SULLIVAN & CROMWELL LLP

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IRS Issues Final and Proposed Regulations on Section 163(j) Interest Deduction Limitation

Final Regulations Adopt 2018 Proposed Regulations With Key Modifications

SUMMARY

On July 25, 2020, the Department of the Treasury (the "Treasury Department") and the Internal Revenue Service (the "IRS") issued final regulations (the "Final Regulations") and proposed regulations (the "New Proposed Regulations" and, together with the Final Regulations, the "New Regulations") with respect to the limitation on deductions for business interest expense under Section 163(j) of the Internal Revenue Code (the "Section 163(j) Limitation"). The Final Regulations adopt the general framework of proposed regulations that were published on December 28, 2018 in the Federal Register (the "2018 Proposed Regulations"), subject to significant modifications that are discussed below.

As discussed in more detail below, the New Regulations address, among other topics, the definition of "interest" for purposes of Section 163(j) and the application of Section 163(j) to partnerships, controlled foreign corporations, and corporate members of a tax consolidated group. This memorandum provides an overview of some of the most important provisions in the New Regulations, but does not address all of the provisions in the more than 900 pages that are included in the New Regulations and accompanying preambles.

Highlights of the New Regulations include:

- The Final Regulations narrow the definition of "interest" for Section 163(j) purposes so that it no longer includes certain types of payments that were treated as interest under the 2018 Proposed Regulations. In addition, the anti-avoidance rule applicable to the definition of "interest" now applies only where there

is a principal purpose of structuring the applicable transaction to reduce interest expense or increase interest income.

- Under the Final Regulations, for taxable years beginning prior to 2022, depreciation, amortization, and depletion expense capitalized into inventory are added back to the base amount of taxable income with respect to which a taxpayer's Section 163(j) Limitation is calculated.
- In the case of partnerships, the Final Regulations confirm the approach of the 2018 Proposed Regulations under which the Section 163(j) Limitation is calculated at the partnership level and then allocated to the partners in the partnership. The Final Regulations, however, add new provisions that govern the application of the Section 163(j) Limitation to tiered partnerships and loans between partnerships and partners, and provide for the partial recovery of excess business interest carryforwards upon a partial disposition of a partnership interest.
- The Final Regulations confirm the approach of the 2018 Proposed Regulations under which a controlled foreign corporation ("CFC") will be subject to the Section 163(j) Limitation for purposes of computing subpart F income, GILTI tested income or loss, and income effectively connected to a United States trade or business. Moreover, a United States shareholder of a CFC must deduct any inclusions of the CFC's income when the United States shareholder calculates its Section 163(j) Limitation.
- The New Proposed Regulations provide for a CFC group election that would treat an affiliated group of CFCs in the same manner as a U.S. consolidated group, with a single Section 163(j) Limitation for the entire electing CFC group. Excess taxable income of a CFC group or certain stand-alone CFCs could be added back to the base amount of taxable income when calculating a United States shareholder's Section 163(j) Limitation.
- Stand-alone CFCs and CFC groups that satisfy certain requirements could make a safe-harbor election to be exempt from Section 163(j).

BACKGROUND

As part of the tax reform bill passed in December 2017 (the "Tax Reform Act"),[1] Congress enacted new rules limiting the deductibility of net business interest expense by taxpayers. Prior to the Tax Reform Act, Section 163(j) disallowed deductions for "disqualified interest" paid or accrued by corporations to related parties if the payor's debt-to-equity ratio exceeded a statutory threshold and the payor's net interest expense exceeded 50 percent of the payor's adjusted taxable income.[2] Section 163(j), as amended by the Tax Reform Act, disallows a taxpayer's business deductions for net interest expense, generally defined as the excess of business interest expense over business interest income, if such net interest expense exceeds 30 percent of the taxpayer's "adjusted taxable income" ("ATI"). This limitation applies irrespective of whether the interest is paid to related or unrelated parties.

For taxable years beginning prior to January 1, 2022, the ATI of a taxpayer is generally equal to its taxable income after adding back non-business and exempt business income and deductions, interest, taxes,

1 The formal name for the Tax Reform Act is "An act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." *See* S&C publication of December 20, 2017, *U.S. Tax Reform*, for a description of the key provisions included in the legislation.

2 *See* Former Section 163(j)(1)(A), (2)(A).

depreciation, and amortization (subject to certain other adjustments).[3] The Section 163(j) Limitation for subsequent taxable years will be determined in the same manner without any add-back for depreciation and amortization.[4]

The Section 163(j) Limitation applies only to business interest and does not apply to investment interest.[5] The statute provides that the Section 163(j) Limitation applies to a partnership at the partnership level and not at the partner level.[6] There is no grandfathering for debt issued prior to the enactment of the Tax Reform Act.

Certain real estate businesses,[7] regulated utilities,[8] and small businesses (with $25 million or less of gross receipts)[9] are exempt from the Section 163(j) Limitation. The Section 163(j) Limitation also does not apply to interest on "floor plan financing indebtedness" (indebtedness used to finance the acquisition of motor vehicles held for sale or lease or secured by such inventory).[10]

Deductions disallowed by the Section 163(j) Limitation are generally carried forward in the same manner as net operating loss carryforwards.[11] Thus, subject to a special rule for partnerships, disallowed business interest deductions may be carried forward indefinitely. A taxpayer's disallowed business interest deductions are also subject to limitation following a change in ownership of the taxpayer.[12]

In March 2020, Congress enacted certain temporary changes to the application of Section 163(j) as part of the "Coronavirus Aid, Relief, and Economic Security Act" (the "CARES Act").[13] Under the CARES Act, the Section 163(j) Limitation for any taxable year beginning in 2019 or 2020 generally is increased to 50 percent of ATI.[14] For a partnership, this increase applies only to the partnership's taxable year beginning in 2020

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3 *See* Section 163(j)(1), (8).

4 *See* Section 163(j)(8)(A)(v).

5 Section 163(j)(5).

6 Section 163(j)(4)(A)(i).

7 Section 163(j)(7)(A)(ii).

8 Section 163(j)(7)(A)(iv).

9 Section 163(j)(3).

10 Section 163(j)(1)(C).

11 *See* Section 163(j)(2).

12 *See* Section 382(d)(3).

13 *See* S&C publication of March 30, 2020, *Coronavirus Aid, Relief, and Economic Security (CARES) Act—Business Tax Provisions*, for a description of the key business tax provisions included in the legislation.

14 *See* Section 163(j)(10)(A)(i).

and not 2019.[15] A taxpayer may generally elect out of the increase in the Section 163(j) Limitation provided in the CARES Act for any taxable year.[16] In addition, for any taxable year beginning in 2020, the CARES Act allows the taxpayer to elect to use its ATI for the last taxable year beginning in 2019.[17]

DISCUSSION

The Final Regulations implement much of the guidance provided in the 2018 Proposed Regulations, subject to certain modifications, and additional guidance provided in the New Proposed Regulations.[18] This memorandum discusses some of the most important provisions of the New Regulations, and highlights significant differences between the New Regulations and the 2018 Proposed Regulations.

A. DEFINITION OF INTEREST

The 2018 Proposed Regulations defined "interest" for Section 163(j) purposes to include not only amounts generally treated as interest for federal income tax purposes, but also certain items of income and expense that are similar to interest or related to debt instruments, such as substitute interest payments under a securities loan, commitment fees, debt issuance costs, guaranteed payments by a partnership for the use of capital, and amounts that alter a taxpayer's effective cost of borrowing or effective yield from holding a debt instrument.[19] Under the latter provision, an issuer or holder of a debt instrument that hedges interest rate or foreign currency risk would treat gain or loss from the hedge as an adjustment to interest expense or income for Section 163(j) purposes, even if the hedge is not otherwise integrated with the debt instrument for tax purposes. This provision was subject to significant criticism, particularly because many taxpayers hedge their interest rate and foreign currency positions on a "macro" basis (i.e., based on the taxpayer's firm-wide daily positions without there being specific hedges that relate to specific debt instruments), and are therefore unable to determine whether a particular hedge alters their effective cost of borrowing or effective yield from holding a debt instrument. In addition, there was concern that the government might apply this expanded definition of interest more broadly for other tax purposes, particularly because the Proposed Section 267A Regulations employed a similar expanded definition of interest.[20]

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15 *See* Section 163(j)(10)(A)(ii)(I).

16 *See* Section 163(j)(10)(A)(iii).

17 *See* Section 163(j)(10)(B).

18 *See* S&C publication of December 31, 2018, *IRS Issues Proposed Regulations on Section 163(j) Interest Deduction Limitation*, for a description of the key provisions included in the 2018 Proposed Regulations.

19 Fmr. Prop. Treas. Regs. §§ 1.163(j)-1(b)(20)(iii)(C), (E), (G), (H), (I).

20 *See* Prop. Treas. Regs. § 1.267A-5(a)(12).

The Final Regulations significantly narrow the definition of interest for Section 163(j) purposes, and generally define interest by reference to the general tax definition of interest,[21] subject to certain specific rules discussed below and the anti-avoidance rule discussed below. In particular, unlike the 2018 Proposed Regulations, the Final Regulations do not treat "amounts that alter a taxpayer's effective cost of borrowing or effective yield from holding a debt instrument" as an adjustment to interest income or expense, although, as discussed below, it is possible that such amounts could be treated as an adjustment to interest income or expense under the anti-avoidance rule.

1. Swaps with Significant Nonperiodic Payments

The 2018 Proposed Regulations treated a swap with significant nonperiodic payments as generating imputed interest income and expense in respect of the nonperiodic payment.[22] The Final Regulations generally adopt this rule, but add an exception for (i) cleared swaps and (ii) non-cleared swaps that require the parties to meet either the margin or the collateral requirements of a federal regulator (including the SEC, CFTC, or certain prudential regulators), or that provide for margin or collateral requirements that are substantially similar to a cleared swap or a non-cleared swap subject to the margin or collateral requirements of a federal regulator.[23] The Final Regulations clarify that this rule applies for all purposes of the Internal Revenue Code, and not solely for Section 163(j) purposes.

The preamble to the Final Regulations notes that this interest imputation rule is a reinstatement of the same rule that applied under Treas. Regs. Section 1.446-3 prior to the replacement of those Regulations in 2015 with a (now expired) Temporary Regulation. Thus, the new interest imputation rule would apply in the same manner as the equivalent Regulations that were in effect prior to 2015. The preamble notes in this regard that while the Final Regulations do not define the term "significant" for this purpose, the authority in the pre-2015 Regulations would apply for purposes of defining the term "significant" under the Final Regulations.[24] The interest imputation rule under the Final Regulations applies only with respect to notional principal

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21 The Final Regulations confirm that interest for this purpose includes items of income and expense that are generally treated as interest for tax purposes, such as original issue discount, market discount, acquisition discount, deductible repurchase premium, certain deferred payments in exchange for property that are treated as interest for tax purposes, imputed interest with respect to certain below-market loans, and amounts treated as interest under certain rental agreements that provide for deferred or prepaid rent. The Final Regulations also treat factoring income and income from Section 1258 conversion transactions as interest income for Section 163(j) purposes.

22 Fmr. Prop. Treas. Regs. § 1.163(j)-1(b)(20)(ii). The 2018 Proposed Regulations reserved with respect to the treatment of cleared swaps.

23 Treas. Regs. § 1.163(j)-1(b)(22)(ii)(B), (C).

24 The pre-2015 Regulations contained examples that suggested that a nonperiodic payment is "significant" where it equals approximately 40 percent of the present value of the periodic payments under a contract, but a nonperiodic payment is not significant where it equals approximately 10 percent of the present value of the periodic payments under a contract. Fmr. Treas. Reg. § 1.446-3(g)(6), Ex. (2), (3).

contracts entered into on or after the date that is one year after the date on which the Final Regulations are published in the Federal Register, though taxpayers may choose to apply the rule to notional principal contracts entered into prior to such date and the delayed effective date does not apply if the anti-avoidance rule applies to the notional principal contract.[25]

2. Substitute Interest Payments

The 2018 Proposed Regulations treated a substitute interest payment under a securities loan or repo transaction as interest income or expense for Section 163(j) purposes. The Final Regulations provide that a substitute interest payment is treated as interest expense to the payor only if the payment relates to a securities loan or repo transaction that is not entered into by the payor in the payor's ordinary course of business, and similarly, a substitute interest payment is treated as interest income to the recipient only if the payment relates to a securities loan or repo transaction that is not entered into by the recipient in the recipient's ordinary course of business.[26] The exclusion of ordinary course substitute interest payments from the definition of interest could pose an administrative burden for taxpayers that treat substitute interest as interest for financial accounting purposes, as they will now need to separately track substitute interest for Section 163(j) purposes to the extent such amounts are paid or received in the ordinary course of business.

3. Anti-avoidance Rule

The Final Regulations include an anti-avoidance rule that expands the definition of "interest" for Section 163(j) purposes. The anti-avoidance rule in the 2018 Proposed Regulations generally treated an item of expense or loss as interest if "incurred by a taxpayer in connection with the use of funds for a period of time where such expense or loss is predominantly incurred in consideration of the time value of money." This rule applied irrespective of whether the taxpayer structured the transaction with an intent to avoid Section 163(j), and thus could apply to ordinary course transactions that are not motivated by Section 163(j) considerations.[27] By contrast, under the Final Regulations, the anti-avoidance rule treats an expense or loss that is "economically equivalent to interest" as interest for Section 163(j) purposes only if a principal purpose of structuring the applicable transaction is to reduce the interest expense that would otherwise be recognized by the taxpayer for Section 163(j) purposes.[28] For this purpose, an expense or loss is "economically equivalent to interest" if the expense or loss is (i) deductible by the taxpayer, (ii) incurred by the taxpayer in a transaction or series of integrated or related transactions in which the taxpayer secures

[25] Treas. Regs. § 1.163(j)-1(c)(3).

[26] Treas. Regs. § 1.163(j)-1(b)(22)(iii)(C). This rule would not apply to repo transactions that are treated as debt for U.S. federal income tax purposes.

[27] Fmr. Prop. Treas. Regs. § 1.163(j)-1(b)(20)(iv).

[28] Treas. Regs. § 1.163(j)-1(b)(22)(iv)(A)(1).

the use of funds, (iii) substantially incurred in consideration of the time value of money, and (iv) otherwise not treated as interest for Section 163(j) purposes.[29]

The Final Regulations also provide that income received by a taxpayer will be treated as interest income if the taxpayer knows that the associated expense or loss is treated by the payor as interest expense under the anti-avoidance rule and the other requirements of the anti-avoidance rule are met.[30]

In addition, the Final Regulations include a corresponding anti-avoidance rule that treats business interest income as other than business interest income for Section 163(j) purposes if a principal purpose for structuring the applicable transaction is to artificially increase the taxpayer's business interest income.[31]

The Final Regulations state that for purposes of the anti-avoidance rule, the fact that the taxpayer has a business purpose for obtaining the use of funds (or for holding interest-generating assets, as applicable) does not affect the determination of whether the taxpayer structured the transaction with a principal purpose of reducing the taxpayer's interest expense or increasing the taxpayer's interest income. In addition, the fact that the taxpayer may have obtained funds at a lower pre-tax cost based on the structure of the transaction does not affect the determination of whether the taxpayer structured the transaction with a principal purpose of reducing the taxpayer's interest expense. Factors to be taken into account in determining whether one of the taxpayer's principal purposes for entering into the transaction is the reduction of the taxpayer's interest expense include the taxpayer's normal borrowing rate in the taxpayer's functional currency; whether the taxpayer would enter into the transaction in the ordinary course of the taxpayer's trade or business; whether the parties to the transaction are related persons; whether there is a significant and bona fide business purpose for the structure of the transaction; whether the transaction is transitory; and the substance of the transaction.[32]

As noted above, the Final Regulations do not include the broad definition of interest under the 2018 Proposed Regulations, and thus, for example, do not treat guaranteed payments on a partnership interest or hedges of debt instruments as interest income or expense for Section 163(j) purposes. The Final Regulations, however, contain examples under the anti-avoidance rule in which amounts that would have been treated as interest under the general definition of interest under the 2018 Proposed Regulations are treated as interest under the anti-avoidance rule in the Final Regulations. In particular, an example in the Final Regulations treats a guaranteed payment to a partner for the use of capital as interest for Section 163(j) purposes if the transaction is structured as such, rather than as debt issued by the partnership, in

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[29] Treas. Regs. § 1.163(j)-1(b)(22)(iv)(A)(1).

[30] Treas. Regs. § 1.163(j)-1(b)(22)(iv)(A)(2).

[31] Treas. Regs. § 1.163(j)-1(b)(22)(iv)(B).

[32] Treas. Regs. § 1.163(j)-1(b)(22)(iv)(C).

order to reduce the interest expense of the partnership.[33] In another example, a taxpayer borrowed in a foreign currency at a low interest rate and simultaneously entered into a foreign currency swap to hedge the currency risk from the borrowing. The example concludes that income or loss from the swap would be treated as an adjustment to interest expense for Section 163(j) purposes if the taxpayer entered into the transactions, as opposed to borrowing in the currency that it receives under the swap, with a principal purpose of reducing its interest expense.[34]

Although the literal words of the anti-avoidance rule could be interpreted broadly to encompass any Section 163(j) tax planning, the examples that accompany the anti-avoidance rule arguably suggest that the rule is only implicated if the applicable transaction includes elements that do not relate to the business objectives of the taxpayer. For example, both of the examples under the anti-avoidance rule that describe transactions in foreign currencies indicate that the applicable taxpayer otherwise has no connection to the applicable foreign currency or the associated foreign country.[35] Similarly, examples under the anti-avoidance rule that describe arrangements involving guarantee fees and a forward purchase of gold both state that the applicable taxpayer would not have entered into such transactions in the course of its trade or business.[36]

4. Guarantee Fees

Neither the 2018 Proposed Regulations nor the Final Regulations provide that guarantee fees are treated as interest for Section 163(j) purposes, but the Final Regulations contain an example under the anti-avoidance rule that indicates that a guarantee fee with respect to a loan could be treated as interest where a principal purpose of the guarantee arrangement is to reduce the amount of interest expense that is realized by the borrower under the loan.[37]

5. RIC Dividends

The New Proposed Regulations contain a rule that would permit a shareholder in a regulated investment company (a "RIC") that earns business interest income to treat a dividend designated by the RIC as a Section 163(j) interest dividend as interest income of the shareholder, subject to certain holding period requirements.[38] The total amount of a RIC's Section 163(j) interest dividends for a taxable year is limited to the excess of the RIC's business interest income for the taxable year over the sum of the RIC's business

[33] Treas. Regs. § 1.163(j)-1(b)(22)(v)(E).

[34] Treas. Regs. § 1.163(j)-1(b)(22)(v)(A).

[35] Treas. Regs. § 1.163(j)-1(b)(22)(v)(A), (C).

[36] Treas. Regs. § 1.163(j)-1(b)(22)(v)(B), (D).

[37] Treas. Regs. § 1.163(j)-1(b)(22)(v)(D).

[38] Prop. Treas. Regs. § 1.163(j)-1(b)(22)(iii)(F)(1), (4).

interest expense for the taxable year and the RIC's other deductions for the taxable year that are properly allocable to the RIC's business interest income.[39]

6. Bond Premium, Negative Interest, and Commitment Fees

Consistent with the 2018 Proposed Regulations, under the Final Regulations, a holder of a debt instrument that elects to amortize bond premium would treat the bond premium deduction as interest expense, and an issuer of a debt instrument with bond premium would treat the ordinary income attributable to the bond premium as interest income.[40] The preamble to the Final Regulations notes that although the Final Regulations do not address negative interest in the context of Section 163(j), in certain cases payments on debt instruments acquired with a negative yield may be treated as bond premium.

In addition, while the Final Regulations (unlike the 2018 Proposed Regulations) do not treat commitment fees as interest, the preamble to the Final Regulations notes that the government is more generally considering the tax treatment of commitment fees, and other similar loan fees, for federal income tax purposes.

B. DEFINITION OF ADJUSTED TAXABLE INCOME

As noted above, for taxable years beginning prior to January 1, 2022, the ATI of a taxpayer is generally equal to its taxable income determined after adding back non-business and exempt business income and deductions, interest, taxes, depreciation, and amortization (subject to certain other adjustments).[41] Under the 2018 Proposed Regulations, depreciation, amortization, or depletion expense capitalized into inventory under the tax accounting rules applicable to certain taxpayers that manufacture or produce inventory would not have been added back for purposes of calculating ATI for such taxable years.[42] The Final Regulations reverse this rule and provide that such amounts are added back for purposes of calculating ATI in the year that such amounts are capitalized into inventory, regardless of when the capitalized amounts are recovered through cost of goods sold.[43]

C. APPLICATION TO PARTNERSHIPS

1. Calculating the Partnership-Level Limitation and Related Allocations

As discussed above, Section 163(j) determines the Section 163(j) Limitation at the partnership level instead of the partner level. The Final Regulations generally retain the framework of the 2018 Proposed

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39 Prop. Treas. Regs. § 1.163(j)-1(b)(22)(iii)(F)(2).

40 Treas. Regs. § 1.163(j)-1(b)(22)(iii)(A).

41 *See* Section 163(j)(1), (8).

42 Fmr. Prop. Treas. Regs. § 1.163(j)-1(b)(1)(iii).

43 Treas. Regs. § 1.163(j)-1(b)(1)(iii).

Regulations for calculating the Section 163(j) Limitation at the partnership level and allocating Section 163(j) items to partners.

Under these rules, if a partner is allocated partnership interest expense that is not deductible under Section 163(j) ("Excess Business Interest Expense"), the partner is not permitted to deduct the interest in the current taxable year, irrespective of whether the partner otherwise has net interest income in such year or business income in excess of the amount necessary to deduct all of its interest expense under Section 163(j) (collectively, "Excess Section 163(j) Limitation").[44] The partner is entitled to carry forward the Excess Business Interest Expense, but is permitted to deduct such amount in future taxable years only to the extent of the partner's share of any Excess Section 163(j) Limitation of the partnership in such year (and subject to its general Section 163(j) Limitation in such year).[45] If interest expense incurred by the partnership is not disallowed at the partnership level under Section 163(j), then a partner can deduct the interest that is allocated to the partner, irrespective of the partner's Section 163(j) position in respect of the partner's non-partnership income and expense.[46]

If a partnership has Excess Section 163(j) Limitation in a taxable year, then the partnership must allocate the excess to the partners of the partnership.[47] A partner would then be entitled to include its share of the partnership Excess Section 163(j) Limitation in ATI for purposes of determining the partner's Section 163(j) Limitation in respect of the partner's non-partnership interest expense in such year.[48]

The determination of a partnership's Section 163(j) Limitation and Excess Section 163(j) Limitation generally is performed in the same manner as the equivalent calculation for non-partnership taxpayers, subject to certain modifications.[49] The Final Regulations generally adopt the complex rules in the 2018 Proposed Regulations for allocating a partnership's Excess Business Interest Expense and Excess Section 163(j) Limitation to partners.[50] The Final Regulations, however, include a simplifying convention whereby a partnership that allocates all relevant partnership items pro rata to partners may bypass these steps and simply allocate Excess Business Interest Expense and Excess Section 163(j) Limitation on a pro rata basis to its partners.[51]

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44 *See* Section 163(j)(4)(A)(i).

45 Section 163(j)(4)(B)(i)(II).

46 *See* Section 163(j)(4)(A)(i).

47 *See* Section 163(j)(4)(A)(ii); Treas. Regs. § 1.163(j)-6(f)(2)(ii).

48 Section 163(j)(4)(A)(ii)(II). A partner will not otherwise include its share of the partnership's income, gains, losses, and expenses in computing the partner's own ATI.

49 Treas. Regs. § 1.163(j)-6(f)(2)(i).

50 *See* Treas. Regs. § 1.163(j)-6(f)(2).

51 *See* Treas. Regs. § 1.163(j)-6(f)(2)(ii).

2. Disposition of a Partnership Interest

A partner that is allocated Excess Business Interest Expense by a partnership is required to reduce the partner's tax basis in the partnership by such amount even though the partner cannot currently deduct the interest.[52] The 2018 Proposed Regulations provided that if a partner sells all or substantially all of its interest in a partnership before the partner is entitled to deduct the Excess Business Interest Expense, the partner may increase its basis by such amount immediately before the sale,[53] but if a partner disposes of less than substantially all of its partnership interest, the partner would not increase its basis by the amount of any remaining Excess Business Interest Expense.[54] The Final Regulations revise this approach and provide that in the case of a partial disposition of a partnership interest, the disposing partner would (i) increase its basis in the disposed interest by a proportionate amount of the Excess Business Interest Expense attributable to such partner's interest in the partnership and (ii) reduce its Excess Business Interest Expense carryover by the same amount.[55]

3. Tiered Partnerships

The New Proposed Regulations contain rules that would apply for purposes of allocating Excess Business Interest Expense in the case of tiered partnerships. Specifically, the New Proposed Regulations would apply an entity approach, such that if a partnership (the "lower-tier partnership") allocates Excess Business Interest Expense to a partner that is also a partnership (the "upper-tier partnership"), such Excess Business Interest Expense would not be subject to further allocation by the upper-tier partnership. The upper-tier partnership would reduce its basis in the lower-tier partnership,[56] but the partners in the upper-tier partnership would not reduce the bases of their upper-tier partnership interests until the upper-tier partnership treats such Excess Business Interest Expense as business interest expense that is paid or accrued for Section 163(j) purposes.[57] The partners in the upper-tier partnership generally would adjust their capital accounts to reflect treatment of the Excess Business Interest Expense as an expense, and the upper-tier partnership would treat the Excess Business Interest Expense as a nondepreciable capital asset with a fair market value of zero.[58] The Excess Business Interest Expense of the upper-tier partnership would subsequently be taken into account when either the upper tier partnership is allocated Excess Section 163(j) Limitation from the lower-tier partnership or the upper-tier partnership disposes of all or a portion of its interest in the lower-tier partnership (in which case the upper-tier partnership would reduce its

52 Section 163(j)(4)(B)(iii)(I).

53 Fmr. Prop. Treas. Regs. § 1.163(j)-6(h)(3)(i).

54 Fmr. Prop. Treas. Regs. § 1.163(j)-6(h)(3)(ii).

55 Treas. Regs. § 1.163(j)-6(h)(3).

56 Prop. Treas. Regs. § 1.163(j)-6(h)(2).

57 Prop. Treas. Regs. § 1.163(j)-6(j)(3).

58 Prop. Treas. Regs. § 1.163(j)-6(j)(4).

amount of Excess Business Interest Expense with respect to the lower-tier partnership and increase its adjusted basis in the transferred interest immediately prior to the disposition by the amount of such reduction).[59]

4. Loans Between a Partnership and a Partner

The 2018 Proposed Regulations reserved on the treatment of business interest expense and income with respect to lending transactions between a partnership and a partner, but stated that the IRS intended to adopt rules that would prevent such amounts from affecting the Section 163(j) Limitation of the lender and borrower.[60] Under the New Proposed Regulations, if a partnership borrows from one of its partners, interest paid by the partnership to the lending partner would constitute business interest expense of the partnership for purposes of Section 163(j). If the partnership allocates Excess Business Interest Expense to the lending partner, the partner would be deemed to be allocated excess business interest income from the partnership to the extent of the lesser of (i) the amount of Excess Business Interest Expense allocated by the partnership to the partner and (ii) the interest income that the partner recognizes in respect of the loan.[61] This rule has the effect of enabling the lending partner to reduce any Excess Business Interest Expense that it is allocated from the partnership by the interest income that it recognizes in respect of its loan to the partnership.

5. Trading Partnerships

Under Section 163(d) of the Internal Revenue Code, investment interest of a non-corporate taxpayer is only deductible to the extent of its investment income. For this purpose, a non-corporate partner in a partnership that conducts a trading business and that does not "materially participate" in the activities of the partnership (a "passive partner") is required to treat its allocable share of the business interest of the partnership as investment interest.[62] As a result, under the 2018 Proposed Regulations, a passive partner in a trading partnership could be subject to a deduction limitation with respect to its share of the business interest of the partnership under both Section 163(d) and Section 163(j).[63] The Final Regulations address this issue by providing that in the case of a trading partnership with a passive partner, the partnership must allocate its business interest between interest that is allocated to passive partners and the remainder of its partners ("non-passive partners"). The portion of the interest expense that is allocable to non-passive partners would potentially be subject to the Section 163(j) Limitation, whereas the interest expense that is allocable to

59 Prop. Treas. Regs. § 1.163(j)-6(j)(5)(ii).

60 *See* Fmr. Prop. Treas. Regs. § 1.163(j)-6(n).

61 Prop. Treas. Regs. § 1.163(j)-6(n).

62 *See* Section 163(d)(5)(A).

63 83 FR 67490, 67510.

passive partners would potentially be subject to the Section 163(d) investment interest limitation but would not be subject to the Section 163(j) Limitation.[64]

6. Allocations from Exempt Partnerships

Under the 2018 Proposed Regulations, if a partner were allocated business interest expense from a partnership that is exempt from Section 163(j) (e.g., if it is exempt under the "small business" exemption referenced above), such allocated business interest expense would have been subject to the partner's own Section 163(j) Limitation, notwithstanding the exemption at the partnership level.[65] Under the Final Regulations, however, business interest expense of an exempt partnership (or of an excepted trade or business conducted by a partnership) does not retain its character as business interest expense and thus is not subject to the Section 163(j) Limitation at the partner level.[66]

D. APPLICATION TO CFCS

The Final Regulations adopt the general framework of the 2018 Proposed Regulation under which Section 163(j) applies to CFCs even if the CFC is not a U.S. taxpayer. However, the New Proposed Regulations would (i) allow an affiliated group of CFCs to compute the Section 163(j) Limitation for the group as a whole and (ii) provide a safe-harbor election to exempt certain CFCs from Section 163(j).

1. The Final Regulations

The preambles to the New Regulations discuss at length comments received by the government that argued that Section 163(j) should not apply to CFCs. The preambles reject this position and conclude that the statutory language supports the application of Section 163(j) to CFCs and that excluding CFCs from Section 163(j) would allow inappropriate leveraging of CFCs. Thus, as under the 2018 Proposed Regulations, Section 163(j) limits the extent to which a CFC's business interest expense is deductible for purposes of computing the subpart F income, GILTI tested income or loss, and income effectively connected to a United States trade or business.

Under the Final Regulations, as under the 2018 Proposed Regulations, any interest deduction that is disallowed under Section 163(j) reduces the earnings and profits of a CFC.[67] Accordingly, a U.S. shareholder of a CFC that solely recognizes subpart F income may not be affected if the CFC's interest

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64 Prop. Treas. Regs. § 1.163(j)-6(c)(1).

65 Fmr. Prop. Treas. Regs. § 1.163(j)-6(m)(1).

66 Treas. Regs. § 1.163(j)-6(m)(1), (2).

67 *See* Treas. Regs. 1.163(j)-4(c)(1) (providing that Section 163(j) does not affect whether and when business interest expense reduces a domestic C corporation's or foreign corporation's earnings and profits).

deductions are disallowed under Section 163(j), because the U.S. shareholder's subpart F inclusion under Section 952(c) cannot exceed the earnings and profits of the CFC.[68]

In addition, the Final Regulations exclude dividends received from related parties from a CFC's ATI.[69]

2. The New Proposed Regulations

Both the 2018 Proposed Regulations and the New Proposed Regulations would allow certain affiliated CFCs to be aggregated for purposes of Section 163(j) under a "CFC group election." However, the CFC group election under the New Proposed Regulations (the "CFC group election") would differ significantly from the CFC group election under the 2018 Proposed Regulations (the "old CFC group election") by treating an affiliated group of CFCs in the same manner as a domestic consolidated tax group. In addition, the New Proposed Regulations would provide new rules with respect to U.S. shareholders of CFCs and would allow certain CFCs to elect to be exempt from Section 163(j).

a. Single Section 163(j) Limitation for a CFC Group

Under the 2018 Proposed Regulations, an affiliated group of CFCs that made an old CFC group election would allocate the net interest expense of the CFC group among the CFC group members, and each CFC would be required to determine its individual Section 163(j) Limitation based on its allocable share of the group's net interest expense. Under this approach, a member of a CFC group could be subject to the Section 163(j) Limitation even though the group as a whole would not be subject to the Section 163(j) Limitation if it were treated as a single corporation.

By contrast, the New Proposed Regulations would compute a single Section 163(j) Limitation for an entire electing CFC group by aggregating the current-year items of each CFC group member.[70] The CFC group's Section 163(j) Limitation would then be allocated to each CFC group member's current-year business interest expense and disallowed business interest expense carryforwards under the consolidated group rules in the Final Regulations.[71] Principles similar to the consolidated group "separate return limitation year" principles would limit disallowed business interest expense carryforwards of CFCs joining a CFC group.[72] In addition, the New Proposed Regulations would provide rules implementing the temporary changes made by the CARES Act at the CFC group level to the extent a CFC group election had been made.[73]

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68 The GILTI rules, however, do not include an earnings and profits limit.

69 *See* Treas. Regs. § 1.163(j)-7(g)(2).

70 *See* Prop. Treas. Regs. § 1.163(j)-7(c)(2).

71 *See* Prop. Treas. Regs. § 1.163(j)-7(c)(3)(i).

72 *See* Prop. Treas. Regs. § 1.163(j)-7(c)(3)(iv).

73 *See* Prop. Treas. Regs. § 1.163(j)-7(c)(5).

As the preamble notes, the New Proposed Regulations are intended to reduce the administrative and compliance burdens for CFCs subject to a CFC group election, as compared to the 2018 Proposed Regulations. Taxpayers with large chains of CFCs would be required to keep track of significantly fewer Section 163(j) Limitations. Furthermore, as a result of the single Section 163(j) Limitation for an entire CFC group, the legal structure of a CFC group and where a CFC group member sits within a CFC group would be less relevant than under the 2018 Proposed Regulations.

b. Definition of CFC Group

The 2018 Proposed Regulations would have defined a CFC group as two or more CFCs owned 80 percent or more, by value, by a single U.S. shareholder or in the same proportion by multiple related U.S. shareholders. Any CFCs conducting a financial services business would have been treated as a separate subgroup subject to special rules.

Consistent with the New Proposed Regulations' consolidated group model for CFCs, the New Proposed Regulations would allow a CFC group election for one or more chains of CFCs (a "specified group" and, if a CFC group election were made, a "CFC group") connected through 80 percent direct or indirect stock ownership, by value, with a common parent (the "specified group parent").[74] The specified group parent could be a U.S. citizen or resident, a U.S. corporation, or a CFC but could not be a partnership.[75] If the specified group parent is a CFC, it would also be a member of the specified group. Unlike the 2018 Proposed Regulations, the New Proposed Regulations would not treat any CFC conducting a financial services business as a separate subgroup or otherwise differently from any other CFCs.[76]

Thus, in order to determine the members of a specified group, the New Proposed Regulations would apply the general Section 1504 affiliated group rules with two modifications. First, the New Proposed Regulations would require 80 percent stock ownership only by value, rather than by vote and value, which the preamble explains is intended to prevent taxpayers from breaking CFC affiliation by diluting voting power below 80 percent.[77] Second, the New Proposed Regulations would take into account both stock owned directly and

[74] *See* Prop. Treas. Regs. § 1.163(j)-7(d)(2)(i). As under the 2018 Proposed Regulations, a CFC would not be included in a CFC group unless the CFC had at least one direct or indirect U.S. shareholder (an "applicable CFC"). *Compare* Treas. Regs. § 1.163(j)-1(b)(2) (defining "applicable CFC" as a CFC with at least one United States shareholder that owns stock of the CFC within the meaning of Section 958(a)) *with* Fmr. Prop. Treas. Regs. § 1.163(j)-7(f)(2) (identical definition of "applicable CFC").

[75] *See* Prop. Treas. Regs. § 1.163(j)-7(d)(2)(iii).

[76] Also unlike the 2018 Proposed Regulations, the New Proposed Regulations would allow a CFC with effectively connected income to be a CFC group member but would exclude such effectively connected income from the CFC group's Section 163(j) calculations. *See* Prop. Treas. Regs. § 1.163(j)-7(f).

[77] *See* Prop. Treas. Regs. § 1.163(j)-7(d)(2)(i) (referencing solely the 80 percent value requirement of Section 1504(a)(2)(B) and not the 80 percent voting power requirement of Section 1504(a)(2)(A)).

stock owned indirectly through a partnership or through a foreign trust or estate.[78] For example, suppose a U.S. corporation wholly owns CFC1 and CFC2, and CFC1 and CFC2 each own 50 percent of a partnership that wholly owns CFC3. CFC1, CFC2, and CFC3 (but not the partnership) would all be part of one specified group that would be eligible to make a CFC group election.

c. Making and Revoking the CFC Group Election

Under the 2018 Proposed Regulations, the old CFC group election would have been made simply by applying the old CFC group rules to compute each CFC group member's deduction for business interest expense. Once made, an old CFC group election would have been irrevocable.

By contrast, under the New Proposed Regulations, to make or revoke a CFC group election for a specified period of a specified group, each "designated U.S. person" would be required to attach an election statement to such person's timely filed tax return for such person's taxable year in which or with which the specified period ended.[79] The designated U.S. persons of a specified group would be either (x) if the specified group parent were a U.S. citizen or resident or a U.S. corporation, the specified group parent, or (y) if the specified group parent were a CFC, its U.S. shareholders who, in the aggregate, own more than 50 percent by vote of the CFC.[80]

Unlike the old CFC group election, a CFC group election under the New Proposed Regulations would be revocable, but not until five years following the last day of the specified period for which the CFC group election was made. Similarly, once a CFC group election had been revoked, a new CFC group election could not be made with respect to any specified period beginning five years following the last day of the specified period for which the election was revoked.[81]

The preamble states that a taxpayer may still make an old CFC group election for any taxable years in which the taxpayer relies on the 2018 Proposed Regulations, and whether a taxpayer has made an old CFC group election has no effect on the taxpayer making a CFC group election for any taxable year in which the taxpayer relies on the New Proposed Regulations.

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78 *See* Prop. Treas. Regs. § 1.163(j)-7(d)(2)(i), (ii). The preamble requests comments on whether and to what extent the indirect stock ownership taken into account should be expanded.

79 Prop. Treas. Regs. § 1.163(j)-7(e)(5)(iv).

80 *See* Prop. Treas. Regs. § 1.163(j)-7(k)(12)(ii).

81 *See* Prop. Treas. Regs. § 1.163(j)-7(e)(3), (e)(5)(ii). The preamble requests comments regarding whether a similar five-year rule should apply to prevent a CFC group election by a specified group that does not make a CFC group election for its first specified period for which a CFC group election may be made.

d. U.S. Shareholders

Under the 2018 Proposed Regulations, a U.S. shareholder of a CFC would generally not have been able to include in the shareholder's ATI any Excess Section 163(j) Limitation of the CFC. However, if an old CFC group election were made, the 2018 Proposed Regulations would have allowed Excess Section 163(j) Limitation to "roll up" from a lower-tier CFC group member to higher-tier CFC group members and from the highest-tier CFC group member to its U.S. shareholders, up to their subpart F and GILTI inclusions.

Similarly, the New Proposed Regulations would generally not allow a U.S. shareholder of a CFC to include in the shareholder's ATI any Excess Section 163(j) Limitation of the CFC, unless the CFC were subject to a CFC group election. Unlike the 2018 Proposed Regulations, the New Proposed Regulations would also allow the Excess Section 163(j) Limitation of a stand-alone CFC to roll up to its U.S. shareholders. However, the Excess Section 163(j) Limitation of a CFC that is a member of a specified group for which a group election has not been made would not be included in the U.S. shareholder's ATI. Furthermore, the Excess Section 163(j) Limitation of neither a CFC group member nor a stand-alone CFC would roll up to U.S. shareholders if a safe-harbor election (discussed below) were in effect.[82]

The preamble states the Treasury Department and the IRS are concerned that U.S. shareholders may inappropriately reduce their U.S. tax liability by incurring internal debt without a CFC group election. For example, if a CFC lends to another CFC that is a member of the same specified group and no CFC group election were made, a U.S. shareholder could use excess GILTI-basket foreign tax credits to offset the lending CFC's interest income while also generating a disallowed business interest expense carryforward for the borrowing CFC. Accordingly, the New Proposed Regulations include the following anti-abuse rule. When a CFC lends to another CFC within the same specified group, the New Proposed Regulations would increase the ATI of the borrower CFC if (i) no CFC group election had been made, and (ii) the loan was incurred with a principal purpose of reducing, and the loan would otherwise reduce, the federal income tax liability of any U.S. shareholder of a specified group member (including over multiple years).[83] In other words, the New Proposed Regulations would deem the loan to be made between members of a CFC group, and thus as effectively disregarded, for purposes of applying Section 163(j). The anti-abuse rule would also apply if the borrower is a partnership whose capital or profits are at least 80 percent owned, directly or indirectly, by CFCs in the same specified group as the lending CFC.[84]

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82 *See* Prop. Treas. Regs. § 1.163(j)-7(j). Since the New Proposed Regulations would provide for a single Section 163(j) Limitation for an entire CFC group, the New Proposed Regulations would not include any rules for rolling up Excess Section 163(j) Limitation from a lower-tier CFC group member to higher-tier CFC group members.

83 *See* Prop. Treas. Regs. § 1.163(j)-7(g)(4).

84 *Id.*

e. Safe-Harbor Election

The New Proposed Regulations would provide a safe-harbor election under which certain CFCs would not be subject to Section 163(j). To be eligible for the election, a CFC must meet two requirements. First, the CFC must be either (a) a stand-alone CFC or (b) a CFC subject to a CFC group election without any disallowed business interest expense carryforward from prior to becoming a CFC group member. If the CFC is a CFC group member, the safe-harbor election would apply to the entire CFC group of which the CFC is a member. Second, the business interest expense of the stand-alone CFC or the CFC group must be no more than 30 percent (50 percent for taxable years or specified periods beginning in 2019 or 2020) of the lesser of (x) the CFC's or CFC group's taxable income attributable to non-excepted trades or businesses and (y) the sum of (i) the CFC's or CFC group members' subpart F income and (ii) the GILTI inclusions of a U.S. corporation if such corporation wholly owned the CFC or CFC group members, where each of (x) and (y) would be determined without regard to Section 163(j).[85]

The safe-harbor election would be an annual election made by each designated U.S. person with respect to a taxable year of the stand-alone CFC or with respect to a specified period of the CFC group.[86] Each designated U.S. person would make the election by attaching an election statement to such person's timely filed tax return for such person's taxable year in which or with which the CFC's taxable year or the CFC group's specified period ended.[87] As discussed above, if a safe-harbor election were made with respect to a CFC, no U.S. shareholder would be allowed to include in the shareholder's ATI any portion of such CFC's Excess Section 163(j) Limitation.[88]

E. ELECTING REAL PROPERTY TRADES OR BUSINESSES

As discussed above, certain businesses are exempt from the Section 163(j) Limitation, including electing real property businesses and farming businesses.[89] The Final Regulations adopt the provisions in the 2018 Proposed Regulations, with certain modifications, that provide rules and procedures to make such an election and for allocating interest income and expense between exempted businesses and non-exempted businesses.

The Final Regulations provide that an election to be treated as an electing real property trade or business is available regardless of whether the trade or business with respect to which the election is made is a trade

85 *See* Prop. Treas. Regs. § 1.163(j)-7(h).

86 For a stand-alone applicable CFC, the designated U.S. persons would be its U.S. shareholders who, in the aggregate, own more than 50% by vote of the CFC. *See* Prop. Treas. Regs. § 1.163(j)-7(k)(12)(i).

87 *See* Prop. Treas. Regs. § 1.163(j)-7(h)(5).

88 *See* Prop. Treas. Regs. § 1.163(j)-7(j)(3)(i).

89 *See* Section 163(j)(7)(A)(ii), (iii).

or business that is subject to the Section 163(j) Limitation.[90] The effect of this provision is that taxpayers that are unsure whether their activities, such as real estate rental activities, rise to the level of a trade or business may nonetheless make the election on a "protective" basis.

The 2018 Proposed Regulations contained an anti-abuse rule pursuant to which a real property business, including a real estate investment trust, would not be eligible for treatment as an exempted business if more than 80 percent of the business's property is leased to related entities.[91] This anti-abuse rule could apply to certain business structures where the real property is owned by one legal entity and leased to a separate but commonly controlled legal entity that operates and manages a business (sometimes referred to as an "OpCo/PropCo" structure). The Final Regulations add two exceptions to this anti-abuse rule. The first exception is a de minimis exception applicable to a lessor where at least 90 percent of the lessor's real property (determined by fair market rental value) is leased to a related party that operates an excepted trade or business and/or to unrelated parties.[92] The second exception is a look-through rule that applies if the related lessee subleases the real property to unrelated third parties and/or related parties that operate an excepted trade or business.[93]

F. CORPORATIONS AND CONSOLIDATED GROUPS

The Final Regulations generally adopt the approach of the 2018 Proposed Regulations with respect to the application of Section 163(j) to "C" corporations and consolidated groups, with some clarifications and modifications. Thus, all interest income and interest expense of a C corporation generally is treated as business interest income and business interest expense, respectively, for purposes of the Section 163(j) Limitation, except to the extent allocable to an exempted business.[94] If a "C" corporation is a partner in a partnership that recognizes investment income and expense, the corporation's allocable share of the partnership's income and expense is also treated as trade or business income and expense for purposes of determining the corporation's Section 163(j) Limitation, but such items are not recharacterized at the partnership level.[95]

Like the 2018 Proposed Regulations, the Final Regulations aggregate consolidated tax groups, but not affiliated groups that do not file consolidated tax returns, so that a consolidated tax group has a single Section 163(j) Limitation.[96] The Final Regulations generally implement the Proposed Regulations' complex

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90 Treas. Regs. § 1.163(j)-9(b)(2)(ii).

91 Fmr. Prop. Treas. Regs. § 1.163(j)-9(h).

92 Treas. Regs. § 1.163(j)-9(j)(2)(i).

93 Treas. Regs. § 1.163(j)-9(j)(2)(ii).

94 Treas. Regs. § 1.163(j)-4(b).

95 Treas. Regs. § 1.163(j)-4(b)(3).

96 Treas. Regs. § 1.163(j)-4(d).

rules for determining each member's allowed business interest expense deduction, the application of Section 163(j) when a corporation leaves or enters a consolidated group, and the interaction of Section 163(j) with the existing consolidated group rules.[97] If a member of a consolidated group purchases a member's note from a third party at a premium, the Final Regulations clarify that the deductible repurchase premium is treated as interest expense for purposes of Section 163(j), regardless of whether the repurchase premium is treated as paid on intercompany indebtedness.[98]

G. GENERAL ANTI-AVOIDANCE RULE

The 2018 Proposed Regulations contained a general anti-avoidance rule that provides that arrangements entered into with a principal purpose of avoiding the rules of Section 163(j) or the 2018 Proposed Regulations may be disregarded or recharacterized to the extent necessary to carry out the purposes of Section 163(j).[99] It was not clear how this anti-avoidance rule would interact with the anti-avoidance rule, discussed above, that applies to the definition of "interest." The Final Regulations finalize the general anti-avoidance rule without change and clarify that the anti-avoidance rule that is specific to the definition of "interest," rather than the general anti-avoidance rule, applies to determine whether an item is treated as interest expense or interest income.[100]

H. EFFECTIVE DATE

The Final Regulations are effective 60 days following the date on which the Final Regulations are published in the Federal Register and generally are applicable for taxable years beginning on or after such date. Taxpayers and their related parties may apply the Final Regulations in their entirety for all taxable years beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the Final Regulations and certain other specified provisions. Alternatively, taxpayers and their related parties may rely on the 2018 Proposed Regulations in their entirety for taxable years beginning after December 31, 2017, and before the effective date of the Final Regulations, so long as the taxpayers and their related parties consistently apply the 2018 Proposed Regulations and certain other specified provisions to those taxable years. Taxpayers and their related parties that otherwise rely on the 2018 Proposed Regulations in their entirety for such taxable years may choose to follow the rule in the Final Regulations described above regarding the add-back of capitalized depreciation, amortization, and

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97 Treas. Regs. § 1.163(j)-5(b)(3).

98 Treas. Regs. § 1.163(j)-4(d)(2)(v)(B).

99 Prop. Treas. Regs. § 1.163(j)-2(h).

100 Treas. Regs. §§ 1.163(j)-1(b)(22)(iv)(D), 1.163(j)-2(j)(1).

depletion to ATI.[101] The anti-avoidance rule applicable to the definition of "interest" applies to transactions entered into on or after the date on which the Final Regulations are published in the Federal Register.[102]

The New Proposed Regulations would generally apply to taxable years beginning on or after 60 days after the New Proposed Regulations are finalized. However, taxpayers and their related parties generally may apply the New Proposed Regulations in their entirety for taxable years beginning before 60 days following the date on which the New Proposed Regulations are finalized, provided that taxpayers and their related parties meet certain consistency requirements as set forth in the New Proposed Regulations.

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[101] Treas. Regs. §§ 1.163(j)-1(c), 1.163(j)-1(b)(1)(iii).

[102] Treas. Regs. § 1.163(j)-1(c)(2).

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CONTACTS

New York			
	Ronald E. Creamer Jr.	+1-212-558-4665	creamerr@sullcrom.com
	David P. Hariton	+1-212-558-4248	haritond@sullcrom.com
	Jeffrey D. Hochberg	+1-212-558-3266	hochbergj@sullcrom.com
	David C. Spitzer	+1-212-558-4376	spitzerd@sullcrom.com
	Davis J. Wang	+1-212-558-3113	wangd@sullcrom.com
	S. Eric Wang	+1-212-558-3328	wangs@sullcrom.com
	Isaac J. Wheeler	+1-212-558-7863	wheeleri@sullcrom.com
	Daniel J. Bleiberg	+1-212-558-3521	bleibergd@sullcrom.com
	Michelle H. Lu	+1-212-558-3204	lum@sullcrom.com
London			
	Ronald E. Creamer Jr.	+44-20-7959-8525	creamerr@sullcrom.com
	S. Eric Wang	+44-20-7959-8411	wangs@sullcrom.com