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TAX REFORM



SUBJECT

SECTION 163(j) INTEREST LIMITATION GUIDANCE: NOTICE 2018-28

SUMMARY

On April 2, the U.S. Department of the Treasury and the IRS (Treasury) released Notice 2018-28 (the Notice) to provide interim guidance on the section 163(j) interest deduction limitation as amended by P.L. 115-97 (the Act) on December 22, 2017.

DETAILS

Background

The Act contains significant new limitations on the ability of a taxpayer to deduct business interest paid or accrued on debt properly allocable to a trade or business (interest expense). The prior limitation under old section 163(j) disallowed a deduction for certain disqualified interest (generally interest expense to: (1) related parties when no federal income tax was imposed, (2) unrelated parties with certain related party guarantees, or (3) a real estate investment trust (REIT) by its taxable REIT subsidiary) when the debtor's debt-to-equity ratio exceeded 1.5-to-1 and the debtor's net interest expense exceeded 50 percent of its adjusted taxable income, as defined in old section 163(j). Old section 163(j) was replaced by an expanded limitation that now applies to most business interest expense. The Notice confirmed Treasury's intent to withdraw its 1991 proposed regulations, 56 FR 27907, under old section 163(j).

New section 163(j) limits the taxpayer's annual deduction of interest expense to the sum of: (1) business interest income, (2) 30 percent of the adjusted taxable income of the taxpayer, and (3) the floor plan financing interest of the taxpayer for the taxable year. The last element, floor plan financing, applies to dealers of self-propelled motor vehicles designed for transporting persons or property on a public street, highway, or road; boats; or self-propelled farm machinery or equipment.

Aside from floor plan financing, a taxpayer's limitation on net interest expense (i.e., interest expense less interest income) will generally be 30 percent of adjusted taxable income.

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Adjusted taxable income for this purpose is the taxable income of the taxpayer with the exclusion of: (1) any nonbusiness income, gain, deduction or loss, (2) business interest and business interest income, (3) any net operating loss (NOL) deduction under section 172, (4) any deduction allowed under section 199A, and (5) in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion. New section 163(j) includes exceptions to the interest expense limitation for certain taxpayers with annual gross receipts under \$25 million, utilities businesses, electing real property trades or businesses, electing farming businesses, and service employees.

The Notice describes certain aspects of the regulations that Treasury intends to issue. This includes how consolidated groups should calculate the limitation, and how amounts disallowed and carried forward under the prior section 163(j) should be treated. The Notice also addresses how partners in partnerships and S corporation shareholders should count business interest income in their limitations. The guidance in the Notice is intended to be used by taxpayers on an interim basis until Treasury issues regulations or other guidance.

Treatment of Carryover Items from Old Section 163(j)

Under the prior version of section 163(j), taxpayers were required in certain circumstances to limit their deduction of disqualified interest to the extent that the interest amount exceeded a calculated limitation amount. Any such excess interest amount was carried forward and treated as interest expense incurred in the following tax year, and then subject to the old section 163(j) limitation. If a corporation had a limitation in excess of the interest amount, then the limitation could be carried forward three years. An affiliated group was treated as a single taxpayer for purposes of this rule, regardless of whether that affiliated group had elected to file a consolidated tax return (i.e., the definition of an affiliated group was expanded for this purpose).

Under the new version of section 163(j), taxpayers are allowed to treat any interest amount that exceeds the limitation as interest incurred in the following year. Unlike the prior version of section 163(j), however, no carry over is allowed of any prior excess limitation amount. This means that if a taxpayer's calculated limitation amount exceeds their net business interest expense for the year, the benefit of the excess limitation cannot carryover. Under the Notice, Treasury intends to issue regulations providing that an affiliated group filing a consolidated return will be treated as a single taxpayer for purposes of the limitation, but such treatment will not be permitted for an affiliated group not filing a consolidated return.

However, the anticipated rules will address the allocation of business interest carried forward under the provisions of old section 163(j) from an affiliated group (including members treated as affiliated under the super-affiliation rules applicable to old section 163(j)) to the specific members of that group.

The Notice states that Treasury intends to issue regulations to allow taxpayers with disqualified interest under old section 163(j) in the last taxable year beginning before January 1, 2018 to carry forward the disallowed interest amount and treat it as business interest incurred in the first taxable year beginning after December 31, 2017. The amount carried forward will be subject to limitation under the provisions of new section 163(j). This amount will also be subject to new section 59A tax on base erosion payments in the same manner as interest paid or accrued in a taxable year beginning after December 31, 2017, and the expected regulations will clarify how section 59A applies to that interest. Thus, interest paid to a foreign related party in 2017 that was disallowed under old section 163(j) will be treated as interest paid to the foreign related party in 2018 for purposes of the tax on base erosion payments, to the extent a deduction is otherwise allowable for such interest.

Since new section 163(j) does not provide for any carryover of excess limitation amounts, the Notice indicates that Treasury will issue regulations providing that no excess limitation carryforward will be allowed from the old section 163(j) provisions to any taxable year beginning after December 31, 2017.

C Corporations: Business Interest

The Notice provides that solely for purposes of section 163(j), all interest expense of a C corporation will be considered properly allocable to a trade or business. Similarly all interest income earned by a C corporation will be considered business interest income. Thus, both interest income and interest expense of a C corporation cannot be treated as excludable investment items under the section 163(j) limitation. The forthcoming regulations will provide guidance on whether and to what extent interest expense of a partnership with a C corporation partner will be treated as non-business interest. If the regulations allow for investment interest at the partnership level to be treated as investment interest at the C corporation level, the expense could avoid the section 163(j) limitation. Accordingly, it is expected that regulations will recharacterize a C corporation's share of partnership investment interest as business interest expense subject to the section 163(j) limitation.

Application to Consolidated Groups

The Notice states that Treasury intends to issue regulations clarifying that the limitation applies at the consolidated group level. Consolidated taxable income is expected to be used for the purposes of calculating adjusted taxable income under section 163(j)(8). The Notice also states that intercompany obligations will be disregarded for the purposes of determining the limitation. This treatment appears consistent with the principles of the existing consolidated return regulations treating a consolidated group under a "single entity" concept. The Notice states this concept is not expected to be extended to affiliated groups not filing a consolidated return.

In addition, the regulations are expected to address other consolidated return issues, including how the limitation is allocated among group members, what happens to disallowed interest deduction carryforwards when a member leaves the group, the treatment of disallowed interest deduction carryforwards of a member that joins the group, including whether incoming members will be subject to the separate return limitation year, or SRLY, rules applicable to NOLs, the application of Treas. Reg. section 1.1502-32 to disallowed interest deductions, and the application of section 163(j) to consolidated groups with one or members that conduct a trade or business described in section 163(j)(7)(A)(ii), (iii), or (iv). As the carryforward of disallowed business interest is an attribute included under section 381(c)(20), it seems likely that the forthcoming regulations will be applied in the same manner as the rules applicable to other carryforwards, such as NOLs, which are allocated pro rata among group members generating losses under Treas. Reg. section 1.1502-21(b)(2)(iv).

Impact on Earnings and Profits

The Notice states that Treasury intends to issue regulations clarifying that the disallowance and carryforward of a deduction under section 163(j) will not affect whether or when such interest expense reduces earnings and profits (E&P). This is consistent with the treatment of other non-deductible, non-capital items that still reduce E&P.

If such treatment is followed, when interest carryforwards are later utilized, an adjustment would be required to add such benefit back similar to the use of an NOL carryforward, which would already be reflected in accumulated E&P. Cf. CCA 201151021 (providing that "an increase to Taxpayer's interest deductions for Year 1 and Year 2 would result in a corresponding increase to its NOLs for those years").

Partnerships and S Corporations

The Notice clarifies that for purposes of calculating a partner's annual deduction for business interest expense, a partner can only include business interest income from a partnership to the extent it exceeds business interest expense of that partnership. Similarly, partners may not include their share of a partnership's floor plan financing interest in the calculation of their annual business interest expense deduction limitation. Both of these rules are designed to avoid the double counting of income and expense items for purposes of the limitation. In the absence of these rules, partners could use the same income to increase the interest deduction at both the partnership and partner levels.

For S corporations, the Notice provides that the rules for C corporations regarding business interest expense and income are not applicable. This clarifies that S corporation interest expense and income are not automatically considered as business interest and is consistent with the statutory requirement that the taxable income of an S corporation is generally determined in the same manner as in the case of an individual. The rules for S corporations are expected to be broadly similar to the forthcoming partnership regulations. For example, the Notice explicitly states that rules similar to those on a partner's share of business interest income and floor plan financing will apply to S corporations and their shareholders.

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