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

Proposed Regulations Would Implement and Provide Guidance Regarding the New Section 163(j) Provisions

SUMMARY

The Internal Revenue Service (the "IRS") and the Treasury Department recently issued proposed regulations (the "Proposed Regulations") addressing the limitation on deductions for business interest expense under Section 163(j) of the Internal Revenue Code (the "Section 163(j) Limitation"). As discussed in more detail below, the Proposed Regulations provide critical guidance regarding many of the technical provisions in Section 163(j) as well as the application of Section 163(j) to different types of entities, including partnerships, controlled foreign corporations and corporate members of a tax consolidated group.

Highlights of the Proposed Regulations include the following:

- The definition of "interest" for Section 163(j) purposes is defined broadly to include not only amounts generally treated as interest for federal income tax purposes, but also certain items of income and expense that are related to debt instruments, such as substitute interest payments under a securities loan, gains and losses from hedges of debt instruments, commitment fees and debt issuance costs.
- The Proposed Regulations include a broad anti-avoidance rule under which any deductible expense or loss "predominantly incurred in consideration of the time value of money" would also be treated as interest expense for Section 163(j) purposes.
- The determination as to whether interest expense that is incurred by a partnership is subject to Section 163(j) is made at the partnership level based on the income and expenses of the partnership. Any disallowed interest under Section 163(j) would then be allocated to the partners in the partnership.
- A controlled foreign corporation ("CFC") would 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.

- The Section 163(j) Limitation of a U.S. consolidated tax group would be applied to the group as a whole as if the group were a single taxpayer and would not be applied separately to each member of the group.
- The Proposed Regulations include detailed rules and procedures in order to elect to treat certain businesses as exempt from Section 163(j) and for allocating interest income and expense between exempted businesses and non-exempted businesses.

BACKGROUND

As part of last year's comprehensive 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% 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% 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, 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

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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).

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).

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]

DISCUSSION

The Proposed Regulations provide guidance on a wide range of issues with respect to the application of Section 163(j). This memorandum discusses some of the most important provisions of the Proposed Regulations and highlights significant consequences and issues under the Proposed Regulations.

A. DEFINITION OF INTEREST

The Proposed Regulations provide that amounts generally treated as interest for tax purposes would also be treated as interest for Section 163(j) purposes.[13] Accordingly, "interest" would include, among other things, 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.

Moreover, solely for purposes of Section 163(j), the Proposed Regulations would broaden the definition of "interest" to encompass various types of payments having similar effects to interest, even if such payments are not otherwise treated as interest for tax purposes.[14] In particular, the Proposed Regulations would treat the following items of income and expense as interest income and expense for Section 163(j) purposes.

- A holder that elects to amortize bond premium would treat the bond premium deduction as interest expense, and an issuer of debt with premium would treat the ordinary income attributable to the premium as interest income.[15]

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9 Section 163(j)(3).

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

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

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

13 Prop. Treas. Regs. § 1.163(j)-1(b)(20)(i).

14 The recently proposed regulations regarding hybrid arrangements and hybrid entities contain a similar definition of "interest." *See* Prop. Treas. Regs. § 1.267A-5(a)(12), REG-104352-18.

15 Prop. Treas. Regs. § 1.163(j)-1(b)(20)(iii)(A).

- Amounts that alter a taxpayer's effective cost of borrowing or effective yield from holding a debt instrument would be treated as an adjustment to interest income or expense.[16] As a result, 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, even if the hedge is not otherwise integrated with the debt instrument for tax purposes. The Proposed Regulations do not address how a taxpayer that hedges its interest rate or foreign currency position on a "macro" basis (i.e., a taxpayer that hedges such position based on the taxpayer's firm-wide daily positions without there being specific hedges that relate to specific debt instruments) would determine whether a particular hedge alters the taxpayer's effective cost of borrowing or effective yield from holding a debt instrument.
- A substitute interest payment under a securities loan or repo transaction would be treated as interest income or expense.[17]
- In the case of a swap (other than a cleared swap) with significant nonperiodic payments, interest income and expense would be imputed for Section 163(j) purposes in respect of the nonperiodic payment.[18] The Proposed Regulations request comments as to whether a similar rule should apply in the case of a cleared swap.
- Commitment fees would be treated as interest income or expense if any portion of the financing with respect to which the commitment fees are paid is actually provided, although the Proposed Regulations do not clarify whether this would include commitment fees paid prior to the financing.[19]
- Debt issuance costs would be treated as interest income or expense. The Proposed Regulations do not, however, address whether such costs should be treated as interest in the year paid or whether such costs should be amortized over the term of the associated debt instrument.[20]
- "Guaranteed payments" from a partnership to a partner for capital would be treated as interest expense to the partnership and interest income to the recipient even though the partner is otherwise treated as holding an equity interest in the partnership for tax purposes.[21]

The expanded definition of interest described above would apply for purposes of determining both the interest income and expense of a taxpayer. Accordingly, this expanded definition may improve the Section 163(j) position of some taxpayers to the extent that the expanded definition results in an increase in a taxpayer's net interest income. It should be noted that the expanded interest definition applies solely for Section 163(j) purposes and does not affect the definition of interest for other tax purposes.

The Proposed Regulations include an anti-avoidance rule that would further expand the ambit of the "interest" definition for purposes of Section 163(j). Under the anti-avoidance rule, "any expense or loss, to the extent deductible, incurred by a taxpayer in a transaction or series of integrated or related transactions in which the taxpayer secures the use of funds for a period of time is treated as interest expense of the taxpayer if such expense or loss is predominantly incurred in consideration of the time

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16 Prop. Treas. Regs. § 1.163(j)-1(b)(20)(iii)(E).

17 Prop. Treas. Regs. § 1.163(j)-1(b)(20)(iii)(C).

18 Prop. Treas. Regs. § 1.163(j)-1(b)(20)(ii).

19 Prop. Treas. Regs. § 1.163(j)-1(b)(20)(iii)(G)(1).

20 Prop. Treas. Regs. § 1.163(j)-1(b)(20)(iii)(H).

21 Prop. Treas. Regs. § 1.163(j)-1(b)(20)(iii)(I); *see also* Section 707(c).

value of money."[22] The anti-avoidance rule would apply to interest expense but not to interest income. Although the preamble and the Proposed Regulations call this provision an anti-avoidance rule, the rule, as drafted, does not require that the taxpayer have an intent or motive to avoid the application of Section 163(j). Accordingly, Section 163(j) could apply to ordinary course transactions that are not motivated by Section 163(j) considerations. For example, the anti-avoidance rule could arguably apply to interest equivalent payments under a swap or prepayments under a financial instrument even if Section 163(j) considerations are not a factor in the structure for the applicable transaction. This may be particularly problematic for financial institutions that enter into offsetting transactions since, as noted above, the interest expense from one side of the transaction could be treated as interest for Section 163(j) purposes, while the income from an offsetting transaction would not likewise be treated as interest income for Section 163(j) purposes.

The Proposed Regulations do not provide that guarantee fees would be treated as interest for Section 163(j) purposes, although the Proposed Regulations do not specifically provide that guarantee fees would not be so treated. In addition, it is possible that in certain cases guarantee fees could be treated as interest under general tax principles (in which case guarantee fees would likewise be so treated for Section 163(j) purposes) or that guarantee fees could be treated as interest for Section 163(j) purposes under the anti-avoidance rule discussed above.

B. APPLICATION TO PARTNERSHIPS

1. Calculating the Partnership-Level Limitation and Related Allocations

As discussed above, Section 163(j), as amended by the Tax Reform Act, determines the Section 163(j) Limitation at the partnership level instead of the partner level. If a partner is allocated partnership interest expense that is not deductible under Section 163(j), the partner would not be 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).[23] The partner would be entitled to carry forward the disallowed interest deduction but the partner would only be permitted to deduct such amount in future taxable years 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).[24] 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.[25]

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

[23] *See* Section 163(j)(4)(A)(i).

[24] Section 163(j)(4)(B)(i)(II).

[25] *See* Section 163(j)(4)(A)(i).

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.[26] 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.[27] It is noteworthy that this approach differs from an allocation of Section 163(j) disallowed interest – specifically, as noted above, a partner cannot use its own ATI to deduct the partner's share of interest that was disallowed at the partnership level under Section 163(j) but the partner can include its share of partnership Excess Section 163(j) Limitation in ATI that could then enable the partner to deduct its non-partnership interest expense under Section 163(j).

The determination of a partnership's Section 163(j) Limitation and Excess Section 163(j) Limitation generally would be performed in the same manner as the equivalent calculation for non-partnership taxpayers, subject to certain modifications.[28] The Proposed Regulations include very complex rules regarding the allocation of a partnership's disallowed interest expense under Section 163(j) and Excess Section 163(j) Limitation to partners.[29] These rules, however, would generally be irrelevant to partnerships that do not have special or disproportionate allocations of partnership income or loss as such partnerships would generally allocate such amounts to partners in the same manner that the partnerships allocate other items of partnership income and expense.

2. Disposition of a Partnership Interest

A partner that is allocated partnership interest expense that is disallowed under Section 163(j) is required to reduce the partner's tax basis in the partnership by such amount even though the partner cannot currently deduct the interest.[30] However, if a partner sells all or substantially all of its interest in a partnership (whether by sale, exchange or redemption) before the partner is entitled to deduct the interest

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

[27] 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.

[28] Prop. Treas. Regs. § 1.163(j)-6(f)(2)(ii). Partner-level adjustments under Sections 704(c) and 743(b) generally would not be taken into account by the partnership in determining the partnership's Section 163(j) Limitation; instead, such adjustments would be taken into account at the partner level in determining a partner's Section 163(j) Limitation, meaning that such adjustments would affect the amount of Section 163(j) Limitation that a partner may apply to interest incurred at the partner level rather than at the partnership level. By contrast, Section 734 basis adjustments would be taken into account at the partnership level.

[29] *See* Prop. Treas. Regs. § 1.163(j)-6(f)(2)(ii).

[30] Section 163(j)(4)(B)(iii)(I).

expense under Section 163(j), the partner may increase its basis by the remaining amount of the disallowed interest immediately before the sale.[31]

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 unused disallowed interest expense – rather, any remaining unused amount would continue to be available to the transferor partner under the rules described above and would be added to such partner's basis in the partnership interest only when the partner disposes of all or substantially all of the partnership interest.[32]

A partner that recognizes gain upon a sale of a partnership interest would generally include the gain in its own ATI, except to the extent that such gain is attributable to an "excepted" trade or business, such as an electing real property trade or business.[33] However, the partner would not include the portion of any such gain in its ATI to the extent attributable to depreciation or amortization deductions in taxable years that begin prior to January 1, 2022 that did not previously reduce the partnership's ATI.[34]

3. Areas of Uncertainty

The Proposed Regulations reserve on certain issues related to partnerships, including the treatment of excess business interest expense in the case of tiered partnerships;[35] the treatment of business interest expense and business interest income with respect to lending transactions between a partnership and a partner;[36] the effect of partnership mergers and divisions on Section 163(j) items;[37] and the treatment of partnership terminations that occur by reason of an intercompany transaction within a consolidated group.[38]

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[31] Prop. Treas. Regs. § 1.163(j)-6(h)(3)(i). Although this rule would cause the partner to recapture some of the tax benefit of the interest expense incurred by the partnership, the increase in the partner's basis generally would offset capital gain rather than ordinary income.

[32] Prop. Treas. Regs. § 1.163(j)-6(h)(3)(ii).

[33] Prop. Treas. Regs. § 1.163(j)-6(e)(3); Prop. Treas. Regs. § 1.163(j)-10(b)(4)(ii).

[34] Prop. Treas. Regs. § 1.163(j)-1(b)(1)(ii)(E). As noted above, for taxable years that begin prior to January 1, 2022, depreciation and amortization deductions are generally added back to a taxpayer's income for purposes of determining the taxpayer's Section 163(j) Limitation. This adjustment is designed to prevent the double counting that would result if such deductions did not reduce the partnership's ATI but would then increase the partner's ATI upon a sale of a partnership interest.

[35] Prop. Treas. Regs. § 1.163(j)-6(i).

[36] Prop. Treas. Regs. § 1.163(j)-6(n). The preamble to the Proposed Regulations states that the IRS intends to adopt rules that would prevent business interest expense and income in such situations from entering or affecting the Section 163(j) Limitation calculations for both the lender and the borrower.

[37] Prop. Treas. Regs. § 1.163(j)-6(k).

[38] Prop. Treas. Regs. § 1.163(j)-4(d)(4)(iii).

C. C CORPORATIONS AND CONSOLIDATED GROUPS

Under the Proposed Regulations, all interest income and interest expense of a C corporation generally would be 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.[39] As a result, generally no interest expense of a C corporation would be treated as investment interest that is not subject to a Section 163(j) Limitation. In addition, all other items of income, gain, deduction or loss of a C corporation would generally be treated as properly allocable to a trade or business (except to the extent allocable to an exempted business) and thus reflected in ATI in applying the corporation's Section 163(j) Limitation.[40] The earnings and profits of a C corporation would be reduced by any interest expense that is disallowed under Section 163(j).[41]

If a C corporation is a partner in a partnership that recognizes investment income and expense, the Proposed Regulations would treat the partner's income and expense as trade or business income and expense for purposes of determining the partner's Section 163(j) Limitation.[42] However, such items would not be recharacterized at the partnership level.[43]

The Proposed Regulations would apply an aggregate approach to consolidated groups, but not to affiliated groups that do not file consolidated returns, unlike Section 163(j) prior to the Tax Reform Act.[44] Under the Proposed Regulations, a consolidated group would have a single Section 163(j) Limitation, with rules for summing up the members' income, interest and interest expense and generally disregarding intercompany obligations within the consolidated group.[45] However, a partnership owned by consolidated group members would have a partnership-level Section 163(j) Limitation, pursuant to the rules discussed above.[46]

Once a consolidated group's Section 163(j) Limitation is determined, the Proposed Regulations include complex rules for determining each member's allowed business interest expense deduction.[47] In addition, the Proposed Regulations include detailed rules regarding 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

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39 Prop. Treas. Regs. § 1.163(j)-4(b)(1).

40 Prop. Treas. Regs. § 1.163(j)-4(b)(2).

41 Prop. Treas. Regs. § 1.163(j)-4(c).

42 Prop. Treas. Regs. § 1.163(j)-4(b)(3)(i).

43 Prop. Treas. Regs. § 1.163(j)-4(b)(3)(ii)

44 Prop. Treas. Regs. § 1.163(j)-4(d); Former Section 163(j)(6)(C).

45 Prop. Treas. Regs. § 1.163(j)-4(d)(2).

46 *See* Preamble to the Proposed Regulations ("[P]artnerships that are wholly owned by members of a consolidated group would not be aggregated with the consolidated group for purposes of applying the section 163(j) limitation.").

47 *See* Prop. Treas. Regs. § 1.163(j)-5(b)(3).

consolidated group rules.[48] For example, the Proposed Regulations would extend the principles of the existing rules on "separate return limitation year" limitations and net operating loss carryforwards.[49]

D. APPLICATION TO CFCS

The Proposed Regulations provide that a CFC's business interest expense is also subject to the Section 163(j) Limitation even if the CFC is not a U.S. taxpayer.[50] As a result, under the Proposed Regulations, Section 163(j) would limit 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 for the CFC and its United States shareholders, as appropriate. For purposes of calculating the Section 163(j) Limitation of a CFC's United States shareholder and subject to the discussion below regarding a CFC group election, the United States shareholder's ATI would not include subpart F income, GILTI, or deemed paid foreign tax credits allocable to the CFC, even if the CFC has Excess Section 163(j) Limitation.[51]

As is the case with respect to a domestic corporation, any interest deduction that is disallowed under Section 163(j) would reduce the earnings and profits of a CFC.[52] Accordingly, a U.S. shareholder of a CFC that solely recognizes subpart F income may not be affected if the CFC's interest 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.[53]

As a general matter, each CFC in an affiliated group would be subject to the CFC's own Section 163(j) limitation, and there is no equivalent to the rule described above for domestic consolidated groups that would apply a single Section 163(j) Limitation to an affiliated group of CFCs. Thus, subject to the CFC group election discussion below, (a) a CFC could have disallowed interest deductions under Section 163(j) even if an affiliate CFC has Excess Section 163(j) Limitation and (b) loans between CFCs would be taken into account in applying the Section 163(j) Limitation.

The Proposed Regulations, however, provide that an affiliated group of CFCs can make a "CFC group election" under which Section 163(j) would not apply to any CFC in the group if the group does not have

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48 *See* Prop. Treas. Regs. § 1.163(j)-5(b)(3)(iii).

49 *See* Prop. Treas. Regs. § 1.163(j)-5(d).

50 Prop. Treas. Regs. §§ 1.163(j)-7, -8.

51 Prop. Treas. Regs. § 1.163(j)-7(d)(1)(i). The United States shareholder's ATI will also be computed without regard to the shareholder's associated Section 250 deduction in respect of a GILTI inclusion.

52 Prop. Treas. Regs. § 1.163(j)-7(e).

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

net interest expense.[54] The need for such a rule could be illustrated by an example in which a United States shareholder wholly owns two CFCs ("CFC 1" and "CFC 2") and the only interest income and expense within the group relates to a loan by CFC 1 to CFC 2. In the absence of the CFC group election described below, CFC 1 would include in income the interest received from CFC 2, but CFC 2's Section 163(j) Limitation would prevent CFC 2 from deducting all of its corresponding interest expense. As a result, without a CFC group election, the United States shareholder's GILTI or subpart F inclusion could be increased solely due to the use of intercompany debt between CFC 1 and CFC 2.

If a CFC group election is in effect, then each CFC's interest expense for purposes of determining its Section 163(j) Limitation would be determined in two steps.[55] First, the CFC group would determine the net interest expense of the CFC group, which would equal the excess of the aggregate interest expense of the CFC group members over the aggregate interest income of the CFC group members, after disregarding interest that is paid between members of the group. If that amount is positive, then each CFC's interest expense would equal the product of the group's net interest expense and the CFC's allocable share of that expense. A CFC's allocable share of the group's net interest expense would equal a fraction the numerator of which is the CFC's net interest expense and the denominator of which is the aggregate net interest expense of all of the members of the CFC group (in each case determined without disregarding transaction within the group). Thus, under these rules, and unlike the rules described above for domestic consolidated tax groups, CFCs that are subject to a CFC group election would still need to determine the Section 163(j) Limitation individually for each member of the CFC affiliated group.

Based on these rules, if the only debt held by a CFC group is intragroup debt (as in the example above), a CFC group would net out the intragroup debt and no Section 163(j) Limitation would apply to any CFC group member. The Proposed Regulations, however, would not completely disregard intragroup debt if the CFC group has net interest expense. If a CFC pays interest to a lender outside the CFC group, the Proposed Regulations would take into account interest income received by the CFC from other members of the CFC group in determining such CFC's Section 163(j) Limitation. Thus, in the example above, if CFC 1 borrowed funds from a third party and on-lent the debt proceeds to CFC 2, CFC 2 (but not CFC 1) would be subject to a Section 163(j) Limitation notwithstanding that all of CFC 2's interest expense is paid in respect of intercompany debt.

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[54] Prop. Treas. Regs. § 1.163(j)-7(b)(3)(i); *see also* Preamble to the Proposed Regulations ("[I]f an election is made to apply the alternative method and if a CFC group has only intercompany debt within the CFC group, then the amount of the CFC group's applicable net business interest expense is zero, and no business interest expense of any CFC group member would be subject to the section 163(j) limitation.").

[55] Prop. Treas. Regs. § 1.163(j)-7(b)(3).

Under the Proposed Regulations, CFCs conducting a financial services business would be treated as a separate subgroup subject to special rules.[56] The preamble to the Proposed Regulations notes that such treatment is appropriate because financial services business typically are highly leveraged and have significant amounts of business interest income and business interest expense, such that the inclusion of such businesses in calculations applicable to a wider CFC group could cause distortions. The definition of a financial services subgroup member is relatively narrow, such that certain entities that are typically thought of as financial services entities may not be included in a financial services subgroup.[57] The fact that separate Section 163(j) calculations would be required with respect to financial services subgroups could help or hurt entities that conduct financial services businesses, depending on the particular circumstances of the applicable CFCs. It is not clear why financial services entities should be segregated from non-financial services entities for purposes of determining the Section 163(j) Limitation applicable to a CFC group in light of the fact the Proposed Regulations do not include a similar segregation rule for purposes of determining the Section 163(j) Limitation applicable to a consolidated group of domestic corporations.

In addition to the CFC group election consequences described above, the Proposed Regulations also provide that a CFC group that is subject to a CFC group election may "roll up" a lower-tier CFC group member's Excess Section 163(j) Limitation to higher-tier CFC group members, until the highest-tier CFC group member.[58] Any Excess Section 163(j) Limitation of the highest-tier CFC group member would roll up to such member's U.S. shareholders, up to their subpart F and GILTI inclusions.[59] Accordingly, a CFC group election may be particularly advantageous to an affiliated group of CFCs that has (a) one or more higher-tier CFCs with interest expense that would be disallowed under Section 163(j) on a standalone basis and lower-tier CFCs that have Excess Section 163(j) Limitation or (b) an upper tier CFC with Excess Section 163(j) Limitation (either directly or through a "roll up" from a lower tier CFC) and a United States shareholder with interest expense that would be disallowed under Section 163(j).

The Proposed Regulations would define a CFC group as two or more CFCs owned 80% or more, by value, by a single U.S. shareholder or in the same proportion by multiple related U.S. shareholders.[60] For

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[56] Prop. Treas. Regs. § 1.163(j)-7(b)(3)(i) and (f)(1)(ii).

[57] Prop. Treas. Regs. § 1.163(j)-7(f)(9); *see also* Sections 953(e)(3) and 954(c)(2)(C) and (h)(2)(A). The Proposed Regulations do not define "financial services subgroup" with reference to the relatively expansive definition of "financial services group" in Section 904(d)(2)(C)(ii).

[58] Prop. Treas. Regs. § 1.163(j)-7(c)(3).

[59] Prop. Treas. Regs. § 1.163(j)-7(d)(2).

[60] Prop. Treas. Regs. § 1.163(j)-7(f)(6)(i). Accordingly, a CFC group that is owned by United States and foreign shareholders (or by a partnership that is owned by United States and foreign shareholders) would not be eligible for the CFC group election unless the foreign shareholders do not own more than 20 percent of the CFCs.

purposes of determining a CFC group, members of a consolidated group and individuals filing jointly would be treated as a single person, and CFC stock owned by certain partnerships would be treated as owned by the partners.[61]

The Proposed Regulations would allow a CFC group election to be made simply by applying the CFC group rules to compute each CFC group member's deduction for business interest expense. Once made, a CFC group election would be irrevocable. In order to be effective, a CFC group election would need to be made by all members of the CFC group. If an entity joins an electing CFC group, the new member must also make the CFC group election. If an entity leaves an electing CFC group, the election would terminate solely with respect to that entity. If an electing CFC group ceases to exist, the election would terminate with respect to all group members.[62]

E. ALLOCATION OF INTEREST EXPENSE

1. Exempted Businesses

As discussed above, certain businesses are exempt from the Section 163(j) Limitation, including electing real property businesses and farming businesses.[63] The Proposed Regulations would provide rules and procedures to make such an election and for allocating interest income and expense between exempted businesses and non-exempted businesses.

An election to be treated as an electing real property trade or business may be made by "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business."[64] Only a real property trade or business that makes the election as described in the Proposed Regulations would be exempt from the Section 163(j) Limitation. If a trade or business makes this election, various types of real property held by the trade or business must be depreciated for tax purposes using the "alternative depreciation system," which means that such property would not be eligible for "bonus" depreciation.[65]

The Proposed Regulations would clarify that an election is made for a particular business, and not necessarily for a particular entity, so that a single entity or consolidated group could have both an electing exempted business and a non-exempted business. An election would be irrevocable. The Proposed Regulations would terminate an election only when the electing taxpayer ceases to engage in the electing business, either by (i) selling or transferring substantially all of the electing business's assets or (ii) by

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[61] Prop. Treas. Regs. § 1.163(j)-7(f)(6)(ii). If CFC group members own 80% or more of a partnership, the partnership itself would be treated as a CFC group member, and interests in the partnership would be treated as stock. Prop. Treas. Regs. § 1.163(j)-7(b)(4).

[62] Prop. Treas. Regs. § 1.163(j)-7(b)(5).

[63] *See* Section 163(j)(7)(A)(ii) and (iii).

[64] Section 469(c)(7)(C); Prop. Treas. Regs. § 1.163(j)-1(b)(12).

[65] Section 163(j)(10)(A); Section 168(g)(1)(F).

terminating the taxpayer's existence or ceasing operation of the electing business. However, an election would not terminate if substantially all of the electing business's assets are transferred either to a related party or in a transaction that is not a taxable asset transfer.[66] In addition, the Proposed Regulations would include an anti-abuse rule that would reinstate a previously terminated election if a taxpayer reacquires substantially all of the prior electing business's assets (or substantially similar assets) and resumes conducting the prior electing business within 60 months of terminating the election by selling or transferring the assets.[67]

Under the Proposed Regulations, a taxpayer would make an election by attaching an election statement to the taxpayer's timely filed original federal income tax return for the year in which the election is made. The election statement would need to specify or describe each business for which an election is being made.

The Proposed Regulations include special rules for real property businesses. Under the Proposed Regulations, a real estate investment trust would be allowed to treat all of its assets as assets of an exempted business if no more than 10% of such assets at the end of the taxable year are real property financing assets.[68] However, a real property business, including a real estate investment trust, would not be eligible for the exemption if more than 80% of the business's property is leased to related entities.[69] The preamble explains that this anti-abuse rule is meant to prevent taxpayers from entering into non-economic structures that separate the real estate components of non-real estate businesses and artificially reduce the applicable Section 163(j) Limitation through leases with related parties.

Simultaneously with releasing the Proposed Regulations, the IRS released a Revenue Procedure that provides a safe harbor allowing taxpayers to treat certain infrastructure businesses as exempted real property trades or businesses under Section 163(j).[70]

Once a taxpayer has determined which of its businesses are exempted businesses, the Proposed Regulations include detailed rules as to how the taxpayer should allocate interest income and expense between an exempted business (such as a real estate business) and a non-exempted business. Generally, interest income and expense would be allocated based on the taxpayer's relative tax basis in the exempted and non-exempted businesses.[71] The allocation rules generally would not look to the businesses' income or implement a tracing regime. However, interest expense would be directly

[66] Prop. Treas. Regs. § 1.163(j)-9(d)(1).

[67] Prop. Treas. Regs. § 1.163(j)-9(d)(4).

[68] Prop. Treas. Regs. § 1.163(j)-9(g).

[69] Prop. Treas. Regs. § 1.163(j)-9(h).

[70] Rev. Proc. 2018-59.

[71] *See* Prop. Treas. Regs. § 1.163(j)-10.

allocated to the relevant assets in the case of qualified nonrecourse indebtedness and interest expense incurred in the conduct of an active financing business.[72]

2. Investment Interest

A taxpayer that is not a corporation must allocate income and expense between trade or business assets and investment assets in order to apply Section 163(j) to trade or business interest expense and Section 163(d) to investment interest. A corporation generally does not need to perform such an allocation because, as noted above, all of a corporation's income and expense are generally treated as trade or business income and expense. However, a partnership and an individual must allocate income and expense to trade or business assets and investment assets, because interest expense that is attributable to each type of asset is subject to separate limitation. The Proposed Regulations do not provide any special rules for performing such an allocation, so taxpayers should follow the general rules for allocating interest between investment and trade or business assets that apply under Section 163(d).[73]

F. ANTI-AVOIDANCE RULE

The Proposed Regulations contain 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 Proposed Regulations may be disregarded or recharacterized to the extent necessary to carry out the purposes of Section 163(j).[74] This anti-avoidance rule states in particular that the use of multiple entities to avoid the application of the gross receipts test for purposes of the $25 million small business exception may be disregarded. It is not clear how this anti-avoidance rule would interact with the anti-avoidance rule, discussed above, that applies to the definition of “interest.”

G. EFFECTIVE DATE

If finalized, the Proposed Regulations would generally apply to taxable years ending after the date the Proposed Regulations are finalized. However, taxpayers and their related parties may apply the Proposed Regulations for all taxable years beginning after December 31, 2017. Taxpayers that make this election are subject to the entirety of the Proposed Regulations and cannot elect to apply only certain portions of the Proposed Regulations.[75] Thus, while some provisions of the Proposed Regulations, such as the CFC group election, could be beneficial if implemented as soon as possible, taxpayers will need to

[72] Prop. Treas. Regs. § 1.163(j)-10(d)(1), (2); *see also* Treas. Regs. §§ 1.861-10T(b), 1.904-4(e)(2).

[73] *See* Prop. Treas. Regs. § 1.163(j)-3(b)(9) (“Except as otherwise provided in the section 163(j) regulations, provisions that characterize interest expense as something other than business interest expense under section 163(j), such as section 163(d), govern the treatment of that interest expense, and such interest expense will not be treated as business interest expense for any purpose under section 163(j).”); *see generally* Treas. Regs. § 1.163-8T.

[74] Prop. Treas. Regs. § 1.163(j)-2(h).

[75] *See* Prop. Treas. Regs. §§ 1.163(j)-1(c), 1.163(j)-2(i), 1.163(j)-3(d), 1.163(j)-4(f), 1.163(j)-5(h), 1.163(j)-6(p), 1.163(j)-7(h), 1.163(j)-8(i), 1.163(j)-9(i), 1.163(j)-10(f), and 1.163(j)-11(c).

assess whether such benefits would be outweighed by drawbacks caused by other provisions of the Proposed Regulations, such as the broad definition of interest rules.

Neither the preamble to the Proposed Regulations nor the Proposed Regulations provide guidance on what it means for taxpayers to apply the Proposed Regulations before they are finalized. Some provisions of the Proposed Regulations, such as the CFC group election rules, are not part of the statute and are clearly provisions that cannot be applied now without applying all of the Proposed Regulations. However, it is unclear whether other provisions of the Proposed Regulations, such as the rules for exempt businesses and partnerships are simply interpretations of the existing statute that could be followed by a taxpayer now without requiring the taxpayer to also apply all of the rest of the Proposed Regulations.

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