

IRS Issues Proposed Regulations on Business Interest Deduction Limitations

Proposed regulations under Section 163(j) governing business interest deduction limitations confirm prior guidance and expand the scope of its application in some important respects.

On November 26, 2018, the Treasury and the Internal Revenue Service (IRS) released proposed regulations (Proposed Regulations) implementing the business interest expense limitation rules under new Section 163(j),¹ enacted last year as part of the Tax Cuts and Jobs Act (TCJA).² Section 163(j) generally limits a taxpayer's business interest deductions to 30% of "adjusted taxable income" (ATI).

The Proposed Regulations provide relevant definitions and detailed rules for calculating and applying the Section 163(j) limitation for different types of business entities — including C corporations, partnerships, S corporations, real estate investment trusts (REITs), real estate mortgage investment conduits (REMICs), and foreign corporations — in various circumstances. This *Client Alert* explains the key aspects of the Proposed Regulations.

Latham & Watkins has written about IRS Notice 2018-28 (previewing these Proposed Regulations) and published other materials analyzing the Section 163(j) limitation and its impact on leveraged finance, as well as the provisions of the TCJA more generally.

In General

Section 163(j) limits interest deductibility for taxpayers by imposing a 30% general cap on net business interest, generally computed as follows:

Section 163(j) limitation = (business interest income) + (30% of ATI) + (floor plan financing interest)

Any excess business interest expense disallowed under Section 163(j) will be carried forward to the next tax year.

The Section 163(j) limitation generally does not apply to any small business taxpayer whose average annual gross receipts for the three-year period ending on the relevant tax year does not exceed \$25 million.³

The Section 163(j) limitation applies to interest expense that would otherwise be deductible, generally after other statutory limitations (including deferrals) applicable to interest expense, and before general loss limitations.

Key Definitions

Broad Definition of “Interest”

The definition of “interest” is expansive and captures certain amounts that have not been traditionally considered interest under the Code. In addition to plain vanilla fixed interest on a debt instrument, the following are considered interest for purposes of the Section 163(j) limitation:

- Original issue discount, accrued market discount, and repurchase premium
- Premium in the case of debt instruments issued or acquired at a premium
- Debt issuance costs and, if any amounts have been borrowed, commitment fees
- Guaranteed payments by partnerships for the use of capital under Section 707(c)
- Income and deductions as well as gains and losses (e.g., foreign currency gain or loss) resulting from certain transactions used to hedge interest-bearing assets or liabilities (regardless of whether such transactions are integrated with the assets or liabilities hedged)
- Substitute interest payments on securities lending or sale-repurchase transactions
- Time value components for non-cleared swaps with significant non-periodic payments
- Ordinary income or loss arising from contingent payment debt instruments

The same definition generally applies for purposes of determining both business interest expense and business interest income. There is also an anti-abuse rule under which any expense or loss “predominantly incurred in consideration of the time value of money” in transactions in which the taxpayer secures the use of funds for certain time periods is considered interest. On the other hand, interest expense capitalized into the basis of assets under Sections 263A and 263(g) and rent paid under a true sale-leaseback are not treated as interest expense for the purposes of these rules.

Definition of ATI

ATI is defined as the taxable income of a taxpayer computed without regard to the application of the Section 163(j) limitation and with certain adjustments.

The adjustments will include adding back any business interest expense, any net operating loss (NOL) deduction, any deduction under Section 199A, and, for tax years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, and depletion. The adjustments will also include subtracting any business interest income, any floor plan financing interest expense and any gain from the sale or disposition of property in an amount not to exceed the amount of depreciation, amortization, or depletion deductions with respect to such property for tax years beginning before January 1, 2022.

Any amount of depreciation, amortization, or depletion capitalized under Section 263A and included in cost of goods sold is not a deduction for purposes of calculating ATI. As discussed below under *Controlled Foreign Corporations and Effectively Connected Income*, “global intangible low-taxed income” (GILTI) inclusions are also excluded from the calculation of ATI.

Observations

- Taxpayers should be mindful of the broad definition of interest in determining whether to elect to apply the Proposed Regulations prior to their enactment as final regulations.

- The inclusion of guaranteed payments for the use of capital is an unexpected expansion of the definition of interest that can have an adverse impact on partnership preferred equity structures that rely on guaranteed payments. Further, this expansion puts additional pressure on the appropriate tax treatment of accrued preferred return in partnership preferred equity structures in which the treatment of the return as a guaranteed payment or partnership allocation is unclear.

C Corporations, Consolidated Groups, and REITs

General Rules for C Corporations

Characterization of Items of Income, Gain, Deduction, or Loss

All interest paid or received by a C corporation will be treated as business interest expense or interest income for purposes of Section 163(j). Thus, all of a C corporation's interest expense will be subject to Section 163(j) and all of a C corporation's interest income, just like other items of income, gain, deduction, or loss, will be taken into account in determining the C corporation's ATI, except to the extent such items are properly allocable to an excepted trade or business (discussed in more detail in *General Rules for Allocating Expenses and Income Between Excepted and Non-Excepted Trades or Businesses* and Figure 6, below).

A partnership may have investment interest expense or interest income that is allocated to its partners, including a C corporation partner. This investment interest expense or interest income will be recharacterized as business interest expense or interest income to any C corporation partner and thus be taken into account in determining any C corporation's Section 163(j) limitation. This recharacterization rule does not apply to any Subpart F or GILTI inclusion that is treated as investment income at the partnership level, which remains excluded from the calculation of the Section 163(j) limitation even for C corporation partners.

See Figure 1, below, for an illustration depicting the general rules discussed above.

Timing for the Reduction of Earnings and Profits

Generally, a C corporation's earnings and profits will be reduced by any business interest expense paid or accrued in a tax year, irrespective of whether the business interest expense is allowed as a deduction under Section 163(j) for that particular tax year. The Proposed Regulations also clarify that for tax years ending after December 31, 2017, a C corporation's earnings and profits will not be reduced to reflect any carryforwards of "disallowed disqualified interest" (within the meaning of "old" Section 163(j) before the passage of the TCJA) to the extent the C corporation previously reduced its earnings and profits to reflect those interest payments in a prior tax year.

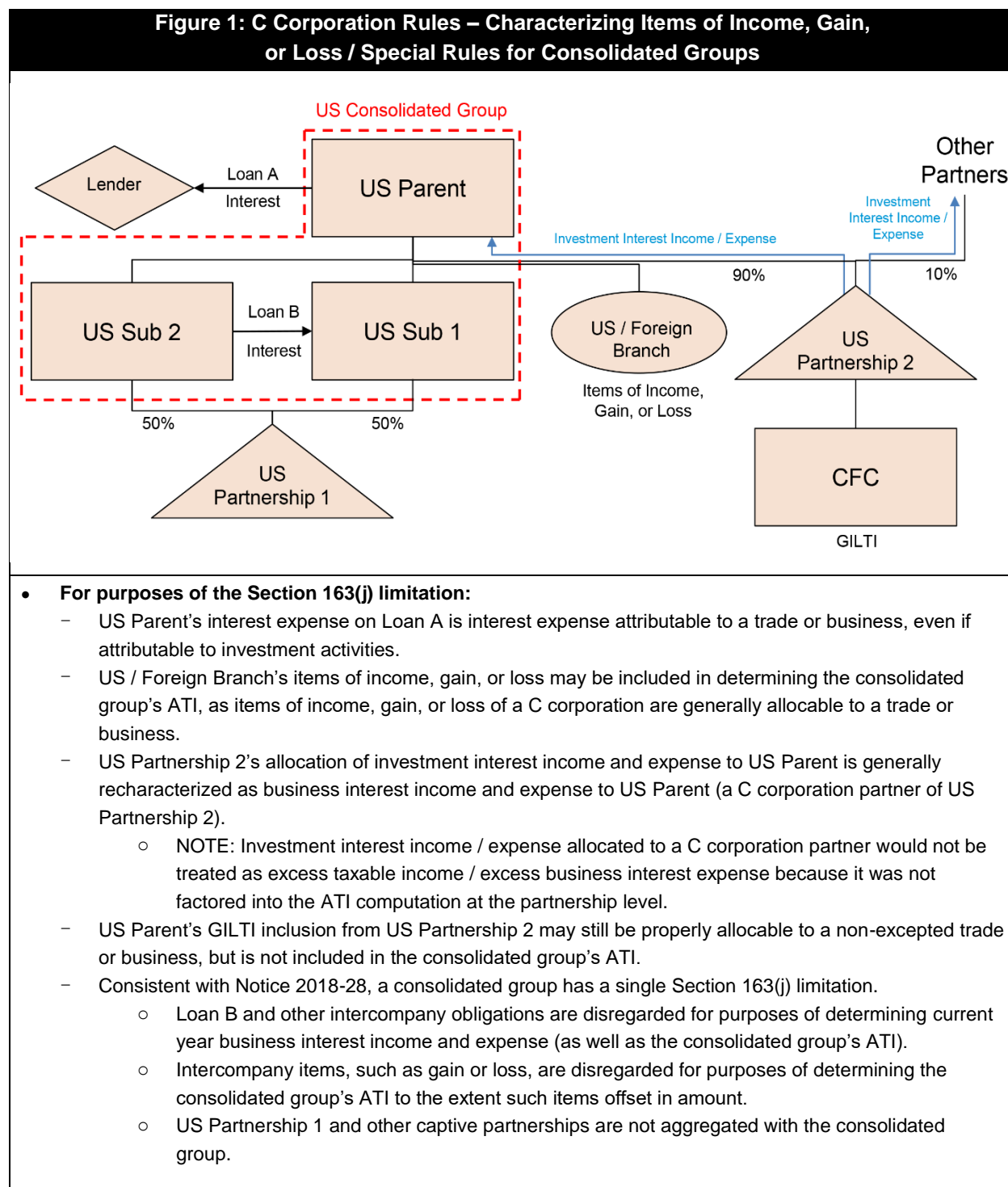
Special Rules for Consolidated Groups

Consolidated groups will have a single Section 163(j) limitation. For purposes of calculating this single Section 163(j) limitation:

- A consolidated group's ATI will be determined based on the consolidated group's taxable income without regard to carryforwards or disallowances under Section 163(j).
- All members of a consolidated group will be treated as a single corporation.
- Captive partnerships (*i.e.*, partnerships that are wholly owned by members of a consolidated group) will not be aggregated with the consolidated group for purposes of Section 163(j).
- Intercompany obligations will be disregarded for purposes of determining current-year business interest expense or interest income and calculating a consolidated group's ATI.
- Intercompany items (other than interest) will be disregarded for purposes of calculating a consolidated group's ATI to the extent the intercompany items offset in amount.

When a corporation subject to the Section 163(j) limitation joins a consolidated group not currently subject to the Section 163(j) limitation because its tax year began before January 1, 2018, the status of the acquiring group will control.

Figure 1, below, depicts the single Section 163(j) limitation for consolidated groups.



Special Rules for REITs

REITs are generally subject to the same rules that apply to other C corporations (as discussed above), with the following exceptions:

- A REIT's taxable income, which is the starting point for calculating the REIT's ATI, is not reduced by the dividends paid deduction ordinarily available to REITs, but takes into account other special corporate deductions that are usually available to other C corporations but unavailable to REITs. In calculating a REIT's ATI, such other special corporate deductions, including the deduction for dividends received and the deductions for foreign-derived intangible income and GILTI, are added back to ATI.
- A REIT's earnings and profits are not reduced for any business interest expense disallowed under Section 163(j) until the tax year(s) in which the business interest expense is deductible or, if earlier, in the first tax year in which the taxpayer is no longer a REIT.

Observations

- With all of its interest paid or received treated as per se business interest expense and income, a C corporation should consider evaluating whether financing activities related to investments are adversely affecting its Section 163(j) limitation.

Disallowed Business Interest Carryforwards

General Application

The amount of any business interest expense not allowed as a deduction for any tax year as a result of the Section 163(j) limitation will be carried forward to the following tax year as a "disallowed business interest expense carryforward" (DBIC).

For a stand-alone C corporation, current-year business interest expense will be deducted in the current tax year before DBICs will be applied. Thereafter, if the C corporation has any remaining Section 163(j) limitation, DBICs are deducted in the order of the tax years in which the DBICs arose, beginning with the earliest tax year (*i.e.*, using a first in, first out method), subject to certain limitations, including Section 382.

The rules for non-consolidated C corporation DBICs will generally apply to consolidated groups with the following additions:

- DBICs from prior "separate limitation years" will be subject to "separate return limitation year" limitations.
- If the aggregate amount of current-year business interest expense, including DBICs, of all members of a consolidated group exceeds the consolidated group's single Section 163(j) limitation for a tax year, specific ordering rules will be applied to determine which member's current-year business interest expense and DBICs will be deducted in the current tax year.

Disqualified Interest Expense under "Old" Section 163(j)

Any disqualified interest expense under "old Section 163(j) (the so-called "earnings stripping" rules) is generally carried forward to the taxpayer's first tax year beginning after December 31, 2017 and becomes subject to the new Section 163(j) rules. But any excess limitation under old Section 163(j) may not be carried forward.

Application of Sections 381, 382, and 383

In the case of certain tax-free asset acquisitions, Section 381(a) generally requires an acquiring corporation to succeed to and take into account certain tax attributes of a transferor corporation. The TCJA added DBICs to the list of tax attributes to which Section 381(a) applies. Similar to NOLs, special rules under Section 381 will determine an acquiring corporation's ability to use DBICs in its first tax year ending after the acquisition date.

The TCJA added DBICs to "pre-change losses" for purposes of Section 382. Consequently, for a tax year in which an ownership change occurs (*i.e.*, generally, a greater than 50 percentage point change in the ownership of stock of a corporation by 5% shareholders over a three-year period), DBICs and current-year business interest expense will be allocated pro rata between the pre- and post-change period based on the number of days in each period, irrespective of whether any closing-of-the books election is made with respect to NOLs and other tax items.

Section 383 provides ordering rules for the utilization of pre-change losses for the absorption of the Section 382 limitation. Generally, DBICs will be absorbed before NOLs, but after pre-change capital losses and all recognized built-in losses.

Observations

- DBICs and all other carryforwards share the same problem — a taxpayer must enjoy an economic change before the carryforward can be utilized. Because many taxpayers' business interest expenses remain relatively constant from year-to-year, absent a change in taxable income, it is likely DBICs may never be utilized.
- A seller may consider its subsidiary's DBICs as "tax attributes" for which the seller should be paid, but a buyer should model whether the buyer's group can utilize such DBICs in the first few post-closing tax years.

Partnerships

Section 163(j) provides that the Section 163(j) limitation applies at the partnership level. Any business interest expense allowed as a deduction by a partnership under Section 163(j) (Deductible Business Interest Expense) will not be subject to further limitations at the partner level for purposes of Section 163(j).

Special Rules for Calculating a Partnership's ATI

A partnership's ATI includes Section 734(b) basis adjustments but excludes partner-level adjustments, such as Section 743(b) basis adjustments, built-in loss amounts with respect to partnership property under Section 704(c)(1)(C), and remedial allocations of income, gain, loss, or deduction to a partner pursuant to Section 704(c). Instead, the partner takes into account these partner-level adjustments in determining its own ATI.

Special Rules for Calculating a Partner's Section 163(j) Limitation

Prevent Double Counting of Partnership Items

Generally, to prevent double counting, a partner's Section 163(j) limitation will be determined as follows:

- The partner's ATI excludes the partner's distributive share of any items of income, gain, deduction, or loss of the partnership (except for "excess taxable income" (ETI) once all of the partner's Excess

Business Interest Expense (as defined below), including any carryforwards, has been treated as paid or accrued);

- Business interest income from a partnership subject to Section 163(j) is excluded from the partner's ATI (except to the extent the amount of business interest income exceeds business interest expense at the partnership level); and
- The partner's allocable share of the partnership's floor plan financing interest is excluded from the partner's ATI.

Sale of Partnership Interests

If a partner sells its partnership interests and the partnership in which the interests being sold owns only non-excepted trade or business assets, the gain or loss from the sale of the partnership interests will be included in the partner's ATI. On the other hand, if the partnership whose interests are being sold owns both excepted and non-excepted trade or business assets, the partner will include the gain or loss from the sale of the partnership interests only to the extent such gain or loss is allocable to trade or business assets subject to Section 163(j).

Deductible Business Interest Expense and Section 163(j) Excess Items

Excess Business Interest Expense and Carryforwards

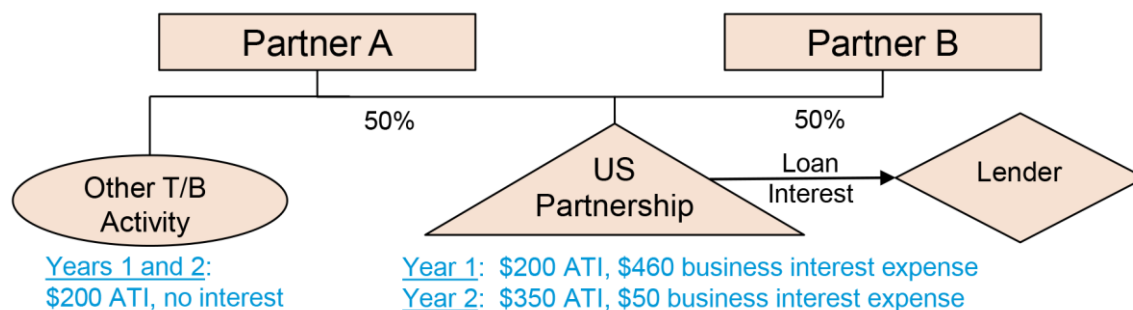
To the extent a partnership has business interest expense in excess of its Section 163(j) limitation (Excess Business Interest Expense), Section 163(j) provides that the Excess Business Interest Expense is not carried forward by the partnership. Rather, the Excess Business Interest Expense is allocated to the partners, which reduces (but not below zero) their outside basis in their partnership interests.

A partner's ability to deduct Excess Business Interest Expense in subsequent years is limited by allocations of ETI and "excess business interest income." ETI is essentially the portion of the partnership's ATI for a given tax year that is not used to support the partnership's deductions of business interest in that year (see Figure 2, below, for the formula). Excess business interest income is the amount by which a partnership's business interest income exceeds its business interest expense in a tax year. When a partner receives an allocation of either item, any Excess Business Interest Expense that was carried forward from a prior tax year will be treated as business interest expense paid or accrued by the partner in that tax year up to the amount of the ETI and excess business interest income, and that amount will be subject to the partner-level Section 163(j) limitation. If any of the partner's Excess Business Interest Expense exceeds the partner's share of the partnership's ETI or excess business interest income for the tax year, the Excess Business Interest Expense remains outstanding and is carried forward to the next applicable tax year.

In the event a partnership becomes exempt from the requirements of Section 163(j) in a tax year, any outstanding Excess Business Interest Expense will be treated as paid or accrued by the partner in the tax year.

See Figure 2, below, for an illustration depicting the Excess Business Interest Expense rules.

Figure 2: Partnerships – Excess Business Interest Expense Rules



- **For US Partnership in Years 1 and 2:**

- Year 1:
 - o US Partnership's Section 163(j) limitation is \$60 ($\$200 \text{ of ATI} \times 30\% = \60).
 - o US Partnership has \$60 of Deductible Business Interest Expense. This \$60 of Deductible Business Interest Expense is includable in US Partnership's non-separately stated income or loss and is not subject to further limitation at the Partner A or B level for purposes of Section 163(j).
 - o US Partnership allocates \$200 of Excess Business Interest Expense to each of Partners A and B ($(\$460 \text{ business interest expense} - \$60 \text{ Deductible Business Interest Expense}) \times 50\% = \200).
- Year 2:
 - o US Partnership's Section 163(j) limitation is \$105 ($\$350 \text{ of ATI} \times 30\% = \105).
 - o US Partnership has \$50 of Deductible Business Interest Expense.
 - o US Partnership allocates \$91.5 of ETI to each of Partners A and B ($(\$350 \text{ of ATI} \times [\$105 \text{ Section 163(j) limitation} - \$50 \text{ net business interest}] / \$105 \text{ Section 163(j) limitation}) \times 50\% = \91.5).

- **For Partner A in Years 1 and 2:**

- Year 1:
 - o US Partnership allocates \$30 of Deductible Business Interest Expense and \$200 of Excess Business Interest Expense to each of Partners A and B.
 - o Partner A's Section 163(j) limitation is \$60 ($\$200 \text{ of ATI from its other trade or business activity} \times 30\% = \60).
 - NOTE: Partner A is not able to use its \$200 of ATI from its other trade or business activity to deduct the Excess Business Interest Expense.
- Year 2:
 - o US Partnership allocates \$25 of Deductible Business Interest Expense and \$91.5 of ETI to each of Partners A and B. As a result, Partner A increases its ATI by \$91.5.
 - o Partner A treats \$91.5 of its \$200 Year 1 Excess Business Interest Expense as business interest paid or accrued in Year 2.
 - \$108.5 of Partner A's Excess Business Interest Expense from US Partnership remains outstanding and is carried forward to the next applicable tax year ($\$200 \text{ from Year 1} - \$91.5 \text{ treated as paid or accrued in Year 2} = \108.5).
 - o Partner A's Section 163(j) limitation is \$87.5 ($(\$200 \text{ of ATI from its other trade or business activity} + \$91.5 \text{ ETI}) \times 30\% = \87.5). Thus, \$87.5 of Partner A's business interest expense is Deductible Business Interest Expense.
 - Partner A's \$4 of business interest expense not allowed as a deduction is treated as business interest expense paid or accrued by Partner A in Year 3 ($\$91.5 \text{ business interest expense} - \$87.5 \text{ Section 163(j) limitation} = \4).

Allocating Section 163(j) Excess Items and Deductible Business Interest Expense to Partners

Section 163(j) provides that Excess Business Interest Expense, excess business interest income, and ETI (collectively, Section 163(j) Excess Items) and Deductible Business Interest Expense are allocated to partners in the same manner as “non-separately stated taxable income or loss of the partnership.” However, the phrase non-separately stated taxable income or loss of the partnership has not previously been defined by statute or regulation and thus Section 163(j) Excess Items and Deductible Business Interest Expense will be allocated to partners using an intricate 11-step method. This 11-step method generally will not have any effect on the partnership’s Section 704(b) allocations.

Application of Section 704(d)

Section 704(d) limits a partner’s allocable share of partnership losses to the amount of the partner’s outside basis in its partnership interests. Deductible Business Interest Expense and Excess Business Interest Expense, taken into account in that order, will be subject to Section 704(d). Any Excess Business Interest Expense suspended by Section 704(d) must be freed from such limitation before it can potentially be treated as paid or accrued by the partner in a subsequent year.

Disposition of *All or Substantially All* of Partnership Interests

If a partner disposes (*i.e.*, by sale, exchange, or redemption) of *all or substantially all* of its partnership interests, the partner’s outside basis in the partnership interest will be increased immediately before the disposition by the amount of the partner’s Excess Business Interest Expense that has not been treated as paid or accrued by the partner. On the other hand, if a partner disposes of less than substantially all of its partnership interests, the partner will not increase its outside basis in such partnership interests, and any Excess Business Interest Expense at the time of disposition will remain outstanding to the partner until the partner is allocated ETI or excess business interest income or disposes of all or substantially of its partnership interests. What constitutes *all or substantially all* is currently unclear under Section 163(j) and the Proposed Regulations.

Observations

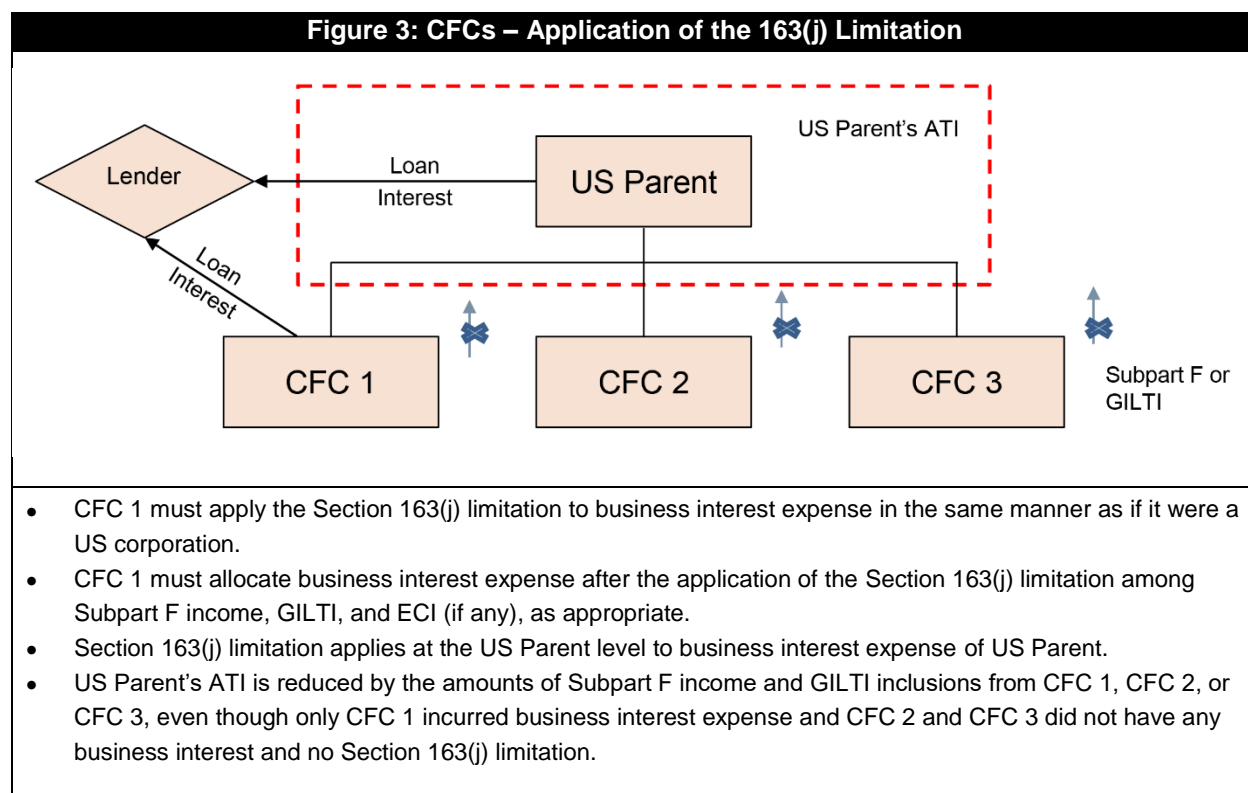
- Partners should keep track of their Excess Business Interest Expense, because, absent a change in the relevant partnership’s taxable income, it generally will not be freed up by ETI until the relevant partnership repays its debt.
- Partnerships electing to apply the Proposed Regulations prior to their finalization should focus on complying with the complex 11-step allocation method used for Section 163(j) Excess Items and Deductible Business Interest Expense.
- If a partnership disposes of all of its assets and liquidates, its partners may be allocated ETI arising from any gain recognized upon such disposition. Thus, any such allocated ETI will free up the partners’ Excess Business Interest Expense carried forward from prior tax years. On the other hand, if a partner disposes of all of its partnership interests, the partner may include any gain from such disposition in its ATI but such gain will not generate ETI. As a result, such partner’s Excess Business Interest Expense from the partnership will not be treated as paid or accrued. Depending on the amount of each partner’s Excess Business Interest Expense, it may be more beneficial in these circumstances for the partnership to dispose of all of its assets and liquidate.

Controlled Foreign Corporations and Effectively Connected Income

General Rule

The Section 163(j) limitation will apply to any controlled foreign corporation (CFC) that has at least one US shareholder that owns 10% of the CFC's stock by vote or value and is therefore required to take into income Subpart F or GILTI inclusions with respect to such a CFC. Such a CFC will be treated as if it were a domestic corporation for purposes of the Section 163(j) limitation. Each CFC generally will be required to limit its net business interest expense deduction to 30% of its ATI, and then allocate such allowed business interest expense deduction among the relevant categories of Subpart F, GILTI, or income effectively connected with the conduct of a US trade or business (ECI), as appropriate. The Proposed Regulations, however, do not provide any guidance on how to allocate the allowed interest expense between such categories. If such a CFC is a partner in a foreign partnership, the Section 163(j) limitation would apply to that foreign partnership as if the CFC partner were a domestic corporation. The general rule will require that each CFC apply the Section 163(j) limitation on a standalone basis, without any netting for related party interest income or expense allowed. Also, the US shareholder's ATI for purposes of determining the Section 163(j) limitation on the US shareholder's own interest expense will be reduced by the amount of all Subpart F and GILTI (reduced by any Section 250 deduction) inclusions, regardless of whether the CFCs that generated the inclusions have incurred any business interest expense.

See Figure 3, below, for an illustration depicting the general application of the Section 163(j) limitation to CFCs.



Alternative Method "CFC Group Election"

To mitigate the impact of the Section 163(j) limitation on interest expense paid and corresponding interest income earned on lending between related CFCs, a group of qualifying CFCs will be permitted to make

an “alternative method” election (the CFC Group Election). To qualify, a group of two or more CFCs must be 80% or more owned by value (vote is irrelevant) by the same US shareholder or by multiple related US shareholders in the same proportion (a CFC Group). In addition, any CFC that has any ECI cannot be a CFC Group member. Partnerships that are wholly owned by CFCs in the same CFC Group are also treated as CFCs.

Making a CFC Group Election has two principal effects:

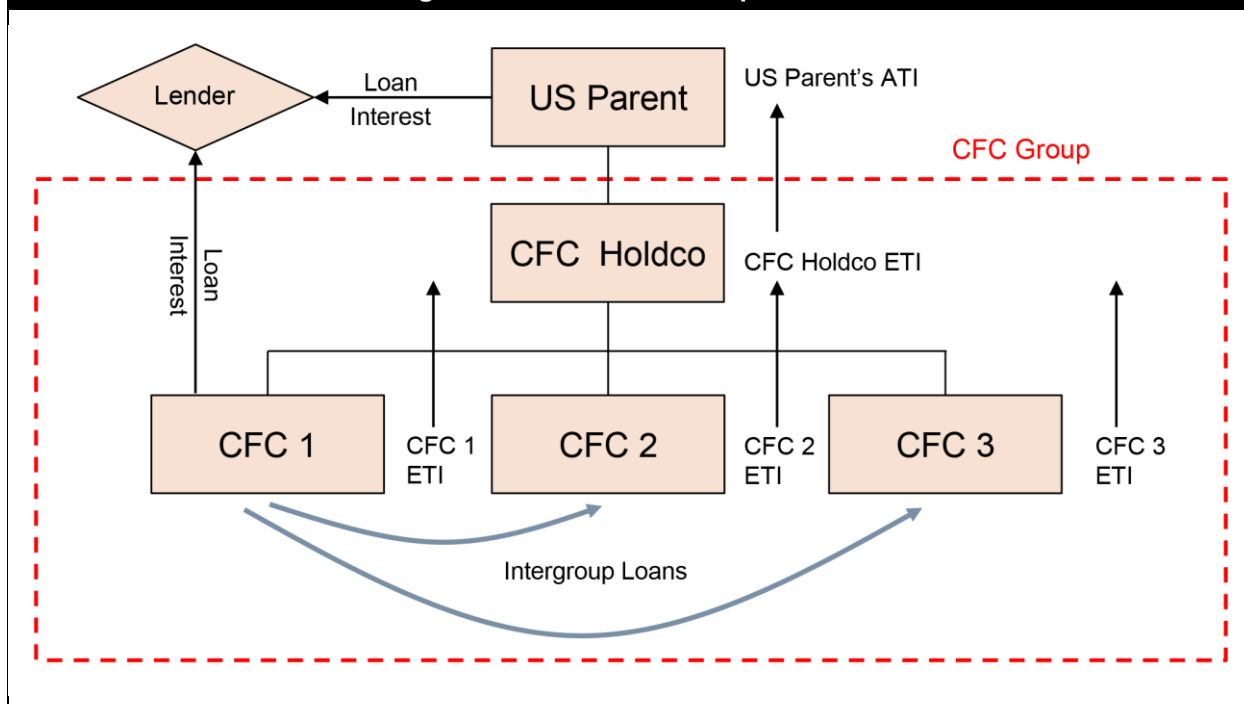
- CFCs in a CFC Group would net the aggregate business interest income earned by all CFCs in the CFC Group against the aggregate business interest expense incurred by all CFCs in the CFC Group. The resulting net business interest expense would then be allocated to each CFC that has business interest expense in proportion to such net business interest expense for purposes of computing the Section 163(j) limitation.
- The CFC Group Election would permit a “roll-up” of a lower-tier CFC’s excess taxable income (CFC ETI) to a higher-tier CFC in a manner similar to the application of Section 163(j) in a partnership context, and ultimately to the US shareholder. A US corporation that is either a US shareholder, or is holding its interest through a domestic partnership that is a US shareholder, of a CFC Group can increase its ATI by such corporation’s share of the CFC ETI of the highest tier member of the CFC Group (capped at the amount of the CFC Group’s Subpart F and GILTI (less any Section 250 deduction)). Any dividends received by CFCs from related parties, however, would be subtracted from the CFCs taxable income in computing their ATI.

The CFC Group Election generally would eliminate any business interest income and interest expense that is generated through intergroup lending and allocate among members only the net interest expense incurred to third parties. The CFC Group Election, nonetheless, stops at netting interest expense and interest income and would not pool the CFC Group members’ ATIs in determining how much interest expense is disallowed, so that the Section 163(j) limitation for each CFC in a CFC Group would be based solely on that CFC’s ATI. Whether a US shareholder with a single CFC would be allowed to benefit from the ETI roll-up provided for under the CFC Group Election is unclear, because a CFC Group technically must contain two or more CFCs.

A CFC Group Election is irrevocable and must be consistently applied to all CFCs, including any subsequently acquired CFCs that meet the requirements.

See Figure 4, below, for an illustration depicting the CFC Group Election.

Figure 4: CFCs – CFC Group Election



- CFC Holdco, CFC 1, CFC 2, and CFC 3 make a CFC Group Election to apply “alternative method.”
- Interest expense incurred by CFC 1, CFC 2, and CFC 3 is netted against interest income earned by CFC 1, thereby eliminating the effect of intercompany loans.
- Business interest expense subject to the Section 163(j) limitation is allocated among CFC 1, CFC 2, and CFC 3 proportionately to interest expense incurred.
- Each CFC must allocate the business interest expense after the application of the Section 163(j) limitation among Subpart F income, GILTI, and other income as appropriate. None of CFC Holdco, CFC 1, CFC 2, or CFC 3 may have any ECI.
- Section 163(j) limitation applies at the US Parent level to business interest expense incurred by US Parent.
- US Parent’s ATI is reduced by the amounts of Subpart F income and GILTI inclusions from CFC Holdco, CFC 1, CFC 2, or CFC 3 and increased by the ETI rolled up from CFC Holdco (whose ETI is increased by ETI roll-up from CFC 1, CFC 2, and CFC 3).

Special Rules for Financial Services CFCs and for Partnerships

“Financial services companies” that are CFCs will be treated as comprising their own subgroups that cannot be aggregated with the non-financial services CFCs for purposes of the CFC Group Election. Financial services companies are defined as companies generating income subject to the active finance exception, qualifying insurance companies, or dealers. There are also specific rules for foreign partnerships owned by CFCs.

Application to ECI

The Section 163(j) limitation will apply to the ECI of a foreign corporation or partnership. A foreign corporation would first determine business interest expense that is allocable to ECI and then compute the amount of disallowed business interest expense under Section 163(j) by scaling the limitation to the applicable US tax base. Complex computational rules also are provided to ensure that only the amounts of business interest income and business interest expense of a foreign partnership engaged in a US trade

or business that are allocable to such ECI are taken into account in computing the Section 163(j) limitation. Similarly, complex rules also are provided for foreign corporations that have ECI due to their ownership of an interest in a US partnership engaged in US trade or business.

No Impact on Computation of Earnings and Profits

The Section 163(j) limitation will not have any effect on the computation of the earnings and profits of a foreign corporation. Therefore, because Subpart F income is limited by the CFC's earnings and profits, the Section 163(j) limitation may have less effect on the amount of Subpart F income. In addition, investors in a "passive foreign investment company" (PFIC) would not be affected by the limitation, even if the investors made a qualified electing fund election, although the Proposed Regulations suggest that the Section 163(j) limitation technically would apply to a PFIC. Similarly, disallowed business interest will not affect determination of effectively connected earnings and profits for purposes of the branch profits tax.

Observations

- There will be a significant increase in the complexity of evaluating not only whether to borrow in the US or offshore, but also where to locate leverage in a group of CFCs. US parented groups may become incentivized to spread their borrowings among the US group and all CFCs in proportion to their US taxable income to utilize the maximum available Section 163(j) limitation at the US parent and at each CFC's level, because a US shareholder's own ATI is reduced by any Subpart F income and GILTI inclusions from CFCs that have non-excepted business.
- In view of the broad definition of interest, CFCs will now be required to closely examine all their costs associated with borrowing and hedging and any business income that may produce interest under the broad definition of interest (discussed above in more detail in *Key Definitions*).
- CFCs will also need to keep track of their disallowed business interest expense. Similar to C corporations, a CFC's DBICs may be carried forward indefinitely, which differs from current law that does not allow CFCs to carry forward NOLs. It is not clear if/how any of the Section 382 limitations would apply to a CFC's DBICs.
- The CFC Group Election appears to be generally beneficial for US parented multinationals that rely on intercompany lending between CFCs and charge intercompany interest with a markup and/or if borrowing is concentrated either at higher-tier CFCs or at the US shareholder level.
- Multinationals that have CFCs that generate any ECI may consider whether such CFCs should not borrow from related CFCs, because such CFCs could not be included in the CFC Group Election and because intercompany lending may create additional frictions.

Elections for Excepted Trades or Businesses

Section 163(j) provides that a taxpayer operating an eligible real property trade or business or an eligible farming business can irrevocably elect to have such trade or business be exempt from the Section 163(j) limitation. However, the taxpayer is required to use an alternative depreciation system to depreciate certain property held by the electing real property trade or business (ERP) or electing farming business. Under the Proposed Regulations, this election can be made with respect to each eligible trade or business by attaching an election statement to the taxpayer's timely filed federal income tax return, including extensions. An election with respect to a partnership's trade or business must be made on the partnership's tax return and does not apply to a trade or business conducted by a partner outside the partnership.

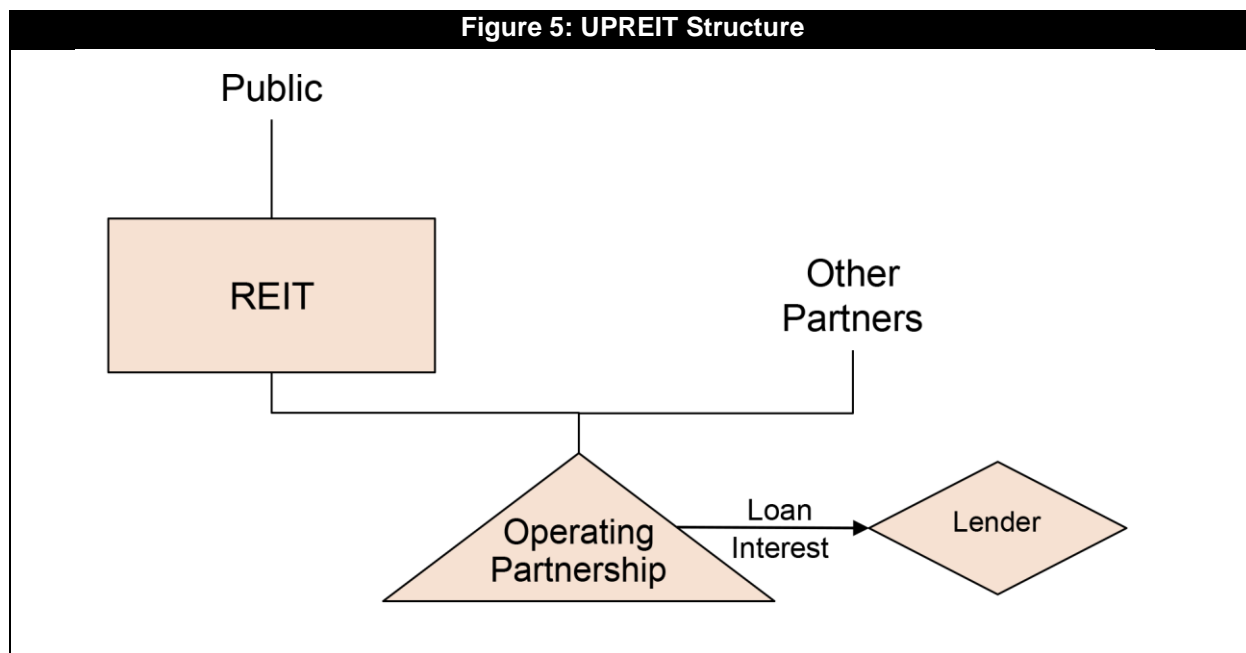
The election ordinarily will remain in effect so long as the taxpayer or a related party continues to conduct the electing trade or business. If the taxpayer sells or transfers substantially all of the business assets to an unrelated party in a taxable asset transfer, the election will terminate unless the taxpayer or a related party reacquires substantially all of the assets, or substantially similar assets, and resumes conducting the prior electing trade or business within 5 years after the sale or transfer. If a taxpayer acquires substantially all of the assets of an electing trade or business in a nontaxable asset transfer from an unrelated party, the election will remain in effect for the acquired trade or business so long as the taxpayer or a related party continues to conduct such trade or business.

Safe Harbor for REITs

A safe harbor will allow REITs that hold real property, interests in partnerships holding real property, or shares in other REITs holding real property to make the election to be an ERP to be exempt from the Section 163(j) limitation. For this purpose, “real property” is defined consistent with the definition used for REIT purposes, which is broader than the definition generally used under the ERP rules. If a REIT makes the ERP election and 10% or less of its assets (by value) are “real property financing assets,” then all of the REIT’s assets will be treated as assets of an excepted trade or business for purposes of the allocation rules described below (see *General Rules for Allocating Expenses and Income Between Excepted and Non-Excepted Trades or Businesses*). However, if more than 10% of the REIT’s assets are real property financing assets, a portion of the REIT’s assets will be treated as assets of a non-excepted trade or business for purposes of such allocation rules. Real property financing assets include mortgages, mortgage-backed securities, and various other instruments often owned by mortgage REITs, and may also include an equity REIT’s leases if and to the extent treated as financings.

Observations

- If a REIT is structured as an UPREIT and the interest expense is incurred at the level of the REIT’s operating partnership (OP) (as illustrated in Figure 5, below), the benefits of the safe harbor may be limited because the safe harbor applies to REITs but the Section 163(j) limitation would apply at the partnership level. Although the OP may still be able to make the ERP election, the OP could not benefit from the safe harbor since it is not a REIT.



General Rules for Allocating Expenses and Income Between Excepted and Non-Excepted Trades or Businesses

ERPs, electing farming businesses, certain regulated utilities businesses, and performing services as an employee are excepted trades or businesses for purposes of Section 163(j).

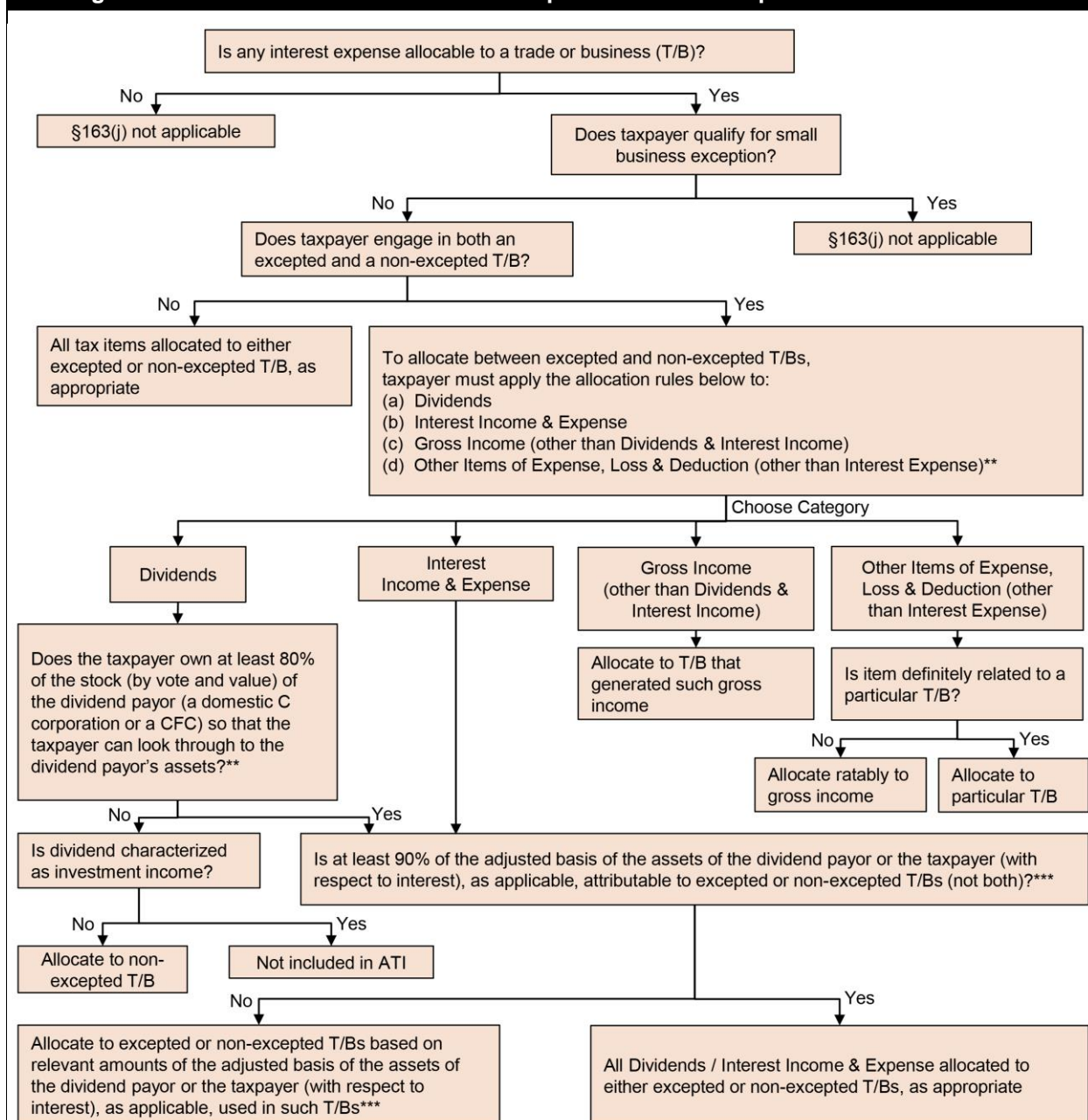
Only interest expense, interest income, and other items of income, expense, gain, deduction, or loss properly allocable to a non-excepted trade or business will be taken into account for purposes of the Section 163(j) limitation. For that reason, allocation of such items generally will be required if both:

- A taxpayer determines that interest expense is properly allocated to a trade or business
- A taxpayer engages in both an excepted and a non-excepted trade or business

For non-corporate taxpayers, the rules for determining whether interest is allocable to a trade or business (versus, for example, investment interest or personal interest) generally are found in Sections 163(d) and (h). With respect to items related to a trade or business, the allocation rules vary depending on whether the items being allocated are:

- Dividends
- Interest income and expense
- Gross income (other than dividends and interest income) or
- Other items of expense (other than interest expense), loss, and deduction

See Figure 6, below, for a decision tree relating to the application of these allocation rules.

Figure 6: Allocation of Items Between Excepted and Non-Excepted T/Bs Decision Tree*

* This decision tree only addresses the general allocation rules for the purposes of Section 163(j). There are numerous special allocation rules, such as direct allocation for interest expenses for qualified non-recourse debt and taxpayers who are engaged in banking, insurance, or finance.

** A consolidated group is treated as a single corporation for the purposes of these allocation rules. Once the percentage of a consolidated group's interest expense that is allocable to excepted T/Bs is determined, this exempt percentage is applied proportionally to each member that has paid interest to a third party during the year.

*** Determine adjusted basis of assets on a quarterly basis and average those amounts to determine the relative amounts of adjusted basis allocable to excepted and non-excepted T/Bs for a tax year. Various methodologies are provided for allocating adjusted basis in an asset that is used in more than one T/B in a tax year, but the taxpayer must use the methodology that most reasonably reflects the use of the asset in each T/B. For partnerships, a partner owning at least 80% of a partnership's capital or profits may look through to the partner's share of the partnership's adjusted basis in the partnership's assets to determine the extent to which the partner's adjusted basis in its partnership interest is allocable to excepted or non-excepted T/Bs (taking into account any Section 734(b) and 743(b) adjustments).

Effective Date and Transition Rules

The Proposed Regulations relating to the Section 163(j) limitation are proposed to apply to tax years ending after the publication date of final regulations in the Federal Register. However, taxpayers may choose to apply the Proposed Regulations for tax years beginning after December 31, 2017, so long as the Proposed Regulations are applied on a consistent basis among related parties.

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Endnotes

¹ All references to "Section" are to sections of the Internal Revenue Code of 1986, as amended (Code).

² Public Law No. 115-97 (Dec. 22, 2017). Shortly before final Congressional approval of the Act, the Senate parliamentarian ruled that the previously attached short title, the "Tax Cuts and Jobs Act," violated procedural rules governing the Senate's consideration of the legislation. Accordingly, the Act does not bear a short title, although commentators generally have continued to refer to it as the Tax Cuts and Jobs Act.

³ All monetary values in US\$.