IRS Issues Proposed Regulations Interpreting the New Section 163(j) Limitation on the Deductibility of Interest

January 2019

On November 26, 2018, the Internal Revenue Service ("IRS") released proposed regulations (the "Proposed Regulations") interpreting the business interest deduction limitation rules under new Section 163(j)[1] which was enacted as part of the Tax Cuts and Jobs Act.[2] The Proposed Regulations generally will only apply to tax years ending after the date they are adopted as final; however, taxpayers may apply the Proposed Regulations to a tax years beginning after December 31, 2017 so long as the taxpayers consistently apply such regulations.

Introduction

Section 163(j) replaced a previous, narrower interest deduction limitation. The old Section 163(j) limitation was limited to interest paid to related parties and only applied to corporations. The new limitation is vastly broader and applies to all interest payments (including many items that are not otherwise treated as interest for tax purposes). In addition, the new rules apply to any taxpayer with business interest expense – not just to corporations.

Under new Section 163(j), taxpayers generally may only deduct net business interest expenses (i.e., interest paid or accrued on indebtedness properly allocable to a trade or business) up to 30% of their "adjusted taxable income." Adjusted taxable income is generally a taxpayer's taxable income computed without regard to certain deductions, including deductions for business interest, net operating losses, the new Section 199A "pass-through" deduction and, for tax years beginning before 2022, depreciation, amortization and depletion. Business interest expense deductions that are disallowed for any taxable year may be carried forward and treated as business interest paid or accrued in succeeding taxable years.

As discussed in greater detail below, Section 163(j) contains several important exceptions and does not apply to:

- "Small businesses" with annual gross receipts of $25 million or less;

[1] All "Section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and to the Treasury Regulations (the "Regulations") promulgated thereunder.

[2] Pub. L. No. 115-97.

- Electing real property trades or businesses;
- Electing farming businesses;
- Regulated utility trades or businesses; and
- The trade or business of providing services as an employee.

The Proposed Regulations are voluminous, numbering some 430 pages, and contain substantial guidance, as well as complexity, on a number of aspects of the Section 163(j) limitation, such as:

- An expansive definition of "interest";
- Guidance on the applicability of the exceptions to Section 163(j);
- Ordering rules governing the interaction between Section 163(j) and other provisions which limit the deductibility of interest;
- Rules governing the application of Section 163(j) to corporations and consolidated groups;
- Rules governing the application of Section 163(j) to partnerships; and
- Rules governing the application of Section 163(j) to foreign corporations and their shareholders.

Interest

The Proposed Regulations define "interest" **very broadly**. Under a comprehensive general definition, "interest" includes "amounts paid, received, or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement… or an amount that is treated as interest under other provisions of the Internal Revenue Code or the regulations thereunder." This general definition encompasses items that are commonly thought of as interest such as original issue discount, market discount, and amounts paid or received in connection with the sale-repurchase agreement that are treated as debt for U.S. federal income tax purposes

In addition the definition also include items that are not consistently treated as interest for all purposes of the Code, and even some items that are not treated as interest under any other Code provision, including:

- Loan commitment fees;
- Gains or losses from transactions used to hedge an interest-bearing asset or liability;
- Certain swap payments; and
- Guaranteed payments to partners for the use of capital.

Exceptions to Section 163(j)

The Section 163(j) limitation applies to all taxpayers except for certain small businesses that meet the gross receipts test and certain excepted trades or business. The excepted trades or businesses include: "electing real property trades or businesses", "electing farming businesses", regulated utility trades or businesses, and the trade or business of performing services as an employee. The small business exception and the electing real property trade or business are discussed in more detail.

(1) Small Business Exemption

The Section 163(j) limitation does not apply to any taxpayer, in any taxable year, if the taxpayer has average annual gross receipts of $25 million or less. The gross receipts test is an annual determination based on the prior three taxable years. Thus, a taxpayer's status as an exempt small business under Section 163(j) may change from year to year. The Proposed Regulations clarify that if a taxpayer who is subject to the limitation under Section 163(j) carries forward disallowed business expense to a taxable year in which the taxpayer qualifies for the small business exemption, the amount of the carryforward is not subject to the Section 163(j) limitation in that tax year.

(2) Electing Real Property Trade or Business

The term "electing real property trade or business" means certain delineated trade or businesses that make an irrevocable election to be so classified. The types of trades and businesses that qualify include: real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. The Proposed Regulations define real property to include: land, natural products and deposits that are unsevered from the land, buildings, and other inherently permanent structures that are permanently affixed to land. However, machines and equipment that serve an active function are not an inherently permanently structure even if permanently affixed to real property (e.g., HVAC systems, elevators, or escalators).

The Proposed Regulations provide a safe harbor that generally permits REITs to be eligible to make an election to be an electing real property trade or business for all or part of its assets if the REIT holds real property, interests in partnerships holding real property or shares in other REITs hold real property. If a REIT elects to be an electing real property trade or business and the value of the REIT's real property financing assets is 10% or less, all of the REIT's assets are treated as assets of an excepted trade or business (i.e., the REIT would not be subject to the Section 163(j) limit).

A taxpayer that makes an election to be treated as an "electing real property trade or business" is required to use the alternative depreciation system, and accordingly, is not

eligible for accelerated depreciation or the additional first-year depreciation deduction under section 168(k).

Ordering Rules

The Proposed Regulations generally provide that the Section 163(j) limitation will only apply to business interest expense that would be deductible in the current taxable year in the absence of Section 163(j). Thus, Section 163(j) only applies after the application of other Code provisions subject interest expense to disallowance, deferral, capitalization or other limitation.

Importantly, this ordering rule means that interest that is required to be capitalized into, for example, the cost of goods sold is not treated as business interest expense and, accordingly, is not subject to the Section 163(j) limitation. Thus taxpayers that have not historically capitalized interest into cost of goods sold may wish to reconsider their position if they have substantial business interest expense that might otherwise be subject to the Section 163(j) limitation.

Application of Section 163(j) to C Corporations and Consolidated Groups

The Proposed Regulations clarify that, solely for purposes of Section 163(j), all interest paid or accrued by a C corporation is treated as business interest expense, and all interest received or accrued by a C corporation and includible in such corporation's taxable income is treated as business interest income.

The Proposed Regulations further clarify that the disallowance of a deduction for a C corporation's business interest will not affect whether such interest reduces the corporation's earnings and profits for purposes of determining when distributions from it are treated as dividends for U.S. federal income tax purposes. Similarly, under the Proposed Regulations, a C corporation that carries forward and utilizes a disallowed business interest deduction in a subsequent tax year would not reduce its earnings and profits by the amount of the utilized carryforward in the year of utilization in the year such interest is applied to reduce taxable income.

With respect to consolidated groups, the Proposed Regulations provide that a consolidated group will have a single Section 163(j) limitation but that members of a Section 1504 affiliated group that do not file a consolidated return will not be aggregated for purposes of applying the limitation. This represents a rare narrowing of the applicability of the limitation versus old Section 163(j) which treated all members of a Section 1504 affiliated group as a single taxpayer for purposes of determining the limitation.

Application of Section 163(j) to Partnerships

In general, the Section 163(j) limitation applies at the partnership level. This is in contrast to the old Section 163(j) limitation which generally only applied to corporations – under old Section 163(j), a corporate partner's interest limitation was determined by treating the corporation as having paid its share of the partnership's interest expense.

The new Section 163(j) limitation generally provides that a partnership can deduct its business interest expense to the extent of its business interest income plus 30% of its ATI. This deductible business interest expense is not subject to an additional Section 163(j) limitation at the partner level because it is taken into account in determining the partnership's "nonseparately stated taxable income or loss". On the other hand, a partner's ATI is generally determined without regard to such partner's distributive share of any items of income, gain, deduction, or loss of the partnership – although the partner's ATI will be increased by partner's distributive share of the partnership's "excess taxable income."[3] To prevent double counting, a partner's ATI generally does not include business interest income from a partnership that is subject to the section 163(j) limitation unless the partner is allocated excess business interest income (i.e., the amount by which business interest income exceeds business interest expense). The Proposed Regulations clarify that a partner's ATI will generally include the partner's gain or loss on the sale of partnership interest except to the extent that such gain is allocated to excepted trade or business assets.

The Proposed Regulations contain a complicated 11-step process for a partnership's allocation of excess taxable income, excess business interest expense (i.e., the portion of business interest that is disallowed under Section 163(j)) and excess business interest income to its partners. These allocations are only for purposes of determining the section 163(j) limitation and do not affect the partnership's allocations under section 704.

The Proposed Regulations provide that, for other purposes of the Code, a partnership's business interest expense retains its character (e.g., as passive or non-passive for Section 469 purposes) at the partner level.

The Proposed Regulations also contain rules governing the treatment of investment interest expense incurred by a partnership with corporate partners. "Business interest" generally does not include investment interest; however, as discussed above, under the Proposed Regulations, all interest earned or interest expense incurred by a corporation will be deemed business interest for purposes of Section 163(j). Accordingly, a partnership's investment interest income or expense is allocated to each partner and the effect of such allocation is determined at the partner-level. A corporate partner will be

[3] Excess taxable income generally means any amount of ATI in excess of the minimum amount of ATI required to fully deduct a given amount of business interest under Section 163(j).

allocated such investment interest income or expense as a separately stated item. The investment interest income or expense will then be recharacterized as business interest income or expense, and the corporate partner will include such items in its calculation of its Section 163(j) limitation. This recharacterization of investment items will not affect the investment interest income and expense allocated to other non-corporate partners.

Application of Section 163(j) to Foreign Corporations and their Shareholders

In the case of controlled foreign corporation ("CFC") owned by a U.S. shareholder, the Proposed Regulations generally provide that the Section 163(j) interest limitation applies in determining the deductibility of a CFC's business interest expense. Thus, for example, a CFC with business interest expense would apply Section 163(j) for purpose of computing the amount of a U.S. shareholder's Subpart F income or GILTI. This represents another departure from old Section 163(j) which generally only applied to domestic corporations.

Generally, where a U.S. shareholder owns interests in multiple CFCs, the Proposed Regulations provide that the Section 163(j) limitation will be separately applied to each CFC. However, the Proposed Regulations permit "CFC groups"[4] to make a special election to effectively apply the limitation on a group basis. The mechanics of the election are complicated but, in general, the election will permit the netting of business interest earned by one CFC against business interest expense incurred by another CFC in order to determine the group's Section 163(j) limitation. If, after netting business income and expense, the CFC group has a net business interest expense, the net expense is allocated to each member that, on a standalone basis, has a net business interest expense by multiplying the CFC group's net business interest expense by a fraction, the numerator of which is CFC group member's net business interest expense (computed on a separate company basis) and the denominator of which is the CFC group's net interest expense as a whole. Each member then compares its separate ATI to the allocated net business interest expense to determine the amount, if any, of the Section 163(j) limitation.

The Proposed Regulations further provide that U.S. shareholder's ATI is generally calculated without regard to any Subpart F income or GILTI (or GILTI deduction) that is included in the U.S. shareholder's gross income under Sections 951 or 951A. However, if a CFC group election is in effect, the U.S. shareholder will be permitted to increase its ATI by its proportionate share of the "eligible CFC group ETI [excess taxable

[4] The Proposed Regulations define a "CFC group" as two or more CFCs, if at least 80% of the stock by value of each CFC is owned by a single U.S. shareholder or, in the aggregate, by related U.S. shareholders that own stock of each member in the same proportion.

income]." Very generally, eligible CFC group ETI is the excess taxable income of the highest-tier group member that is attributable to CFC group income that generates Subpart F income or GILTI.

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