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International Tax ADVISORY ■

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Proposed Regulations Address Post-Reform Interest Expense Limitation

On November 26, the Treasury and IRS issued proposed regulations under Section 163(j), as amended by 2017's Tax Cuts and Jobs Act (TCJA). The proposed regulations, while not technically applicable until published as final in the *Federal Register*, provide crucial guidance on the TCJA's new business interest limitation provision, including in the international context. Unfortunately, the guidance presents taxpayers with an all-new, expansive definition of "interest," paired with subjective anti-abuse cudgels, a host of complex computational snares, and a smattering of interpretive gaps. For U.S. shareholders of controlled foreign corporations (CFCs), these proposed rules add to a growing morass of post-TCJA compliance and tax burdens. Taxpayers can choose to apply the proposed rules for tax years beginning after December 31, 2017, which may mitigate (slightly) the headache for some groups of CFCs. However, early adopters—and their related parties, as applicable—must be consistent in applying the proposed rules, which leave a number of important conceptual questions unanswered.

Background

For tax years starting after December 31, 2017, post-TCJA Section 163(j) limits the deduction for business interest expense to the sum of (1) a taxpayer's business interest income; (2) 30% of the taxpayer's adjusted taxable income; and (3) the taxpayer's floor plan financing interest. The new Section 163(j) is a significant departure from its predecessor, which had focused on earnings stripping in connection with related-party interest. Post-TCJA, the interest limitation is not restricted to corporations nor related parties. Only taxpayers with no more than $25 million average gross receipts for the preceding three years (the small business exemption) and certain real property, farming, and regulated utilities businesses are not subject to the new Section 163(j) limitation.

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General Provisions

The proposed regulations elaborate on the definitions of several key terms in the Code, notably expanding the concept of "interest." The proposed definition casts a wide net, extending beyond items treated as interest under the Code or regulations to reach items that the Treasury and IRS view as "closely related" to interest or "affect[ing] the economic yield or cost of funds of a transaction involving interest." Among items expressly caught up in this broad construction are income from hedges or derivatives that changes a taxpayer's effective borrowing cost, debt issuance premium (for issuers and holders), certain debt issuance fees and costs, guaranteed payments for the use of capital under Section 707(c), income from factored receivables, and substitute interest payments on securities lending or sale-repurchase agreements. In addition, the proposed rules would bifurcate a swap with "significant nonperiodic payments" into an on-market, level-payment swap and a loan with interest on the deemed loan subject to the limitation. For good measure, the regulations also propose a one-sided anti-avoidance rule to ensnare "essentially financing transactions": the rule treats as interest expense for purposes of Section 163(j) "an expense or loss predominantly incurred in consideration of the time value of money in a transaction or series of integrated or related transactions in which a taxpayer secures the use of funds for a period of time."

As defined in the Code, adjusted taxable income (ATI) essentially corresponds to earnings before income, taxes, depreciation, and amortization (EBITDA) or, for tax years beginning after 2021, EBIT. Relying on statutory authority to provide for other ATI adjustments, the proposed regulations would subtract floor plan financing interest expense and require adjustments to prevent double benefit due to dispositions of (1) property subject to depreciation, amortization, or depletion for tax years starting before 2022; and (2) a partnership interest or stock of a consolidated group member. The proposed rules also clarify that depreciation, amortization, and depletion capitalized and included as costs of goods sold under Section 263A are not added back to compute ATI. The proposed regulations also discuss the allocation of interest and non-interest items for purposes of computing ATI, with look-through rules for dividends from 80%-owned C corporations or CFCs and for owners of partnerships and S corporations. (Taxable income generally carries the same meaning as under Section 63, computed before application of Section 163(j), though the proposed regulations provide special rules for certain taxpayers, such as RICs, REITs, consolidated groups, partnerships, CFCs, and foreign persons with ECI.)

In large part, the proposed regulations hew closely to the Code in describing the general operation of the Section 163(j) limitation and the carryforward of disallowed interest. For purposes of the small business exemption, the proposed regulations would apply the rules of Section 448, with special provisions addressing taxpayers who are not taxable corporations or partnerships, as well as the aggregation rules of Sections 52 and 414. The proposed regulations clarify that disallowed interest carried to a year when a taxpayer meets the small business exemption (no more than $25 million in gross receipts, as defined in the Code) would be fully deductible, subject to other Code sections. But the regulations do propose a sweeping anti-abuse provision: the IRS can ignore or recast any arrangement entered with a principal purpose of avoiding Section 163(j)—including using multiple entities to fall below the $25 million gross receipts threshold—to the extent necessary to carry out the purposes of Section 163(j).

All interest expense and interest income of a C corporation would be considered business interest expense and income, except amounts allocable to exempt businesses. Under the proposed rules, interest is allocated to exempt and nonexempt businesses based on the relative adjusted bases of the assets used in the respective businesses (subject to a de minimis rule), with the adjusted bases of dual- or multipurpose assets subject to preliminary divvying. Even investment items

from a partnership would be treated as business related if allocated to a corporate partner—except to the extent the corporate partner is allocated Subpart F or global intangible low-taxed income (GILTI) inclusions treated as investment income at the level of a domestic partnership. Interest disallowed under Section 163(j) is generally carried forward as interest expense, though the proposed rules would require that current-year expense be deducted before the use of carryforwards. Disallowed business interest expense and carryforwards generally do not affect when the associated interest reduces earnings and profits. Similar rules would apply to RICs and REITs, subject to special ATI adjustments. A consolidated group would have one Section 163(j) limitation under the proposed regulations, with all members treated as a single taxpayer in determining whether non-intercompany items constitute interest, and offsetting intercompany items would be disregarded in computing the group's ATI.

For partnerships, Section 163(j) applies at both the partnership and partner levels. Business interest expense disallowed at the partnership level becomes a partner-level tax attribute called excess business interest (EBI). A partner may only use EBI to offset excess taxable income (ETI) allocated from the same partnership. Generally, a partner determines its ATI without regard to its distributive share of partnership items, but a partner can increase its own ATI for any ETI that remains after utilization of any EBI from the same partnership. Proposed rules present an 11-step process for allocating EBI and ETI, dizzyingly employing entity and aggregate concepts in an effort to apply the limitation while preventing double-counting of partnership ATI and business interest income. The proposed regulations do not comment on tiered partnerships or partnership mergers or divisions.

The proposed regulations generally provide that Section 163(j) applies after other Code or regulatory provisions that otherwise limit or affect the deductibility of interest. Interest expense permanently disallowed under the Code, such as under Section 267A regarding hybrid payments, is not treated as business interest expense under Section 163(j). The proposed rules also coordinate the application of certain Subchapter C and consolidated return rules with disallowed interest expense. The proposed regulations are silent, however, on the interaction of Section 163(j) and Section 59A (BEAT) and request comments on coordination with Section 108's cancellation-of-debt rules.

International Aspects

Section 163(j) does not apply just to domestic taxpayers. The proposed rules provide that Section 163(j) applies to "applicable CFCs"—CFCs that have at least one U.S. shareholder that owns stock, within the meaning of Section 958(a), in the CFC; partnerships owned by applicable CFCs; and foreign persons with ECI. The proposed regulations do not expressly address how the gross-receipts test for the small business exemption applies to foreign taxpayers with ECI, but it seems reasonable to take into account only ECI for purposes of the test—similar to the way the proposed rules require that tax-exempt entities only take into account potentially taxable unrelated business income.

The same general operating rules for C corporations apply to an applicable CFC to determine how much business interest expense can be deducted to compute the CFC's Subpart F income, tested income under GILTI, and ECI, as applicable. If the applicable CFC is a partner in a partnership, the partnership and CFC would be subject to the partnership provisions (with certain tweaks). Dividends received by an applicable CFC from a related person would be excluded from the CFC's ATI. In general, the principles of Section 1.952-2 and, if the CFC has ECI, Section 882 apply for purposes of computing an applicable CFC's taxable income.

To avoid inappropriate federal tax mismatches in the case of debt between related CFCs but in recognition of the fungibility of money among such groups, the proposed regulations offer an elective alternative (the CFC group election) for computing the limitation for applicable CFCs in a "CFC group." A CFC group election means that a CFC group member's Section 163(j) limitation would equal that member's allocable share of the group's applicable net business interest expense, which is the excess, if any, of the group's aggregate business interest expense over business interest income. A member's net business interest expense exceeding its allocable share of the group's net interest expense may still be deductible. If a CFC group election applies, excess ATI of lower-tier group members would tier up proportionately to upper-tier group members.

A CFC group means two or more applicable CFCs if 80% or more of the total stock value of each CFC is owned, within the meaning of Section 958(a), by one U.S. shareholder or related U.S. shareholders (within the meaning of Section 267(b) or 707(b)(1)) that hold stock in each applicable CFC in the same proportion. If one or more members of the same CFC group own more than 80% of the capital or profits of a partnership, that partnership would also be treated as a CFC group member. Although an applicable CFC with ECI cannot use the elective method, its ownership in a lower-tier applicable CFC is still relevant to determining CFC group members. The proposed regulations, for purposes of determining a CFC group, would treat consolidated group members and joint filers as one person and stock owned by pass-through entities as owned by the entities' owners or beneficiaries. If one or more CFC group members conduct a financial services business—i.e., is an eligible CFC as defined in Section 954(h)(2), is a qualified insurance company as defined in Section 953(e)(3), or is eligible for the dealer exception (described in Section 954(c)(2)(C))—such members would constitute a separate "financial services subgroup" the elective method applies to separately. Special rules address the CFC group election when members have different tax years. The CFC group election, which is irrevocable, would terminate only for a member if it ceases to be in the group or for all members if the group ceases to exist.

The preamble to the proposed regulations observes that, under the CFC group election rules, none of the group members' business interest expense would be disallowed under Section 163(j) if the members of the CFC group only have debt with other group members. As a result, the preamble continues, the GILTI inclusion should not increase due solely to intragroup debt. If a CFC group member has no allocable share of applicable net business interest expense—e.g., because the member has net business interest income—then that member's business interest expense is not subject to the Section 163(j) limitation (though this would also be the case if Section 163(j) applied to the member separately).

Under the proposed regulations, a U.S. shareholder's ATI is determined without regard to (1) gross income inclusions under Section 78, Subpart F, or GILTI that are allocable to non-excepted businesses of the shareholder; (2) the GILTI deduction; or (3) the taxable income limitation of Section 250(a)(2). If a CFC group election were in effect, a U.S. shareholder must also determine whether its ATI should include any "eligible CFC group ETI," as defined in the proposed rules.

While the CFC group election may be beneficial for some taxpayers, its provisions are quite complex and still require tracking of certain entity-level attributes, such as ETI. Taxpayers will want to crunch the numbers to determine if and to what extent the election makes sense for them.

Foreign persons with ECI are also subject to Section 163(j). For these taxpayers—including foreign persons who are partners in a partnership engaged in a U.S. trade or business—the proposed regulations use modified definitions to restrict relevant items to ECI and expenses allocable to ECI and provide coordination rules. For example, under the proposed rules, a foreign corporation would first compute its interest expense allocable to ECI under Section 1.882-5 and then apply Section 163(j)

to see how much of that expense may be disallowed. An applicable CFC that has ECI, which is excluded from the CFC group election, would compute its general Section 163(j) limitation under the proposed CFC-related provisions described above, then a portion of any disallowed interest expense would be allocated to the CFC's ECI, based on the ratio of the CFC's ECI to its overall ATI.

Transition Rules

The proposed regulations contain several transition rules for various scenarios involving the pre-TCJA Section 163(j) limitation rules. For taxpayers with disqualified interest under the prior rules, disqualified interest is carried forward and subject to the new Section 163(j) limitation, except to the extent the disqualified interest was allocable to an excepted business. Excess limitation under the old Section 163(j) would not be carried forward to tax years that begin in 2018. Other transition rules address disqualified interest carryforwards for affiliated groups treated as a single taxpayer under the old Section 163(j) and interaction with Section 382.

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