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Report No. 1412
February 26, 2019

The Honorable David J. Kautter
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Re: *Report No. 1412 – Report on Proposed Section 163(j) Regulations*

Dear Messrs. Kautter, Rettig, and Paul:

I am pleased to submit Report No. 1412, commenting on the proposed regulations issued by the Internal Revenue Service and the Department of the Treasury under Section 163(j) of the Internal Revenue Code.

This report follows our prior Report dated March 28, 2018 which discussed certain significant issues arising from the recent amendments to Section 163(j). In this Report, we make recommendations to clarify and, in some cases, simplify the Proposed Regulations. We commend the IRS and Treasury for their comprehensive and thoughtful efforts in drafting the Proposed Regulations.

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We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Deborah L. Paul
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Report No. 1412

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON PROPOSED SECTION 163(j) REGULATIONS

February 26, 2019

TABLE OF CONTENTS

I. SUMMARY OF RECOMMENDATIONS 1

A. Definitions. 1

1. **Adjusted Taxable Income.** 1
2. **Interest.** 2
3. **Trade or Business.** 3
4. **Tax-Exempt Corporation.** 4

B. General rules applicable to C corporations (including REITs, RICs, and members of consolidated groups) and tax-exempt corporations. 4

1. **Intercompany Transfers of Partnership Interests.** 4

C. Partnerships and Subchapter S Corporations. 4

1. **Application of Section 163(j) at the Partnership Level.** 4
2. **The Eleven Step Process.** 5
3. **Section 704(b).** 5
4. **Tiered Partnerships.** 5
5. **Excess Business Interest Expense.** 6
6. **Debt-Financed Partnership Distributions.** 7
7. **Self-charged Interest.** 7

D. Application to Foreign Corporations and United States Shareholder 7

1. **General.** 7
2. **The CFC Group Election.** 7
3. **ECI Exclusion.** 8
4. **CFC Group Election and United States Shareholder ATI.** 8
5. **Termination of CFC Group Election.** 8
6. **CFC Group Calculation of ATI.** 8

E. Elections for Excepted Trades or Businesses and Safe Harbor for REITs. 9

1. **Electing and Terminating Excepted Trade or Business Status.** 9
2. **Safe Harbor for Real Estate Investment Trusts.** 9
3. **Clarification of the Partnership Look-through Rule as Applied to REITs.** 10
4. **Anti-Abuse Rule.** 10

F. Allocations Between Excepted and Non-Excepted Trades or Businesses 10

1. **CFC Look-Through Rule.** 10
2. **Cash and Cash Equivalents.** 10
3. **Anti-Abuse.** 11
4. **Direct Allocations.** 11
5. **Financial Services Entities.** 11
6. **Assets Used in More than One Trade or Business.** 11

G. Transition Rules. 12

1. **Disallowed Disqualified Interest Carryforwards.** 12

II. OVERVIEW OF SECTION 163(j) 12

A. Section 163(j) Prior to the Act. 12

B. Section 163(j) as amended by the Act. 13
1. General. 13
2. Partnerships. 15
3. Exceptions to Section 163(j). 16
4. Effective Date. 18
5. Conforming Amendments. 18

III. DISCUSSION 18

A. Comments on Proposed Regulations Section 1.163(j)-1 – Definitions. 18
1. Adjusted Taxable Income. 18
2. Definition of Interest. 23
3. Trade or Business. 34
4. Tax Exempt Corporation. 35
B. Comments on Proposed Regulations Section 1.163(j)-4 – General rules applicable to C Corporations (including REITs, RICs, and members of consolidated groups) and tax-exempt corporations. 36
1. Transfers of a Partnership Interest by a Member of a Consolidated Group to Another Member 36
C. Comments on Proposed Regulations Section 1.163(j)-6 – Application of the business interest expense limitation to partnerships and S corporations. 37
1. Application of Section 163(j) at the Partnership Level. 37
2. The Eleven Step Process. 38
3. Section 704(b). 45
4. Tiered Partnerships. 45
5. Excess Business Interest Expense. 46
6. Debt-Financed Partnership Distributions. 50
7. Self-Charged Interest. 51
D. Comments on Proposed Regulations Section 1.163(j)-7 – Application of the business interest expense deduction to foreign corporations and United States shareholders. 53
1. Treatment of Controlled Foreign Corporations and Shareholders. 53
2. Definition of CFC Group. 54
3. ECI Exclusion. 55
4. CFC Group Election and United States Shareholder ATI. 55
5. Termination of CFC Group Election. 60
6. CFC Group Calculation of ATI. 60
7. Additional Considerations. 61
E. Comments on Proposed Regulations Section 1.163(j)-9 – Elections for excepted trades or businesses; safe harbor for certain REITs. 62
1. Electing and Terminating Excepted Trade or Business Status. 62
2. Safe Harbor for Real Estate Investment Trusts. 62
3. Clarification of the Modified Partnership Look-Through Rule. 64
4. Anti-abuse rule for Certain Real Property Trades or Businesses. 65

F. Comments on Proposed Regulations Section 1.163(j)-10 – Allocation of interest expense, interest income, and other items of expense and gross income to an excepted trade or business. 65

1. **Look-Through Rule.** 66
2. **Cash and Cash Equivalents.** 69
3. **Anti-Abuse Rule.** 69
4. **Direct Allocations.** 70
5. **Financial Services Entities.** 70
6. **Assets Used in More than One Trade or Business.** 71

G. Comments on Proposed Regulations Section 1.163(j)-11 Transition rules. 72

1. **Disallowed Disqualified Interest Carryforwards.** 72

REPORT OF THE TAX SECTION OF THE NEW YORK STATE BAR ASSOCIATION ON PROPOSED SECTION 163(j) REGULATIONS

This report ("**Report**") of the New York State Bar Association Tax Section comments on proposed regulations (the "**Proposed Regulations**") issued by the Internal Revenue Service ("**IRS**") and the Department of Treasury ("**Treasury**") to implement 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].

This Report follows our prior report (the "**Prior Report**") dated March 28, 2018 which discussed certain significant issues arising from the Act's amendment to Section 163(j). In this Report, we make recommendations to clarify and, in some cases, simplify the Proposed Regulations. We commend the IRS and Treasury for their comprehensive and thoughtful efforts in drafting the Proposed Regulations. Section 163(j) is a complex statutory provision.

This Report is divided into three parts. Part I summarizes our recommendations. Part II describes Section 163(j) as in effect before and after the Act. Part III provides a detailed discussion of our recommendations.[3]

I. SUMMARY OF RECOMMENDATIONS

A. Definitions.

1. Adjusted Taxable Income.

a. Negative ATI Adjustments on the Sale of Depreciable Assets.

We generally support the decision to require adjusted taxable income ("**ATI**") adjustments to deny a double benefit to a taxpayer who was able to increase ATI during a taxable year beginning after December 31, 2017 and before January 1, 2022 through depreciation, amortization, or depletion deductions (the "**EBITDA period**") and then sell the related property for a gain. The Proposed Regulations accomplish this result by reducing ATI by the lesser of (1) gain on the sale or other disposition of the property, and (2)

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

[2] The principal drafter of this report is John T. Lutz with substantial assistance from Pamela Lawrence Endreny, Lucy W. Farr, Edward E. Gonzalez, Stuart Rosow, and Michael L. Schler. Helpful comments were provided by William Alexander, Andrew H. Braiterman, Robert Cassanos, Peter Connors, Patrick Cox, Steven Dean, Michael Farber, Phillip J. Gall, Kevin P. Glenn, Andrew M. Herman, Monte A. Jackel, Robert Kantowitz, Rafael Kariyev, Shane J. Kiggen, Stephen B. Land, Jeffrey W. Maddrey, Erika W. Nijenhuis, Richard M. Nugent, Deborah L. Paul, Eric Sloan, Karen Sowell, and Dana L. Trier. Special thanks to Terence McAllister for his assistance in preparing this report. 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.

[3] Given the short time period to provide comments, we do not summarize the Proposed Regulations.

any depreciation, amortization or depletion deductions for the taxable years beginning after December 31, 2017 and before January 1, 2022.

We recommend, however, that the final Section 163(j) regulations allocate the gain on the sale of depreciated property between depreciation deductions taken during the EBITDA period and depreciation deductions taken in other periods and reduce ATI based on that allocation, rather than assuming that all of the gain is attributable to deductions claimed in the EBITDA period to the full extent of such deductions. Although we describe a number of methods for achieving this allocation, a plurality of us believe that a last-in, last-out method is appropriate.

b. Application to Trusts.

Trusts taxable under Section 641 are permitted to deduct certain distributions made to trust beneficiaries to determine the trust's taxable income. ATI should be increased to take into account deductible distributions. Further, to the extent a distribution is taken into account by a trust to support an interest expense deduction under Section 163(j), such distribution should not be included in the beneficiary's ATI so that the same income cannot support a Section 163(j) deduction at both the trust and beneficiary levels.

2. Interest.

The Proposed Regulations define interest extremely broadly to include four categories: a basic definition generally covering what is typically considered interest under federal income tax law, amounts related to embedded loans in certain swap transactions, additional specified types of payments not typically considered interest under federal income tax law, and an anti-avoidance rule for amounts predominantly associated with the time value of money.

We recommend the final Section 163(j) regulations adopt a definition of interest that consists of three categories. The first category would consist of the basic definition along the lines of that contained in Proposed Regulations Section 1.163(j)-1(b)(20)(i). The second category would consist of a number of items that are not considered interest under current law but we believe should properly be treated as interest in light of the policy of Section 163(j), including certain items set forth in Proposed Regulations Section 1.163(j)-1(b)(20)(iii). We refer to this category as the "Interest-Equivalents Category". It would include the items in Proposed Regulations Section 1.163(j)-1(b)(20)(iii)(A), (B), (D), and (J) (premium, certain ordinary income or loss on debt instruments, ordinary gain under Section 1258, and factoring income). The third category would consist of an anti-avoidance rule subject to the taxpayer having a principal purpose of circumventing Section 163(j). The anti-avoidance rule should only cover transactions that are economically equivalent to interest and should set forth examples of transactions that are and are not covered. The anti-avoidance rule should be symmetrical and clear.

Whether substitute interest payments should be treated as interest equivalents subject to Section 163(j) is a complex question. We recommend that consideration be given to whether the taxpayer posted (or has received) collateral consisting of cash or liquid assets, whether the borrowed security is due to mature shortly after the scheduled termination date of the securities borrowing and whether the securities borrowing was executed in the ordinary course of the taxpayers trade or business. Abusive transactions should be subject to the anti-avoidance rule.

With respect to hedges we recommend several possible approached that are intended to provide a clear administrable standard for when a derivative has a close enough connection to a debt obligation to fall within the scope of Section 163(j).

We believe that fees related to the issuance of debt that are paid to persons other than the lender should not be treated as interest and that fees paid to a lender should be treated as interest for Section 163(j) purposes if such fees are treated as creating or increasing original issue discount on the debt.

Similarly, a majority of us believe that guaranteed payments for the use of capital should not be treated as interest for Section 163(j) purposes unless the guaranteed payment was structured with a principal purpose of circumventing Section 163(j). A substantial minority of us believe that Section 163(j) should never apply to guaranteed payments for the use of capital.

We recommend that Treasury and the IRS provide guidance regarding the treatment of swaps with significant nonperiodic payments under Section 446. We are generally supportive of guidance bifurcating swaps with significant nonperiodic payments into an on-market swap and a loan and treating the time value component of the embedded loan as interest for Section 163(j) purposes. However, until Section 446 regulations are issued, we believe Section 163(j) should not include any special rule for swaps with significant nonperiodic payments.

As described in more detail below, although we believe that Treasury and the IRS have authority to promulgate an anti-avoidance rule, we question whether there is statutory authority to expand the definition of interest beyond the longstanding meaning under the Code and case law.

3. Trade or Business.

We recommend the final Section 163(j) regulations expressly exempt any qualifying activity under Section 163(d)(5)(A)(ii) from the definition of trade or business. This will remedy a current disparity with respect to the treatment of securities and commodities trading businesses between Section 163(d) and Section 163(j). As currently drafted, the Proposed Regulations could be read to subject passive investors in a securities or commodities trading partnership to both the Section 163(j) and Section 163(d) limitations.

4. Tax-Exempt Corporation.

Final Section 163(j) regulations should clarify that Section 163(j) applies to all entities subject to tax pursuant to Section 511(i), not just corporations. In addition, consideration should be given to exempting government owned or operated colleges or universities that are subject to tax under Section 511 from the definition of "tax-exempt corporation".

B. General rules applicable to C corporations (including REITs, RICs, and members of consolidated groups) and tax-exempt corporations.

1. Intercompany Transfers of Partnership Interests.

If one member of a consolidated group transfers a partnership interest in an intercompany transaction that does not result in a termination of the partnership, the Proposed Regulations treat the transfer as a disposition for purposes of the basis adjustment rule in Section 163(j)(4)(B)(iii)(II), regardless of whether the transfer is one in which gain or loss is recognized. Under this approach, the selling partner's basis would be increased by the partner's excess business interest expense and no deduction would be allowed to either the transferor or transferee partner.

A consolidated group has a single Section 163(j) limitation, and Treasury Regulation Section 1.1502-13 generally follows the approach of treating each member as a division of a single corporation in accounting for intercompany transactions. Under that view, the transferee should be permitted to claim deductions for excess business interest expense to the same extent that the transferor would have been entitled to claim such deductions. Thus, under an alternative approach to that of the Proposed Regulations, the specific manner in which such deductions may be claimed and the corollary consequences, including the timing of any gain or loss recognition, would be addressed through amplification of the rules under Treasury Regulation Section 1.1502-13.

C. Partnerships and Subchapter S Corporations.

1. Application of Section 163(j) at the Partnership Level.

As an initial matter, we believe that consideration should be given to seeking a statutory amendment to apply the Section 163(j) limit at the partner or taxpayer level, rather than the partnership entity level. Much of the complexity described in this Report and potential ability of taxpayers to manipulate the Section 163(j) limitation is derived from the Congressional decision to apply Section 163(j) at the partnership level. We believe it would be far more effective to limit the deductibility of interest incurred in connection with a trade or business at the level of the taxpayer whose business income is actually subject to tax.

2. The Eleven Step Process.

The Proposed Regulations provide an eleven step process for allocating deductible business interest expense and Section 163(j) excess items. While the eleven step process achieves reasonable results, we are concerned that the procedure is overly complex and taxpayers may be unable to comply with the process. The eleven step process admirably attempts to match, to the largest degree possible given the application of Section 163(j), the allocation of deductible interest with the partner's ability to claim the deduction based upon its allocation of interest income and ATI.

The eleven step process exists solely for Section 163(j) purposes. Taxpayers must maintain a parallel set of books, and make parallel allocations, simply to comply with Section 163(j). Further, the process involves numerous computations that, although required, may actually impact the allocation of deductible business interest expense in few situations. Accordingly, we believe that the final Section 163(j) regulations should retain the eleven step process as a safe harbor, but the final Section 163(j) regulations should also offer alternatives. In this regard, Treasury and the IRS should consider simpler methods. In all events, the allocation methods should preserve the overall amount of each Section 163(j) item.

In addition, we recommend that partnerships that allocate items of income and expense on a pro rata basis should be exempt from the eleven step process. This result would be consistent with the provisions applicable to S corporations, which require allocations based solely upon share ownership.

3. Section 704(b).

Whether Treasury and the IRS adopt our recommendations in C2. above, or retain the eleven step process, the final Section 163(j) regulations should confirm that if a partnership complies with the allocation process, such allocation will be considered to meet the requirements of Section 704(b).

4. Tiered Partnerships.

The final Section 163(j) regulations should address the application of Section 163(j) to tiered partnerships. The statute mandates that Section 163(j) be applied at the partnership level. That approach conflicts with the general view regarding tiered partnerships, under which the Code typically treats each upper-tier partnership as owning its proportionate share of the assets of the lower-tier partnership. The general approach serves an anti-abuse policy by limiting the use of multiple entities to achieve tax results at odds with the partners' economic interests in the underlying partnership assets. These approaches can be reconciled through a rule that generally computes the Section 163(j) limit at both the upper and lower-tier partnership levels coupled with an anti-abuse rule to the effect that if a principal purpose of the use of tiered partnerships is to achieve a result that is more favorable than if the upper-tier partnership owned the assets directly, the Section 163(j) limit would be computed under the general look-through approach for tiered partnerships.

5. Excess Business Interest Expense.

a. Meaning of Substantially All.

Proposed Regulations Section 163(j)-6(h)(3) provides for basis adjustments upon the disposition of all or substantially all of a partner's interest in the partnership. The final Section 163(j) regulations should define "substantially all" of a partner's interest in the partnership for Section 163(j) purposes.

b. Partial Sale of Partnership Interest.

Under the Proposed Regulations, a partner is not permitted to increase its outside basis by the amount of its allocated excess business interest expense unless it disposes of its entire partnership interest. This outside basis adjustment should be extended to partial sales of partnership interests. We recommend that the final Section 163(j) regulations permit a selling partner to allocate its excess business interest expense based on existing basis allocation regulations. Any such increase in basis would result in a matching decrease in such partner's excess business interest expense carryover.

c. Sale of All or Substantially All of a Partnership's Assets.

The final Section 163(j) regulations should address a sale by a partnership of all or substantially all of the partnership's assets. We believe a sale of all or substantially all of a partnerships assets should be treated as a deemed disposition of each partner's interest in the partnership within the meaning of Section 163(j)(4)(B)(iii)(II). Although the sale of assets may give rise to ATI if there is gain, the final Section 163(j) regulations should clarify whether taxpayers have the option to continue the partnership, potentially permitting partners to claim interest deductions in the future for any excess business interest, or whether the partnership should be considered terminated, with the accompanying basis adjustment. In addition, if the partnership is treated as terminated upon the sale of substantially all of its assets, the final Section 163(j) regulations should clarify the meaning of "substantially all" in this context.

d. Partnership Termination.

The final Section 163(j) regulations should address the consequences to the partners if the partnership terminates. We recommend that the final Section 163(j) regulations provide that upon a partnership termination, the termination should be treated as a disposition within the meaning of Section 163(j)(4)(B)(iii)(II). Accordingly, the adjusted basis of each partner's interest in the partnership should be increased by the amount of the excess business interest expense that has previously been allocated to such partner.

6. Debt-Financed Partnership Distributions.

If a partnership distributes borrowed funds, as stated in our Prior Report, 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. The interest expense should not be allocated based on the distributee partners' use of funds.

7. Self-charged Interest.

Treasury and the IRS should issue guidance addressing the treatment of self-charged interest. We believe that regulations should minimize the impact of any self-charged interest for the passthrough entity and the partner making or receiving the loan.

D. Application to Foreign Corporations and United States Shareholder.

1. General.

The application of Section 163(j) to a CFC presents extraordinarily complex issues. Accordingly, we recommend that either Section 163(j) should not apply to a CFC or that, at least, consideration should be given to suspending its application to CFCs until the issues associated with applying Section 163(j) to CFCs can be given more consideration.

2. The CFC Group Election.

The definition of CFC group should be based on the definition of affiliated group under the consolidated return regulations. As drafted, the definition of CFC group requires that if one shareholder does not own 80 percent of each CFC, each CFC must be owned in the same proportion by each related United States shareholder. This highly technical approach represents a trap for the unwary and a planning opportunity to pick and choose CFCs in the

CFC group. We recommend the final Section 163(j) regulations adopt Section 1504 principles to define a CFC group because they are more flexible and readily understood by taxpayers.

The final Section 163(j) regulations should clarify that a single CFC can make the CFC group election. This would permit a United States shareholder to include the CFC's ATI in such United States shareholder's Section 163(j) calculation.

In addition, we request clarity regarding the scope of the direct allocation rule for financial services entities. For these purposes a financial services subgroup is defined by reference to Sections 954(h)(2)(A) (banks and similar financial institutions), 953(e)(3) (insurance companies), and 954(c)(2)(C) (dealers). Financial services groups frequently engage in related financial service activities that may not qualify under the rather rigid requirements of some of those sections. Consideration should be given to whether using the definition that applies for purposes of Section 904, including Treasury Regulations Section 1.904-4(e)(3) would be more appropriate. Consideration should be given to eliminating this rule altogether, or coordinating the financial services entity rule under Proposed Regulation Section 1.163(j)-7 with the direct allocation rule for domestic financial services entities contained in Proposed Regulations Section 1.163(j)-10.

3. ECI Exclusion.

The Proposed Regulations exclude from the CFC group determination an applicable CFC with effectively connected income ("**ECI**"). We believe that a better approach would be to exclude ECI from the CFC group determination in a manner consistent with Proposed Regulations Section 1.163(j)-8.

4. CFC Group Election and United States Shareholder ATI.

When a group election is made, the computational rules for increasing the ATI of a United States shareholder on account of GILTI inclusions from CFCs should be modified and clarified in several respects.

5. Termination of CFC Group Election.

The final Section 163(j) regulations should provide guidance to United States shareholders as to the Section 163(j) consequences if a CFC group makes the CFC group election but it is ultimately determined that one or more of the CFC group members were ineligible to make the election. The Proposed Regulations are silent on the topic.

6. CFC Group Calculation of ATI.

Proposed Regulations Section 1.163(j)-7(c) provides rules for determining the calculation of ATI and by extension the Section 163(j) limitation of a CFC group member. In very general terms, ATI of an upper-tier CFC is increased by a lower-tier CFC's excess taxable income. We recommend that the final Section 163(j) regulations provide that rules similar to the consolidated group provisions set forth in Proposed Regulations Section 1.163-4(d) apply to the CFC group members making a CFC group election.

E. Elections for Excepted Trades or Businesses and Safe Harbor for REITs.

1. Electing and Terminating Excepted Trade or Business Status.

Final Section 163(j) regulations should provide a definition of the term "substantially all" for purposes of determining when an electing trade or business terminates.

The Proposed Regulations provide that a taxpayer is considered to cease to engage in an electing trade or business if the taxpayer sells or transfers substantially all of the assets of the electing trade or business to an acquirer that is not a related party in a taxable asset transfer. Final Section 163(j) regulations should clarify what happens when an acquirer operating a particular type of business acquires the assets of a target operating the same type of business in a nonrecognition transaction. That is, can such an acquiror somehow cease to operate the acquired business for purposes of Proposed Regulations Section 1.163-9 (e.g., by ensuring the target ceases to exist for U.S. federal income tax purposes, or by not using the target's branding) so as to eliminate the target's prior election, or does the fact that the acquiror continues to use the assets in the same type of business cause the acquired business to continue to exist for purposes of Proposed Regulations Section 1.163-9?

2. Safe Harbor for Real Estate Investment Trusts.

The safe harbor in Proposed Regulations Section 1.163(j)-9(g) applies to real estate investment trusts ("**REITs**"), but not to partnerships even if the REIT owns the majority of the partnership. This effectively denies REITs owning partnerships the benefit of the safe harbor because the partnership is required to allocate between its exempted real property trade or business assets and its non-excepted assets. We believe that Treasury and the IRS should consider adopting a rule that the REIT tests its eligibility for the safe harbor by treating the REIT as the owner of its share of the partnership's assets.

The final Section 163(j) regulations should also clarify how an upper-tier REIT determines whether a lower-tier REIT qualifies under Proposed Regulations Section 1.163(j)-9(g)(2) (on the basis that the value of the lower-tier REIT's real property financing assets is 10 percent or less of its total asset value). It would be helpful if the final Section 163(j) regulations provided an example to clarify this point or specified that the upper-tier REIT can make this determination based on all of the facts available to it. It may also be appropriate to consider whether an upper-tier REIT that concludes in good faith that a lower-tier REIT qualifies under Proposed Regulations Section 1.163-9(g)(2) but is incorrect should nevertheless be permitted to treat all of the value of the lower REIT's shares as assets other than real property financing assets.

3. Clarification of the Partnership Look-through Rule as Applied to REITs.

We recommend that the final Section 163(j) regulations clarify that the modified partnership look-through rule in Proposed Regulations Section 1.163(j)-9(g)(4)(ii) and the REIT look-through rule in Proposed Regulations Section 1.163-9(g)(4)(iii) apply to tiered partnership arrangements held by a REIT.

4. Anti-Abuse Rule.

We generally support the special anti-abuse rule for real property trades or businesses set forth in Proposed Regulations Section 1.163-9(h)(1). As drafted, the anti-abuse rule does not distinguish between typical "Opco/Propco" structures (situations when the real property is owned or leased by one partnership and leased or sub-leased to a partnership under common control) and a non-real property business that "manufactures" a real property business that is intended to be an eligible real property trade or business. We recommend that the final Section 163(j) regulations provide an exception to the anti-abuse rule if, on a combined basis, the lessor and lessee under common control constitute a real property trade or business that is eligible to elect out of Section 163(j).

F. Allocations Between Excepted and Non-Excepted Trades or Businesses.

1. CFC Look-Through Rule.

We recommend that the CFC look-through rule set forth in Proposed Regulations Section 1.163(j)-10(c)(5)(ii) permit taxpayers to elect look-through treatment in respect of a CFC, for purposes of allocating basis and dividends between excepted and non-excepted trades or businesses, if such taxpayer owns 50 percent or more of the CFC's stock rather than 80 percent under the Proposed Regulations. This would be consistent with Section 954(c)(6).

2. Cash and Cash Equivalents.

Under the Proposed Regulations, cash and cash equivalents are excluded from a taxpayer's allocation of adjusted basis among excepted and non-excepted trades or businesses. We recommend that working capital, however funded, be included in the basis allocation determination. We further recommend that collateral that secures derivatives that hedge business assets and liabilities within the meaning of Treasury Regulations Section 1.1221-2 be included in the adjusted basis allocation determination.

3. Anti-Abuse.

We support adopting an anti-abuse rule, but believe that the principal purpose test contained in Proposed Regulations Section 1.163(j)-10(c)(8) is difficult to apply. We believe Treasury and the IRS should eliminate the principal purpose element of the anti-abuse rule and rely instead on a rule based on asset acquisitions, dispositions or changes in use that do not have a substantial business purpose.

4. Direct Allocations.

We appreciate the Proposed Regulations adopt, in principle, our earlier recommendation to require a taxpayer to allocate interest expense from qualified nonrecourse indebtedness to the taxpayer's assets as provided in Temporary Regulations Section 1.861-10T(b). The Proposed Regulations require the taxpayer to reduce the adjusted basis in its assets by the entire basis allocable to the asset financed with the qualified nonrecourse indebtedness. We believe that taxpayers should, however, be allowed to include adjusted basis funded by equity in the adjusted basis allocation determination.

5. Financial Services Entities.

We request clarity regarding the scope of the direct allocation rule for financial services entities. Also, we recommend the Treasury and IRS provide that if a sufficiently large percentage of a taxpayer's interest expense is attributable to a banking, insurance, financing or similar business that derives active financing income as described in Treasury Regulations Section 1.904-4(e)(2), then all of its interest income and expense would be allocated directly to such banking, insurance or active finance business. For this purpose, the final Section 163(j) regulations could use the Treasury Regulations Section 1.904-4(e)(3) definition of financial services entity, which adopts an 80 percent gross income test. Alternatively, the threshold could be set at 90 percent as is consistent with other Proposed Regulation provisions regarding excepted businesses.

6. Assets Used in More than One Trade or Business.

The Proposed Regulations provide three methods for allocating the basis of assets used in more than one trade or business for purposes of attributing basis between excepted and non-excepted trades or businesses. These include allocations based on gross income generated or expected to be generated by the asset, use of physical space in the case of land or an inherently permanent structure, and units of output (where units are consistent between the businesses). The Proposed Regulations disregard an asset if none of the three methodologies reasonably reflects its use. Disregarding such assets may cause significant distortion and seems unjustified. We propose that the approach be changed to cause a less severe result.

Under Proposed Regulations Section 1.163(j)-10(c)(3)(iii)(A), a taxpayer may not vary its allocation methodology within a taxable year or from one taxable year to the next without permission from the IRS. We recommend that the final Section 163(j) regulations clarify that this consistency requirement does not require a taxpayer to use a single methodology for different categories of assets.

G. Transition Rules.

1. Disallowed Disqualified Interest Carryforwards.

We recommend that the final Section 163(j) regulations provide that disallowed disqualified interest under Section 163(j) prior to the Act that is attributable to excepted trades or businesses should be carried forward to the taxpayer's first taxable year beginning after December 31, 2017.

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[4] to a related person[5] where such interest income was exempt (in whole or in part) from U.S. tax.[6] Old Section 163(j) did not apply unless the corporation's debt to equity ratio exceeded 1.5 to 1.[7] 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

[4] 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. See 1991 Proposed Regulations Section 1.163(j)-1(a)(1).

[5] 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). References to "1991 Proposed Regulations" are to regulations proposed under old Section 163(j).

[6] 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.

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

deduction for amounts paid or accrued to a related tax-exempt (generally, foreign) person[8] to the extent that the corporation's net interest expense[9] exceeded 50 percent of its adjusted taxable income (i.e., taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under Section 199, depreciation, amortization and depletion).[10] Net interest expense in excess of 50 percent of the corporation's adjusted taxable income was defined as "excess interest expense."[11] Any interest deduction disallowed under Section 163(j) was treated as interest paid or accrued in the succeeding taxable year.[12]

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.[13] 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.[14]

In the case of partnerships, 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 to the corporate partner; a corporate partner's distributive share of interest paid or accrued by the partnership was treated as interest paid or accrued by the corporate partner; and a corporate partner's share of the partnership's liabilities was treated as liabilities of the corporate partner.[15]

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

1. General.

The Act amended Section 163(j). 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, certain utilities, certain small businesses and floor plan financing interest. The statutory provisions are described in greater detail below.

[8] 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.

[9] 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. 1991 Proposed Regulations Section 1.163(j)-2(d).

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

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

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

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

[14] 1991 Proposed Regulations Section 1.163(j)-5(a)(2). In addition, the 1991 Proposed Regulations would have expanded the definition of affiliated group beyond that provided in Section 1504(a).

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

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.[16] The statute defines "business interest expense," "business interest income," and "adjusted taxable income."

"Business interest expense", for Section 163(j) purposes, 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)).[17]

"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)).[18]

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, and (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 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.[19]

The Proposed Regulations define "adjusted taxable income" as 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.[20] As discussed herein, the Proposed Regulations include a number of adjustments to ATI under the authority granted in Section 163(j)(8)(B).

[16] Section 163(j)(1). Although "floor plan financing interest" 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).

[17] 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.

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

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

[20] The Treasury is granted the authority under Section 163(j)(8) to make other adjustments to ATI.

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.[21]

2. Partnerships.

In the case of any partnership,[22] Section 163(j) is applied at the partnership level and any deduction for business interest expense is to be taken into account in determining the non-separately stated taxable income or loss of the partnership. In addition, 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.[23] 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.[24]

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. Instead, subject to the rules in the next paragraph, it 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.[25]

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 applying the excess taxable income limitation, is treated as business interest expense paid or accrued in succeeding taxable years.[26] 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 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 percent 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

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

[22] 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).

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

[24] *Id.*

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

[26] Section 163(j)(4)(B)(ii).

business interest income of the partnership, bears to 30 percent of the partnership's adjusted taxable income for the taxable year.[27]

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.[28] 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.[29]

3. Exceptions to Section 163(j).

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

a. Electing Real Property Businesses.

An "electing real property trade or business" is carved out of the Section 163(j) definition of trade or business. An "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).[30] Section 469(c)(7)(C) describes the term "real property trade or business" as "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business." The statute grants authority to Treasury to determine the time and manner of the election. Once made, the election is irrevocable.[31]

b. Electing Farming Businesses.

An "electing farming business" is excluded from the Section 163(j) definition of trade or business. An "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 elects to be excluded from Section 163(j).[32] The statute grants authority to the Treasury to determine the time and manner of the election. Once made, the election is irrevocable.[33]

[27] Section 163(j)(4)(C).

[28] Section 163(j)(4)(B)(iii)(I) and Proposed Regulations Section 1.163(j)-1(b)(12).

[29] Section 163(j)(4)(B)(iii)(II) and Proposed Regulations Section 1.163(j)-1(b)(12).

[30] Proposed Regulations Section 1.163(j)-1(b)(12).

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

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

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

c. Small Businesses.

Section 163(j) contains an exemption for certain small businesses. Section 163(j) does not apply to a taxpayer[34] which meets the gross receipts test of Section 448(c) for any taxable year, 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 three taxable year period ending with the immediately prior taxable year does not exceed $25 million.[35] 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.[36]

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.[37] 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.[38]

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 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). [39]

f. Floor Plan Financing Interest.

Interest paid or accrued on "floor plan financing indebtedness" is not subject to limitation under Section 163(j).[40] The term "floor plan financing indebtedness" means indebtedness used to

[34] 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).

[35] Proposed Regulations Section 1.163(j)-2(d). 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).

[36] Section 163(j)(3) and Proposed Regulations Section 1.163(j)-2(d).

[37] Section 163(j)(7)(A)(i) and Proposed Regulations Section 1.163(j)-1(b)(38)(ii)(A).

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

[39] Section 163(j)(7)(A) and Proposed Regulations Section 1.163(j)-1(b)(13).

[40] Section 163(j)(1)(C) and (j)(9). 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

finance the acquisition of motor vehicles[41] held for sale or lease, and secured by the inventory so acquired.[42]

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 or transfer. Section 382(d) was amended to include disallowed interest expense within the definition of "pre-change loss."[43]

III. DISCUSSION

A. Comments on Proposed Regulations Section 1.163(j)-1 – Definitions.

1. Adjusted Taxable Income.

The Proposed Regulations define ATI as the taxable income of the taxpayer with the following additions: (A) any business interest expense; (B) any net operating loss deduction under Section 172; (C) any deduction under Section 199A; (D) for taxable years beginning before January 1, 2022, any deduction for depreciation under Section 167, Section 168, or Section 168 of the Internal Revenue Code of 1954 (former Section 168); (E) for taxable years beginning before January 1, 2022, any deduction for the amortization of intangibles (for example, under Section 167 or 197) and other amortized expenditures (for example, under Section 195(b)(1)(B), 248, or 1245(a)(2)(C)); (F) for taxable years beginning before January 1, 2022, any deduction for depletion under Section 611; (G) any deduction for a capital loss carryback or carryover; and (H) any deduction or loss that is not properly allocable to a non-excepted trade or business.[44]

The Proposed Regulations require the following amounts to be subtracted from ATI: (A) any business interest income; (B) any floor plan financing interest expense for the taxable year; (C) with respect to the sale or other disposition of property, the lesser of (1) any gain recognized on the sale or other disposition of such property, and (2) any depreciation, amortization, or

fully deductible and to limit the deduction for net interest expense (less floor plan financing interest) to 30 percent 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.

[41] 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).

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

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

[44] Proposed Regulations Section 1.163(j)-1(b)(1)(i).

depletion deductions for the taxable years beginning after December 31, 2017, and before January 1, 2022, with respect to such property; (D) with respect to the sale or other disposition of stock of a member of a consolidated group that includes the selling member, the investment adjustments, as defined under Treasury Regulations Section 1.1502-32, with respect to such stock that are attributable to deductions described in (C) above; (E) with respect to the sale or other disposition of an interest in a partnership, the taxpayer's distributive share of deductions described in (C) above with respect to property held by the partnership at the time of such sale or other disposition to the extent such deductions were allowable under Section 704(d); and (F) any income or gain that is not properly allocable to a non-excepted trade or business.[45]

Finally, the Proposed Regulations state that, depreciation, amortization, or depletion expense that is capitalized to inventory under Section 263A is not a depreciation, amortization, or depletion deduction for purposes of adding these amounts to adjusted taxable income prior to January 1, 2022.[46]

a. Negative ATI Adjustments on the Sale of Depreciable Assets.

The Proposed Regulations include a number of adjustments to ATI under the authority granted in Section 163(j)(8)(B). The preamble to the Proposed Regulations (the "**Preamble**") states that the adjustments are designed to prevent double counting. Proposed Regulations Section 1.163(j)-1(b)(1)(i)(D), (E), and (F) provide that in determining the amount of a taxpayer's ATI for a taxable year, deductions for depreciation under Section 167 or 168, the amortization of intangibles, and depletion under Section 611 are added back to a taxpayer's taxable income. As a result, the taxpayer would have increased its taxable income by these amounts for Section 163(j) purposes. However, the Preamble notes that a taxpayer can receive a double benefit associated with the depreciation, amortization, and depletion, for ATI calculation purposes, if the taxpayer's ATI is increased in respect of a deduction associated with depreciation, amortization, or depletion and then the taxpayer sells or otherwise disposes of the property that was depreciated, amortized, or depleted. This double benefit would result because the amount of the gain that would otherwise be reflected in ATI in respect of the sale or other disposition would reflect the decreased basis in such assets as a result of the depreciation, amortization, or depletion. Similar concerns are present if the property is held by either a partnership or member of a consolidated group and the partnership interest or the stock of the member is sold or otherwise disposed of, because the adjusted basis in the partnership interest or member stock would have been reduced to reflect the depreciation, amortization, or depletion. As a result, the Proposed Regulations eliminate the double benefit associated with these sales or other dispositions by requiring the taxpayer to decrease ATI by the lesser of (1) any gain recognized on the sale or other disposition of such property or (2) any depreciation, amortization, or depletion deductions for the taxable years beginning after December 31, 2017 and before January 1, 2022 with respect to such property.

As a general matter, ATI is an annual determination and is not adjusted for tax benefits that occurred in prior years. For example, ATI excludes net operating loss deductions under Section 172. The Proposed Regulations further exclude from ATI any deduction for a capital loss

[45] Proposed Regulations Section 1.163(j)-1(b)(1)(ii).

[46] Proposed Regulations Section 1.163(j)-1(b)(1)(iii).

carryback or carryover. Congress also denied taxpayers the ability to carry forward excess business interest income or excess taxable income into future taxable years to support additional business interest expense deductions under Section 163(j). Furthermore, it is clear that Congress intended to apply Section 163(j) on one base for the first four taxable years after enactment (for taxable years beginning before January 1, 2022, ATI is increased by any deduction for depreciation, amortization and depletion) and another base thereafter (no ATI increase for depreciation, amortization, or depletion deductions). We refer to the initial four years as the "EBITDA period".

We generally support Treasury's and the IRS' decision to deny a double benefit if a taxpayer increases ATI for depreciation, amortization, or depletion deductions and the taxpayer sells the related property for a gain. If the sale takes place during the EBITDA period, it seems appropriate for the taxpayer to decrease ATI by the lesser of the gain recognized on the sale or other disposition of such property or any depreciation, amortization, or depletion deductions claimed during the EBITDA period with respect to such property, as provided in the Proposed Regulations. This results in the net amount of the addition to ATI being no greater than the depreciation, amortization, or depletion deductions claimed during the period.

However, a counterargument would be that the Proposed Regulations deprive the taxpayer of the benefit of Section 163(j)(8)(A)(v) in that the Proposed Regulations merely accelerate to the year of depreciation income that would be included in ATI in the year of the sale. Suppose a taxpayer owns property with a basis of $100, takes $10 of depreciation deductions for 2018 and then sells the asset at the beginning of 2019 for $100. For regular tax purposes, the taxpayer's basis is reduced to $90 because of the depreciation deductions and then the taxpayer recognizes gain (treated as a reduction in ATI) of $10 on the sale. Thus, if taxable income were the base for measuring the Section 163(j) limitation, the limitation would be reduced by $3 (30% of $10 of depreciation deductions) in 2018 on account of the 2018 depreciation deduction and increased by $3 (30% of $10 of depreciation recapture, that is, ATI reduction, on the sale) in 2019. Section 163(j)(8)(A)(v) appears to be intended to widen the base for calculating the Section 163 (j) limitation for the EBITDA period relative to taxable income. Yet, under the approach of the Proposed Regulations, what would otherwise be a reduction in the base in 2018 for the $10 of depreciation deductions is reversed (consistent with Section 163(j)(8)(A)(v)) and the $10 of depreciation recapture on the sale is reversed resulting in no expansion of the ATI base relative to regular taxable income. Rather, under the Proposed Regulations, all that has occurred is an acceleration of $3 of Section 163(j) limitation from 2019 to 2018.

On the other hand, one can argue that Section 163(j)(8)(A)(v) achieves a widening of the base if there is no sale, but if there is a sale, then the base widening that would otherwise be achieved via Section 163(j)(8)(A)(v) is achieved through the sale. Thus, it is not a failure of the Proposed Regulations that they do not widen the base relative to regular taxable income if the property is sold, except to the extent that the depreciation is not fully recaptured.

If depreciation, amortization or depletion deductions are claimed during the EBITDA period but the property is sold after the EBITDA period, the appropriateness of an ATI reduction for recognized gain is a more difficult question. Although it can be argued that no reduction should be required in such a case, on the ground that the definition of ATI is simply different in the EBITDA and post-EBITDA periods, we agree that it is appropriate to have an ATI reduction for gain recognized after the EBITDA period to prevent a double benefit for the amounts added to ATI during the EBITDA period. Significantly, however, if a taxpayer sells or otherwise disposes of property for a gain and that property was depreciated, amortized, or depleted during the EBITDA period, the Proposed Regulations treat all of the gain as attributable to the deductions to which the add-back applied during the EBITDA period for purposes of calculating ATI in the year of sale, to the extent that gain does not exceed those deductions. We disagree with this approach.

Consider the following example. Suppose a calendar year taxpayer buys depreciable property for $100 in taxable year 2018 and depreciates the property over ten years. For simplicity, we assume straight line depreciation. If the taxpayer sells the property in 2025 for $60 at a time when the taxpayer's adjusted basis was $20, the Proposed Regulations require the taxpayer to decrease ATI by the lesser of gain ($40) or the amount of depreciation taken during the EBITDA period ($40). Thus, all of the taxpayer's gain on the sale of depreciable property is attributed to the EBITDA period. This negative adjustment to ATI applies even if the taxpayer began depreciating the property prior to the enactment of the Act.

There are a number of methods that Treasury and the IRS could adopt in the final Section 163(j) Regulations to address the potential double benefit without penalizing taxpayers, including first-in first-out, last-in first-out, or pro rata.

Under a last-in, first-out method, all of a taxpayer's gain would be attributable to the most recently claimed depreciation. Using our example, if the taxpayer sells the property in 2025, the taxpayer would reduce ATI by $0 when it sells the property for $60 and recognizes $40 of gain because all of the taxpayer's gain would be treated as attributable to depreciation claimed in taxable years 2022 through 2025 ($10 per year for four years), and there would be no adjustment to ATI in the year of sale. If instead the property were sold for $80, the total amount of gain would be $60. $20 of which would be treated as attributable to depreciation claimed in taxable years 2020 and 2021 and therefore subtracted from ATI. The rationale of this approach is that it ensures that where depreciation is claimed in years after the EBITDA period and thus reduces ATI, gain on a subsequent sale is fully reflected in ATI (with no subtraction) to the extent that the gain exceeds the amount that would have been recognized if basis had not been reduced by post-EBITDA period depreciation; otherwise, post-EBITDA depreciation could be viewed as reducing ATI twice, once when the post-EBITDA period depreciation is claimed and a second time when an amount of gain on sale up to the amount of such depreciation is added back.

Under a first-in, first out method all of a taxpayer's gain would be attributable to the earliest taxable years in which the taxpayers took depreciation deductions with respect to the sold property. Using our example, the result would be the same as under the Proposed Regulations; the taxpayers would reduce ATI by $40 because the taxpayers deducted $40 depreciation with respect to the property during the four year EBITDA period. If the taxpayer had placed the property in service during 2015, however, under a first-in, first-out method, the taxpayer would decrease ATI by $10 because $30 of the taxpayer's gain would be attributed to the 2015-2017 taxable years and $10 of the gain would be attributable to the EBITDA period. The rationale for a first-in, first-out method is that, like the rule in the Proposed Regulations, it ensures that the benefit of adding back depreciation to the ATI in the EBITDA period is only temporary when the property is placed in service during the EBITDA period and later sold at a gain, but arguably is more logically consistent in terms of ordering in cases where property was placed in service prior to the EBITDA period.

Further, one could argue that a first-in first-out method is consistent with a theory that there is an "ATI basis" unreduced for depreciation taken during the EBITDA period and consistent with a "cash flow" theory of ATI for depreciation taken and sales made in either period.

Under a pro rata approach, the taxpayer would reduce ATI by an amount equal to the product of any gain recognized on the sale or other disposition of property and a fraction with a numerator equal to the amount of depreciation, amortization, and depletion deductions for the taxable years during the EBITDA period with respect to such property and a denominator equal to the total amount of depreciation, amortization, and depletion deductions taken by the taxpayer with respect to such property.[47] Thus, in the example above, the taxpayer's ATI would be decreased by $20. ($40 gain multiplied by a fraction equal to $40 depreciation during the EBITDA period over $80 total depreciation on the sold property). The pro rata approach represents a balancing between the other approaches and arguably is justified by the difficulty in determining whether actual changes in value of the sold property occurred during or after the EBITDA period.

On balance, a plurality of us believe that a last-in, last-out method is appropriate. We believe this is a sensible result as it addresses the potential for double counting while not unfairly penalizing taxpayers that depreciate property outside of the EBITDA period.

b. Determination of ATI for Trusts.

Trusts taxable under Section 641 are permitted to deduct under Sections 651 and 661 certain distributions made to beneficiaries.[48] The Proposed Regulations' definition of ATI does not contain an addback for deductible trust distributions. Logically, Section 163(j) should apply before a trust takes a deduction for distributions to beneficiaries. The Proposed Regulations adopt this approach for RICs and REITs.[49] Accordingly, we recommend that the final Section 163(j) regulations provide a positive adjustment to ATI for trust distributions deductible pursuant to Section 651 or Section 661.

Of course, we agree that if a deductible trust distribution is added back to the trust's ATI and thus taken account in determining the amount of interest expense allowable to the trust under Section 163(j), such trust distribution should be excluded from the recipient beneficiaries' calculation of ATI. A trust beneficiary should not be able to utilize a trust distribution to support additional business interest expense deductions at the beneficiary level. Proposed Regulations Section 1.163(j)-2(f) seems to be intended to reach this result. That provision is somewhat unclear so a clearer rule or examples illustrating the application of Section 163(j) to trusts and their beneficiaries would be helpful. For example, if a trust has $100 of ATI (without regard to distributions) and $30 of interest expense and pays $100 to its beneficiary as a deductible distribution, the beneficiary should not include the $100 in determining its ATI because the $100 of income at the trust supported a $30 business interest expense at the trust level.

[47] Another pro-rata approach would compare the relative time period the taxpayer owned the depreciable asset during the EBITDA period to the time period outside of the EBITDA period, rather than the relative amount of depreciation described in the text.

[48] Section 661.

[49] Proposed Regulations Section 1.163(j)-4(c)(2).

2. Definition of Interest.

The Proposed Regulations adopt an exceptionally broad definition of interest to include four categories: a basic definition generally covering what is typically considered interest under federal income tax law, amounts related to embedded loans in certain swap transactions, additional specified types of payments not typically considered interest under federal income tax law, and an anti-avoidance rule for amounts predominantly associated with the time value of money.

We recommend the final Section 163(j) regulations adopt a definition of interest that consists of three categories. The first category would be along the lines of that contained in Proposed Regulations Section 1.163(j)-1(b)(20)(i). The second category would consist of a number of items that are not considered interest under current law but that we believe should properly be treated as interest in light of the policy of Section 163(j) (the "Interest-Equivalents Category"). The Interest-Equivalents Category would include the items in Proposed Regulations Section 1.163(j)-1(b)(20)(iii)(A), (B), (D), and (J) (premium, certain ordinary income or loss on debt instruments, ordinary gain under Section 1258, and factoring income). The third category under our approach would consist of an anti-avoidance rule covering transactions where the taxpayer has a principal purpose of circumventing Section 163(j). The anti-avoidance rule should contain specific examples of transactions that are and are not covered. For Section 163(j) purposes, interest and interest equivalents should not include loan commitment fees, debt issuance costs, obligations to deliver goods or services or distributions in respect of stock. Further as discussed below in subsection d. although we believe that Treasury and the IRS have authority to promulgate an anti-avoidance rule, we question whether there is statutory authority to expand the definition of interest beyond the longstanding meaning under the Code and case law, that is, to include the Interest-Equivalents Category in the definition of interest. Section 163(j) itself does not define interest.

a. Interest under Current Law.

Proposed Regulations Section 1.163(j)-1(b)(20)(i) defines interest to include an amount paid, received or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement that is treated as a debt instrument for purposes of Section 1275 and Treasury Regulations Section 1.1275-1(d), and not treated as stock under Treasury Regulations Section 1.385-3.[50] Interest also includes amounts treated as interest under other provisions of the Code or the regulations.

The general definition of interest thus includes (a) original issue discount ("**OID**"), as adjusted for any acquisition premium or amortizable bond premium, (b) qualified stated interest, as adjusted for amortizable bond premium or bond issuance premium; (c) acquisition discount; (d) amounts treated as taxable OID under Section 1286 (related to stripped bonds and stripped coupons); (e) accrued market discount on a market discount bond to the extent includible in income under either Section 1276(a) or Section 1278(b); (f) OID includible in income by a holder that has made an election under Treasury Regulations Section 1.1272-3 to treat all interest on a debt instrument as OID; (g) OID on a synthetic debt instrument arising from an integrated transaction under Treasury Regulations Section 1.1275-6; (h) repurchase premium to the extent deductible by the issuer under Treasury Regulations Section 1.163-7(c); (i) deferred payments treated as interest

[50] Proposed Regulations Section 1.163(j)-1(b)(20)(i).

under Section 483; (j) amounts treated as interest under a Section 467 rental agreement; (k) amounts treated as interest under Section 988; (l) foregone interest under Section 7872; (m) de minimis OID taken into account by the issuer; (n) amounts paid or received in connection with a sale-repurchase agreement treated as indebtedness under Federal income tax principles; in the case of a sale-repurchase agreement relating to tax-exempt bonds, however, the amount is not tax-exempt interest; (o) redeemable ground rent treated as interest under Section 163(c); and (p) amounts treated as interest under Section 636.[51]

This definition of interest has long been accepted, is consistent with longstanding precedent and reduces the risk of inconsistency within the Code and Regulations. We support this provision of the Proposed Regulations.

b. Interest Equivalents.

i. Payments that Should be Considered Interest Equivalents.

Proposed Regulations Section 1.163(j)-1(b)(20)(iii) treat as interest for Section 163(j) purposes certain other amounts that involve a time value of money component but are not interest for federal income tax purposes, namely,

> (a) if a debt instrument is issued at a premium within the meaning of Treasury Regulations Section 1.163-13, any ordinary income under Treasury Regulations Section 1.163-13(d)(4) is treated as interest income of the issuer; similarly, if a taxable debt instrument is acquired at a premium within the meaning of Treasury Regulations Section 1.171-1 and the holder elects to amortize the premium, any amount otherwise deductible under Section 171(a)(1) as a bond premium deduction under Treasury Regulations Section 1.171-2(a)(4)(i)(A) or (C) is treated as interest expense of the holder;
>
> (b) if an issuer of a contingent payment debt instrument subject to Treasury Regulations Section 1.1275-4(b), a nonfunctional currency contingent payment debt instrument subject to Treasury Regulations Section 1.988-6, or an inflation-indexed debt instrument subject to Treasury Regulations Section 1.1275-7 recognizes ordinary income on the debt instrument in accordance with Treasury Regulations Section 1.1275-4(b), Treasury Regulations Section 1.988-6(b)(2), or Treasury Regulations Section 1.1275-7(f), whichever is applicable, the ordinary income is treated as interest income of the issuer and, to the holder, the ordinary loss is treated as interest expense;
>
> (c) a substitute payment described in Treasury Regulations Section 1.861-2(a)(7) is treated as interest expense to the payor or interest income to the recipient, in the case of a sale-repurchase agreement or a securities lending transaction related to tax-exempt bonds, however, the recipient of a substitute payment does not receive tax exempt interest income;

[51] Proposed Regulations Section 1.163(j)-1(b)(20)(i).

(d) any gain treated as ordinary income under Section 1258 is treated as interest income;

(e) income, deduction, gain, or loss, from a derivative, as defined in Section 59A(h)(4)(A), that alters a taxpayer's effective cost of borrowing with respect to a liability of the taxpayer is treated as an adjustment to the interest expense of the taxpayer;

(f) income, deduction, gain, or loss from a derivative, as defined in Section 59A(h)(4)(A), that alters a taxpayer's effective yield with respect to a debt instrument held by the taxpayer is treated as an adjustment to interest income by the taxpayer;

(g) any fees in respect of a lender commitment to provide financing are treated as interest if any portion of such financing is actually provided;

(h) any debt issuance costs subject to Treasury Regulations Section 1.446-5 are treated as interest expense of the issuer;

(i) any guaranteed payments for the use of capital under Section 707(c) are treated as interest; and

(j) the excess of any amount that a taxpayer collects on a factored receivable (or realizes upon the sale or other disposition of a factored receivable) is treated as interest income.[52]

We are sympathetic to the desire of Treasury and the IRS to cover many of the transactions specifically identified in the Proposed Regulations. For example, as discussed below, we agree with covering the structured commodity loan/forward sale strategy described in Example 3. We are sympathetic to Treasury's and the IRS' concern expressed in the Preamble that taxpayers could engage in transactions that generate deductions economically similar to interest but outside the scope of Section 163(j). We believe that a number of the amounts treated as interest under Proposed Regulations 1.163(j)-1(b)(20)(iii) should be treated as interest under Section 163(j) from a policy perspective. Specifically, premium described in Proposed Regulations Section 1.163(j)-1(a)(20)(iii)(A), ordinary income or loss on debt instruments described in Proposed Regulations Section 1.163(j)-1(a)(20)(iii)(B), ordinary gain under Section 1258 described in Proposed Regulations Section 1.163(j)-1(a)(20)(iii)(D) and factoring income described in Proposed Regulations Section 1.163(j)-1(a)(20)(iii)(J) should be included in the Interest-Equivalents Category (if Treasury and the IRS believe they have authority to do so). We discuss the other items on the list below.

ii. Substitute Interest Payments.

Whether substitute interest payments should be treated as interest equivalents is a complex question, the answer to which may depend on the type of payment and the transaction in question. We set forth below some considerations.

[52] Proposed Regulations Section 1.163(j)-1(b)(20)(iii).

We appreciate the policy arguments for treating substitute interest on securities loans and sale-repurchase transactions in the same manner as interest under Section 163(j) to the extent the transactions are economically akin to a borrowing. If a taxpayer borrows a Treasury security under a securities loan, for example, and substitute payments are not subject to Section 163(j), the taxpayer could sell the borrowed security and use the cash 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 subject to Section 163(j).

That argument is most persuasive if (i) the taxpayer has not posted cash or cash-equivalents as security for the securities borrowing, and (ii) the taxpayer is not taking significant market risk with respect to the borrowed security. Where the taxpayer posts cash or liquid assets as collateral, the transaction is not akin to a borrowing since the taxpayer has no increase in its net cash position and thus it is difficult to see the policy justification for including interest equivalents on these types of transactions.[53] Moreover, the taxpayer could have used the cash on hand to buy the purchased debt security, so the securities loan does not improve the taxpayer's overall Section 163(j) position even if the substitute interest is not treated as an interest equivalent.

However, substitute interest is treated in the same manner as interest for a number of other purposes of the Code. The list includes sourcing and withholding rules under international tax provisions,[54] and a number of rules applicable to substitute interest payments made in connection with short sales.[55] The policy considerations underlying those rules differ from those of Section 163(j) but the fact that the Code (typically explicitly by statute) treats substitute interest as interest for some purposes provides some support for doing so in other circumstances.

We recommend that consideration be given to the following factors in determining whether substitute interest should be treated as interest-equivalent income or expense:

- Whether the taxpayer has provided/received collateral consisting of cash, cash-equivalents or other liquid assets such as marketable securities;[56]

- Whether the borrowed security is due to mature shortly after the scheduled termination date of the securities borrowing; and

- Whether the transaction is an ordinary course transaction for the taxpayer in the regular course of its business.

[53] Cf. Section 956(c)(2)((J) (exemption of certain collateralized obligations from the definition of United States property).

[54] *See, e.g.,* Treasury Regulations Sections 1.861-2(a)(7) (substitute interest sourced like interest for purpose of specified regulations), 1.871-7(b)(2) (for purposes of section 871, substitute interest is characterized as interest), and 1.881-2(b)(2) (same).

[55] Section 265(a)(5) (expenses related to tax-exempt income); Section 1277(c) flush language (applying rules similar to Section 265(a)(5) to market discount income); Section 1282(c) (applying rules similar to Section 1277(c) with respect to short-term bonds).

[56] Taxpayers with multiple transactions between them typically determine collateral on a net basis.

Abusive transactions should be addressed under the anti-abuse rule discussed below.

iii. Hedges.

The Proposed Regulations provide two rules with respect to hedges. First, with respect to the issuer of a debt instrument, the Proposed Regulations treat income, deduction, gain, or loss from a derivative that alters a taxpayer's effective cost of borrowing as an adjustment to interest expense.[57] Second, with respect to the holder, the Proposed Regulations treat income, deduction, gain, or loss from a derivative that alters the taxpayer's effective yield as an adjustment to interest income of the taxpayer.[58]

These rules eliminate the ability of taxpayers to choose whether or not to integrate certain hedges with borrowings in order to achieve different results under Section 163(j), a concern we highlighted in the Prior Report.[59] Yet the rules raise significant questions as to their scope. The examples set forth in Proposed Regulations Section 1.163(j)-1(b)(20)(iii)(E) and (v) Example 2 are straightforward, yet more guidance is needed as to how close of a connection is required between a particular derivative and a borrowing in more complex situations. For example, taxpayers may enter into derivatives that hedge a group of liabilities on a macro level. Alternatively, taxpayers may enter into derivatives to hedge the mismatch or "gap" between their assets and liabilities; although the derivatives are related to debt, they also relate to non-debt items and so it is not clear the derivatives would be considered to alter the taxpayer's cost of borrowing.

Neither the Proposed Regulations nor the Preamble addresses how a taxpayer that hedges its interest rate or foreign currency position on a "macro" basis (i.e., a taxpayer that hedges such a

[57] Proposed Regulations Section 1.163(j)-1(b)(20)(iii)(E) gives an example of a taxpayer that borrows at a floating rate of interest and enters into an interest rate swap that entitles the taxpayer to receive an amount that is equal to or that closely approximates the floating interest rate on the note in exchange for a fixed amount. The Proposed Regulations treat income, deduction, gain, or loss from the swap as an adjustment to interest expense, and any gain or loss resulting from a termination or other disposition of the swap is an adjustment to interest expense, with the timing of gain or loss subject to the rules of Section 1.446-4.

[58] Proposed Regulations Section 1.163(j)-1(b)(20)(iii)(F). The Proposed Regulations give an example of a foreign currency swap pursuant to which the taxpayer, engaged in a manufacturing business, borrows Japanese yen from a bank in an amount equivalent to $2000x with an interest rate of 1 percent (at the time of the loan, the U.S. dollar equivalent interest rate on a loan of $2,000x is 5 percent); and enters into a foreign currency swap transaction with the same bank with a notional principal amount of $2000x under which the taxpayer receives Japanese yen at 1 percent multiplied by the amount of Japanese yen borrowed from the bank (which for 2019 equals $20x) and pays U.S. dollars at 5 percent multiplied by a notional amount of $2000x ($100x per year). The taxpayer does not integrate the swap with the loan under Treasury Regulations Section 1.988-5. The example concludes that the swap alters the taxpayer's cost of borrowing and, as a result, for purposes of section 163(j), the $100x paid by the taxpayer on the swap is treated as interest expense and the $20x paid by the bank to the taxpayer on the swap is treated by the taxpayer as a reduction of interest expense. Although not completely clear, the example suggests that foreign currency gain or loss resulting from the swap adjusts the taxpayer's interest expense on the borrowing, although presumably this should not be the result to the extent the foreign currency gain or loss does not relate to the time value of money. Proposed Regulations Section 1.163(j)-1(b)(20)(v) Ex. 2.

[59] New York State Bar Association Tax Section Report No. 1393, *Report Commenting on Section 163(j)* (March 28, 2018).

position based on the taxpayer’s firm-wide daily positions without there being specific hedges that relate to specific debt instruments) would determine whether a particular hedge alters the taxpayer’s effective cost of borrowing or effective yield on a debt instrument.

We recommend that the Treasury and the IRS provide a clear, administrable standard for when a derivative has a close enough connection to a debt obligation that it falls within the scope of Section 163(j). One approach would apply the hedge rules to derivatives that qualify for integration with the associated debt or liability under Treasury Regulations Sections 1.988-5 or 1.1275-6. Another approach would apply the hedge rules to derivatives that have a close enough connection to qualify as hedging transactions with respect to a borrowing under Treasury Regulations Section 1.1221-2 and Section 1.446-4. Alternatively, the hedge rules could apply when a taxpayer treats a derivative as a hedge of a borrowing or liability for financial reporting purposes.

iv. Commitment Fees & Debt Issuance Costs.

The Proposed Regulations address the treatment of a commitment fee paid in connection with a lending transaction. This treatment is based on Treasury Regulations Section 1.954-2(h), which treats commitment fees to provide financing as an interest equivalent if any portion of such financing is actually provided. The Proposed Regulations do not include other types of fees, but the Treasury and the IRS have requested comments on whether other types of fees should be included.

Borrowers often pay different types of fees in connection with a borrowing, including commitment fees, arranger and underwriter fees, and other upfront fees. Uncertainty exists as to how to characterize these fees for federal income tax purposes. For example, many of these fees seem more appropriately treated as fees for services rather than compensation for borrowed funds, such as arranger or underwriter fees. Even commitment fees have been subject to uncertainty and treated by some authorities as option premiums.[60]

In general, fees paid to the lender on a funded term loan create or increase original issue discount (OID)[61] whereas fees paid to an arranger or underwriter are treated as fees for services.[62] Fees paid on a revolver or delayed draw term loan, on the other hand, are subject to uncertainty.[63]

[60] See, e.g., Revenue Ruling 81-160, 1981-1 C.B. 312 (“A loan commitment fee in the nature of a standby charge is an expenditure that results in the acquisition of a property right, that is, the right to the use of money. Such a loan commitment fee is similar to the cost of an option, which becomes part of the cost of the property acquired upon exercise of the option. Therefore, if the right is exercised, the commitment fee becomes a cost of acquiring the loan and is to be deducted ratably over the term of the loan.”).

[61] Treasury Regulations Section 1.1273-2(g)(2)(i) (“[i]n a lending transaction to which Section 1273(b)(2) applies, a payment from the borrower to the lender (other than a payment for property or for services provided by the lender, such as commitment fees or loan processing costs) reduces the issue price of the debt instrument evidencing the loan.”).

[62] See Treasury Regulations Section 1.1273-2(e).

[63] See Revenue Ruling 81-160, 1981-1 C.B. 312 and Treasury Regulations Section 1.1273-2(g)(2)(i).

The rule included in the Proposed Regulations raises technical issues in its disparate treatment of a commitment fee paid when no financing is ultimately drawn versus treatment of the fee when any amount is drawn, no matter how small the amount relative to the commitment. Likewise, timing questions with this treatment arise where a commitment fee is paid in one year but the financing is drawn in another or when the draw period terminates.[64]

On balance, we believe fees related to the issuance of debt that are paid to persons other than the lender should not be treated as interest for Section 163(j) purposes and fees paid to a lender should be treated as interest for Section 163(j) purposes if such fees are treated as creating or increasing original issue discount on the debt.

v. Guaranteed Payments.

The Proposed Regulations adopt an unusual approach in treating guaranteed payments for the use of capital under Section 707(c) as interest. The rationale for this treatment is apparently that such guaranteed payments can be similar to interest economically, and we acknowledge this similarity. However, such guaranteed payments represent payments for partnership equity and not debt and thus they arguably do not implicate the policy, explained in the Preamble, to reduce incentives for taxpayers to incur debt financing. Partners having rights to guaranteed payments for equity capital have no creditor rights and are in a different position than lenders legally.

Moreover, we question the administrability of treating guaranteed payments as interest given that significant uncertainty often exists in distinguishing guaranteed payments for capital from a distributive share of partnership income.[65] As drafted, the Proposed Regulations create an artificial distinction between preferred returns and guaranteed payments. A preferred return can simply attract the first dollars of net income earned and thus constitute a distributive share in a partnership that recognizes sufficient net income but, to the extent the return exceeds partnership net income in a given year, it may be treated as a guaranteed payment. Such distinction does not seem justified as a policy matter. In fact, the economic consequences to the partners are not meaningfully different between a deduction at the partnership level and an allocation of net income to other partners.

Also, treating guaranteed payments as interest could create unwarranted incentives for partners to affirmatively structure returns as guaranteed payments to increase their business interest income. That is, the Proposed Regulations' inclusion of guaranteed payments in the concept of interest creates the possibility of taxpayers "creating" interest income by negotiating for greater guaranteed payments for the use of capital.

Finally, we note that the Proposed Regulations do not limit the treatment of guaranteed payments for the use of capital to guaranteed payments for the use of money; many guaranteed

[64] Additional questions arise as to how the lender side of the transaction is affected and what justification exists for non-reciprocal treatment. See Revenue Ruling 1970-1, C.B. 73 (situation 3) (commitment fee is not interest because it is not paid for the use or forbearance of money but rather for agreeing to make funds available).

[65] We described this issue in New York State Bar Association Tax Section Report No. 1357, *Report on Guaranteed Payments and Preferred Returns* (November 14, 2016).

payments represent payments for the use of property other than money and arguably seem even less appropriately treated as interest under Section 163(j).

A majority of us believe that guaranteed payments for capital only should be treated as interest under an anti-avoidance rule, that is, if the taxpayer has a principal purpose of circumventing Section 163(j). A substantial minority of members believe that guaranteed payments should never be treated as interest under Section 163(j) based on the arguments above.

c. Treatment of Swaps with Nonperiodic Payments.

The Proposed Regulations treat a portion of the payments on a swap with nonperiodic payments as interest income to the recipient and interest expense to the payor.[66] The Proposed Regulations achieve this result by treating a swap (other than a cleared swap) with significant nonperiodic payments as two separate transactions consisting of an on-market, level swap and a loan. The loan must be accounted for by the parties to the contract independently of the swap. The time value of money component associated with the loan, determined in accordance with Treasury Regulations Section 1.446-3(f)(2)(iii)(A), is recognized as interest expense to the payor and interest income to the recipient.[67] The Proposed Regulations reserve on the subject of cleared swaps.

Treasury and the IRS should issue guidance under Section 446 clearly defining when and to what extent swap payments will be considered interest or otherwise attributable to the time value of money. Prior to such guidance, we believe Section 163(j) should not include any special rule for swaps with significant nonperiodic payments.[68]

As noted the Proposed Regulations refer to Treasury Regulations Section 1.446-3(f)(2)(iii)(A), which addresses prepaid swaps but not swaps with other types of nonperiodic payments. Moreover, the cited Section 446 regulation does not treat a prepaid swap as both an on-market level pay swap and a "loan." Rather that regulation provides a method to amortize an upfront payment over the term of the swap contract. Treasury and the IRS may have intended to refer to Treasury Regulations Section 1.446-3(f)(2)(iii)(B) for the proposition that a swap with significant nonperiodic payments should be bifurcated into an on-market swap and a loan, but that regulation also does not treat the time value component of the deemed loan as interest.

The reference to significant nonperiodic payments in the Proposed Regulations and the statement in the Preamble that this provision would apply as Treasury Regulations Section 1.446-3(g)(4) did prior to now-expired 2015 temporary regulations, suggests a return to the 1993 notional principal contract regulations that treated swaps with "significant" nonperiodic payments as both an on-market swap and the time value components as interest.[69] We welcome a return to the "significant" standard for bifurcation of swaps with nonperiodic payments but urge that the timing

[66] See Proposed Regulations Section 1.163(j)-1(b)(20)(ii).

[67] *Id.*

[68] Of course, if a prepaid swap is treated as debt under common law principles the time value of money component of such swap should be treated as interest and subject to Section 163(j). Cf. Merck & Co., Inc. v. United States, 65 F.3d 475 (3d Cir. 2011).

[69] See former Treasury Regulations Section 1.446-3(g).

and character aspects of swaps with nonperiodic payments be worked out under Section 446, rather than Section 163(j) The Tax Section, in prior reports, has asked for guidance on this important issue.[70] If the Proposed Regulations are finalized as proposed, in the absence of Section 446 guidance, taxpayers would apparently be required to calculate and track interest amounts solely for Section 163(j) purposes without any applicable guidance as to how to measure those amounts, and in the absence of those amounts being treated as interest for any other tax purpose.

Regarding cleared swaps the Preamble states that the rules would not require testing the assets used for collateralization or condition the exception for collateralized cleared swaps on the extent of collateralization. The Treasury and the IRS requested comments on the proper treatment of cleared swaps and any requirements with respect to collateralization to identify swaps that could be used to effectively advance funds through the use of nonperiodic payments.

We note that an exception for cleared swaps is generally consistent with Proposed and Temporary Regulations under Section 446 issued in 2015 which would exempt swaps that are fully collateralized from the requirement to bifurcate a swap with nonperiodic payments into an on-market, level payment swap and a loan and treat the time value component associated with the loan as interest.[71] Recipients of upfront payments are required immediately to post an offsetting amount of collateral known as "variation margin" or "**VM**."[72] The recipient of the collateral or VM pays interest (known as Price Adjustment Interest or "**PAI**") on the VM. The exception for cleared swaps under Section 163(j) is consistent with the principle that such fully collateralized swaps are not like a loan or borrowing as there is no net cash being advanced or received by either party.

However, there are considerations relevant in the Section 163(j) context that were not relevant to the general question of whether cleared swaps should be treated as consisting of an at-market swap and a loan. Those considerations call for further study of how cleared swaps should be treated under Section 163(j).

To the extent a party makes an upfront nonperiodic payment, the other party posts VM; the recipient of VM has interest expense (in the amount of the PAI paid on the VM) and the pledgor of the VM has a corresponding amount of interest income. Thus, the treatment of interest income and expense on VM should be considered in deciding whether it is appropriate for Section 163(j) purposes to take into account for Section 163(j) purposes the corresponding time value component of the nonperiodic payment giving rise to the VM. One approach might be to take the view that since the actual interest income or expense on the VM economically corresponds to time value of

[70] See New York State Bar Association Tax Section Report No. 1348, *Report on Temporary Regulations Addressing Notional Principal Contracts With Nonperiodic Payments* (May 16, 2016) and New York State Bar Association Tax Section Report No. 705, *Report on Proposed Regulations on Methods of Accounting for Notional Principal Contracts* (January 6, 1992).

[71] See Temporary Regulations Section 1.446-3(g)(4)(ii)(B)(2). The preamble to the temporary regulations states that deemed loan treatment should not apply to upfront payments on cleared swaps when the recipient of the payment must post an equivalent amount of cash or collateral.

[72] In some circumstances, parties may post non-U.S. dollar currency or other collateral such as Treasury securities and there may not always be perfect matching of the daily value of collateral including by reason of the manner in which exposures may be netted across contracts or entities.

money components of the upfront payment, either both should be taken into account for Section 163(j) purposes, or neither should be. More generally, in the Section 163(j) context it is not obvious that the differences between cleared and uncleared swaps justify different treatment from one another.

On balance, we recommend that the approach to cleared swaps under Section 163(j) be addressed only after future regulations are issued under Section 446. We also would expect that any rule applicable to cleared swaps would apply equally to non-cleared swaps that are fully collateralized by contract or under the requirements of a Federal regulator, as was the case in the 2015 Temporary Regulations issued under Section 446.

d. The Anti-Avoidance Rule.

Proposed Regulations Section 1.163(j)-1(b)(20)(iv) (the "**anti-avoidance rule**") provides, that "Any expense or loss, to the extent deductible, incurred by a taxpayer in a transaction or series of integrated or related transactions in which the taxpayer secures the use of funds for a period of time is treated as interest expense of the taxpayer if such expense or loss is predominantly incurred in consideration of the time value of money."[73] As an example of the application of the anti-avoidance rule, Example 3 of Proposed Regulations Section 1.163(j)-1(b)(20)(v) treats a portion of the amount paid on a forward contract to buy gold as interest in a scenario where the taxpayer has sold gold short and entered into an offsetting forward contract to buy gold.

One concern with the approach of the Proposed Regulations is that, in light of the comprehensiveness of the list of types of payments in Proposed Regulations Section 1.163(j)-1(b)(20)(iii), one is left to wonder what the anti-avoidance rule in Proposed Regulations Section 1.163(j)-1(b)(20)(iv) is meant to cover. While Example 3 is helpful, it does not alleviate the concern. The rule offers no guidance as to when a gain or loss is predominantly, as distinguished from tangentially or even significantly, incurred in consideration of the time value of money. As drafted, the anti-avoidance rule potentially applies to many payments, accruals and receipts not typically considered interest above and beyond the list set forth in Proposed Regulations Section 1.163(j)-1(b)(20)(iii). It is arguably unclear whether the anti-avoidance rule applies, for example, to prepayments for goods or services, as such prepayments have a time value of money component. Prepaid dance lessons, gift cards, magazine subscriptions, and annual membership dues are a few commonplace examples. Further examples of payments with a time value of money component, but not typically considered to contain interest are preferred dividends,[74] nonqualified deferred compensation, death proceeds payable under a life insurance policy, prepaid forward contracts and substitute payments on a loan of highly preferred stock (even if the taxpayer does not hedge the delivery obligation), and it may be unclear in certain cases whether the anti-avoidance rule applies to these types of payments.

[73] Proposed Regulations Section 1.163(j)-1(b)(20)(iv).

[74] Preferred dividends paid by RICs and REITs are generally deductible. Further, while Section 163(j) should only apply to deductible items, preferred dividends payable by CFCs may impact E&P calculations and it is unclear whether CFC preferred dividends could impact the Section 163(j) calculation of United States shareholders if the CFC preferred dividends are treated as interest for this purpose.

The anti-avoidance rule may be particularly problematic for financial institutions, especially in the context of offsetting transactions. The rule creates a possibility that expense from one side of the transaction will be treated as interest expense for Section 163(j) purposes while the income from the offsetting transaction would not be treated as interest income.

We recommend an anti-avoidance rule covering scenarios where the taxpayer has a principal purpose to circumvent Section 163(j), and setting forth examples of transactions that are and are not covered by the anti-avoidance rule. The anti-avoidance rule should only cover transactions that are economically equivalent to interest and should be symmetrical (in the sense that a taxpayer that acts with a bad principal purpose of creating interest income could be deprived of the characterization of the income as interest) and clear.

We believe that our approach comports better than the Proposed Regulations with the statutory language ("interest paid or accrued on indebtedness") and the legislative history. It seems questionable whether there would be authority for guidance applying new Section 163(j) to interest equivalents, other than as part of an anti-avoidance rule, absent a statutory amendment. The amounts described in Proposed Regulations Section 1.163(j)-1(b)(20)(iii) go beyond the traditional definition of interest, and, in many cases, are expressly excluded from the concept of interest in other Code sections. The Conference Report states that "any amount treated as interest for purposes of the Code is treated as interest for purposes of Section 163(j)." One could argue that the Conference Report indicates a Congressional decision to apply Section 163(j) more narrowly than old Section 163(j), which, for example, included substitute payments made under a securities loan that met the requirements of Section 1058(a) as interest for Section 163(j) purposes. The Preamble to the Proposed Regulations states that treating amounts that are closely related to interest as interest income or expense when appropriate to achieve a statutory purpose is not new and refers to Treasury Regulations Sections 1.861-9T and 1.954-2 in that regard. We note that those regulations implement specific statutory provisions, namely section 864(e) (providing for allocation of expenses) and section 954(c)(1)(E) (treating "income equivalent to interest" as foreign personal holding company income). Neither those statutory provisions nor the regulations issued thereunder recharacterize interest equivalents as actual interest and thus are arguably distinguishable. If Treasury believes that it does not have authority to apply Section 163(j) to appropriate interest equivalents, then we recommend it seek a statutory amendment.

If our recommendation is not adopted, the final Section 163(j) regulations should clarify the meaning of "predominantly". There is currently no indication of how such test would be evaluated or if this requirement is equivalent to a percentage threshold.

e. Coordination with other Code Sections.

The proposed definition of interest is different from the definition of interest for purposes of Treasury Regulations Sections 1.861-8 and 1.882-5.[75] Those regulations provide rules for allocating interest in order to determine a U.S. corporation's allocation of interest expense for foreign tax credit purposes, and a foreign corporation's interest deduction, respectively. Final

[75] Treasury Regulations Section 1.882-5, which limits the amount of interest expense that may be deducted by a foreign corporation engaged in a U.S. trade or business to "the amount of interest on indebtedness paid or accrued by the taxpayer within the taxable year." See Treasury Regulations Section 1.882-5(a).

Section 163(j) regulations should clarify how a taxpayer coordinates the Section 163(j) definition of interest with these allocation rules. In particular, if Section 163(j) applies to deny a portion of a taxpayer's deduction for amounts subject to Section 163(j), how is that deduction allocated between the "real" interest and the interest-equivalent deductions that the taxpayer otherwise would be entitled to take? Because special rules apply in multiple parts of the Code to interest, and not to interest equivalents, it will be important to know what deduction has been disallowed and carried to a future year.

3. Trade or Business.

The Proposed Regulations reference Section 162 to define trade or business.[76] We generally agree with that approach. However, we believe changes to the list of exempted trades or businesses may offer clarity in some circumstances.

We recommend the final Section 163(j) regulations expressly exempt any activity described in Section 163(d)(5)(A)(ii) from the definition of trade or business. This will clarify that passive investors in securities and commodities trading businesses are subject to Section 163(d), not Section 163(j). It is currently not clear that these activities are exempt from the Section 163(j)(7) definition of trade or business and thus interest expense stemming from these activities could be considered business interest expense under Section 163(j)(5) and investment interest under Section 163(d). As discussed below, the unclarity stems from the interaction of the statute, Proposed Regulations, and Preamble, as well as from the fact that Section 163(d) treats the partnership as an aggregate of its partners while Section 163(j) treats it as a single entity.

Section 163(d) treats interest expense from "property held for investment" as investment interest expense.[77] Property held for investment includes an interest in an activity involving the conduct of a trade or business, which is not a passive activity and in which the taxpayer does not materially participate. A securities or commodities trading activity is both a trade or business and is not a passive activity at the entity level. Therefore, under current law, a non-materially participating partner in such a business treats interest expense attributable to securities and commodities trading activities as Section 163(d) investment interest subject to the 163(d) limitation.

Section 163(j)(5) states that "business interest" means any interest paid or accrued on indebtedness properly allocable to a trade or business. Such term shall not include investment interest (within the meaning of subsection (d))."[78] Additionally Proposed Regulations Section 1.163(j)-3(b)(9) states that except as otherwise provided interest expense characterized as something other than business interest expense elsewhere in the Code and including Section 163(d) should not be considered business interest expense. This suggests that interest expense cannot be both investment interest expense and business interest expense. The proper treatment of 163(d)(5)(A)(ii) interest expense specifically is called into question, however, by the Preamble to the Proposed Regulations, which states that "with respect to passthrough entities, including S

[76] Proposed Regulations Section 1.163(j)-1(b)(38).

[77] Section 163(d).

[78] Section 163(j)(5).

corporations, engaged in trades or businesses that are not passive activities and with respect to which certain owners of the passthrough entities do not materially participate for purposes of section 469, as described in section 163(d)(5)(A)(ii) and as illustrated in Revenue Ruling 2008-12, the rules of section 163(j)(4) will apply to business interest expense allocable to such trades or businesses of those passthrough entities if those entities are otherwise subject to section 163(j)."[79]

We believe that the statutory scheme requires that interest expense allocable to a trade or business be included in either the Section 163(j) limit or the Section 163(d) limit but not both. The most straightforward way to achieve this result in a framework where Section 163(d) is applied on an aggregate basis but Section 163(j) is applied on an entity basis is to expressly exempt activities of a partnership covered under Section 163(d)(5)(A)(ii) from the Section 163(j)(7) definition of trade or business, at least with respect to Section 163(j)(4).[80] There is substantial precedent for exempting these activities from provisions affecting trades or businesses generally. Notably, securities in the hands of traders are considered capital assets,[81] securities traders are excluded from self-employment tax under Section 1402(a)(2),[82] trading in securities or commodities does not establish a U.S. trade or business under Section 864(b)(2) and losses stemming from trading securities are excluded from the passive activity loss rules under Section 469.[83] We believe that similar treatment is appropriate in these circumstances. Clarifying that Section 163(d) investment interest expense is separate from business interest expense for all purposes is also consistent with the Proposed Regulations treatment of allocation of interest expense, interest income, and other items of expense and gross income to excepted trades or businesses. These rules require backing out any personal and investment interest before a taxpayer calculates their allocations.[84]

While it is true that our proposal to exclude securities and commodities trading activities from the scope of Section 163(j)(7) definition of trade or business would allow an individual partner in a partnership that materially participates in such activities to avoid both Section 163(j) and 163(d), we believe that other approaches can be used to ameliorate this situation. For example, the regulations could provide for a narrow exception that would treat interest expense allocated from such a partnership as being subject to the limits of 163(j) at the partner level. At the partner level, non-materially participating partners would not be subject to Section 163(j) as Section 163(j)(5) would clearly cede to Section 163(d) while materially participating partners would be subject to Section 163(j) at the partner level.

4. Tax Exempt Corporation.

[79] Preamble to Proposed Regulations at 85.

[80] The regulations at times make minor exceptions to the entity approach under 163(j); notably corporate partners receive unique treatment under Proposed Regulations Section 1.163(j)-4.

[81] See 1221(a)(1) and Marrin v. Commissioner, 147 F.3d 147 (2d Cir. 1998) (explaining that traders do not hold securities for sale to "customers").

[82] Section 1402(a)(2).

[83] Section 1402(a)(2), Section 864(b)(2) and Section 1.469-1T(e)(6).

[84] Proposed Regulations Section 1.163(j)-10(a)(2).

The Proposed Regulations define the term tax exempt corporation as "any corporation subject to tax under Section 511."[85] Section 511 is not limited to corporations, as it applies to organizations and trusts, including government owned colleges and universities.

Section 511(a)(1) imposes a tax on the unrelated business taxable income for each taxable year of any organization described in Section 511(a)(2). Section 511(a)(2) imposes the unrelated business income tax on any organization which is exempt from taxation by reason of Section 501(a) as well as any college or university which is an agency or instrumentality of any government or any political subdivision thereof, or which is owned or operated by a government or any political subdivision thereof, or by any agency or instrumentality of one or more governments or political subdivisions. The tax also applies in the case of any corporation wholly owned by one or more such colleges or universities.

Section 511(b) imposes a tax on the unrelated business taxable income for each taxable year of any trust (except for certain private foundations) that is exempt from tax by reason of Section 501(a) and which, if it were not for such exemption, would be subject to subchapter J (relating to estates, trusts, beneficiaries, and decedents).

It is not clear whether Treasury and the IRS intended to limit the application of Section 163(j) to tax exempt corporations or all entities subject to tax under Section 511. We recommend that the final Section 163(j) regulations clarify this point.

In addition, Treasury and the IRS should consider exempting government owned or operated colleges and universities from Section 163(j). Government owned or managed colleges and universities have limited ability to fund operations and activities through equity sources. Such colleges and universities also are unlikely to generate taxable income (or sell leveraged assets or businesses) sufficient to utilize Section 163(j) carryforwards.

B. Comments on Proposed Regulations Section 1.163(j)-4 – General rules applicable to C Corporations (including REITs, RICs, and members of consolidated groups) and tax-exempt corporations.

1. Transfers of a Partnership Interest by a Member of a Consolidated Group to Another Member

Generally, a consolidated group has a single Section 163(j) limitation. Proposed Regulations Section 1.163(j)-4(d) treats a consolidated group as a single taxpayer when calculating interest except for intercompany obligations, intercompany items, and corresponding items. The group's business interest expense and income is the sum of all members' current year business interest expense and income. The Proposed Regulations disregard offsetting intercompany items and corresponding items. The Proposed Regulations disregard any intercompany obligations for purposes of determining business interest income and expense.

The Proposed Regulations provide special rules regarding the ownership and transfer of partnership interests by members of the consolidated group. If one member of a consolidated

[85] Proposed Regulations Section 1.163(j)-1(b)(36).

group transfers a partnership interest in an intercompany transaction that does not result in a termination of the partnership, the Proposed Regulations treat the transfer as a disposition for purposes of the basis adjustment rule in Section 163(j)(4)(B)(iii)(II), regardless of whether the transfer is one in which gain or loss is recognized.[86] Under this approach, the selling partner's basis would be increased by the partner's excess business interest expense and no deduction would be allowed to either the transferor or transferee partner.

The approach in the Proposed Regulations might differ from the general approach of determining the consequences of an intercompany transaction as if the transacting members were divisions of a single taxpayer. Thus, another approach would be to effectively permit the transferee member to claim deductions for excess business expense to the extent that such transferee is allocated excess taxable income from the partnership (for example, the attributes of the members' items could be redetermined to effectively provide for this effect).

Such an approach would require amplification of the rules under Treasury Regulation Section 1.1502-13. First, if the partnership has made, or makes, a Section 754 election, the application of the matching rule under Treasury Regulation Section 1.1502-13(c) would need to address the interaction between the basis increase for the transferor partner under Section 163(j)(4)(B)(iii)(II) with the step up in basis adjustment under Section 743(b). Assume selling partner S has a partnership interest in PRS with a zero basis and value of $100 and has $20 of excess business interest expense. Also assume that PRS has a zero basis in its assets. In this case, if S sells its partnership to B for $100, S will have a deferred intercompany gain of $80 (reflecting a basis increase from $0 to $20 attributable to the excess business interest expense) and B will be entitled to a basis increase under Section 743(b) of $100 (the difference between the $100 outside basis in PRS and PRS's $0 inside basis in its assets). To the extent that B is allocated excess business taxable income from PRS, B should effectively be entitled to additional interest deductions. Amortization (or equivalent deductions) for $80 of B's basis step up, will be offset by S's taking into account its deferred intercompany gain. The additional $20 of amortization or other deductions, however, will not be offset by the deferred intercompany gain. Treasury Regulation Section 1.1502-13(c) would have to be amended to address this issue. One, but not the only, possibility would be to treat the $20 of Section 743(b) basis increase in excess of the deferred intercompany gain, as relating to the potential excess business interest expense. In that event, the benefit of this additional $20 should effectively be disallowed or deferred in the same manner as if the transferor member and transferee member were divisions of a single corporation (for example, the additional amortization could be deferred until there is sufficient excess taxable income generated by the partnership, or the basis step up could be reduced by any excess business interest deduction that is claimed, and the balance used to offset gain on a sale by B to a third party.)

C. Comments on Proposed Regulations Section 1.163(j)-6 – Application of the business interest expense limitation to partnerships and S corporations.

1. Application of Section 163(j) at the Partnership Level.

[86] Proposed Regulations Section 1.163(j)-4(d)(4).

We believe that consideration should be given to seeking a statutory amendment of Section 163(j) to apply the limitation on deductibility of interest on a partnership's trade or business at the partner level instead of the partnership level.

First, as evidenced by detailed provisions in the Proposed Regulations and reflected in our comments below, application of Section 163(j) at the partnership level presents inordinate complexity. In particular, this entity level rule clashes with the more common approach of treating partnerships on an aggregate basis and attributing to each partner its share of partnership activities. Compliance with the eleven-step process in the Proposed Regulations requires extensive recordkeeping and computations. While the process can be transferred to a spreadsheet program, we question whether taxpayers should be required to undertake that effort in order to comply with the rules. Other areas involving very complex issues include self-charged interest and sales of partnership interests within consolidated groups. The issues are described in detail below.

Second, we believe that imposing the limitation at the partnership level could provide inappropriate planning opportunities for taxpayers. As described below in our examples involved tiered partnerships, taxpayers could potentially exploit the application of Section 163(j) at the partnership level in order to increase the total amount of interest deductions. Similarly, loans between a partnership and its partners could potentially be used to distort the allocation and amount of interest deductions available. Further, a partnership could potentially employ disproportionate allocations to result in distortions.

Finally, we believe that the statutory purpose of limiting leverage on trade or business activities through restricting deductibility of business interest expense will be better served by applying the rules at the partner level. Under traditional partnership taxation principles, each partner would be treated as engaged in the trade or business of the partnership and would have its share of business income or loss and its share of business interest expense. Each partner would then be able to determine separately the amount of business interest expense it is entitled to deduct under Section 163(j). It would be a separate question whether the determination should be made solely based upon a partner's income or loss from a particular partnership or whether there is some permitted aggregation. In any event, such an approach would ensure that a partner is entitled to a deduction for business interest expense only to the extent there is business interest income or other taxable income to support the deduction. While this approach would not eliminate all opportunity for inappropriate planning, applying the test at the partner level would seem to reduce the potential. Accordingly, we suggest that consideration be given to seeking a statutory amendment of Section 163(j) to apply the limit at the partner level.

2. The Eleven Step Process.

Among the more difficult tasks for the regulations is addressing the application of Section 163(j) at the partnership rather than partner level. The principal difficulty arises in integrating the general aggregate approach of partnerships in which all items of income, gain, deduction or loss are separately allocated to the partners with the partnership level determination of the deductible amount of business interest. This requires the regulations to address not only situations in which all income, gain, loss and deductions taken into account in determining the relevant Section 163(j) items are allocated pro rata, but also those in which such items are specially allocated among the partners in differing ratios.[87]

We commend the drafters of the Proposed Regulations for the thoroughness and balance of the approach taken in the Proposed Regulations. In general, we believe that the methodology set forth in the Proposed Regulations for the determination of the amount of interest deductible under Section 163(j) and the amount of excess business income and the allocation among the partners achieves reasonable results. As set forth below, we are concerned, however, about the complexity of the Proposed Regulations in this respect. In particular, we believe that the computations and recordkeeping required to comply with the eleven step method set forth in the Proposed Regulations is unduly burdensome for many taxpayers, and fear that this will lead to widespread non-compliance.[88] Accordingly, we recommend that alternative methods be provided to simplify compliance without disturbing the basic goal of ensuring that the allocation of the deduction for interest to the partners is consistent with the partnership level determination of the amount deductible.[89]

The approach under the Proposed Regulations begins with the determination of the Section 163(j) items, which include "business interest expense", "business interest income" and items included in determining the partnership's adjusted taxable income. Under the Proposed Regulations, the determination of these items is generally made in the same manner as the determination for other business entities, with certain adjustments. In particular, the Proposed Regulations exclude from these determinations any partner level items of income or deduction under Section 743, remedial items allocated under Section 704(c) and Treasury Regulations Section 1.704-3(d). The Proposed Regulations also exclude from the determinations any interest that would not be treated as business interest expense or business interest income.

The Proposed Regulations then define a large number of terms which are used primarily or exclusively to enable partnerships to determine the allocation of relevant Section 163(j) items. In particular, the Proposed Regulations define "excess business interest expense", "excess business interest income", "deductible business interest expense" and "excess taxable income". The determination of these items is made at the partnership level, and the items are to be allocated among the partners. Thus, for example, a partnership in any year may have either excess business interest income or excess business interest expense, but not both. Similarly, a partnership will either have excess taxable income or not. While these definitions are needed because they are

[87] In contrast, for S corporations, all allocations of the relevant Section 163(j) items are allocated in proportion to share ownership eliminating much of the complexity faced in the partnership context.

[88] We understand that the formula can be placed on a spreadsheet program. Whether taxpayers will be willing, or should be required, to take this kind of action (or be forced to engage professionals to do so) is beyond the scope of this Report.

[89] We note that the proposed Tax Technical and Clerical Corrections Act, introduced by Congressman Brady, would adopt a simplified approach to the allocation of items involved in the computation of deductible business interest expense for purposes of Section 163(j) at the partnership level. H.R. 88; Retirement, Savings, and Other Tax Relief Act of 2018. The proposed legislation would eliminate the requirement that deductible business interest expense be allocated in accordance with non-separately stated income. The proposal does not specify an alternative method for allocating deductible business interest expense, but does provide that the Section 163(j) items be allocated in accordance with the manner in which the underlying interest income or interest expense is allocated.

items to be allocated, many of the other definitions are adjuncts to computations and are evidence of the extensive complexity of the approach in the Proposed Regulations.

The Proposed Regulations apply an eleven step procedure in order to determine each partner's share of deductible business interest expense, excess business expense to be carried over, excess business interest income and excess taxable income that may be used by a partner to support deductions of business interest of the partner. Under the eleven step process, the partnership first determines its Section 163(j) excess items and the amount of its deductible business interest expense. Second, the partnership determines each partner's allocable share of items of income, gain, loss and deduction that are taken into account by the partnership in determining its Section 163(j) items. That determination is based upon the allocations under Section 704(b). Steps three through five provide a method for determining each partner's share of the partnership's excess business interest income or excess business interest expense. Step six specifies the method for determining each partner's share of the partnership's adjusted taxable income. Steps 7 through 10 provide an intricate series of computations intended to determine each partner's capacity to absorb interest deductions based upon its share of the partnership's ATI. Finally, in step eleven, the partnership's deductible business interest expense and excess Section 163(j) items (excess business interest income, excess taxable income and excess business interest expense) are allocated to the partners based upon the determinations made in the preceding steps. These computations are then illustrated through a series of examples which, while very helpful, emphasize the complexity and intricacy of the computations required.

Although the "eleven step process" works as a technical matter to produce a reasonable result, we are concerned that the process is very complex and taxpayers may be unable to comply with it. In general, the approach attempts to match, where possible, deductible interest expense with both the allocation of interest deductions and with items of income that would support the deduction.[90] A similar approach is used in the Proposed Regulations for excess Section 163(j) items. We believe the attempted precision of the eleven step process needs to be weighed against its complexity and compared to the reduced precision that could be achieved through simpler methods. Accordingly, we believe that Treasury and the IRS should consider one or more simpler approaches as described below. One such approach would permit taxpayers to allocate the relevant Section 163(j) items in any reasonable method that is consistent with the allocations under Section 704(b) of the underlying income, gain, loss and deduction and complies with certain other limitations, including that the allocations preserve the overall amount of each Section 163(j) item.

The approach of the Proposed Regulations imposes significant recordkeeping requirements, complexity, and compliance burden. As an initial matter, the eleven step process exists solely for Section 163(j) purposes. Taxpayers must maintain a parallel set of books (and make parallel allocations simply to comply with Section 163(j)). The process itself involves multiple different computations to be made for each partner, almost without regard to the underlying allocations of items of income or deduction made to the partner. To be sure, implementation of the statute requires the computation of various partnership level items, such as business interest income, business interest expense, and adjusted taxable income and the determination of whether the partnership has deductible business interest expense, excess business

[90] For instance, see Example 14 of Proposed Regulations Section 1.1613(j)-6(o)(14) in which deductible interest expense is essentially allocated in proportion to the allocation of taxable income among the partners.

interest expense or excess taxable income. However, the eleven step process goes much further. For example, the eleven step process requires that a partnership determine for each partner the following items: "allocable business income excess", and "allocable business income deficit". After these amounts are initially determined, the Proposed Regulations require a redetermination in accordance with a mathematical formula, resulting in each partner having a "final allocable business income excess" and "final allocable business income deficit". Similar determinations and redeterminations are also made with respect to a partner's "remaining business interest expense" and "allocable ATI", as well as determinations of a partner's "ATI capacity excess", "ATI capacity deficit" and a computation of a partner's "priority amount". Taken together, we believe that the work required and record keeping needed to comply with the eleven step process are simply excessive.

We believe that those taxpayers that wish to use the eleven step process should be able to do so. Accordingly, we suggest that the final Section 163(j) regulations retain the eleven step process as a safe harbor. In particular any allocations that are made in accordance with that process should generally be respected for federal income tax purposes.

For other taxpayers, Treasury and the IRS should consider simpler methods that provide greater flexibility but less assurance of matching the partner's deduction with an allocation of income, and methods that, like the eleven step process, more closely match business interest expense deductions with the income supporting those deductions. The allocation methods should preserve the overall amount of each Section 163(j) item under all methodologies.

Under all approaches, the partnership will still be required to determine the amount of its business interest that is deductible, whether it has excess business interest expense, excess business interest income or excess taxable income. Once those determinations are made, one alternative would be to permit the partnership to allocate each of those items in a manner that is reasonably consistent with the allocations of the corresponding items under Section 704(b). This approach would be subject to the limitation that the sum of the amounts of each of the Section 163(j) items allocated to the partners not exceed the amount of such item determined at the partnership level. Thus, in concept, the partnership should be able to allocate its deductible business interest among all of the partners to whom business interest deductions are allocated in any manner the partnership selects that is reasonably consistent with the allocation of the underlying interest expense provided that the aggregate amount of business interest income that may be deducted by each partner does not exceed the total amount deductible by the partnership. For these purposes an allocation would be considered reasonable if it is in proportion to the allocation of the underlying allocation of interest expense, in proportion to the manner in which the partners bear liability for the debt or, in the case of non-recourse debt, in proportion to the manner in which profits will be allocated in order to repay the debt.[91]

An allocation could also be considered reasonable if all of the partners to the allocation had tax interests that were adverse to each other. In that situation, the allocation of the Section 163(j) items would result from arms-length bargaining. An allocation of deductible interest to one partner

[91] We suggest that the regulations could look to the reasonableness test under Treasury Regulations Section 1.704-2(b) for guidance.

would presumably reduce the current deductions available to another partner. If that reduction represents a current cost, that the allocation should arguably be respected.

This approach can be illustrated by the following example. Consider PRS, a partnership with partners A, B and C, that has total interest expense of $160 of which only $100 is deductible. The partnership should be able to allocate the $100 deductible amount in any manner among the three partners that is reasonably consistent with the allocation of the interest expense. Thus, if the interest expense under Section 704(b) has been allocated $80 to partner A, and $40 each to partners B and C, the partnership could allocate the $100 deductible amount $50 to A and $25 to each of B and C. In addition, an allocation of $80 of deductible amount to A would be considered reasonable if the debt was recourse only to A.[92] The total amount of interest that may be deducted under Section 163(j) for all of the partners could not exceed $100, regardless of the manner in which the deductible amount is allocated.

A similar approach could be taken with respect to the allocation of other Section 163(j) items. Thus, excess business interest expense or excess taxable income would be allocated to partners in a manner that corresponds to the allocation either of the interest deductions or the items of gain or income included in the partnership's determination. In both cases, the allocation would need to be reasonably consistent with the allocation of the interest expense or items of income or gain corresponding to the Section 163(j) item.

The differences in result between this approach and the eleven step process in Proposed Regulations can be illustrated by applying the different approaches to Example 14 in the Proposed Regulations. In that Example, A, B, C, and D own all of the partnership interests in partnership PRS. In year 1, PRS has $200 of ATI, zero business interest income and $140 of business interest expense. PRS's ATI consists of $600 of gross income and $400 of gross deductions. PRS allocates the components of ATI such that A has income of $100, B has income of $100, C has income of $400 and D has a loss of $400. The business interest expense is allocated $0 to A, $40 to B, $60 to C and $40 to D. Under these facts, PRS has deductible business interest of $60 and excess business interest expense of $80. Under the methodology in the Proposed Regulations, the deductible business expense would be allocated $12 to B and $48 to C. The excess business expense would be allocated $28 to B, $12 to C and $40 to D. Under our recommended approach, PRS would have the ability to allocate the deductible interest expense proportionately to B, C and D. It would also likely be able to allocate the expense solely to B and C, as the income allocated to them could be considered to have been used to fund the interest expense. In each case, the total deductible business interest would be limited to $60 and the excess business expense of $80 would be required to be allocated to those partners with interest deductions in excess of the allocation of the deductible amount.

We note that the above approach provides considerable, but not unlimited, flexibility to partners and partnerships to allocate deductions in a manner which does not match the interest deduction with the interest income that supports the interest deduction at the partnership level.[93]

[92] In the example, the allocation of the interest expense deduction to B and C could result from the partnership's use of income that would have been allocated to B and C to pay interest on the debt.

[93] As previously noted, the application of Section 163(j) at the partnership level theoretically permits a partnership to allocate deductible business interest expense to a partner even though that partner is allocated no income.

As illustrated by the example above, under this approach, D could be allocated $40 of deductible interest expense, even though it has been allocated a loss. To some degree, this result is mandated by the statute that determines deductibility at the partnership level but one could argue that greater matching should be required.

Another simple approach would be to follow the model in the proposed legislation on the application of Section 163(j) at the partnership level.[94] Under the proposal, excess business interest expense is allocated is allocated among the partners in proportion to the allocation of business interest expense. A similar approach could be adopted, pursuant to which deductible business expense could also be allocated in proportion to the allocation of interest expense. This approach specifies a particular rule, rather than offering taxpayers a choice. However, there is still considerable flexibility in that taxpayers may determine the allocation of deductible business interest expense by specially allocating interest expense. To be sure, the rules governing substantiality under Treasury Regulation Section 1.704-1(b)(2)(iii) provide some limits.

A third approach would attempt to match the business interest deduction with business interest income and ATI in a more general way. This could be accomplished as follows: for each partner that is allocated business interest expense, determine the portion of the interest expense allocated to such partner that would be considered deductible business interest expense taking into account only the business interest income and ATI allocated to such partner. If the aggregate amount determined for all partners is equal to, or less than, the amount of the partnership's deductible interest expense, then each partner would be allocated deductible business interest expense in the amount determined in the first step—in other words, the amount of interest expense would have been entitled to deduct under Section 163(j) if only partnership items of income and deduction are taken into account. If the first step produced deductible interest in excess of the limitation determined at the partnership level, each partner's allocation of deductible business interest expense would equal the proportion of the partnership's total deductible business expense that the deductible amount determined in the first step for such partner constitutes of the deductible amount determined for all partners. Also, any deductible business interest expense as determined at the partnership level that is not allocated through the first step would then be allocated among the partners that have been allocated business interest deductions in proportion to the amount of interest expense of each partner remaining after the first step.

This approach can be illustrated by the following examples. Consider first the facts of Example 14 of Proposed Regulations Section 1.163(j)-6(o).[95] Partnership PRS had $140 of business interest expense, $200 of ATI and no business interest income. Accordingly, PRS has $60 of deductible business interest expense. PRS' items of ATI have been allocated such that A,

That result is inconsistent with the result that would have been obtained if the Section 163(j) limitation was applied at the partner level. The eleven step process attempts to moderate that result in situations in which partners have been allocated both interest expense and interest income, In that situation, in substance, the eleven step process attempts to allocate interest expense to those partners that have also been allocated interest income or ATI in a manner that approximates the result that would have been applicable if Section 163(j) were applied at the partner level, taking into account only the income or loss of the partnership.

[94] See H.R. 88; Retirement, Savings, and Other Tax Relief Act of 2018.

[95] Section 1.163(j)-6(o).

B and C have income of $100, $100 and $400 respectively, while D has a loss of $400. PRS' business interest expense has been allocated $40 to B, $60 to C and $40 to D.

Under the suggested approach, PRS would first determine for each of B, C and D the amount of the business interest allocated to each partner that would be deductible under Section 163(j) taking into account solely the ATI and business interest income allocated to such partner. In this case, the entire $60 of interest expense allocated to C would have been deductible, $30 of the interest expense allocated to B would have been deductible and no amount of business interest expense allocable to D would have been deductible. The total amount of business interest expense determined in the first step (or $90) exceeds the total amount deductible under Section 163(j) applied at the partnership level (or $60). Under this approach the partnership would determine the proportion of the interest expense allocated to each partner that is determined to be deductible in the first step and allocate the total deduction in those proportions.[96] Thus, C would be entitled to two-thirds of the $60 deduction (60/90) and B would be entitled to one-third (30/90) of the $60 deduction. D would not be entitled to any business interest deduction. Once the deductible business interest income is determined, the other Section 163(j) items can be computed.[97]

Also consider the next example with the same facts as Example 14 except that PRS has $450 of ATI and that C is allocated $300 of ATI and D is allocated a loss of $50. Under these facts, PRS has deductible interest of $135 (or 30% of $450). B would still be entitled to deduct up to $30 and C would be entitled to deduct up to $90, taking into account only the partnership items of income or deduction allocated to them. D would still have a deductible amount of zero. Because the aggregate amount determined to be deductible in this first step ($90, which is the sum of $30 of the $40 of interest expense allocated to B and the $60 of interest expense allocated to C) is less than PRS' Section 163(j) limit, each of B and C would be allocated deductible interest expense equal to the amounts determined in this first step. The balance of the deductible interest to be allocated ($45) would be allocated to B and D in proportion to the interest deductions actually allocated and not otherwise deducted in the first step. Thus, B would be allocated 20% (10/50) or $9 of deductible interest and D would be allocated 80% (40/50) or $36 of deductible interest.

We believe other simplification measures should be adopted in order to mitigate the complexity of the eleven step process. The allocation process is already substantially simplified in the case of S corporations and exempt partnerships which only conduct excepted trades or businesses. In the case of S corporations, allocations of excess taxable income and excess business interest income are made in accordance with the shareholders' respective pro rata interests in the S corporation pursuant to Section 1366(a)(1) after determining the S corporation's Section 163(j) limitation pursuant to Proposed Regulations Section 1.163(j)-2(b).[98] Additionally, to the extent a partnership or S corporation is not subject to Section 163(j) because it has an excepted trade or

[96] We recognize that other ratios could also be used, For example, the partnership's deductible business interest expense could be allocated based upon the amount that each partner would be entitled to deduct if Section 163(j) applied at the partner level and the computation included only partnership items. Use of this method, however, would require further steps in situations in which the result of the formula would allocate to a partner an amount of deductible business interest in excess of the amount of interest expense actually allocated.

[97] We note that this result is different than the result in Example 14, which allocates more deductible interest to C because C has greater capacity given the larger allocation of ATI to C.

[98] Proposed Regulations Section 1.163(j)-6(l)(1).

business as defined in Proposed Regulations Section 1.163(j)-1(b)(38)(ii) (excepted entity), the entity does not apply its Section 163(j) limitation under Proposed Regulations Section 1.163(j)-2 and -4 with respect to the business interest expense that is allocable to such excepted trade or business.[99]

Thus, partnerships that allocate all items of income and expense on a pro rata basis should be exempt from the eleven step process. This result would be consistent with the provisions applicable to S corporations, and excepted entities. Simplifying the process for these partnerships will reduce complexity and mitigate their administrative burden. These partnerships by nature do not make the kind of allocations the eleven step process appears concerned with.

3. Section 704(b).

Whether Treasury and the IRS adopt our recommendations in C1. above, or retain the eleven step process, the final Section 163(j) regulations should confirm that if a partnership complies with the allocation process, such allocation will be considered to meet the requirements of Section 704(b).

4. Tiered Partnerships.

The Proposed Regulations do not offer guidance on the application of Section 163(j) to tiered partnerships. However, the Preamble requests comments on this issue, and the Proposed Regulations reserve on the topic. Section 163(j)(4) requires Section 163(j) to be applied at the partnership level with any business interest expense carryforwards allocated to the partners. Treasury specifically asked for guidance on whether carryforwards should be allocated through upper-tier partnerships and how or when, an upper-tier partner's basis should be adjusted when a lower-tier partnership is subject to a Section 163(j) limitation.

We believe that the final Section 163(j) regulations should address the application of Section 163(j) to tiered partnerships. This issue requires reconciling the application of Section 163(j) at the partnership level as required by the statute with the traditional treatment of tiered partnerships that treats each upper-tier partnership as owning its proportionate share of the assets of the lower-tier partnership. The traditional aggregate approach to tiered partnerships furthers the policy objective of limiting the ability of taxpayers to use separate entities to achieve results that would be inconsistent with the results of having the upper-tier partnership own its share of the assets directly. We believe that these apparently conflicting objectives can be reconciled through a rule that generally computes the Section 163(j) limit at both the upper- and lower- tier partnership levels, but making that approach subject to an anti-abuse rule to the effect that if a principal purpose of the use of tiered partnerships is to achieve a result that is more favorable than would be the case if the upper-tier partnership owned the assets directly, then the Section 163(j) limit would be computed under the traditional look-through approach for tiered partnerships.

The issue can be illustrated by the following example. Assume Partnership PRS, with partners A and B, has business interest income of $100, business interest expense of $180 and ATI

[99] Proposed Regulations Section 1.163(j)-6(m)(2).

of $200, which consists of $600 of gross income and $400 of gross deductions. Under these facts, PRS would have deductible business interest of $160 and excess business interest expense of $20.

In contrast, assume PRS decides to conduct the same business activities through a tiered partnership arrangement, PRS1, in which PRS and B are partners. In addition, assume that PRS1 holds the assets which generate the business interest income of $100, incurs $100 of business interest expense and has ATI of ($100), consisting of gross income of $200 and gross deductions of $300. Assume that the ATI of ($100) is allocated to B and all other items are allocated to PRS. In addition, assume PRS retains the remaining assets and liabilities so that PRS would now have $300 of ATI and business interest expense of $80.

Under the tiered partnership structure, if Section 163(j) is applied at the partnership level, PRS1 would have deductible business interest expense of $100. PRS would have no business interest income and ATI of $300 resulting in $80 of deductible business interest and $10 of excess taxable income at PRS. In the aggregate, the use of the tiered partnership structure results in an increase in the amount of deductible interest expense as compared to the more traditional approach of treating the upper-tier partnership as owning its proportionate share of the assets of the lower-tier partnership.

Although the traditional approach may reach results more aligned with the intent of Section 163(j), we believe that the statutory language forecloses that approach. Instead, we believe it would be appropriate for the regulations to adopt an anti-abuse rule that would apply the traditional approach in circumstances in which a principal purpose of the use of tiered partnerships is to increase the Section 163(j) limit. We believe that the test would be measured based upon all of the facts and circumstances. These would include consideration as to whether there are non-tax business reasons for operating the business through separate partnerships as well as an examination of the overall allocations of income and loss. For example, the use of special allocations of items of income or loss among the partners in the tiered arrangement to achieve essentially the same net allocation that would have been made in a single partnership, while nonetheless purporting to increase the Section 163(j) limitation relative to the single partnership, would ordinarily warrant application of the anti-abuse rule.

In order to limit the application of the rule only to those situations in which there is a likely manipulation, the rule would apply only where the same taxpayers own, directly or indirectly, substantially all of the profits or capital of the tiered partnerships. For these purposes, we suggest an 80 percent test of substantially all. Thus, we would not expect the anti-abuse rule to apply to a partnership which invests in a lower-tier partnership but holds only a minority position, such as a partnership that invests in a real estate fund that is engaged in business.

5. Excess Business Interest Expense.

Excess business interest expense is one of the excess items allocated among the partners of the partnership via the eleven step process outlined above. A partnership which has deductible business interest expense applies this deduction at the partnership level in calculating its non-separately stated taxable income or loss. Any additional business interest expense is not deductible at the partnership level and becomes an excess item allocated to the partners. However, both deductible and excess business expense retain their character as business expense generally for all other purposes.

A partner's unused excess business interest expense is carried over from year to year. If a partner has excess business interest expense which is carried over to another year it is treated as business interest expense paid or accrued by the partner in the following taxable year solely for Section 163(j) purposes. A partner who has excess business interest expense from a prior year and is allocated excess taxable income or excess business income must treat the partner's excess business interest expense as paid or accrued in an amount equal to the partner's allocated excess taxable income or excess business income.

Both deductible business interest expense and excess business interest expense are subject to Section 704(d) and compose the same Section 704(d) loss class. A partner's adjusted basis in the partnership is reduced, but not below zero, by the partner's share of excess business interest expense. However, any negative business interest expense suspended under Section 704(d) is not considered excess business until it becomes accessible. Final Section 163(j) regulations should provide further clarity on the impact of various partner and partnership level events, outlined below, upon a partner's accumulated excess business interest expense.

a. Basis Adjustment on Disposition of Interest.

Proposed Regulations Section 163(j)-6(h)(3) provides for basis adjustments upon the disposition of all or substantially all of a partner's interest in the partnership. Under the Proposed Regulations, immediately before a disposition of all or substantially of the partner's interest in the partnership, the basis of the partnership interest is increased by the amount of the partner's excess business interest expense that has been applied to reduce the partner's basis in the partnership interest over the amount of excess business interest expense that has been treated as paid or accrued by the partner as a result of the allocation of either excess business interest income or excess taxable income. The increase applies in the case of any taxable or non-taxable transaction. There is no deduction permitted to either the transferor or the transferee with respect to the excess business interest expense resulting in a basis increase.

Effectively then, it appears that the approach under the Proposed Regulations for the disposition of the entire interest in the partnership is to convert what would otherwise be an interest deduction resulting from the transferor partner's historic share of excess business expense into basis in the partner's partnership interest (and therefore less gain or more loss on the disposition of the partnership interest). Suppose, for example, a partner has basis of $100 in the partner's partnership interest, and the value of the partnership interest is $100. Suppose that the partnership then uses $1 of the partner's share of assets to pay interest which is not deductible on account of Section 163(j). The partnership then allocates $1 of excess business interest expense to the partner, and the partner's basis is reduced to $99 (consistent with the reduction in value of the partner's partnership interest to $99). Assume the partner then sells the partner's partnership interest for its value of $99. Immediately before the sale, the partner's basis is increased to $100 resulting in a $1 loss recognized by the partner. The $1 of excess business interest expense is never allowed. The final Section 163(j) regulations should confirm these results.

Further, the Proposed Regulations do not provide a definition of "substantially all" in this context. Final Section 163(j) regulations should offer guidance in this area.

b. Basis Adjustment on Disposition of Partial Interest.

Under the Proposed Regulations, the basis increase does not apply if there is only a partial disposition of the partner's interest in the partnership. In that case, the entire business interest expense carryover remains suspended to be used when there is an allocation to the partner of either excess business interest income or excess taxable income. As noted in the Preamble, this approach is similar to the approach under Section 469 which provides that passive losses remain suspended until the disposition of the entire partnership interest.

The Preamble has requested comments on this approach and noted that Treasury and the IRS considered two alternatives in the case of a partial sale. One approach would increase the partner's basis in the partnership interest to the extent that a partner's capital account was reduced due to the partial disposition. The second approach would increase the partner's remaining basis in its partnership interest by the amount of the excess business interest carryover that is proportionate to the interest disposed of in the transaction. In the latter case, the Preamble notes that the partner would be required to track its basis in its partnership interest in a manner similar to that set forth in Revenue Ruling 84-53.

We believe that the regulations should provide a mechanism under which the basis in a partner's interest in the partnership is adjusted in the event of a partial disposition.[100] The approach in the Proposed Regulations denying such an increase seems to impose a potentially unfavorable result on taxpayers that is not supported either by the statute or its purposes. Under the approach of the Proposed Regulations, the transferor partner retains the entire amount of the excess business expense carryover, which will be treated as business interest paid or accrued only upon the allocation of either excess business interest income or excess taxable income. That remains the situation, even though as a result of the transfer of a portion of the partnership interest the likelihood of such an allocation may have been reduced. In addition, the result of the rule in the Proposed Regulation may be to distort the taxpayer's overall position. By not increasing the basis upon a partial disposition, the taxpayer may recognize gain due to reductions in basis for tax deductions that may never be used. Similarly, by delaying the application of the basis addition attributable to the excess business interest carryover until the final disposition of the partnership interest, the final disposition of the partnership interest may result in a tax loss which may not otherwise be usable either because such loss would be capital or represents a mismatch with the underlying economic result. Nothing in the statute or its policy of limiting interest deductions requires these potentially harsh results. The purpose of the carryover rule for excess business interest expense is to limit the partner's ability to claim an interest deduction that would otherwise exceed the statutory threshold. That statutory purpose can be accomplished by denying the interest deduction and eliminating the carryforward upon a partial disposition of the partnership interest. In other words, to the extent that a partner foregoes an interest deduction, we think the purposes of the statute are fulfilled. In that case, it would be appropriate to permit the basis increase.

[100] As noted in the Preamble, Revenue Ruling 84-53, 1984-1 C.B. 159 addresses allocation of basis in the case of a partial disposition, and requires a partner to track its basis in the partnership interest.

In addition, while we think the analogy to the rules under Section 469 is appropriate, we believe that the analogy is incomplete. Under Section 469, a suspended passive loss may be used to offset passive income recognized by a taxpayer in a subsequent year. In that case, in effect, the rules are applied in a manner to prevent timing mismatches. We believe that Treasury and the IRS should consider a similar approach with respect to partial dispositions of partnership interests. In those situations we believe it would be appropriate to increase the basis of the partnership interest being disposed of by an amount equal to the same proportion of the total amount of excess business interest as the proportion of the partnership interest being disposed of. Any amount so applied to increase the partner's tax basis would cease to be excess business interest expense.

As with any of the alternatives, our suggested approach would require certain recordkeeping. We believe that such tracking is not burdensome. Moreover, we would recommend that the rule be mandatory rather than provide the taxpayer with an election to either retain the excess business interest income expense or apply the increase in basis.

Even if Treasury and the IRS disagree with our suggested approach, the final Section 163(j) regulations should provide examples addressing the basis adjustment rules for partial dispositions of partnership interests.

c. Sale of All or Substantially All Partnership Assets.

The Proposed Regulations currently do not provide guidance on the effect of a sale of partnership assets on allocated excess business expense. Sales in the ordinary course of a partnership's business or even some more significant sales should not require special rules to address excess business interest expense. However, provisions should be made for the sale of all or substantially all of the partnership's assets.

We believe that these sales are similar in nature to the disposition of a partner's interest in the partnership as they fundamentally change the value and nature of that interest. Therefore, rules similar to Proposed Regulations Section 1.163(j)-6(h)(3) basis adjustments should be available under these circumstances. The sale of assets may generate ATI at the partnership and excess taxable income allocable to the partners freeing up previously suspended excess business interest expense. Excess business interest expense may remain, however, after such allocations. We suggest that such remaining excess business interest expense should be eliminated and instead the partners' bases in their partnership interests should be increased. To achieve this we recommend for these purposes treating a sale of all or substantially all of a partnership's assets as a deemed disposition of each partner's interest in the partnership within the meaning of Section 163(j)(4)(B)(iii)(II). If this recommendation is adopted Treasury and the IRS will need to provide guidance on the meaning of "substantially all" as we have requested in the case of a disposition of a partnership interest.

d. Basis Adjustment upon Partnership Termination.

The final Section 163(j) regulations should address the consequences to the partners if the partnership terminates. Under Section 708(b)(1), a partnership will terminate only if no part of the business or activities of the partnership is carried on by the partners in the partnership form. In addition, a partnership may be considered to be terminated as a result of partnership mergers or divisions. In any of these situations in which a partnership is considered to have terminated, it would be appropriate to treat such transaction as a disposition within the meaning of Section 163(j)(4)(B)(iii)(II). Generally, a partnership will be terminated because all of its assets have either been transferred to the partners or transferred to another entity with the interests in that entity being treated as distributed to the original partners in liquidation of their interests. Any of these transactions effectively results in a disposition of the partners' interests in the partnership. Accordingly, the adjusted basis of each partner's interest in the partnership should be increased by the amount of the excess business interest expense that has previously been allocated to such partner.[101] In such event, the partner would forego any further deduction for the disallowed interest.

6. Debt-Financed Partnership Distributions.

The Proposed Regulations do not address the treatment of interest expense incurred by a partnership to fund distributions. As stated in our Prior Report, debt-financed partnership distributions may merit different treatment from the general allocation of partnership interest expense.[102] 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. The interest expense should not be allocated based on the distributee partners' use of funds.

By comparison, Notice 89-35 applied the principles of Treasury Regulations 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 a 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 that partner, 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.[103] It appears that a rule that is based on how a partner uses the proceeds of a debt-financed partnership distribution, does not 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

[101] See Section 163(j)(4)(B)(iii)(II).

[102] New York State Bar Association Tax Section Report No. 1393, *Report Commenting on Section 163(j)* (March 28, 2018).

[103] 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. 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.

the assets and activities of the partnership would more fully comport with this statutory requirement.[104]

7. Self-Charged Interest.

The Proposed Regulations reserve on the treatment of self-charged interest. Self-charged lending transactions occur when there is a lending transaction between a passthrough entity and an owner of the entity. The Preamble states that Treasury intends to adopt rules which will prevent business interest income or expense from affecting both parties' Section 163(j) limitation in these situations. The Preamble proposes rules similar to those in Treasury Regulations Section 1.469-7 as a possible approach.

We agree that the regulations should minimize the impact of any self-charged interest for both the passthrough entity as well as the owner of the entity that is either making or receiving the loan. Achieving this result may be difficult due in part to the requirement to compute the interest limitation at the entity level. The following example illustrates the issue. Assume partnership ABC with three partners, A, B and C, borrows $900 from partner C and incurs $90 of interest on that loan. Assume that is the only interest expense for ABC and that A, B and C share all items of income and deduction equally. In addition, assume that ABC has $100 of ATI and therefore has deductible business interest expense of $30. The amount of deductible interest expense for each of the partners will vary depending upon whether the $10 of interest expense allocated to C—the self-charged interest-- is taken into account or disregarded for purposes of Section 163(j). If the interest allocated to C is taken into account, the $30 of deductible business interest expense would be allocated equally among the three partners, since all items are pro rata. If the self-charged interest allocated to C is disregarded for purposes of Section 163(j), then A and B would each be allocated $15 of deductible interest expense.[105] It is not clear to us that disregarding the self-charged interest is required in this fact pattern where the result would be to increase the allocation of deductible business interest expense to certain partners in a manner that may be inconsistent with the allocation of income supporting the deduction.[106]

The previous situation can be contrasted with the case in which all of the interest expense is allocated to partner C, but the ATI is allocated to the other partners. In that case, using the facts of the previous example, C would be entitled to deduct $30 of the interest incurred at the partnership level and potentially has an additional $90 of Section 163(j) capacity at the partner level if C has other interest expense to the extent that the $90 of interest income qualifies as business interest income. In this latter case, C has used self-charged interest to earn a larger overall interest deduction than it would otherwise be entitled to. We believe that regulations should address this case.

[104] 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.

[105] Because items are pro rata among the partners, if the interest paid to C is not treated as interest, then the total deductible amount of 30 should be shared equally by A and B.

[106] In this case, A and B have each been allocated one-third of ABC's 100 of ATI, which would support an interest deduction of 10.

An approach to eliminate the potential abuse where the partnership is the borrower would be to disregard the interest expense for purposes of Section 163(j) to the extent that the lending partner (or a related person) is allocated the interest expense without also being allocated business interest income or ATI that would support the interest deduction. For example, if a partner lends money to the partnership and is allocated 100 percent of the interest deduction by the partnership, but none of the ATI supporting the interest deduction, the interest expense would not be taken into account as interest by the partnership for purposes of Section 163(j). In addition, the partner would not take the interest income into account for purposes of Section 163(j) computation, even if the loan was made in the conduct of the partner's trade or business.[107]

There is also a potential for abuse if the partnership lends money to a partner and that loan is used to generate additional Section 163(j) capacity. The interest income received from the partner generally increases the Section 163(j) capacity at the partnership level. If the business interest income is allocated by the partnership to the borrowing partner, we think such interest income should not be taken into account in computing the partnership's Section 163(j) limit. The amount not taken into account as interest income should also not be treated as interest expense by the borrower.[108]

We believe it would be appropriate for the final regulations to limit the ability of a partnership and its partners to manipulate the interest deduction limitation available to the partnership under Section 163(j) through owner/passthrough entity lending transactions. We recognize, however, that distinguishing those situations which are abusive from those that represent ordinary commercial transactions may be difficult, as illustrated by the examples above. Accordingly, one approach to be considered would be to apply the self-charged rules only to situations in which the partner that is a lender or borrower and its related parties own a substantial interest in the partnership. For these purposes, 50% or more of the capital or profits of the partnership could be considered to constitute a substantial interest and the related parties definition used in Treasury Regulation Section 1.752-4(b) (80% common ownership) could be considered to be appropriate. The approach of omitting both the interest income and interest expense from the computation under Section 163(j) in these circumstances should minimize the ability of partners and partnerships to manipulate the determination of business interest income and business interest expense for both the partnership and its partners.

Because an S corporation effectively allocates all items pro rata, the rules would also need to address the treatment of the interest income or interest expense of a shareholder that is a lender or borrower. We suggest that the rules adopt the same approach as in the case of a partnership. This rule could result in allowing a deduction to the lending shareholder for its share of the corporation's interest expense (which would only serve to offset that amount of interest income received by the shareholder). That interest income would similarly not be considered business interest income, even if made as part of the shareholder's trade or business.

[107] This approach is only for purposes of Section 163(j). The borrower and lender would still be required to report and account for the interest for other purposes of the Code.

[108] This situation also presumes that the borrowing partner would otherwise be able to deduct the interest incurred on the loan from the partnership.

D. Comments on Proposed Regulations Section 1.163(j)-7 – Application of the business interest expense deduction to foreign corporations and United States shareholders.

1. Treatment of Controlled Foreign Corporations and Shareholders.

The Proposed Regulations apply Section 163(j) to a CFC. In particular, Proposed Regulations Section 1.163(j)-7 provides two methods for applying Section 163(j) to "applicable CFCs," defined as controlled foreign corporations described in Section 957 so long as at least one United States shareholder owns stock in the corporation.[109] Under the general rule, a CFC is treated as a separate entity and determines its limitation in much the same way as a domestic corporation. Taxpayers may also make a group election as described below in Part III.D.2.

To a degree, the choice to apply Section 163(j) to a CFC is understandable because Treasury Regulations Section 1.952-2(a)(1) provides that the income of a CFC should generally be determined as if the CFC were a domestic corporation. Yet, we believe that either Section 163(j) should not apply to a CFC or that, at least, consideration should be given to suspending its application to CFCs until the issues associated with applying Section 163(j) to CFCs can be given more consideration.

First, as illustrated in this Part III.D., applying Section 163(j) to CFCs is extraordinarily complex and raises numerous issues that would need to be understood. Enormous complexity arises, for example, in cases involving CFC groups.

Second, it is not clear that the Treasury will derive significant revenues in return for the complexity. For example, it is not clear that applying Section 163(j) to CFCs is necessary to discourage taxpayers from shifting interest deductions from the United States shareholder to a CFC, a concern raised in a prior report, since taxpayers might not have the incentive to engage in such shifting regardless of Section 163(j).[110] The lower rate applicable to GILTI income is already a disincentive to shifting deductions. And, Section 951A(b)(2) can cause interest deductions to reduce the shareholder's "net deemed tangible income return" through the operation of Section 951A(b)(2)(B). Further, if a CFC issues preferred stock with terms similar to the debt that is potentially subject to Section 163(j), there would be an effective deduction with respect to the income allocable to the preferred stock because a United States shareholder only includes in income its pro rata share for purposes of both Section 951 and 951A. Finally, in the case of a CFC with only Subpart F income the E&P limitation can significantly limit the impact of Section 163(j).

Assuming that Section 163(j) applies to CFCs we discuss below additional issues that should be addressed by the regulations. These issues highlight some of the complexities that underlie our recommendation.

[109] Proposed Regulations Section 1.163(j)-7(f)(2).

[110] New York State Bar Association Tax Section Report No. 1394, *Report on the GILTI Provisions of the Code* (May 4, 2018).

2. Definition of CFC Group.

The Proposed Regulations permit taxpayers to make an irrevocable election to apply the Section 163(j) limitation on a CFC group basis. The Preamble states that this election was necessary in the case of highly related CFCs. The Proposed Regulations define a CFC group as "two or more applicable CFCs if 80 percent or more of the total value of shares of all classes of stock of each applicable CFC is owned, within the meaning of Section 958(a), either by a single United States shareholder or by multiple United States shareholders that are related persons, within the meaning of Section 267(b) or 707(b)(1), (each a related United States shareholder and collectively related United States shareholders), provided the stock of each applicable CFC is owned in the same proportion by each related United States shareholder." The Proposed Regulations depart from the definition of a consolidated group by permitting a partnership, 80 percent of the capital and profits interests of which are owned by members of a CFC group, to be treated as a CFC group member provided that such partnership has no ECI.[111] This provision makes sense in light of the fact that the income from the CFCs held below the partnership flows up to the same United States shareholders.

We believe that the definition of CFC group should be based on affiliated group principles under the consolidated return regulations except that we agree with the approach in the Proposed Regulations that treats a captive partnership as a CFC group member As drafted, the definition of CFC group in the Proposed Regulations requires that if one shareholder does not own 80 percent of each CFC, each CFC must be owned in the same proportion by each related United States shareholder. This highly technical approach represents a trap for the unwary and a planning opportunity to pick and choose CFCs in the CFC group. We recommend using Section 1504 principles because they are more flexible and readily understood.

The Proposed Regulations further create a CFC subgroup for any CFCs that conduct a financial services business. The Preamble states that this treatment is appropriate because financial services companies are typically highly leveraged and have high amounts of business interest income and expense, which might cause distortions throughout the larger CFC group. We request additional clarity regarding the scope of the direct allocation rule for financial services entities.

The Proposed Regulations define a financial services subgroup by reference to Sections 954(h)(2)(A) (banks and similar financial institutions), 953(e)(3) (insurance companies), and 954(c)(2)(C) (dealers). Financial services groups frequently engage in related financial service activities that may not qualify under the rather rigid requirements of some of those Sections. Consideration should be given to whether using the definition that applies for purposes of Section 904, Treasury Regulations Section 1.904-4(e)(3) would be more appropriate. Consideration should also be given to eliminating this rule altogether, or coordinating the financial services entity rule under Proposed Regulation Section 1.163(j)-7 with the direct allocation rule for domestic financial services entities contained in Proposed Regulations Section 1.163(j)-10.

A CFC group election is made by applying the rules of Proposed Regulations Section 1.163(j)-7 to the CFC group, and no additional filing is required. The election is not considered effective unless all CFC group members make it. If a new entity becomes a member of the CFC

[111] Proposed Regulations Section 1.163(j)-7(b)(4).

group, it must make the election in order for the elections of all other group members to be effective. This rule seemingly turns an otherwise irrevocable election into an optional election. A CFC group may render its election ineffective simply by adding a group member that does not elect or by causing a CFC to engage in an activity giving rise to ECI. Given that all CFCs in a group need to make a valid election for it to be effective, the final Section 163(j) regulations should clarify what happens if a CFC group makes the election but it is ultimately determined that one or more of the CFC group members were ineligible to make the election.

The final Section 163(j) regulations should also clarify that a single CFC can make the CFC group election. We believe that the CFC group election rules should apply in the case of a United States shareholder with one CFC who wants to benefit from the CFC's ATI under Proposed Regulations Section 1.163(j)-7(d)(2).

3. ECI Exclusion.

The Proposed Regulations exclude from the CFC group determination of the Section 163(j) limitation any applicable CFC with ECI.[112] Despite the ECI exclusion, Proposed Regulations Section 1.163(j)-7(c)(1) states that for purposes of computing taxable income of an applicable CFC, the applicable CFC's gross income and allowable deductions are computed under the principles of Treasury Regulations Section 1.952-2 or the rules of Section 882 for determining taxable income that is effectively connected to a U.S. trade or business, as applicable. Therefore, the Proposed Regulations do appear to contemplate CFC group members with ECI.

We believe that instead of excluding altogether from a CFC group a CFC that has ECI, a better approach would be to exclude ECI from the CFC group determination in a manner consistent with Proposed Regulations Section 1.163(j)-8. This approach is sensible because some CFCs may inadvertently have ECI and would otherwise lose the benefit of the election. In addition, a blanket prohibition on CFCs that have ECI gives a CFC the option of intentionally failing out of the CFC group election by simply having a small amount of ECI.

4. CFC Group Election and United States Shareholder ATI.

In the case of a group election, the computational rules for increasing the ATI of a United States shareholder on account of GILTI inclusions from CFCs should be modified and clarified in several respects.

Under Proposed Regulations Section 1.163(j)-1(b)(37), if a taxpayer is allowed a deduction under Section 250(a)(1) allocable to a non-excepted trade or business, taxable income for purposes of determining ATI is determined without regard to the income limitation of Section 250(a)(2). Moreover, for this purpose, the deduction so allowed under Section 250 is determined without regard to the application of Section 163(j).

[112] Proposed Regulations Section 1.163(j)-7(b)(4) with respect to certain partnerships and Proposed Regulations Section 1.163(j)-7(f)(8) more broadly.

Under Proposed Regulations Section 1.163(j)-7(d)(1), if a United States shareholder of a CFC has an inclusion under Sections 78, 951 or 951A allocable to a non-excepted trade or business (a "**specified deemed inclusion**"), then, in calculating ATI of the shareholder, taxable income is reduced by the specified deemed inclusion, reduced by the portion of the deduction allowed under Section 250(a)(1) without regard to the taxable income limitation of Section 250(a)(2).

This calculation is the final calculation in the absence of the CFC group election. We have considered whether the rule in Proposed Regulations Section 1.163(j)-1(b)(37) is fair to taxpayers. On its face, by disregarding the Section 250(a)(2) limitation, it reduces taxable income for ATI purposes by more than the deduction that the United States shareholder was actually entitled to, and therefore arguably reduces the Section 163(j) limitation by more than is justified. However, we believe this potential effect is exactly offset by the fact that Proposed Regulations Section 1.163(j)-7(d)(1)(i) reduces the subtraction from ATI by likewise disregarding Section 250(a)(2). As a result, we believe that the net effect of Proposed Regulations Section 1.163(j)-1(b)(37) and Proposed Regulations Section 1.163(j)-7(d)(1) is to properly eliminate any effect of the specified deemed inclusions and related Section 250 deduction from the calculation of the ATI of the United States shareholder.

For example, suppose the United States shareholder has an unrelated operating loss of $30 aside from a GILTI inclusion of $100. The Section 250(a)(1) deduction is $50, but this is limited by Section 250(a)(2) to $35. Under Proposed Regulations Section 1.163(j)-1(b)(37), taxable income for Section 163(j) purposes, and therefore ATI, is increased by $100 (Section 951A inclusion) and reduced by $50 (Section 250(a)(1) deduction without regard to the Section 250(a)(2) limitation). Under Proposed Regulations Section 1.163(j)-7(d)(1)(i), ATI is reduced by $100 (Section 951A) minus $50 (Section 250(a)(1)), or $50. These two items offset each other, and the result is no adjustment to the ATI of the United States shareholder as a result of the GILTI inclusion.

Moreover, we observe that taking into account the Section 250(a)(2) limitation in these formulas could result in a circularity. The reduction in taxable income under Proposed Regulations Section 1.163(j)-1(b)(37) would depend upon the size of the actual Section 250 deduction, which, if Section 250(a)(2) applied, would itself depend upon the amount of taxable income of the United States shareholder. At least in this case where no group election is made, it therefore makes sense for these formulas to be based on Section 250(a)(1) without regard to Section 250(a)(2).

We now turn to the situation where a CFC group election is made. Under Proposed Regulations Section 1.163(j)-1(b)(37) and Proposed Regulations Section 1.163(j)-7(d)(2)(i), the adjustments to taxable income and ATI described above are made first. Then, a multi-step calculation is required. In simplified form, these steps are the following:

First, under Proposed Regulations Section 1.163(j)-7(f)(5), the "CFC excess taxable income" ("**CFC ETI**") for each CFC group member is calculated. As in the partnership context, this is the portion of the CFC's ATI that is not used to support the business interest expense of the CFC.

Second, under Proposed Regulations Section 1.163(j)-7(c)(3), if an upper tier CFC directly owns a lower tier CFC, the CFC ETI of the higher tier CFC is increased by the CFC ETI of the lower tier CFC. The top tier of a chain of CFCs is referred to herein as a "parent CFC".

Third, the United States shareholder's Section 951A inclusion is allocated to each CFC under the rules of Section 951A(f)(2) (pro rata based on positive tested income of each CFC).

Fourth, under Proposed Regulations Section 1.163(j)-7(f)(14), for each parent CFC, a "specified ETI ratio" for the relevant chain of CFCs is determined. The numerator of the fraction is the sum of the Section 951A inclusions for all CFCs in the chain that have positive CFC ETI without regard to the rule for tiering up of CFC ETI. The denominator of the fraction is the taxable income of all such CFCs in the chain with positive CFC ETI.

Fifth, under Proposed Regulations Section 1.163(j)-7(d)(2)(ii), for each parent CFC, the "eligible CFC group ETI" is the CFC ETI of the parent CFC, taking into account the tiering up of lower tier CFC ETI, multiplied by the specified ETI ratio of the parent CFC.

Sixth, under Proposed Regulations Section 1.163(j)-7(d)(2)(i), the taxable income (and therefore ATI) of the United States shareholder is increased by the sum of the eligible CFC group CFC ETI of all the parent CFCs. However, the total inclusion is subject to a "cap" equal to the "CFC group inclusions". Under Proposed Regulations Section 1.163(j)-7(d)(2)(iii), the CFC group inclusions are the specified deemed inclusions under Section 951A that are initially subtracted from the shareholder's taxable income, "reduced by the portion of any specified Section 250 deduction .... that is allowable by reason of such specified deemed inclusions".

We have three technical concerns about this methodology. First, in one respect, it increases ATI of the United States shareholder by more than the increase in taxable income of such shareholder arising from the CFC ETI. This result seems unduly favorable to taxpayers.

To illustrate, assume the United States shareholder owns 100 percent of a CFC, the shareholder has no ATI except for any inclusions from the CFC, and Section 250(a)(2) does not apply as a factual matter (Also assume a second CFC with no income items, as required to make the group election.) We believe the formula reaches the proper result when the CFC has no interest expense. For example, if the CFC has $1000 of taxable income and ATI, then the Section 951A inclusion is $1000, the CFC ETI is $1000, the specified ETI ratio is 100%, the eligible CFC group ETI is $1000, and the ATI of the United States shareholder is increased by $500, i.e., the lesser of $1000 (eligible CFC group ETI) and $500 (the CFC group inclusion reflecting the Section 250 deduction). The $500 increase in ATI reflects the actual increase in taxable income of the United States shareholder as a result of the GILTI inclusion.

Likewise, we believe the formula reaches the proper result when the CFC has taxable income that is fully utilized to allow an interest deduction under Section 163(j). In the above example, suppose the CFC has $1000 of taxable income before interest expense, and $300 of interest expense. Then, the CFC ETI is $0 and the eligible CFC group ETI is $0, and so there is no increase in the United States shareholder's taxable income. Since the CFC's ATI has been fully utilized at the CFC level, it is logical that the shareholder should not have an increase in its ATI.

However, we believe that the formula does not work properly when the CFC has interest expense that utilizes some, but not all, of the ATI of the CFC. The reason is that the "cap" on the increase in shareholder ATI is 50 percent of the Section 951A inclusion. The CFC ETI is the income of the CFC that has not been utilized by the CFC for Section 163(j) purposes. Even if the full amount of that income is included in taxable income of the United States shareholder, the Section 250 deduction will result in an increase in taxable income of the United States shareholder equal to 50 percent of such CFC ETI. It is not logical for the ATI attributable to such CFC ETI to increase by more than this amount.

For example, suppose that the United States shareholder has no taxable income or ATI except that it owns a CFC with $2,000 of tested income (pre-interest expense) and $300 of interest expense. The CFC ETI is $1000. The specified ETI ratio is 100%, since the Section 951A inclusion and taxable income of the CFC are both $1700. Thus, the eligible CFC group ETI is $1000. Then, the ATI of the United States shareholder increases by the lesser of $1000 (eligible CFC group ETI) and $850 (the Section 951A inclusion of $1700 reduced by the Section 250 deduction of $850), or $850. However, the $1000 of eligible CFC group ETI results in a Section 951A inclusion of $1000 and an increased Section 250 deduction of $500, for a net increase in taxable income of the shareholder of $500. It would appear that the ATI of the United States shareholder should only increase by $500, not $850. (Likewise, in the previous example, when the CFC had only $1000 of pre-interest tested income and $300 of interest expense, there was no ETI and no increase in ATI of the shareholder. The only difference here is an additional $1000 of tested income of the CFC.) The increase of $500 rather than $850 in ATI would be achieved if the "cap" was 50% of the eligible CFC group ETI rather than 50% of the Section 951A inclusion.

Second, in a different situation, we believe the formula in the Proposed Regulations in some cases provides insufficient ATI to the United States shareholder. For a chain of CFCs where an upper-tier CFC has a loss the formula does not properly take account of the positive CFC ETI of a CFC that is a subsidiary of the loss CFC. The effect is to unfairly restrict the use of all CFC ETI from all chains of CFCs, not just the chain with the loss member.

To take an extreme case, suppose that the United States shareholder owns CFC1 with a loss of $900, CFC1 owns CFC2 with income of $900, and the United States shareholder also owns CFC3 with income of $100. Assume no interest expense at the CFC levels so the prior issue does not arise. The total Section 951A inclusion to the shareholder is $100, and under Section 951A(f)(2), $90 of the inclusion is allocated to CFC2 and $10 of the inclusion is allocated to CFC3. CFC1 has no CFC ETI, with or without the tiering up from CFC2. As a result, the eligible group ETI of CFC1 is $0, resulting in no tiering up of CFC ETI from CFC2 to the shareholder.

This result standing alone seems reasonable, since CFC1 and CFC2 together have no net positive ETI so there is nothing to tier up to the shareholder. However, the formula also in effect "takes away" CFC ETI from CFC3, creating a double penalty to the shareholder from the loss in CFC1. CFC3 has CFC ETI of $100. However, the specified ETI ratio of CFC3 is $10 (the Section 951A inclusion from CFC3) divided by $100 (taxable income of CFC3), or 10 percent. As a result, the eligible CFC group ETI of CFC3 is the CFC ETI of $100 multiplied by 10 percent, resulting in a total ATI increase to the shareholder of only $10. The loss in CFC1 has not only reduced the ETI arising in the CFC1 chain, but also reduced the specified ETI ratio of CFC3 (which would be 100% in the absence of the loss) and therefore the ATI arising from the CFC3 chain.

This result appears to be unfair. The benefit to the United States shareholder from the CFC ETI in CFC2 is reduced on account of the loss in CFC1, but the allocation of GILTI inclusion to CFC2 is based on the unreduced tested income of CFC2. Likewise, the specified ETI ratio of CFC1 does not take account of this dilution of the benefit of the CFC ETI in CFC2, and the specified ETI ratio of CFC3 is nevertheless reduced on account of the loss in CFC1.

This result is also arbitrary, since it would not arise if CFC2 was directly owned by the United States shareholder. In that case, CFC2 would be a CFC parent with CFC ETI and eligible CFC group ECI of $900, its specified ETI ratio would be 10%, and its eligible CFC group ETI would be $90. The eligible CFC group ETI of CFC3 would remain $10, for a total ATI inclusion to the United States shareholder of $100 subject to the cap of $50. This is the economically correct answer in light of the overall net tested income of the CFCs of $100.

The result under the Proposed Regulations therefore encourages tax planning and is a trap for the unwary. We believe that the Proposed Regulations should be changed to avoid this result. One possible way might be that solely for purposes of calculating the specified ETI ratio for a parent CFC, GILTI inclusions should be allocated not under the usual statutory formula, but rather on the basis of net ETI or net tested income of each chain of CFCs.

Third, we have considered the "cap" in Proposed Regulations Section 1.163(j)-7(d)(2)(iii) under which the increase in shareholder ATI is limited to the specified deemed inclusion subtracted from taxable income under Proposed Regulations Section 1.163-7(d)(1)(i), minus the portion of any specified Section 250 deduction described in Proposed Regulations Section 1.163(j)-7(d)(1)(i) that is allowable by reason of such specified deemed inclusion. The question is whether "allowable" for this purpose takes account of Section 250(a)(2). While the Section 250 deduction described in Proposed Regulations Section 1.163(j)-7(d)(1)(i) is expressly determined without regard to Section 250(a)(2), it is not clear whether the reference here to the "allowable" portion of the deduction means that the deduction is also determined without regard to Section 250(a)(2).

Return to the case above where the United States shareholder has an unrelated operating loss (and negative ATI) of $30 and owns a CFC with tested income and CFC ETI of $100. The Section 951A inclusion is $100, the Section 250(a)(1) deduction is $50, and Section 250(a)(2) limits the deduction to $35. The taxable income of the shareholder for regular tax purposes is $100 (Section 951A inclusion) minus $35 (Section 250 deduction) minus $30 (operating loss), or $35. Absent a CFC group election, ATI of the United States shareholder is negative $30.

The Section 951A inclusion and eligible CFC group ETI are $100, and so, absent the cap, the shareholder ATI increases by $100. Under the cap, if the reference to the "allowable" portion of the Section 250 deduction disregards Section 250(a)(2), the ATI increase would be limited to $100 (the Section 951A inclusion) minus $50 (the Section 250(a)(1) deduction), or $50, resulting in positive United States shareholder ATI of $20. We believe this result would be unfair, since in fact the Section 250 deduction would be limited to $35 because of the operating loss of $30. As a result, the $100 of tested income of the CFC is in fact contributing $65, not $50, to the taxable income of the shareholder, increasing it from a loss of $30 to income of $35. We therefore believe that Proposed Regulations Section 1.163(j)-7(d)(2)(iii) should take into account Section 250(a)(2) in this situation, so that the increase in United States shareholder ATI is $100 minus $35, or $65 (resulting in United States shareholder ATI of $35), rather than $100 minus $50, or $50 (resulting in United States shareholder ATI of $20).

However, after the addback of ATI to the United States shareholder, the shareholder has positive ATI, and can use interest expense that was otherwise limited by Section 163(j). In the example, under our approach, if the United States shareholder has ATI of $35 and could use some interest deductions, those deductions would apparently be taken into account in determining the Section 250(a)(2) limit of the shareholder. This would create a circularity if the Proposed Regulations Section 1.163(j)-7(d)(2)(iii) reference to the "allowable" portion of the Section 250 deduction took this adjustment to the deduction into account. The Proposed Regulations Section 1.163(j)-7(d)(2)(iii) amount would depend upon the Section 250(a)(2) limit, but the Section 250(a)(2) limit would depend upon the allowable interest deductions that would in turn depend upon the increase in ATI under Proposed Regulations Section 1.163(j)-7(d)(2)(iii).

We believe that the best resolution of this issue is for Proposed Regulations Section 1.163(j)-7(d)(2)(iii) to take account of Section 250(a)(2) to the extent the limit arises because of losses of the United States shareholder without regard to any CFC items. This appears to be the best interpretation of the current language of the Proposed Regulations. However, Proposed Regulations Section 1.163(j)-7(d)(2)(iii) should not take account of any further adjustments arising under Section 250(a)(2) arising because of interest deductions allowed to the shareholder on account of increases in ATI under Proposed Regulations Section 1.163(j)-7(d)(2) arising from CFCs of the shareholder. We believe this is the best way to achieve results that are fair to taxpayers without creating circularity in the formula for Section 250 adjustments. In any event, Proposed Regulations Section 1.163(j)-7(d)(2)(iii) should be clarified to state the extent, if any, to which Section 250(a)(2) is to be taken into account in determining the allowable Section 250 deduction.

5. Termination of CFC Group Election.

We have already noted the effective optionality of the CFC group election when a CFC has ECI or does not join in the group election inadvertently. The Proposed Regulations do not address what happens if a CFC group makes the election but it is ultimately determined that one or more of the CFC group members were ineligible to make the election. The final Section 163(j) regulations should provide guidance to United States shareholders regarding the Section 163(j) consequences under these circumstances.

6. CFC Group Calculation of ATI.

Proposed Regulations Section 1.163(j)-7(c) adopts a tier approach for determining the calculation of ATI, and by extension the Section 163(j) limitation, of a CFC group member.[113] The Proposed Regulations allow an upper-tier CFC group member to take a lower-tier member's ETI into account in determining the upper-tier CFC group member's ATI. ETI can only be taken into account to the extent of the upper-tier CFC's ownership percentage. Thus, the rule allows for upward adjustments to ATI, but does not provide for similar sideways or downward adjustments where a CFC in the same tier or a higher tier has ETI. This is illustrated by Example 2 of Proposed Regulations Section 1.163(j)-7(g) in which the results of CFCs at the same tier are not

[113] Proposed Regulations Section 1.163(j)-7(c).

aggregated.[114] We believe it is sensible to allow sideways and downward adjustments to ATI (i.e., an adjustment to ATI of a CFC group member on account of ETI of a sister CFC or a higher-tier CFC) so that ETI may be used to support a Section 163(j) deduction throughout the CFC group.

The CFC group concept seems to be based on the consolidated group concept. It is not clear why the results of all CFCs should not be aggregated. We recommend that the final Section 163(j) regulations provide that rules similar to the consolidated group provisions set forth in Proposed Regulations Section 1.163(j)-4(d) apply to the CFC group members making a CFC group election.

7. Additional Considerations.

The Preamble indicates that a CFC determines its Section 163(j) limitations prior to determining its income inclusions or ECI. This suggests that the Section 163(j) limitation is calculated on the basis of all of a CFC's income (except possibly ECI) before such expense is allocated to either Subpart F income or tested income. That approach of computing the Section 163(j) limitation on an overall basis has some appeal because all of the CFC's assets generally support the payment of interest and principal on the debt. On the other hand one could argue for a separate calculation with respect to each relevant category of income consistent with the general approach of allocating expenses first between Subpart F and GILTI and then with respect to Subpart F income, among the categories of such income. Nevertheless, under this latter approach, if there were, for example, 100 of GILTI and a 100 Subpart F loss (in each case, before interest expense), the Section 163(j) limitation for interest expense allocated to GILTI would be 30, which might appear overly generous in light of the aggregate zero income or loss when GILTI and Subpart F are considered together.

Another complexity relates to E&P. Proposed Regulations Section 1.163(j)-7(e) provides "… §1.163(j)-2 will not affect whether and when business interest expense reduces the corporation's earnings and profits." One could debate whether a disallowed interest deduction should immediately reduce E&P or whether the reduction should be deferred until the interest deduction is permanently disallowed. Historically, Subpart F inclusions have been limited by E&P on the theory that Subpart F was designed to tax currently amounts that could be distributed. At the same time, some deductions that are deferred, such as under Sections 163(e) and 267, do not reduce E&P until the amounts are deductible (e.g., in the case of accrued interest with respect to related party debt E&P is reduced when the interest is paid in cash). E&P is reduced by expenses that are not deductible or allowable.[115] In the case of Subpart F, reducing E&P in the case of a cash interest expense would be consistent with the purpose of the E&P limitation on Subpart F inclusions. This result may be less clear when the interest is accrued such as OID. In addition, to the extent the disallowed interest expense currently reduces E&P, what should be the result if a CFC were subsequently able to utilize a carryover of disallowed business interest expense? Should a carryover be allowed if E&P is reduced? Should a carryover be used against any recharacterized income under Section 952(c)(2)? This problem may be more complicated when CFCs have a mix

[114] Proposed Regulations Section 1.163(j)-7(g).

[115] See, for example, Revenue Ruling 71-165, 1971-1 C.B. 111; Revenue Ruling 77-442, 1977-2 C.B. 264.

of income (GILTI, Subpart F, ECI) and the Section 163(j) limitation is determined on an overall basis.

E. Comments on Proposed Regulations Section 1.163(j)-9 – Elections for excepted trades or businesses; safe harbor for certain REITs.

1. Electing and Terminating Excepted Trade or Business Status.

Proposed Regulations Section 1.163(j)-9 provides rules for making an electing real property and electing farming trade or business election. Elections under this section are irrevocable and are generally made on a business by business basis.

An electing trade or business terminates if the taxpayer ceases to engage in the electing trade or business. The Proposed Regulations state, "A taxpayer is considered to cease to engage in an electing trade or business if the taxpayer sells or transfers substantially all of the assets of the electing trade or business to an acquirer that is not a related party in a taxable asset transfer. A taxpayer is also considered to cease to engage in an electing trade or business if the taxpayer terminates its existence for Federal income tax purposes or ceases operation of the electing trade or business, except to the extent that such termination or cessation results in the sale or transfer of substantially all of the assets of the electing trade or business to an acquirer that is a related party, or in a transaction that is not a taxable asset transfer."[116] However, the Proposed Regulations do not define "substantially all". Final Section 163(j) regulations should define "substantially all". The Section 368 concept of "substantially all" may serve as a useful model.

Examples 4 and 5 of Proposed Regulations Section 1.163(j)-9(f) generally provide that, if a taxpayer operating an electing trade or business transfers the trade or business in a norecognition transaction and the acquiror "continues to operate" the acquired business, the acquiror is subject to the target's prior election and the election cannot be revoked. It is not clear how this principle would be applied in the case of an acquiror operating a particular type of business that acquires the assets of a target operating the same type of business in a nonrecognition transaction. That is, can such an acquiror cease to operate the acquired business for purposes of Proposed Regulations Section 1.163-9 (e.g., by ensuring the target ceases to exist for U.S. federal income tax purposes, or by not using the target's branding) so as to eliminate the target's prior election, or does the fact that the acquiror continues to use the assets in the same type of business cause the acquired business to continue to exist for purposes of Proposed Regulation 1.163-9? Example 5 could be read to suggest that such an acquiror cannot eliminate the election, and must track this sub-business indefinitely, which seems like an inappropriate result.

2. Safe Harbor for Real Estate Investment Trusts.

The Proposed Regulations provide special rules for REITs that elect to be treated as electing real property trades or businesses, and thus as excepted trades or businesses.[117] Under these rules, if a REIT elects to be treated as an electing real property trade or business, but significantly invests in real property financing assets (within the meaning of Proposed Regulations

[116] Proposed Regulations Section 1.163(j)-9(d).

[117] See Proposed Regulations Section 1.163(j)-9(g).

Section 1.163(j)-9(g)(3)), then the REIT must allocate its interest expense, interest income, and other items of expense and gross income to its excepted and non-excepted trades or businesses under the rules set forth in Proposed Regulations Section 1.163(j)-10, as modified by Proposed Regulations Section 1.163(j)-9(g)(4).[118] Proposed Regulations Section 1.163(j)-9(g)(4) in turn provides that assets held by the REIT that meet the definition of real property under Treasury Regulations Section 1.856-10 are treated as assets of an excepted trade or business. Treasury Regulations Section 1.856-10 defines real property to mean land and improvements to land, including inherently permanent structures and their structural components ("**1.856-10 Real Property**"). Under the proposed safe harbor, an electing REIT that holds 1.856-10 Real Property and does not hold significant real property financing assets, may elect to treat all of its assets as assets of an excepted trade or business. Under the Proposed Regulations, a REIT is considered to hold significant real property financing assets if the value of those assets at the close of the taxable year is more than 10 percent of the value of the REIT's assets, and it is not considered to hold significant real property financing assets if the value of those assets is 10 percent or less of the total value of the REIT's assets.

For these purposes, the Proposed Regulations look through certain interests held by a REIT in partnerships and other REITs. Under these rules, a REIT may generally apply the partnership look-through rule to its stock in another REIT and treat such stock as allocable to an excepted trade or business to the extent that the underlying REIT's assets are allocable to excepted trades or businesses. However, if the upper-tier REIT does not obtain information about the lower-tier REIT's real property financing assets, the upper-tier REIT must treat its stock in the lower-tier REIT as entirely allocable to a non-excepted trade or business.[119]

The safe harbor in Proposed Regulations Section 1.163(j)-9(g) applies to REITs, but not to partnerships even if the REIT owns the majority of the partnership. These structures are common in the lodging industry and in New York City where they are preferred due to considerations surrounding the New York City unincorporated business tax. Because the partnership is required to allocate between its excepted real property activities and its non-excepted other activities without the benefit of any safe harbor, the REIT is effectively denied the benefit of the safe harbor. In such a situation, we believe that Treasury and the IRS should consider adopting a rule to the effect that the REIT tests its eligibility for the safe harbor by treating the REIT as the owner of the REIT's share of the partnership's assets. In that event, the partnership would determine its Section 163(j) limitation without taking into account the REIT's share of income or loss. Further, this approach for testing eligibility for the safe harbor should only apply to situations in which the partnership essentially functions as the REIT and thus we would suggest that it apply only where the REIT owns more than 50 percent of the profits and capital of the partnership.

The Proposed Regulations generally permit an upper-tier REIT, for purposes of measuring the amount of its real property financing assets, to treat shares of a lower-tier REIT that it owns as assets other than real property financing assets if the lower-tier REIT qualifies under Proposed Regulations Section 1.163(j)-9(g)(2) (by holding less than 10 percent of its asset value in real property financing assets). It does not seem clear when and how an upper-tier REIT can determine

[118] Proposed Regulations Section 1.163(j)-9(g)(3).

[119] Proposed Regulations Section 1.163(j)-9(g)(4)(iii).

that a lower-tier REIT so qualifies. It would be helpful if final Section 163(j) regulations provided an example to clarify this point or specified that the upper-tier REIT can make this determination based on all of the facts available to it. It may also be appropriate to consider whether an upper-tier REIT that concludes in good faith that a lower-tier REIT qualifies under Proposed Regulations Section 1.163(j)-9(g)(2) but is incorrect should nevertheless be permitted to treat all of the value of the lower REIT's shares as assets other than real property financing assets.

3. Clarification of the Modified Partnership Look-Through Rule.

We recommend that the final Section 163(j) regulations clarify that the modified partnership look-through rule in Proposed Regulations Section 1.163(j)-9(g)(4)(ii) and the REIT look-through rule in Proposed Regulations Section 1.163(j)-9(g)(4)(iii) apply to tiered partnership arrangements held by a REIT.[120]

Proposed Regulations Section 1.163(j)-9(g)(4)(ii) states that if a REIT holds an interest in a partnership, then in applying the partnership look-through rule,[121] the REIT treats any 1.856-10 Real Property held by the partnership as assets of an excepted trade or business (the "**Modified Partnership Look-Through Rule**").[122] Clause (g)(4)(iii) generally provides that if a REIT holds an interest in another REIT, then the shareholder REIT must apply the partnership look-through rule to the assets of the lower-tier REIT in determining the extent to which the shareholder REIT's adjusted basis in the shares of the lower-tier REIT is allocable to an excepted or non-excepted trade or business of the shareholder REIT (the "**REIT Look-Through Rule**").

As presently drafted, clause (g)(4)(ii) does not address a situation where a REIT owns an interest in a partnership that in turn owns an interest in another partnership. In the absence of any guidance addressing this situation, a REIT would have to apply the partnership look-through rule to a lower-tier partnership interest held indirectly through an upper-tier partnership without the benefit of the Modified Partnership Look-Through Rule treating Treasury Regulation Section 1.856-10 Real Property held by the lower-tier partnership as a per se excepted trade or business asset. We believe that the final Section 163(j) regulations should provide that, when a REIT applies the Modified Partnership Look-Through Rule to its interest in an upper-tier partnership, the REIT also applies the Modified Partnership Look-Through Rule to any interest in a lower-tier partnership held directly or indirectly by the upper-tier partnership (and therefore treats any 1.856-10 Real Property held by any such lower-tier partnership as an excepted trade or business asset).

Clause (g)(4)(ii) also does not address a situation where a REIT owns an interest in a partnership that in turn owns an interest in another REIT. As a result, the upper-tier REIT would

[120] The recommended treatment is consistent with Treasury Regulation 1.856-3(g) which applies a look-through rule when determining the percentage of "real estate assets" held by a REIT. Since the proposed Section 163(j) regulations already import the definition of real property from Treasury Regulations Section 1.856-10 of the REIT rules, it is reasonable that the look-through rule in Treasury Regulations Section 1.856-3(g) should similarly apply.

[121] See Proposed Regulations Section 1.163(j)-10(c)(5)(ii)(A)(2).

[122] Clause (g)(4)(ii) further clarifies that the REIT's application of the real property definition under Treasury Regulations Section 1.856-10 "does not affect the characterization of the partnership's assets at the partnership level or for any non-REIT partner."

be unable to apply the REIT Look-Through Rule to the stock that it indirectly holds in the lower-tier REIT. Therefore, the upper-tier REIT would not be able to look through the stock of such lower-tier REIT to the assets held by such lower-tier REIT and would have to treat the lower-tier REIT stock as a non-excepted trade or business asset unless the upper-tier REIT indirectly held stock possessing at least 80 percent of the total voting power and total value of the stock of such lower-tier REIT.[123] We believe that the REIT Look-Through Rule should apply regardless of whether a REIT holds stock in another REIT directly or indirectly through a partnership. Thus, we recommend that the final Section 163(j) regulations provide that, when a REIT applies the Modified Partnership Look-Through Rule to its interest in a partnership, the REIT applies the REIT Look-Through Rule to any stock of another REIT held by such partnership.

4. Anti-abuse rule for Certain Real Property Trades or Businesses.

Proposed Regulations Section 1.163(j)-9(h) contains an anti-abuse rule applicable to real property trades or businesses. The anti-abuse rule provides, in general, that a real property trade or business does not constitute a trade or business eligible to be an electing real property trade or business if at least 80 percent, determined by fair market value, of the business's real property is leased, whether or not the arrangement is pursuant to a written lease or pursuant to a service contract or another agreement that is not denominated as a lease, to a trade or business under common control with the real property trade or business. For this purpose, two trades or businesses are under common control if 50 percent of the direct and indirect ownership of both businesses are held by related parties within the meaning of Sections 267(b) and 707(b).

This rule seems to be intended to prevent taxpayers from using "crack and pack" structures to manufacture a real property trade or business eligible to elect out of Section 163(j). We share this concern. However, the Proposed Regulations do not seem to distinguish between those structures which are manufactured and those which are typical "lease sublease" structures where the operating company is in a qualified real property trade or business (and does not fit within the narrow safe harbor for REITs). For example, if taxpayer, Propco leases a building to a related person, Opco, who operates a real property business within the building, whether Propco is looked at on a standalone basis or on a combined basis with Opco, it may still be in a real property trade or business. However the special anti-abuse rule seems to disregard that possibility. In the example Propco leases 100 percent of its assets to an operating company under common control. Accordingly, we recommend that the final Section 163(j) regulations provide an exception to the anti-abuse rule if the Opco and Propco, on a combined basis, meet the requirements of an "eligible" real property trade or business.

F. Comments on Proposed Regulations Section 1.163(j)-10 – Allocation of interest expense, interest income, and other items of expense and gross income to an excepted trade or business.

Proposed Regulations Section 1.163(j)-10 provides rules to allocate interest expense, interest income and other tax items between excepted and non-excepted trades or businesses of a taxpayer. The taxpayer must first determine whether such items are allocable to a trade or business before applying the allocation rules of Proposed Regulations Section 1.163(j)-10; accordingly, for

[123] See Proposed Regulations Section 1.163(j)-10(c)(5)(ii)(B)(2) and (c)(5)(ii)(E).

example, an individual must first determine under Temporary Regulations Section 1.163-8T whether interest expense is investment interest subject to Section 163(d).[124] The rules then follow the principle that money is fungible and therefore provide that business interest expense (and interest income) are allocated ratably based on the relative amounts of the taxpayer's basis in assets used in excepted and non-excepted trades or businesses.[125] Basis is computed by averaging the amounts measured at the end of each quarter during the taxable year. "Trade or business" excludes purely internal functions, such as in-house legal services.[126]

For purposes of computing ATI, gross business income (other than interest, dividends and gain from the disposition of certain entities) is allocated to the trade or business that generated it,[127] and non-interest expenses are allocated to the trade or business to which they definitely relate (by reference to the principles of Treasury Regulations Section 1.861-8(b)(2)).[128] Expenses not definitely related to a trade or business are allocated according to asset basis.[129]

If an asset is used in both excepted and non-excepted trades or businesses, its adjusted basis is allocated in a manner that most reasonably reflects the asset's use under one of three permissible methodologies.[130] The permissible methodologies are based on (1) relative amounts of gross income generated and expected to be generated by the asset, (2) relative physical space used, in the case of land or an inherently permanent structure and (3) the relative units of output generated by the asset.[131] A utility business must use method (3).[132]

Consolidated groups are treated as a single entity for purposes of the allocation rules. Thus, intercompany stock and obligations are ignored for purposes of the basis computations, and income and deduction items arising from intercompany transactions (even if not deferred) are ignored.[133] Property of the group is not treated as used in a trade or business if that use derives from an intercompany transaction.[134] A single exempt percentage applies across all corporations in the consolidated group that pay interest to non-group members, without regard to whether each such member is engaged in excepted or non-excepted businesses.[135]

1. Look-Through Rule.

[124] Proposed Regulations Section 1.163(j)-10(a)(2)(i).

[125] Proposed Regulations Section 1.163(j)-10(a)(1)(i).

[126] *Id.*

[127] Proposed Regulations Section 1.163(j)-10(b)(2).

[128] Proposed Regulations Section 1.163(j)-10(b)(5).

[129] *Id.*

[130] Proposed Regulations Section 1.163(j)-10(c)(3)(i).

[131] Proposed Regulations Section 1.163(j)-10(c)(3)(ii)(A).

[132] Proposed Regulations Section 1.163(j)-10(c)(3)(ii)(C).

[133] Proposed Regulations Section 1.163(j)-10(a)(4)(i).

[134] *Id.*

[135] Proposed Regulations Section 1.163(j)-10(a)(4)(ii).

Generally, the taxpayer's basis in an entity (other than a consolidated group member) is treated as an asset of the taxpayer for purposes of the allocation of the taxpayer's interest income and expense. This basis must be categorized as an investment asset or a business asset that is allocable (in whole or part) to excepted or non-excepted trades or businesses. Proposed Regulations Section 1.163(j)-10(c)(5)(ii) provides a complex set of rules for determining when a partner or shareholder may or must look through the entity to its assets for purposes of making this determination. The rules apply to taxpayers that own interests in partnerships, S corporations, non-consolidated C corporations and CFCs.[136]

The look-through rule is mandatory for all of these entity types if the taxpayer owns at least 80 percent of the entity.[137] For partnerships and S corporations, a taxpayer may elect to look through the entity if the taxpayer owns less than 80 percent of the entity.[138] For C corporations and CFCs, the taxpayer may not look through the entity if the taxpayer owns less than 80 percent of the entity.[139]

In the case of a C corporation that owns an interest in another entity and looks through to the assets of the entity, those assets are allocated between excepted and non-excepted trades or businesses.[140] In the case of a C corporation that owns an interest in a partnership, this rule applies even if the assets are investment assets in the hands of the partnership. If the C corporation does not look through the other entity, then the C corporation's basis in the other entity is treated as a non-excepted business asset. Accordingly, failure or inability to look through the other entity is generally adverse to a C corporation taxpayer, and therefore the 80 percent ownership requirement in the case of interests in non-consolidated C corporations and CFCs seems unnecessarily punitive.

In the case of a non-C corporation taxpayer holding an interest in a partnership, the investment character of an asset flows through to the partner for purposes of the partner's own calculations. If a non-C corporation taxpayer holding an interest in a partnership or S corporation elects not to look through the entity, the taxpayer's basis in the entity will be treated as either an investment asset or a non-excepted business asset, based on Section 163(d) principles. If a non-C corporation taxpayer holding an interest in a C corporation or CFC cannot look through the entity, the taxpayer's basis in the entity will be treated as an investment asset and therefore be excluded from the allocation calculation.

We recommend that taxpayers (both C corporations and non-C corporation taxpayers) have greater flexibility to look through non-consolidated C corporations and CFCs. In particular, the CFC look-through rule set forth in Proposed Regulations Section 1.163(j)-10(c)(5)(ii) should permit taxpayers to elect look-through treatment if such taxpayer owns 50 percent or more of the CFC's stock. Section 954 supports this position as Section 954(c)(6) applies a look-through rule for purposes of determining foreign personal holding company income where one corporation

[136] Proposed Regulations Section 1.163(j)-10(c)(5)(ii)(A), (B), (C).

[137] In the case of S corporations, C corporations and CFCs, the test is based on 80 percent of vote or value, while in the case of partnerships the test is based on 80 percent of either capital or profits.

[138] Proposed Regulations Section 1.163(j)-10(c)(5)(ii)(A).

[139] Proposed Regulations Section 1.163(j)-10(c)(5)(ii)(B).

[140] *Id.*

holds more than 50 percent of the total voting power of all classes of stock entitled to vote or 50 percent of the value of another corporation.[141]

The application of the look-through rules in the Proposed Regulations seems likely to produce distortive results where Section 163(j) might also apply at the lower-tier level. For example, imagine a corporate taxpayer whose assets and income are split 50-50 between excepted and non-excepted trades or businesses and therefore has a 50 percent exempt percentage applied to its interest expense. If the taxpayer instead holds the excepted business and issues half of the external debt through a wholly-owned non-consolidated C corporation, the interest expense at the lower-tier corporation would be fully deductible because it is entirely allocable to an excepted trade or business. However, the taxpayer (the upper-tier corporation) would also be able to allocate a portion of its own interest expense to an excepted trade or business by virtue of the fact that its basis in the lower-tier corporation is treated as an excepted business asset. The opposite effect would result if, instead, the non-excepted business is held at the lower-tier corporation and the excepted business is held at the upper-tier corporation.

Other potentially distortive effects can result from the look-through rules in the Proposed Regulations, including for an individual that has a direct trade or business and also has a separate investment in a C corporation that has its own trade or business. For such an individual, interest expense attributable to the C corporation investment under Temporary Regulations Section 1.163-8T retains its character as investment interest expense. But if the taxpayer also has other business interest expense, the allocation of that business interest expense would appear also to take into account the C corporation's assets on a look-through basis. In effect, the taxpayer's shares in the C corporation may be double-counted, in that they affect the character of both the directly attributable investment interest expense and the unrelated business interest expense, albeit in different ways.

An additional problem arising from the operation of the look-through rules relates to the Proposed Regulations' failure to coordinate the special asset basis adjustments mandated by the Proposed Regulations with a taxpayer's outside basis in a partnership interest. The Proposed Regulations calculate basis for depreciable property (other than inherently permanent structures) based on the alternative depreciation system under Section 168(g) before the application of the additional first-year depreciation deduction (for example, under Section 168(k) or (m)). Presumably, this rule is intended to avoid the distortion that would arise if a taxpayer's debt is used to fund a valuable asset that is treated for tax purposes as having a zero basis by reason of immediate expensing. However, if the asset is held through a partnership, the taxpayer's outside basis in the partnership is not adjusted in a comparable way, with the result that the immediate expensing reduces the taxpayer's basis in its partnership interest and therefore results in the distortion that the special adjustment rule would have avoided had the asset been held directly.

The Proposed Regulations also require a taxpayer that looks through to the assets of a corporation to treat dividend income received from such corporation as allocable to excepted or non-excepted trades or businesses based on the relative amounts of the corporation's adjusted basis

[141] Section 954(c)(6) and (d)(3).

in the assets used in its trades or businesses.[142] This rule adopts the same Section 1504(a)(2) 80 percent test as is used under Proposed Regulations Section 1.163(j)-10(c)(7)(i)(A) in allocating a taxpayer's basis between excepted and non-excepted trades or businesses. Symmetry and simplicity point in favor of using the same standard for both purposes. Therefore, we believe that the 50 percent rule outlined above by reference to Section 954(c)(6) should similarly be applied in the context of allocating dividend income between excepted and non-excepted trades or businesses.

2. Cash and Cash Equivalents.

The Proposed Regulations exclude cash and cash equivalents from a taxpayer's allocation of adjusted basis among excepted and non-excepted trades or businesses, except for financial services entities.[143] This rule also applies to lower-tier entities under the look-through rules outlined above. The Proposed Regulations state that cash and cash equivalents include "cash, foreign currency, commercial paper, any interest in an investment company registered under the Investment Company Act of 1940 (1940 Act) and regulated as a money market fund under 17 CFR 270.2a-7 (Rule 2a-7 under the 1940 Act), any obligation of a government, and any derivative that is substantially secured by an obligation of a government, or any similar asset."[144]

We recommend that working capital, however funded, be included in the basis allocation determination. We further recommend that collateral that secures derivatives that hedge business assets and liabilities within the meaning of Treasury Regulations Section 1.1221-2 be included in the adjusted basis allocation determination.

3. Anti-Abuse Rule.

Proposed Regulations Section 1.163(j)-10(c)(8) contains an anti-abuse rule intended to prevent manipulation of the allocation of interest income and expense between excepted and non-excepted trades or businesses. If a principal purpose of an acquisition, disposition or change in use of an asset is to "artificially shift" the basis allocable to an asset prior to a determination date the change will be disregarded.[145] The Proposed Regulations further clarify that a principal purpose may exist along with other purposes – indeed, it may be outweighed by other purposes, taken together or separately – and that there is a presumption of an invalid purpose when the acquisition, disposition or change (1) has no substantial business purpose and (2) increases the taxpayer's basis in assets used in its excepted trades or businesses by more than 10 percent during the taxable year.

We support the anti-abuse rule, but note that a principal purpose standard is difficult to apply in practice. An argument could be made that the Treasury and the IRS should eliminate the

[142] Proposed Regulations Section 1.163(j)-10(c)(7)(i)(B).

[143] Proposed Regulations Section 1.163(j)-10(d)(2).

[144] Proposed Regulations Section 1.163(j)-10(c)(5)(iii).

[145] Proposed Regulations Section 1.163(j)-10(c)(8).

principal purpose element of the anti-abuse rule and rely instead on a rule based on asset acquisitions, dispositions or changes in use that do not have a substantial business purpose.

4. Direct Allocations.

The Proposed Regulations generally require a taxpayer to allocate interest expense arising from Temporary Regulations Section 1.861-10T(b) qualified nonrecourse indebtedness in the manner and to the extent provided in Temporary Regulations Section 1.861-10T(b). Additionally, a taxpayer engaged in the trade or business of banking, within the meaning of section 581, insurance, financing, or a similar business that derives active financing income as described in Treasury Regulations Section1.904-4(e)(2) must make direct allocations of interest expense and interest income from that business to assets used in the business.

We appreciate the Proposed Regulations adopt, in principle, our earlier recommendation to require a taxpayer to allocate interest expense from qualified nonrecourse indebtedness to the taxpayer's assets as provided in Temporary Regulations Section 1.861-10T(b). However, the Proposed Regulations require the taxpayer to reduce the adjusted basis in its assets, for purposes of allocating other interest, by the entire basis allocable to the asset financed with the qualified nonrecourse indebtedness. Under the Proposed Regulations' general principle that money is fungible, we believe that taxpayers should be allowed to include the portion of the adjusted basis that is funded by equity, rather than nonrecourse indebtedness, in the allocation calculation for the taxpayer's other interest.

5. Financial Services Entities.

We request additional clarity regarding the scope and effect of the direct allocation rule for financial services entities. The Proposed Regulations require direct allocations of interest expense and interest income for a taxpayer that is engaged in the trade or business of banking, insurance, financing, or a similar business that derives active financing income to assets used in that business.

As in the case of qualified nonrecourse indebtedness, the Proposed Regulations appear to require the basis of financial services business assets to which interest is directly allocated to be reduced for purposes of allocations with respect to interest on other debt. However, unlike the case of qualified nonrecourse indebtedness, it is likely not possible to trace all financial services business-related interest expense to specific assets. As a result, it is unclear whether the full basis of all the assets in the financial services business is intended to be eliminated for purposes of allocating other interest expense, or only some portion thereof. The former approach seems potentially distortive, in that the taxpayer's general debt obligations (i.e., the taxpayer's obligations as to which interest is not directly allocated to the financial services business) are most likely economically carrying at least some portion of the taxpayer's financial services business assets.

The financial services entity rule may apply to taxpayers that are not doing much actual financing, since the definition in Treasury Regulations Section 1.904-4(e)(2) includes income from certain services, such as investment advisory services.[146] The need for a direct allocation rule for such an entity is not readily apparent.

We recommend the Treasury and IRS provide that if a sufficiently large percentage of a taxpayer's interest expense is attributable to a banking, insurance, financing or similar business that derives active finance income as described in Treasury Regulations Section 1.904-4(e)(2), then all of its interest income and expense would be allocated directly to such banking, insurance or active finance business. The final Section 163(j) regulations might use the Treasury Regulations Section 1.904-4(e)(3) definition of financial services entity. Under this definition a financial services entity is one which predominantly engages in an active financing business. The Treasury Regulations further clarify that "an individual or entity is predominantly engaged in the active financing business for any year if for that year at least 80 percent of its gross income is income described in paragraph (e)(2)(i) of this section."[147] Using this definition offers symmetry with the Proposed Regulations' reference to Treasury Regulations Section 1.904-4(e)(3)(i) in defining financial services income.[148] Alternatively, the threshold could be set at 90 percent as is consistent with other Proposed Regulation provisions regarding exempted businesses.

Finally, it appears that Proposed Regulations Section 1.163(j)-10(d)(2) only applies if a financial services entity also owns excepted trades or businesses. The final Section 163(j) regulations should confirm this conclusion. In addition, consideration should be given to coordinating Proposed Regulations Section 1.163(j)-10(d)(2) with the CFC rules for financial services entities under Proposed Regulations Section 1.163(j)-7 which do not seem to require an excepted trade or business to apply.

6. Assets Used in More than One Trade or Business.

The Proposed Regulations contain three specific methodologies to allocate the basis of assets used in more than one trade or business: gross income generated or expected to be generated by the asset, use of physical space in the case of land or an inherently permanent structure, and units of output (where the units are consistent between the businesses). A taxpayer may not vary its allocation methodology within a taxable year or from one taxable year to the next without permission from the IRS. We recommend that the final Section 163(j) regulations clarify that this consistency requirement does not require a taxpayer to use a single methodology for different categories of assets, since, for example, a reasonable methodology for allocating the basis in an office building between businesses may not be reasonable for allocating the basis of an intangible.

If none of the three specific methodologies reasonably reflects the use of an asset in each of the taxpayer's trades or businesses, the asset is simply disregarded for purposes of the interest allocation calculation. This rule seems unnecessarily extreme, as it could have the effect of disregarding a significant asset and therefore artificially shifting the ratio between the taxpayer's excepted and non-excepted business assets.

[146] Treasury Regulations Section 1.904-4(e)(2)(i)(X).

[147] Treasury Regulations Section 1.904-4(e)(3)(i).

[148] Proposed Regulations Section 1.163(j)-10(d)(2).

G. Comments on Proposed Regulations Section 1.163(j)-11 Transition rules.

1. Disallowed Disqualified Interest Carryforwards.

We recommend that the final Section 163(j) regulations provide that disallowed disqualified interest that is attributable to excepted trades or businesses be carried forward to the taxpayer's first taxable year beginning after December 31, 2017. The Proposed Regulations use the term "disallowed disqualified interest" to refer to "interest expense, including carryforwards, for which a deduction was disallowed under Old Section 163(j) in the taxpayer's last taxable year beginning before January 1, 2018, and that was carried forward pursuant to Old Section 163(j)."[149]

For non-excepted businesses, the Proposed Regulations state that "any disallowed disqualified interest that is properly allocable to a non-excepted trade or business" is "carried forward to the taxpayer's first taxable year beginning after December 31, 2017, and is subject to disallowance as a disallowed business interest expense carryforward."[150] The Proposed Regulations reserve on the treatment of disallowed disqualified interest attributable to an excepted trade or business.[151]

Deductions for interest expense generated in taxable years beginning after December 31, 2017 that are allocable to an excepted trade or business are not subject to limitation under new Section 163(j). It would be incongruous with this framework for the final Section 163(j) regulations to provide that disallowed disqualified interest carryforwards that are allocable to an excepted trade or business are subject to limitation or are entirely disallowed simply because such carryforwards were generated in years prior to the effectiveness of new Section 163(j). We believe that allowing such disallowed disqualified interest to be carried forward to the taxpayer's first taxable year beginning after December 31, 2017 would align more with the spirit and intent of new Section 163(j).[152]

[149] Proposed Regulations Section 1.163(j)-1(b)(10).

[150] Proposed Regulations Section 1.163(j)-2(c)(1) and 1.163(j)-11(b)(1).

[151] Proposed Regulations Section 1.163(j)-10(a)(6).

[152] IRS Notice 2018-28 IRB 2018-16 (April 16, 2018).