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Global Tax Alert

US proposed regulations offer much-needed guidance on Section 163(j) business interest expense limitation

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On 26 November 2018, the United States Treasury Department (Treasury) and Internal Revenue Service (IRS) released proposed regulations (REG-106089-18) under Section 163(j), which was modified in December 2017 by the law commonly known as the *Tax Cuts and Jobs Act* or "TCJA." The proposed regulations package also includes proposed regulations under various other Code provisions, including Sections 381, 382, 383, 469, 860C and 1502 (collectively, the Proposed Regulations).

The Proposed Regulations would apply to tax years ending after the date the Treasury decision adopting the regulations as final regulations is published in the Federal Register. Taxpayers and their related parties may, however, apply the Proposed Regulations to a tax year beginning after 31 December 2017, so long as the taxpayers and their related parties consistently apply the Section 163(j) Proposed Regulations, and if applicable, other relevant Proposed Regulations to those tax years. Thus, unlike some of the other proposed regulations issued in response to the TCJA, the Proposed Regulations would not be retroactive to the date that the TCJA was enacted.

The Proposed Regulations include provisions addressing:

- What constitutes interest for purposes of Section 163(j)
- Ordering and operating rules to address the interaction of the Section 163(j) limitation with other provisions of the Code

Building a better working world

- The application of Section 163(j) to consolidated groups, partnerships, S corporations, controlled foreign corporations, and foreign persons with effectively connected income
- The treatment of disallowed business interest expense carryforwards
- Elections made available under Section 163(j)
- Allocating interest expense, interest income and other tax items when the taxpayer conducts a trade or business that is not subject to Section 163(j), as well as a trade or business that is subject to Section 163(j)

Also on 26 November the IRS issued Revenue Procedure 2018-59. The revenue procedure provides a safe harbor under which taxpayers may treat certain infrastructure trades or businesses as real property trades or businesses solely for purposes of qualifying as an electing real property trade or business under Section 163(j)(7)(B).

This Alert provides a general overview of the Proposed Regulations. Tax Alerts on the effects of the Proposed Regulations on various industries are forthcoming.

Background

Section 163(j), as amended by the TCJA, limits the deduction for business interest expense for tax years beginning after 31 December 2017. Specifically, for any taxpayer to which Section 163(j) applies, Section 163(j)(1) limits the amount of business interest expense that may be deducted in a tax year to the sum of (1) the taxpayer's business interest income, as defined in Section 163(j)(6), (2) 30% of the taxpayer's adjusted taxable income (ATI), as defined in Section 163(j)(8), and (3) the taxpayer's floor plan financing interest, as defined in Section 163(j)(9). For purposes of Section 163(j), business interest expense is interest that is paid or accrued on indebtedness that is properly allocable to a trade or business. The limitation under Section 163(j) does not apply to certain trades or businesses (excepted trades or businesses). Certain activities are excluded from being a trade or business. Specifically, performing services as an employee, an electing real property trade or business, an electing farming business, and certain activities of regulated utilities are not a trade or business for this purpose.

In Notice 2018-28 (Notice), issued 2 April 2018, the IRS and Treasury announced their intent to issue proposed regulations under Section 163(j). The Notice describes several issues that the IRS and Treasury intended to cover, including (1) rules for carrying forward interest disallowed under prior Section 163(j)(1)(A), (2) the application of Section 163(j) to consolidated groups, and (3) the application of Section 163(j) to partnerships and S corporations. The Proposed Regulations address each of these and provide additional guidance on multiple other fronts.

Prop. Reg. Section 1.163(j)-1: Definitions

Prop. Reg. Section 1.163(j)-1 provides common definitions used throughout the Proposed Regulations. The more significant definitions follow.

Adjusted taxable income

Under Section 163(j)(8)(A), ATI is the taxable income of the taxpayer, computed without regard to (1) any item of income, gain, deduction, or loss not properly allocable to a trade or business, (2) business interest expense and income, (3) net operating loss deductions under Section 172, (4) deductions for qualified business income under Section 199A, and (5) deductions for depreciation, amortization, or depletion (for years beginning before 1 January 2022).

Section 163(j)(8)(B) authorizes the Treasury to provide for additional adjustments to ATI. Under this authority, the Proposed Regulations would refine ATI by (1) subtracting floor plan financing interest expense, (2) requiring, in tax years beginning before 1 January 2022, an adjustment for sales or dispositions of property subject to depreciation, amortization, or depletion, and (3) requiring an adjustment with respect to sales or dispositions of stock of a member of a consolidated group or partnership interest. The latter two adjustments were included to prevent taxpayers from receiving a double benefit. As an example, the Preamble points out that ATI is computed for tax years beginning before 1 January 2022, without regard to depreciation, amortization, or depletion. If the property subject to depreciation, amortization or depletion were sold, the amount of gain included in ATI would reflect the decreased basis in those assets as a result of the depreciation, amortization or depletion. Thus, an adjustment upon the sale of such property is necessary to prevent a double benefit.

The Proposed Regulations prohibit adjustments to ATI that are not specifically listed.

In response to a comment, the Proposed Regulations clarify that an amount incurred as depreciation, amortization or depletion that is capitalized under Section 263A and included in the cost of goods sold is not a deduction for depreciation, amortization or depletion for purposes of Section 163(j), and therefore would not be added back to determine ATI.

Taxable income

Under the Proposed Regulations, taxable income has the same meaning as in Section 63, computed before the application of Section 163(j) and the Proposed Regulations (i.e., treating all business interest as deductible). For certain taxpayers, however, including regulated investment companies (RICs), real estate investment conduits (REITs), consolidated groups, partnerships, certain controlled foreign corporations (CFCs), and foreign persons with effectively connected income (ECI), the Proposed Regulations contain special rules for determining taxable income when Section 63 may not provide an adequate basis for determining taxable income or when additional adjustments are needed.

Interest

The Proposed Regulations would adopt an expansive list of items that are treated as interest for purposes of Section 163(j). These items generally include items that are treated as interest under general Federal income tax principles, or that are treated as interest under a provision of the Code or regulations. These items include amounts paid, received or accrued as compensation for the use or forbearance of money under the terms of an instrument that is treated as a debt instrument for purposes of Section 1275, including original issue discount, qualified stated interest, acquisition discount relating to short-term debt instruments, accrued market discount, repurchase premium deductible by an issuer, imputed interest under Sections 483, or 7872, and amounts treated as interest under Section 467 rental agreements, Section 163(c) redeemable ground rents, Section 636 mineral production payments, and amounts treated as interest under Section 988.

The Proposed Regulations also include in the definition of interest many items that are not treated as interest under general Federal income tax principles, the Code or regulations, but that the IRS and Treasury viewed as "closely related" to interest and that "affect the economic yield or cost of funds of a transaction involving interest." Consequently, for purposes of Section 163(j), interest includes:

- Income, deduction, gain or loss from transactions used to hedge interest bearing assets or liabilities, or from other derivatives that alter a taxpayer's effective cost of borrowing
- Debt issuance costs
- Guaranteed payments for the use of capital under Section 707(c)
- Income from factored receivables
- Commitment fees, to the extent that amounts have been borrowed
- Substitute interest payments on securities lending or sale-repurchase transactions
- Ordinary gain from Section 1258 conversion transactions
- Ordinary income from bond issuance premium by an issuer or a bond premium deduction by a holder
- Ordinary income or loss arising from contingent payment debt instruments, including foreign currency contingent payment debt instruments

The Proposed Regulations would also treat swaps with "significant nonperiodic payments" that are not "cleared swaps" as two separate transactions: an on-market swap and a loan. Interest on the deemed loan would be treated as interest expense or income for purposes of Section 163(j).

Finally, to prevent transactions that are "essentially financing transactions" from avoiding the application of Section 163(j), the Proposed Regulations would establish an anti-avoidance rule. Under that rule, any deductible expense or loss incurred by a taxpayer in a transaction or series of integrated or related transactions in which the taxpayer secures the use of funds would be treated as interest expense if the expense or loss were predominantly incurred in consideration of the time value of money. Unlike the other interest provisions, the anti-avoidance rule is asymmetric in that it would only apply to deductible expense or loss (treated as interest expense), and not to income or gain (which would not be treated as interest income).

Trades or businesses and excepted trades or businesses

Section 163(j) does not define the term trade or business. The Proposed Regulations provide that the term has the same meaning as it does under Section 162. The Proposed Regulations provide additional guidance as to excepted trades or businesses, including the trade or business of providing services as an employee, certain electing real property businesses, electing farming business, and regulated utility businesses.

Prop. Reg. Section 1.163(j)-2: Deduction for business interest expense limited

Prop. Reg. Section 1.163(j)-2 provides rules that are consistent with the statutory language of Section 163(j)(1) for determining the amount of business interest that is deductible, including amounts allowed as a carryforward to the next tax year. Under this provision, a taxpayer may not deduct business interest expense for the tax year that exceeds the sum of (1) the taxpayer's business income for the tax year, (2) 30% of the taxpayer's ATI for the tax year (but not less than zero), and (3) the taxpayer's floor plan financing interest expense for the tax year. Any business interest that may not be deducted in the current year is carried forward to the following year and treated as business interest expense for that subsequent year.

Exemption for certain small-business taxpayers

Consistent with Section 163(j)(3), the Proposed Regulations would not subject taxpayers that meet the gross receipts test of Section 448(c) (generally, average annual gross receipts for the preceding three years of $25 million or less) to the Section 163(j) limitation (the Small-Business Exemption). Because a taxpayer's status can change from year-to-year, the Proposed Regulations provide that any disallowed business interest expense carried forward to a year to which the Small-Business Exemption applies is not subject to limitation by Section 163(j) for that year and, therefore, would be deductible in full in that year unless limited or disallowed under another provision of the Code or regulations.

Anti-avoidance rule

The Proposed Regulations contain a broad anti-avoidance rule providing that any arrangement entered into with a principal purpose of avoiding the rules of Section 163(j) or the Proposed Regulations (including the use of multiple entities to avoid the gross receipts test) may be disregarded or recharacterized by the Commissioner to the extent necessary to carry out the purposes of Section 163(j).

Proposed Reg. Section 1.163(j)-3: Relationship of business interest deduction to other provisions affecting interest

Prop. Reg. Section 1.163(j)-3 addresses the interaction between Section 163(j) and various other Code sections that also affect interest. Under the general rule, Section 163(j) applies only to business interest expense that would otherwise be deductible in the current tax year, absent the section's application. Furthermore, unless provided otherwise, Section 163(j) applies after the various provisions that subject interest expense to disallowance, deferral, capitalization or some other limitation. In addition to these general rules, the Proposed Regulations specifically provide that:

- Business interest expense does not include interest expense that is permanently disallowed as a deduction under another provision of the Code, such as in Section 163(e)(5)(A)(i), Section 163(l), Section 265, Section 267A, or Section 279
- Code provisions that defer the deductibility of interest expense other than Sections 461(l), 465, and 469, such as Section 163(e)(3) and Section 267(a)(2) and (3), apply before Section 163(j)
- Sections 263A and 263(g) apply before Section 163(j)
- Section 246A applies before Section 163(j)

Though the Notice indicated that the Proposed Regulations would address the interaction between Sections 163(j) and 59A (BEAT), the Proposed Regulations reserve on that issue. Additionally, in the Preamble to the Proposed Regulations, Treasury requested comments on the interaction of Section 163(j) and the discharge-of-indebtedness rules under Section 108.

Prop. Reg. Section 1.163(j)-4: General rules applicable to C corporations and tax-exempt corporations

Prop. Reg. Section 1.163(j)-4 provides rules for computing items of income and expense under Section 163(j) for C corporations (including members of a consolidated group, REITs and RICs) and tax-exempt corporations.

C corporations

Solely for purposes of Section 163(j), all of a C corporation's interest expense and interest income are relevant (i.e., they are considered business interest income and expense) to the C corporation's Section 163(j) limitation calculation, except those amounts that are allocable to an excepted trade or business under Prop. Reg. Section 1.163(j)-10. Further, except as otherwise provided in Prop. Reg. Section 1.163(j)-10, all other items of income, gain, deduction, or loss of a C corporation would be properly allocable to a trade or business, and thus would be factored into a C corporation's calculation of its ATI.

C corporations that are partners

Although a C corporation cannot have investment interest, investment expenses, or investment income, within the meaning of Section 163(d), for purposes of Section 163(j), a partnership in which a C corporation is a partner may have such tax items. The Proposed Regulations would treat such items allocated to a C corporation partner as properly allocable to the C corporation's trade or business. This rule would not apply, however, to the extent a C corporation partner was allocated a share of a domestic partnership's gross income inclusions under Section 951(a) or 951A(a) that are treated as investment income at the partnership level.

The recharacterization of investment items at the C corporation partner level under the Proposed Regulations would not affect the character of these items at the partnership level. It also would not affect the character of the investment interest, investment income, and investment expenses allocated to other (non-C corporation) partners. Investment interest expense of a partnership that was treated as business interest expense by the C corporation partner would not be treated as excess business interest expense under Section 163(j)(4)(b)(i) and the Proposed Regulations. Similarly, investment interest income of a partnership that was treated as business interest income by the C corporation partner would not be treated as ETI under Section 163(j)(4)(C) and the Proposed Regulations.

RICs and REITs

The rules that apply to C corporations would also apply to RICs and REITs, subject to the following conditions: The taxable income of a RIC or REIT for purposes of calculating ATI would be the corporation's taxable income, without any adjustment that would be made under Section 852(b)(2) or 857(b)(2) to compute RIC taxable income or REIT taxable income, respectively. For example, the taxable income of a RIC or REIT would not be reduced by the deduction for dividends paid, but would be reduced by the dividends received deduction (DRD) and the other deductions described in Sections 852(b)(2)(C) and 857(b)(2)(A), taking into account Prop. Reg. Section 1.163(j)-1(b)(37)(ii). For a taxpayer that, for a tax year, is a RIC to which Section 852(b) applies or a REIT to which Section 857(b) applies, the taxpayer's ATI for the tax year would be increased by the amounts of any deductions described in Section 852(b)(2)(C) or 857(b)(2)(A), taking into account Prop. Reg. Section 1.163(j)-1(b)(37)(ii).

Tax-exempt corporations

The Proposed Regulations would apply to a corporation that is subject to the unrelated business income tax under Section 511 only for that corporation's items of income, gain, deduction, or loss that are taken into account in computing the corporation's unrelated business taxable income, as defined in Section 512.

Effect on earnings and profits - C corporations

In general, the Proposed Regulations provide that the disallowance and carryforward of a deduction for a C Corporation's business interest expense will not affect whether or when the business interest expense reduces the taxpayer's earnings and profits.

Effect on earnings and profits – RICs and REITs

For a taxpayer that is a RIC or a REIT for the tax year in which the taxpayer's business interest expense deduction was disallowed, or in which the RIC or REIT was allocated any excess business interest expense from a partnership, the taxpayer's earnings and profits would be adjusted in the tax year or years in which the business interest expense was deductible or, if earlier, in the first tax year for which the taxpayer no longer is a RIC or a REIT.

Effect on earnings and profits – C corporations that are partners

If a C corporation were allocated any excess business interest expense from a partnership, and if any amount of the excess business interest expense had not yet been treated as business interest expense by the C corporation at the time of the C corporation's disposition of all or substantially all of its interest in the partnership, then the C corporation would have to increase its earnings and profits by that amount immediately before disposing of the partnership interest.

Consolidated groups

Under the Proposed Regulations, a consolidated group would have a single Section 163(j) limitation. For purposes of determining whether amounts (other than intercompany obligations, intercompany items, or other corresponding items under the consolidated group regulations) would be treated as interest under the Proposed Regulations, all members of consolidated group would be treated as a single taxpayer.

The consolidated group's current-year business interest expense and business interest income, respectively, would generally the sum of each consolidated group member's current-year business interest expense and business interest income. For purposes of calculating the ATI for a consolidated group, the relevant taxable income would be the consolidated group's consolidated taxable income, determined without regard to any carryforwards or disallowances under Section 163(j). Additionally, if a member of a consolidated group were allowed, for a tax year, a deduction under Section 250(a)(1) that is properly allocable to a non-excepted trade or business, then, for purposes of calculating ATI, consolidated taxable income for the tax year would be determined as if the deduction were not subject to the limitation in Section 250(a)(2). For this purpose, the amount of the deduction allowed under Section 250(a)(1) would be determined without regard to the application of Section 163(j) and the Proposed Regulations. Further, for purposes of calculating the group's ATI, intercompany items and corresponding items would be disregarded to the extent that they offset in amount. For purposes of determining a member's business interest expense and business interest income, and for purposes of calculating the consolidated group's ATI, all intercompany obligations would be disregarded.

The transfer of a partnership interest in an intercompany transaction (i.e., between members of a consolidated group) that did not result in the termination of the partnership would be treated as a disposition for purposes of the basis adjustment rule in Section 163(j)(4)(B)(iii)(II), regardless of whether the transfer was one in which gain or loss was recognized. A change in status of a member (becoming or ceasing to be a member) would not be treated as a disposition for purposes of Section 163(j)(4)(B)(iii)(II).

For purposes of the member stock basis investment adjustment system, a member's allocation of excess business interest expense from a partnership and the resulting decrease in basis in the partnership interest under Section 163(j)(4)(B) would not be a noncapital, nondeductible expense. Additionally, an increase in a member's basis in a partnership interest under Section 163(j)(4)(B)(iii)(II) to reflect excess business interest expense not deducted by the consolidated group would not be tax-exempt income. Investment adjustments would be made under Reg. Section 1.1502-32(b)(3)(i) when the excess business interest expense from the partnership was absorbed by the consolidated group. The Proposed Regulations reserve on the intercompany transfer of a partnership interest that results in termination of the partnership.

Prop. Reg. Section 1.163(j)-5: General rules governing disallowed interest expense carryforwards for C corporations

Prop. Reg. Section 1.163(j)-5 provides rules for carrying forward interest expense that is incurred by a corporation and disallowed under Section 163(j)(1). In general, any interest expense that is disallowed under Section 163(j)(1) would be carried forward to the next tax year as a disallowed interest expense carryforward. Further, under the ordering rule in Prop. Reg. Section 1.163(j)-5(b), current-year interest expense would be deducted first before any disallowed interest expense carryforward. Disallowed interest expense carryforwards would then be deducted in the order in which they arose, beginning with the earliest tax year. The Preamble explains that this ordering rule was adopted for several reasons, including concern that, if a taxpayer were required to deduct disallowed business interest expense carryforwards before or simultaneously with current-year business interest expense, the taxpayer's Section 382 limitation might be used up on disallowed interest expense carryforwards, rather than on NOLs or other items subject to the Section 382 limitation. The Proposed Regulations provide additional ordering rules for when a consolidated group's aggregate interest expense, including carryforwards, exceeds the group's Section 163(j) limitation.

In addition to ordering rules, Prop. Reg. Section 1.163(j)-5(c) through (f) provide rules to address the application of certain subchapter C provisions and consolidated return rules to disallowed interest expense carryforwards. More specifically, Prop. Reg. Section 1.163(j)-5(c) crosses references Prop. Reg. Section 1.381(c)(20)-1 for rules addressing disallowed business interest expense carryforwards in a transaction to which Section 381(a) applies. Prop. Reg. Section 1.163(j)-5(d) provides rules addressing the treatment of disallowed interest expense carryforwards that arose in a year when the member did not join in the filing of consolidated return with the current group. Prop. Reg. Section 1.163(j)-5(e) cross-references proposed regulations under Section 382 and Prop. Reg. 1.163(j)-11 for rules addressing the interaction of Section 382 with disallowed interest expense carryforwards. Finally, Prop. Reg. Section 1.163(j)-5(f) coordinates the application of Prop. Reg. Section 1.163(j)-5(e) and (f) to cases in which the rules overlap.

Prop. Reg. Section 1.163(j)-6: Application of the business interest expense deduction limitations to partnerships and Subchapter S corporations

Statutory background

For partnerships, Section 163(j) applies both at the partnership and partner level.

Section 163(j)(4) provides that Section 163(j) "should be applied at the partnership-level." As a result, partnerships deduct the business interest expense allowed by Section 163(j). Unlike other taxpayers, however, partnerships do not treat business interest expense not allowed as a deduction for any tax year as business interest expense paid or accrued by the partnership in the succeeding tax year. Instead, the disallowed amount creates a partner-level tax attribute, excess business interest (EBI). A partnership's EBI is allocated to each partner in the same manner as the partnership's non-separately stated taxable income or loss. EBI allocated to a partner may only be deducted by that partner in succeeding tax years to extent the partner is allocated excess taxable income (ETI) from the same partnership. Thus, for example, if a partner that is allocated EBI also has ATI from other sources, the partner will not be able to deduct any of the EBI to reduce its taxable income from other sources. Instead, the partner will only be able to deduct that EBI if and when the same partnership allocates the partner ETI.

Section 163(j) requires that a partner perform its own Section 163(j) calculation. The statute generally requires a partner to compute its ATI without regard to the partner's distributive share of any items of income, gain, deduction or loss from a partnership. A partner may, however, increase its ATI by the partner's distributive share of a partnership's ETI, which is allocated to each partner in the same manner as the partnership's non-separately stated taxable income or loss. More specifically, ETI must first be used by a partner to apply against any EBI allocated by the same partnership and carried forward by the partner. Once all the EBI has been treated as used by the partner as a result of the ETI allocation, any additional ETI is taken into account by the partner in computing the partner's ATI.

Computation of partnership ATI and partner ATI: Impact of partner-specific items and no-double counting rule

Section 163(j) requires a partnership-level calculation but does not address the impact, if any, on partnership ATI (which provides the partnership's Section 163(j) limitation) of certain partner-specific items, such as Section 743(b) adjustments. Under the Proposed Regulations, Section 743(b) adjustments, Section 704(c)(1)(C) amounts and remedial allocations (collectively, partner-level adjustments) would not be taken into account at the partnership level. Instead, partner-level adjustments would be taken into account at the partner level in computing the partner's ATI.

Consistent with the statute, the Proposed Regulations would also preclude the double counting of partnership ATI, generally by requiring a partner to calculate its ATI without regarding to the partner's distributive share of partnership items, and instead by increasing the partner's ATI only by any partnership ETI. Similarly, consistent with Notice 2018-28, the Proposed Regulations would preclude the double counting of business interest income.

Allocation of partnership EBI and ETI: Meaning of non-separately stated taxable income or loss and 11-step process

Section 163(j)(4) generally allocates partnership EBI (which is not allowed as a deduction in the current year) and partnership ETI to each partner in the same manner as the non-separately stated taxable income or loss of the partnership.

The Proposed Regulations would give limited effect to the statutory phrase "allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership" by purging the character of allowed business interest expense in the partner's hands so that it would not be subject to further Section 163(j) limitations. Business interest expense otherwise would retain its character as interest at the partner level and thus may be subject to other limitations, such as Section 163(d).

The Proposed Regulations, moreover, would give effect to the statutory allocation requirements for partnership ETI, excess business interest income (EBII), and EBI (collectively, Section 163(j) excess items) and for deductible business interest expense using an 11-step process, attempting to reconcile the entity-level application of Section 163(j) with the flow-through nature of partnerships.

Treatment of EBI

Section 163(j)(4)(B)(ii) provides rules for the carryforward of EBI. The Proposed Regulations restate Section 163(j)(4)(B)(ii), providing that EBI is carried forward by the partner and not the partnership, and would clarify that a partner must treat as paid or accrued carried-forward EBI to the extent, dollar-for-dollar, of current-year partnership ETI and EBII. The Proposed Regulations, however, would mute the dollar-for-dollar benefit by imposing a partner-level Section 163(j) calculation on the carried-forward EBI. It thus appears advantageous to have EBI in year 1 and ETI in year 2, instead of having both items in the same tax year if the partner has available a partner-level Section 163(j) limitation.

Per Section 163(j)(4)(B)(iii)(I), a partner's adjusted basis in its partnership interest is reduced (but not below zero) by the amount of EBI allocated to the partner. If a partner disposes of a partnership interest, Section 163(j)(4)(B)(iii)(II) generally provides for an increase in outside basis for unused carried-forward EBI. The Proposed Regulations would limit the Section 163(j)(4)(B)(iii)(II) basis adjustment to only dispositions (whether by reason of taxable or non-taxable transactions) of at least substantially all of the partner's interest in the partnership.

Other key provisions

The Proposed Regulations address several issues stemming from the entity-level application of Section 163(j) to partnerships. For example, the Proposed Regulations provide rules regarding the treatment of gain or loss from the sale of a partnership interest on a partner's ATI calculation. The Proposed Regulations also provide complex rules coordinating Section 163(j) with Section 704(d).

Prop. Reg. Section 1.163(j)-6 reserved on key issues – tiered partnerships; partnership mergers and divisions, and self-charged interest

Section 163(j) does not on its face address tiered-partnership structures, mergers or divisions. The Proposed Regulations reserve on whether business interest expense carryforwards allocated to a pass-through partner should be further allocated to that partner's partners. Similarly, the Proposed Regulations reserve on any basis adjustments made to a partner's basis in the partner's upper-tier partnership. The Proposed Regulations also reserve on the effect of partnership mergers and divisions and thus do not address whether a resulting partnership with ETI may free up EBI of a formerly separate partnership.

Section 163(j) on its face applies to all business interest and does not make an exception for so-called self-charged interest. The Preamble indicates that self-charged interest income and expense should be excluded from the partnership and its partner's Section 163(j) limitation calculations. The Proposed Regulations reserve on the issue.

Prop. Reg. Section 1.163(j)-7: Application of Section 163(j) to foreign corporations and their shareholders

Prop. Reg. Section 1.163(j)-7 would clarify that Section 163(j) applies to certain foreign corporations that constitute an "Applicable CFC" and partnerships owned by an Applicable CFC and provides detailed rules (including an elective alternative method) and definitions for determining the Section 163(j) limitation, as well as the ATI of Applicable CFCs and their US shareholders. For purposes of the Proposed Regulations, an Applicable CFC is a controlled foreign corporation described in Section 957 but only if at least one US shareholder (within the meaning of Section 951(b)) owns stock (within the meaning of Section 958(a)) in the foreign corporation.

General rule – Prop. Reg. Section 1.163(j)-7(b)(2)

Under the general rule of the Proposed Regulations, an Applicable CFC's deduction for business interest expense would be determined in the same manner as a domestic C corporation's deduction for business interest expense. Similarly, if an Applicable CFC were a partner in a partnership, Section 163(j) and the Proposed Regulations would apply to that partnership in the same manner as those provisions would apply if the Applicable CFC were a domestic C corporation. Consequently, an Applicable CFC with business interest expense would be required to apply the rules of Prop. Reg. Section 1.163(j)-2(b) to determine the extent to which its business interest expense is deductible for purposes of computing subpart F income under Section 952, tested income under Section 951A(c)(2)(A), and any ECI, as applicable. In doing so, an Applicable CFC that is a partner in a partnership would also have to apply the rules of Prop. Reg. Section 1.163(j)-1(b)(15) and -6. As discussed later, additional rules in Prop. Reg. Section 1.163(j)-8(d) would apply if an Applicable CFC had ECI or were a partner in a partnership that is engaged in a US trade or business.

Elective alternative method – Prop. Reg. Section 1.163(j)-7(b)(3) through (5)

Because the strict application of Section 163(j) could result in inappropriate US federal income tax mismatches in certain situations, the Proposed Regulations provide a complex elective alternative method for computing an Applicable CFC's Section 163(j) limitation if the Applicable CFC is a member of a "CFC Group" and all members of the CFC Group properly make a "CFC Group Election" described in Prop. Reg. Section 1.163(j)-7(b)(3) and (5). Special rules provide that, while an Applicable CFC with ECI cannot use the elective alternative method, its ownership interest in a lower-tier Applicable CFC can be relevant in determining the members of a CFC Group. As noted in the Preamble, Treasury and the IRS determined that the alternative method "should be elective, rather than required, because for certain situations, the general application of Section 163(j) may be preferable to taxpayers." There is a multiple step process for applying the elective alternative method including determining whether there is a CFC Group, determining each CFC Group Member's allocable share, if any, of the CFC Group's "Applicable Net Business Interest Expense," and determining the ATI of Applicable CFCs.

Determining the CFC Group – A CFC Group generally means two or more Applicable CFCs if 80% or more of the total stock by value of each Applicable CFC is owned (within the meaning of Section 958(a)) by either a single US shareholder or multiple US shareholders that are related persons (within the meaning of Section 267(b) or 707(b)(1), so long as the stock of each Applicable CFC is owned in the same proportion by each related US shareholder. In addition, if one or more CFC Group members of the same CFC group, in the aggregate, own more than 80% of the capital or profits interests in a partnership, then the partnership would be treated as a CFC Group member and interests in that partnership would be treated as stock for purposes of applying Prop. Reg. Section 1.163(j)-7. For purposes of identifying the members of a CFC Group, special aggregation rules in Prop. Reg. Section 1.163(j)-7(f)(6)(ii) would treat members of a consolidated group and individuals filing a joint return as a single person and would treat stock owned by certain pass-through entities as owned by their owners or beneficiaries.

If one or more CFC Group members conducted a financial services business, those members would comprise a separate "Financial Services Subgroup," and the elective alternative method would apply separately for that Financial Services Subgroup. Consequently, taxpayers will need to identify and segregate the financial services business CFC Group members from the non-financial services business CFC Group members. An entity conducts a financial services business if it is an eligible CFC (as defined in Section 954(h)(2)(A)), is a qualified insurance company (as defined in Section 953(e)(3)), or is eligible for the dealer exception in computing foreign personal holding company income (as described in Section 954(c)(2)(C)).

If not all members of the CFC Group (or Financial Services Subgroup) had the same tax year and the CFC Group Election were made, then all group-level computations would be required to be made with respect to a "Majority US Shareholder Taxable Year," as defined in Prop. Reg. Section 1.163(j)-7(f)(11).

Effect of the CFC Group Election – If a CFC Group Election is properly made, then the portion of the CFC Group (or Financial Services Subgroup) member's business interest expense that is subject to the Section 163(j) limitation would equal the member's allocable share of the group's Applicable Net Business Interest Expense. The Proposed Regulations define that term as "the excess, if any, of the sum of the amounts of business interest expense of each CFC group member over the sum of the amounts of business interest income of each CFC group member."

Each member of the CFC Group (or Financial Services Subgroup) would use its allocable share, if any, in computing its Section 163(j) limitation on a separate company basis. As noted in the Preamble, if the group members only have debt with other members of the same group, then the CFC Group Election would result in no Applicable Net Business Interest Expense, and thus, no disallowance of any group member's business interest expense for the year. In addition, if a member of a CFC Group (or Financial Services Subgroup) has no allocable share (e.g., because such member has net business interest income), then such member's business interest expense is not subject to the Section 163(j) limitation.

The effect of the CFC Group Election can be seen in the following simplified example from the Proposed Regulations:

> *Facts*. USP, a domestic corporation, wholly owns CFC1, CFC2 and CFC3. None of CFC1, CFC2, and CFC3 conduct a financial services business or have ECI. USP, CFC1, CFC2 and CFC3 all use the calendar year as their tax year. CFC1 has business interest expense of $90x, attributable to a third-party bank loan and business interest income of $100x, attributable to notes from CFC2 and CFC3. CFC2 has business interest expense of $50x, attributable to its note to CFC1. CFC3 has business interest expense of $50x, attributable to its note to CFC1. Each of CFC1, CFC2, and CFC3 has ATI of $100x, computed on a separate-company basis for the tax year ending 31 December 2018. USP has no business interest expense.
>
> *Analysis*. Each of CFC1, CFC2, and CFC3 is an Applicable CFC owned by USP and a member of USP's CFC Group. The Applicable Net Business Interest Expense of USP's CFC Group is $90x, with each of CFC2 and CFC3 having an allocable share of $45x that is subject to the Section 163(j) limitation. The remaining $5x of net business interest expense for each of CFC2 and CFC3 is not subject to the Section 163(j) limitation. The deductible business interest expense for CFC1, CFC2 and CFC3, with and without the CFC Group Election in 2018, is as follows:

	CFC1	CFC2	CFC3
Without CFC Group Election	$90x (No limitation)	$30x ($100x ATI * 30%)	$30x ($100x ATI * 30%)
With CFC Group Election	$90x (No limitation)	$35x ($100x ATI * 30%) plus $5x not subject to limitation	$35x ($100x ATI * 30%) plus $5x not subject to limitation

The remaining $15x of business interest expense for CFC2 and CFC3 is not deductible and will be carried forward as a disallowed business interest expense carryforward.

Rules for computing the ATI of Applicable CFCs and their US Shareholders – Prop. Reg. Section 1.163(j)-7(c) through (d)

The Proposed Regulations provide that the principles of Treas. Reg. Section 1.952-2 (or the rules of Section 882 for Applicable CFCs with ECI) apply for purposes of computing the Applicable CFC's taxable income. To mitigate potential double counting of income in ATI, any dividend received by an Applicable CFC from a related person would not be included in the taxable income of the Applicable CFC for purposes of computing ATI.

If a CFC Group Election were in effect, an upper-tier CFC Group (or Financial Services Subgroup) member would take into account a proportionate share of the "excess" ATI of each lower-tier member in which it directly owned stock in computing the upper-tier member's ATI. The process of computing and tracking members' ETI would begin with a lowest-tier member and continue through the chain of ownership to a highest-tier member of the group. Thus, a lowest-tier member would compute its Section 163(j) limitation; if the lowest-tier member had excess ATI, the excess would be taken into account proportionately by one or more higher-tier members that directly own stock of the lower-tier member for purposes of computing ATI; and, if that higher-tier member has excess ATI, the excess would be taken into account by a next higher-tier member, and so forth. Special rules would apply to partnerships that are part of the CFC Group (or Financial Services Subgroup).

For US shareholders, the Proposed Regulations generally provide that the ATI of a US shareholder is computed without regard to any amounts included in gross income under Sections 78, 951(a) and 951(A)(a) that are properly allocable to a non-excepted trade or business of such shareholder, without regard to any deduction allowable under Section 250(a)(1)(B), and without regard to the taxable income limitation in Section 250(a)(2). In addition, if a CFC Group Election were in effect, a US shareholder would also need to determine whether any "Eligible CFC Group ETI" (as defined in Prop. Reg. Section 1.163(j)-7(d)(2)(ii) is included in its ATI).

Making the CFC Group Election – A CFC Group would properly make a CFC Group Election by applying the election in its computation of a CFC Group (or Financial Services Subgroup) member's deduction for business interest expense. Absent further guidance from Treasury or the IRS, a separate statement or form evidencing the election need not be filed. Once made, a CFC Group Election is irrevocable. If an entity ceased to be a member of the CFC Group (or Financial Services Subgroup), the election would terminate solely with respect to that entity. If a CFC Group (or Financial Services Subgroup) ceased to exist, the election would terminate for all members of the CFC Group (or Financial Services Subgroup).

Effect on earnings and profits – Prop. Reg. Section 1.163(j)-7(e)

Consistent with the rules in Prop. Reg. Section 1.163(j)-4(c), the disallowance and carryforward of an Applicable CFC's business interest expense would not affect whether and when the business interest expense reduces the Applicable CFC's E&P, including for purposes of the E&P limitation under Section 952(c) and the determination of E&P for passive foreign investment companies (as defined in Section 1297).

Examples – Prop. Reg. Section 1.163(j)-7(g)

The Proposed Regulations provide two examples illustrating the application of Prop. Reg. Section 1.163(j)-7. Example 1 illustrates the computation of the Section 163(j) limitation of CFC Group members with and without the CFC Group Election, as previously discussed. Example 2 illustrates the computation and allocation of CFC ETI. The examples highlight the importance of and complexities in (1) determining the members of a CFC Group (or Financial Services Subgroup) and allocable shares of Applicable Net Business Interest Expense, (2) tracking an Applicable CFC's ETI, and (3) computing ATI for Applicable CFCs and their US shareholders.

Prop. Reg. Section 1.163(j)-8: Application of the Section 163(j) limitation to foreign persons with effectively connected income

Prop. Reg. Section 1.163(j)-8 provides rules for applying the Section 163(j) limitation to foreign persons with income effectively connected with the conduct of a US trade or business (ECI). Nonresident individuals and foreign corporations engaged in a US trade or business are only subject to US tax on ECI (or income treated as ECI). As a result, the Proposed Regulations would modify the definitions for ATI, business interest expense, business interest income, and floor plan financing interest expense to limit these items to income that is ECI and expenses allocable to ECI when applying the Section 163(j) limitation to these foreign persons. The Proposed Regulations accordingly provide rules to coordinate the application of the Section 163(j) limitation with the amount of interest expense of a foreign corporation determined to be allocable to ECI under Reg. Section 1.882-5. Specifically, the Proposed Regulations would first require a foreign corporation with ECI to determine its business interest expense allocable to ECI under Reg. Section 1.882-5, and then require the foreign corporation to apply the Section 163(j) limitation to determine the amount (if any) of that business interest expense that is disallowed business interest expense.

To illustrate with an example from the Proposed Regulations: FC is a foreign corporation engaged in a US trade or business with $100 of gross income that is ECI. FC has $60 of other income that is not ECI, and $100 of total expenses. Of the $100, $30 is business interest expense allocable to ECI as determined under Treas. Reg. Section 1.882-5 and $40 is other expenses properly allocated and apportioned to ECI under Section 882(c). FC's ECI taxable income for the year is $30 ($100 - $30 - $40), and its ATI as modified is $60 ($30 + $30), resulting in a Section 163(j) limitation of $18 ($60 x 30%). FC may only deduct $18 of business interest expense in the current tax year. The remaining $12 is disallowed business interest expense carryforward and treated as paid or accrued by FC in the succeeding tax year (but is not taken into account for purposes of determining the interest expense of FC in the succeeding tax year under Treas. Reg. Section 1.882-5).

For a foreign corporation that is an Applicable CFC subject to the rules of Prop. Reg. Section 1.163(j)-7 (discussed earlier), the Proposed Regulations provide that an Applicable CFC with ECI is first subject to the general Section 163(j) limitation under Prop. Reg. Section 1.163(j)-7(b)(2) that determines the amount (if any) of disallowed business interest expense. A portion of that disallowed amount of business interest expense would then be treated as interest expense allocable to ECI of the Applicable CFC. The allocable portion would equal the disallowed business interest expense of the Applicable CFC multiplied by a fraction; the fraction's numerator consists of the Applicable CFC's effectively connected taxable income for the year, adjusted for the items taken into account to compute ATI (only by those items taken into account in determining ECI), while the denominator consists of the applicable CFC's overall ATI for the tax year.

The Proposed Regulations would also modify the general Section 163(j) partnership rule (discussed earlier) to apply when a nonresident alien or foreign corporation is a partner in a partnership that engages in a US trade or business. The ETI, excess business interest expense, and excess business interest income of that partnership would be modified to take into account the limitation on the foreign person's US tax liability to income that is ECI.

Consistent with the general principles of the Proposed Regulations for earnings and profits, the Proposed Regulations provide that disallowed business interest expense and carryforward of disallowed business interest expense would not affect the determination of "effectively connected earnings and profits" or "U.S. net equity" for purposes of the branch profits tax under Section 884.

Prop. Reg. Section 1.163(j)-9: Elections for excepted trades or businesses; safe harbor for certain REITs

Under Section 163(j)(7)(B), a real property trade or business, as defined in Section 469(c)(7)(C), may elect to not be treated as a trade or business for purposes of Section 163(j). A trade or business described in Section 469(c)(7)(C) includes any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. Similarly, Section 163(j)(7)(C) allows a farming business, as defined in that subparagraph, not to be treated as a trade or business for purposes of Section 163(j). Thus, if made, the elections allow those trades or business to be exempted from the limitations in Section 163(j). An electing real property trade or business and an electing farm business must use the alternative depreciation system.

Prop. Reg. Section 1.163(j)-9 provides rules for making the elections. Taxpayers interested in making the election would do so by attaching an election statement to their timely filed Federal income tax return, including extensions. The election would have to be made for each eligible trade or business, though elections for multiple trades or business could be made on a single election statement. Prop. Reg. Section 1.163(j)-9(c)(2) sets forth the required information for the statement.

Consistent with statute, the Proposed Regulations would make the election irrevocable. The election would terminate if the taxpayer ceased to engage in the electing trade or business. The cessation of an electing trade or business would occur if (1) the taxpayer sells or transfers substantially all of the assets of the electing trade or business to an acquirer that is not a related party in a taxable asset transfer or (2) the taxpayer terminates its existence for US federal income tax purposes or ceases the operation of the electing trade or business, unless that termination or cessation results in a sale or transfer of substantially all of the assets to a related person or in a transaction that is not a taxable asset transfer. An anti-abuse rule would reinstate the election, if, within 60 months of the sale or transfer of assets, the taxpayer or a related person reacquired substantially all of the assets, or substantially similar assets, and resumed conducting the prior electing trade or business. The Proposed Regulations do not define the term "substantially all."

Safe harbor for REITs

In general, if a REIT holds real property (as defined in Reg. Section 1.856-10), interests in partnerships holding real property, or shares in other REITs holding real property, the REIT may elect to be an electing real property trade or business for purposes of Sections 163(j)(7)(B) and 168(g)(1)(F) for all or part of its assets.

If a REIT made the election and the value of its real property financing assets (defined as including interests in mortgages, deeds of trust, and installment land contracts; mortgage pass-through certificates guaranteed by certain Government agencies, and REMIC regular interests) at the close of the tax year is 10% or less of the value of the REIT's total assets at the close of the tax year, then all of the REIT's assets would be treated as assets of an excepted trade or business. If the value of the REIT's real property financing assets were more than 10% of the value of the REIT's total assets, then the REIT would have to apply the rules set forth in Reg. Section 1.163(j)-10, with certain modifications, as provided in Prop. Reg. Section 1.163(j)-9(g)(3), for allocation of interest expense, interest income, and other items of expense and gross income to excepted and non-excepted trades or businesses,

In addition, the Proposed Regulations provide additional rules for applying the value test when a REIT holds shares in another REIT.

Anti-abuse rule for certain real property trades or businesses

In general, a real property trade or business does not constitute a trade or business eligible for an election under Prop. Reg. Section 1.163(j)-9(b)(1) if at least 80%, determined by fair market value, of the business's real property is leased, whether or not the arrangement is under a written lease, a service contract or another agreement that is not denominated as a lease, to a trade or business under common control with the real property trade or business. For purposes of this paragraph (h), two trades or businesses are under common control if 50 percent of the direct and indirect ownership of both businesses is held by related parties within the meaning of Sections 267(b) and 707(b). This special anti-abuse rule would not apply to REITs that lease qualified lodging facilities, as defined in Section 856(d)(9)(D), and qualified health care properties, as defined in Section 856(e)(6)(D).

Prop. Reg. Section 1.163(j)-10: Allocation of interest expense, interest income, and other items of expense and gross income to an excepted trade or business

As previously discussed, Section 163(j)(7) and Prop. Reg. Section 1.163(j)-2 exempt certain trades or businesses from the application of Section 163(j). Prop. Reg. Section 1.163(j)-10 provides the exclusive rules for allocating tax items, including interest expense and interest income, between excepted and non-excepted trades or businesses for purposes of Section 163(j). The general method of allocation is based upon the relative amounts of the taxpayer's adjusted basis in the assets used in its trades or businesses, which generally reflects the principle that money is fungible and that interest expense is attributable to all activities and property, regardless of any specific purpose for incurring an obligation on which interest is paid.

Prop. Reg. Section 1.163(j)-10(a): Overview and general rules

Prop. Reg. Section 1.163(j)-10 would apply after a taxpayer has determined whether any tax items are properly allocable to a trade or business. All members of a consolidated group would be treated as a single corporation. After the consolidated group determined the percentage of the group's interest expense allocable to excepted trades or businesses for the tax year, this exempt percentage would apply to the interest paid or accrued by each member during the tax year to any lender that is not a group member. Intercompany obligations and intercompany transactions (along with the resulting offsetting items) would generally be ignored for these purposes.

Prop. Reg. Section 1.163(j)-10(b): Allocation of tax items other than interest income and expense

A taxpayer's gross income (other than dividends and interest income) would be allocated to the trade or business generating the income. Special "look-through" rules may apply to dividends received from non-consolidated domestic corporations and gain or loss from the disposition of stock in non-consolidated C corporations, partnership interests and S corporation stock. Expenses (other than interest expense), losses and other deductions (collectively, deductions) that definitely relate to a trade or business would be allocable to the trade or business to which they relate. Deductions definitely related to one or more excepted and non-excepted trades or businesses would be apportioned based on the relative amounts of the taxpayer's adjusted basis in the assets used in those trades or businesses. Deductions not definitely related to a trade or business would be ratably apportioned to all gross income.

Prop. Reg. Section 1.163(j)-10(c): Allocation of interest expense and interest income

Interest expense and interest income generally would be allocated among excepted and non-excepted trades or businesses based upon the relative amounts of the taxpayer's adjusted basis in the assets used in those trades or businesses, determined as of the last day of each quarter of the taxpayer's tax year (a determination date). The average of those amounts would be used as the relative amounts of asset basis for the taxpayer's excepted and non-excepted trades or businesses for that year. If 90% or more of the taxpayer's basis in its assets for the tax year were allocable to either excepted or non-excepted trades or businesses, then all of the taxpayer's business interest expense and business interest income would be treated as allocable to either excepted or non-excepted trades or businesses, respectively.

To the extent an asset is used in more than one trade or business between determination dates (each a determination period), the taxpayer could allocate the adjusted basis to each trade or business using one of the prescribed permissible methodologies that most reasonably reflects the use of the asset in each trade or business during that determination period. A taxpayer could not change its allocation methodology from one determination period to the next, or from one tax year to the next, without obtaining the consent of the Commissioner. Special rules would apply for allocating the taxpayer's asset basis for utility trades or businesses that distinguish between excepted and non-excepted regulated utility trades or businesses.

Additional rules relating to basis apply to specific items such as non-depreciable property other than land, depreciable property other than inherently permanent structures, and land and inherently permanent structures (among other items). For example, the adjusted basis of depreciable property other than inherently permanent structures generally must be determined by using the alternative depreciation system (ADS) under Section 168(g) before applying bonus depreciation. Because most taxpayers don't maintain ADS depreciation schedules for their domestic assets, complying with the allocation rules under Treas. Reg. Section 1.163(j)-10 may be administratively burdensome for some taxpayers. In addition, rules governing the allocation of basis of a partner's interest in a partnership, and stock held in a non-consolidated domestic corporation or an S corporation, generally require the taxpayer to look through to the assets of the partnership or corporation. These look-through rules do not apply to a partnership, S corporation or non-consolidated corporation that is eligible for the Small-Business Exemption.

To discourage taxpayers from moving cash to excepted trades or businesses, cash, cash equivalents, and customer receivables generally would not be taken into account for these purposes. In addition, the Commissioner may make appropriate adjustments to prevent a taxpayer from intentionally and artificially increasing its basis in assets attributable to an excepted trade or business.

Taxpayers would have to substantiate the use of an asset in an excepted trade or business, as well as any adjustments to asset basis for purposes of applying Treas.

Reg. Section 1.163(j)-10(c), by preparing and attaching an information statement to its timely filed Federal income tax return for the tax year that includes five different categories of information. Failure to file this information statement, or the filing of a statement that does not comply with Treas. Reg. Section 1.163(j)-10(c)(6)(iii), permits the Commissioner to treat the taxpayer as if all of its interest expense were properly allocable to a non-excepted trade or business (unless the failure to comply was due to reasonable cause and the taxpayer acted in good faith).

Finally, a broad anti-abuse rule may apply to ignore any additional basis or change in use of an asset if a principal purpose for the acquisition, disposition or change in use of the asset was to artificially shift the amount of basis allocable to excepted or non-excepted trades or businesses on a determination date. The proposed regulations provide that a purpose may be a principal purpose even though it is outweighed by other purposes. Factors that may be considered in determining whether a taxpayer has a principal purpose include: the business purpose for the acquisition, disposition, or change in use; the length of time the asset was used in a trade or business; and whether the asset was acquired from a related person. A taxpayer would be presumed to have a principal purpose when the transaction lacks substantial business purpose and increases the taxpayer's basis in assets used in its excepted trades or businesses by more than 10% during the tax year.

These allocation rules would not apply to disallowed business interest expense carryforwards (except disallowed disqualified interest) or floor-plan financing interest expense.

Prop. Reg. Section 1.163(j)-10(d): Direct allocations

A taxpayer with nonqualified recourse indebtedness (within the meaning of Treas. Reg. Section 1.861-10T(b) could not apply the asset basis allocation rules discussed earlier and instead must directly allocate interest expense from the indebtedness to the taxpayer's assets in the manner described in Temp. Reg. Section 1.861-10T(b).

Prop. Reg. Section 1.163(j)-11: Transition rules

Prop. Reg. Section 1.163-11 provides transition rules. Subsection (a) provides rules for applying Section 163(j) to a corporation when it joins a consolidated group whose tax year began before 1 January 2018. Subsection (b) provides rules for taxpayers with disqualified interest, within the meaning of former Section 163(j). The disqualified interest would be carried forward to the taxpayer's 2018 tax year and subject to disallowance under new Section 163(j), except to the extent that the disqualified interest was allocable to an excepted trade or business under the rules in Prop. Reg. Section 1.163(j)-10. The transition rules also address the allocation of disqualified interest carryforwards among members of an affiliated group treated as a single taxpayer under former Section 163(j) and the application of Section 382 to disqualified interest carryforwards. Finally, the transition rules would confirm that any excess limitation under former Section 163(j)(2)(B) may not be carried forward to tax years beginning in 2018.

Implications

The term interest is broadly defined and includes many items generally understood to not constitute interest for tax purposes. As a consequence of the broad definition, taxpayers with complex financing structures, especially ones involving factoring or the use of derivatives (such as interest rate swaps, interest rate caps, and foreign currency hedges, regardless of whether those items are treated as hedges for tax purposes) will face a substantial compliance burden to determine to what extent amounts not previously treated as interest may be subject to limitation under Section 163(j).

The provisions addressing the treatment of partnerships, the allocation rules in Prop. Reg. Section 1.163(j)-10, and the rules for Applicable CFCs add significant complexity and are certain to impose significant administrative burdens on the taxpayers subject to those rules. In addition, because the elective alternative method is irrevocable, taxpayers will need to carefully consider the organizational structures and debt profiles of their Applicable CFCs, as well as any anticipated changes to such structures and profiles before electing that method. Such features and burdens are not limited to partnerships: for example, shareholders of closely-held, standalone C corporations must "look through" a corporation's basis in its assets, for purposes of determining the extent to which the shareholder's basis in the corporation's stock is allocable to an excepted or non-excepted trade or business.

Regarding capitalization, the Proposed Regulations would apply provisions requiring the capitalization of interest (such as Section 263A(f)) before Section 163(j); they would also clarify that interest capitalized under those provisions would not be treated as interest for any purpose under Section 163(j). The ability to capitalize interest under a required provision before applying Section 163(j) may be favorable for certain taxpayers. Such capitalized interest may be recovered (either as depreciation or with basis when sold) earlier than if the interest were first limited under Section 163(j) and carried forward. Further, to the extent interest were capitalized under Section 263A(f) to depreciable assets benefiting inventory production or resale activities, the interest recovered as depreciation would be capitalized to inventory under Section 263A and recovered as cost of goods sold. To the extent such interest was incurred for debt with a foreign related party, such interest would appear to escape BEAT.

As noted, the regulations are prospective unless a taxpayer elects to apply them early. In evaluating whether to apply them early, taxpayers should thoroughly analyze the provisions to determine whether provisions that may be favorable (e.g., the CFC Group Election) outweigh provisions that may be unfavorable (e.g., the broad definition of interest). If a taxpayer does not apply the regulations early, consideration should be given to what extent the provisions of the regulations must be taken into account for a pre-effective date tax year(s).

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