Report No. 1393

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON SECTION 163(j)

March 28, 2018

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REPORT OF THE TAX SECTION OF THE NEW YORK STATE BAR ASSOCIATION ON AMENDMENTS TO SECTION 163(j)

This report ("**Report**") of the New York State Bar Association Tax Section comments on Section 163(j)[1] as amended by "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," P.L. 115-97 (the "**Act**")[2].

We thank the Department of the Treasury ("**Treasury**") and the Internal Revenue Service (the "**IRS**") for considering our comments on Section 163(j). In this Report, we recommend that Treasury and the IRS issue guidance to address some uncertainties surrounding the application of the statute.

This Report is divided into four parts. Part I summarizes our recommendations for future guidance. Part II describes Section 163(j) as in effect before and after the Act. Part III provides a detailed discussion of our recommendations. Part IV sets forth some additional issues that we have identified, but regarding which we have not yet developed a formal recommendation.

I. Summary of Recommendations

We recommend that Treasury and the IRS issue guidance providing for the following:

A. General Recommendations

1. It should be confirmed that "interest" for purposes of Section 163(j) includes any item of income or expense that is treated as interest under the Code. In addition, it should be considered whether administrative guidance (or a statutory amendment) should provide that items economically equivalent to interest will be treated as such for purposes of Section 163(j). Particularly if the government seeks to address this issue through administrative guidance, we recommend that the guidance apply only to a limited set of specifically identified types of transactions (in all of which one party secures the use of funds for a period of time and makes payments that are determined solely or almost solely by reference to the time value of money). Such guidance also should take a symmetrical approach for

[1] Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended (the "**Code**") and the Treasury Regulations promulgated thereunder.

[2] The principal drafters of this report are John T. Lutz and Philip Wagman with contributions from William Alexander, Daniel Z. Altman, Kimberly S. Blanchard, Peter H. Blessing, Andrew H. Braiterman, James R. Brown, Robert Cassanos, Peter Connors, Daniel M. Dunn, Timothy J. Devetski, Lucy W. Farr, Phillip J. Gall, Marcy G. Geller, Kevin Glenn, Edward E. Gonzalez, David Hardy, Andrew M. Herman, Monte A. Jackel, Robert Kantowitz, Shane J. Kiggen, Stephen B. Land, John P. MacMaster, Jeffrey Maddrey, Michael T. Mollerus, Richard M. Nugent, Deborah L. Paul, James M. Peaslee, Elliot Pisem, Michael L. Schler, David Schnabel, Peter F. G. Schuur, Michael B. Shulman, David R. Sicular, Eric B. Sloan, Andrew P. Solomon, Karen G. Sowell, Shun Tosaka, Adina T. Wagman, Gordon E. Warnke and Sara B. Zablotney. This report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or House of Delegates.

purposes of identifying income and expenses equivalent to interest under Section 163(j).

2. All interest income of a corporation (other than interest income attributable to a business exempt from Section 163(j)) should be treated as "business interest income" under Section 163(j)(5), and all interest expense of a corporation (other than interest expense attributable to an exempt business) should be treated as "business interest" under Section 163(j)(6). In the case of a noncorporate taxpayer, all interest income other than investment income as defined in Section 163(d) (and interest income attributable to an exempt business) should be treated as "business interest income," and all interest expense other than investment interest under Section 163(d) and personal interest under Section 163(h) (and interest expense attributable to an exempt business) should be treated as "business interest."

3. "Adjusted taxable income" of a corporation should include all items of income and expense that are included in its taxable income, other than those specifically excluded by Section 163(j)(8)(A)(ii), (iii) and (v) (i.e., business interest income, business interest, the net operating loss deduction and, beginning in 2022, deductions for depreciation and amortization) or that are attributable to exempt businesses. In the case of a non-corporate taxpayer, adjusted taxable income should include (a) all of the taxpayer's non-interest income, other than items that are investment income under Section 163(d), are attributable to exempt businesses or (for a taxpayer that is not a business entity) are clearly personal in nature (such as interest income imputed under Section 7872 on a gift loan), and (b) all of the taxpayer's non-interest deductible expenses, other than investment expenses under Section 163(d), expenses attributable to exempt businesses and (for a taxpayer that is not a business entity) specifically enumerated non-business deductions.

4. A framework should be provided for a corporation to allocate interest expense between businesses it conducts that are exempt from Section 163(j), and businesses that are not exempt. Allocation methods based on the relative assets, or the relative income, of these businesses should be considered. If an asset-based or income-based allocation method is adopted, then the government should consider also providing some exceptions from that allocation method, in order to address limited, specific cases where a particular indebtedness is clearly tied to a particular business: for example, where particular debt is taken into account by a regulatory authority that has oversight over a specific business; or where nonrecourse debt is used to finance the acquisition or construction of property that is used in a particular business.

5. Individuals should allocate interest expense between exempt and non-exempt businesses using tracing principles that are consistent with Treasury Regulation Section 1.163-8T.

6. Tracing principles also should generally apply to partnerships, for purposes of allocating a partnership's interest expense between exempt and non-exempt businesses. However, in the case of a partnership whose partners are solely or mainly corporations, it should be considered whether an allocation method should be used which corresponds to the method required for businesses that are directly owned by a corporation.

7. Section 163(j) should be applied to interest expense for which a deduction otherwise would be allowed to the taxpayer in a given year, after having taken into account all the other statutory and regulatory rules that would disallow or defer such deductions.

8. If a loss is allowed under Sections 465 and 469 which consists in part of interest expense, and a deduction for part or all of that interest expense is then disallowed for the year under Section 163(j), then Sections 465 and 469 should be re-applied after Section 163(j), so that the taxpayer is allowed to deduct additional amounts of other items and claim the full amount of loss permitted under Sections 465 and 469.

9. Interest expense that was disallowed under Section 163(j) as in effect before the Act should be carried forward and treated as interest paid or accrued by the taxpayer in the first year new Section 163(j) is effective. However, a corporation that had a carryforward of excess limitation under old Section 163(j) should lose that limitation carryforward, under the new statute.

10. It should be confirmed how the rules for computing a corporation's "adjusted taxable income" under Section 163(j) interact with Section 246(b) and Section 250(a)(2) (both of which limit specific deductions of a corporation by using formulas that are based on the amount of the corporation's taxable income).

B. Corporate Recommendations

1. Interest expense disallowed by reason of Section 163(j) should reduce a corporation’s earnings and profits in the year that the interest expense was paid or accrued in accordance with the corporation’s method of accounting.

2. All members of the same consolidated group should be treated as a single taxpayer for Section 163(j) purposes.

3. There should be rules that deal with disallowed business interest expense carryforwards of a corporation that joins a consolidated group, as well as apportionment of a consolidated group's disallowed business interest carryforwards to a corporation that leaves a consolidated group. These rules should generally be similar to the rules that deal with similar issues in the case of net operating loss carryforwards. However, some special rules may be appropriate, in order to deal with issues that could arise when a member

that has operations that generate applicable taxable income but little or no debt (or vice versa) leaves a group.

4. Section 163(j) should not be applied on a group basis to a Section 1504(a) affiliated group that does not file a consolidated return, or to an expanded affiliated group of the type described in the proposed regulations under old Section 163(j). In addition, a partnership among members of a consolidated group should not be treated as a single taxpayer together with the members of the consolidated group, for purposes of applying Section 163(j).

C. **Partnership Recommendations**

1. The character of a partnership's interest income and expense as business interest income and business interest expense should be determined at partnership level.

2. A partnership generally should use tracing principles to divide its interest expense between investment interest and business interest expense (and, as noted in A.6 above, between exempt and non-exempt businesses). Such allocation should not be dependent on whether the partnership distributes the borrowed funds to its partners. As indicated in A.6 above, in the case of a partnership whose partners are solely or mainly corporations, it should be considered whether an allocation method should be used that corresponds to the method required for businesses that are directly owned by a corporation.

3. A partnership's deductible business interest expense that is taken into account in the partnership's non-separately stated income for purposes of Section 163(j) should retain its character as interest for all other purposes of the Code.

4. To the extent that a partnership's business interest income is taken into account in determining the amount of interest expense allowable under Section 163(j) at the partnership level, such business interest income should be included in the partnership's non-separately stated income for Section 163(j) purposes, so that a partner cannot utilize such business interest income to support an additional interest expense deduction at the partner level.

5. It should be clarified that if a partner has excess business interest expense carryforwards, and the partner is allocated a share of the partnership's "excess taxable income" for a subsequent year, then the partner can only deduct carried forward interest equal to at most 30% (not 100%) of the allocable excess taxable income.

6. A partner should be permitted to utilize its excess business interest expense carryforwards against such partner's share of the partnership's business

interest income (net of such partnership's business interest expense) for a subsequent taxable year.

7. If a partnership has interest expense characterized at the partnership level as investment interest, a corporate partner should treat its share of that interest expense as business interest expense that is subject to Section 163(j) at the partner level; and a non-corporate partner should treat its share of the interest expense as subject to Section 163(d).

8. The statutory exemptions of certain businesses from Section 163(j), including the electing real property trade or business exemption, the electing farming business exemption, the utilities business exemption and small business exemption, should be determined at the partnership level. Elections for the first two of these exemptions should be made at the partnership level.

9. If a partner incurs interest expense at the partner level that is allocable, under the allocation principles described above in A.4 and A.5, to the partner's interest in a partnership that conducts an exempt trade or business, then such interest expense should be exempt from Section 163(j).

10. It should be clarified how Section 163(j) applies in the case of a partnership that has special allocations, as well as how Section 743 adjustments and Section 704(c) allocations impact the application of Section 163(j) to partnerships and partners.

D. **International Recommendations**

1. Guidance should confirm whether Section 163(j) applies to business interest expense of controlled foreign corporations and passive foreign investment companies, and, if it does, the manner in which it applies. If Section 163(j) applies to CFCs then, when calculating the Section 163(j) limit in connection with determining the amount of a CFC's Subpart F income, the CFC's adjusted taxable income and business interest income should be computed taking into account only items that are Subpart F income, and its business interest expense should be computed taking into account only interest expense which is allocable to Subpart F income.

2. In the case of a foreign corporation that has a U.S. trade or business, Section 163(j) should be applied in order to compute the corporation's liability for corporate net income and branch profits taxes by taking into account only adjusted taxable income and business interest income that are included in the corporation's effectively connected income, and business interest expense that is allocated to effectively connected income pursuant to the regulations under Sections 882 and 884.

II. Overview of Section 163(j)

A. Section 163(j) Prior to the Act

In general terms, prior to the Act, Section 163(j) limited the deductibility of interest paid or accrued by a corporate taxpayer[3] to a related person[4] where such interest was exempt (in whole or in part) from U.S. tax.[5] Old Section 163(j) did not apply unless the corporation's debt to equity ratio exceeded 1.5 to 1.[6] Assuming a corporate taxpayer's debt-to-equity ratio exceeded 1.5:1 as of the end of such corporate taxpayer's taxable year, old Section 163(j) denied an interest deduction for amounts paid or accrued to a related tax-exempt (generally, foreign) person [7] to the extent that the corporation's net interest expense[8] exceeded 50% of its adjusted taxable income (i.e., taxable income computed without regard to deductions for net interest expense, net operating losses, net interest expense, domestic production activities under Section 199, depreciation, amortization and depletion).[9] Net interest expense in excess of 50% of the corporation's adjusted taxable income was defined as "excess interest expense."[10] Any interest deduction disallowed under Section 163(j) was treated as interest paid or accrued in the succeeding taxable year. [11]

Under old Section 163(j), all members of the same affiliated group (within the meaning of Section 1504(a)) were treated as a single taxpayer.[12] Pursuant to proposed regulations issued under old Section 163(j), all members of an affiliated group are treated as one taxpayer for Section 163(j) purposes without regard to whether the affiliated group files a consolidated return. [13]

Old Section 163(j) was applied at the partner level. A corporate partner's distributive share of interest income paid or accrued to the partnership was treated as interest income paid or accrued

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[3] Prior to the Act, Section 163(j) applied to domestic "C" corporations and foreign corporations with income, gain or loss that was effectively connected to a U.S. trade or business, but did not apply to 'S' corporations. Proposed Regulation Section 1.163(j)-1(a)(1).

[4] For convenience, we sometimes refer to "**old Section 163(j)**" rather than Section 163(j) prior to the Act. Old Section 163(j) also applied to interest paid or accrued to an unrelated person if the debt was guaranteed by a related person and certain additional requirements were met. See old Section 163(j)(3)(B).

[5] Exempt related party interest referred to interest expense that was exempt in whole or in part from U.S. tax in the hands of the recipient, taking into account treaty benefits.

[6] Section 163(j)(2)(A)(ii) prior to the Act.

[7] Theoretically, old Section 163(j) could apply to interest paid by a taxable subsidiary to a tax-exempt parent corporation, although amendments to Section 512(b)(13) effectively limited the application of old Section 163(j) to interest paid or accrued to foreign persons.

[8] Net interest expense is the amount by which all interest paid or accrued during the taxable year exceeds the amount of interest includible by the taxpayer in gross income for taxable such year. Proposed Regulation Section 1.163(j)-2(d).

[9] Section 163(j)(1)(A), (2)(B)(i) prior to the Act.

[10] Section 163(j)(2)(B)(i) prior to the Act.

[11] Section 163(j)(1)(B) prior to the Act.

[12] Section 163(j)(6)(C) prior to the Act.

[13] Proposed Regulation Section 1.163(j)-5(a)(2). In addition, the proposed regulations would have expanded the definition of affiliated group beyond that provided in Section 1504(a).

to a corporate partner; a corporate partner's distributive share of interest paid or accrued by the partnership was treated as interest paid or accrued by a corporate partner; and a corporate partner's share of the partnership's liabilities was treated as liabilities of a corporate partner.[14]

B. Section 163(j) as amended by the Act

1. General

The Act amended Section 163(j) in several material ways. Section 163(j), as amended, applies to both corporate and noncorporate taxpayers. The debt-to-equity ratio test was removed, and Section 163(j) now applies at the partnership level rather than the partner level. Finally, new exceptions were added for electing real property businesses, electing farming businesses, utilities, certain small businesses and floor plan financing interest. The statutory provisions are described in greater detail below.

Section 163(j) provides, in pertinent part, that a taxpayer cannot deduct business interest expense for a taxable year to the extent that such interest exceeds the sum of (a) the business interest income of such taxpayer for such taxable year, and (b) 30 percent of the taxpayer's adjusted taxable income for such taxable year.[15] The statute defines "business interest expense," "business interest income," and "adjusted taxable income."

For Section 163(j) purposes, "business interest expense" means any interest paid or accrued on indebtedness properly allocable to a trade or business. It does not include investment interest (within the meaning of Section 163(d)).[16] (In this Report, we refer to business interest expense as "business interest expense," for ease of distinguishing it from "business interest income.")

The term "business interest income," for Section 163(j) purposes, means the amount of interest includible in the gross income of the taxpayer for the taxable year which is properly allocable to a trade or business. The term does not include investment income (within the meaning of Section 163(d)).[17]

Accordingly, the application of Section 163(j) turns on whether interest is properly allocable to a trade or business. The term "trade or business" is not defined affirmatively in Section 163(j) but the statute expressly excludes (i) the trade or business of performing services as an employee, (ii) any electing real property trade or business, (iii) any electing farming business, or (iv) the trade or business of the furnishing or sale of (a) electrical energy, water, or sewage disposal services, (b) gas or steam through a local distribution system, or (c) transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, have been established or

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[14] Section 163(j)(8) prior to the Act.

[15] Section 163(j)(1). Although "floor plan financing interest" technically falls within the definition of business interest expense, such interest nevertheless is not subject to limitation under Section 163(j). Section 163(j)(1)(C).

[16] Section 163(j)(5). In very general terms, Section 163(d)(3) defines "investment interest" as interest paid or accrued on indebtedness properly allocable to property held for investment other than "qualified residence interest" under Section 163(h)(3) or interest which is taken into account under Section 469 in computing gain or loss from a passive activity of a taxpayer.

[17] Section 163(j)(6).

approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative.[18]

The term "adjusted taxable income" ("**ATI**") means the taxable income of the taxpayer computed without regard to (i) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business, (ii) any business interest expense or business interest income, (iii) the amount of any net operating loss deduction under Section 172, (iv) the amount of any deduction allowed under Section 199A, and (v) in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion.[19]

Any business interest expense not allowed as a deduction for any taxable year is treated as business interest expense paid or accrued in the succeeding taxable year.[20]

2. **Partnerships**

In the case of any partnership,[21] (a) Section 163(j) is applied at the partnership level and any deduction for business interest expense is be taken into account in determining the non-separately stated taxable income or loss of the partnership, and (b) the adjusted taxable income of each partner of such partnership, (i) is determined without regard to such partner's distributive share of any items of income, gain, deduction, or loss of such partnership, and (ii) is increased by such partner's distributive share of such partnership's excess taxable income.[22] For this purpose, a partner's distributive share of partnership excess taxable income shall be determined in the same manner as the partner's distributive share of non-separately stated taxable income or loss of the partnership.[23]

The amount of any business interest expense not allowed as a deduction to a partnership for any taxable year is not treated as business interest expense paid or accrued by the partnership in the succeeding taxable year, but, subject to the rules in the next paragraph, is treated as excess business interest expense which is allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership.[24]

If a partner is allocated any excess business interest expense from a partnership for any taxable year (a) such excess business interest expense is treated as business interest expense paid or accrued by the partner in the next succeeding taxable year in which the partner is allocated excess taxable income (defined below) from such partnership, but only to the extent of such excess taxable income, and (b) any portion of such excess business interest expense remaining after

[18] Section 163(j)(7)(A).

[19] The Treasury is granted the authority to make other adjustments to ATI.

[20] Section 163(j)(2).

[21] Rules similar to the special Section 163(j) partnership rules also apply to any 'S' corporation and its shareholders. See Section 163(j)(4)(D).

[22] Section 163(j)(4)(A).

[23] Id.

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

applying the excess taxable income limitation, is treated as business interest expense paid or accrued in succeeding taxable years.[25] In addition, once all such excess business interest expense for all preceding taxable years has been treated as paid or accrued by a partner as a result of allocations of excess taxable income to the partner a partner by the partnership for any taxable year, any remaining excess taxable income that has been allocated to the partner will be taken into account when computing the partner's own Section 163(j) limitation with respect to any business interest expense the partner has incurred at the partner level.

The term "excess taxable income" ("**ETI**") means, with respect to any partnership, the amount which bears the same ratio to the partnership's adjusted taxable income as the excess (if any) of (a) 30% of the adjusted taxable income of the partnership for the taxable year, over (b) the amount (if any) by which the business interest expense of the partnership exceeds the business interest income of the partnership, bears to 30% of the partnership's adjusted taxable income for the taxable year.[26]

The adjusted basis of a partner in a partnership interest is reduced (but not below zero) by the amount of excess business interest expense allocated to the partner.[27] If a partner disposes of a partnership interest, the adjusted basis of the partner in the partnership interest is increased immediately before the disposition by the amount of the excess (if any) of the amount of such basis reduction over the portion of any excess business interest expense allocated to the partner which has previously been treated as business interest expense paid or accrued by the partner. This provision also applies to transfers of a partnership interest (including by reason of death) in a transaction in which gain is not recognized in whole or in part. No deduction is allowed to the transferor or transferee for any excess business interest expense resulting in a basis increase.[28]

3. **Exceptions to Section 163(j)**

Section 163(j) does not apply to certain activities and certain small businesses. Each of these exceptions will be described below.

a. **Electing Real Property Businesses**

Section 163(j) does not apply to an "electing real property trade or business" because that phrase is carved out of the Section 163(j) definition of trade or business. The term 'electing real property trade or business' means any trade or business which is described in Section 469(c)(7)(C) that elects to be excluded from Section 163(j). Section 469(c)(7)(C) defines "real property trade or business" as "any real property development redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business."

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25 Section 163(j)(4)(B)(ii).

26 Section 163(j)(4)(C).

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

28 Section 163(j)(4)(B)(iii)(II).

The statute grants authority to Treasury to determine the time and manner of the election. Once made, the election is irrevocable.[29]

b. **Electing Farming Businesses**

Similarly, Section 163(j) does not apply to an electing farm business because that term is excluded from the Section 163(j) definition of trade or business. The term "electing farming business" means a farming business (as defined in Section 263A(e)(4)) or any trade or business of a specified agricultural or horticultural cooperative (as defined in Section 199A(g)(2)) that elect to be excluded from Section 163(j).[30] The statute grants authority to the Treasury to determine the time and manner of the election. Once made, the election is irrevocable.[31]

c. **Small Business Exception**

There is an exemption for certain small businesses. In the case of any taxpayer[32] which meets the gross receipts test of Section 448(c) for any taxable year, Section 163(j) does not apply to such taxpayer for such taxable year. In general, a corporation or partnership meets the gross receipts test of Section 448(c) for any taxable year if the average annual gross receipts of such entity for the 3 taxable year period ending with the immediately prior taxable year does not exceed $25 million.[33] In the case of any taxpayer which is not a corporation or a partnership, the gross receipts test of Section 448(c) shall be applied in the same manner as if such taxpayer were a corporation or partnership.[34]

d. **Employees**

The trade or business of performing services as an employee is not treated as a trade or business for purposes of the Section 163(j) limitation.[35] As a result, the wages of an employee are not counted in the ATI of the taxpayer for purposes of determining the interest expense limitation.[36]

e. **Utilities Exception**

The trade or business of the furnishing or sale of (a) electrical energy, water, or sewage disposal services, (b) gas or steam through a local distribution system, or (c) transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, have been

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[29] Section 163(j)(7)(B).

[30] Section 163(j)(7)(C).

[31] Section 163(j)(7)(C).

[32] Other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under Section 448(a)(3). Section 163(j)(3).

[33] All persons treated as a single employer under Section 52(a) or (b) or Section 414(m) or (o) are treated as one person for purposes of the $25 million gross receipts test. Section 448(c)(2).

[34] Section 163(j)(3).

[35] Section 163(j)(7)(A)(i).

[36] Section 163(j)(7)(A)(i).

established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative (a "**utilities business**") is not a trade or business for purposes of Section 163(j). [37]

f. **Floor Plan Financing Interest**

Interest paid or accrued on "floor plan financing indebtedness" is not subject to limitation under Section 163(j).[38] The term "floor plan financing interest" means indebtedness used to finance the acquisition of motor vehicles[39] held for sale or lease, and secured by the inventory so acquired.[40]

4. **Effective Date**

The amendments to Section 163(j) apply to taxable years beginning after December 31, 2017.

5. **Conforming Amendments**

The Act amended Section 381(c) to include the carryover of disallowed business interest expense to taxable years ending after the date of distribution and transfer. Section 382(d) was amended to include disallowed interest expense within the definition of "pre-change loss."[41]

III. Discussion

A. Interest

Section 163(j) contains no special rules defining interest. The Conference Report, however, states that "any amount treated as interest for purposes of the Code is treated as interest for purposes of Section 163(j)." The Conference Report appears to indicate a Congressional decision to apply Section 163(j) more narrowly than old Section 163(j). Old Section 163(j), for example, took a more expansive view of interest by including substitute payments made under a

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[37] Section 163(j)(7)(A).

[38] Section 163(j)(1)(C) and (j)(9). Section 163(j)(1). The Conference report to the Act states "by including business interest income and floor plan financing interest in the limitation, the rule operates to allow floor plan financing interest to be fully deductible and to limit the deduction for net interest expense (less floor plan financing interest) to 30% of adjusted taxable income." H.R. Rep. 115-466, at 387.

In this Report, references to business interest expense are to interest that qualifies as such under Section 163(j)(5) and is not floor plan financing interest; and in all examples, the interest expense is not floor plan financing interest.

[39] The term "motor vehicle" means any (a) self-propelled vehicle designed for transporting persons or property on a public street, highway, or road, (b) a boat, or (c) farm machinery or equipment. Section 163(j)(a)(C).

[40] Section 163(j)(9)(B).

[41] Section 382(d)(3). Section 382(k)(1) was amended to include any corporation entitled to use a carry forward of disallowed interest.

securities loan that met the requirements of Section 1058(a) as interest for Section 163(j) purposes.[42]

We recommend that the Treasury and Service issue guidance confirming that Section 163(j) applies to all amounts treated as interest under the Code. Accordingly, under our recommendation for Section 163(j) purposes, interest would include:

- original issue discount, adjusted for any acquisition premium;
- acquisition discount;
- amounts treated as interest under Section 1286 (related to stripped bonds);
- gain treated as ordinary income on the disposition of a market discount bond;
- amounts treated as interest under Treas. Reg. Sec. 1.446-3T (related to notional principal contracts with nonperiodic payments);
- payments treated as interest under Section 483;
- amounts treated as interest under a Section 467 rental agreement;
- redeemable ground rent treated as interest under Section 163(c);
- amounts treated as interest under Section 988; and
- foregone interest treated as interest under Section 7872.

There is a reasonable policy argument that deductions for expenses that are the functional equivalent of interest ought to be limited in the same manner as interest deductions under Section 163(j). For example, if a taxpayer borrows a debt security in a Section 1058(a) transaction, substitute payments it makes on account of interest on that security logically should be subject to Section 163(j); otherwise the taxpayer could use that securities loan to generate cash which it uses to purchase a separate debt security, with interest income on the purchased debt security increasing the taxpayer's Section 163(j) limitation and substitute payments on the borrowed security not be subject to the limitation. As a similar example, if a taxpayer holds a fixed-rate debt instrument and a derivative swapping fixed for floating rate interest, then the taxpayer again may receive interest income that increases its Section 163(j) limitation and make interest-like payments under the swap that are not subject to the limitation. By comparison, if the taxpayer integrated the debt instrument with the hedge, all of the payments would be taken into account in applying Section 163(j). However, while the right answer in these examples may seem clear, we believe it becomes more difficult fairly quickly to determine where to draw the line, if a broader range of transactions

[42] The legislative history to old Section 163(j), by comparison, indicated that Congress contemplated Treasury could issue guidance, if it wished, regarding "expense items not denominated interest but appropriately characterized as equivalent to interest expense." H.R. Rep. 101-386 at 566-567 (1989).

(having some time-value element, but not solely or predominantly providing for payments that are determined by reference to the time value of money) is considered.

To the extent that certain deductible payments should be treated as interest expense for purposes of applying the statute, it would seem logical that receipt or accrual of the same types of payments should be treated as interest income for that purpose. There does not seem to be a principled justification for adopting an asymmetrical approach.

In view of the statutory language ("interest paid or accrued on indebtedness"), the legislative history, and the fact that Congress did not give any indication of following the long-established approach that was taken under old Section 163(j), it seems questionable whether there would be authority for guidance applying new Section 163(j) to interest equivalents, absent a statutory amendment. However, we note that to the extent guidance applies only to a limited set of specifically identified types of transactions, in all of which one party secures the use of funds for a period of time and makes payments that are determined solely or almost solely by reference to the time value of money (including making net payments determined taking into account a hedge of the cost of borrowing, as in the example above), such guidance would appear to be more easily defensible, as an antiabuse measure designed to protect the intended operation of the statute rather than to materially expand it. Similarly, guidance takes a symmetrical approach for purposes of identifying income and expenses equivalent to interest under Section 163(j) would seem more likely to be upheld, as applying in a relatively neutral way that is not intended to disadvantage taxpayers.

B. Business Interest Expense; Business Interest Income

Guidance should confirm that all interest expense of a corporation is business interest expense, and all interest expense of a non-corporate taxpayer, other than personal interest and Section 163(d) investment interest, is business interest expense. The goal of Section 163(j) is to limit a taxpayer's ability to use interest deductions to increase its after-tax rate of return from its activities, and thereby to curb the tax law's tendency to encourage excessive levels of debt in taxpayers' capital structures.[43] It is consistent with that goal for the concept of business interest expense to have a broad scope, with Section 163(j)(5)'s references to "trade or business" and "properly allocable" not being interpreted as imposing significant limitations. For example, a corporation should not be able to claim that, to the extent its interest expense is attributable to investment activities that do not rise to the level of a trade or business under general tax principles, or is not closely connected to a particular activity that constitutes a trade or business but instead has been incurred on debt borrowed for general corporate purposes, the interest is not subject to limitation Section 163(j). Similarly, a non-corporate taxpayer should not be able to successfully

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[43] See H.R. Rep. 115-409, at 247-248 ("The Committee believes that the general deductibility of interest payments on debt may result in companies undertaking more leverage than they would in the absence of the tax system. The effective marginal tax rate on debt-financed investment is lower than that on equity-financed investment. Limiting the deductibility of interest along with reducing the corporate tax rate narrows the disparity in the effective marginal tax rates based on different sources of financing. This leads to a more efficient capital structure for firms.").

argue that it has interest expense that falls into an area uncovered by any of Sections 163(j), 163(d) or 163(h). The statute's legislative history provides direct support for such an approach.[44]

Logically, business interest income for purposes of Section 163(j) would be determined under a rule symmetrical to the one just described for business interest expense; that is, all interest income of a corporation, and all interest income of a non-corporate taxpayer other than investment income as defined in Section 163(d), would be business interest income. (In the case of a non-corporate taxpayer that is not a business entity, Treasury and the IRS could consider also excluding interest income on loans clearly made for personal reasons, such as interest income imputed under Section 7872 on a gift loan to a friend or relative of the taxpayer.) The legislative history just referenced supports such an approach.[45]

C. **Adjusted Taxable Income**

In our view, it logically follows from our recommended approach to defining the business interest income and business interest expense of a corporation, that all of its other items of income and expense (exclusive of items attributable to a business exempt from Section 163(j)) should be included in the corporation's ATI. The legislative history discussed above suggests that for purposes of Section 163(j), all activities of a corporation constitute a trade or business, with the result that all its income and expense is "properly allocable" to a trade or business. In addition, assuming that (as recommended) all of the corporation's interest expense (not allocated to an exempt business) is treated as business interest expense, it seems fair to treat all of its non-interest income (other than from exempt businesses) as ATI; otherwise, there would be the potential for arbitrary mismatches, in which a taxpayer's interest expense is subject to the Section 163(j) limitation, while the taxpayer's income from an activity financed by the relevant borrowing is not taken into account as ATI to increase the amount of the limitation under Section 163(j)(1)(B). There is no apparent policy reason for applying the statute in a manner that creates such mismatches, and the text of the statute readily lends itself to a more symmetrical approach. Moreover, our recommended approach is relatively easily administrable, as compared to an

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[44] See H.R. Rep. 115-409, at page 248 note 444 ("Section 163(d) applies in the case of a taxpayer other than a corporation. Thus, a corporation has neither investment interest nor investment income within the meaning of section 163(d). Thus, interest income and interest expense of a corporation is properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of the provision."); H.R. Rep. 115-466, at 386 n. 688 ("a corporation has neither investment interest nor investment income within Section 163(d). Thus, interest income and interest expense of a corporation's properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of [Section 163(j)].").

In Part III of this report, except where specifically stated, all references to a "corporation" are to a C corporation (as defined in Section 1361(a)(2)) that is not a real estate investment trust, a regulated investment company.

[45] As noted in the legislative history, if a taxpayer conducts a business that is explicitly exempted from Section 163(j), then interest income and interest expense allocable to that business is excluded from the definitions of business interest income and business interest expense, pursuant to Section 163(j)(7). We discuss further in Part III.D below recommendations for the method to be used to allocate interest expense, and other items of income and expense, to an exempt business conducted by a taxpayer.

approach that requires a fact-intensive inquiry into the connection between items of income and a trade or business of the corporation.

Similar logic should apply to a non-corporate taxpayer. As proposed above, all of a non-corporate taxpayer's interest income and interest expense, other than investment income and investment interest under Section 163(d), interest income and expense from exempt businesses, and personal interest under Section 163(h) (and, possibly, interest income on loans clearly made for personal reasons, such as interest imputed under Section 7872 on gift loans), would be treated as business interest income and business interest expense under Section 163(j). It is thus seems reasonable to treat all of a non-corporate taxpayer's non-interest income as being included in the taxpayer's ATI, other than items that are investment income under Section 163(d), or that are attributable to exempt businesses or (in the case of a taxpayer that is not a business entity) are specifically enumerated items of income that are personal in nature, such as gain on the sale of the taxpayer's home. In addition, all of the taxpayer's non-interest deductible expenses, other than investment expenses under Section 163(d), expenses attributable to exempt businesses, and (in the case of a taxpayer that is not a business entity) specifically enumerated non-business deductions including for charitable contributions, state or local property taxes not related to a business, and medical or dental expenses, should be taken into account in ATI.

D. Allocation of Interest Expense Among a Taxpayer's Activities

Application of Section 163(j) requires that interest expense be allocated among different activities of a taxpayer. Under Section 163(j)(5) and 163(j)(7)(A), interest expense allocable to a trade or business of acting as an employee, an electing real property trade or business, an electing farming business, or a utilities business is exempted from the Section 163(j) limitation. Other provisions of the Code adopt a range of different approaches to allocating interest expense to different assets or activities: tracing based on the taxpayer's use of the borrowed funds;[46] tracing based on the purpose for the borrowing;[47] and allocation rules based on the relative amounts of assets used in different activities of the taxpayer.[48]

On balance, we recommend that guidance be issued under Section 163(j) allocating interest expense of a corporation based on the relative amounts of assets used in the corporation's exempt and non-exempt businesses, or based on the relative amounts of income the businesses generate, rather than an approach based on tracing or the purpose of a borrowing. We believe that an asset- or income-based approach to allocating interest expense would be more difficult for corporate taxpayers to manipulate, and would lead to significantly less litigation based on factual disputes, than a system based on tracing or the taxpayer's purpose would. However, we recognize that the

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[46] See Treasury Regulation Section 1.163-8T; see also Treasury Regulation Section 1.108(i)-2(d)(1) (adopting certain safe harbors based on the use of borrowed funds, for purposes of determining whether debt was issued by a partnership or S corporation "in connection with the conduct of a trade or business").

[47] See Section 265(a)(2) (denying a deduction for interest on debt incurred or continued to purchase or carry tax-exempt securities; was issued by a partnership or S corporation "in connection with the conduct of a trade or business"); Treasury Regulation Section 1.265-1(c); Rev. Proc. 72-18 (describing standards, including based on objective factors, for determining whether debt in incurred for the purpose of purchasing or carrying tax-exempt securities).

[48] See Treasury Regulation Sections 1.861-9 – 1.861-12T, 1.882-5, 1.884-4.

considerations for corporate and non-corporate taxpayers are somewhat different relating to the choice of a Section 163(j) allocation method, and we acknowledge that, as a practical matter, it may be necessary to adopt a method for non-corporate taxpayers that is based largely or entirely on tracing principles.

Although we outline below multiple possible approaches to allocation for the government's consideration, we believe that guidance should provide mandatory rules, rather than taxpayer elections between allocation methods, in order to maximize the likelihood of consistent outcomes that do not unduly disadvantage the government.

1. Corporations

a. Asset-Based Allocation Method

Corporate taxpayers in many cases may find an asset-based approach familiar, from their calculations under Section 861 for foreign tax credit purposes. The basic principles of the Section 861 rules are well-understood and have been fairly stable over a long period of time, and it would appear those principles could be applied under Section 163(j) without undue difficulty in the case of a corporation with exempt and non-exempt businesses. A system based on tracing the use of funds or based on the purpose of a borrowing, by comparison, would be a relatively new exercise for many corporate taxpayers, and could be a complex one for large corporate groups.

Either fair market value or tax basis could be used to measure a taxpayer's assets. Fair market value could be seen as a less arbitrary metric for measuring the assets used in different businesses, than tax basis would be (for example, valuable self-developed intangibles may have a low or no tax basis); and the Code and regulations provide several other examples of determinations made based on the relative fair market values of different groups of assets.[49] However, fair market values often can be difficult to determine, thus increasing opportunities for disagreements between taxpayers and the IRS. Possibly for that reason, the Act adopted Section 864(e)(2), which eliminated taxpayers' right under prior law to allocate interest expense between domestic and foreign assets for sourcing purposes based on fair market value, and instead mandated the use of tax basis.[50]

If tax basis is used to measure a corporation's assets, there would be a natural tendency for exempt businesses to attract a relatively large share of interest expense, because those businesses tend to be capital-intensive and to involve assets with longer depreciation schedules (or non-depreciable assets). However, as a practical matter, it often would be relatively easy for taxpayers to use basis, as it would be computed for other purposes; and it would generally be difficult to manipulate basis for purposes of skewing the apportionment.[51] In addition, a number of businesses of the types that are exempted from Section 163(j) may be relatively heavily levered, for reasons

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[49] See, e.g., Section 856(c)(4) (asset tests for REIT status); Section 897(c)(2) and Treasury Regulation Section 1.897-2 (determination of a corporation's status as a U.S. real property holding corporation).

[50] See Treasury Regulation Section 1.861-9T(g) (which historically permitted taxpayers to choose to use fair market value).

[51] Congress has used basis as a way of measuring capital investment in assets in multiple other places in the Act (see new Sections 199A, 951A, and 250).

unrelated to tax; indeed, that might have been one of the reasons Congress had for exempting them from Section 163(j).

Regardless of whether basis or fair market value is used, Treasury and the IRS should consider adopting special rules that allow interest expense on a particular debt obligation to be allocated to a business, in specific cases where there is a relatively clear economic link between the business and that debt. For example, in the case of a utilities business, the regulatory authority that approves the rates the business is entitled to charge customers may have taken into account particular debt incurred by the business in the ratemaking process, permitting the business to charge rates that cover the expected debt service. This would be an objective measure of the debt attributable to the utilities business. Similarly, if a non-exempt business is subject to regulatory oversight that involves a review of particular debt owed by the taxpayer, then interest expense on that debt could be treated as allocable entirely to the non-exempt business. In addition, a taxpayer often may incur nonrecourse debt to finance the construction, improvement or purchase of real property. In a case where the lenders are looking exclusively to the property built or purchased with the borrowed funds and the cashflows generated by that property for repayment, there would seem to be reasonable grounds for allocating the interest expense on the debt to the business in which the property is used. This traditional type of financing arrangement has been taken into account in other contexts when allocating interest expense.[52] Such a rule could also apply to a future refinancing of a construction or acquisition loan; in such a case, we would propose that the rule apply only to the extent the amount of the new debt does not exceed the amount of debt being refinanced.

b. Income-Based Allocation Method

In our view, it is worth considering an income-based approach to allocation of interest expense as an alternative to an asset-based approach. We are not aware of an existing statutory or regulatory regime that provides for taxpayers to allocate interest expense on the basis of income (or cash flow) from different activities.[53] The Act has amended Section 864(e)(2), in a manner that prohibits such an allocation methodology. Nevertheless, we believe such an approach may have merit under Section 163(j). Debt capacity often is determined by lenders using income-based metrics, rather than asset values. In addition, and more importantly, an income-based approach can be seen as fitting well with the basic design of Section 163(j). As noted above, the legislative history indicates that the goal of the statute is to prevent a taxpayer from making excessive use of interest deductions to increase its after-tax rate of return from its activities.[54] The statute accomplishes this goal by limiting the extent to which each dollar of net interest expense can shield the ATI of a non-exempt business from tax. Allocating a taxpayer's interest expense between exempt and non-exempt businesses based on those businesses' relative contributions to the

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[52] See Treasury Regulations Sections 1.861-10(e), 1.861-10T(b), 1.882-5(a)(2).

[53] Prior to the Act, it was permissible to compute a controlled foreign corporation's Subpart F income, by allocating its interest expense among different activities based on the relative amounts of gross income generated by each activity. See Treasury Regulation Section 1.861-9T(j).

[54] See H.R. Rep. 115-409, at 247-248.

taxpayer's overall net income[55] fits well with the basic proposition that a dollar of interest expense is meant to shield from tax at most $0.30 of the ATI generated by a non-exempt business.[56]

2. Non-Corporate Taxpayers

For non-corporate taxpayers, the considerations relating to the choice of a Section 163(j) allocation method are somewhat different than described above. In particular, individuals have long characterized their interest expense as personal interest under Section 163(h), investment interest under Section 163(d), an expense of passive activities under Section 469, or an expense of non-passive businesses in which they materially participate, using the tracing rules of Treasury Regulation Section 1.163-8T. The most straightforward way to apply new Section 163(j) to individuals, which would require the least administrative guidance in the near term, would be for individuals simply to continue to trace interest expense under Treasury Regulation Section 1.163-8T to each of their business and non-business activities; and interest that is traced to an exempt business under these principles would not be subject to Section 163(j), while interest traced to a non-exempt business would be subject to limitation.

Treasury and the IRS might consider applying a set of rules to individuals that is based only in part on tracing. For example, as a first step, tracing could be used to divide an individual's interest expense between personal interest and other interest.[57] Then, asset-based or income-based rules like the ones described above for corporations could be applied, to allocate the other interest expense between the individual's investments and businesses, and between exempt and non-exempt businesses. This would reduce, at least to some extent, the potential for an individual to manipulate the allocation of business interest expense between exempt and non-exempt businesses, for purposes of applying Section 163(j). However, it is questionable whether such an approach would be fair, if it applied to allocate interest expense on existing indebtedness among an individual's business and investment activities for purposes other than just applying Section 163(j) – for example, for purposes of determining how much interest is allocable to a particular activity of an individual for purposes of applying Section 469. Treasury Regulation Section 1.163-8T has long been a part of the framework of rules that individuals have taken into account when planning business transactions; and many of those transactions may extend well into future periods. It appears that such an approach also would apply to a relatively limited population of individual taxpayers, in view of the exception in Section 163(j)(2) for taxpayers that have average annual gross receipts under $25 million. As a result, at least in the near term, it is questionable whether individuals should be subject to rules that depart from a tracing approach.

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[55] For this purpose, the taxpayer's overall net income would be computed taking into account income and expenses from its exempt businesses, in the same manner as ATI is computed under the statute for non-exempt businesses.

[56] By comparison, if a taxpayer's interest expense is allocated based on the relative amounts of assets used in different businesses, then the result could be that each dollar of the taxpayer's interest expense ends up sheltering more than $0.30 of income from a non-exempt business. For instance, that would be the case if a taxpayer's debt, and interest expense, was allocated largely to an asset-intensive exempt business carried on by the corporation that generated little net income, resulting in a net loss attributable to that business. That loss could be used to shelter ATI generated by the taxpayer's non-exempt businesses without the 30% limitation applying.

[57] It appears it would be difficult to use an approach other than tracing, to identify an individual's personal interest.

By comparison, in the case of a partnership, an approach not based purely on tracing principles may make more sense. In particular, if a partnership used rules based purely on tracing, then opportunities could arise for a corporation to avoid the rules described in Part III.D.1 above providing for asset-based or income-based allocation of business interest expense, simply by investing in those businesses through a partnership rather than directly. We discuss issues relating to the application of Section 163(j) to a partnership and its partners in detail in Part III.H below.

3. Additional Issues Related to the Choice of Allocation Method

a. Allocation of Income and Expenses (Other than Interest Expense) to Exempt Businesses

In order to apply Section 163(j) to a taxpayer that conducts both exempt and non-exempt businesses, it will be necessary to determine not only the amount of the taxpayer's interest expense, but also the amounts of its other items of income and expense, that are attributable to the taxpayer's exempt businesses (and thus excluded from ATI). We believe that, in general, it should be more straightforward to allocate these items than to allocate interest expense, and that such determinations are generally best made based on a practical review of the facts that link an item to an exempt business. In cases where the appropriate allocation of an item of income is not entirely clear, principles that are similar to those in Section 864(c) could be applied.[58] A reasonable rule could be developed to identify investment assets held for the reasonable present and anticipated future needs of an exempt business, income from which would be part of that business's income.[59] In addition, principles can be used to allocate a taxpayer's expenses (other than interest) to an exempt business that are similar to those used in Treasury Regulation Section 1.861-8 and Treasury Regulation Section 1.954-1(c).

b. Grouping of Taxpayers for Purposes of Allocating Interest Expense to Exempt and Non-Exempt Businesses

An additional point related to the choice of allocation method, is whether guidance will provide for grouping of different taxpayers or entities. As discussed further below, we believe grouping is appropriate for members of a consolidated group. On the whole, however, the basic approach taken by Congress in drafting Section 163(j) suggests it did not contemplate broad grouping or aggregation rules. For example, if a partner owns interests in two partnerships, one of which conducts an exempt electric power business and the other of which conducts a non-exempt trade or business, it does not appear that the assets and interest expense of those two partnerships ought to be aggregated, for purposes of determining how much of the interest expense should be viewed as allocable to the exempt electric power business; as discussed in more detail

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[58] This would be consistent with the approach taken in Section 199A, a provision that could be expected to be applied in tandem with Section 163(j). See Section 199A(c)(3)(A)(i). The Tax Section intends to submit separately recommendations for guidance under Section 199A.

[59] See Treasury Regulation Section 1.897-1(f) (amount of cash and investment assets considered to be business assets for purposes of applying Section 897(c)); Treasury Regulation Section 1.537-1 (principles for determining whether a corporation has accumulated earnings and profits that exceed the reasonable needs of its business).

later in this Report, Section 163(j)(4) contemplates fairly clearly that the statutory limitation (or lack thereof) will be computed separately, partnership by partnership.

E. Coordination of Section 163(j) With Other Limits in the Code on Interest Deductions and Non-Interest Deductions

1. Coordination with Other Limits on Interest Deductions

A straightforward reading of Section 163(j) indicates that it places a cap on the amount of interest for which a deduction otherwise would be allowed to a taxpayer in a given year, after having taken into account all the other statutory and regulatory rules that would disallow or defer such deductions. ("The amount allowed as a deduction under this chapter for business interest expense shall not exceed…").[60] This application of the statute is justified as a policy matter: as noted above, the statute is intended to prevent taxpayers from relying excessively on interest deductions to increase their after-tax returns;[61] and that purpose is achieved in a simple, effective manner by applying the formula for the annual Section 163(j) limit to interest expense that would otherwise be currently deductible. Consistent with that logic, the Congressional reports state that: "It is generally intended that, similar to present law, section 163(j) apply after the application of provisions that subject interest to deferral, capitalization, or other limitation. Thus, section 163(j) applies to interest deductions that are deferred, for example under section 163(e) or section 267(a)(3)(B) in the taxable year to which such deductions are deferred. Section 163(j) applies after section 263A is applied to capitalize interest and after, for example, section 265 or section 279 is applied to disallow interest." [62]

New Section 59A contains a special ordering rule, for application of the "Base Erosion and Anti-Abuse Tax" ("**BEAT**"). Section 59A generally requires that a U.S. corporation that (together with affiliates) has average annual gross receipts of at least $500 million to pay a minimum tax, equal to 10% of its "modified taxable income"; and modified taxable income, in turn, is generally defined as taxable income computed without regard to any deductible payment to a foreign related party (including interest) (a "base erosion payment"). Section 59A(c)(3) provides that for purposes of computing a taxpayer's modified taxable income, "in the case of a taxpayer to which section 163(j) applies for the taxable year, the reduction in the amount of interest for which a deduction is allowed by reason of such subsection shall be treated as allocable first to interest paid or accrued to persons who are not related parties with respect to the taxpayer and then to such related parties." Thus, in effect, Section 163(j) is applied before BEAT, so that there is the maximum possible disallowance of interest under the former, and the imposition of the greatest possible amount of tax under the latter. Although the BEAT statute is not drafted as a limitation on the deductibility of base erosion payments, it does function in a somewhat similar manner, in effect limiting the maximum reduction in a U.S. corporation's tax liability that can be achieved through such payments; and it can be asked whether Section 59A(c)(3) should be seen as suggesting a broader approach to how Section 163(j) should be coordinated with other limits on deductibility of interest

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[60] Section 163(j)(1).

[61] See H.R. Rep. 115-409, at 247-248.

[62] H.R. Rep. 115-409, at 249; H.R. Rep. 115-466, at 228-229 (repeating this statement, in describing the House bill, and then going on to describe changes to the House bill made by the Senate and in the Conference Committee that do not impact this point).

payments (i.e., in a manner that maximizes the effect of each limit). In our view, the fact that Congress added a specific rule in the Code to achieve this result, and did so in the BEAT statute instead of in Section 163(j), indicates that Congress viewed BEAT as a special case that required a unique, and relatively harsh, rule, rather than an indication more broadly of how Section 163(j) is meant to interact with other limits in the Code. [63] Except in the case of BEAT, the approach described in the preceding paragraph – applying other limits before applying Section 163(j), and thus applying its formula only to interest otherwise allowable as a current deduction – appears preferable.

We recommend that guidance be issued confirming these conclusions.

In the case of Sections 465 and 469, if Section 163(j) is applied to a taxpayer's interest expense after those provisions, the effect may be that the taxpayer's income from a passive or limited-risk activity is not sheltered to the full extent permitted by those provisions even though the taxpayer has substantial non-interest expenses from the activity. It would seem in keeping with the purposes of Section 465 and 469 to remove the possibility for such results, by having the taxpayer re-apply the limits these provisions impose, after taking into account the Section 163(j) limitation on interest expense from the relevant activity. In addition, such an approach would not undercut the goals of Section 163(j). In this connection, we note that proposed regulations under old Section 163(j) took a contrary approach, and Congress opted to overrule those proposed regulations. [64]

The Tax Section plans to submit comments on whether Treasury Regulation Section 1.385-3 should be withdrawn or modified as a result of various changes made pursuant to Act, including the enactment of Section 163(j).

2. Carryforwards of Disallowed Interest Under Old Section 163(j)

Interest expense that was disallowed by reason of Section 163(j) as in effect prior to the Act should be treated as interest paid or accrued by the taxpayer in the first year new Section 163(j) is effective. Old Section 163(j)(1)(B) expressly provided for the carryforward of such interest to that year: such interest would be treated as "paid or accrued within" that year for purposes of Section 163(a), as well as for purposes of the annual limitation on the Section 163(a) interest deduction set forth in Section 163(j).

The new statute and its legislative history do not expressly state whether this carryforward will be recognized in the period following the statute's enactment. However, the Act did not amend Section 163(a); and there would seem to be no reason why Treasury and the IRS cannot simply continue to interpret the reference in Section 163(a) to "interest paid or accrued within" 2018, as including disallowed interest carried forward from 2017. Doing so would be fully consistent with the policy of the new provision, as the carried forward interest would simply become subject to

[63] We note that the BEAT, unlike Section 163(j), also applies to a corporation's gross, rather than net, interest expense.

[64] See Section 163(j)(7).

the same formulaic limitation as interest paid or accrued after the effective date of the amendments to Section 163(j).

Old Section 163(j) also provided that if a corporation's Section 163(j) limit for a taxable year exceeded its interest expense, the corporation was entitled to carry forward that excess to increase its Section 163(j) limit in the next three taxable years.[65] We recommend that guidance confirm that a corporation with such a carryforward from the last year old Section 163(j) was in effect, will simply lose the benefit of that carryforward under the new provision. The new provision includes no concept of carrying forward an unused limitation to future years. In addition, the old Section 163(j) limit was considerably different than the new one, reaching only interest paid to a related party not subject to U.S. tax on that amount, and only to the extent interest expense exceeded 50% of EBITDA; it would seem to give taxpayers a significant advantage to be able to use a carryforward designed to provide leniency under the relatively narrowly targeted former provision, in order to lessen the impact of the new, broader restriction.

3. Interaction Between Section 163(j), and Sections 246(b) and 250(a)

Under our recommendation in Part III.C above, a corporation's ATI would include dividends received by it, Subpart F income, global intangible low-taxed income ("**GILTI**") as defined in Section 951A and "foreign-derived intangible income" ("**FDII**") as defined in Section 250. The corporation's ATI also would take into account the dividends-received deductions provided by Sections 243, 245 and 245A, as well as the deductions in respect of GILTI and FDII provided in Section 250(a)(1).

Section 246(b) provides that, in general, the total of a corporation's dividends-received deductions under Sections 243(a)(1) and 245 and its deduction under Section 250 cannot exceed 50% of the corporation's taxable income, determined without regard to any Section 172 deduction for a net operating loss carryover and with certain other adjustments. It is not entirely clear how this limitation interacts with the one in Section 163(j)(1)(B), generally restricting interest deductions to 30% of ATI. If one of these limits is applied before the other (i.e., by simply disregarding the other), then a taxpayer may end up with a result that is not in literal compliance with the latter Code provision. In similar circumstances, the IRS and the courts have approved of the use of simultaneous linear equations.[66] We recommend that guidance confirm whether such an approach also applies when applying the two limits in the present case.[67]

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[65] Old Section 163(j)(2)(B)(ii).

[66] See Rev. Rul. 79-347, 1979-2 C.B. 122 (corporation had (i) a Section 243(a)(1) dividends received deduction, subject to the limitation in Section 246(b), and (ii) depletion deductions under Section 613A, subject to the limitation in Section 613A(d)(1) based on 65% of the corporation's taxable income; the IRS approved the use of simultaneous equations to apply these two limits); Shell Oil Co. v. Comm'r, 89 T.C. 371, 419-421 (1987) (describing situations under the Code in which use of simultaneous equations has been necessary), rev'd. in part and remanded in part, 952 F.2d 885 (5th Cir. 1992).

[67] Under Section 246A, if a corporation owns "debt-financed portfolio stock," then the corporation's dividends received deduction with respect to a dividend paid on that stock generally is limited to (a) the portion of the dividend that is attributable to the part of the stock that has not been financed with debt plus (b) the excess (if any) of the portion of the dividend that is attributable to the debt-financed part of the stock over the interest

The interaction between Sections 163(j) and 250(a)(2) raises similar ordering questions. In general, Section 250(a)(1) provides that a U.S. corporation is entitled to a deduction equal to the sum of (a) 37.5% of its FDII for the taxable year and (b) 50% of (i) the GILTI amount included in its gross income under Section 951A for the taxable year. However, Section 250(a)(2) adds the limitation that, if the sum of the corporation's FDII and GILTI amounts exceeds its taxable income (computed without regard to the deduction provided in Section 250), then the corporation's deduction under Section 250(a)(1) must be reduced under a formula. Again, Treasury and the IRS should confirm whether simultaneous equations need to be used in order to apply Sections 163(j) and 250(a)(2) in tandem.

The FDII rules also require the resolution of one additional ordering question related to Section 163(j). In general, FDII is defined as a portion of the excess of a U.S. corporation's "deduction eligible income" over a deemed return on its investment in tangible assets – specifically, the portion of such excess income that is attributable to selling property or services to foreign persons.[68] "Deduction eligible income" is defined as the excess of the corporation's gross income (computed without regard to specified items) over "the deductions (including taxes) properly allocable to such gross income."[69] Guidance should be provided regarding whether, for this purpose, "the deduction" for interest takes into account the limitation on deductibility imposed by Section 163(j).

F. Impact on Earnings and Profits

We recommend that Treasury and the IRS confirm that disallowance of a corporation's interest expense under Section 163(j) should not have an effect on the year in which the expense reduces the corporation's earnings and profits ("**E&P**"). Caselaw and rulings have established a principle that, generally, E&P should be determined in a manner that is consistent with the economic reality of a corporation's ability to make distributions in excess of a return of capital.[70] Consistent with that principle, Treasury and the IRS have concluded that when a corporation has an economic outlay in a particular year and the tax deduction or loss associated with that outlay is disallowed for the year and carried forward, the corporation reduces its E&P in the year the outlay

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deduction allocable to the dividend. Generally, debt financed portfolio stock is a minority stockholding in a corporation, to the extent there is debt that is "directly attributable" to the corporation's investment in that stock. Section 246A does not present the same kind of issue that Section 246(b) does, regarding the order of applying Section 163(j)(1)(B) and a separate deduction limitation in the Code that uses a formula based on taxable income. However, depending on what method is used to allocate a corporation's interest expense between exempt and non-exempt businesses for purposes of Section 163(j), it is possible that a different allocation method will need to be used under Section 246A to determine whether any portion of the corporation's investment in stock is considered to be debt-financed portfolio stock under Section 246A (Section 246A generally requires that debt be incurred for the purpose of investing in the portfolio stock or is otherwise directly traceable to the purchase of the stock). In addition, the portion of the interest on such debt that is deductible under Section 163(j) will need to be determined.

[68] See Section 250(b).

[69] See Section 250(b)(3)(A)(ii).

[70] See Beck v. Comm'r, 52 T.C. 1 (1969) (E&P is "an economic concept which the tax law has utilized 'to approximate a corporation's power to make distributions which are more than just a return of investment.'), aff'd, 433 F.2d 309 (5th Cir. 1970); Bittker & Eustice, Federal Income Taxation of Corporations & Shareholders ¶8.04.

is made notwithstanding the disallowance.[71] Treasury and the IRS adopted that approach in proposed regulations under old Section 163(j);[72] and we believe it would be appropriate to do the same under new Section 163(j).

G. Consolidated Groups

1. Single Taxpayer Approach

The statute applies Section 163(j) to a "taxpayer." It appears appropriate to view a consolidated group as a single "taxpayer" for this purpose, in keeping with the consolidated group regulations' basic approach of computing a single consolidated taxable income for a group's members, which is reduced by the aggregate amount of interest expense incurred by the group's members.[73] Such an approach would make sense as a policy matter, and is consistent with Section 163(j)'s legislative history. The House report states: "In the case of a group of affiliated corporations that file a consolidated return, the limitation applies at the consolidated tax return filing level."[74] In addition, a similar statement appears in the Joint Committee's description of the Senate's version of the legislation; and the Conference Committee report notes this would have been the approach under the House's proposal, and then goes on to describe changes to the House's proposal made by the Senate and Conference Committee, none of which impact this point.[75]

Under a "single taxpayer" approach, a consolidated group's ATI, business interest income, and business interest expense all would be computed at the group level, by reference to items included each year in consolidated taxable income.[76] One refinement to this basic approach, is that interest on intercompany loans could be disregarded for purposes of determining the amount

[71] See Treasury Regulation Section 1.312-7(b)(1) (corporation's capital loss reduces E&P in the year recognized, even if disallowed under Section 1211, not the year to which carried forward under Section 1212); Rev. Rul. 75-515, 1975-2 C.B. 117 ("In general, the computation of earnings and profits of a corporation for dividend purposes is based upon reasonable accounting concepts that take into account the economic realities of corporate transactions as well as those resulting from the application of tax law. Thus, losses and expenses that are disallowed as a deduction for Federal income tax purposes, charitable contributions in excess of the limitations provided therefore, and other items that have actually depleted the assets of the corporation, even though not reflected in the income computation, are allowed as deductions in computing earnings and profits."); see also Field Service Advice 1993-540 (noting that a corporation's E&P is reduced by a net operating loss in the year the loss is incurred, rather than the year to which it is carried forward under Section 172).

[72] See Proposed Regulation Section 1.163(j)-1(e), 1.163(j)-8(g).

[73] See Treasury Regulation Section 1.1502-11.

[74] H.R. Rep. 115-409 at 248.

[75] See JCT Description of Senate Finance Committee Chairman's Mark of the Tax Cuts and Jobs Act, at 71 (same statement); H. Rep. 115-466, at 228.

[76] Compare Treasury Regulation Section 1.1502-24 (computing Section 170(b)(2) limit on charitable contribution deduction at the consolidated group level); Treasury Regulation Section 1.1502-26 (same for Section 246 limit on dividends received deduction); Treasury Regulation Section 1.1502-44 (same for Section 613A(d) limit on percentage depletion deductions); proposed Treasury Regulation Section 1.163(j)-5(b) (same for old Section 163(j) limit).

of the consolidated Section 163(j) limitation. This would be consistent with the basic principle here that a group is a single economic unit for purposes of Section 163(j).[77]

> **Example 1**. Parent, S1 and S2 are the members of a consolidated group. In 2018, Parent has no income or deductions; S1 has 100 of business interest expense on loans from non-group members and 10 of ATI; and S2 has 20 of business interest expense on loans from non-group members and 290 of ATI.

In Example 1, the consolidated group's ATI is 300 (= 290 + 10), and its Section 163(j) limit should be 90 (90 = 30% x 300). Thus, the group should be entitled to deduct 90 of its 120 of business interest expense for 2018, with the remaining 30 being a carryforward.[78]

For years prior to 2022, ATI is computed without reference to the taxpayer's depreciation and amortization deductions. However, gain from a sale of a depreciable or amortizable asset is included in ATI. In a case where one consolidated group member sells a depreciable or amortizable asset to another in an intercompany transaction, it is not entirely clear how these rules should apply. It would appear that, since the selling member's gain is generally taken into account under the "matching rule" in a manner designed to produce the same effect as a transaction between divisions (i.e., the character and timing of the selling member's gain will match the purchasing member's deductions), and since the purchasing member's deductions are disregarded in computing ATI, the gain also logically should be disregarded.[79] This result would be consistent with the basic principle recommended, to treat the consolidated group as a single taxpayer for purposes of Section 163(j).

More broadly, we note that in general, items from intercompany transactions either could be disregarded when computing a consolidated group's ATI, or included in the calculation. Because intercompany transactions normally should result in items of offsetting amount and the same character in a particular year under the matching rule, it appears such items normally would not result in a net change in the amount of the group's consolidated ATI, whether such items are disregarded when computing consolidated ATI or not.[80]

2. Exempt Businesses of a Consolidated Group

A logical corollary of the single taxpayer approach, and of the allocation principles recommended above, is that a consolidated group would allocate its interest expense between a trade or business that is exempt from Section 163(j), and another one that is not, based on the relative assets or income of each business – regardless of the location of each business, or of the interest expense, within the consolidated group.

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[77] Compare Treasury Regulation Section 1.385-4T (taking a similar approach for purposes of applying the debt recharacterization rules in Treasury Regulation Section 1.385-3 to consolidated groups).

[78] In Part III.G.4 below, we consider the appropriate treatment of intragroup loans when applying Section 163(j) to a consolidated group.

[79] See Treasury Regulation Section 1.1502-13(c).

[80] We discuss in the next section, however, a case where Section 163(j) might be applied differently to a consolidated group, depending on whether items from intercompany transactions are taken into account.

Example 2. Parent, S1 and S2, are the members of a consolidated group. Parent has incurred no debt, and owns no assets other than the shares of S1 and S2. S1 owns 1,000 of assets, which it uses in a non-exempt trade or business, and has 200 of ATI and 50 of interest expense on loans from non-group members in 2018. S2 owns 500 of assets, which it uses in a real property trade or business for which S2 has made an election under Section 163(j)(6)(B), and has 50 of income from that trade or business and 100 of third-party interest expense on loans from non-group members in 2018.

In Example 2, assuming that an asset-based approach is used to allocate interest expense to the consolidated group's exempt and non-exempt businesses, it appears that the consolidated group should disregard members' stock when making that allocation.[81] The group should compute a consolidated ratio of assets used in an exempt business (500) to total assets (1,500), and thus should treat 1/3 of the group's 150 of total interest expense as being allocated to S2's real property trade or business and not being subject to Section 163(j), notwithstanding that S2 has actually incurred 100 of interest expense. All of the group's remaining 100 of interest expense should be treated as being allocated to S1's trade or business and being subject to Section 163(j). For purposes of computing the group's limitation, only S1's 200 of ATI from its non-exempt business should be taken into account. Thus, the consolidated group should be limited to a deduction of 60 under Section 163(j) with respect to the group's 100 of non-exempt business interest expense, resulting in a disallowance of 40.

Alternatively, if an income-based method is used to allocate interest expense in Example 2, then the group's ratio of exempt income (50) to total group income (250) is computed, with the result that 20% of the group's 150 of interest expense (30) should be treated as not subject to Section 163(j). The Section 163(j) limitation would apply to the remaining 120 of interest expense, resulting in a disallowance of 60.

We note that, consistent with the basic approach described in Part III.G.1 above, the income that is taken into account for purposes of making an income-based allocation of interest expense between exempt and non-exempt businesses conducted by a consolidated group should take into account all items that are included in consolidated taxable income. Generally speaking, it appears that it should not make a difference whether items from intercompany transactions are taken into account. However, this may not always be the case, as when a subsidiary that conducts an exempt business has intercompany items from transactions with a subsidiary that conducts a non-exempt business. In such a case, it seems that either taking into account those intercompany items (or else, possibly, seeking to allocate income and non-interest expenses from transactions with non-group members in some fashion between the exempt and non-exempt businesses) may be appropriate.

In Example 2, if S2's business consists solely or predominantly of leasing real property to (or conducting other activities described in Section 469(c)(7)(C) for) other members of the consolidated group, it can be asked whether it is consistent with a single taxpayer approach to view S2 as conducting a real property trade or business for which a Section 163(j)(6)(B) election can be made. In other contexts, the separate existence of a trade or business that principally serves

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[81] Compare Treasury Regulation Section 1.1502-91(g)(1) and 1.1502-93(b)(1) (member stock and intercompany debt is disregarded for purposes of certain consolidated group Section 382 computations).

affiliates is respected.[82] However, the basic consolidated return principle of treating members as divisions of a single corporation, and the application of that principle in the Section 163(j) context to treat a group as a single "taxpayer," suggest that S2's activities should be viewed as an indivisible part of the group's overall (non-exempt) business activity.[83] (This view has particular force, if it is the case that items from intercompany transactions are not taken into account in allocating interest expense among the group's businesses.)

3. Corporations Joining a Consolidated Group

When a corporation joins a consolidated group, in a transaction that results in a Section 382 ownership change for the corporation, the corporation's carryforward of disallowed business interest expense from a separate return year would be subject to the resulting Section 382 limitation. It would appear consistent with the treatment of other Section 382-limited attributes to allow the consolidated group to take into account the portion of the corporation's business interest expense carryforward permitted under Section 382 to be treated as incurred in a consolidated return year, and to subject that amount of interest of such corporation to the consolidated Section 163(j) limitation for the consolidated return year in the same manner as any other interest expense incurred by a group member in that year – without any special treatment or limitation as a result of the fact the interest has been carried forward from a separate return year.[84]

4. Corporations Leaving a Consolidated Group; Apportionment of Consolidated Group's Carryforwards

Although Section 163(j) generally should be applied to a consolidated group as if it were a single taxpayer, in the manner described above, it nevertheless may be appropriate to apportion among the members the effects of any disallowance and carryforward of the group's business interest expense. In particular, such apportionment may be appropriate in order to determine how

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[82] Cf. Proposed Regulation Section 1.355-3(d)(2), Example 16 (manufacturing corporation has an R&D department that develops new products for the corporation to manufacture; R&D department's activity can be transferred to a separate corporation and used to satisfy the Section 355(b) active trade or business requirement), Example 17 (corporation that sells meat products carries on activity of processing meat, which it sells to customers; meat processing activity can be held in a separate corporation from the sales function and used to satisfy the active trade or business requirement).

In addition, as noted above in the text, our basic recommended methodology recognizes intercompany transactions and takes into account items from those transactions for purposes of applying Section 163(j), rather than simply disregarding such items.

[83] Support for this approach can be found in Treasury Regulation Section 1.1502-13(c)(7)(ii), Example 2. S, a member of a group that holds land for investment, sells the land to B, a member of the group that develops the land as residential real estate and sells the developed lots to customers. In the example, the character of S's gain from its sale of land must be determined by treating S and B as a single corporation and assessing whether, based on their combined activities, the land is described in Section 1221(a)(1). By analogy, in the case described in the text above, the character of S2's rental income and activities giving rise to that income, would be determined by treating S2 and the subsidiaries to which it leases property as a single corporation.

[84] We do not analyze in this Report the proper result in a case where a corporation joins a consolidated group in a transaction not resulting in an ownership change under Section 382.

much of the group's business interest expense carryforward a member should take with it, if it leaves the group. We consider several different potential apportionment methods below.[85]

a. Method One: Apportionment Based on Each Member's Business Interest Expense on Debt Owed to Non-Group Members

One relatively simple method would be to treat each member that has business interest expense on debt owed to non-group members in the year a carryforward is generated, as having a portion of that business interest expense disallowed and carried forward, corresponding to the portion of the group's total business interest expense owed to non-group members that is disallowed and carried forward.

Under this method, if the group has any business interest expense on intercompany debt for the year in which the carryforward is generated, none of that interest expense would be considered to have been disallowed and carried forward; rather, only business interest expense on debt owed to lenders outside the group would be so treated. The rationale is that each dollar of intercompany business interest expense is matched by a dollar of intercompany business interest income and, thus, should not be viewed as causing or contributing to any disallowance and carryforward of business interest expense by the group under Section 163(j).

> **Example 3**. Parent, S1 and S2 are members of a consolidated group. Parent is a holding company that has borrowed from third parties and lent to S1 and S2, which are both operating subsidiaries. In 2018, Parent's only items of income and expense are 150 of business interest expense on a loan from an unrelated lender, 100 of business interest income from S1 and 50 of business interest income from S2. S1 has 100 of business interest expense and 200 of ATI. S2 has 50 of business interest expense and 100 of ATI. At the end of the year, Parent sells S1 to an unrelated buyer.

In this example, the consolidated group's Section 163(j) limit for 2018 would be 90 (90 = 30% x 300). Under Method One, S1's 100 of business interest expense, S2's 50 of business interest expense, and Parent's 150 of business interest income, would be disregarded for purposes of applying Section 163(j) to the group. Parent's 150 of business interest expense owed to the unrelated lender would be limited, with 60 of that interest expense being disallowed and carried forward. When Parent sells S1, none of that carryforward would go with S1; rather, the entire carryforward would remain with Parent.

Method One would be generally similar to the principles for apportionment of other group attributes to a departing member.[86]

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[85] As discussed below, each of the apportionment methods that we have considered may lead to what can be seen as distortions in some cases, and involve potential complexity. A possible alternative that could be considered, is for none of a group's business interest expense carryforwards to be apportioned to a member that leaves the consolidated group. Instead, the entire disallowed business interest expense carryforward would simply remain with the group. Cf. Treasury Regulation Section 1.1502-36(d).

[86] See Treas. Regulation Sections. 1.1502-21(b) (apportioning a consolidated net operating loss carryover based on the approach that the consolidated loss consists of a ratable portion of each loss-making member's separate

b. Method Two: Apportionment Based on Each Member's Net Business Interest Expense (Determined Taking into Account Interest on Intragroup Debt)

A second possible method would be to apportion the disallowance and carryforward of business interest expense based on each member's net business interest expense (i.e., the excess, if any, for each member of its business interest expense over its business interest income) for the year in which the Section 163(j) carryforward is generated. Under this method, a member's net business interest expense would be determined by taking into account not only interest on debt that the member has borrowed from or loaned to non-members, but also interest on intragroup debt.

Under Method Two, the consolidated group would be treated as a single taxpayer, and loans between members would be disregarded, when computing the amount of the group's consolidated Section 163(j) limit, and the total amount of business interest expense to be disallowed. However, unlike Method One, that disallowed interest would not all be apportioned to the members with external business interest expense, but instead would be spread among the members in a manner that takes into account intercompany debt.

The rationale for this approach is that often, external borrowing may be done by only one or a few holding companies in the consolidated group, which members then on-lend the funds to other group members that are operating companies (as in Example 3). If one of these operating subsidiaries ultimately leaves the consolidated group, it is that subsidiary which could generate ATI that would provide capacity to use carryforwards of disallowed business interest expense; thus, it would seem logical to choose an apportionment methodology that is relatively likely to apportion carryforwards to the operating subsidiary.

For instance, in Example 3, the consolidated group's Section 163(j) limit continues to be 90, and the total amount of interest disallowed continues to be 60, as was the case under Method One. However, the manner in which the disallowed interest expense is apportioned to the various group members would be different. In 2018 Parent's net business interest expense is 0; S1's is 100; and S2's is 50. As a result, of the 60 of business interest expense disallowed in 2018, 40 would be apportioned to S1 (40 = 60 x 100/150). When Parent sells S1, S1 would take 40 of the carryforward with it; and the remaining 20 would stay with the consolidated group.

Under Method Two, S1 would be entitled to deduct only 60 of its 100 of business interest expense on its loan from Parent in 2018. Parent, however, would have 100 of business interest income and 100 of currently deductible business interest expense. This result represents an (arguably anomalous) departure from the matching principles that would normally apply to Parent's and S1's interest income and expense on their intercompany loan.[87] However, an advantage of this method is that when S1, which (at least in 2018) possesses most of the group's

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net operating loss for the year), 1.1502-79 (applying a similar approach to apportion a consolidated group's investment tax credit carryforwards, foreign tax credit carryforwards, and excess charitable contribution carryforwards to a departing group member).

[87] See Treasury Regulation Section 1.1502-13(c).

capacity to generate ATI, leaves the group, S1 will take most of the business interest expense carryforward.[88]

An additional advantage of Method Two, is that it appears to lead to more appropriate results than Method One in cases where the group conducts both businesses that are exempt from Section 163(j), and non-exempt businesses.

> **Example 4**. Parent, S1 and S2 are members of a consolidated group. In 2018, Parent, a holding company, borrows from third parties and on-lends the funds to S1, which conducts a non-exempt business, and S2, which conducts an exempt business. Parent's interest income on these loans matches its interest expense on its third-party debt. At the end of the year, P sells S1 to a third party.

In Example 4, any carryforward of disallowed business interest expense that the consolidated group generates in 2018 logically should be attributed to S1. However, under Method One, when Parent sells S1, the entire carryforward would remain with the consolidated group – which at that point will own only an exempt business. Presumably, in 2019, the consolidated group would be entitled under Section 163(j) to deduct the full amount of the carried-forward interest assuming sufficient pre-deduction taxable income.

By comparison, under Method Two, S2 could logically be treated as not having any business interest expense in 2018, since its sole activity is an exempt business. Under that approach, none of the carryforward would be apportioned to it. In addition, Parent would have no net business interest expense. Thus, the entire amount of disallowed interest, and carryforward, would be apportioned to S1.

c. Method Three: Apportionment Based on Members' Relative Assets or Income

A third possibility would be to apportion a group's disallowed interest expense among its members using one of the asset-based or income-based methodologies described above in Part III.D. Similar to Method Two, this approach is intended to achieve suitable results in cases where the group members that have business operations (and thus have capacity to use the carryforward) are different than the ones borrowing from third parties; it also is intended to address cases where a group conducts both exempt and non-exempt businesses. This approach is also designed to eliminate a potential weakness of Method Two – that outcomes can differ depending on whether a particular group member has net business interest expense, or not.

> **Example 5**. The facts are the same as in Example 4, except that Parent does not on-lend any funds to S1 and S2. Instead, Parent makes capital contributions to S1 and S2.

[88] Such an approach can be seen as consistent, at a practical level, with the rules for apportioning a group's NOLs to a departing member. The rules governing that issue generally have the effect of apportioning the NOLs to a group member that carries on revenue-generating activities, which activities might in the future become profitable and utilize the NOLs.

Under both Method One and Method Two, none of the group's disallowed interest expense would be apportioned to S1 when it is sold by Parent. By comparison, in Method Three, rules would be established to apportion the disallowed interest expense to the members of the group that conduct non-exempt businesses, based on the relative assets they use, or income they generate, in those businesses. Thus, in the example, the carryforward of disallowed interest expense is apportioned to S1.

As Example 5 indicates, Method Three often would impute interest expense to group members that in form have no debt. Thus, while this method achieves results that can be seen as more economically accurate, and less susceptible to manipulation, than either of the other methods, this method also would represent a substantial departure from traditional tax principles. On the other hand, this departure might be seen as appropriate given its matching of the methodology employed to determine disallowed interest during the time that S1 and S2 were members of the group.[89]

5. Captive Partnerships

It can be asked whether the single taxpayer approach discussed above should be extended to a case where a partnership that is wholly owned by members of a consolidated group incurs business interest expense. A rational argument could be made that such a partnership is part of a single economic unit to the same extent as any of the partnership's partners are, and that to refrain from subjecting the partnership's business interest expense to the consolidated group's Section 163(j) limit is at odds with economic reality. It also could be asserted that treating group members as a single taxpayer for purposes of Section 163(j) is conceptually consistent with treating a partnership wholly owned by the group as (for purposes of Section 163(j)) a disregarded entity with a single owner, rather than as a partnership with separate existence. A minority of us would propose to take this position.

However, while there may be reasonable policy arguments for such a position, it nevertheless appears it would be difficult to reconcile any guidance applying the group's Section 163(j) limit to the partnership's interest expense, with the terms of the statute. As discussed in Part III.H below, Congress clearly intended that Section 163(j) would apply at the partnership level, and that a partnership's business interest expense for which it is allowed a deduction would not then be subject to a further Section 163(j) limitation in a partner's hands.[90] See Section

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[89] If Method Three were adopted, then additional rules addressing adjustments to basis of member stock and other attributes might be required in order to explain the migration of interest expense to a non-borrower member.

In a related point, it also would be appropriate to consider whether, in a case where a departing member's business tends to be relatively heavily leveraged for non-tax reasons (e.g., a financial institution), it would be reasonable for carryforwards of interest expense attributable to debt incurred by that member to be apportioned only to that member, rather than being apportioned at least in part to non-borrower members remaining in the group. Method Three appears potentially to raise this question to a greater extent than either Method One or Method Two above.

[90] Section 163(j)(4)(A)(i) and (j)(7)(A). When it decided to apply Section 163(j) at the partnership level, it appears Congress may have been motivated, at least in part, by a belief that a business organized in the form of a partnership is as likely to try to generate large interest deductions to shelter its profits, as is a business organized in the form of a corporation. See H.R. Rep. 115-409 at 247 ("The Committee believes that it is necessary to apply the limitation on the deductibility of interest to businesses regardless of the form in which such businesses

163(j)(4)(A)(i). If a partnership had one partner that was a member of a consolidated group, and another that was not, it would seem highly difficult as a technical matter to take a bifurcated approach, computing ATI, business interest income and business interest expense at the partnership level for the non-member partner, as mandated by the statutory text, and computing these items under an aggregate approach for the partner that was a member of the consolidated group. In view of this, it appears questionable whether a special aggregate approach should be adopted for a partnership all of whose partners, in a given period, are members of a consolidated group. Such a partnership is treated as a separate entity for purposes of other provisions of the tax law; and Section 163(j)(4) gives no indication that, notwithstanding those other provisions, the Section 163(j) limit is not meant to be applied at the partnership level when the partners are all members of a group, or otherwise closely related.

While Treasury and the IRS might have authority for such an approach under Section 1502, it would appear to create significant potential for complexity, and also would entail a novel decision to disregard a partnership (at least for a limited purpose) merely because its owners are group members.[91] An approach more consistent with precedent would be to conclude that, if the partnership passes muster under economic substance, business purpose, and similar doctrines, its existence as a partnership should be respected and the normal rules applicable to partnerships should govern.[92]

6. Application to Affiliated (Rather than Consolidated) Group

Old Section 163(j)(6)(C) provided that the members of an affiliated group, as defined in Section 1504(a), would be treated as a single taxpayer for purposes of the interest limitation formula. The regulations that were proposed in 1991 under old Section 163(j) would have determined whether the ownership requirements of Section 1504(a) were met based not only on actual ownership, but also on constructive ownership under Section 318. Thus, for example, two

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are organized so as not to create distortions in the choice of entity."). That rationale would seem to be as relevant in a case where a partnership's owners are members of a consolidated group, as in a case where they are not.

[91] In the proposed version of the anti-avoidance rule relating to intercompany transactions, Treasury and the IRS included an example in which a bona fide partnership is owned solely by members of a consolidated group, and one of those members obtains a tax advantage by selling an asset to the partnership. (In the example, there was no subsequent transfer by the partnership, or another person, to a group member.) It was concluded in the example that the sale could be disregarded as a sale to a non-member and, instead, treated as an intercompany transaction. Proposed Regulation Section 1.1502-13(h)(2), Example 2, in 59 Fed. Reg. 18,011, 18,043 (Apr. 15, 1994). After receiving substantial criticism of this example from stakeholders, Treasury and the IRS did not include it in the final version of the regulations. Instead, they indicated in the preamble that such a transaction in an appropriate case could be attacked under other anti-avoidance rules and authorities not specifically tied to the consolidated return context. T.D. 8597, 60 Fed. Reg. 36,677 (July 12, 1995).

[92] See PLR 200252070 (partnership wholly owned by members of consolidated group, treated as preventing consolidation with subsidiaries owned by the partnership until it liquidated); PLR 9645015 (sale by a consolidated group member to an entirely captive partnership was not an intercompany transaction or subject to the intercompany transaction anti-avoidance rule); TAM 9644003 (deferred intercompany gain with respect to stock of a consolidated group member triggered when the member merged into a partnership wholly owned by two other members of the consolidated group); cf. Rev. Rul. 83-156 (respecting a partnership between parent and wholly owned subsidiary in a corporate group).

separate consolidated groups, owned by the same foreign parent corporation, would be considered a single group for purposes of applying old Section 163(j).[93]

We do not recommend that a similar approach be taken under new Section 163(j). In 2017, Congress acted with old Section 163(j) as a long-established, well-understood precedent – and did not adopt any rule similar to old Section 163(j)(6)(C) or the proposed regulations. It is difficult in such circumstances to find statutory support for application of the new interest limitation at the level of an affiliated group. Indeed, the statute provides detailed rules under which Section 163(j) must be applied separately at the partnership level, and not at the partner level using aggregate principles. That conceptual approach seems antithetical to any rule requiring aggregation of separate corporations. Even under old Section 163(j), where there was an express prompt in the statute, the affiliated group rules were viewed as highly complex; it is not warranted to attempt to duplicate those rules here.[94]

We note that one consequence of not treating an affiliated group as a single taxpayer under new Section 163(j), is that if such an affiliated group has a carryforward of disallowed interest under the old statute, it will need to allocate that disallowed interest expense among the consolidated groups, and/or separate U.S. corporations, that were components of that affiliated group. For simplicity, we recommend that such allocation be done using the existing rules in Proposed Regulation Section 1.163(j)-5(c)(2)(iii) for allocations to a member leaving an affiliated group. These rules generally allocate the impact of disallowance of a portion of the affiliated group's interest expense in a particular year among the members of the group, based on their relative amounts of interest paid or accrued to non-taxable related parties. We recognize that other approaches are possible (including allocation based on the relative amount of business assets of each group member), but do not believe it is necessary to create a new rule for this limited purpose.

H. Partnership Issues

1. Applying the Statute at the Partnership Level

The starting point for applying Section 163(j) to a partnership and its partners, is to classify that partnership's interest income, interest expense, and other income and expense at the partnership level: "In the case of any partnership (i) this subsection shall be applied at the partnership level and any deduction for business interest expense shall be taken into account in determining the non-separately stated taxable income or loss of the partnership."[95]

Generally speaking, a partnership should be treated in the same manner as other non-corporate taxpayers for purposes of identifying its business interest income, its business interest

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[93] Legislative history to old Section 163(j) contemplated that, at least in some cases, the affiliated group definition might be broadened, where non-member entities had been inserted in a structure that had the effect of breaking apart what otherwise would be a single affiliated group. It was viewed as questionable, however, whether the general statutory grant of authority in Section 163(j)(7) to issue regulations under old Section 163(j) contemplated an approach as broad as that taken in the proposed regulations. See NYSBA Tax Section Report No. 701, Report on Proposed Regulations under Section 163(j), at 20 - 22 (Oct. 23, 1991).

[94] See id.

[95] Section 163(j)(4)(A)(i).

expense, and its ATI.[96] Thus, a partnership's interest income should not be treated as business interest income to the extent such interest income is treated as "investment income" under Section 163(d) (e.g., interest income from passive investment in debt securities). In addition, as discussed further below, a partnership can have interest expense that is not treated as business interest expense because such interest expense qualifies as "investment interest" under Section 163(d).

Once a partnership has computed its business interest income, business interest expense, and ATI, the partnership should first apply its business interest expense against its business interest income under Section 163(j)(1)(A).[97] The partnership will be entitled to a deduction for business interest expense to the extent such business interest expense does not exceed the partnership's business interest income. Next, any remaining business interest expense should be deducted to the extent such remaining business interest expense does not exceed 30% of the partnership's ATI.[98] Finally, to the extent the partnership has any business interest expense remaining after the deductions just described, the partnership will not be allowed a deduction for that excess interest; instead, the carryforward rules of Section 163(j)(4)(B) (discussed below) will apply to such excess. While the statute does not expressly mandate that a partnership's business interest expense will be applied in the manner described in the three preceding sentences, this is the result – for example, the provisions in Section 163(j)(4)(ii)(II) and Section 163(j)(4)(C) concerning "excess taxable income" make this clear.

2. Classification of a Partnership's Interest Expense As Business Interest or Investment Interest

In the case of a partnership whose partners are solely or mainly individuals, it would seem reasonable to allocate its interest expense between business interest expense and investment interest using the tracing principles of Treasury Regulation Section 1.163-8T, consistent with the approach recommended in Part III.D.2 above for interest expense incurred directly by individuals. In addition, tracing could be used to allocate interest expense to such a partnership's businesses that are exempt from Section 163(j), and those that are not.

This approach has significant practical advantages. Under both Section 163(d) and Section 469, current law provides that a determination is made at the partnership level whether interest expense of a partnership is attributable to a particular activity pursuant to Treasury Regulation Section 1.163-8T; and then each partner makes a determination, at the partner level, whether their distributive share of the interest expense attributable to that activity is investment interest or is an expense of a passive activity of the partner. If tracing principles are also used to determine whether interest expense of a partnership should be treated as business interest expense under Section 163(j), then the framework just described can be left unchanged. By comparison, if a partnership owned largely or entirely by individuals was required to use an asset-based or income-based allocation method to determine what portion of its interest expense was business interest expense, it would seem the partnership would need to apply consistent principles to allocate interest expense

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96 See Section 703(a), providing that a partnership generally computes its taxable income in the same manner as an individual.

97 If the partnership has any floor plan financing interest, this interest should be separated out from the rest of its business interest expense, and deducted in full by the partnership under Section 163(b)(1)(C).

98 Section 163(j)(1)(B).

to all its activities (including investment activities and passive activities). This in turn would have an impact on how all the partners applied Sections 163(d) and 469 to their shares of interest expense; they would use different rules than would apply for interest expense attributable to activities that a partner conducted directly.[99] In addition, when an individual made a contribution to, or received a distribution from, a partnership, rules would need to be developed in order to coordinate between the special allocation methodology that would apply at the partnership level and the traditional tracing principles applying to individual partners. Moreover, in interest of fairness, grandfathering rules would likely need to be provided in order to exclude pre-existing partnership debt, which had already been traced to a partnership activity under Treasury Regulation Section 1.163-8T prior to the Act, from the new allocation methodology. The complexity involved in implementing such an approach, would seem to outweigh any benefits it might provide.

However, as noted in Part III.D.2, it is questionable whether the same conclusion applies, where a partnership is owned solely or mainly by corporations. In such a case, it would seem preferable for the partnership to apply an asset-based or income-based approach to allocate its interest expense between investment interest and business interest expense, and between exempt and non-exempt businesses. Such an approach would limit opportunities for a corporation to use a partnership to manipulate how much interest expense could be allocated to exempt businesses.

Whatever method is generally used by a partnership to allocate its interest expense, we believe that at least one limited departure from traditional tracing principles is appropriate. If a partnership distributes borrowed funds, we believe that for purposes of applying Section 163(j) at the partnership level (and only for that purpose), the partnership's interest expense should be allocated among the partnership's exempt and non-exempt businesses, and its investments, based on the relative assets or income attributable to each business and its investment portfolio. None of the interest should be allocated based on the distributee partners' use of funds.

By comparison, Notice 89-35 applied the principles of Treasury Regulation Section 1.163-8T to a partnership borrowing that funded a distribution, to determine how to characterize the partnership’s interest expense under Section 163. In the case of the partner that received the distribution, the character of that partner’s interest expense generally depended on how the partner used the borrowed funds. If a partner was allocated interest expense on a share of the debt exceeding the amount (if any) of the borrowing proceeds distributed to him, then the partner was free to allocate the interest expense on that excess debt using any reasonable method, including by reference to the nature of the partnership’s expenses during the year.[100] It appears that a rule that is based on how a partner uses the proceeds of a debt-financed partnership distribution, does not

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[99] As discussed in Part III.H.7 below, the exception in Section 163(j)(3) for small taxpayers (those with average annual gross receipts of not more than $25 million) appears to apply at the partnership level rather than the partner level. Thus, if a partnership had gross receipts of at least $25 million, its methodology for allocating interest expense among its activities would impact all of its partners, large and small.

[100] In addition to the general rules described in the text, Notice 89-35 provides an optional alternative. Under that alternative, a partnership can choose to determine the character of its interest expense on debt used to fund a distribution by allocating the debt to any one or more expenditures made by the partnership during the year of the distribution. However, the portion of the debt allocated in this manner cannot exceed the amount of the selected expenditures. Any excess portion of such debt, and the related interest expense, must be allocated under the general rules described in the text.

fit well with the statutory mandate in Section 163(j)(4) that Section 163(j) should be applied separately at the partnership level. A rule that allocates the interest expense on the debt based on the assets and activities of the partnership would more fully comport with this statutory requirement.[101]

3. Treatment of a Partnership's Business Interest Expense That Is Allowed as a Deduction

Section 163(j)(4)(A)(i) states that all business interest expense of a partnership for which a deduction is allowed under Section 163(j), is taken into account in the partnership's "non-separately stated income." Although "non-separately stated income" is not defined in Section 163(j), we understand it to mean the partnership's "taxable income or loss, exclusive of items requiring separate computation under other paragraphs of [Section 702(a)]."[102]

In general, an item of income or deduction that is included in the non-separately stated income of a partnership, as determined under Section 702(a)(8), loses its tax character in the hands of the partner to whom the item is allocated.[103] In the case of a partnership's deduction for business interest expense, it is clear such deduction loses its character as interest, when applying Section 163(j) at the partner level. As a result, such deduction is not subject to any additional Section 163(j) limit at the partner level – only the limit, if any, imposed at the partnership level applies.

However, while not entirely clear, it seems very unlikely that such interest loses its character for purposes of applying other provisions of the Code. The legislative history and structure of the statute suggest that the purpose of the rule is to help coordinate the Section 163(j) limit imposed at the partner and partnership levels; there is no suggestion the rule is intended to apply more broadly. Thus, for example, the source of a partner's share of the partnership's business interest expense deduction presumably is determined under Section 861 under the normal rules that apply to interest expense.

We recommend that Treasury and the IRS issue guidance confirming that partnership business interest expense that is deductible for Section 163(j) purposes and taken into account in determining the partnership's "non-separately stated income" nevertheless retains its character for all other Code purposes.

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[101] For avoidance of doubt, this Report is not suggesting that Treasury undertake a broader re-examination of the guidance provided in Notice 89-35, for any purpose other than the application of Section 163(j) at the partnership level.

[102] Section 702(a)(8). See also Section 6225(a)(2)(A), referring to "non-separately stated income or….non-separately stated loss (whichever is appropriate) under section 702(a)(8).").

[103] See Rev. Rul. 71-278 (partnership is subject to Indiana gross receipts tax; partnership is entitled to a deduction for this tax under Section 164 when computing its taxable income and its partners' distributive shares of such taxable income; partnership's partners do not get a separate Section 164 deduction, and they are not precluded from choosing the standard deduction instead of itemized deductions); McKee, Nelson & Whitmire, Federal Taxation of Partnerships & Partners, ¶ 9.01[3][a] ("Partnership items that are not separately stated are lumped together in an undifferentiated residual hotchpot that constitutes partnership Section 702(a)(8) "bottom-line" taxable income or loss.").

Because, under our recommendation, partnership business interest expense would retain its character as interest at the partner level other than for purposes of applying Section 163(j), it could be asked whether a non-corporate partner's share of such interest expense could be subject to limitation under Section 163(d). We believe this result is not intended; rather, it would seem that under Section 702 principles a partner's share of interest expense allocable to a business of the partnership should retain that character in the partner's hands.[104]

4. **Rules Relating to a Partnership's Business Interest Income**

Section 163(j) does not provide that a partnership's business interest income is treated as part of its non-separately stated income. The statute does not contain any express rule regarding how the partnership's business interest income should be treated in the hands of its partners.

> **Example 6**. A owns 10% of partnership (PS) and B owns the remaining 90%. In 2018, PS has $1,000 of business interest income, $990 of business interest expense, and no other items of income or deduction. In the same year, A has 100 of business interest expense on debt that A has incurred outside PS, and $0 of ATI from sources other than PS.

The statute does not provide guidance about how A should be treated in Example 6 – in particular, whether A is allowed under Section 163(j) to claim a deduction for A's 100 of business interest expense on partner-level debt, as a result of the allocation of 100 of PS's business interest income to A.

In general, if a partnership has business interest income, it appears that under Section 702, a partner's distributive share of that income would retain its character as such; and, as a result, the partner would be able to increase the partner's Section 163(j) limitation by its share of that interest income, pursuant to Section 163(j)(1)(A).

However, in a case like Example 6, it seems logical, and consistent with the statutory scheme, to provide in administrative guidance that to the extent PS's business interest income has been taken into account in determining the amount of PS's business interest expense deduction allowed under Section 163(j)(1)(A), such business interest income cannot then be taken into account a second time, in computing the limit under Section 163(j) on A's deduction for business interest expense incurred by A on partner-level debt. Such a rule would be a reasonable interpretation of the statutory requirement that Section 163(j) must be applied "at the partnership level" (i.e., 990 of PS's business interest income should be taken into account at the PS level only, in computing PS's interest deduction limit under Section 163(j)(1)(A) – and not at the partner level). This result would also would be conceptually similar to the statute's express rules to ensure that, once a dollar of a partnership's ATI is used to support a deduction of the partnership's business interest expense under Section 163(j)(1)(B), that same dollar of ATI cannot then be used a second time, to support a deduction of a partner's business interest expense on partner-level debt.

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[104] This result also comports with legislative history that suggests the same dollar of interest expense is not meant to be subject to limitation under both Section 163(j) and Section 163(d). See H.R. Rep. 115-409, at page 248 note 444; H.R. Rep. 115-466, at 386 n. 688.

Under the guidance proposed above, A would not be entitled to use the whole $100 of business interest income allocated to A, to support a deduction under Section 163(j)(1)(A) of A's partner-level business interest expense. Instead, A would be entitled to use only $1 out of the $100 of PS's business interest income allocated to A, to deduct A's partner-level interest expense in 2018.

As a mechanical matter, a relatively straightforward way to achieve the desired results would be to require that a partnership's business interest income must be included in the partnership's non-separately stated income, to the extent such business interest income does not exceed the partnership's business interest expense for the year.

By comparison, in the absence of the proposed guidance, A would appear to have a compelling argument that the business interest income allocated to A supports a deduction of the full $100 of A's business interest expense under Section 163(j)(1)(A). In that case, the result would be that PS’s $100 of business interest income allocated to A would have supported $200 of deductions of business interest expense – a $100 deduction at the PS level, allocated to A; plus a second $100 deduction at the partner level for A. It would be difficult to justify such a result as a policy matter.

5. Business Interest Expense Disallowed at the Partnership Level: Carryforward Rules

a. In General

A partnership's business interest expense for which a deduction is not allowed at the partnership level under Section 163(j) is allocated to the partners per Section 163(j)(4)(B) as “excess business interest.” Any excess business interest of a partner may not be deducted until the partner is allocated "excess taxable income" ("**ETI**") from the partnership in futures years. When a partner is allocated ETI, it treats an equivalent amount of excess business interest as business interest expense paid or accrued by the partner in the year of the ETI allocation.

It seems clear that ETI is intended to be defined as that portion of a partnership’s ATI for a given year that is not needed to support the partnership’s deduction under Section 163(j)(1)(B) for business interest expense in that year.

> **Example 7**. C owns 10% of PS. In Year 1, PS incurs $1,000 of business interest expense that it is not able to deduct by reason of the partnership-level limitation under Section 163(j). PS allocates 10 percent, or $100, of that amount to C as excess business interest expense under Section 163(j)(4)(B)(ii).
>
> In Year 2, PS has 1,500 of ATI and 150 of business interest expense. PS allocates 150 of ATI and 15 of business interest expense to C in Year 2.

Under Section 163(j)(1)(B) and (j)(4)(i), PS uses 500 of its ATI to support PS’s deduction of 150 of business interest expense for Year 2. This leaves PS with 1,000 of ETI. Because PS allocates 10% (or 150) of its ATI to C, this means 10% (or 100) of PS's ETI is allocated to C. Logically, it is appropriate for C to be able to use the 100 of ETI to deduct only 30 of its carryforward of interest expense from Year 1. That result would put C in the same position as it

would have been in had the 100 of business interest expense in Year 1 been incurred by PS and allocated to C in Year 2 – rather than being carried forward by C from Year 1.

However, Section 163(j)(4)(B)(ii) indicates that C is entitled to deduct (at least to the extent it has excess available ATI) its carried-forward 100 of interest expense "to the extent of such excess taxable income," i.e., to the extent of the ETI that PS allocates to C in Year 2. The relevant provision reads, in full:

> If a partner is allocated any excess business interest expense from a partnership under clause (i) [requiring the allocation among partners of business interest expense for which a deduction is not allowed for a taxable year] for any taxable year—
>
> (I) such excess business interest expense shall be treated as business interest expense paid or accrued by the partner in the next succeeding taxable year in which the partner is allocated excess taxable income from such partnership, but only to the extent of such excess taxable income, and
>
> (II) any portion of such excess business interest expense remaining after the application of subclause (I) shall, subject to the limitations of subclause (I), be treated as business interest expense paid or accrued in succeeding taxable years.

Under this provision, because C recognizes 100 of ETI in Year 2, all 100 of its carryforward is treated as business interest expense "paid or accrued by" C in Year 2.

We believe that the reference to "paid or accrued" should not be interpreted as providing that C is automatically entitled to a deduction under Section 163(a) for 100 of interest paid or accrued in Year 2, without any limitation under Section 163(j) applying. Instead, this provision should be interpreted to treat such business interest expense in a manner similar to any other business interest expense paid or accrued by C in Year 2. That is, because that business interest expense is treated as having been "paid or accrued by C" in Year 2, it should be subject to the same limitations under Section 163(j)(1) as other business interest expense incurred by C.

Under this approach, pursuant to Section 163(j)(4)(A)(ii)(II), C's 100 of ETI is added to C's ATI, thus supporting a deduction of 30 of the business interest expense C is deemed to have accrued in Year 2. The remaining 70 of business interest expense is treated like any other business interest expense incurred by C in Year 2; that is, C is entitled to deduct it to the extent C has sufficient ATI and/or business interest income, and C is required to carry forward to future years any portion of that business interest expense that it cannot deduct. Thus, because that business interest expense is treated as having been "paid or accrued by C" in Year 2, it ceases to be a carryforward of excess business interest that can be used only against C's share of PS's ETI pursuant to Section 163(j)(4)(B)(ii).

We recommend that guidance make clear that any excess business interest expense of a partner "freed up" as a result of an allocation of ETI must be treated like any other business interest expense of the partner paid or accrued in the same year (and thus potentially subject to limitation at the partner level). In the absence of such guidance, we believe taxpayers might argue that the statutory language entitles a partner to an immediate deduction for the full amount of business

interest expense that has been "freed up" and is treated as paid or accrued as a result of an allocation of ETI.

Even if such guidance is provided, however, Section 163(j)(4)(B)(ii) will lead to the apparently inappropriate result of each dollar of ETI allowing one dollar of excess business expense to be deducted by a partner (subject to such partner having sufficient excess ATI from other sources), even though one dollar of ATI recognized by a partnership only permits the deductibility of thirty cents of business interest expense. While we recommend that this issue be addressed, it is unclear that regulatory authority exists for preventing this result, in which case a technical correction would be appropriate.

In addition, guidance should provide a clear ordering rule under which a partner's share of ETI, to the extent such share exceeds the amount the partner needs in order to be entitled to deduct carryforwards of disallowed business interest expense, is added to the partner's ATI. Section 163(j)(4)(A)(ii)(II) indicates fairly clearly this result is intended. However, the last sentence of Section 163(j)(4)(B)(ii) may cause some confusion: the sentence states that "For purposes of applying this paragraph [i.e., Section 163(j)(4), which applies Section 163 in the partnership context], excess taxable income allocated to a partner from a partnership for any taxable year shall not be taken into account under paragraph ***(1)(A)*** with respect to any business interest expense other than excess business interest expense from the partnership until all such excess business interest expense for such taxable year and all preceding taxable years has been treated as paid or accrued" (emphasis added). Treasury and the IRS should clarify that such ETI in fact will be taken into account by the partner under Section 163(j)(1)(B).

b. Use of a Partner's Share of the Partnership's Business Interest Income to Absorb a Carryforward

We recommend providing guidance under which, if a partnership has business interest income in a particular year that exceeds the partnership's business interest expense for the year, then a partner will be permitted to use its share of that excess business interest income to absorb the partner's carryforwards of excess business interest from prior years.

> **Example 8**. D owns 10% of PS. In Year 1, PS has $1,000 of ATI and $1,000 of business interest expense, and 10% of this ATI and business interest expense is allocated to D. In Year 2, PS has $1,000 of business interest income and $300 of business interest expense, and again 10% of these items are allocated to D.

In Example 8, under Section 163(j)(4)(i)(A), PS is entitled to deduct $300 of its $1,000 of business interest expense in Year 1. Under Section 163(j)(4)(ii)(B), $70 out of the remaining $700 of interest is allocated to D and treated as excess business interest expense, which is carried forward to Year 2. Section 163(j)(4)(B)(ii) allows D to apply the $70 against D's share of any ETI that PS recognizes in future years. In Example 8, PS has no ETI in Year 2; but, it would seem logical, and justified as a policy matter, to allow D to apply the $70 of excess business interest expense against D's share of PS's business interest income for Year 2, as reduced by PS's business interest expense for Year 2. Under this approach, PS's business interest income of $1,000 for Year 2, net of PS's $300 of business interest expense for the year, leaves $700 of excess business interest

income, of which $70 is allocable to D; D thus would be entitled to deduct the entire $70 of disallowed interest in Year 2.

While the statute sets forth a detailed formula for the computation of a partnership's ETI, and specific rules prescribing how a partner is allowed to use its distributive share of ETI to absorb carryforwards of excess business interest expense, it does not incorporate "excess" business interest income into the formula for ETI. The statute also does not, however, expressly prohibit guidance permitting the use of excess business interest income to absorb carryforwards; and such guidance seems consistent with legislative intent. Section 163(j)'s legislative history indicates that the carryforward rules in Section 163(j) are intended to deal with the fact that, due to due to business cycles or other factors, a business might sometimes incur an amount of interest expense that is large, relative to the business' income.[105] In the partnership context, Congress dealt with the most obvious manifestation of this issue when it adopted rules allowing a partner to use the partner's share of ETI to claim deductions for excess business interest expense. Congress did not adopt specific rules for a partnership whose principal income from its trade or business in fact happens to be interest, as with a lending business, rather than (say) income from the sale of inventory or provision of personal services. Indeed, there may not be a large number of partnerships that fit this description, relative to the total number of partnerships in the United States.[106] However, the fact that Congress focused on providing relief for the most common cases that warranted it, logically should not be interpreted as precluding Treasury and the IRS from extending the principles of the statute to equally appropriate, if less mainstream, cases involving a partnership that has excess business income that happens to be interest, rather than ATI.

6. Cases Where a Partnership Has Interest Income/Expense that is Not Treated as Business Interest Income/Expense at the Partnership Level, Or Has Other Items That Are Treated as Investment Income at the Partnership Level

A partnership can have interest income and expense that is not treated as business interest income or business interest expense at the partnership level.

> **Example 9**. E, a U.S. corporation, and F, an individual, each own 50% of PS. PS has passive investments in securities, which it finances partially by incurring debt. In 2018, PS incurs 100 of interest expense on the debt, which it allocates pro rata to E and F.

PS’s 100 of interest expense would qualify in Example 9 as investment interest under Section 163(d), if PS were an individual. Thus, such interest is not business interest expense, in PS’s hands.

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[105] See H.R. Rep. 115-409, at 248 (Nov. 9, 2017).

[106] IRS data indicates that in 2011 through 2014, partnerships in the finance and insurance sector represented about 9% of all partnerships filing returns. IRS data also indicates that in 2011 through 2013, S corporations in that sector represented about 4% of S corporations filing returns. See IRS, Total Assets, Trade or Business Income and Deductions, Portfolio Income, Rental Income and Total Net Income; IRS, Returns of Active Corporations, Form 1120S - Table 7).

In E's hands, however, that interest should be treated as business interest expense.[107] Section 163(j)(4) does not require that such interest be included in PS's non-separately stated income. Instead, under Section 702(a)(7) and Section 702(b), the interest expense ought to be treated in E's hands in the same manner as interest on debt incurred directly by E to finance direct investments in securities by E. Such interest expense of E would be business interest expense that is subject to limitation under Section 163(j).

By comparison, if Section 163(j) did not apply to the interest expense allocated to E, that would create an opportunity for E to avoid Section 163(j) by borrowing through a partnership, rather than borrowing directly. That result appears to be contrary to the intent of the statute: the statute's drafters clearly placed emphasis on preventing the use of partnerships to avoid the Section 163(j) limit.

An approach similar to the one just described should be taken in the case of F. Thus, similar to the analysis in E's case, the 50 of interest expense allocated to F should be treated as incurred by F to finance an investment in securities. Under Section 163(d), that interest should be treated as investment interest.

In Example 9, if PS earns interest income on its securities then it seems that the same approach as described above for interest expense, should apply to that income. Thus, E's share of PS's interest income should be treated as business interest income, in E's hands. F's share of such interest should be treated as investment income as defined in Section 163(d), in F's hands.

In addition, a partnership may have items other than interest income which are treated, at the partnership level, as investment income that is not part of the partnership's ATI. For example, it would appear that dividends, Subpart F income and qualified electing fund inclusions that are included in income by a partnership should be treated as investment income at the partnership level that does not enter into its ATI.[108] Similarly, the partnership's ATI should not include any dividends received deduction claimed by a corporate partner, as such items are not partnership-level deductions but, instead, are tied to the corporate status of the partner.[109]

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[107] See H.R. Rep. 115-409, at 248 note 444 (Nov. 9, 2017) ("Section 163(d) applies in the case of a taxpayer other than a corporation. Thus, a corporation has neither investment interest nor investment income within the meaning of section 163(d). Thus, interest income and interest expense of a corporation is properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of the provision.").

[108] See Section 163(d)(5)(A)(i), 469(e)(1)(A)(i)(I); cf. Treasury Regulation Section 1.1411-10(c)(5), (g) (for purposes of calculating net investment income, a taxpayer can elect whether to compute his Section 163(d) investment interest limitation based on different timing for inclusion of Subpart F income and QEF amounts, than applies for regular income tax purposes).

The Tax Section plans to make a separate submission on the GILTI rules that will address, among other issues, the application of Sections 250 and 951A to partners and partnerships.

[109] If a corporate partner borrows at the partner level to finance an investment in a partnership that owns stock, the result under Section 163(j) will be different (generally less favorable) than if the borrowing had been at the partnership level. The corporate partner's ATI will take into account both its share of the dividend income and the dividends received deduction, whereas the partnership's ATI would not take into account the dividends received deduction. It could be asked whether that difference is justifiable as a policy matter. On balance, we believe it is. The difference in treatment is a direct consequence of Congress' decision in Section 163(j)(4) that

Guidance confirming the above results would be useful.

7. **Application of Exemptions/Exclusions from Section 163(j)**

a. **Election for a Real Property Trade or Business/Electing Farming Business (Section 163(j)(7)(B) & (C))**

Guidance should provide that, where a partnership conducts a real estate business of a type that qualifies for the election under Section 163(j)(7)(B), or a farming business that qualifies for the election under Section 163(j)(7)(C), the election should be made at the partnership level, rather than at the partner level.

In general, most elections affecting the treatment of partnership items are required to be made by the partnership.[110] In addition, Section 163(j)(4) specifically provides that Section 163(j) must be applied at the partnership level. It would be consistent with Section 163(j)(4), and simple as a mechanical matter, to have a partnership make the elections under Sections 163(j)(7)(B) and (C) with respect to a business it conducts. By comparison, if it is desired to give each partner the option to elect out, with respect to that partner's distributive share of income and interest expense from a partnership's real estate or farming business, the necessary mechanics for the election would be significantly more complicated. Among other things, a partner that elected out would need to take into account that partner's distributive share of depreciation deductions using a slower depreciation schedule, than a partner who did not elect out would use. In addition, it would seem hard to reconcile a partner-by-partner approach with the basic principle of applying Section 163(j) at the partnership level.

b. **Impact on the Partners Where a Partnership Conducts an Exempt Business**

If a partnership conducts an electing real property or farming trade or business, or a utilities business, then the partnership's interest expense allocable to that business, as well as all the other items of income and deduction that are allocable to such business, should retain their character in the hands of the partners to whom such items are allocated. In other words, under Section 702(a), such items should be treated as received/incurred by a partner in the conduct of a business that is excluded from Section 163(j), and so should not enter into the partner's ATI, business interest income or business interest expense.

> **Example 10**. PS conducts a business of renting real estate to third parties, for which PS makes an election under Section 163(j)(7)(B), as well as a non-exempt business. In 2018, G, a partner in PS, is allocated 3 of income from PS's real estate business and 7 of ETI from the non-exempt business. G has business interest expense allocable (under the allocation principles described in Part III.D above) to non-exempt activities unrelated to its investment in PS.

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it is appropriate to apply the Section 163(j) limit at the partnership level, rather than adopting an aggregate approach to partnerships.

[110] See Section 703(b).

On these facts, G should add its 7 of ETI to its ATI, thus increasing its Section 163(j)(1)(B) limit for purposes of deducting its business interest expense unrelated to PS. G's 3 of income from PS's real estate business, however, should not be included in G's ATI or increase G's Section 163(j) limitation.

In a case where a partner incurs debt which is allocable to its interest in a partnership that conducts an exempt business, guidance should provide that interest on the partner-level debt is exempt from Section 163(j).

> **Example 11**. PS conducts a business of renting real estate to third parties as PS's sole activity and makes an election under Section 163(j)(7)(B). H, a partner in PS, borrows and its interest expense is allocable (under the allocation principles described in Part III.D above) to H's interest in PS.

In Example 11, it is appropriate for H's interest expense to be exempted from Section 163(j), because the interest is allocable entirely to an asset (H's interest in PS) that generates income from an electing real property trade or business. Such an approach is conceptually similar to the approach taken in the statute to PS's ETI, which a partner can use to support a deduction of partner-level interest expense.

If PS in Example 11 conducts both a real estate business, and a trade or business that is not excluded from the scope of Section 163(j) (similar to Example 10), then the treatment described above would apply only for the portion of H's partner-level interest expense that is properly allocable to the real estate rental business.

c. **Small Businesses (Section 163(j)(3))**

> **Example 12**. PS conducts a business and has business interest expense. However, PS has average annual gross receipts of less than $25 million, as determined for purposes of Section 448(c). One or more of PS's partners has average annual gross receipts of over $25 million.

In Example 12, it seems clear that, at the partnership level, Section 163(j) does not apply to limit PS's interest deductions, because PS qualifies for the small business exception in Section 163(j)(3). However, a question remains as to whether, at the partner level, each partner should separately determine whether that partner is below the $25 million threshold in Section 163(j)(3).

The general principle that Section 163(j) will be applied at the partnership level indicates that, if PS is exempt by reason of the small business exception in Section 163(j)(3), then the interest expense of PS allocated to its partners should remain exempt from Section 163(j) in their hands – rather than being re-tested at the partner level. In addition, Section 163(j)(3) incorporates the $25 million threshold from Section 448(c), which by its terms clearly applies that threshold at the partnership level to allow the partnership to use the cash method of accounting, notwithstanding that the partnership may have large, accrual-method partners.

Such a result is permitted under Section 448(c) because it contains aggregation rules, pursuant to which the $25 million threshold is applied taking into account the gross receipts of all entities related under Sections 52(a) or (b) or 414(m) or (o) (broadly, all entities in a group

connected to one another through greater than 50% ownership, as well as entities that are functionally connected by conducting integrated activities). The effect of these rules is to limit opportunities for gamesmanship, by forcing a partner that has a significant relationship to a partnership to add the partner's (and its affiliates') gross receipts to those of the partnership. These aggregation rules are incorporated by reference in Section 163(j)(3), with a similar effect.

Arguably, there is not a compelling reason for a partner with a large amount of gross receipts to be able to claim deductions for its share of business interest expense incurred by small partnerships with which the partner is not closely related, without any Section 163(j) limitation on those deductions. However, on balance, that result seems to provide little opportunity for abuse, and it appears consistent with the statutory scheme. We recommend that Treasury and the IRS confirm that result is correct.

8. Special Allocations

Guidance should expressly confirm that special allocations by a partnership of items of ATI, ETI, business interest income and/or business interest expense do not affect the determination of the Section 163(j) limitation at the partnership level.

> **Example 13**. I and J own all of the interests of PS. In 2018, PS has no business interest income, 300 of ATI, and 60 of business interest expense. PS allocates all items comprising its ATI solely to I and its business interest expense solely to J. Assume these allocations are respected under Section 704(b).

In Example 13, the Section 163(j) limitation is applied at the partnership level, and PS's limitation is 60 with the result that PS's business interest expense should not be subject to limitation. We note that because PS's business interest expense (but not its ATI) is allocated to J, applying the limitation at the partnership level can result in a better outcome for J (i.e., full deductibility of the business interest expense allocated from PS) than had the limitation been applied at the partner level. Nevertheless, we believe that it is consistent with the plain language of the statute to apply the limitation at the partnership level only (and not again at the partner level where special allocations have effect).

Once the limitation has been applied at the partnership level, however, it is important that regulations, consistent with the statutory provision, make clear that, in then applying Section 163(j) at the partner level, the partners should take into account neither (i) their shares of the partnership's business interest expense that is deductible after application of the limitation at the partnership level, nor (ii) their share of the partnership's ATI that was used to allow its business interest expense to be deductible (and thus not included in ETI) (collectively, "**Post-Calculation Items**"). Thus, in Example 13, 200 of the 300 of ATI allocated to I and all 60 of business interest expense allocated to J would be considered Post-Calculation Items. As a result, I would be unable to use 200 of the ATI it is specially allocated to calculate its own Section 163(j) limitation. Correspondingly, the 60 of business interest expense allocated to J would be subject to no further limitation regardless of the amount of ATI and business interest income otherwise recognized by J. The remaining 100 of ATI allocated to I for 2018 would constitute ETI (and not a Post-Calculation Item), and thus would be potentially usable by I in determining its own Section 163(j) limitation.

A more challenging fact pattern would be present where a partnership specially allocates deductions that are included in its ATI in a manner that differs from how it allocates items of income that are included in its ATI.

> **Example 14**. I, J and K own all of the interests of PS. In 2018, PS has no business interest income, 300 of ATI, and 60 of business interest expense. PS's ATI consists of 500 of gross income and 200 of gross deductions. PS allocates that gross income solely to I, those gross deductions solely to J, and its business interest expense solely to K. Assume these allocations are respected under Section 704(b).

In Example 14, like in Example 13, because the Section 163(j) limitation is applied at the partnership level, PS's business interest expense should be fully deductible. Thus, the 60 of business interest expense allocated to K should be considered a Post-Calculation Item and, thus, not subject to further limitation on K's return.

In Example 14, PS will also have 100 of ETI. Because, however, PS's items of income and deduction comprising its ATI will be allocated to different partners, it is not clear how the gross items of income and deduction allocated to I and J, respectively, should be treated. We believe the simplest approach would be to (i) treat gross income included in ATI ("**ATI Income**") allocated to a partner as ETI on a proportionate basis based on the proportion of the partnership's ATI Income allocated to each partner (with any remaining ATI Income allocated to the partner treated as a Post-Calculation Item) and (ii) treat all deductions included in ATI ("**ATI Deductions**") allocated to a partner as Post-Calculation Items. Under this approach, because PS has 100 of ETI, and all 500 of PS's ATI Income was allocated to I, 100 of the 500 of ATI Income allocated to I will be ETI, with the remaining 400 of ATI income allocated to I, and all 200 of ATI Deductions allocated to J, being treated as Post-Calculation Items.

Our recommended approach to cases like Examples 13 and 14 comports with the final sentence of Section 163(j)(4)(A), which provides that a partner's distributive share of ETI must be determined in the same manner as the partner's share of the partnership's non-separately stated income or loss. Under our approach, a proportionate part of the ATI Income allocated to each partner (whether as part of an allocation of net ATI, as in Example 13, or through an allocation of gross income items, as in Example 14) is treated as ETI. The remaining proportionate part of the ATI Income allocated to each partner (i.e., the part that is a Post-Calculation Item) loses its character in the partner's hands as ATI, and so cannot be used by the partner to support deductions of partner-level business interest expense. This proportionate allocation is, in our view, contemplated by the statute.

It would be appropriate to apply a similar approach to allocations of a partnership's excess business interest.

> **Example 15**. Same facts as Example 14, except that in 2018, PS has 100 of business interest expense.

In Example 15, PS's Section 163(j) limitation is 90 (90 = 0 business interest income + {30% x 300 of ATI}). Thus, PS can deduct only 90 of its 100 of business interest expense, and has 10 of excess business interest. Under our approach, each dollar of business interest expense that is

allocated to a partner, must consist of a proportionate part of (i) business interest expense for which the partnership was allowed a deduction under Section 163(j) (a Post-Calculation Item), and (ii) excess business interest. Thus, since PS allocated all of its business interest expense to K in Example 15, the entire 10 of excess business interest must be allocated to K.

In this connection, we note that Section 163(j)(4)(B)(ii)(II) provides that excess business interest must be allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership. We believe our approach, in which excess business interest is allocated among the partners in the same proportions as business interest expense for which the partnership is allowed a deduction, meets this requirement.

9. **Section 704(c) Allocations**

Where a partnership owns Section 704(c) property, it is required to allocate items with respect to that property so as to take into account any variation between the property's adjusted tax basis and its fair market value at the time of contribution (or revaluation) using a reasonable method that is consistent with the purposes of Section 704(c). The three methods that are deemed to be generally reasonable for purposes of making those allocations (the traditional method, the traditional method with curative allocations, and the remedial method) affect how partnership items are allocated among its partners and, in the case of the remedial method, may cause offsetting items of income and loss to be created and allocated among the partners.

None of the Section 704(c) methods affects the net amount of income or loss recognized by a partnership. As a result, and consistent with our discussion of special allocations above, we believe that the Section 163(j) limitation should be applied at the partnership level without regard to the manner in which partnership items are allocated among its partners under Section 704(c). While disregarding the allocation of items under Section 704(c) can result in a different amount of interest disallowance under Section 163(j) than had the limitation been applied at the partner level, we believe that it is consistent with the plain language of the statute to apply the limitation at the partnership level only by ignoring the effect of Section 704(c) on the partnership's allocations.

10. **Section 743 Allocations**

A partner's items of depreciation or amortization (or adjustment to gain or loss on sale of an asset) that results from a Section 743(b) basis adjustment appears similar, in some ways, to a special allocation. As a technical matter, basis adjustments under Section 743(b) increase or decrease the basis of partnership property. Such adjustments, however, do not enter into the partnership's taxable income or loss as computed under Section 703; instead, such adjustments affect only the adjusted partner (and have no effect on the partnership's other partners).[111] In other words, notwithstanding the fact that the basis adjustment occurs at the partnership level, the existing regulatory framework makes clear that such basis has no effect on the calculation of the partnership's taxable income. Accordingly, we recommend that regulations clarify that (i) Section 743(b) adjustments of a partnership's partners are not taken into account in applying the Section 163(j) limitation to the business interest expense of the partnership and (ii) each partner's Section 743(b) adjustments are taken into account as items derived directly by the partner in determining

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[111] See Treasury Regulation Section 1.743-1(j).

its own Section 163(j) limitation. If a rule was adopted requiring that a partner's Section 743(b) adjustment be included in the computation of a partnership's ATI for purposes of applying Section 163(j) at the partnership level, then a particular partner's Section 743(b) items could impact the deductibility of partnership interest by other partners. Such a result seems inconsistent with the basic approach taken in the Section 743(b) regulations. Instead, a Section 743(b) adjustment is appropriately taken into account at the partner (rather than partnership level) in determining ATI.

Our recommended approach creates potentially significant differences between a transaction in which a partnership purchases assets (where depreciation and amortization deductions generated by the stepped-up basis of those assets will, until the end of 2021, enter into the partnership's ATI), and a transaction structured as a purchase of partnership interests (where depreciation and amortization deductions generated by the Section 743 basis adjustment will not enter into the partnership's ATI). However, we believe these differences are unavoidable consequences of the decision to exclude a partner's Section 743(b) items from the partnership's taxable income.

I. International Issues

1. Outbound Investment

We recommend that guidance be issued discussing how (if at all) Section 163(j) applies to business interest expense of a controlled foreign corporation ("**CFC**") or passive foreign investment company ("**PFIC**").

We believe the analysis for a U.S. investor in a PFIC (specifically, a PFIC for which the investor elects qualified electing fund status) is relatively straightforward. Under Section 1293(a), such an investor's annual income inclusion is limited to the investor's pro rata share of the PFIC's E&P for the year. Thus, the key point for a U.S. investor is the impact on the calculation of the PFIC's E&P of a disallowance of business interest expense under Section 163(j). As explained in Part III.F above, such a disallowance should not cause a delay in time the interest expense is taken into account in computing E&P.[112]

The picture for a U.S. shareholder of a CFC is more complicated. It appears that the U.S. shareholder's computation of its Subpart F income will be impacted by application of Section 163(j) to the CFC's interest expense, unless guidance provides relief from that result. However, it is not entirely clear that it makes sense for Section 163(j) to apply to a CFC's interest expense, for purposes of computing Subpart F income. In addition, assuming Section 163(j) should have an impact on the computation of Subpart F income, guidance could be developed in order to clarify exactly how big that impact will be.

As an initial question, it can be asked whether, as a policy matter, Section 163(j) should apply at all to interest expense of a CFC. On one hand, if Section 163(j) did not apply to CFCs, then it would be possible for U.S. taxpayers to conduct leveraged activities through a CFC and get

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[112] We note that Congress has on occasion specifically instructed that departures from the normal E&P rules be made, when computing a PFIC's E&P. <u>See</u> Section 1293(e)(3). It has not done so in the case of new Section 163(j).

the effect of a full interest deduction. However, the strength of this concern appears to be diluted, in cases where a CFC earns not only Subpart F income, but also material amounts of income that is not subject to Subpart F. This will particularly be the case if it is difficult to predict of the mix of Subpart F and non-Subpart F income from year to year. In addition, to the extent that a CFC's business interest expense is disallowed and then, in future years, a U.S. shareholder's percentage ownership goes below 10%, or the CFC does not have Subpart F income, the U.S. shareholder may have a limited, or no, ability to benefit from a carryforward of the interest by the CFC under Section 163(j)(2).

In the proposed regulations under old Section 163(j), Treasury and the IRS decided not to apply the statutory limitation to the interest expense of any foreign corporation (including a CFC) that did not conduct a U.S. trade or business. The Preamble stated that "The disallowance rules do not apply if the payor corporation is either an S corporation or a foreign corporation (except as provided under 1.163(j)-8, related to foreign corporations with effectively connected income)."[113] Consistent with that statement, the proposed rules for a foreign corporation with a U.S. trade or business applied only with respect to the corporation's income and expense attributable to that trade or business; and the proposed affiliated group rule referenced above applied only to U.S. corporations that were in an affiliated relationship (foreign corporations were not treated as members of the affiliated group).[114]

However, in the absence of similar guidance under new Section 163(j), it appears the provision would apply to CFCs. Pursuant to Section 954(b)(5), when a CFC has foreign base company income ("**FBCI**"), that income is reduced by "deductions…properly allocable to such income" (including interest expense) for purposes of computing the amount of a U.S. shareholder's income inclusion under Section 951.[115] For this purpose, a CFC computes the amounts of its items of income and deduction under largely the same U.S. federal income tax principles as apply to determine the taxable income of a U.S. corporation, including any applicable limits under the Code on the deductibility of particular expenses.[116] Thus, a CFC would compute its interest deduction for purposes of Section 954(b)(5) taking into account the Section 163(j) limit.

Under a straightforward reading of the rules, that limit would be computed by reference to a CFC's ATI from all its activities, other than exempt businesses, and all of its interest expense. Part of that deduction then would be apportioned to the CFC's FBCI, apparently by reference to the tax basis of the assets used to generate that income as compared to the assets of its business.[117]

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113 See Fed. Reg. Vol. 56, No. 117, p. 27907, at 27908 (June 18, 1991).

114 Proposed Regulation Section 1.163(j)-5(a)(3).

115 A CFC's interest expense is allocated to foreign base company income and other income using an asset-based allocation method. See Treasury Regulation Sections 1.861-9T(f)(3), 1.954-1(c)(1)(i). Historically, allocation on the basis of gross income was permitted as an alternative to allocation based on assets. Treasury Regulation Section 1.861-9T(j).

116 See Treasury Regulation Sections 1.952-2(b), (c).

117 Section 864(e)(2) (as amended by the Act) requires interest expense to be allocated using the tax basis of a taxpayer's assets, for purposes of the sourcing rules (and, presumably, rules that incorporate the sourcing rules by reference, such as the Section 954(b)(5) regulations).

It would appear reasonable for guidance to reverse the order of operations here, for purposes of computing a CFC's FBCI (and other Subpart F income): that is, a CFC's interest expense first would be allocated between its FBCI and other Subpart F income on one hand, and its non-Subpart F income on the other; and the CFC then would apply Section 163(j) to its FBCI or other Subpart F income and the interest expense allocated to such income. Such an approach would avoid seemingly distortive results, in which the amount of a CFC's non-Subpart F income or loss impacts its ATI and, thus, the amount of its Section 163(j) limitation. (We have recommended a conceptually similar approach in Part III.I.2 below regarding application of Section 163(j) to a foreign corporation with a U.S. branch.)

In a related point, if business interest expense allocated to a CFC's Subpart F income is disallowed under Section 163(j), then that interest expense should automatically be carried forward and allocated against Subpart F income in future years (rather than first being allocated in those years between Subpart F income, and other income included in ATI).

The Tax Section intends to submit separate comments on the provisions of the Act that deal with GILTI. This Report thus does not address questions about how Section 163(j) should be applied to a CFC for purposes of applying the GILTI rules.

2. Inbound Investment

We recommend that Treasury and the IRS issue guidance confirming that new Section 163(j) applies to a foreign corporation with a U.S. trade or business in a manner similar to the methodology adopted in the proposed regulations under old Section 163(j). That is, when applying Section 163(j) in order to determine the corporation's liability for corporate income and branch profits taxes, only business interest income and ATI that are included in the corporation's effectively connected taxable income and business interest expense that is allocated to effectively connected income pursuant to the regulations under Sections 882 and 884 would be taken into account. [118] This approach properly focuses on the economic activity a foreign corporation has in the United States, for purposes of computing the applicable Section 163(j) limitation.[119]

If a foreign corporation's interest expense allocable to its effectively connected income is disallowed under Section 163(j) and carried forward to a future year, it seems to us that the carryforward should automatically be treated in such future year as interest expense properly allocable to the corporation's effectively connected income for such year. That is, the corporation

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We note that it sometimes may be difficult for a U.S. shareholder that owns a non-controlling stake in a CFC to obtain the detailed information about tax basis that will be needed in order to make an allocation of the CFC's interest expense in accordance with new Section 864(e)(2).

[118] See Proposed Regulation Section 1.163(j)-8(c); Treasury Regulation Section 1.882-5(a)(5).

[119] An approach could be imagined under which the limitation is computed by reference to the foreign corporation's worldwide ATI, business interest income and business interest expense; the resulting limitation is then applied to the corporation's worldwide interest expense; and the post-limitation interest expense is then allocated between the corporation's effectively connected income, and its other income. However, such an approach would appear to have the potential to lead to more arbitrary results than the one recommended.

should not be required, in the year to which the interest expense is carried forward, to allocate that interest expense between the corporation's effectively connected income and its other income.

IV. Additional Issues Under Section 163(j)

The issues addressed above do not represent all the significant issues raised by Section 163(j). A non-exclusive list of additional issues that Treasury and the IRS should consider addressing in subsequent guidance includes:

- Confirmation of whether a corporation that undergoes an ownership change under Section 382 is treated as using its carryforwards of disallowed business interest expense before it uses other tax attributes limited by Sections 382 and 383.

- An explanation of how a corporation that inherits carryforwards of disallowed business interest expense pursuant to new Section 381(c)(20) should treat those carryforwards following a Section 381(a) transaction, including confirmation whether rules analogous to those in Treasury Regulation Section 1.381(c)(1)-1 apply.

- Treatment of disallowed business interest carryforwards upon a taxable liquidation of a corporation under Section 331.

- Treatment of a non-corporate taxpayer's disallowed business interest carryforwards, upon death or other final disposition or termination of all trade or business activities.

- Application of Section 163(j) to S corporations, including (i) the treatment of shareholder carryforwards of an S corporation's disallowed business interest expense, in the event the S corporation subsequently converts to a C corporation, and (ii) the treatment of corporate carryforwards of disallowed business interest expense, in the event a C corporation converts to an S corporation.

- Application of Section 163(j) to trusts, estates and their beneficiaries.

- Whether Section 163(j) should apply, or not, to real estate investment trusts, regulated investment companies, and real estate mortgage investment conduits.

- The scope of activities that may be treated as an electing real property trade or business, including whether making mortgage loans constitutes such a trade or business.

- The time and manner for making an election for an electing real property trade or business or an electing farming business.

- Application of Section 163(j) to tiered partnership structures.

- Whether a taxpayer that cancels a debt with accrued, unpaid interest that has been disallowed under Section 163(j) should have a reduction in its cancellation of debt income, by the amount of such disallowed interest.

- Whether, in cases where a taxpayer excludes COD income under Section 108(a), the taxpayer's carryforwards of disallowed business expense should be reduced and, if so, the appropriate ordering for reduction of those carryforwards relative to the other attributes listed in Section 108(b).

- Whether the issuer of a contingent payment debt instrument should be entitled to offset disallowed business interest expense that has accrued under Treasury Regulation Section 1.1275-4, against the income inclusion that otherwise would be required under Treasury Regulation Section 1.1275-4(b)(6)(iii)(B) when there is a negative adjustment to the projected amount of a contingent payment.

The Tax Section would be happy to submit an additional report addressing some or all of the issues listed above or any other issues on which the government would like our input.