ALSTON & BIRD

WWW.ALSTON.COM

International Tax ADVISORY ■

MARCH 15, 2018

The Tax Act's New Business Interest Expense Limitation – Dear IRS: Some Guidance, Please?

The legislation commonly known as the Tax Cuts and Jobs Act replaced the "earnings stripping" rules with "new" Section 163(j), which generally limits deductions for net interest expense of a business. Former Section 163(j) was somewhat narrower. It generally limited interest deductions for certain related-party debt and applied to corporations with a debt-to-equity ratio greater than 1.5 to 1 and whose net interest expense exceeded 50% of the corporation's adjusted taxable income in a taxable year. New Section 163(j) applies to *all* debt, whether between related parties or incurred by a corporation, and regardless of the taxpayer's debt-to-equity ratio.

The Basics

New Section 163(j) disallows deductions for business interest expense that exceeds an adjusted earnings-based threshold. In general, deductions are disallowed to the extent business interest expense is incurred in a taxable year in excess of (1) business interest income; (2) 30% of the taxpayer's adjusted taxable income; and (3) floor plan financing interest. The limitation applies after other potential limitations on deductibility of interest expense are considered, including interest capitalization rules or other disallowance provisions. Disallowed interest expense may be carried forward indefinitely to succeeding taxable years.

"Business interest" includes interest allocable to a trade or business and excludes "investment interest" (as defined in Section 163(d), which contains a separate limitation applicable to investment interest expense of non-corporate taxpayers).

"Adjusted taxable income" is generally computed using a formula that mimics EBITDA through 2021, but starting in 2022, a harsher definition kicks in that mimics EBIT.

This advisory is published by Alston & Bird LLP to provide a summary of significant developments to our clients and friends. It is intended to be informational and does not constitute legal advice regarding any specific situation. This material may also be considered attorney advertising under court rules of certain jurisdictions.

There are notable exclusions for specified trades or businesses: the performance of services as an employee, electing real estate businesses, electing farm businesses, and certain regulated public utilities. Once made, the elections for real estate and farming businesses are irrevocable and, as a trade-off, those businesses will be required to use longer depreciation methods. Businesses with average annual gross receipts over the prior three years of $25 million or less are also excluded.

Special Rules for Partnerships and S Corporations

The business interest limitation applies at the partnership, not the partner, level. Business interest deductions are taken into account at the entity level as items of non-separately stated partnership income and loss. Each partner computes its adjusted taxable income without regard to its distributive share of partnership income and loss. This prevents partners from using their allocable shares of partnership adjusted taxable income to generate larger interest deductions as the taxable income is passed through.

To the extent a partnership has excess capacity for interest deductions (i.e., it could have deducted more had it incurred more interest expense), a partner can use its proportionate share of the excess capacity to avail itself of greater deductions for other interest expense it incurred at the partner level. The rules accomplish this by permitting partners to add their allocable share of the partnership's "excess taxable income" to their separate computation of adjusted taxable income for the business interest expense deduction calculation.

Rules for entity-level interest expense deductions and the ability of pass-through owners to use a portion of the entity's excess capacity also apply to S corporations and their shareholders.

Special carryforward rules apply if a partnership has excess interest expense that is disallowed under the new limitation. The excess interest expense is allocated to partners based on their distributive shares of non-separately stated taxable income and loss of the partnership and will be treated as paid or accrued by the partners starting in the *next* taxable year in which the partners are allocated excess taxable income from the partnership. Thus, carryforwards of disallowed interest expense can only be used by partners against (and to the extent of) subsequent excess taxable income of the partnership.

A partner's basis in its partnership interest is decreased (not below zero) at the time the excess interest expense is allocated to the partner, even though the carryover can only give rise to partner deductions in later years. The result is a timing mismatch between the deduction and the basis reduction, which limits the partner's ability to receive tax-free actual or deemed cash distributions and other partnership loss deductions. However, if a partnership interest is disposed of in a taxable or non-recognition transaction before a deduction is taken, the partner's basis in the interest is increased immediately before the disposition by the partner's share of the excess interest expense allocated to, but not yet deducted by, it. The rules also prohibit a transferor and a transferee from taking a deduction for the excess interest expense that creates this basis increase.

These special carryforward and corresponding basis rules do *not* apply to S corporations and their shareholders.

Rules for Corporations

Carryovers of disallowed interest expense are treated as attributes that can be carried over in certain non-recognition transfers. However, carryovers of disallowed interest expense are treated as items of pre-change loss that are subject to limitation under Section 382 upon certain ownership changes.

An Evolving State of Affairs

The most remarkable aspects of the new interest expense limitation are probably what its final provisions leave out.

Earlier versions of the legislation would have also limited interest deductions for U.S. members of international groups based on certain worldwide proportionality ratios. These provisions were abandoned in the final law.

On whether the new Section 163(j) limitations should be applied at the consolidated group level, the text is silent, but the legislative history indicates that it should. During a recent public event, a Treasury official indicated that forthcoming guidance would confirm that new Section 163(j) applies at the consolidated group level (and not on an elective basis), but then a few weeks later another Treasury official at another public event indicated that this still remains under consideration at the IRS, including whether to apply the limitation on a single-entity, separate-entity, or hybrid basis for consolidated groups. It is unclear how this ultimately will be applied.

Perhaps attributable to the speed with which this monumental tax reform effort was translated into law, the provisions do not grant specific regulatory authority for additional guidance. Old Section 163(j) granted such authority in numerous places. Nevertheless, administrative guidance is needed to address several open issues, such as rules applicable to consolidated groups and to foreign taxpayers with income effectively connected to a U.S. trade or business, and the ability to use carryforwards beyond 2017 for disallowed interest expense under the old Section 163(j) earnings stripping rules.

Also unclear is whether and how any guidance in this area might dovetail with a recent focus by the Treasury on debt recharacterization rules under Section 385. Recent final and temporary regulations issued under Section 385 that purported to expand its reach have since been delayed. Shortly before the enactment of the Tax Cuts and Jobs Act, the Treasury issued a statement announcing its intent to revoke and/or substantially revise them. Perhaps those proposals are being reconsidered in light of new Section 163(j).

For more information, please contact Edward Tanenbaum at 212.210.9425 or Danny Reach at 704.444.1272.

You can subscribe to future *International Tax* advisories and other Alston & Bird publications by completing our **publications subscription form**.

Click **here** for Alston & Bird's Tax Blog.

If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

International Tax Group

Sam K. Kaywood, Jr.
Co-Chair
404.881.7481
sam.kaywood@alston.com

Edward Tanenbaum
Co-Chair
212.210.9425
edward.tanenbaum@alston.com

George B. Abney
404.881.7980
george.abney@alston.com

John F. Baron
704.444.1434
john.baron@alston.com

Henry J. Birnkrant
202.239.3319
henry.birnkrant@alston.com

Seth M. Buchwald
404.881.7836
seth.buchwald@alston.com

James E. Croker, Jr.
202.239.3309
jim.croker@alston.com

Jasper L. Cummings, Jr.
919.862.2302
jack.cummings@alston.com

Scott Harty
404.881.7867
scott.harty@alston.com

Brian D. Harvel
404.881.4491
brian.harvel@alston.com

L. Andrew Immerman
404.881.7532
andy.immerman@alston.com

Stefanie Kavanagh
202.239.3914
stefanie.kavanagh@alston.com

Ryan J. Kelly
202.239.3306
ryan.kelly@alston.com

Brian E. Lebowitz
202.239.3394
brian.lebowitz@alston.com

Clay A. Littlefield
704.444.1440
clay.littlefield@alston.com

Ashley B. Menser
919.862.2209
ashley.menser@alston.com

Daniel M. Reach
704.444.1272
danny.reach@alston.com

Heather Ripley
212.210.9549
heather.ripley@alston.com

Michael Senger
404.881.4988
michael.senger@alston.com

ALSTON & BIRD

WWW.ALSTON.COM

© ALSTON & BIRD LLP 2018

ATLANTA: One Atlantic Center ▪ 1201 West Peachtree Street ▪ Atlanta, Georgia, USA, 30309-3424 ▪ 404.881.7000 ▪ Fax: 404.881.7777
BEIJING: Hanwei Plaza West Wing ▪ Suite 21B2 ▪ No. 7 Guanghua Road ▪ Chaoyang District ▪ Beijing, 100004 CN ▪ +86 10 8592 7500
BRUSSELS: Level 20 Bastion Tower ▪ Place du Champ de Mars ▪ B-1050 Brussels, BE ▪ +32 2 550 3700 ▪ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ▪ 101 South Tryon Street ▪ Suite 4000 ▪ Charlotte, North Carolina, USA, 28280-4000 ▪ 704.444.1000 ▪ Fax: 704.444.1111
DALLAS: 2828 North Harwood Street ▪ 18th Floor ▪ Dallas, Texas, USA, 75201 ▪ 214.922.3400 ▪ Fax: 214.922.3899
LOS ANGELES: 333 South Hope Street ▪ 16th Floor ▪ Los Angeles, California, USA, 90071-3004 ▪ 213.576.1000 ▪ Fax: 213.576.1100
NEW YORK: 90 Park Avenue ▪ 15th Floor ▪ New York, New York, USA, 10016-1387 ▪ 212.210.9400 ▪ Fax: 212.210.9444
RALEIGH: 555 Fayetteville Street ▪ Suite 600 ▪ Raleigh, North Carolina, USA, 27601-3034 ▪ 919.862.2200 ▪ Fax: 919.862.2260
SAN FRANCISCO: 560 Mission Street ▪ Suite 2100 ▪ San Francisco, California, USA, 94105-0912 ▪ 415.243.1000 ▪ Fax: 415.243.1001
SILICON VALLEY: 1950 University Avenue ▪ 5th Floor ▪ East Palo Alto, California, USA, 94303-2282 ▪ 650-838-2000 ▪ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ▪ 950 F Street, NW ▪ Washington, DC, USA, 20004-1404 ▪ 202.239.3300 ▪ Fax: 202.239.3333