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Report No. 1444
November 2, 2020

The Honorable David J. Kautter
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The Honorable Charles P. Rettig
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Re: *Report No. 1444 – Report on Final and Proposed Section 163(j) Regulations*

Dear Messrs. Kautter, Rettig, and Desmond:

I am pleased to submit our Report No. 1444 commenting on certain aspects of the recently issued final and proposed regulations under Section 163(j) of the Code.

We commend the Internal Revenue Serivce and the Department of the Treasury for their thoughtful guidance in the final and proposed regulations. Issues addressed in our report include the calculation of adjusted taxable income, the definition of interest, rules relating to partnerships, and the applicability of Section 163(j) to controlled foreign corporations and their United States shareholders.

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

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Report No. 1444

New York State Bar Association Tax Section

Report on Final and Proposed Section 163(j) Regulations

November 2, 2020

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

This report ("Report") of the New York State Bar Association Tax Section comments on certain aspects of both the final (the "Final Regulations")[1] and proposed regulations (the "Proposed Regulations")[2] issued by the Internal Revenue Service ("IRS") and the Department of Treasury ("Treasury") on September 14, 2020 to implement Section 163(j)[3] 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")[4].

This Report follows our prior reports, one dated March 28, 2018, which discussed certain significant issues arising from the Act's amendment to Section 163(j) and one dated February 26, 2019 (the "2019 Report"), which discusses the proposed regulations issued by Treasury and the IRS on November 26, 2018 (the "2018 Proposed Regulations"). In this Report, we comment on certain aspects of the Final Regulations and address the IRS' and Treasury's request for comments on the Proposed Regulations.

We commend Treasury and the IRS for their efforts in drafting the Final Regulations and adopting many of our prior comments. This Report asks Treasury and the IRS to clarify or reconsider several aspects of the Final Regulations. We also appreciate the IRS's and Treasury's efforts in drafting the Proposed Regulations. The Proposed Regulations provide much needed additional guidance to taxpayers. Nevertheless, this Report respectfully requests Treasury and the IRS to modify some of the aspects of the Proposed Regulations.

This Report is divided into three parts. Part I summarizes our recommendations regarding the Final and Proposed Regulations. Part II describes Section 163(j) as in effect before and after the Act. Part III summarizes relevant portions of the Final and Proposed Regulations, and provides a detailed discussion of our recommendations.

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[1] Limitation on Deduction for Business Interest Expense, TD 9905, 26 CFR 1, 85 Fed. Reg. 56686 (Sep. 14, 2020).

[2] Limitation on Deduction for Business Interest Expense, REG-107911-18, 85 Fed. Reg. 56848 (Sep. 14, 2020).

[3] Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended (the "Code") or to the regulations thereunder.

[4] The principal drafter of this report is John T. Lutz with assistance from Michael Shulman and Stuart Rosow. Helpful comments were received from William D. Alexander, Kimberly Blanchard, Andy Braiterman, Robert Cassanos, Phillip Gall, Shane Kiggen, Jeffrey W. Maddrey, Michael Schler, Marina Vishnepolskaya, Philip Wagman, and Gordon Warnke. Special thanks to Terence McAllister for his assistance with preparing the 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.

Part I. Summary of Recommendations.

(A) Adjusted Taxable Income.

(1) Negative Adjustment for Depreciation, Amortization and Depletion Deductions Taken During the EBITDA Period.

The negative adjustment to adjusted taxable income ("ATI") for depreciation, amortization, or depletion deductions ("Depreciation Deductions") taken after December 31, 2017 and before January 1, 2022 (the "EBITDA period") should be amended, including with respect to sales or other dispositions of member stock and partnership interests. As discussed below, we suggest two methods to better reflect the relationship between Depreciation Deductions taken during the EBITDA period and the value of the taxpayer's assets that were the subject of the Depreciation Deductions.

(2) Anti-Duplication Rule.

When the Proposed Regulations are finalized, we recommend that examples are added which describe how the anti-duplication rule functions when the taxpayer's negative ATI adjustment is based on gain recognized, rather than the Depreciation Deductions taken during the EBITDA period.

(3) Depreciation Deduction Modifications.

Guidance is needed regarding the negative ATI adjustment for certain Depreciation Deductions if the taxpayer did not treat capitalized depreciation, amortization and depletion as Depreciation Deductions for taxable years prior to the applicability of the Final Regulations.

Additionally, further guidance is needed on how a partnership can treat capitalized depreciation, amortization and depletion as Depreciation Deductions for prior taxable years if they are unable to amend their prior tax returns. We suggest partnerships should be permitted to amend their returns and that Treasury and the IRS adopt procedures similar to those outlined in Revenue Procedure 2020-23.

(4) Depreciation Deduction upon Deconsolidation.

We recommend correcting the cross references in Final Regulation Section 1.163(j)-1(b)(1)(iv)(D)(2) to ensure Depreciation Deductions are not ignored for purposes of applying the anti-duplication rules.

(5) Reverse Acquisitions.

The final regulations should affirmatively provide that transactions described in Treasury Regulation Section 1.1502-13(j)(5)(i)(B) (where the common parent is no longer in existence or reverse acquisitions) are not dispositions for purposes of Section 163(j).

(6) Negative ATI.

The provision denying negative ATI should be removed from the Final Regulations with respect to determining ATI of a controlled foreign corporation ("CFC") group.[5]

(B) The Definition of Interest.

(1) Bifurcation of Swaps with Significant Nonperiodic Payments.

We recommend that the Section 446 regulations define "significant" for purposes of the bifurcation of swaps with significant nonperiodic payments and provide examples of swaps with both significant and nonsignificant nonperiodic payments.

(2) The Anti-Avoidance Rule.

Treasury and the IRS should clarify the scope and meaning of the anti-avoidance rule. In particular it is unclear whether the principal purpose required to cause the anti-avoidance rule to apply is (i) a purpose to reduce the amount of the taxpayer's interest expense as an economic matter or (ii) a principal purpose to reduce the amount treated as interest expense for Section 163(j) purposes.

Treasury and the IRS should provide an example of a guaranteed payment which does not violate the anti-avoidance rule.

Treasury and the IRS should confirm the extent (if any) to which taxpayers can affirmatively rely on the anti-avoidance rule.

(C) Effect on Earnings and Profits.

The Final Regulations should be clarified to provide that a corporation reduces its earnings and profits to reflect a direct or indirect allocation of excess business interest expense ("EBIE") from a lower-tier partnership in which the corporation indirectly (through an upper-tier partnership) owns an interest.

(D) Responses to Requests for Comments in the Final Regulations.

(1) Intercompany Transfers of Partnership Interests.

We support the approach to intercompany transfers of partnership interests set forth in the Preamble to the Final Regulations and suggest that Treasury and the IRS adopt this approach in the next set of Section 163(j) guidance.

(2) Current Distributions of Money or Property by a Partnership in Consideration for Interest in the Partnership.

We believe that a current distribution by a partnership in consideration for a portion of a partner's interest generally should not result in an increase in the basis of the partner's interest in

[5] The terms CFC group, CFC group election and CFC group member are defined in Proposed Regulation Section 1.163(j)-7(k)(6)-(8).

the partnership. It may, however, be appropriate to allow a partner receiving a distribution in excess of basis that recognizes gain to increase its basis to the extent of excess business interest expense ("EBIE") previously allocated to such partner.

(3) Appropriate Methods for Determining the Amount of Deductible BIE and Disallowed BIE Carryforward of a Nonresident Alien, Foreign Corporation, or Partnership that is Properly Allocable to ECI.

A nonresident alien, foreign corporation, or partnership should allocate deductible BIE and disallowed BIE carryforwards to effectively connected income ("ECI") in a manner similar to the allocation of business income and expense between a CFC and ECI deemed corporation under Proposed Regulation Section 1.163(j)-7(f) by treating the relevant nonresident alien, foreign corporation, or partnership as a CFC with ECI for this purpose.

(E) Effective Date of the Final Regulations.

Further guidance should address application of these rules to related parties with different taxable years.

(F) Election to use 2019 ATI to Determine 2020 Section 163(j) Limitation.

Treasury and the IRS should provide further guidance regarding circumstances where the change to a taxpayer's 2019 ATI would not change a taxpayer's 2019 Section 163(j) limitation (i.e., 2019 Section 163(j) limitation without any adjustment exceeds 2019 BIE). Further guidance is needed on how to apply this rule to partnerships that cannot amend their 2019 returns.

(G) Proposed Regulations Concerning Passthrough Entities.

(1) Debt Financed Distributions and Debt Financed Acquisitions.

We recommend that partnerships that make debt financed distributions should be permitted to allocate excess interest among partnership assets based on fair market value rather than adjusted basis, and a similar rule for debt financed acquisitions. As explained in more detail below, we recommend that a fair market value allocation election be irrevocable absent consent from the IRS.

(2) Requirements for Taxpayers to Rely on the Passthrough Provisions of the Proposed Regulations.

Treasury and the IRS should confirm the extent to which taxpayers must apply other provisions of the regulations under Section 163(j) in order to be able to rely on the provisions of the Proposed Regulations dealing with passthrough entities to years beginning after December 31, 2017.

(3) Aggregating Activities.

A limited partner should be permitted to aggregate activities of multiple trading partnerships for Section 469 purposes.

(4) Self-Charged Lending Transactions.

We support the Proposed Regulations' treatment of self-charged lending transactions and recommend that the self-charged interest rule be expanded to include lenders in the same consolidated group as the partner and cases where the interest expense would ultimately flow up through passthrough entities to the same taxpayer that recognizes the interest income.

(5) Partnership Basis Adjustments.

We generally agree that when a partner receives distributions in liquidation of its partnership interest or sells its partnership interest, an increase in inside basis is appropriate. In the case of the transaction described in the Preamble, which involves a liquidating distribution to a partner, we agree that the remaining partners should have the benefit of the step-up in partnership asset basis. However, where a partner sells its interest to a third party, similar to a basis adjustment under Section 743, the benefit of the asset basis step-up should inure solely to the purchaser.

Contrary to the approach taken in the Proposed Regulations, we do not see a reason why depreciation or amortization deductions should be denied with respect to such an increase in basis of a depreciable or amortizable asset.

We believe special rules should be adopted for an inside basis increase that occurs in connection with a transfer of a partnership interest in a nontaxable transaction and offer alternative frameworks.

(H) Foreign Corporations and United States Shareholders.

(1) CFC Group Election.

We recommend that Treasury and the IRS consider an additional exception to the irrevocability of the CFC group election. This exception should apply where there is a change in control of the CFC group.

(2) Allocations to Excepted Trades or Businesses.

Treasury and the IRS should consider whether an allocation based on the approach that money is fungible and that interest expense is attributable to all activities and property, regardless of any specific purpose for incurring interest expense, makes sense in the context of excepted trades or businesses.

(3) GILTI High Tax Exception.

If a US shareholder of a CFC elects to exclude certain high tax GILTI income from a CFC's tested income, Treasury and the IRS should consider whether the related ATI and interest expense should be taken into account for purposes of applying Section 163(j) to the remaining income of the CFC or CFC group. Additionally, Treasury and the IRS should confirm that a CFC for which a high-tax exception applies can still have an EBIE carryforward from the current year.

(4) Allocations between a CFC and an ECI Deemed Corporation.

Where a CFC earns ECI, the Proposed Regulations are silent as to the method for allocating assets between the ECI deemed corporation and the remainder of the CFC. Final Regulation Section 1.163(j)-10 should be clarified to expressly apply to allocations between the CFC group member and the ECI deemed corporation.

(5) Overlap Rule.

The Proposed Regulations contain a limitation on the use of EBIE carryforwards within a CFC Group similar to the SRLY rules. While we generally support the intent of the limitation, Treasury and the IRS should adopt the overlap rule set forth in Treasury Regulation Section 1.1502-21(g) if Section 382 and SRLY principles apply to a CFC group.

(6) Accounting for Foreign Income Taxes in ATI.

We recommend that the Proposed Regulations be modified so that the ATI of a CFC is not reduced by foreign income taxes.

(7) Specified Deemed Inclusions.

The Final Regulations should treat specified deemed inclusions in a manner similar to dividends under Final Regulation Section 1.163(j)-10(b)(3). Thus, solely for purposes of allocating a specified deemed inclusion during the taxable year to excepted or non-excepted trades or businesses, the specified deemed inclusion should be treated as allocable to excepted or non-excepted trades or businesses based upon the relative amounts of the CFC group's adjusted basis in its assets used in the trades or businesses.

Part 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[6] to a related person[7] where such interest income was exempt (in whole or in part) from U.S. tax.[8] Old Section 163(j) did not apply unless the corporation's debt

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[6] 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 Regulation Section 1.163(j)-1(a)(1). References to "1991 Proposed Regulations" are to regulations proposed under old Section 163(j).

[7] 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).

[8] 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. Where the interest was exempt only in part (e.g. a reduced rate of withholding applied) only a portion of the interest was treated as exempt related party interest.

to equity ratio exceeded 1.5 to 1.[9] Assuming a corporate taxpayer's debt-to-equity ratio exceeded 1.5:1 as of the end of such corporate taxpayer's taxable year, old Section 163(j) denied an interest deduction for amounts paid or accrued to a related tax-exempt (generally, foreign) person [10] to the extent that the corporation's net interest expense[11] exceeded 50% 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).[12] Net interest expense in excess of 50% of the corporation's ATI was defined as "excess interest expense."[13] Any interest deduction disallowed under Section 163(j) was treated as interest paid or accrued in the succeeding taxable year.[14]

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.[15] Pursuant to proposed regulations issued under old Section 163(j), all members of an affiliated group were treated as one taxpayer for old Section 163(j) purposes without regard to whether the affiliated group filed a consolidated return.[16]

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.[17]

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

(1) General.

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9 Section 163(j)(2)(A)(ii) prior to the Act.

10 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.

11 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 Regulation Section 1.163(j)-2(d).

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

13 Section 163(j)(2)(B)(i) prior to the Act.

14 Section 163(j)(1)(B) prior to the Act.

15 Section 163(j)(6)(C) prior to the Act.

16 1991 Proposed Regulation 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).

17 Section 163(j)(8) prior to the Act.

Section 163(j), as amended by the Act, applies to both corporate and non-corporate taxpayers. The debt-to-equity ratio test was removed, and Section 163(j) now applies at the partnership level rather than the partner level. In addition, Section 163(j) now applies without regard to the identity of the recipient or the taxability of the interest to the interest recipient. Finally, exceptions were added for electing real property businesses, electing farming businesses, certain utilities, and certain small businesses. The statutory provisions are described in greater detail below.

Section 163(j) provides, in pertinent part, that a taxpayer cannot deduct business interest expense for a taxable year to the extent that such interest exceeds the sum of (a) the business interest income of such taxpayer for such taxable year, (b) 30% of the taxpayer's adjusted taxable income for such taxable year and (c) the taxpayer's floor plan financing interest for such taxable year.[18] The statute defines "business interest expense," "business interest income," and "adjusted taxable income".

"Business interest expense" ("BIE"), for Section 163(j) purposes, means any interest paid or accrued on indebtedness properly allocable to a non-excepted trade or business.[19]The term does not include investment interest (within the meaning of Section 163(d)).[20]

"Business interest income" ("BII"), 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 non-excepted trade or business. The term does not include investment income (within the meaning of Section 163(d)).[21]

ATI, for Section 163(j) purposes, means the taxable income of the taxpayer computed without regard to any item of income, gain, deduction, or loss which is not properly allocable to a trade or business, any BIE or BII, the amount of any net operating loss deduction under Section 172, the amount of any deduction allowed under Section 199A, and, in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion, and computed with such other adjustments as provided by the Treasury.

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

[18] Section 163(j)(1). The term "floor plan financing indebtedness" means indebtedness used to finance the acquisition of motor vehicles held for sale or lease, and secured by the inventory so acquired. This Report does not discuss "floor plan financing interest" in any detail.

[19] The Final Regulations provide that business interest expense includes disallowed BIE carryforwards but does not include interest expense carried forward from a prior taxable year due to the application of Section 465, or Section 469, which apply after the application of Section 163(j). Final Regulation Section 1.163(j)-1(b)(3)(i).

[20] 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.

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

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. Those trades or business excluded from the definition are referred to herein as excepted trades or businesses.[22]

(2) Partnerships.

In the case of a partnership,[23] Section 163(j) is applied at the partnership level and any deduction for BIE is to be taken into account in determining the non-separately stated taxable income or loss of the partnership. In addition, each partner's ATI (i) is determined without regard to such partner's distributive share of any items of income, gain, deduction, or loss of the partnership, and (ii) is increased by such partner's distributive share of the partnership's excess taxable income.[24] 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.[25]

The amount of any BIE not allowed as a deduction to a partnership for any taxable year is not treated as BIE paid or accrued by the partnership in the succeeding taxable year. Instead, subject to the rules in the next paragraph, it is treated as EBIE which is allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership.[26]

If a partner is allocated any EBIE from a partnership for any taxable year (a) such EBIE is treated as BIE 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 EBIE remaining after applying the excess taxable income limitation, is treated as BIE paid or accrued in succeeding taxable years.[27] In addition, once all such EBIE 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

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

[23] Rules similar to the special Section 163(j) partnership rules also apply to S corporations and their shareholders. See Section 163(j)(4)(D).

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

[25] *Id.*

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

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

the partner will be taken into account when computing the partner's own Section 163(j) limitation with respect to any BIE 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 ATI as the excess (if any) of (a) 30% of the partnership's ATI for the taxable year, over (b) the amount (if any) by which the partnership's BIE exceeds the BII of the partnership, bears to 30% of the partnership's ATI for the taxable year.[28]

The adjusted basis of a partner in a partnership interest is reduced (but not below zero) by the amount of EBIE allocated to the partner.[29] 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 EBIE allocated to the partner which has previously been treated as BIE paid or accrued by the partner.[30] This provision also applies to a transfer 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 EBIE resulting in a basis increase.[31]

(3) Exceptions to Section 163(j).

As previously discussed, Section 163(j) does not apply to certain excepted trades or businesses the trade or business of performing services as an employee,[32] an "electing real property trade or business,"[33] an "electing farming business,"[34] and an excepted regulated utility trade or

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

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

[30] The Final Regulations do not define "disposition" however, the Preamble suggests it has a broad application for this purpose.

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

[32] 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. Section 163(j)(7)(A)(i) and Final Regulation Section 1.163(j)-1(b)(44)(ii).

[33] 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). Once the election is made it is irrevocable. Section 163(j)(7)(B) and Final Regulation Section 1.163(j)-1(b)(14).

[34] Section 163(j)(7)(C). 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). Once the election is made it is irrevocable. Section 163(j)(7)(C).

business.[35] In addition, Section 163(j) does not apply to a taxpayer[36] for any year in which the taxpayer meets the gross receipts test of Section 448(c).[37]

(4) Effective Date.

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

(C) CARES Act Amendments.

Section 163(j) was amended by the Coronavirus Aid, Relief, and Economic Security Act (P.L. 116-36) (the "CARES Act"). The CARES Act provides special rules for applying Section 163(j) to taxable years beginning in 2019 or 2020.

The CARES Act increases the Section 163(j) limitation from 30% to 50% of ATI for taxable years beginning in 2019 and 2020.[38] Taxpayers may elect to continue using the 30% ATI limitation, but if a taxpayer makes the election, IRS consent is required to revoke it.[39] In addition, the CARES Act permits a taxpayer to use its ATI for the last taxable year beginning in 2019 instead of its 2020 ATI in computing its 2020 Section 163(j) limitation.[40]

The CARES Act contains additional provisions for partnerships. The 30% ATI limitation for partnerships is increased to 50% for the 2020 taxable year only. However, one half of a partnership's EBIE allocated to a partner for the 2019 taxable year can be treated as deductible interest expense in the partner's first taxable year beginning in 2020. Partners may elect out of

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[35] 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 is not a trade or business for purposes of Section 163(j). Section 163(j)(7)(A) and Final Regulation Section 1.163(j)-1(b)(15).

[36] 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).

[37] 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. Final Regulation Section 1.163(j)-2(d). In the case of any taxpayer which is not a corporation or a partnership, the gross receipts test of Section 448(c) is applied in the same manner as if such taxpayer were a corporation or partnership. Section 163(j)(3) and Final Regulation 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).

[38] Section 163(j)(10)(A)(i).

[39] Section 163(j)(10)(A)(iii).

[40] Section 163(j)(10)(B).

this EBIE modification, while the partnership itself is required to elect out of the increase in the ATI limitation to 50% for 2020.[41]

Part III. Overview and Discussion of the Final and Proposed Regulations.

(A) The Final Regulations.

A complete summary of the Final Regulations is beyond the scope of this Report, but, in very general terms, the Final Regulations are divided into eleven sections. Final Regulation Section 1.163(j)-1 provides relevant definitions. Final Regulation Section 1.163(j)-2 provides general rules regarding the application of Section 163(j), including the CARES Act amendments. Final Regulation Section 1.163(j)-3 provides ordering rules and general guidance regarding the relation of Section 163(j) to other Code provisions affecting the deductibility of interest. Final Regulation Section 1.163(j)-4 provides rules applicable to C corporations (including REITs, RICs, and consolidated groups) and tax exempt corporations. Final Regulation Section 1.163(j)-5 provides rules governing disallowed BIE carryforwards for C corporations. Final Regulation Section 1.163(j)-6 describes the application of Section 163(j) to partnerships and S corporations. Final Regulation Section 1.163(j)-7 confirms that Section 163(j) applies to CFCs and United States shareholders[42] but reserves on the application of these rules, which are addressed in the Proposed Regulations. Similarly, Final Regulation Section 1.163(j)-8 reserves on the application of Section 163(j) to foreign persons with ECI and the Proposed Regulations provide a detailed proposal regarding such application. Final Regulation Section 1.163(j)-9 describes the election for excepted trades or businesses and provides a safe harbor for REITs. Final Regulation Section 1.163(j)-10 provides allocation rules regarding the allocation of interest income, interest expense and other items of expense and gross income to an excepted trade or business. Finally, Final Regulation Section 1.163(j)-11 provides transition rules.

In the Preamble to the Final Regulations, Treasury and the IRS asked for comments on the following: (1) approaches to intercompany transfers of partnership interests; (2) whether a current distribution of money or other property by a partnership to a continuing partner as consideration for an interest in the partnership should trigger an addback and, if so, how to determine the appropriate amount of the addback of EBIE and (3) appropriate methods for determining the amount of deductible BIE and disallowed BIE carryforward of a nonresident alien, foreign corporation, or partnership that is properly allocable to ECI.[43]

The following summary highlights portions of the Final Regulations relevant to responding to these requests for comments and discusses portions of the Final Regulations we feel should be

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[41] Section 163(j)(10)(A)(ii). As discussed below Final Regulation Sections 1.163(j)-2(b)(3) and (4) provide general rules regarding this election. Proposed Regulation Section 1.163(j)-6(d)(5) provides further guidance on this election in the partnership context.

[42] Section 951(b).

[43] The Final Regulations also asked for commentators views on the frequency of a partner (i) having zero basis in all partnership interests for purposes of Section 163(j), and (ii) owning no other trade or business assets. We are not aware of a circumstance in which such a fact pattern would occur and therefore do not discuss these concerns.

reconsidered or clarified. When relevant to our recommendations, the Final Regulations and Proposed Regulations are discussed together.

Except as described below, the Final Regulations are effective for taxable years beginning on or after November 13, 2020.

(1) The Definition of Adjusted Taxable Income.

The Final Regulations modify the definition of ATI contained in the 2018 Proposed Regulations. The Final Regulations define ATI as the tentative taxable income of the taxpayer for the taxable year, with certain specified adjustments.[44] If the ATI of a taxpayer would otherwise be less than zero, the ATI of the taxpayer is zero.[45]

Under the Final Regulations, the following amounts that were included in the computation of a taxpayer's tentative taxable income for the taxable year are added back to tentative taxable income to determine ATI: (a) any BIE, other than disallowed BIE carryforwards; (b) any net operating loss deduction under Section 172; (c) any deduction under Section 199A; (d) for the EBITDA period, any depreciation under Section 167, Section 168, or Section 168 of the Internal Revenue Code of 1954 (former Section 168); (e) for the EBITDA period, any amortization of intangibles (for example, under Section 167 or 197) and other amortized expenditures (for example, under Section 174(b), 195(b)(1)(B), 248, or 1245(a)(2)(C)); (f) for taxable years beginning before January 1, 2022, any 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.[46]

Also, the following amounts are subtracted from the taxpayer's tentative taxable income to determine ATI: (a) any BII that was included in the computation of the taxpayer's tentative taxable income; (b) any floor plan financing interest expense for the taxable year that was included in the computation of the taxpayer's tentative taxable income; (c) with respect to the sale or other disposition of property, the greater of the allowed or allowable Depreciation Deductions, as provided under Section 1016(a)(2), for the taxpayer (or, if the taxpayer is a member of a consolidated group, the consolidated group) for the EBITDA period with respect to such property; (d) with respect to the sale or other disposition of stock of a member of a consolidated group by another member, the investment adjustments under Treasury Regulation 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

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[44] Final Regulation Section 1.163(j)-1(b)(1). Tentative taxable income generally is determined in the same manner as taxable income under Section 63 but, for this purpose, computed without the application of the Section 163(j) limitation, which would in turn disregard disallowed BIE carryforwards. Final Regulation Section 1.163(j)-1(b)(43).

[45] Final Regulation Section 1.163(j)-1(b)(1)(vii).

[46] Final Regulation Section 1.163(j)-1(b)(1)(i).

allowable under Section 704(d); (f) any income or gain that is not properly allocable to a non-excepted trade or business and that was included in the computation of the taxpayer's tentative taxable income; and (g) an amount equal to the sum of any "specified deemed inclusions" that were included in the computation of the taxpayer's tentative taxable income, reduced by the portion of the deduction allowed under Section 250(a) by reason of the specified deemed inclusions. For this purpose, a specified deemed inclusion is the inclusion of an amount by a United States shareholder in gross income under Sections 78, 951(a), or 951A(a) with respect to an applicable CFC[47] that is properly allocable to a non-excepted trade or business.[48] Furthermore, a specified deemed inclusion includes any amount included in a domestic partnership's gross income under Sections 951(a) or 951A(a) with respect to an applicable CFC to the extent such amount is attributable to investment income of the partnership and is allocated to a domestic C corporation that is a direct (or indirect partner) and treated as properly allocable to a non-excepted trade or business of the domestic C corporation. For purposes of determining the amount of a specified deemed inclusion in calculating the above subtraction, the portion of a United States shareholder's inclusion under Section 951A(a) treated as being with respect to an applicable CFC is determined under Section 951A(f)(2) and Treasury Regulation Section 1.951A-6(b)(2).

The Final Regulations state that for purposes of the definition of ATI, the term sale or other disposition does not include a transfer of an asset to an acquiring corporation in a transaction to which Section 381(a) applies. In addition, the term sale or disposition excludes all intercompany transactions, within the meaning of Treasury Regulation Section 1.1502-13(b)(1)(i). Finally, the definition states, "any transaction in which a member leaves a consolidated group is treated as a sale or other disposition…unless the transaction is described in Treasury Regulation Section 1.1502-13(j)(5)(i)(A)."[49]

We believe the definition of ATI, on balance, reflects the intent of the statute. Nevertheless, we suggest some modifications to the definition. In particular, this discussion addresses comments regarding the adjustment for Depreciation Deductions during the EBITDA period,[50] the treatment of specified deemed inclusions,[51] the anti-duplication rule,[52] the treatment of reverse acquisitions, and the rule stating that ATI cannot be less than zero.[53]

(i) ATI Negative Adjustments for Depreciation Deductions.

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[47] Final Regulation Section 1.163(j)-1(b)(2).

[48] Final Regulation Section 1.163(j)-1(b)(1)(ii).

[49] Final Regulation Section 1.163(j)-1(b)(1)(iv)(A)(2).

[50] See Final Regulation Section 1.163(j)-1(b)(1)(ii)(C).

[51] See Final Regulation Section 1.163(j)-1(b)(1)(ii)(G).

[52] See Final Regulation Section 1.163(j)-1(b)(1)(ii)(D).

[53] See Final Regulation Section 1.163(j)-1(b)(1)(vii).

a. Background.

The 2018 Proposed Regulations provided that if property is sold or otherwise disposed of, the lesser of (i) the amount of gain on the disposition, or (ii) the Depreciation Deductions with respect to the property for the EBITDA period, is subtracted from taxable income to determine ATI.[54] The 2018 Proposed Regulations also provided that a taxpayer was required to subtract any Depreciation Deductions taken during the EBITDA period that are reflected in basis when determining ATI upon the sale or disposition of stock of a member of a consolidated group by another member or upon the sale or disposition of an interest in a partnership.

The Final Regulations removed the "lesser of" approach for purposes of reducing a taxpayer's tentative taxable income in the case of a sale or other disposition of property. Instead, they require a subtraction of the full amount of EBITDA period Depreciation Deductions, and retain the rule governing the sale or disposition of stock of a member of a consolidated group by another member and the sale or disposition of an interest in a partnership.[55]

The Proposed Regulations allow taxpayers to choose between the rule in the Final Regulations (that is, a negative ATI adjustment for all Depreciation Deductions taken during the EBITDA period) and the "lesser of" standard contained in the 2018 Proposed Regulations. Thus, with respect to sales or other dispositions of property, Proposed Regulation Section 1.163(j)-1(b)(1)(iv)(E) allows a taxpayer (or if the taxpayer is a member of a consolidated group, the consolidated group) to reduce its tentative taxable income by the lesser of: (i) the amount of gain recognized on the sale or other disposition and (ii) the Depreciation Deductions for the taxpayer for the EBITDA period with respect to such property.

While the 2018 Proposed Regulations applied this "lesser of" standard solely to dispositions of property, the Proposed Regulations extend this standard to dispositions of member stock and partnership interests in an attempt to eliminate the discontinuity between the ATI adjustment for different types of dispositions. Thus, with respect to the sale or other disposition of stock of a member of a consolidated group by another member, for purposes of calculating a taxpayer's ATI, such taxpayer's tentative taxable income is reduced by the lesser of any gain recognized on the sale or other disposition of such stock and the investment adjustments under Treasury Regulation Section 1502-32 with respect such stock that are attributable to Depreciation Deductions taken or accrued by the taxpayer during the EBITDA period. Similarly, with respect to the sale or other disposition of an interest in a partnership, for purposes of calculating a taxpayer's ATI, such taxpayer's tentative taxable income is reduced by the lesser of any gain recognized on the sale or other disposition of such interest and the taxpayer's (or if the taxpayer is a member of a consolidated group, the consolidated group's) distributive share of Depreciation Deductions taken or accrued during the EBITDA period with respect to property held by the partnership at the time of such sale or disposition to the extent such deductions were allowable under Section 704(d).

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[54] 2018 Proposed Regulation Section 1.163(j)-1(b)(1)(ii)(C).

[55] Final Regulation Section 1.163(j)-1(b)(1)(ii)(C)-(E).

Taxpayers opting to use the ”lesser of” standard in the Proposed Regulations are required to do so for all sales or other dispositions that would otherwise be subject to these rules when the taxpayer computes tentative taxable income. Treasury and the IRS requested comments on the “lesser of” approach, including how such an approach should apply to dispositions of member stock and partnership interests.

b. Possible Approaches.

The Preamble to the Final Regulations states, without cite to legislative history or other sources supporting the proposition, that “Congress intended this adjustment to be a timing provision that delays the inclusion of depreciation deductions in calculating a taxpayer’s section 163(j) limitation. Stated differently, Congress intended to allow taxpayers to accelerate the recognition of gain attributable to depreciation deductions when computing ATI”. Based on the Preamble, it appears that Treasury and the IRS are of the view that Congress was trying to afford taxpayers with a benefit by shifting a positive adjustment into an earlier period to, in part, ease the transition into the Section 163(j) regime. There is no indication, however, that Congress intended the provision to be detrimental to any taxpayers. Although the Preamble refers to acceleration of the recognition of gain, under the approach implemented by the operative provisions of the Final Regulations (the “Timing Approach”) the question apparently is merely when the ATI add back should be reversed by way of a corresponding negative adjustment to ATI, not whether or how much of the ATI add back should be reversed.

Assuming the making of subsequent adjustments to ATI with respect to Depreciation Deductions taken during the EBITDA period is appropriate,[56] we believe there are at least two alternative approaches to the Timing Approach taken in the Final Regulations that should be considered. Under the first approach (the “Economic Depreciation Approach”), ATI would be decreased upon a subsequent taxable sale or other disposition of an asset for which Depreciation Deductions had been taken during the EBITDA period in an amount equal to the lesser of the Depreciation Deductions taken during the EBITDA period or the gain recognized upon the disposition. The theory behind the Economic Depreciation Approach is that the aggregate Depreciation Deductions added back to ATI during the EBITDA period with respect to a property less the negative ATI adjustment upon a taxable disposition of the property (i.e., the net ATI adjustment resulting from Depreciation Deductions and sale of the asset) should equal the economic depreciation of the asset. This approach, which is essentially the elective approach that would be implemented under the Proposed Regulations, would also appear to be consistent with the acceleration of gain recognition language in the Preamble to the Final Regulations cited above.

The second alternative approach (the “No Double Benefit Approach”) would be similar to the Economic Depreciation Approach, but the negative ATI adjustment upon a taxable sale or other disposition of the property would be further limited to be no greater than the amount, if any, of Depreciation Deductions during the EBITDA Period whose add back to ATI provided a Section

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[56] We do not comment in this Report on whether, in principle, it is appropriate to make subsequent adjustments to ATI with respect to any Depreciation Deductions taken during the EBITDA period. Rather, we assume for discussion that adjustments of some type will be made, and we address herein alternatives for making those adjustments.

163(j) benefit to the taxpayer. The theory behind the Double Benefit Approach is that the taxpayer should not receive a double benefit by both having its Section 163(j) limitation increased by the increase in ATI occasioned by the Depreciation Deduction add back during the EBITDA period and then again by the increase in ATI occasioned by the gain attributable to the Depreciation Deduction upon a taxable disposition of the property. Conversely a taxpayer that did not benefit from the resulting increase in ATI during the EBITDA period because Section 163(j) would not have limited the taxpayer's deductible interest expense without regard to the increase should not be required to reduce its ATI in the year of disposition, which could result in a net decrease in deductible interest expense compared to a situation in which the Depreciation Deductions were never added back to ATI in the first place.[57] In other words, this approach prevents what appears to have been intended to be a taxpayer favorable rule from being a detrimental rule.

c. Possible Approaches and Direct Asset Dispositions.

The Final Regulations create an anomalous disparity between intangible assets like goodwill and going concern value, which are not generally disposed of apart from dispositions of a business, and physical assets, which often are. In this respect, the Final Regulations may create an incentive to keep assets that might otherwise not merit retention solely because the adverse tax consequences of disposing of the asset outweigh the cost of keeping the asset. Further, we believe that both the Economic Depreciation Approach and the No Double Benefit Approach are superior conceptual approaches to addressing the reversal of any Depreciation Deductions taken during the EBITDA period.

Accordingly, we view the Proposed Regulations' elective adoption of the Economic Depreciation Approach with respect to sales or other dispositions of property for which Depreciation Deductions have been taken during the EBITDA period to be an improvement on the Final Regulations. We also recommend, however, that consideration be given to permitting the taxpayer to adopt the No Double Benefit Approach.

Regardless of which elective approach is permitted, we think consideration should be given to adjusting the Proposed Regulations' treatment of dispositions of stock in a consolidated subsidiary and partnership interests, as discussed below.

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[57] None of the three approaches – the Timing, Economic Depreciation and No Double Benefit Approaches -- actually reverses any previous Section 163(j) benefit in all cases. This is because the adjustment is a decrease in a taxpayer's ATI in the year the asset is sold and the taxpayer may have excess Section 163(j) capacity or a reduced amount of interest expense in that year. Additionally, both the Economic Depreciation and No Double Benefit Approaches are limited so that economic depreciation is not added back even if a previous Section 163(j) benefit was obtained for such depreciation. However, the Timing and Economic Depreciation Approaches may result in a decreased Section 163(j) limitation that adversely affects the taxpayer even where no Section 163(j) benefit was occasioned by the Depreciation Deduction add backs in the past. In that sense, they are all somewhat blunt tools. But if a more perfect matching were desired, rather than merely decreasing ATI (which may have no impact depending on the remaining amount of ATI and interest expense in the particular year), one would need to actually defer interest expense deductions upon the triggering event equal to any extra interest expense allowed in earlier years, as well as not decrease ATI where there had been no past benefit.

d. Possible Approaches and Entity Interest Dispositions.

In the case of dispositions of stock of a member of a consolidated group and dispositions of partnership interests, the relief provided by the Proposed Regulations is likely to be less accurate than asset dispositions, as the "lesser of" limitation in the Proposed Regulations is based on the gain on the member stock or the partnership interest rather than the gain that would be recognized on sale of the underlying assets. This is true both under the “lesser of” approach that would be implemented by the Proposed Regulations and the No Double Benefit Approach that we recommend be considered.

Applying the “lesser of” approach by reference to stock or partnership interest gain, compared to looking through to asset level gains and losses, can result in either too great or too little negative ATI adjustments, depending on the circumstances. For example, using the elective approach in the Proposed Regulations, assume P owns all the stock of S and has a basis in the S stock of $120. S has a value of $160 and owns two assets – Asset A, which is nondepreciable, and Asset B, for which $80 of Depreciation Deductions have been taken during the EBITDA period. S has a basis in Asset A of $50 and a basis in Asset B of $70. P sells S for $160 recognizing a gain of $40. Assume first that at the time of sale of S, the value of Asset A is $150 and the value of Asset B is $10. In this case, under the “lesser of” approach in the Proposed Regulations, P would be required to add back to ATI $40 with respect to Depreciation Deductions taken during the EBITDA period, even though had S instead sold its assets there would have been no add back. Conversely, assume that at the time of sale of S the value of Asset A is $10, and the value of Asset B is $150. As in the first case, under the “lesser of” approach in the Proposed Regulations, P would be required to add back to ATI $40 with respect to Depreciation Deductions taken during the EBITDA period, even though in this case had S instead sold its assets the ATI add back would have been $80.

Thus, under the Proposed Regulations, a negative adjustment can be required even if gain on the stock or partnership interest sale is due entirely to appreciation in value of non-depreciable assets such as land or self-developed goodwill or other intangibles. Conversely, a negative adjustment can be reduced due to the reduction in value of non-depreciable assets. Also, a negative adjustment can be reduced if all assets are depreciable, but stock basis exceeds asset basis. Likewise, even if stock basis equals asset basis, the negative adjustment can be reduced if one depreciable asset has a value in excess of basis but another depreciable asset has a value less than basis.

Given these shortcomings of the current approach in the Proposed Regulations, we believe that consideration should be given to instead having the negative adjustment upon disposition of stock in a consolidated subsidiary or partnership interest be based on the adjustment that would apply under the “lesser of” rule (whether under the Economic Benefit Approach or the No Double Benefit Approach) if the assets of the subsidiary or partnership were sold. We can understand the government's reluctance as an administrative matter to replace the approach in the Proposed Regulations with an adjustment dependent on valuations of assets, especially given that the Proposed Regulations' rule would operate years into the future and the Act generally disfavors allocations based on values, rather than adjusted tax basis. We also understand, as noted below, that an “underlying assets” approach could result in a negative adjustment to ATI even where the stock or partnership interest is disposed of at a loss.

We note, however, that the burden of determinations based on asset values is not insurmountable. Under existing law, without regard to Section 163(j), in the case of a sale of a partnership interest, valuation of the partnership's assets is necessary to calculate the seller's ordinary income under Section 751(a), and in the case of a sale of stock of a consolidated subsidiary, such a valuation is needed if a Section 338(h)(10) election is made. Moreover, the valuation determination is no more difficult than that required to allocate sale price when all the assets of a business are sold in an actual asset sale. While many of us prefer an allocation based on fair market values, the negative adjustment could alternatively be based on an assumption that Depreciation Deductions are generally economic, and that only the timing element of accelerated depreciation is not. Based on this assumption, the gain element of the "lesser of" comparison would be between the negative basis adjustments from Depreciation Deductions taken during the EBITDA period and the excess of earnings and profits basis[58] (or possibly GAAP net book value) over tax basis for the EBITDA period assets at the time of the stock disposition.[59] This approach would avoid valuation burdens and disputes. It would also have an endpoint – the need to make adjustments for Depreciation Deductions taken during the EBITDA period would not extend beyond the class lives of the underlying assets. This approach would not necessarily require gain on the stock or partnership interest disposition in order to trigger a negative adjustment– loss could also be attributable to non-depreciable assets and reduced by Depreciation Deductions taken during the EBITDA period. [60] We concede, however, that this approach likely would not be appropriate, and a rule based on actual values would be needed, for example, for real estate or purchased goodwill for which depreciation or amortization deductions are claimed during the EBITDA period and earnings and profits basis or book value are not a good proxy for fair market value.

e. Other Considerations.

In the context of consolidated group member stock sales, the Proposed Regulations only apply to gain, and thus, would appear to effectively override the deemed disposition rules in the Final Regulations for deconsolidating transactions that do not involve recognition of the stock gain. If the focus is shifted to the accelerated element of the Depreciation Deductions, it would nevertheless be appropriate to have no adjustment on a non-taxable disposition or deconsolidation of the stock. If the theory is that the stock gain is a distortion in ATI to the extent it replicates the underlying asset gain, there is no distortion in ATI without recognition at the shareholder level. The focus of the Final Regulations on triggering the adjustment in the particular group that had the Depreciation Deductions during the EBITDA period is misplaced.[61]

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[58] In the case where what is sold is a partnership interest or earnings and profits basis records have not otherwise been kept, such basis could be calculated at the time of the relevant sale or other disposition.

[59] We note that in transactions involving sales of businesses taking the form of asset sales it is common practice for buyers and sellers to agree to allocate purchase price to tangible assets based on book value.

[60] Some complexities might possibly arise if the rule applied where stock is sold at a loss, because of the operation of the Treasury Section 1.1502-36 limitations.

[61] Because the Final Regulations set out to recapture all of the EBITDA benefit eventually, acceleration on actual and deemed member stock dispositions presents an opportunity to bunch the recapture into a single

Using a "lesser of" comparison tied to accelerated depreciation remaining in the underlying assets would automatically eliminate duplicative negative ATI adjustments if the assets were disposed of before the stock. If member stock is sold in a taxable transaction while the asset remains with non-economic depreciation in the member, arguably, given the theory for the adjustment, each potential duplicative gain is equally distortive to ATI and merits an adjustment.[62] But stock gain that does not reflect negative adjustments for Depreciation Deductions taken during the EBITDA-period (e.g., in the hands of a group that bought the stock with a cost basis after the EBITDA period) should not give rise to any adjustment.[63]

Finally, regardless of whether Treasury and the IRS adopt our ATI recommendations, if a taxpayer elects to use the method prescribed by the Proposed Regulations, it is unclear how the anti-duplication rule works. When the Proposed Regulations are finalized, we recommend examples describe how the anti-duplication rule functions when the taxpayer's negative ATI adjustment is based on gain recognized, rather than the Depreciation Deductions taken during the EBITDA period.

(ii) Capitalized Depreciation Deductions.

The Final Regulations expanded the definition of Depreciation Deductions to include depreciation, amortization, or depletion amounts that are capitalized into inventory under Section 263A in the year they are capitalized, regardless of the period in which the capitalized amount is recovered through cost of goods sold.

This change may cause a trap for the unwary for taxpayers that do not elect to apply the Final Regulations to taxable years beginning before November 13, 2020 and therefore do not treat capitalized depreciation, amortization and depletion deductions arising in those years as giving rise to an increase in ATI. This is because it appears that the negative ATI adjustment will still apply if the underlying property is sold or disposed of (or, subject to the discussion in the second succeeding paragraph, the stock of the member of the consolidated group or the partnership interest in the partnership that capitalized the amounts into inventory is sold) in a year in which the Final Regulations are applicable. Therefore, unless taxpayers elect earlier application of the Final Regulations, the Final Regulations could result in a permanent reduction of ATI. It is not clear whether this result was intended. In light of the fact that this change was made in the Final Regulations, we recommend that the negative ATI adjustment not apply to capitalized depreciation, amortization and depletion amounts that were incurred in a taxable year that began prior to the applicability date of the Final Regulations unless the taxpayer included a positive adjustment reflecting such amounts in calculating its ATI.

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year. Because ATI is an annual concept, the worst a group can do is no interest deduction for that year, but it can do better in the succeeding years for having done this.

[62] Intercompany gains on member stock presumably would not be taken into account, but the "lesser of" comparison could be triggered when the member leaves the group.

[63] Built-in gain from accelerated depreciation on member shares that are deconsolidated without recognition (e.g., if the subsidiary issues shares or a minority interest is sold, in either case, outside the group) would be taken into account on a later disposition to be logically consistent.

Additionally, further guidance is needed on how a partnership can treat capitalized depreciation, amortization and depletion as Depreciation Deductions that are added to ATI for prior taxable years if it is unable to amend its prior tax returns. We suggest that partnerships should be permitted to amend their returns rather than being required to file administrative adjustment requests and that Treasury and the IRS adopt procedures similar to those outlined in Revenue Procedure 2020-23.

Another question arises with respect to the ATI adjustment associated with capitalized depreciation, amortization and depletion deductions. Final Regulation Section 1.163(j)-1(b)(1)(ii)(D) provides that with respect to a sale or other disposition of stock of a member of a consolidated group by another member, there is an ATI adjustment associated with Depreciation Deductions to the extent of the investment adjustments under Regulation Section 1.1502-32 associated with the Depreciation Deductions. Final Regulation Section 1.163(j)-1(b)(1)(ii)(E) provides a similar rule with respect to the sale or other disposition of an interest in a partnership. As there is no basis adjustment or distributive share of such deductions in the year in which the capitalized depreciation, amortization and depletion deductions is capitalized, it is unclear whether the ATI adjustment applies (and if it applies, how it applies) to the capitalized depreciation, amortization and depletion deductions that are part of the Depreciation Deductions.

(iii) Deconsolidations.

Further guidance is required for calculating ATI following deconsolidation to ensure that the same Depreciation Deductions do not cause multiple downward adjustments. Specifically, Final Regulation Section 1.163(j)-1(b)(1)(iv)(D)(2) provides that "Depreciation, amortization, or depletion deductions allowed or allowable for a corporation for a consolidated return year of a group are disregarded in applying this paragraph (b)(1)(iv)(D) to any year that constitutes a separate return year (as defined in Section 1.1502-1(e)) of that corporation." However, it is unclear whether the rules actually work as intended. By referencing the rules in Final Regulation Section 1.163(j)-1(b)(1)(iv)(D), but not -1(b)(1)(ii)(C), the Depreciation Deductions are ignored for purposes of applying the anti-duplication rules. As a result, it is not entirely clear that the subtractions under Final Regulation Section 1.163(j)-1(b)(1)(ii)(C) are modified. Therefore, although the example in the Final Regulations' text[64] provides that there is no subtraction with respect to the Depreciation Deductions taken while the property was held within the consolidated group upon the sale of property following the sale of stock of a consolidated group member that held such property, the operative rules do not appear to provide such result. We agree that such result is correct in the case of a taxable deconsolidation transaction and ask Treasury to correct the cross-reference. If, however, as recommended above, a transaction in which a member leaves a group in a transaction where no gain or loss is recognized with respect to the member's stock does not result in a negative ATI adjustment, the anti-duplication rule should not apply.

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[64] The last sentence of Final Regulation Section 1.163(j)-1(b)(1)(iv)(D)(2) contains an example that does not expressly state that, for a subsidiary that departs from a consolidated group, no subtraction is made under Final Regulation Section 1.163(j)-1(b)(1)(ii)(C) for Depreciation Deductions the subsidiary had claimed while it was in the group. Final Regulation Section 1.163(j)-1(b)(1)(viii)(C)(2). Example 3 is to the same effect.

Two additional questions arise in the context of a deconsolidation. Final Regulation Section 1.163(j)-1(b)(1)(iv)(A)(3) provides that a transaction in which a member leaves a consolidated group is treated as a sale or other disposition for purposes of applying the ATI adjustment associated with Depreciation Deductions, unless the transaction is described in Treasury Regulation Section 1.1502-13(j)(5)(i)(A).

First, it is unclear to us whether the ATI adjustment occurs in the case of a transaction described in Treasury Regulation Section 1.1502-13(j)(5)(i)(B) (where the common parent is no longer in existence or reverse acquisitions). By referencing Treasury Regulation Section 1.1502-13(j)(5)(i)(A) as opposed to Treasury Regulation Section 1.1502-13(j)(5)(i) more generally, the regulations suggest there is no adjustment where the common parent is no longer in existence or where a reverse acquisition takes place. The final regulations should affirmatively state that reverse acquisitions described in Treasury Regulation Section 1.1502-13(j)(5)(i)(B) are not dispositions for purposes of Section 163(j).

Second, if a transaction is described in Treasury Regulation Section 1.1502-13(j)(5)(i)(A), it appears that the anti-duplication rules of Final Regulation Section 1.163(j)-1(b)(1)(iv)(D) apply. However, if there was no ATI adjustment for Depreciation Deductions upon the deconsolidation, it is unclear to us why the anti-duplication rules should then in turn prohibit an addition when the property is subsequently sold.

(iv) Specified Deemed Inclusions.

Final Regulation Section 1.163(j)-1(b)(1)(ii)(G) requires a taxpayer to reduce ATI by the sum of any specified deemed inclusions that were included in the taxpayer's tentative taxable income, reduced by the portion of the Section 250(a) deduction allowed by reason of the specified deemed inclusions. A specified deemed inclusion is defined as "the inclusion of an amount by a United States shareholder in gross income under Section 78, 951(a), or 951A(a) with respect to an applicable CFC that is properly allocable to a nonexcepted trade or business."

Based on the definition, it appears that Treasury and the IRS intended the possibility that an inclusion under Sections 78, 951(a) or 951A could be properly allocable to an excepted trade or business, and therefore would reduce a taxpayer's tentative taxable income under Final Regulation Section 1.163(j)-1(b)(1)(ii)(F), as opposed to (G). We provide a more detailed discussion and recommendation regarding allocation of specified deemed inclusions to excepted trades or businesses in Section B(2)(i) below.

(v) Negative ATI.

Final Regulation Section 1.163(j)-1(b)(1)(vii) provides that if a taxpayer's ATI would be less than zero, the taxpayer's ATI is zero. This limitation was not included in the 2018 Proposed Regulations. Rather, the 2018 Proposed Regulations contained a rule that is now found in Final Regulation Section 1.163(j)-2(b)(1)(ii), which provides that in calculating a taxpayer's Section 163(j) limitation, it includes "30 percent of the taxpayer's ATI for the taxable year, or zero if the taxpayer's ATI for the taxable year is less than zero"; this rule, by reason of its retention in the Final Regulations, implies that a taxpayer's ATI may in fact be less than zero, notwithstanding Final Regulation Section 1.163(j)-1(b)(1)(vii).

For consolidated groups, application of either rule would result in the same Section 163(j) limitation because a consolidated group has a single Section 163(j) limitation and a single ATI amount.[65] In contrast, Proposed Regulation Section 1.163(j)-7(c)(2) provides that the ATI of a CFC group equals the sum of each CFC group member's ATI. A CFC group member's ATI is generally determined on a separate company basis. Thus, if one CFC group member has a loss, it is unclear whether such loss is factored into the CFC group's ATI calculation. Pursuant to Final Regulation Section 1.163(j)-1(b)(1)(vii), it would appear that its ATI is zero and the loss does not reduce the ATI of the CFC group. On the other hand, Final Regulation Section 1.163(j)-2(b)(1)(ii) suggests that its negative ATI is included in the determination of the CFC's group ATI calculation and the ATI is only treated as zero for purposes of computing the Section 163(j) limitation (which is done at the group level).

We recommend that Final Regulation Section 1.163(j)-1(b)(1)(vii) (which states that a taxpayer cannot have negative ATI) be removed for purposes of determining ATI of a CFC group.

(2) The Definition of Interest.

The Final Regulations follow the 2018 Proposed Regulations by defining interest using four separate categories. These categories can be described as amounts that fit the traditional definition of interest, swaps with significant nonperiodic payments, other amounts treated as interest, and an anti-avoidance rule.

Both the 2018 Proposed Regulations and the Final Regulations provide that interest is an amount paid received or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement, including a series of transactions, that is treated as a debt instrument for purposes of Section 1275(a) and Treasury Regulation Section 1.1275-1(d) and not treated as stock under Treasury Regulation Section 1.385-3 or an amount that is treated as interest under other provisions of the Code or the Treasury Regulations.[66] We refer to this provision of the Final Regulations as the first category.

The first category includes the following items: original issue discount ("OID"), as adjusted by the holder for any acquisition premium or amortizable bond premium; qualified stated interest, as adjusted by the holder for any amortizable bond premium or by the issuer for any bond issuance premium; acquisition discount; amounts treated as taxable OID under Section 1286 (relating to stripped bonds and stripped coupons); accrued market discount on a market discount bond to the extent includible in income by the holder under either Section 1276(a) or 1278(b); OID includible in income by a holder that has made an election under Treasury Regulation Section 1.1272-3 to treat all interest on a debt instrument as OID; OID on a synthetic debt instrument arising from an integrated transaction under Treasury Regulation Section 1.1275-6; repurchase premium to the extent deductible by the issuer under Treasury Regulation Section 1.163-7(c) (determined without regard to Section 163(j)); deferred payments treated as interest under Section 483; amounts treated as interest under a Section 467 rental agreement; amounts treated as interest under Section 988; forgone interest under Section 7872; de minimis OID taken into

[65] Final Regulation Section 1.163(j)-4(d)(2)(i) and (iv).

[66] Final Regulation Section 1.163(j)-1(b)(22)(i).

account by the issuer; amounts paid or received in connection with a sale-repurchase agreement treated as indebtedness under Federal tax principles; however, in the case of a sale-repurchase agreement relating to tax-exempt bonds, the amount is not tax-exempt interest; redeemable ground rent treated as interest under Section 163(c); and amounts treated as interest under Section 636.

The first category is consistent with the Code, the legislative history of Section 163(j), and longstanding precedent. We have no comments on the first category of interest.

The second category of interest relates to swaps with significant nonperiodic payments. Except as provided below, a swap with significant nonperiodic payments is treated as two separate transactions, consisting of an on-market, level payment swap and a loan. The loan must be accounted for independently of the swap. The time value of money component associated with the loan is recognized as interest expense to the payor and interest income to the recipient. The effective date for application of Section 163(j) to swaps with significant nonperiodic payments is delayed so that it only applies to notional principal contracts entered into one year or more after September 14, 2021, unless the taxpayer elects earlier application.[67]

The rule does not apply to cleared swaps and non-cleared swaps that require the parties to meet the margin or collateral requirements of a federal regulator or provide for margin or collateral requirements that are substantially similar to those of a cleared swap or a non-cleared swap subject to the margin or collateral requirements of a federal regulator.[68] The term "cleared swap' means a swap that is cleared by a derivatives clearing organization, as such term is defined in section 1a of the Commodity Exchange Act (7 U.S.C. 1a), or by a clearing agency, as such term is defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c), that is registered as a derivatives clearing organization under the Commodity Exchange Act or as a clearing agency under the Securities Exchange Act of 1934, respectively, if the derivatives clearing organization or clearing agency requires the parties to the swap to post and collect margin or collateral.[69]

Concurrent with the release of the Final Regulations under Section 163(j), Treasury and the IRS issued regulations under Section 446. These regulations include the substantive text of the embedded loan rule and the exceptions to that rule along with a cross reference to Final Regulation Section 1.163(j)-1(b)(22)(ii) in the description of notional principal contracts.[70] We would like to thank Treasury and the IRS for adopting our recommendations regarding the treatment of swaps with significant nonperiodic payments, but recommend that the Section 446

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[67] Final Regulation Section 1.163(j)-1(c)(3).

[68] For purposes of this exception, the term "federal regulator" means the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), or a prudential regulator, as defined in section 1a(39) of the Commodity Exchange Act (7U.S.C. 1a), as amended by section 721 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Public Law No. 111-203, 124 Stat. 1376, Title VII (the Dodd-Frank Act). Final Regulation Section 1.163(j)-1(b)(22)(ii)(c).

[69] Final Regulation Section 1.163(j)-1(b)(6).

[70] Final Regulation Section 1.446-3(g)(4).

regulations define 'significant' for purposes of the bifurcation of swaps with significant nonperiodic payments and provide examples of swaps with both significant and nonsignificant nonperiodic payments.

The third category of interest was significantly revised in the Final Regulations. The Final Regulations include the following items under "other amounts treated as interest": bond premium, factoring income, substitute interest payments on securities lending transactions and repos not entered into in the ordinary course of business, Section 1258 gain and ordinary income or loss on a nonfunctional currency contingent payment debt instrument subject to Treasury Regulation Section 1.988-6, or an inflation-indexed debt instrument subject to Treasury Regulation Section 1.1275-7.

Unlike the 2018 Proposed Regulations, the Final Regulations do not include the following items in the definition of interest: (a) 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; (b) 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; (c) any fees in respect of a lender commitment to provide financing if any portion of such financing is actually provided; (d) with respect to the issuer, any debt issuance costs subject to Treasury Regulation Section 1.446-5; and (e) guaranteed payments for the use of capital under Section 707(c). While the Final Regulations eliminated these items from the definition of interest definition, non-integrated hedges, guarantee fees, and guaranteed payments can be treated as 'interest' under the anti-avoidance rule. This treatment leads to confusion in certain circumstances as discussed below.

Finally, the fourth category of interest set forth in the Final Regulations is a modified anti-avoidance rule. The anti-avoidance rule in the Final Regulations tests whether an amount was incurred with a principal purpose of structuring a transaction to reduce the amount treated as interest. This approach differs from the approach contained in the 2018 Proposed Regulations which tested whether an expense or loss was predominantly incurred in consideration of the time value of money.[71] The first portion of the anti-avoidance rule provides in part:

> Any expense or loss economically equivalent to interest is treated as interest expense if a principal purpose of structuring the transaction(s) is to reduce an amount incurred by the taxpayer that otherwise would have been described in paragraph (b)(22)(i), (ii) or (iii) of this Section [i.e., treated as interest under the other categories of interest set forth in the Final Regulations].[72]

Per the anti-avoidance rule, the fact that the taxpayer has a business purpose for obtaining the use of funds or has obtained funds at a lower pre-tax cost based on the structure of the transaction(s)

[71] 2018 Proposed Regulations Section 1.163(j)-1(b)(20)(iv).

[72] Final Regulation Section 1.163(j)-1(b)(22)(iv).

does not affect the determination of whether the manner in which the taxpayer structures the transaction(s) is with a principal purpose of reducing the taxpayer's interest expense.[73]

The Final Regulations further state that any expense or loss is economically equivalent to interest to the extent that the expense or loss is (i) deductible by the taxpayer; (ii) incurred by the taxpayer in a transaction or series of integrated or related transactions in which the taxpayer secures the use of funds for a period of time; (iii) substantially incurred in consideration of the time value of money; and (iv) not otherwise defined as interest under the regulations.

The Final Regulations also include a corresponding rule treating certain amounts as interest income. Specifically, this rule states:

> If a taxpayer knows that an expense or loss is treated by the payor as interest expense… the taxpayer provides the use of funds for a period of time in the transaction(s) subject to [the anti-avoidance rule], the taxpayer earns income or gain with respect to the transaction(s), and such income or gain is substantially earned in consideration of the time value of money provided by the taxpayer, such income or gain is treated as interest income to the extent of the expense or loss treated by the payor as interest expense under [the anti-avoidance rule].[74]

The second portion of the anti-avoidance rule provides:

> any income realized by a taxpayer in a transaction or series of integrated or related transactions is not treated as interest income of the taxpayer if and to the extent that a principal purpose for structuring the transaction(s) is to artificially increase the taxpayer's business interest income. For this purpose, the fact that the taxpayer has a business purpose for holding interest generating assets does not affect the determination of whether the manner in which the taxpayer structures the transaction(s) is with a principal purpose of artificially increasing the taxpayer's business interest income.[75]

(i) Treasury and the IRS Should Clarify the Scope and Meaning of the Anti-Avoidance Rule.

The anti-avoidance rule in the 2018 Proposed Regulations would have applied to an arrangement without regard to the taxpayer's purpose for entering into the arrangement. Our 2019 Report recommended that the anti-avoidance rule cover only scenarios where the taxpayer has a principal purpose to circumvent Section 163(j).

In response to comments made regarding the anti-avoidance rule in the 2018 Proposed Regulations, Section 1.163(j)-1(b)(22)(iv)(A)(1) of the Final Regulations now provides: "Any expense or loss economically equivalent to interest is treated as interest expense if a principal

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[73] Final Regulation Section 1.163(j)-1(b)(22)(iv)(A)(1).

[74] Final Regulation Section 1.163(j)-1(b)(22)(iv)(A)(2).

[75] Final Regulation Section 1.163(j)-1(b)(22)(iv)(B).

purpose of structuring the transaction(s) is to reduce an amount incurred by the taxpayer that otherwise would have been described in paragraph (b)(22)(i), (ii), or (iii) of this section." The same provision later refers to "a principal purpose of reducing the taxpayer's interest expense." In each case, it is unclear whether the purpose required to cause the anti-avoidance rule to apply is (i) a purpose to reduce the amount of the taxpayer's interest expense (or other items described in clauses (ii) or (iii) of -1(b)(22)) as an economic matter or (ii) a purpose to reduce the amount treated as interest expense for purposes of Section 163(j).[76]

A typical hallmark of an abusive transaction is that it improves the taxpayer's after-tax position in a manner that is disproportionate to the improvement in the taxpayer's pre-tax position. The ambiguity regarding whether the principal purpose needed to invoke the anti-avoidance rule is an economic purpose or a tax purpose is particularly important for arrangements that, by their nature, are intended to reduce the overall economic cost of a transaction, including the amount of interest actually paid by a taxpayer, but are routinely entered into by taxpayers independent of considerations relating to Section 163(j). For example, when a subsidiary corporation borrows and its parent guarantees its obligations, the arrangement generally has the effect of reducing the total borrowing costs to the subsidiary (and the parent-subsidiary group as a whole), and the economic benefit of such reduced expense (including the reduced interest expense) could be viewed as a principal purpose of the arrangement.[77] However, the purpose in this case may have nothing to do with avoiding Section 163(j). We recognize that having a business purpose is not in and of itself sufficient to avoid the anti-avoidance rule but anti-avoidance rules typically require an intent to obtain a specific tax outcome.

The Final Regulations include the following example of a guarantee that violates the anti-avoidance rule because a principal purpose of entering into the transactions was to reduce the amount incurred by A that otherwise would be interest expense.

> Example 1: A is wholly owned by FC, a foreign corporation organized in foreign country X. A uses the calendar year for its annual accounting period. FC has a better credit rating than A. A needs to borrow $2,000x in the taxable year ending December 31, 2021, to fund its business operations. A also projects that, if it borrows $2,000x on January 1, 2021, and pays a market rate of interest, it will have business interest expense of $100x in its taxable year ending December 31, 2021. In early 2021, A enters into the following transactions: A enters into a loan obligation in which A borrows $2,000x from Bank with

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[76] While the Preamble to the Final Regulations notes that "[m]ost commenters recommended that any anti-avoidance rule in the final regulations contain a requirement that the taxpayer have a principal purpose to avoid section 163(j)," it does not make clear whether the anti-avoidance rule in the Final Regulations was intended to adopt this approach or was instead focused on the taxpayer's non-tax motivation for the arrangement. However, in its discussion of the government's authority to promulgate regulations treating certain amounts not conventionally considered interest as interest for purposes of Section 163(j), the Preamble to the Final Regulations states that "an anti-avoidance rule is needed to address situations in which a taxpayer's principal purpose in structuring a transaction or series of transactions is to artificially reduce the taxpayer's business interest expense or to increase the taxpayer's business interest income," suggesting that a principal purpose relating to Section 163(j) may be needed.

[77] The use of a parent guarantee may have additional benefits, such as allowing for the use of a less restrictive covenant package than had the subsidiary borrowed without the parent guarantee.

> an interest rate of 3 percent (Loan 1); FC and Bank enter into a guarantee arrangement (Guarantee) under which FC agrees to guarantee Bank that Bank will be timely paid all of the amounts due on Loan 1; and A enters into a guarantee fee agreement with FC (Guarantee Fee Agreement) under which A agrees to pay FC $40x in return for FC entering into the Guarantee, which was not an agreement that A would have entered into in the ordinary course of A's trade or business.

The example concludes that the guarantee fee of $40x paid by A to FC is recharacterized as interest expense for purposes of Section 163(j). It is unclear, however, whether the anti-avoidance rule applies because the arrangement had a principal purpose of reducing the economic interest expense of A or because it had a principal purpose of reducing the amount of interest expense for purposes of Section 163(j). The Analysis section of the example (rather than the Facts section) states: "A principal purpose of A entering into the transactions was to reduce the amount incurred by A that otherwise would be interest expense." This language could be read as suggesting the anti-avoidance rule applies simply because A had a principal purpose to reduce the amount of interest it pays, regardless of whether there was any tax motivation for the arrangement. It appears from the facts of the example that A's total cost of borrowing (taking into account the guarantee fee) is the same as it would be if it had borrowed without the guarantee), but that the FC/A group as a whole has in fact substantially reduced its borrowing costs as a result of the guarantee arrangement. We think that such a transaction would not fit the ordinary definition of an abusive transaction, and that it would be helpful if Treasury and the IRS provided an example of a transaction involving a guarantee that does not fall within the anti-avoidance rule.

On the other hand, if a principal purpose to reduce the taxpayer's economic interest expense were sufficient to trigger the anti-avoidance rule, arrangements that by their nature are designed to reduce overall economic expense (including interest expense) would always (or nearly always) be covered. For example, under that interpretation, it would appear that guarantee fees (which generally are intended to reduce interest expense) would always be treated as interest expense. If that is the intended result it is not clear why they are subject to the anti-avoidance rule rather than simply being treated as interest under the substantive definition in Final Regulation Section 1.163(j)-1(b)(22)(iii). In other words it is unclear whether the anti-avoidance rule operates as a per-se rule under these circumstances. We believe that it would be more sensible for the anti-avoidance to be invoked only where the taxpayer has a principal purpose to reduce the amount of its deductions treated as interest expense (or to increase the amount of its income treated as interest income) for purposes of Section 163(j). In any event, we believe that the government should clarify the Final Regulations to remove the ambiguity.

Finally, as indicated in our 2019 Report, we believe that the IRS and Treasury have a stronger statutory basis to issue regulations defining interest broadly in cases where doing so is needed in order to prevent the avoidance of Section 163(j) (i.e. to issue and anti-avoidance rule) than they do to define the term interest to include amounts not conventionally considered interest for tax purposes without in cases where there is not a tax avoidance objective (i.e. to issue per se rules). To the extent that the Final Regulations' more limited definition of interest in Final Regulation Section 1.163(j)-1(b)(22)(i)-(iii), coupled with the revised anti-avoidance rule, was intended to put the Final Regulations on a stronger footing from a regulatory authority perspective, it is not clear that interpreting the principal purpose requirement in the anti-avoidance rule as meaning an

economic (rather than tax) purpose would achieve that objective if in fact the anti-avoidance rule is intended to apply on a per se basis.

If Treasury and the IRS intended the principal purpose requirement as meaning an economic purpose (rather than tax), we recommend that guarantee fees (and possibly other items as well) be expressly included in the third category of interest, rather than the anti-avoidance rule, because a guarantee involving the need to pay a guarantee fee will almost always reduce the issuer's cost of funds.

Regardless of whether Treasury and the IRS intended the principal purpose requirement to be an economic purpose or a tax purpose, the regulations should be clarified to state that the anti-avoidance rule applies solely for purposes of Section 163(j). Final Regulation Section 163(j)-1(a) states that the definitions provided in the Final Regulations apply for Section 163(j) purposes. The anti-avoidance rule, however, could be read to expand the definition of interest beyond Section 163(j), which does not appear to be the intent. This reading could have broader unintended implications such as triggering withholding on amounts treated as interest under the anti-avoidance rule. Clarifying the Final Regulations would eliminate the potential for these unintended consequences.

(ii) Treasury and the IRS Should Provide an Example of a Guaranteed Payment which Does not Violate the Anti-Avoidance Rule.

Only one example in the anti-avoidance rule addresses guaranteed payments for the use of capital:

> Example 2: A, B, and C are equal partners in ABC partnership. ABC is considering acquiring an additional loan from a third-party lender to expand its business operations. However, ABC already has significant debt and interest expense. For the purpose of reducing the amount of additional interest expense ABC would have otherwise incurred by borrowing, A agrees to make an additional contribution to ABC for use in its business operations in exchange for a guaranteed payment for the use of capital under section 707(c).[78]

The Final Regulations determine that this fact pattern violates the anti-avoidance rule because, according to the Analysis of the example, a principal purpose of A making a contribution in exchange for a guaranteed payment for the use of capital was to reduce the amount incurred by ABC that otherwise would be interest expense. As a result, such guaranteed payment is treated as interest expense of ABC for Section 163(j) purposes. In addition, the Analysis of the example states, if A knows that the guaranteed payment is treated as interest expense of ABC for Section 163(j) purposes, the guaranteed payment is treated as interest income of A for purposes of Section 163(j).

This example creates additional confusion as to whether the principal purpose test is intended to be an economic purpose, rather than a tax one. One sentence from the Analysis seems to focus on the economic purpose of A's capital contribution in exchange for a guaranteed payment and

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[78] Final Regulation Section 1.163(j)-1(b)(22)(v)(E)(1). Example 5.

another seems to focus on whether A knows that the guaranteed payment will be treated as interest expense for Section 163(j) purposes by ABC. While we appreciate Treasury's and the IRS's efforts to provide examples to supplement the anti-avoidance rule, we feel further clarification is required. The example provided does not provide sufficient facts to determine precisely when a taxpayer will run afoul of the anti-avoidance rule, suggesting that such rule could plausibly cover any taxpayers who evaluate the Section 163(j) treatment of a guaranteed payment prior to issuance. Inclusion of an example of a guaranteed payment which does not violate the rule may offer further helpful guidance. For example, suppose that incurrence of additional debt would have violated financial covenants in ABC's existing loans, and that ABC understandably wishes to avoid an event of default, and that was the reason for seeking additional equity capital. Would the result in the example change? If not, it would be useful to know what facts if any would be necessary to produce a different result. Similarly, would there be a different result if the guaranteed payment for use of capital was in exchange for a contribution of business assets where a loan from a third party lender was not an economically equivalent alternative, rather than an advance of cash, in which case a loan from a related or third party lender would have been an economically equivalent alternative? We further note that broadly applying the anti-avoidance rule to guaranteed payments puts pressure on the often elusive distinction between guaranteed payments and preferred returns.

(iii) Treasury and the IRS Should Confirm the Extent to Which Taxpayers Can Affirmatively Rely on the Anti-Avoidance Rule.

As drafted, while the title of the provision is "anti-avoidance," it would appear that taxpayers could affirmatively rely on the rule to treat certain expenses that are economically equivalent to interest as interest income and expense for Section 163(j) purposes. If this was not intended it should be clarified. For example, if a taxpayer, in connection with its trade or business, incurs a loan obligation in a non-functional currency and enters into a non-integrated foreign currency swap transaction to hedge the currency risk, the taxpayer should be able to treat income received on the non-integrated swap as business interest income for Section 163(j) purposes.[79]

Affirmative use of the anti-abuse rule seems especially appropriate if the economic approach to reducing interest expense is taken. In that case, for example, since the payor will almost invariably have an interest deduction for 163(j) purposes for guarantee fees, GPUCs and the like, the recipient should equally have an interest inclusion, irrespective of the reason the payor and the recipient engaged in the alternative transaction. So if, for example, in the case above in which ABC enters into a GPUC to stave off default on its debt, if in fact the GPUC payment is treated as interest expense for 163(j) purposes then that same payment should be treated as interest income in the hands of the recipient, even if GPUCs are not restored to a per se category of interest equivalent under the 163(j) rules.

(3) Effect on Earnings and Profits.

Under Final Regulation Section 1.163(j)-4(c)(1), the disallowance and carryforward of a deduction for BIE of the taxpayer or of a partnership in which the taxpayer is a partner does not

[79] Example 1 provided in Final Regulation Section 1.163(j)-1(b)(22)(iv)(A)(1) presents a similar fact pattern.

affect whether or when the BIE reduces the taxpayer's earnings and profits. Thus, a corporate partner's earnings and profits is reduced to reflect the EBIE of a partnership in which the corporation is a direct partner. The Final Regulations are unclear, however, as to whether this applies to a EBIE generated by a lower tier partnership. The regulations should be clarified to provide that a corporation reduces its earnings and profits to reflect a direct or indirect allocation of EBIE.

(4) Responses to Requests for Comment and Items Requiring Further Consideration.

The Preamble to the Final Regulations requests comments on each of the following, (1) approaches to intercompany transfers of partnership interests; (2) whether a current distribution of money or other property by a partnership to a continuing partner as consideration for an interest in the partnership should trigger an basis addback of EBIE and, if so, how to determine the appropriate amount of the addback and (3) appropriate methods for determining the amount of deductible BIE and disallowed BIE carryforward of a nonresident alien, foreign corporation, or partnership that is properly allocable to ECI.[80]

(i) Intercompany Transfers of Partnership Interests.

The Final Regulations reserve on issues relating to intercompany partnership interest transfers, and the Preamble states that Treasury and the IRS welcome further comments on the issue.

The 2018 Proposed Regulations provided that a transfer of a partnership interest in an intercompany transaction that does not result in a termination of the partnership is treated as a disposition for purposes of Section 163(j)(4)(B)(iii)(II), regardless of whether the transfer is one in which gain or loss is recognized.[81] Under this approach, the selling partner's basis would be increased by the partner's EBIE and no deduction would be allowed to either the transferor or transferee partner. Thus, the transferor member's EBIE would be eliminated rather than transferred to the transferee member.[82]

According to the Preamble to the Final Regulations, Treasury and the IRS are considering various possible approaches to intercompany partnership interest transfers. Under one possible approach, such a transfer would be treated as a disposition by the selling member (S), thus, S's EBIE would be eliminated (and its basis in its partnership interest would be increased accordingly immediately before the transfer), as would S's negative Section 163(j) expense.[83]

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[80] The Preamble also states that the interaction between Section 163(j) and Section 108, concerning income from the discharge of indebtedness, may be the subject of future guidance. The treatment of income from the discharge of indebtedness is beyond the scope of this Report; however, we may address this interaction in a forthcoming report.

[81] 2018 Proposed Regulation Section 1.163(j)-4(d)(4).

[82] Preamble to the Final Regulations at 104.

[83] Final Regulation Section 1.163(j)-6(h)(1) defines negative Section 163(j) interest expense as any deductible BIE and BIE of an exempt entity (whether allocated to the partner in the current taxable year or suspended

However, unlike the approach in the 2018 Proposed Regulations, the buying member (B) would be treated as if B had been allocated EBIE or negative Section 163(j) interest expense from the partnership in an amount equal to the amount of S's EBIE or negative section 163(j) expense, respectively, immediately before the transfer. B's basis in its partnership interest would be adjusted to reflect the deemed allocation of EBIE (but not a negative Section 163(j) expense) from the partnership. Similar rules would apply to intercompany transfers of partnership interests in nonrecognition transactions.

According to the Preamble to the Final Regulations, the foregoing approach attempts to approximate single-entity treatment while treating the intercompany transfer of a partnership interest as a disposition for purposes of Section 163(j)(4)(B)(iii)(II). To ensure that B has the same amount of EBIE, negative Section 163(j) expense, and disallowed BIE carryforwards as if S and B were divisions of a single corporation, this approach also would include special basis rules. For example, if S transfers its partnership interest to B at a gain, the excess of B's basis in the partnership interest at any time after the transfer over S's basis in the partnership interest immediately before the transfer would not be available to convert negative Section 163(j) expense into EBIE in the hands of B or to prevent EBIE from converting into negative Section 163(j) expense in the hands of B. Additionally, if adjustments to B's basis in its partnership interest under Section 163(j)(4)(B)(iii)(I) and Final Regulations Section 1.163(j)-6(h) (upon the deemed allocation of EBIE from the partnership) would exceed B's basis, B would be treated as having a suspended negative basis adjustment in the partnership interest (similar to an excess loss account within the meaning of Treasury Regulation Section 1.1502-19(a)(2)(i)).

We support the approach taken in the Preamble to the Final Regulations and suggest that Treasury and the IRS adopt this approach in the next set of Section 163(j) guidance. In our 2019 Report, we suggested an approach generally similar to the one in the Proposed Regulations.

The approach taken by the Preamble can be demonstrated with the following example. Assume selling partner S has a partnership interest in PRS with a zero basis, $20 of previously allocated EBIE and a value of $100. If S sells its partnership interest to member B for $100, S will have a deferred intercompany gain of $80 (reflecting a basis increase from $0 to $20 attributable to the EBIE) and B will have a basis of $80 ($100 purchase price less the $20 of EBIE allocated from S). If S had been allocated $20 of EBIE at a time S's basis was zero, S would have $20 of negative Section 163(j) interest expense. If S then sold the partnership interest to an unrelated party X, for $100, S would have gain of $100 ($100 purchase price less zero basis) and the negative Section 163(j) interest expense would be eliminated. If instead S sells the partnership interest to member B for $100, the $20 of negative Section 163(j) interest expense would not increase S's basis. If B is later allocated ETI from the partnership, the ETI could 'convert' negative Section 163(j) interest expense to EBIE, and B would reduce its basis in the partnership interest by such amount.

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under Section 704(d) in a prior taxable year), any EBIE allocated to a partner in the current taxable year, and any EBIE from a prior taxable year that was suspended under Section 704(d).

(ii) Current Distributions of Money or Property by a Partnership to a Continuing Partner as Consideration for an Interest in the Partnership Should Not Result in a Basis Addback of EBIE.

Pursuant to Proposed Regulation Section 1.163(j)-6(h)(4), a disposition of a partnership interest includes a distribution of money or other property in complete liquidation of the partner's interest in the partnership. However, the Proposed Regulations further provide that a current distribution of money or other property by the partnership to a continuing partner is not a disposition for Section 163(j) purposes. We agree with both of these provisions.

The tax differences between a sale of a partnership interest to one or more existing partners versus a non-liquidating distribution are well established and we see no reason to add to that complexity for Section 163(j) purposes. Under Section 731, a current distribution of money or property by a partnership to a continuing partner as consideration for an interest in the partnership is not treated as a sale or exchange, unlike the treatment of a non-dividend equivalent stock redemption under Section 302, and generally does not result in recognition of gain or loss, except to the extent that the partner receives cash (or, subject to certain exceptions, marketable securities with a fair market value) in excess of the partner's basis in its partnership interest We do not think that such a distribution generally should result in an adjustment to basis for EBIE or an inability to deduct the EBIE in the event of a subsequent allocation of ETI from the partnership. It may, however, be appropriate to allow a partner receiving a distribution in excess of basis that would otherwise recognize gain to increase its basis to the extent of EBIE previously allocated to such partner.

(iii) Appropriate Methods for Determining the Amount of Deductible BIE and Disallowed BIE Carryforward of a Nonresident Alien, Foreign Corporation, or Partnership that Is Properly Allocable to ECI.

The Preamble to the Final Regulations states that Treasury and the IRS are continuing to study methods of determining the amount of deductible BIE and disallowed BIE carryforwards that are allocable to ECI. Accordingly, the final regulations reserve on the application of the BIE deduction limitation to foreign persons with ECI. The Preamble requests comments on appropriate methods for determining the amount of deductible BIE and disallowed BIE carryforward of a nonresident alien, foreign corporation, or partnership that is properly allocable to ECI. Further, the Preamble provides that comments should consider the appropriate method for determining the extent to which business interest expense determined under Treasury Regulation Section 1.882-5 should be treated as attributable to a partnership and subject to the Section 163(j) limitation at the partnership level.

We believe that a nonresident alien, foreign corporation, or partnership should allocate deductible BIE and disallowed BIE carryforward to ECI in a manner similar to the allocation of business income and expense between a CFC and ECI deemed corporation under Proposed Regulation Section 1.163(j)-7(f) by treating the relevant nonresident alien, foreign corporation, or partnership as a CFC with ECI for this purpose. We see no reason for Treasury or the IRS to create a different methodology for allocating deductible BIE and disallowed BIE carryforward for a non-US taxpayer that has both ECI and non-ECI.

(5) Application of Final Regulations before 2020.

The Preamble to the Final Regulations states that taxpayers and their related parties may generally apply the Final Regulations "in their entirety, to a taxable year beginning after December 31, 2017, and before November 13, 2020, so long as the taxpayers and their related parties consistently apply these rules… for such taxable year". Further guidance should address related parties with different taxable years. For example, assume X and Y are related entities, X has an October 31 taxable year end and Y has a December 31 taxable year end. If Y wants to apply the Final Regulations for its December 31, 2019 tax year, does X have to apply the Final Regulations for its taxable year ending October 31, 2019 or October 31, 2020 (or both), and, regardless of the answer, does that then have further ramifications for the year(s) for which Y must apply the Final Regulations and so on?

(6) Election to use 2019 ATI to Determine 2020 Section 163(j) Limitation.

The Final Regulations provide that a taxpayer can elect to use its 2019 ATI in 2020. However, the Final Regulations do not provide a mechanism for a taxpayer to adjust its 2019 ATI, for purposes of calculating its 2020 Section 163(j) limitation, to reflect Final Regulation Section 1.163(j)-1(b)(1)(iii) (the expansion of the ATI adjustment for capitalized Depreciation Deductions). As a result if a taxpayer wants to take advantage of the expansion of the ATI adjustment, it needs to amend its 2019 return even if such change would not alter the amount of interest that is deducted in 2019 (for example, if a taxpayer's Section 163(j) limitation for 2019 without regard to capitalized Depreciation Deductions exceeds such taxpayer's BIE for 2019). Further, for partnerships that generally cannot amend their returns, Treasury and the IRS should exercise their authority to permit amended returns under Section 6031(b)(4) in a manner similar to Revenue Procedure 2020-23.

(B) The Proposed Regulations.

The Proposed Regulations are divided into 9 primary parts. Part (1) of the Proposed Regulations provides proposed rules that would allocate interest expense for purposes of Sections 469, 163(d), 163(h), and 163(j) in connection with certain transactions involving passthrough entities. Part (2) provides proposed rules relating to distributions of debt proceeds from any taxpayer account or from cash so that interest expense may be allocated for purposes of Sections 469, 163(d), 163(h), and 163(j). Part (3) provides proposed modifications to the definitions and general guidance, including proposed rules permitting taxpayers to apply a different computational method in determining adjustments to tentative taxable income to address sales or other dispositions of depreciable property, stock of a consolidated group member, or interests in a partnership, and proposed rules allowing RIC shareholders to treat certain RIC dividends as interest income for purposes of Section 163(j). Part (4) provides proposed modifications to Section 1.163(j)-6, relating to the applicability of the Section 163(j) limitation to passthrough entities, including proposed rules on the applicability of the Section 163(j) limitation to trading partnerships and publicly traded partnerships, the application of the Section 163(j) limitation in partnership self-charged lending transactions, proposed rules relating to the treatment of EBIE in tiered partnerships, proposed rules relating to partnership basis adjustments upon partner dispositions, proposed rules regarding the election to substitute 2019 ATI for the partnership's 2020 ATI in determining the partnership's Section 163(j) limitation for a taxable year beginning

in 2020, and proposed rules regarding EBIE allocated to a partner in a taxable year beginning in 2019. Part (5) provides re-proposed rules regarding the application of the Section 163(j) limitation to foreign corporations and United States shareholders of CFCs. Part (6) provides re-proposed rules regarding the application of the Section 163(j) limitation to nonresident alien individuals and foreign corporations with ECI. Part (7) provides proposed modifications to the definition of a real property trade or business under Section 1.469-9 for purposes of the passive activity loss rules and the definition of an electing real property trade or business under Section 163(j)(7)(B). Part (8) provides proposed rules regarding the definition of a "tax shelter" for purposes of Section 1.163(j)-2 and Section 1256(e), as well as proposed rules regarding the election to use 2019 ATI in determining the taxpayer's Section 163(j) limitation for a taxable year beginning in 2020. Part (9) provides proposed modifications regarding the application of the corporate look-through rules to tiered structures. This report only discusses the Proposed Regulations to the extent that we are making recommendations to clarify or alter the provisions when the Proposed Regulations are finalized.[84]

(1) Passthrough Entities.

(i) Debt Financed Distributions and Debt Financed Acquisitions.

The Proposed Regulations extend beyond Section 163(j). Proposed Regulation Section 1.163-14 provides additional rules for purposes of applying Temporary Treasury Regulation Section 1.163-8T to passthrough entities and to account for the entity-level limitation under Section 163(j)(4). As with the rules under Temporary Treasury Regulation Section 1.163-8T, Proposed Regulation Section 1.163-14 would provide that interest expense on a debt incurred by a passthrough entity is allocated in the same manner as the debt to which such interest relates is allocated, and that debt is generally allocated by tracing disbursements of the debt proceeds to specific expenditures.

Proposed Regulation Section 1.163-14(d) provides that distributed debt proceeds would first be allocated to the partnership's available expenditures. Available expenditures are those partnership expenditures made in the same taxable year as the distribution, but only to the extent that debt proceeds (including other distributed debt proceeds) are not otherwise allocated to such expenditures. Proposed Regulation Section 1.163-14(d)(3)(iii) would generally provide that a partnership must allocate excess interest expense (i.e., a partner's allocable share of interest expense with respect to debt the proceeds of which are not allocated to available expenditures or distributions to that partner) based on the adjusted tax basis of the passthrough entity's assets reduced by any debt otherwise allocated to the assets.[85]

Proposed Regulation Section 1.163-14(f) provides a similar rule that would allocate interest expenses for debt proceeds allocated to contributions to the capital of or to the purchase of an

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[84] Our recommendations regarding provisions in the Proposed Regulations relating to the definition of ATI are included in the discussion of the Final Regulations in Part III.A.1, above.

[85] Adjusted basis for these purposes may also be determined under the rules of Proposed Regulations Section 1.163(j)-10(c)(5)(i), but also reduced by any debt otherwise allocated to such assets.

interest in a passthrough entity based upon the adjusted basis of the entity's assets reduced by debt otherwise allocable to such assets.[86]

Treasury and the IRS request comments on Proposed Regulations Section 1.163-14(f) regarding whether using asset basis in this manner is appropriate as the sole method for allocating interest expense in this context.

While the incurrence of debt often produces basis in assets that is not always the case, particularly in the context of intangible assets. The issue arises both in connection with the acquisition of an interest in a partnership as well as in financings obtained by the partnership in order to fund distributions to the partners. The ability of a partnership to leverage its assets and make a distribution of the debt proceeds to its partners is a function of the value of the partnership's assets, and not their adjusted basis. Similarly, a partner may obtain debt financing to fund a partnership in which the expenditures do not produce assets with an adjusted basis, but rather are used for deductible expenditures, such as research and development. We believe it is therefore appropriate for taxpayers to have the option to allocate the debt proceeds in accordance with the fair market value of the partnership's assets both for excess interest as well for acquisitions of partnership interests.

This approach reflects more accurately the nature of partnership businesses, particularly where the most valuable assets are intangibles with little or no basis. Consider for example a partnership that as its principal business provides management services through management contracts and that owns assets consisting mainly of the management contracts (with a zero basis), but that also owns some investment securities not used in the business. Under these rules, a partner that funds a capital contribution through debt would be considered to have investment interest, even though the proceeds of the capital contribution are used to fund salaries. In such a case, an allocation of the debt to the securities, rather than the management contracts, is a distortion of the economic arrangement and would produce an incorrect result under the policies of Section 163(j). The same issue is presented in the case of a partnership which incurs debt to make distributions to the partners on the basis of intangible assets with zero tax basis. In that case, any excess interest would also be allocated to assets which did not contribute to the ability to incur the indebtedness.

Partners and partnerships are regularly required to determine the fair market value of partnership assets. For example, when a partnership interest is purchased, the determination of fair market value of the assets is usually made. Implicit in the purchase is an aggregate value and other provisions of the Code, including Sections 754 and 755, operate on the basis that the value of the assets may be derived from the purchase price for the partnership interest.

In making this recommendation, we understand that this approach would be inconsistent with Congressional intent based on the recent Act amendments to Section 864(e). We further recommend that if Treasury and the IRS adopt this approach, it should apply for all Section 163(j) purposes. In this regard, we recommend that Final Regulations Section 1.163(j)-10 be

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[86] Proposed Regulation Section 1.163-14(f) also permits the use of the rules for determining adjusted basis in Section 1.163(j)-10(c)(5)(i) reduced by debt.

amended to permit taxpayers to use a fair market value allocation method when determining allocations of business interest expense for Section 163(j) purposes. To discourage taxpayers from shifting allocation methods, we recommend that a fair market value allocation election be irrevocable absent consent from the IRS.

(ii) Treasury and the IRS Should Clarify the Requirements for Taxpayers to Rely on the Passthrough Provisions of the Proposed Regulations.

The Preamble to the Proposed Regulations provides that taxpayers and their related parties, "may rely on the rules in Section 1.163(j)-6 of these Proposed Regulations for a taxable year beginning after December 31, 2017, and before 60 days after the Treasury Decision adopting these rules as final regulations is published in the Federal Register, provided that taxpayers and their related parties also apply the rules of Section 1.163(j)-6 in the Final Regulations and consistently follow all of those rules for that taxable year and for each subsequent taxable year".

Treasury and the IRS should confirm whether this language is intended to allow passthrough entities to apply these portions of the Proposed Regulations in isolation or whether such taxpayers must consistently apply the Proposed Regulations in their entirety.

The extent to which taxpayers must apply the entirety of the Final Regulations in order to apply Proposed Regulation Section 1.163(j)-6 is also unclear. Proposed Regulation Section 1.163(j)-6(p)(2) indicates that in order to apply several provisions of Proposed Regulation Section 1.163(j)-6 retroactively, taxpayers must also "apply the provisions of section 1.163(j)-6 in the [final] section 163(j) regulations, and consistently apply all of the rules of section 1.163(j)-6 in the [final] section 163(j) regulations to that taxable year and to each subsequent taxable year." It is unclear whether this rule is intended to require taxpayers to apply only Final Regulation Section 1.163(j)-6 or the Final Regulations more generally.

(iii) A Limited Partner Should be Permitted to Aggregate Activities of Multiple Trading Partnerships for Section 469 Purposes.

The Final Regulations did not alter the definition of "trade or business" for Section 163(j) purposes to address the complexities of passive investors in trading partnerships. Instead, the Proposed Regulations adopt an "inside/out" approach by examining the activities of the partners to determine a trading partnership's Section 163(j) limitation. While the BII and BIE of a partnership is generally determined in accordance with the general rules of Final Regulation Section 1.163(j)-1(b)(2) and (3), the Proposed Regulations provide that, to the extent BII or BIE of a partnership that is properly allocated to trades or businesses that are per-se non-passive activities and is allocated to partners that do not materially participate (within the meaning of Section 469), as described in Section 163(d)(5)(A)(ii) ("trading partnerships"), such interest income and interest expense is not considered BII or BIE for purposes of determining the partnership's Section 163(j) limitation.[87] Thus, for trading partnerships, interest income and expense (that has historically been treated as business income and expense) that is allocated to

[87] Proposed Regulation Section 1.163(j)-6(c).

non-materially participating partners subject to Section 163(d) is not included in the Section 163(j) limitation calculation of the partnership. In effect, the Proposed Regulations require a trading partnership to bifurcate its interest expense from a trading activity between partners that materially participate in the trading activity and partners that are passive investors, and subject only the portion of the interest expense that is allocable to the materially participating partners to limitation under Section 163(j) at the partnership level. Interest expense allocable to non-materially participating partners is subject to Section 163(d) at the partner level, but not Section 163(j) at the partnership level.

In addition, the Proposed Regulations require that a trading partnership bifurcate all of its other items of income, gain, loss and deduction from its trading activity between partners that materially participate in the partnership's trading activity and partners that are passive investors.[88]

The Proposed Regulations presume that a trading partnership generally will possess knowledge regarding whether its partners are material participants in its trading activity. In addition, the Proposed Regulations would amend the Section 469 passive activity loss regulations to provide that "an activity described in Section 163(d)(5)(A)(ii) that involves the conduct of a trade or business which is not a passive activity of the taxpayer and with respect to which the taxpayer does not materially participate may not be grouped with any other activity or activities of the taxpayer, including any other activity described in Section 163(d)(5)(A)(ii)."[89] The Preamble to the Proposed Regulations explains that the proposed change to the Section 469 regulations is intended to avoid the possibility (and potential abuse) that could occur if a trading partnership presumes that an individual investor is a passive investor in the partnership's trading activity based solely on the partnership's understanding as to the lack of work performed by partner in that activity, whereas the partner may in fact be treated as a material participant in the partnership's trading activity by grouping that activity with one or more activities of the partner in which the partner materially participates.[90]

Treasury and the IRS invite comments regarding whether other approaches may be feasible and preferable to a special rule that prohibits the grouping of trading activities with other activities of a partner, such as adoption of a rule or reporting regime requiring all partners in the partnership to annually certify or report to the partnership whether they are material participants in a grouped activity that includes the partnership's trading activity.

We disagree with the decision in the Proposed Regulations to deny a limited partner's ability to aggregate activities of multiple trading partnerships for Section 469 purposes. While there may be an administrative burden associated with partnerships evaluating the activities of their limited

[88] Proposed Regulation Section 1.163(j)-6(d)(4).

[89] Proposed Regulation Section 1.469-4(d)(6).

[90] Preamble to the Proposed Regulations at 32.

partners, we note that partnerships are already required to collect certain details about their partner's tax status in analogous situations.[91]

(iv) Self-Charged Lending Transactions.

The Proposed Regulations provide that, in the case of a lending transaction between a partner (lending partner) and partnership (borrowing partnership) in which the lending partner owns a direct interest (self-charged lending transaction), any BIE of the borrowing partnership attributable to a self-charged lending transaction is BIE of the borrowing partnership for purposes of Proposed Regulation Section 1.163(j)-6. If, in a given taxable year, the lending partner is allocated EBIE from the borrowing partnership and has interest income attributable to the self-charged lending transaction (interest income), the lending partner treats such interest income as an allocation of excess BII from the borrowing partnership in such taxable year, but only to the extent of the lending partner's allocation of EBIE from the borrowing partnership in such taxable year. To prevent the double counting of BII, the lending partner includes interest income that was re-characterized as excess BII[92] only once when calculating the lending partner's own Section 163(j) limitation. In cases where the lending partner is not a C corporation, to the extent that any interest income exceeds the lending partner's allocation of EBIE from the borrowing partnership for the taxable year, and such interest income otherwise would be properly treated as investment income of the lending partner for purposes of Section 163(d) for that year, such excess amount of interest income will continue to be treated as investment income of the lending partner for that year for purposes of Section 163(d).

We support the Proposed Regulations' treatment of self-charged lending transactions and expect that many taxpayers will benefit from the rule. As drafted, the rule only applies to loans between the direct lender/partner and the partnership. We believe that the rule is too narrow. For example, a corporate partner may be included in a consolidated group that includes a financing subsidiary that performs a treasury function for the group and has made a loan to the partnership. That corporate partner should be permitted to benefit from the self-charged lending rule. Accordingly, we recommend that the self-charged interest rule be expanded to include lenders in the same consolidated group as the partner and cases, such as partners in upper tier partnerships who make loans to lower tier partnerships, where the interest expense would ultimately flow up to the same taxpayer that recognizes the interest income.

(v) Partnership Basis Adjustments.

Proposed Regulation Section 1.163(j)-6(h)(5) provides that if a partner disposes of its partnership interest, the partnership shall increase the adjusted basis of partnership property by an amount equal to the increase in the partner's basis in its interest pursuant to Final Regulation Section 1.163(j)-6(h)(3). Such increase in the adjusted basis of partnership property is allocated among capital gain property of the partnership in the same manner as a positive Section 734(b)

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[91] Examples of these requirements include determining whether a partner is a corporation in order to apply Final Regulation Section 1.163(j)-4(b)(3) and determining whether a partnership has only eligible partners for purposes of electing out of the centralized partnership audit regime under Section 6221.

[92] Pursuant to Proposed Regulation Section 1.163(j)-6(n).

adjustment. Because a basis adjustment is taken into account when determining the gain or loss upon a sale of the asset, the basis adjustment required by Proposed Regulation Section 1.163(j)-6(h)(5) prevents the shifting of built-in gain to the remaining partners. The Proposed Regulations treats the increase in the adjusted basis of any partnership property resulting from a basis adjustment under Proposed Regulation Section 1.163(j)-6(h)(5) as not depreciable or amortizable under any Section of the Code, regardless of whether the partnership property allocated such Proposed Regulation Section 1.163(j)-6(h)(5) basis adjustment is otherwise generally depreciable or amortizable.

The Preamble to the Proposed Regulations suggests the inside basis step-up is appropriate because "the absence of a corresponding increase to the partnership's basis immediately before the partner's disposition would create distortions that are inconsistent with the intent of both Section 163(j) and subchapter K of the Code". Thus, the rationale for the asset basis step-up is equalizing inside and outside basis and avoiding a shift of built-in gain to the remaining partners. Treasury and the IRS request comments on this approach and whether treating a Proposed Regulation Section 1.163(j)-6(h)(5) basis adjustment as potentially depreciable or amortizable is consistent with Section 163(j)(4)(B)(iii)(II).

Partnership basis adjustments under the Proposed Regulations can generally be divided into the following three categories: (i) adjustments in the case of liquidating partnership distributions, (ii) adjustments in the case of taxable sales of partnership interests and (iii) adjustments in the case of non-taxable transfers of partnership interests.

We generally agree that an asset basis increase is appropriate. In the case of the transaction described in the Preamble, which involves a liquidating distribution to a partner, we agree that the remaining partners should have the benefit of the asset basis step-up because they have in effect purchased the departing partner's interest; this is similar to a basis step-up under Section 734.

However, where a partner sells its interest to a third party, similar to a basis adjustment under Section 743, the benefit of the asset basis step-up should inure solely to the purchaser; the economic situation of the remaining partners has not changed. Mechanically, final regulations could simply apply Section 734 or Section 743 principles, regardless of whether a Section 754 election is made.

We do not agree with the provision in the Proposed Regulations that denies depreciation or amortization deductions with respect to an increase in basis of a depreciable or amortizable asset. Allowing depreciation or amortization deductions to the continuing partners (in the case of a liquidation of a partnership interest) or to a purchasing partner (in the case of a sale) does not convey the benefit of the EBIE. Rather, it gives the remaining partners (in the case of a liquidation of a partnership interest) or the new buyer the benefit of the purchase price. If the partnership makes a Section 754 election, the increase in basis of the departing partner's basis in its interest and the partnership's basis in its assets reduces the partnership's Section 734 adjustment (in the case of a liquidating distribution) or the purchasing partner's Section 743 adjustment (in the case of a purchase). The rule in the Proposed Regulations therefore appears to reduce the otherwise available future depreciation or amortization deductions for the continuing

partners or the purchasing partner; there is no reason for the Section 163(j) rules to reduce these deductions.

Alternatively, the rules could provide that Proposed Regulation Section 1.163(j)-6(h)(5) does not apply to a partnership that makes a Section 754 election, and that in the case of a liquidating distribution, the rules could provide that the Section 734 basis adjustment rules should be determined without regard to the effect of the Section 163(j) basis adjustment on the gain or loss recognized by the departing partner.

We further note that the Proposed Regulations provide for an asset basis step-up when a partnership interest is transferred in a non-taxable transaction. Conceptually, the more appropriate approach might be to simply have the transferee succeed to the transferor's EBIE carryforward, with no step-up in basis of either the partnership interest or partnership assets. We recognize, however, that this is likely contrary to the statute.[93] As an alternative, final regulations could provide for an asset basis step-up that inures solely to the benefit of the transferee in a non-taxable transaction, but not to permit depreciation or amortization with respect to the stepped-up basis. Alternatively, depreciation or amortization could be permitted when there is ETI allocated to the transferee partner that would have permitted the EBIE to be used by the transferor partner.

(2) Foreign Corporations and United States Shareholders.

(i) General Rules Concerning CFCs, CFC Groups, and United States Shareholders.

The Final Regulations contain very little guidance regarding the application of Section 163(j) to CFCs and United States shareholders. There are two exceptions. First, Final Regulation Section 1.163(j)-7(b) confirms the conclusion set forth in the 2018 Proposed Regulations that Section 163(j) applies to CFCs to determine the deductibility of a relevant foreign corporation's BIE for purposes of computing its taxable income.[94] Second, for purposes of computing the tentative taxable income of a relevant foreign corporation for a taxable year, the Final Regulations provide that the relevant foreign corporation's gross income and allowable deductions are determined under Treasury Regulation Section 1.952-2 principles or, in the case of a relevant foreign corporation with ECI, under the Section 882 rules and, for purposes of determining tentative taxable income, a relevant foreign corporation excludes dividends received from a related person.[95] Given the complexities of applying Section 163(j) to CFCs and United States shareholders, virtually all of the guidance is set forth in the Proposed Regulations, some of the key aspects of which we briefly summarize below.

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[93] We note, however, that in the case of a tiered partnership, where a partner in the upper tier partnership transfers its interest in the upper tier partnership to another partnership in a Section 721 transaction, the Proposed Regulations appear to allow the transferee to succeed to any future deductions with respect to lower tier EBIE carryforwards to which the transferor would have been entitled absent the transfer.

[94] Final Regulation Section 1.163(j)-7(b).

[95] Final Regulation Section 1.163(j)-7(g).

The Proposed Regulations generally apply 163(j) on a group wide basis to electing CFC groups. Each CFC group has a group-wide ATI, a group-wide amount of interest income, a group-wide Section 163(j) limitation and a group-wide amount of interest expense that is subject to the limitation. Generally, the CFC group's ATI, interest income and interest expense is the sum of each CFC's ATI, interest income and interest expense, respectively, and the group's Section 163(j) limitation is equal to the group's interest income plus 30% of the group's ATI.[96] CFC group members are allocated shares of group-wide items such as disallowed interest expense where the group wide interest expense exceeds the group's Section 163(j) limitation.

The 2018 Proposed Regulations defined a CFC group as two or more applicable CFCs if 80% 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.[97]

The Proposed Regulations adopt a broader approach and define CFC group simply as all CFC group members for their specified taxable years. The term "CFC group member" means a "specified group member" of a "specified group" for which a CFC group election is in effect.[98] The term "specified group" means one or more chains of applicable CFCs connected through stock ownership with a specified group parent (which is included in the specified group only if it is an applicable CFC), but only if the specified group parent owns directly or indirectly stock meeting the requirements of Section 1504(a)(2)(B) in at least one applicable CFC;[99] and stock meeting the requirements of Section 1504(a)(2)(B) in each of the applicable CFCs (except the specified group parent) is owned directly or indirectly by one or more of the other applicable CFCs or the specified group parent.[100] An applicable CFC is a CFC that has at least one United States shareholder that owns stock in the CFC within the meaning of Section 958(a).[101] A specified group parent is an applicable CFC or a qualified U.S. person, which is defined in turn as an individual citizen or resident of the United States (treating a married couple filing joint returns as a single person) or a United States corporation (treating members of a consolidated group as a single corporation). If an applicable CFC has multiple taxable years that end with or within a specified period, each year is tested separately to determine if the applicable CFC is a specified group member for such taxable year.[102] The principles of Treasury Regulation Section 1.1502-75(d)(1), (d)(2)(i) through (d)(2)(ii), and (d)(3)(i) through (d)(3)(iv) (regarding when a

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[96] Proposed Regulation Section 1.163(j)-7(c)(2). As well as the group's floor plan financing interest where applicable.

[97] 2018 Proposed Regulation Section 1.163(j)-7(f)(6).

[98] Proposed Regulation Section 1.163(j)-7(e)(2).

[99] Requiring a value equal to at least 80% of the total value of the stock of such corporation.

[100] Proposed Regulation Section 1.163(j)-7(d)(2).

[101] Final Regulation Section 1.163(j)-1(b)(2).

[102] Proposed Regulation Section 1.163(j)-7(d)(3).

consolidated group remains in existence) apply for purposes of determining when a specified group ceases to exist.[103]

Under the 2018 Proposed Regulations, the CFC group election was irrevocable. The Proposed Regulations require a formal statement to make a CFC group election, but the election is only binding for five years. Once revoked, a CFC group election cannot be made again with respect to any period of the specified group that begins during the 60 month period following the last day of the first specified period for which the election was revoked.[104]

Under the Proposed Regulations, a United States shareholder's ATI is increased, with respect to a CFC that is a "stand-alone applicable CFC" (defined as an applicable CFC that is not a member of a specified group) or a member of a CFC group by the amount of income inclusions taken into account by the United States shareholder (excluding for this purpose the inclusion under Section 78) multiplied by a fraction, the numerator of which is the CFC's excess taxable income and the denominator of which is the CFC's ATI.[105] No increase to the United States shareholder's ATI is allowed with a respect to a CFC that is a member of a specified group for which a CFC group election is not made.

The Proposed Regulations generally treat the attributes of a CFC group member that are attributable to ECI as attributes of a separate applicable CFC referred to as an "ECI deemed corporation". The ECI deemed corporation is not treated as a specified group member.[106]

We would like to thank Treasury and the IRS for providing helpful guidance with respect to CFCs and addressing many of the issues raised in our 2019 Report. Nevertheless, we have several issues that should be considered when the Proposed Regulations are finalized.

First, unlike the 2018 Proposed Regulations, the Proposed Regulations provide that a CFC group election may be revoked after five years. We recommend Treasury and the IRS consider an additional exception to the irrevocability of the CFC group election that would apply where there is a change in control of the CFC group.

Second, a CFC group is treated as a single corporation for purposes of allocating items to an excepted trade or business.[107] The general method of allocation is based on the approach that money is fungible and that interest expense is attributable to all activities and property, regardless of any specific purpose for incurring interest expense.[108] Treasury and the IRS should consider whether this approach makes sense in the context of excepted trades or businesses and

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[103] Proposed Regulation Section 1.163(j)-7(d)(2)(vii).

[104] Proposed Regulation Section 1.163(j)-7(e)(5)(ii).

[105] Proposed Regulation Section 1.163(j)-7(j).

[106] Proposed Regulation Section 1.163(j)-7(f).

[107] Final Regulation Section 1.163(j)-10(a)(3) and Proposed Regulation Section 1.163(j)-7(c)(2)(iii).

[108] Final Regulation Section 1.163(j)-10(a)(1)(i).

groups in which the CFCs are not all wholly owned. Additionally, this approach appears to be contrary to the rules governing the calculation of the CFC group's section 163(j) limitation and allocation. Specifically, under Proposed Regulation Section 1.163(j)-7(c)(2)(i), a CFC group's current-year BIE and BII is equal to the sum of each CFC group member's current-year BIE and BII. The determination of BIE and BII requires the taxpayer to determine the portion of its interest expense and interest income that is not allocable to an excepted trade or business. Therefore, under the section 163(j) calculation rules, it appears that this determination is made on a CFC by CFC basis, while under the allocation rules, it appears that the allocation is made at the CFC group level. It would be helpful if this would be clarified. Additionally, under the Proposed Regulations, debt obligations between members of a CFC group are respected. As a result, in applying the allocation rules of Final Regulations Section 1.163(j)-10, it would appear that the note that a CFC group member has from another CFC group member would be respected and treated as an asset that needs to be allocated. However, if the CFC group is treated as a single taxpayer, it would appear that the intercompany obligation would not exist. Therefore, Treasury and the IRS should clarify how inter-CFC group obligations are treated for purposes of applying the Final Regulations Section 1.163(j)-10 allocation rules.

Third, consideration should be given to issues regarding the application of the CFC rules to CFC groups that include CFCs for which United States shareholders elect to exclude subpart F income and GILTI under the high tax exception.[109] It appears that under the Proposed Regulations, interest expense, ATI, and the Section 163(j) limit are determined for the CFC group. If the group's interest expense exceeds the Section 163(j) limit, the deductible interest expense is generally allocated among the group members in proportion to each member's interest expense without regard to individual members' ATI.[110] Only then is it determined whether, taking into account deductible interest, group members qualify for the high-tax exception. Because there is no specified deemed inclusion with respect to a CFC that qualifies for (and with respect to which an election is made to apply) the high-tax exception, none of its ATI is included in the United States shareholder's ATI under Proposed Regulation Section 1.163(j)-7(j).

Although we believe that these rules are generally reasonable, they can lead to some arguably anomalous results. Assume that a CFC group consists of two members, CFC1, which is not eligible for the high-tax exception, and CFC2, which is eligible. If CFC1 has 90 in interest expense and 100 in ATI, and CFC2 has no interest expense and 200 in ATI, CFC1's interest expense is fully deductible in determining the United States shareholders' subpart F and GILTI inclusions, even though Section 163(j) would limit the interest deduction absent CFC2's ATI, which is not taxed under subpart F or GILTI. Although we believe that this result can be justified on the basis that the CFC group in this example has not incurred excess interest expense, Treasury and the IRS may want to consider whether it is appropriate. Conversely, a CFC can be resident in a high tax jurisdiction, have interest expense that is less than 30% of its ATI and is fully deductible for foreign tax purposes, but fail to qualify for the high tax exemption because other CFC group members have excessive interest expense, resulting in the United States not

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[109] See Section 954(b)(4) and Treasury Regulation Section 1.951A-2(c)(7).

[110] Proposed Regulation Section 1.163(j)-7(c)(3)(A), referencing the rules of Final Regulation Section 1.163(j)-5(a)(2) and (b)(3)(ii) that apply to consolidated groups.

treating the CFC's interest expense as fully deductible. An alternative approach that could be considered would be to first determine whether a member of a CFC group is eligible for the high-tax exception by applying Section 163(j) on a separate company basis, and if it does qualify, excluding its interest expense and ATI from the calculations for the group. Additionally, it would be helpful if Treasury and the IRS confirmed that a CFC for which a high-tax exception applies can still have an EBIE carryforward from the current year.[111]

Fourth, if a CFC group member has ECI, for Section 163(j) purposes, the items, disallowed BIE carryforwards, and other attributes of the CFC group member that are allocable to ECI are treated as items, disallowed BIE carryforwards, and attributes of a separate applicable CFC referred to as a ECI deemed corporation. The ECI deemed corporation is not treated as a specified group member for the specified taxable year and the items, disallowed BIE carryforwards, and other attributes are allocated between the CFC group member and the ECI deemed corporation before the application of Proposed Regulation Section 1.163(j)-8(d). The Proposed Regulations are silent, however, as to the method for allocating assets between the CFC group member and the ECI deemed corporation. Final Regulation Section 1.163(j)-10 should be clarified to expressly apply to allocations between the CFC group member and the ECI deemed corporation.

Fifth, Treasury and the IRS should clarify whether Section 382 is intended to apply to CFCs without ECI in order to limit carryforwards of disallowed BIE and/or to limit use of built-in losses.[112] In addition, the Proposed Regulations contain a limitation on EBIE carryforwards similar to the SRLY rules. While we generally support the intent of the limitation Treasury and the IRS should adopt the overlap rule set forth in Treasury Regulation Section 1.1502-21(g) if both Section 382 and SRLY principles apply to a CFC group.

Sixth, Treasury and the IRS have asked for comments on Proposed Regulation Section 1.163-7(g)(3), which provides that for purposes of determining the ATI of a CFC there is a deduction for foreign income taxes paid by the CFC. We believe that this rule would have the anomalous result that a CFC that is resident in a foreign country the tax laws of which are identical to those of the United States, including Section 163(j), could be fully entitled to deduct its interest expense for foreign tax purposes but be limited for purposes of calculating United States shareholders' subpart F and GILTI inclusions and/or required to reduce the amount of excess taxable income that would flow up to United States shareholders and be included in their ATI.

(ii) Specified Deemed Inclusions.

The final regulations should treat specified deemed inclusions in a manner similar to dividends under Final Regulation Section 1.163(j)-10(b)(3). The Proposed Regulations modify the look-through rule for domestic non-consolidated C corporations and CFCs to limit the potentially distortive effect of this look-through rule on tiered structures in situations to which the anti-

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[111] The issue with respect to the high-tax exception reflects a broader tension between determining the Section 163(j) on a CFC group basis and then calculating subpart F income and GILTI on a CFC-by-CFC basis.

[112] The question of whether and how a CFC that does not have ECI is subject to Section 382 is beyond the scope of this report.

avoidance and anti-abuse rules do not apply. More specifically, the Proposed Regulations would modify the look-through rule for non-consolidated C corporations to provide that, for purposes of determining a taxpayer's basis in its assets used in excepted and non-excepted trades or businesses, any such corporation whose stock is being looked through may not itself apply the look-through rule. Treasury and the IRS request comments on the proposed limitation on the application of the corporate look-through rules. Treasury and the IRS also request comments on whether there are other situations in which the look-through rules for domestic non-consolidated C corporations or CFCs should apply and whether there are other approaches for addressing the distortions that these proposed rules are intended to minimize.

Final Regulation Section 1.163(j)-1(b)(1)(ii)(G) suggests that a portion of the specified deemed inclusion can be properly allocable to an excepted trade or business. However, Final Regulation Section 1.163(j)-10 does not include a special allocation rule for this type of income. Treasury and the IRS should clarify in what circumstances a specified deemed inclusion is supposed to be allocable to an excepted trade or business and how such allocated specified deemed inclusion is treated for purposes of determining ATI.

We recommend that the Section 163(j) regulations treat specified deemed inclusions in a manner similar to dividends under Final Regulation Section 1.163(j)-10(b)(3). Thus, solely for purposes of allocating a specified deemed inclusion during the taxable year to excepted or non-excepted trades or businesses, the specified deemed inclusion should be treated as allocable to excepted or non-excepted trades or businesses based upon the relative amounts of the CFC's adjusted basis in its assets used in the trades or businesses.