financial services business, the CFC Group Method is applied with respect to such financial services group members on a separate subgroup basis.

It is important to note that under the CFC Group method, deductible interest will be limited to 30 percent of the entire group's ATI without regard to business interest income and floor plan financing. In this regard, any business interest income of a group member will not separately increase the limitation as such business interest income will already have been accounted for in computing net business interest expense of all CFC group members. Additionally, under the CFC Group Method, the Proposed Regulations exclude floor plan financing interest for purposes of computing the limitation. The Group Method also provides a complicated set of rules under which lower-tier CFCs can share their excess taxable income with upper-tier CFCs within the same CFC group. Further, dividends from related persons will be excluded for purposes of computing the CFC group's ATI.

Effective Date

The Proposed Regulations would be effective for taxable years ending after the date on which the final regulations are published in the Federal Register. However, taxpayers may apply the Proposed Regulations retroactively to a taxable year beginning after Dec. 31, 2017, on a consistent basis.

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