The Slimmed Down Summer Version of the Limitation on Interest Deductions Regulations

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On July 28th, Treasury and the IRS released finalized regulations and a new set of proposed regulations (the 2020 proposed regulations) under section 163(j), TCJA's limitation on the deduction of interest. The final regulations are generally consistent with the proposed regulations released in 2018 (the 2018 proposed regulations), which were discussed previously here. However, there are several noteworthy, mostly taxpayer-favorable, modifications. In addition, the 2020 proposed regulations allow taxpayers to revisit their past treatment of certain aspects of the interest expense deduction.

As discussed in greater detail in our prior alert, TCJA limited a taxpayer's ability to deduct its business interest expense (interest expense that is properly allocable to a trade or business) by subjecting it to a new annual limitation (the section 163(j) limitation). This alert highlights several of the key changes from the 2018 proposed regulations in the final regulations, and discusses the 2020 proposed regulations, open questions, and choices taxpayers currently have in determining how to apply the section 163(j) limitation.

Specifically, the following topics are covered in this alert:

- Applicability Dates Give Taxpayers Choices
- What is Interest? … Interest by another name is not interest.
- The Section 163(j) Limitation
- Consolidated Groups
- Partnerships
- CFCs and United States Shareholders

Applicability Dates Give Taxpayers Choices

Before going into what the final regulations and the 2020 proposed regulations provide, it is important to highlight that the applicability dates of the various regulatory packages provide taxpayers with options. The following table summarizes which regulations taxpayers can rely upon:

Time period	2018 Proposed Regulations	Final Regulations	2020 Proposed Regulations

Taxable years beginning after December 31, 2017 and before 60 days after the final regulations are published in the Federal Register. [1]	Generally, taxpayers can rely on the proposed regulations.	Generally, taxpayers can rely on the final regulations.	Generally, taxpayers can rely on the proposed regulations so long as they also rely on the final regulations.
Taxable years beginning 60 days or more after publication date of the final regulations, and before the 2020 proposed regulations are finalized.	No reliance.	Generally, these regulations are applicable.	Generally, taxpayers can rely on the 2020 proposed regulations.

A&M Insight: As highlighted in the table above, taxpayers can determine which regulations package is most advantageous for them to apply or choose not to apply any of the regulations before the applicability date. It is possible that the application of one package could increase the amount of interest expense that can be deducted, reducing a taxpayer's taxable income or increasing its net operating loss, which can be carried back under the CARES Act.

To make this determination, careful modeling may be necessary, including the potential effects of the election in subsequent years. A taxpayer may rely on the final regulations only if it applies those regulations in all subsequent taxable years. Fortunately, the final regulations provide that the application of the section 163(j) limitation is not a method of accounting, so that taxpayers can change methods without IRS consent (as long as the change is permitted by the regulations themselves).

What is Interest? … Interest by another name is not interest.

In determining the application of the section 163(j) limitation, the first gating issue is the definition of business interest expense. The concept of business interest expense, or interest expense that is properly allocable to a trade or business, may seem straightforward, but as demonstrated by the 2018 proposed regulations, the definition may be subject to debate. The following table highlights the differences between the definition of interest in the 2018 proposed regulations and the final regulations.

2018 Proposed Regulations	**Final Regulations**
An amount paid, received, or accrued as compensation for the use or forbearance of money under the terms of an instrument or a contractual arrangement, including a series of transactions, that is treated as a debt instrument, or an amount that is treated as interest under other provisions of the Code or the Income Tax Regulations.	
A non-cleared swap with significant nonperiodic payments is treated as consisting of an on-market, level payment swap and a loan, with the time value component of the loan treated as interest.	Same as 2018 proposed regulations, except for swaps that are subject to margin or collateral requirements of a federal regulator (e.g., the SEC) or substantially similar requirements. [2]
Specifically listed items treated as interest, including debt issuance premium, acquisition debt premium, ordinary income on certain debt instruments, factoring income, substitute interest payments, gain on conversion transactions, debt issuance costs, commitment fees, guaranteed payments, and hedging gains and losses that affect the yield of a debt instrument.	Same as 2018 proposed regulations, except: • Substitute interest is interest only if the payment relates to a sale-repurchase or securities lending transaction that is not entered into in the ordinary course of business. • Debt issuance costs, commitment fees, guaranteed payments, and hedging gains and losses are not identified as interest.
Anti-avoidance rule for amounts predominantly incurred in consideration of the time value of money.	Anti-avoidance rule for expenses or losses economically equivalent to interest if a principal purpose is to reduce the amount that otherwise would be interest.

A&M Insight: The final regulations generally scaled back the definition of interest. However, the anti-avoidance rule, the application of which is based on all of the facts and circumstances, nevertheless disregards a taxpayer's business purpose and pre-tax cost of funds in determining its application. As a result, careful consideration is necessary to determine whether an item (including guarantee fees) is treated as interest. Additionally, it is important to note that the anti-avoidance rule applies to all transactions that are executed on or after the date the final regulations are published in the Federal Register and does not apply to any payments (irrespective of when they occur) with respect to transactions entered into before the regulations are published in the Federal Register. A taxpayer that is concerned a pending transaction may fall within the scope of the anti-avoidance rule in the final regulations, and who has not chosen to apply any of the regulation packages before the final regulations come into force, should consider entering into the transaction as soon as possible. This does not, of course, ensure that the transaction will have the desired tax consequences, as other anti-avoidance principles could apply.

The Section 163(j) Limitation

In general, the section 163(j) limitation is equal to the sum of the taxpayer's business interest income, 30% (or 50%, if the CARES Act applies) of the taxpayer's adjusted taxable income (ATI), and the taxpayer's floor plan financing interest for the taxable year. The determination of ATI starts with tentative taxable income (TTI), which is taxable income determined without regard to the section 163(j) limitation and any disallowed business interest expense carryforwards and reflects certain adjustments. While the final regulations generally adopt the 2018 proposed regulations' approach to calculating ATI, there are three notable changes. The first two changes involve the addback to TTI of depreciation, amortization, and depletion for taxable years beginning after 2017 and before 2022 (DAD deductions), and the corresponding subtraction from ATI on the sale of the property (or the direct or indirect sale of the stock of the consolidated group member or interests in partnerships that took the DAD deductions). The following table shows how the subtraction is calculated under the various regulation packages:

	2018 Proposed Regulations	**Final Regulations**	**2020 Proposed Regulations**
Sale of property that gave rise to DAD deductions	Lesser of the DAD deductions or the gain recognized	DAD deductions	Taxpayers can choose to use the lesser of DAD deductions or the gain recognized
Sale of stock of a consolidated group member	DAD deductions reflected in basis of stock	DAD deductions reflected in basis of stock	Taxpayers can choose to use the lesser of DAD deductions reflected in stock basis or the gain recognized on sale of stock
Sale of partnership's interest	Distributive share of DAD deductions	Distributive share of DAD deductions	Taxpayers can choose to use the lesser of distributive share of DAD deductions with respect to property held at the time of the sale or the gain recognized on sale of partnership interest

A&M Insight: The treatment of partnership interests is a potential trap for unwary partners in partnerships that do not ratably allocate all items of income, gain, loss, or deduction. For those partners, careful consideration should be given to the effect of the sale of the partnership interest on the partner's ATI calculation.

The second change involves the characterization of capitalized depreciation, amortization, and depletion (capitalized DAD). The following table shows how the capitalized DAD is treated:

	2018 Proposed Regulations	**Final Regulations**

Addition to TTI for capitalized DAD for taxable years beginning after 2017 and before 2022	None	Yes, in the year DAD is capitalized and not in the year the capitalized amount reduces taxable income
Subtraction from TTI for disposition of property that generated capitalized DAD for taxable years beginning after 2017 and before 2022 or sale of member's stock or partnership's interest	None	Same as non-capitalized DAD in table above

A&M Insight: As noted above, the final regulations require an adjustment for capitalized DAD if the underlying property is sold. However, it is unclear whether the adjustment applies on the sale of stock of a consolidated group member or of a partnership interest. If a member or partnership has capitalized DAD, the potential effect on TTI should be considered in deciding whether to sell the stock or interests of the entity, or the underlying assets.

Additionally, Taxpayers that have capitalized DAD should consider whether it is worthwhile to adopt the final regulations (or at least this portion of the final regulations) retroactively to obtain the benefit of treating capitalized DAD as a DAD deduction. Early adoption would also prevent a potential whipsaw when the taxpayer disposes of the property that generated the capitalized DAD. As the regulation is drafted, if a taxpayer disposes of property that generated capitalized DAD in a year beginning before 2022, the taxpayer is required to reduce its ATI in the year of sale by the amount of capitalized DAD, even if it never increased its ATI for the capitalized DAD in the year it was incurred. We anticipate that Treasury may address this whipsaw.

The last significant change is the treatment of inclusions with respect to controlled foreign corporations and is discussed in greater detail below.

Consolidated Groups

As a general matter, the final regulations adopt the provisions of the 2018 proposed regulations related to consolidated groups, with two notable changes. The first change corrects what many regarded as a glitch in the 2018 proposed regulations. Under the consolidated group rules, when a member acquires debt of another member of the consolidated group from a nonmember, the debtor is deemed to satisfy its debt with new debt, which could generate repurchase premium that is deductible as interest. Under the 2018 proposed regulations, this interest would not have been subject to the section 163(j) limitation, because it is paid between members of the same consolidated group. Because this would produce a different result than if the debtor had actually incurred the repurchase premium by satisfying its third-party debt directly, the final regulations subject the repurchase premium to the section 163(j) limitation.

The second change involves the determination of a member's separate return limitation year (SRLY) register. When a member with a section 163(j) carryforward joins a consolidated group, both the 2018 proposed regulations and the final regulations subject the carryforward to a SRLY limitation. Although the SRLY limitation is determined based on the group's section 163(j) limitation, determined by reference only to the member's tax items, the limitation was modified in a taxpayer-friendly manner in the final regulations as illustrated below.

Example: P has owned all the stock of S and S1 since Year 1. P, S, and S1 (the P group) join in filing a consolidated return. P has also owned 60% of the stock of T since Year 1. In Year 8, P purchases the remaining 40% of T at a time when T has a section 163(j) carryforward of $100x. In Year 9, the P group has a section 163(j) limitation of $0 (due to losses), but on a standalone basis, T's section 163(j) limitation would have been $30.

Under the 2018 proposed regulations, T would be unable to use any of its SRLY limited carryforwards and beginning in Year 10, its SRLY register would be $0. However, under the final regulations, T's SRLY register beginning in Year 10 is $30. The effect of this is to increase the likelihood that T will be able to use its disallowed interest carryforward in Year 10 or in a future year.

Partnerships

The section 163(j) limitation is computed at the partnership level and any "partnership excess items" are passed through to the partners annually. The 2018 proposed regulations provided an 11-step mechanical procedure to determine the partnership-level section 163(j) limitation and the allocation of any excess partnership items to partners. The final regulations adopt this procedure.

The 2020 proposed regulations include a few additional notable items that may encourage some taxpayers to adopt those regulations:

- The interest tracing rules are modified to accommodate the section 163(j) limitation.
- Trading partnerships are required to allocate interest expense from trading activities between partners that materially participate in the activities and partners that are passive investors, and treat only the portion attributable to the partners that materially participate as business interest expense subject to section 163(j) at the partnership level.
- For lending transactions between a partner (lending partner) and a partnership (borrowing partnership) in which the lending partner owns a direct interest (a self-charge lending transaction):
    - Interest expense of the borrowing partnership attributable to the self-charge lending transaction is business interest expense of the borrowing partnership, and
    - The lending partner treats any interest income from the transaction as an allocation of excess business interest income, which can be utilized in the partner's section 163(j) calculation only to the extent of the partner's allocation of excess business interest expense from the partnership.
- Tiered partnership structures apply an entity-level approach (i.e., there is no look-through). Therefore, if a lower-tier partnership has excess business interest expense (EBIE) it retains that character in the hands of the upper-tier partnership and is not passed through to the partners of the upper-tier partnership.
- Units in publicly traded partnerships (PTP) are fungible.

> A&M Insight**:** This approach is likely to create an additional tax compliance burden because of the requirement to perform a section 163(j) calculation for each partnership in a tiered structure. With that said, this approach may yield planning opportunities as it appears that corporate partners would reduce their earnings and profits only for EBIE at the top tier, and not for any lower-tier partnership's EBIE. A corporation that invests in one or more partnerships should consider the application of these rules when structuring those investments.

CFCs and U.S. Shareholders

Under both the 2018 proposed regulations and the final regulations, section 163(j) applies both to foreign corporations that have income effectively connected with a U.S. trade or business (ECI) and to controlled foreign corporations (CFCs) that have at least one direct or indirect U.S. shareholder. However, the application of the section 163(j) limitation differs between the two cases, as illustrated by the following chart:

	2018 Proposed Regulations	**2020 Proposed Regulations**
Application of 163(j) to a foreign corporation	Generally, each foreign corporation applies section 163(j) on a separate entity basis.	

However, if a CFC group election is made, then generally, each CFC within the CFC group calculates its own section 163(j), but excess BII is shared within the group and a CFC's excess section 163(j) limitation flows up to an upper tier CFC.

Generally, each foreign corporation applies section 163(j) on a separate entity basis.

However, if a CFC group election is made, then generally, the CFC group calculates a single section 163(j) limitation. If the limitation is greater than or equal to the CFC group's aggregate current year business interest expense, then all current year business interest expense is deducted and any remaining limitation is allocated within the group based on the age of their carryforwards, if any. If the limitation is less than the CFC group's aggregate current year business interest expense, then each member deducts its business interest expense to the extent of its BII, and any remaining limitation is allocated ratably based on each CFC's remaining current business interest expense.Composition of the CFC Group In general, two or more CFCs if at least 80% of the value of the stock of each CFC is owned by a single U.S. shareholder (or a consolidated group) or, in the aggregate, by related U.S. shareholders that own stock of each member in the same proportion. For this purpose, a partnership in which CFC group members own, in the aggregate, at least 80 percent of the interests, is treated as a CFC group member and any CFC that has ECI is excluded. One or more chains of CFCs having at least one U.S. shareholder, connected through stock ownership with a group parent, but only if the group parent owns at least 80% of the value of the stock of at least one other CFC, and at least 80% of the value of the stock of the other CFCs is owned by one or more of the CFC group members. The group parent may be a CFC or a U.S. shareholder. Revocability of CFC group election Irrevocable Revocable after 60 months Application of 163(j) to a U.S. Shareholder of a CFC

Generally, a U.S. Shareholder does not take into account its subpart F and GILTI inclusions (and corresponding section 250 deduction) in calculating ATI.

However, a U.S. Shareholder of a CFC group may be able to increase its ATI based on the lesser of the upper-tier CFC's excess section 163(j) limitation or the shareholder's deemed inclusions.

Generally, a U.S. Shareholder does not take into account its subpart F or GILTI inclusions (and corresponding section 250 deduction) in calculating ATI.

However, a U.S. Shareholder of a stand-alone CFC or a CFC group member may be able to include a portion of its deemed income inclusions attributable to the CFC in the U.S. Shareholder's ATI.

A&M Insight: The determination whether the 2018 proposed regulations approach or the 2020 proposed regulations approach is more advantageous must be made on the basis of the particular taxpayer's facts and circumstances. For example, as a result of the tiering up of ETI in the 2018 proposed regulations, it is important which CFC issued the debt. This is because interest expense of a lower-tier group member could not benefit from ETI of a higher-tier or brother-sister member. However, it may be more beneficial for taxpayers to generate ETI in the upper-tier CFC that can increase the U.S. shareholder's ATI, rather than using that capacity to free otherwise disallowed business interest expense within the CFC group (which is the result of the 2020 proposed regulations). Additionally, the requirements for membership in a group differ between the two sets of proposed regulations and so the composition of a CFC group may depend on which set of proposed regulations is applied.

A&M Taxand Says

The final regulations under section 163(j) are, for the most part, consistent with the 2018 proposed regulations. However, in areas in which the final regulations diverge from the 2018 proposed regulations, the difference may be significant. In light of the volume of guidance included in the new set of regulations and the complexity associated with the implementation of these rules (e.g., the 11-step mechanical procedure for partnership), we strongly recommend that businesses work with their tax advisors to determine the effect of these regulations on their financial statements and cash tax models. In addition, since taxpayers can apply the final regulations and 2020 proposed regulations retroactively, we recommend that they consider whether applying these new regulations retroactively could be beneficial. A&M Taxand is happy to assist our clients to analyze the tax consequences of section 163(j).

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[1] Although the Final Regulations have been released, they have yet to be published in the Federal Register.

[2] The characterization of payments with respect to swaps as interest applies to notional principal contracts entered into on or after the date that is 365 days after the final regulations are published in the Federal Register.

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