FINAL AND PROPOSED RELIANCE REGULATIONS ON BUSINESS INTEREST EXPENSE UNDER SECTION 163(J)

SUMMARY

On July 28, 2020, the U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) issued long-awaited final regulations (T.D. 9905) about the limitation on the deduction for business interest expense under Section 163(j) as amended by the Tax Cuts and Jobs Act (TCJA), which was enacted on December 22, 2017, and the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), which was enacted on March 27, 2020. Concurrent with the issuance of the final regulations, the government also issued a new set of proposed regulations (REG-107911-18) to address certain complex issues that warrant additional study and comments from the public.

The final regulations largely adopted the Section 163(j) proposed regulations (REG-106089-18) published in the Federal Register on December 28, 2018, with major revisions to certain controversial rules provided in the 2018 proposed regulations. Taxpayers, especially manufacturers and producers of property, may see a significant increase in their ability to deduct business interest expense under Section 163(j), because the final regulations now provide that depreciation, amortization, and depletion capitalized into inventory under Section 263A can be added back for purposes of calculating adjusted taxable income (ATI).

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Additionally, the final regulations meaningfully narrowed the definition of "interest" in the Section 163(j) context. As a result, commitment fees, debt issuance costs, guaranteed payments for the use of capital under Section 707(c), and hedging gains and losses are generally no longer considered interest to which Section 163(j) may apply. The final regulations also brought some good news for taxpayers who wish to make the real property trade or business election. Small business taxpayers and taxpayers who are unsure whether their rental real estate activities (such as a triple net lease arrangement) rise to the level of a trade or business under Section 162 can now make an election to be treated as conducting electing real property trades or businesses. However, the regulations also clarify that an election must be made for each of the taxpayer's eligible real property trades or businesses. Further, in order to be valid, the election must sufficiently describe the taxpayer's real property trades or businesses to demonstrate qualification for the election. Together with the issuance of the final regulations, the IRS issued Notice 2020-59 to provide a proposed safe harbor under which a taxpayer who operates residential living facilities (such as assisted living facilities) may elect to treat such trade or business as a real property trade or business.

With limited exceptions, the final regulations will take effect for taxable years beginning on or after 60 days after they are published in the Federal Register. However, taxpayers may apply the final regulations retroactively to taxable years beginning after December 31, 2017, so long as the final regulations are consistently applied by the taxpayers and their related parties. As an alternative, taxpayers may apply the 2018 proposed regulations to taxable years beginning after December 31, 2017, and before the final regulations take effect, so long as the 2018 proposed regulations are applied consistently by the taxpayers and their related parties.

The 2020 proposed regulations are proposed to take effect for taxable years beginning on or after 60 days after they have been adopted as final regulations and published in the Federal Register. However, taxpayers may apply the 2020 proposed regulations to taxable years beginning after December 31, 2017, so long as the 2020 proposed regulations are consistently applied by the taxpayers and their related parties.

BACKGROUND: NEW SECTION 163(J) AND THE 2018 PROPOSED REGULATIONS

Before Section 163(j) was amended by TCJA (old Section 163(j)), a deduction was generally disallowed for "disqualified interest" paid or accrued by a corporation in a taxable year if the corporation's debt-to-equity ratio exceeded 1.5 to 1.0, and if the corporation's net interest expense exceeded 50% of its ATI. In general, disqualified interest only included interest paid or accrued to (1) related parties when no federal income tax was imposed with respect to such interest; (2) unrelated parties in certain instances in which a related party guaranteed the debt; or (3) certain real estate investment trusts (REIT). The interest limitation under old Section 163(j) was designed to prevent a taxpayer from deducting interest from its U.S. taxable income without a corresponding inclusion in U.S. taxable income by the recipient, or to prevent the stripping of earnings from the U.S. tax system.

In contrast, Section 163(j) as amended by TCJA applies broadly to all business interest expense regardless of whether the related indebtedness is between related parties or incurred by a corporation, and regardless of the taxpayer's debt-to-equity ratio. Section 163(j) provides an entirely new limitation on the deduction for "business interest expense" of all taxpayers, including, for example, individuals, C corporations, partnerships, and S corporations, unless a specific exclusion applies under Section 163(j). Section 163(j) generally limits the amount of business interest expense that can be deducted in the current year. Under Section 163(j)(1), the amount allowed as a deduction for business interest expense is limited to the sum of (1) the taxpayer's business interest income for the taxable year; (2) 30% of the taxpayer's ATI for the taxable year; and (3) the taxpayer's floor plan financing interest expense for the taxable year.

On December 28, 2018, Treasury and the IRS published the 2018 proposed regulations in the Federal Register, requesting comments on all aspects of the proposed regulations within 60 days. The 2018 proposed regulations provided much-needed guidance on a plethora of issues that were not specified by the TCJA, such as what constitutes "interest" for purposes of Section 163(j), the treatment of depreciation, amortization, or depletion expenses capitalized into inventory under Section 263A for purposes of calculating ATI, operating rules for making excepted trade or business elections, and the Section 163(j) application to partnerships, S corporations, C corporations, consolidated groups, foreign corporations and their shareholders as well as foreign persons with effectively connected income.

The CARES Act, which was enacted on March 27, 2020, further amended Section 163(j). Under the CARES Act, the amount of business interest that is deductible under Section 163(j)(1) for taxable years beginning in 2019 or 2020 is computed using 50%, rather than 30%, of the taxpayer's ATI for the taxable year. A taxpayer may elect not to apply the 50% ATI limitation to any taxable year beginning in 2019 or 2020, and instead apply the 30% ATI limitation. In the case of a partnership, the 50% ATI limitation does not apply for taxable years beginning in 2019, and the election not to apply the 50% ATI limitation may be made only for taxable years beginning in 2020. However, a partner treats 50% of its allocable share of a partnership's excess business interest expense for 2019 as a business interest expense in the partner's first taxable year beginning in 2020 that is not subject to the Section 163(j) limitation. The remaining 50% of the partner's allocable share of the partnership's excess business interest expense remains subject to the Section 163(j) limitation applicable to excess business interest expense carried forward at the partner level. Lastly, the CARES Act allows a taxpayer to elect to use its ATI for the last taxable year beginning in 2019 for the taxpayer's ATI in determining the taxpayer's Section 163(j) limitation for any taxable year beginning in 2020.

REVISED ADJUSTMENTS TO ATI

New Term: Tentative Taxable Income

Consistent with Section 163(j)(8), the 2018 proposed regulations defined ATI as the "taxable income" for the taxable year with certain specified adjustments. In the 2018 proposed regulations, the term "taxable income" refers to taxable income provided in Section 63 in some instances and refers to taxable income without regard to the application of Section 163(j) in other instances. To prevent confusion from using the term "taxable income" in different contexts, the final regulations use a new term, "tentative taxable income," to refer to the amount to which adjustments are made in calculating ATI. Tentative taxable income is generally determined in the same manner as taxable income under Section 63 but is computed without regard to the application of the Section 163(j) limitation and without regard to any disallowed business interest expense carryforwards.

BDO Insight: With the introduction of the new term "tentative taxable income," the final regulations clarify that the starting point to calculate a taxpayer's ATI is the taxpayer's current year taxable income determined under Section 63, as if all current-year business interest expense of the taxpayer is deductible and none of the disallowed business interest expense carryover of the taxpayer from prior years is deductible notwithstanding the Section 163(j) limit. This approach should have no impact on the taxpayer's overall Section 163(j) limit because the same amount of business interest expense allowed as a deduction in computing the taxpayer's tentative taxable income will be backed out as a statutorily required adjustment when computing the taxpayer's ATI.

Depreciation, Amortization, and Depletion Capitalized into Inventory under Section 263A

The 2018 proposed regulations provide that depreciation, amortization, or depletion expense capitalized into inventory under Section 263A may not be added back to taxable income in computing ATI. Many commenters raised questions and concerns regarding this provision and requested that the addback be permitted. In light of these comments, Treasury and the IRS reconsidered this rule and provided in the final regulations that the amount of any depreciation, amortization, or depletion that is capitalized into inventory under Section 263A during taxable years beginning before January 1, 2022, is added back to tentative taxable income when calculating ATI for that taxable year, regardless of the period in which the capitalized amount is recovered through cost of goods sold.

For example, if a taxpayer capitalized an amount of depreciation to inventory under Section 263A in the 2020 taxable year, but the inventory is not sold until the 2021 taxable year, the entire capitalized amount of depreciation is added back to tentative taxable income in the 2020 taxable year, and such capitalized amount of depreciation is not added back to tentative taxable income when the inventory is sold and recovered through cost of goods sold in the 2021 taxable year.

For taxpayers, and their related parties within the meaning of Sections 267(b) and 707(b)(1), who relied on the 2018 proposed regulations in their entirety and disallowed an addback for any depreciation, amortization, or depletion that is capitalized into inventory under Section 263A for taxable years beginning before the final regulations take effect, the final regulations allow these taxpayers to choose to follow the final regulations rather than the 2018 proposed regulations.

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BDO Insight: The final regulations' departure from the 2018 proposed regulations regarding the addback of depreciation deductions capitalized into inventory under Section 263A has broad implications for taxpayers who previously relied on the 2018 proposed regulations. Many taxpayers may wish to amend their 2018 and 2019 tax returns or file a superseding 2019 tax return to claim additional business interest expense deductions. As a result, taxpayers may be able to lower their tax liabilities for the 2018 and 2019 taxable years or, if applicable, increase the amount of net operating loss (NOL) that can be carried back to prior taxable years under the temporary NOL carryback provisions in the CARES Act.

In addition, thanks to the exception to the general applicability date of the final regulations provided solely for the addback rule for depreciation deductions capitalized into inventory under Section 263A, even if a taxpayer applies the final regulations prospectively only, and relies on the 2018 proposed regulations for earlier taxable years, the taxpayer may retroactively apply this favorable change in computing its ATI.

Section 179 Expensing

The final regulations confirmed that for purposes of calculating a taxpayer's ATI, Section 179 deductions are allowed to be added back for taxable years beginning before January 1, 2022.

Sale or Disposition of Depreciable Property, Partnership Interests, or Consolidated Group Member Stock

The 2018 proposed regulations include several adjustments to taxable income in computing ATI to address certain sales or dispositions of depreciable property, stock of a consolidated group member, or interests in a partnership. Proposed §1.163(j)-1(b)(1)(ii)(C) provides that, if property is sold or otherwise disposed of, the lesser of the amount of gain on the disposition or the amount of depreciation, amortization, or depletion deductions (collectively, depreciation deductions) with respect to the property for the taxable years beginning after December 31, 2017, and before January 1, 2022 (such years, the EBITDA period) is subtracted from taxable income to determine ATI.

Proposed §1.163(j)-1(b)(1)(ii)(D) provides that, with respect to the sale or other disposition of stock of a member of a consolidated group that includes the selling member, the investment adjustments with respect to such stock that are attributable to deductions described in proposed §1.163(j)-1(b)(1)(ii)(C) are subtracted from taxable income. In turn, proposed §1.163(j)-1(b)(1)(ii)(E) provides that, with respect to the sale or other disposition of an interest in a partnership, the taxpayer's distributive share of deductions described in proposed §1.163(j)-1(b)(1)(ii)(C) with respect to property held by the partnership at the time of such disposition is subtracted from taxable income to the extent such deductions were allowable under Section 704(d).

As previously mentioned, the final regulations would allow an addback (i.e., a positive adjustment) to ATI for any depreciation, amortization, and depletion that are deducted in the current year or capitalized to inventory under Section 263A. The intention of the subtraction items provided in the proposed §1.163(j)-1(b)(1)(ii)(C), (D), and (E) summarized above is to ensure that the positive adjustment for depreciation deductions during the EBITDA period merely defers (rather than permanently excludes) depreciation deductions from a taxpayer's calculation of the Section 163(j) limitation.

In the final regulations, Treasury and the IRS decided to revise proposed §1.163(j)-1(b)(1)(ii)(C) by eliminating the "lesser of" standard and requiring taxpayers to back out depreciation deductions that were allowed or allowable during the EBITDA period with respect to sales or dispositions of property. Even though the "lesser of" standard has been removed in the final regulations, the 2020 proposed regulations would provide taxpayers the option to apply the "lesser of" standard, if they do so consistently.

BDO Insight: Generally, when a taxpayer takes depreciation deductions with respect to an asset, the taxpayer must reduce its adjusted basis in the asset accordingly. As a result, the taxpayer will realize additional gain (or less loss) upon the subsequent disposition of the asset than the taxpayer would have realized absent depreciation deductions. As the taxpayer will realize additional gain (or less loss), without a corresponding adjustment to ATI, the taxpayer may have an inappropriately increased Section 163(j) limit.

Treasury and the IRS state in the final regulations that Congress did not intend this result. Except with regard to timing (and, in some cases, character), depreciation deductions should have no net effect on a taxpayer's ATI. The final regulations require taxpayers that added back depreciation deductions for the purposes of calculating ATI during the EBITDA period also subtract the same amount of depreciation deductions when they sell or otherwise dispose of such assets.

Alternatively, instead of subtracting the depreciation deductions taken during the EBITDA period in the years of sale or disposition, the taxpayer may rely on the "lesser of" standard provided in the 2018 proposed regulations and then re-proposed in the 2020 proposed regulations. However, the "lesser of" standard may yield benefits only if the taxpayer does not expect large amount of gains for the sale or disposition of assets, including goodwill and intangible assets.

Additionally, commenters noted that, in situations to which both the proposed §1.163(j)-1(b)(1)(ii)(C) and (D) apply, the subtraction reflecting the same economic depreciation deductions may be required twice. For example, S (a member of P's consolidated group) takes a $50x depreciation deduction in 2020 with respect to asset X, P's basis in its S stock is reduced accordingly under §1.1502-32, and $50x is added back to the P group's tentative taxable income in computing its 2020 ATI. In 2021, S realizes a $50x gain upon the sale of asset X, P's basis in its S stock is increased accordingly by $50x under §1.1502-32, and the P group subtracts $50x from its tentative taxable income under proposed §1.163(j)-1(b)(1)(ii)(C) in computing its 2021 ATI. Then, in 2022, P sells the S stock to an unrelated buyer. Must P subtract another $50x from its tentative taxable income under proposed §1.163(j)-1(b)(1)(ii)(D)?

Treasury and the IRS agree that the application of proposed §1.163(j)-1(b)(1)(ii)(C) and (D) to the same consolidated group member would result in an inappropriate double inclusion, and that proposed §1.163(j)-1(b)(1)(ii)(C) should not apply to a former group member with respect to depreciation deductions claimed by the member in a former group. Thus, §1.163(j)-1(b)(1)(iv)(D) provides anti-duplication rules to ensure that neither §1.163(j)-1(b)(1)(ii)(C) nor §1.163(j)-1(b)(1)(ii)(D) applies if a subtraction for the same economic amount already has been required under either provision.

BDO Insight: The anti-duplication rule provided in the final regulations should be welcomed by taxpayers because it eliminates the inappropriate double subtractions reflecting the same economic depreciation deductions when the stock of a consolidated group member is sold or deemed sold. However, taxpayers may find it administratively burdensome to track asset sales or dispositions even after such sales or dispositions have occurred. Additionally, if a consolidated group has multiple tiers of members, the complexity increases to track asset sales and dispositions of not only direct lower-tier members but also indirect lower-tier members, because the consolidated return regulations require a tier-up of investment adjustments from lower-tier members, direct or indirect.

Adjustments to ATI in Respect of U.S. Shareholders of CFCs

Since the issuance of the 2018 proposed regulations, some commenters argued that U.S. shareholders, as defined in Section 951(b), of controlled foreign corporations (CFCs), as defined in Section 957(a), should be allowed to include in their ATI the amounts included in gross income under Section 951(a) (Subpart F inclusions), Section 951A(a) global intangible low-taxed income (GILTI) inclusions, and Section 78 "gross-up" inclusions (collectively, CFC income inclusions) attributable to non-excepted trades or businesses. Because Section 163(j) applies to CFCs, Treasury and the IRS have determined that allowing a U.S. shareholder to include its CFC income inclusions in its ATI would not be appropriate and thus, rejected these comments. However, see our **August tax alert** regarding the rules in the new proposed regulations that allow a U.S. shareholder to include a portion of its deemed income inclusions attributable to an applicable CFC in the U.S. shareholder's ATI in certain situations.

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NARROWED DEFINITION OF INTEREST

The 2018 proposed regulations contain a relatively broad definition of the term “interest” for purposes of Section 163(j). This definition was proposed to provide a complete definition of interest that addresses all transactions that are commonly understood to produce interest income and expense, including transactions that otherwise may have been entered into to avoid the application of Section 163(j).

Under the 2018 proposed regulations, the term “interest” means any amount described in one of four categories. First, proposed §1.163(j)-1(b)(20)(i) generally provides 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, or an amount that is treated as interest under other provisions of the Code or the Income Tax Regulations. For example, this category includes qualified stated interest, original issue discount (OID), and accrued market discount. Commenters agree that this definition of interest has long been accepted, is consistent with longstanding precedent, and reduces the risk of inconsistency within the Code and regulations. No commenters requested any changes to this category, and the final regulations adopt this category in the definition of the term “interest” without any substantive changes.

Second, proposed §1.163(j)-1(b)(20)(ii) treats a swap (other than a cleared swap) with significant nonperiodic payments as two separate transactions consisting of an on-market, level payment swap and a loan. Under the 2018 proposed regulations, the time value component of the loan is recognized as interest expense to the payor and as interest income to the recipient. The final regulations generally adopted the 2018 proposed regulations but provide two exceptions to the embedded loan rule. Specifically, the final regulations add exceptions for cleared swaps and for non-cleared swaps that require the parties to meet the margin or collateral requirements of a federal regulator or that provide for margin or collateral requirements that are substantially similar to a cleared swap or a non-cleared swap subject to the margin or collateral requirements of a federal regulator. In addition, the final regulations delay the applicability date of the embedded loan rule for purposes of Section 163(j) to allow taxpayers additional time to develop systems to implement these rules (the delayed applicability date), though taxpayers may choose to apply the rules to swaps entered into before the delayed applicability date.

Third, proposed §1.163(j)-1(b)(20)(iii) treats as interest certain amounts that are closely related to interest and that affect the economic yield or cost of funds of a transaction involving interest, but that may not be compensation for the use or forbearance of money on a stand-alone basis. For example, this category includes substitute interest payments, debt issuance costs, commitment fees, guaranteed payments for the use of capital, and hedging gains and losses that affect the yield of a debt instrument. Treasury and the IRS appear to have scaled back on this category in the final regulations. While substitute interest payments (only if the payments relate to a sale-repurchase or securities lending transaction that is not entered into by the taxpayer in the ordinary course of its business) are still considered interests in the final regulations, commitment fees, debt issuance costs, guaranteed payments for the use of capital under Section 707(c), and hedging gains and losses have been removed from the definition of interest in the final regulations. Consequently, commitment fees, debt issuance costs, guaranteed payments for the use of capital under Section 707(c), and hedging gains and losses are no longer subject to Section 163(j).

BDO Insight: Taxpayers who relied on the 2018 proposed regulations and treated as interest any of their debt issuance costs, commitment fees, and guaranteed payments for the use of capital under Section 707(c) may find it beneficial to amend their 2018 and 2019 tax returns or file a superseding 2019 tax return to claim additional deductions. At a minimum, on a prospective basis, taxpayers may need to adjust their NOL and Section 163(j) disallowed business interest expense carryovers if they wish to retroactively adopt the final regulations. As a result, taxpayers may be able to lower their tax liabilities for the 2018 and 2019 taxable years or if applicable, increase the amount of NOL that can be carried back to prior taxable years under the temporary NOL carryback provisions in the CARES Act.

Fourth, proposed §1.163(j)-1(b)(20)(iv) provides an anti-avoidance rule under which 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 is treated as interest expense for purposes of Section 163(j). Treasury and the IRS modified the anti-avoidance rule in the final regulations by introducing "a principal purpose" standard. Under §1.163(j)-1(b)(22)(iv)(A)(1), any expense or loss economically equivalent to interest is treated as interest expense for purposes of Section 163(j) if a principal purpose of structuring the transaction(s) is to reduce an amount incurred by the taxpayer that otherwise would have been interest expense. Under §1.163(j)-1(b)(22)(iv)(B), 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 for purposes of Section 163(j) if and to the extent that a principal purpose for structuring the transaction(s) is to artificially increase the taxpayer's business interest income.

BDO Insight: The final regulations clarify that a purpose may be a principal purpose even though it is outweighed by other purposes (taken separately or together). In other words, the taxpayer's business purpose for acquiring the funds is not relevant to the principal purpose inquiry, nor is the fact that the taxpayer has obtained funds at a lower pre-tax cost based on the structure of the transaction. In the partnership context, there is concern of the potential application of this rule whereby guaranteed payments for the use of capital and certain preferred returns may be viewed as economically similar to interest. In the absence of additional guidance, it is likely that taxpayers with these arrangements will face some degree of uncertainty.

SMALL BUSINESS EXEMPTION AND TAX SHELTER

Gross Receipts Test and Aggregation

Section 163(j)(3) exempts certain small businesses from the Section 163(j) limitation. Under Section 163(j), a small business taxpayer is one that meets the gross receipts test in Section 448(c) and is not a tax shelter under Section 448(a)(3). The gross receipts test is met if a taxpayer has average annual gross receipts for the three taxable years prior to the current taxable year of $25 million or less. For taxable years beginning after December 31, 2018, the gross receipts threshold reflects an annual adjustment for inflation as provided for in Section 448(c)(4); thus, the gross receipts threshold for taxable years beginning in 2019 is $26 million.

Additionally, Section 448(c)(2) requires gross receipts to be aggregated for certain controlled corporations, partnerships, and proprietorships, and affiliated service groups for purposes of applying the gross receipts test. While Treasury and the IRS acknowledge that the aggregation rules set forth under Section 448(c) by reference to Sections 52(a) and (b) and Sections 414(m) and (o) are complex, no further clarification or simplification of such rules has been provided under the regulations. However, frequently asked questions that explain the basic operation of these rules are provided on the IRS newsroom site. See **FAQs Regarding the Aggregation Rules Under Section 448(c)(2) that Apply to the Section 163(j) Small Business Exemption**.

Tax Shelter

Consistent with Section 163(j)(3), the 2018 proposed regulations provide that the small business exemption does not apply to a tax shelter as defined in Section 448(d)(3). The definition of a tax shelter includes any syndicate within the meaning of Section 1256(e)(3)(B). Section 1.448-1T(b)(3) provides, in part, that a syndicate is a partnership or other entity (other than a C corporation) if more than 35% of its losses during the taxable year are allocated to limited partners or limited entrepreneurs, whereas Section 1256(e)(3)(B) refers to losses that are allocable to limited partners or limited entrepreneurs. As a result, the scope of the small business exemption in Section 163(j)(3) is unclear. To provide a consistent definition of the term "syndicate" for purposes of Sections 163(j), 448, and 1256, Treasury and the IRS propose to define the term "syndicate" using the actual allocation rule from the definition in §1.448-1T(b)(3).

Commenters requested specific relief for small business taxpayers from the definition of a syndicate based on the "active management" exception under Section 1256(e)(3)(C). Section 1256(e)(3)(C) lists several examples of interests in an entity that "shall not be treated as held by a limited partner or a limited entrepreneur," thus excluding the entity from the definition of a syndicate. The commenters requested that Treasury use its authority under Section 1256(e)(3)(C)(v) to provide relief from the definition of a syndicate to small business entities that (1) qualify under the gross receipts test of Section 448(c), (2) meet the definition of a syndicate, and (3) do not qualify to make an election as an electing real property business or electing farming business.

If a small business satisfies these three conditions, the commenters requested that Treasury and the IRS provide relief that would not treat such small business as a tax shelter. Treasury and the IRS considered these comments and concluded that such relief would be contrary to the statutory language of, and legislative history to, Section 163(j)(3). Therefore, Treasury and the IRS decline to adopt the commenters' request.

BDO Insight: Although Treasury and the IRS declined to provide any relief or simplification rules for the determination of syndicates, taxpayers will welcome the clarification that the determination of an entity's status as a syndicate is based upon actual losses allocated (versus losses allocable) under the definition provided in §1.448-1T(b)(3). This means that a passthrough entity allocating more than 35% of losses to limited partners or entrepreneurs in a given year generally will not be considered a syndicate in other years in which it generates taxable income. Accordingly, passthrough entities with limited partners or entrepreneurs must evaluate whether they meet the definition of a syndicate on an annual basis.

For example, assume a partnership that met the gross receipts test under Section 448(c) was considered a syndicate in the prior year because it actually allocated 35% or more of its losses to limited partners and allocated excess business interest expense to its partners. In the current year, the partnership continues to meet the gross receipts test under Section 448(c), but is now generating taxable income and allocating the income to all of its partners via Schedule K-1s. In the current year, the partnership is eligible for the small business exemption; thus, any excess business interest expense from the prior year would be fully deductible by the partners even though no excess business interest income or excess taxable income is allocated from the same partnership in the current year.

Treasury and the IRS also released proposed regulations under Section 448 shortly after the issuance of the final and proposed Section 163(j) regulations. Under these Section 448 regulations, taxpayers may elect to use the allocated taxable income or loss of the immediately preceding taxable year, instead of the current taxable year, to determine whether the taxpayer is a syndicate. Once made, the election applies to all subsequent taxable years, and for all purposes for which status as a tax shelter is defined under Section 448(a)(3), including Section 163(j), unless the taxpayer obtains the IRS's consent to revoke the election by filing a private letter ruling request.

BDO Insight: As the definition of a syndicate is tied to a passthrough entity's taxable income or loss generated in a given tax year, many taxpayers may not realize that they are considered a syndicate until after the close of the taxable year, which could then cause procedural constraints associated with the Section 163(j) computation (as well as other provisions that rely on the tax shelter determination, such as the ability to use the cash method of accounting). In light of these administrative difficulties, the election described above may be helpful for passthrough entities with limited partners/entrepreneurs to obtain certainty at the beginning of the year as to whether they are a syndicate and are therefore subject to Section 163(j).

EXCEPTED TRADES OR BUSINESSES

Expanded Eligibility for Elections

The preamble to the 2018 proposed regulations provides that a taxpayer that qualifies for the small business exemption under Section 163(j)(3) is not eligible to make an election for a trade or business to be an electing real property trade or business or an electing farming business. Commenters requested that taxpayers be allowed to make such an election without regard to whether the gross receipts test of Section 448(c) has been tested or is met. Treasury and the IRS agree with the commenters. Accordingly, the final regulations provide that taxpayers may make an election for a trade or business to be an electing real property trade or business or an electing farming business, provided that they qualify to make such elections, even if the gross receipts test under Section 448(c) may be satisfied by the electing trades or businesses. As is the case for all other electing real property trades or businesses and electing farming businesses, the elections are irrevocable and affect depreciation as provided in Section 163(j)(11) (i.e., required use of the alternative depreciation system (ADS) for certain types of property and ineligibility to claim additional first-year depreciation deduction for those types of property).

BDO Insight: The determination of whether a taxpayer meets the gross receipts test under Section 448(c) can prove difficult because the taxpayer may be unsure whether it is part of a controlled group or an affiliated services group. In these instances, the final regulations now allow these taxpayers to make an excepted trade or business election provided that the taxpayers are otherwise eligible without requiring the taxpayers to first determine whether they qualify the small business exemption. This simplified approach should be welcomed by taxpayers who have limited visibilities of the larger organizational structures they operate in or who cannot obtain the gross receipts information from related parties to make the determination.

Additionally, the 2018 proposed regulations generally intended that interest expense associated with an activity that does not rise to the level of a Section 162 trade or business is not subject to the Section 163(j) limitation. Commenters requested a protective election for taxpayers engaged in rental real estate activities if it is unclear whether the activities rise to the level of a trade or business under Section 162 standards. For example, for purposes of Section 469(c)(7)(C), a taxpayer who owns real property and rents to tenants under a triple net lease arrangement will be treated as engaged in a real property trade or business even though the renting under the terms of a triple net lease arrangement may not rise to the level of a Section 162 trade or business. Since the triple net lease arrangement may not rise to the level of a Section 162 trade or business, absent any revisions in the final regulations, taxpayers would be uncertain as to whether a real property trade or business election would be valid.

In light of the foregoing, Treasury and the IRS provide in the final regulations that an election to treat rental real estate activities as an electing real property trade or business is available regardless of whether the taxpayer making the election is engaged in a trade or business within the meaning of Section 162. As with all other electing real property trades or businesses, once the election is made, all other consequences of the election outlined in §1.163(j)-9 apply, such as the irrevocability of the election and the required use of ADS for certain assets.

BDO Insight: Section 163(j) generally refers to Section 162 for the determination of whether a taxpayer's activities constitute a trade or business. Although the term "trade or business" has been used extensively in Section 162 and other Code provisions, it is never defined in the Code for general application, and no regulation has been issued expounding its meaning for all purposes. Taxpayers generally need to rely on case laws (such as the seminal Supreme Court case, Commissioner v. Groetzinger, 480 U.S 23, 32-36 (1987)) to interpret the meaning of "trade or business." The additional protective real estate trade or business election provided by the final regulations should be welcomed because it alleviates the taxpayers who conduct certain rental real estate activities from the burden of analyzing whether such activities rise to the level of a Section 162 trade or business.

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One-Time Late Election or Withdrawal of Election Procedures

Commenters requested a one-time automatic extension of time for certain taxpayers to file an excepted trade or business election under Section 163(j)(7)(B) or Section 163(j)(7)(C) due to uncertainty about the effect of a decision to make or not make such an election and about which taxpayers are eligible to make such an election prior to the publication of the final regulations. Additionally, commenters requested a one-time opportunity to withdraw an excepted trade or business election made under Section 163(j)(7)(B) or Section 163(j)(7)(C) prior to the publication of the final regulations. Treasury and the IRS agree with the commenters' requests. Thus, months before the final regulations were issued, Revenue Procedure 2020-22 was issued to provide an automatic extension of time to make, or an opportunity to withdraw, an election for taxable years beginning in 2018, 2019, or 2020.

Residential Living Facilities Safe Harbor

Concurrent with the release of the final regulations, the IRS issued Notice 2020-59 to provide a proposed revenue procedure detailing a proposed safe harbor under which a taxpayer that operates a qualified residential living facility is treated as eligible to be an electing real property trade or business under Section 163(j)(7)(B). A qualified residential living facility is a facility that (1) consists of multiple rental dwelling units within one or more buildings or structures that generally serve as primary residences on a permanent or semi-permanent basis to individual customers or patients, (2) include the provision of supplemental assistive, nursing, and other routine medical services, and (3) has an average period of customer or patient use of the individual rental dwelling units of 90 days or more. The proposed revenue procedure is proposed to apply to taxpayers with taxable years ending after December 31, 2017. Until such time that the proposed revenue procedure is published in final form, taxpayers may use the safe harbor described in the proposed revenue procedure for purposes of determining whether a residential living facility, as defined in the proposed revenue procedure, may be treated as a real property trade or business solely for purposes of Section 163(j).

BDO Insight: Since the release of the 2018 proposed regulations, taxpayers in the residential living industry requested clarifications regarding whether they would be eligible for the real property trade or business election provided by Section 163(j)(7)(B). These taxpayers will likely welcome the guidance provided in Notice 2020-59 about the proposed residential living facilities safe harbor.

Taxpayers who operate residential living facilities were uncertain whether they would be eligible for the real property trade or business election because in addition to providing a place of residence for their customers (which may be considered real property trades or businesses), these residential living facilities often provide other ancillary or substantial services, such as nursing, healthcare, specialized medical services, transportation, meals and entertainments, and so forth. With the safe harbor provided by the IRS, taxpayers will have more certainty on whether and to what extent their residential living facilities would be eligible to make the election.

In the preamble to the final regulations, Treasury and the IRS acknowledge that further guidance might be needed to determine whether a particular trade or business can make an election. Accordingly, the definitions of electing real property trade or business and electing farming business include a new provision noting that the Secretary of the Treasury may issue guidance on whether a trade or business can be an electing real property trade or business or electing farming business.

Anti-Abuse Rule

The real property trade or business election anti-abuse rule provided in the 2018 proposed regulations prohibits an otherwise qualifying real property trade or business from making an election under Section 163(j)(7)(B) if at least 80% of the business's real property, determined by fair market value, is leased to a trade or business under common control (that is, 50% of the direct and indirect ownership of both businesses is held by related parties within the meaning of Sections 267(b) and 707(b)) with the real property trade or business.

With respect to the anti-abuse rule, commenters raised concerns about its applicability to specific types of business structures where the real property is owned by one legal entity (referred to as PropCo) and leased to a separate but commonly controlled legal entity that operates and manages a business (referred to as OpCo). This PropCo/OpCo structure often has valid business protection, lending, and regulatory purposes in certain industries, and this structure was in existence for many years prior to the enactment of the Section 163(j) limitation and was not created in an attempt to circumvent application of the Section 163(j) limitation.

To address these concerns, the final regulations provide two additional exceptions to the anti-abuse rule. Under the first exception, if at least 90% of a lessor's real property, determined by fair market rental value, is leased to a related party that operates an excepted trade or business and/or to unrelated parties, the lessor is eligible to make an election to be an electing real property trade or business for its entire trade or business (de minimis exception). The second exception is a look-through rule under which if a lessor trade or business leases to a trade or business under common control (lessee), the lessor is eligible to make an election to be an electing real property trade or business, to the extent that the lessor leases to an unrelated party or to an electing trade or business under common control with the lessor or lessee, and to the extent that the lessee trade or business under common control subleases (or licenses) to unrelated third parties and/or related parties that operate an excepted trade or business.

Excepted Regulated Utility Trade or Business

The 2018 proposed regulations provide that utilities that sell or furnish the regulated items at rates that are established or approved by a regulatory body described in proposed §1.163(j)-1(b)(13)(i)(B)(1), other than an electric cooperative, are considered to be excepted only to the extent that such rates are determined on a "cost of service and rate of return" basis. The "cost of service and rate of return" requirement was intended to provide certainty to taxpayers because many utilities are familiar with the definition of "cost of service and rate of return."

Concerns have been raised that the "cost of service and rate of return" requirement does not exist in the statute. Treasury and the IRS agreed. While they decided to retain the "cost of service and rate of return" requirement in the final regulations, taxpayers are allowed to make an election to be an excepted regulated utility trade or business to the extent that the rates for the furnishing or sale of the items described in §1.163(j)-1(b)(15)(i)(A)(1) have been established or approved by a regulatory body described in §1.163(j)-1(b)(15)(i)(A)(2), if the rates are not determined on a "cost of service and rate of return" basis.

Similar to elections for electing real property trades or businesses and electing farming businesses, the election to be an excepted regulated utility trade or business is irrevocable. Electing taxpayers are required to use ADS for certain types of property under Section 163(j)(11) and cannot claim the additional first-year depreciation deduction under Section 168(k) for those types of property.

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CLARIFICATIONS TO FLOOR PLAN FINANCING INTEREST

Adjustment to ATI

Consistent with Section 163(j)(8)(A)(ii), the 2018 proposed regulations provide that any business interest expense or business interest income is added back to or subtracted from taxable income in computing ATI. Because business interest expense includes floor plan financing interest expense, ATI is further adjusted by subtracting from it any floor plan financing interest expense under proposed §1.163(j)-1(b)(1)(ii)(B). The reason that this subtraction is necessary is that floor plan financing interest expense is also separately included in the Section 163(j) limitation as provided in Section 163(j)(1)(C). Although commenters argued that a subtraction of floor plan financing interest expense is not required by the statute, Treasury and the IRS decided to adopt this adjustment to ATI in the final regulations, because without the adjustment, taxpayers will get a double benefit for floor plan financing interest expense, once through an increase to ATI and another through a direct increase to the Section 163(j)(1) limit.

Coordination with Section 168(k) (Relating to Additional First-Year Bonus Depreciation)

Several commenters requested clarification and submitted recommendations on the interaction between Section 168(k)(9) and Section 163(j). Section 168(k)(9)(B) provides that the additional first-year depreciation deduction is not allowed for any property used in a trade or business that has had floor plan financing indebtedness, if the floor plan financing interest related to such indebtedness was taken into account under Section 163(j)(1)(C).

First, commenters requested that floor plan financing indebtedness not be treated as taken into account if the sum of business interest income and 30% of ATI (the sum of Section 163(j)(1)(A) and Section 163(j)(1)(B)) is greater than the business interest expense paid or accrued in the taxable year. Second, if the sum of business interest income and 30% of ATI is less than the business interest expense paid or accrued in the taxable year, commenters requested that taxpayers be given the option to either include floor plan financing interest to increase the Section 163(j) limitation, or to forgo the use of floor plan financing interest to increase the Section 163(j) limitation in order to utilize the additional first-year depreciation deduction under Section 168(k).

Regarding these recommendations, Treasury and the IRS decided that Section 163(j) does not provide any guidance on the availability of Section 168(k) for taxpayers that have had floor plan financing interest expense. As these comments relate to the operation of Section 168(k)(9), taxpayers should look to Treasury or IRS guidance provided under Section 168(k) for clarification. On September 24, 2019, Treasury and the IRS published in the Federal Register final regulations (T.D. 9874) and proposed regulations (REG-106808-19) under Section 168(k). The rules regarding when floor plan financing interest expense is "taken into account" for purposes of 168(k) are in the proposed regulations under §1.168(k)-2(b)(2)(ii)(G).

BDO Insight: In the proposed regulations under Section 168(k), Treasury and the IRS clarified that they do not believe that Section 163(j) is optional and thus rejected the notion that taxpayers can choose between deducting floor plan financing interest without limit and deducting additional first-year bonus depreciation.

However, Treasury and the IRS agree that, for purposes of Section 168(k)(9)(B), floor plan financing interest is not taken into account by a trade or business that has had floor plan financing indebtedness if the sum of the amounts calculated under Section 163(j)(1)(A) and (B) for the trade or business for the taxable year equals or exceeds the business interest, as defined in Section 163(j)(5) (including carryforwards of disallowed business interest under Section 163(j)(2)), which includes floor plan financing interest of the trade or business, for the taxable year. Additionally, Treasury and the IRS have decided that, for purposes of Section 168(k)(9)(B), the determination of whether a trade or business that has had floor plan financing indebtedness has taken into account floor plan financing interest is made annually.

Definition of Motor Vehicle

Proposed §1.163(j)-1(b)(25) provides that the term "motor vehicle" means a motor vehicle as defined in Section 163(j)(9)(C). Under Section 163(j)(9)(C), a motor vehicle means any self-propelled vehicle designed for transporting persons or property on a public street, highway, or road; a boat; and farm machinery or equipment. A few commenters requested that towed recreational vehicles and trailers be included in the definition of "motor vehicle." Because Section 163(j)(9)(C) specifically defines motor vehicles as self-propelled vehicles, Treasury and the IRS do not have the authority to expand the definition of motor vehicles in the final regulations to include vehicles that are not self-propelled, such as towed recreational vehicles and trailers. For this reason, Treasury and the IRS decline to adopt these comments in the final regulations.

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COORDINATION OF SECTION 163(J) WITH OTHER CODE PROVISIONS

Coordination with Sections 461(l), 465 and 469

Since the issuance of the 2018 proposed regulations, Treasury and the IRS received informal questions about the interaction between Section 163(j) and Sections 465 and 469, which may operate to disallow a deduction for business interest expense even if such expense was allowable after the application of Section 163(j). If amounts of business interest expense that are disallowed under Section 465 or 469 are treated as business interest expense in subsequent taxable years, the Section 163(j) limitation could operate to disallow a deduction even though such amounts were allowable in the prior taxable year after application of the Section 163(j) limitation. Treasury and the IRS do not intend such a result. Therefore, the final regulations clarify that amounts allowable as a deduction after application of the Section 163(j) limitation but disallowed by Section 465 or 469 are not business interest expense subject to the Section 163(j) limitation in subsequent taxable years.

Additionally, the 2018 proposed regulations provide that Sections 461(l), 465 and 469 apply after the application of Section 163(j). Treasury and the IRS received informal questions about the effect of these sections on the calculation of ATI. Therefore, the final regulations clarify whether and how Sections 461(l), 465 and 469 are applied when determining tentative taxable income. The final regulations also include examples to demonstrate the calculation of ATI if a loss tentatively is suspended in the calculation of tentative taxable income, and if a loss is carried forward from a prior taxable year under Section 469.

Coordination with Sections 250 and 172

The 2018 proposed regulations provide a rule to coordinate the application of Sections 163(j) and 250. Section 250(a)(1) generally provides a deduction based on the amount of a domestic corporation's foreign-derived intangible income and GILTI. Section 250(a)(2) limits the amount of this deduction based on the taxpayer's taxable income—the greater the amount of a taxpayer's taxable income for purposes of Section 250(a)(2), the greater the amount of the taxpayer's allowable deduction under Section 250(a)(1).

In particular, proposed §1.163(j)-1(b)(37)(ii) provided that, if a taxpayer is allowed a deduction for a taxable year under Section 250(a)(1) that is properly allocable to a non-excepted trade or business, then the taxpayer's taxable income for that year is determined without regard to the limitation in Section 250(a)(2). Treasury and the IRS have determined that further study is required to determine the appropriate rule for coordinating Sections 250(a)(2), 163(j) and other code provisions (such as Sections 170(b)(2) and 172(a)(2)) that limit the availability of deductions based, directly or indirectly, upon a taxpayer's taxable income (taxable income-based provisions).

Therefore, the final regulations withdrew the rule in proposed §1.163(j)-1(b)(37)(ii). Until such additional guidance is effective, taxpayers may choose any reasonable approach (which could include an ordering rule or the use of simultaneous equations) for coordinating taxable income-based provisions if that approach is applied consistently for all relevant taxable years. For this purpose, the ordering rule contained in proposed §1.163(j)-1(b)(37)(ii) and 1.250(a)-1(c)(4) is treated as a reasonable approach for coordinating Sections 163(j) and 250.

BDO Insight: Although taxpayers are not required to rely on proposed §1.163(j)-1(b)(37)(ii) and 1.250(a)-1(c)(4) for purposes of calculating their Section 163(j) limit, taxpayers may see a benefit of relying such proposed rules, because the taxpayers may be able to reduce the amount of subtraction to ATI required for GILTI inclusions.

For example, a taxpayer has a GILTI inclusion of $100 in the current year, but the taxpayer is at significant loss position such that likely its deduction under Section 250(a)(1) would be zero due to the limitation imposed by Section 250(a)(2). Pursuant to the proposed §§1.163(j)-1(b)(37)(ii) and 1.250(a)-1(c)(4), because the Section 250(a)(1) deduction is determined without regard to the limitation in Section 250(a)(2), the taxpayer is deemed to have a Section 250(a)(1) deduction of $50 (i.e., 50% of the $100 GILTI inclusion) solely for purposes of ATI calculation. As a result, the taxpayer is only required to reduce $50 (i.e., $100 GILTI inclusion less $50 deemed Section 250(a)(1) deduction) rather than $100 when computing ATI.

Coordination with Section 108

In the preamble to the proposed regulations, Treasury and the IRS requested comments on the interaction between Section 163(j) and the rules addressing income from the discharge of indebtedness under Section 108. In response, commenters noted, for example, that it is unclear whether cancellation of indebtedness income under Section 61(a)(11) arises when the taxpayer only receives a benefit in the form of a disallowed business interest expense carryforward, or whether any exclusions, such as Sections 108(e)(2) or 111, or any tax benefit principles, should apply. In light of the complex and novel issues raised in these comments, Treasury and the IRS have determined that the interaction between Section 163(j) and Section 108 requires further consideration and may be the subject of future guidance.

BDO Insight: Section 108 interacts with Section 163(j) in one of two ways. First, Section 108(e)(2) generally provides that no income will be realized from the cancellation of debt to the extent that payment of the liability would have given rise to a deduction. When interests of a taxpayer are cancelled or otherwise forgiven, the application of Section 108(e)(2) becomes uncertain because Section 163(j) could disallow an otherwise eligible interest deduction. Thus, it is unclear as to how to interpret the "give rise to a deduction" standard in the Section 163(j) context.

Second, Section 108(a) provides, in part, that if the cancellation of debt occurs in a title 11 case or when the taxpayer is insolvent, while no income shall be recognized by the taxpayer, the tax attributes (such as NOL and asset basis) of the taxpayer need to be reduced. However, Section 108(b) currently does not include disallowed business interest carryover under Section 163(j) as one of the tax attributes to which a reduction is required. As such, it is uncertain whether and to what extent disallowed business interest carryover would need to be reduced in a title 11 case or when the taxpayer is insolvent.

Coordination with Capitalized Interest Rules

Proposed §1.163(j)-3(b)(5) provides that provisions that require interest to be capitalized, such as Sections 263A and 263(g), apply before Section 163(j). Commenters suggested that this section is too restrictive by referring solely to sections 263A and 263(g), and that other provisions could require interest to be capitalized. Treasury and the IRS agree with this comment, and an appropriate revision has been made in the final regulations to account for any possible additional provisions that could require interest to be capitalized.

APPLICATION TO C CORPORATIONS AND CONSOLIDATED GROUPS

Earnings and Profits

The 2018 proposed regulations generally provide that the disallowance and carryforward of a deduction for a C corporation's business interest expense under proposed §1.163(j)-2 does not affect whether or when the business interest expense reduces the corporation's earnings and profits (E&P). With respect to excess business interest expense allocated to a C corporation partner from a partnership, the final regulations clarify that the C corporation reduces its E&P when it is allocated excess business interest expense from the partnership, and the C corporation does not reduce its E&P a second time when the C corporation is later permitted to deduct such excess business interest expense. Additionally, the final regulations continue to provide that the C corporation partner must increase its E&P upon the disposition of the partnership interest to reflect the amount of excess business interest expense that the partner did not take into account while it held the partnership interest. Treasury and the IRS have determined that the same rule should apply with respect to negative Section 163(j) expense, and the final regulations have been modified accordingly.

BDO Insight: The impact of Section 163(j) on a C corporation's E&P should only be a timing issue. Treasury and the IRS are of the view that the business interest expense incurred by a C corporation should reduce its E&P regardless of the Section 163(j) limit. This view, which is in line with the treatment of other similar items (such as meals and entertainment fees and penalties), is favorable to taxpayers because taxpayers may be able to reduce their E&P in the years that the business interest expenses incur. The timing of the business interest expense that is taken into account for purposes of E&P is not the same for the timing of making an investment adjustment in the consolidated return context. The final regulations provide that the Section 163(j) disallowed business interest expense is taken into account as an investment adjustment only in the carryover years that the disallowed amounts are allowed as a deduction.

Partnership Investment Income and Corporate Partners

In general, the 2018 proposed regulations provide that any investment interest, investment income and investment expense allocated by a partnership to a C corporation partner is treated by the partner as allocable to a non-excepted trade or business of the partner for purposes of Section 163(j). The final regulations adopted the 2018 proposed regulations with revision to cover not only a partnership's items of investment interest, investment income and investment expense, but also a partnership's other separately stated tax items that are subject to neither Section 163(j) nor Section 163(d). Such items might include tax items allocable to rental activities that do not rise to the level of a Section 162 trade or business that otherwise give rise to allowable deductions that are subject to Section 469. Thus, such items are treated as properly allocable to a trade or business of a C corporation partner as well.

Application of Unified Loss Rule to Excess Business Interest Expense Allocated from Partnerships

Section 1.1502-36 contains the unified loss rule, which limits the ability of a consolidated group to recognize non-economic or duplicated losses on the transfer of stock of a subsidiary member of the group (S). The rule applies when a group member transfers a loss share of S stock. If §1.1502-36(d) applies to the transfer of a loss share, the attributes of S and its lower-tier subsidiaries generally are reduced as needed to prevent the duplication of any loss recognized on the transferred stock. Such attributes include capital loss carryovers (Category A), NOL carryovers (Category B), deferred deductions (Category C) and basis in assets other than cash and general deposit accounts (Category D).

As noted in the preamble to the 2018 proposed regulations, Treasury and the IRS have determined that disallowed business interest expenses should be treated as deferred deductions for purposes of §1.1502-36. A commenter recommended that excess business interest expense also be treated as a deferred deduction in determining the net inside attribute amount for purposes of §1.1502-36(c) and (d). Treasury and the IRS agree that excess business interest expense should be treated as an attribute that is taken into account in determining the net inside attribute amount for purposes of §1.1502-36(c) and (d). However, Treasury and the IRS have determined that excess business interest expense allocated from partnerships is more akin to basis (a Category D attribute) than to deferred deductions (a Category C attribute). Additionally, Treasury and the IRS also have determined that excess business interest expense should not be eligible for reattribution under §1.1502-36(d)(6) because the election is not available with respect to Category D attributes.

Intercompany Transactions and Intercompany Obligations

Proposed §1.163(j)-4(d)(2) contains rules governing the calculation of the Section 163(j) limitation for members of a consolidated group. These rules provide, in part, that: (i) a consolidated group has a single Section 163(j) limitation; (ii) for purposes of calculating the group's ATI, the relevant taxable income is the consolidated group's consolidated taxable income, and intercompany items and corresponding items are disregarded to the extent they offset in amount; and (iii) for purposes of calculating the group's ATI and determining the business interest expense and business interest income of each member, all intercompany obligations (as defined in §1.1502-13(g)(2)(ii)) are disregarded. Thus, interest expense and interest income from intercompany obligations are not treated as business interest expense and business interest income for purposes of Section 163(j). Comments have been received that request changes to the above proposed rules, but Treasury and the IRS decided to adopt the 2018 proposed regulations, with one limited exception discussed below related to repurchase premium on obligations that are deemed satisfied and reissued.

In general, if debt that is not an intercompany obligation becomes an intercompany obligation (for example, if a member of a consolidated group acquires another member's debt from a non-member), the debt is treated for all federal income tax purposes, immediately after it becomes an intercompany obligation, as having been satisfied by the issuer for cash in an amount equal to the holder's basis in the note and as having been reissued as a new intercompany obligation for the same amount of cash. Additionally, if a debt instrument is repurchased by the issuer for a price in excess of its adjusted issue price (as defined in §1.1275-1(b)), the excess (repurchase premium) generally is deductible as interest for the taxable year in which the repurchase occurs.

For example, S is a member of P's consolidated group, and S has borrowed $100x from unrelated X. At a time when S's note has increased in value to $130x due to a decline in prevailing interest rates, P purchases the note from X for $130x. Under §1.1502-13(g)(5)(ii), S's note is treated as satisfied for $130x immediately after it becomes an intercompany obligation. As a result of the deemed satisfaction of the note, P has no gain or loss, and S has $30x of repurchase premium that is deductible as interest. Similarly, if S were to repurchase its note from X for $130x, S would have $30x of repurchase premium that is deductible as interest.

To ensure that the same result would be achieved regardless of S repurchasing its note directly from X or another member of the consolidated group in which S is a member purchasing the note from X, final regulations provide that, for purposes of Section 163(j), if any member of a consolidated group purchases a member's note from a third party at a premium, the repurchase premium that is deductible under §1.163-7(c) is treated as interest expense for purposes of Section 163(j), regardless of whether the repurchase premium is treated as paid on intercompany indebtedness.

Anti-Avoidance Rule

Under the 2018 proposed regulations, members of a consolidated group are aggregated for purposes of Section 163(j), and the consolidated group has a single Section 163(j) limitation. In contrast, partnerships that are wholly owned by members of a consolidated group are not aggregated with the group for purposes of Section 163(j), and members of an affiliated group that do not file a consolidated return are not aggregated with each other for purposes of Section 163(j).

Treasury and the IRS are concerned that the application of Section 163(j) on an entity-by-entity basis outside the consolidated group context could create the potential for abuse in certain situations by facilitating the separation of excepted and non-excepted trades or businesses. The anti-avoidance rule in proposed §1.163(j)-2(h) and the anti-abuse rule in proposed §1.163(j)-10(c)(8) would preclude taxpayers from undertaking transactions with a principal purpose of circumventing the Section 163(j) limitation. The final regulations add an example illustrating the application of the anti-avoidance rule in proposed §1.163(j)-2(h) to the use of a controlled corporation to avoid the Section 163(j) limitation, as well as an example illustrating the application of this anti-avoidance rule to the use of a lower-tier partnership to avoid the Section 163(j) limitation in a similar manner.

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SRLY AND SECTION 382 IMPACT ON DISALLOWED BUSINESS INTEREST EXPENSE CARRYFORWARDS

Carryforwards from Separate Return Limitation Years (SRLY)

The 2018 proposed regulations provide that the disallowed business interest expense carryforwards of a member arising in a SRLY that are included in a group's business interest expense deduction for any taxable year may not exceed the group's Section 163(j) limitation for that year, determined by reference only to the member's tax items for that year (the Section 163(j) SRLY limitation). Additionally, disallowed business interest expense carryforwards of a member arising in a SRLY would be available for deduction by the consolidated group in the current year only to the extent the group had remaining Section 163(j) limitation after deducting current-year business interest expense and disallowed business interest expense carryforwards from earlier taxable years, and only to the extent the Section 163(j) SRLY limitation for the current year exceeded the amount of the member's business interest expense already deducted by the group in that year. In addition, SRLY-limited disallowed business interest expense carryforwards must be deducted on a pro rata basis with non-SRLY limited disallowed business interest expense carryforwards from taxable years ending on the same date.

Treasury and the IRS received comments regarding why the Section 163(j) SRLY limitation is calculated annually rather than on an aggregate or cumulative basis, as is the case for NOLs. Section 1.1502-21(c)(1)(i) generally limits the amount of a member's NOL carryforwards and carrybacks from a SRLY that may be included in the group's consolidated NOL deduction to the member's aggregate contribution to the group's consolidated taxable income for the entire period the member has been a group member, not just for the taxable year in question. After considering the comments received, Treasury and the IRS have determined that a cumulative Section 163(j) SRLY register would better approximate the results under Section 163(j) if the SRLY member had not joined a consolidated group, and that this approach is not inconsistent with congressional intent. Therefore, the final regulations adopt a cumulative Section 163(j) SRLY register. The cumulative Section 163(j) SRLY register operates in a manner similar to, but is separate and distinct from, the cumulative register for NOLs described in §1.1502-21(c).

BDO Insight: The 2018 Proposed Regulation adopted an annual approach rather than an aggregate or cumulative approach to the Section 163(j) SRLY limitation because Treasury and the IRS believed that Congress did not retain the excess limitation carryforward provisions from the old Section 163(j). However, commenters correctly noted that applying a cumulative Section 163(j) SRLY register would not effectuate the carryforward of excess limitation at the level of the consolidated group. In other words, although the SRLY member would be able to deduct its SRLY disallowed business interest expense carryforwards in a taxable year to the extent of that member's cumulative (rather than annual) contribution to the group's Section 163(j) limitation, the SRLY member's ability to deduct such carryforwards still would be subject to the group's annual Section 163(j) limitation.

Although adopting a cumulative Section 163(j) SRLY register appears more reasonable to extend the consolidated return policies, it may create administrative complexity for taxpayers as they will need to track the cumulative Section 163(j) SRLY register in addition to the cumulative register for NOLs. However, in situations in which a SRLY event overlaps with a Section 382 event, taxpayers generally only need to apply Section 382 and do not need to track separate registers for either Section 163(j) disallowed business interest carryovers or NOLs.

Section 382 Limitation on Disallowed Business Interest Expense Carryforwards

Section 382(k)(1) provides that, for purposes of Section 382, the term "loss corporation" includes a corporation entitled to use a carryforward of disallowed interest described in Section 381(c)(20), which refers to carryovers of disallowed business interest described in Section 163(j)(2). Section 163(j)(2) permits business interest expense for which a deduction is disallowed under Section 163(j)(1) to be carried forward to the succeeding taxable year. In the final regulations, Treasury and the IRS clarified that a "pre-change loss" for purposes of Section 382(d)(1) includes the portion of any disallowed business interest expense of the old loss corporation paid or accrued in the taxable year of the testing date that is attributable to the pre-change period, and that a "loss corporation" includes a corporation that is entitled to use a carryforward of such a disallowed business interest expense. Consequently, the final regulations revise the definition of a "Section 382 disallowed business interest carryforward" (which includes both disallowed business interest expense carryforwards and current-year disallowed business interest expense allocable to the pre-change period) in §1.382-2(a)(7).

Section 382 Application to S Corporations

The 2018 proposed regulations provide that Sections 381 and 382 apply to S corporations with respect to disallowed business expense carryforwards. For S corporations, any business interest expense not allowed as a deduction for any taxable year by reason of the Section 163(j) limitation is not allocated to the S corporation shareholders and is treated as an attribute of the S corporation. An S corporation shareholder's stock basis is reduced, but not below zero, and an S corporation's accumulated adjustments account (AAA) balance is adjusted, when a disallowed business interest expense becomes deductible under Section 163(j).

Because disallowed business interest expense is treated as an attribute of the S corporation, the S corporation's disallowed business interest expense carryforwards will be treated as pre-change losses subject to a Section 382 limitation. Accordingly, consistent with the treatment of C corporations under Section 382, the final regulations provide that a disallowed business interest expense carryforward of an S corporation is treated as pre-change loss and will be subject to a Section 382 limitation only if an S corporation undergoes an ownership change within the meaning of Section 382(g). Treasury and the IRS continue to consider the extent to which Section 382 should apply to S corporations for purposes other than Section 163(j). The application of Section 382 to S corporations for purposes of Section 163(j) should not be construed as creating any inference regarding the application of Section 382 to S corporations for other purposes.

BDO Insight: Section 163(j) as amended by the TCJA has created a new category of tax attribute that is subject to Section 382. This is significant to corporations and consolidated groups that expect to generate disallowed business interest carryforwards, especially to S corporations with Section 163(j) disallowed business interest expense carryovers and those that have historically been in taxable income. Corporations with disallowed business interest carryforwards will need to start tracking the ownership shifts of their shareholders in case of a Section 382 ownership change. Challenges presented to consolidated groups are even greater because consolidated groups will need to track not only their shareholder ownership shifts but also disallowed business interest carryforward of each member to which the SRLY rules may apply.

Closing-of-the-Books Election

Section 1.382-6 provides rules for the allocation of income and loss to periods before and after the change date for purposes of Section 382. Section 1.382-6(a) generally provides that a loss corporation must allocate its NOL or taxable income, and its net capital loss or modified capital gain net income, for the change year between the pre-change and post-change periods by ratably allocating an equal portion to each day in the year. Section 1.382-6(b), which contains an exception to this general rule, permits a loss corporation to elect to allocate the foregoing items for the change year between the pre-change and post-change periods as if the loss corporation's books were closed on the change date.

The 2018 proposed regulations provide that, regardless of whether a loss corporation has made a closing-of-the-books election under §1.382-6(b), the amount of the corporation's deduction for current-year business interest expense is calculated based on ratable allocation for purposes of calculating the corporation's taxable income attributable to the pre-change period. After considering the comments received, Treasury and the IRS withdrew this rule and acknowledge that a ratable allocation approach may lead to distortions and administrative burdens in certain situations. Thus, the final regulations permit a loss corporation to allocate current-year business interest expense between the pre-change and post-change periods using the closing-of-the-books method set forth in §1.382-6(b)(4) if the loss corporation makes a closing-of-the-books election under §1.382-6(b).

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Ordering Rule for Absorption of NOLs and Disallowed Business Interest Carryforwards

The final regulations continue to provide that a taxpayer's Section 382 limitation would be absorbed by disallowed business interest expense carryforwards before being absorbed by NOLs because taxpayers must calculate their current-year income or loss in order to determine whether and to what extent they can use an NOL in that year, and deductions for business interest expense, including carryforwards from prior taxable years, factor into the calculation of current-year income or loss.

Application of Section 382(l)(5)

Section 382(l)(5) provides an exception to the general loss limitation rule under Section 382(a) for an old loss corporation in Title 11 proceedings or in similar cases if the historic shareholders and creditors of such corporation own at least 50% of the stock of the new loss corporation as a result of being shareholders or creditors immediately before the ownership change. If this exception applies, the corporation's pre-change losses and excess credits that may be carried over to a post-change year must be "computed as if no deduction was allowable under this chapter for the interest paid or accrued" on debt converted into stock under Title 11 (or in a similar case) during the three-year period preceding the year of the ownership change (change year) or during the pre-change period in the change year. In other words, because the old loss corporation gets the benefit of treating certain creditors as shareholders for purposes of determining whether the corporation has undergone an ownership change within the meaning of Section 382(g), the corporation must treat the debt held by such creditors as equity for federal income tax purposes. As a result, the corporation must treat the interest payments as non-deductible distributions on equity.

As provided in proposed §1.382-2, Section 382 disallowed business interest carryforwards are pre-change losses, so commenters asked whether such carryforwards must be recomputed under Section 382(l)(5)(B). Although Treasury and the IRS determined that no clarification of the rule is necessary, they confirmed in the preamble to the final regulations that the corporation must recompute the amount of such carryforwards as if the business interest expense that generated such carryforwards were not interest.

Application of Section 382(h)(6)

The Section 382 proposed regulations issued in September 2019 included a rule expressly providing that Section 382 disallowed business interest carryforwards are not treated as RBILs, thus precluding a double detriment under Section 382 with respect to such carryforwards. Due to the uncontroversial nature of this rule, Treasury and the IRS have determined that finalization of this portion of the Section 382 proposed regulations is appropriate at this time.

APPLICATION TO PARTNERSHIPS

Partnership-Level Calculation and Allocation of Section 163(j) Excess Items

Section 163(j)(4) provides that a partner's excess taxable income (ETI) is determined in the same manner as the non-separately stated taxable income or loss of the partnership. Section 163(j)(4) further provides that excess business interest expense (EBIE) is allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership. Similarly, excess business interest income (EBII) is allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership.

As highlighted in the 2018 proposed regulations, the phrase "non-separately stated taxable income or loss of the partnership" is not defined in Section 163(j), and it has not previously been defined by statute or regulations. The phrase "in the same manner as" is also undefined. The 2018 proposed regulations established an 11-step process intended to create a system of allocating the appropriate Section 163(j) items.

While the proposed 11-step process created a workable system, commenters required clarification and modification in several areas. In particular, the 2020 final regulations confirm the following:

- Any calculations performed under the 11-step process are solely for purposes of Section 163(j) and do not impact the partnership's allocations under Section 704(b).
- Regulation §1.704-1(b)(4)(xi) has been added as part of the final regulations in order to confirm that allocations made in accordance with the 11-step process will be deemed to be in accordance with the partner's interests in the partnership.
- The final regulations do not adopt the recommendation that the 11-step process take remedial allocations into consideration.
- The final regulations do not adopt the recommendation to allow remedial allocations of ETI to partners allocated greater taxable income than ETI.

Treasury and the IRS received numerous comments with requests for possible exceptions and alternatives to the 11-step process described in the 2018 proposed regulations. For the most part, none of these suggestions were incorporated into the final regulations. Treasury and the IRS determined that the 11-step process produces results that are most consistent with the principle that the amount of business interest expense a taxpayer is capable of deducting should increase as its ATI and business interest income (BII) increase.

Notwithstanding adoption of the 11-step process, the final regulations incorporate an exception to the general requirement that partnership taxpayers must apply the 11-step process. In particular, the final regulations establish a "pro rata" exception from steps three through 11.

BDO Insight: Many partnerships will need to continue applying the full 11-step process and will find themselves ineligible for the pro rata exception to steps three through 11. The inability to apply this exception will be primarily due to the extensive use of so-called targeted allocation agreements. Consequently, affected partnership taxpayers will be well-advised to develop standardized procedures for applying the 11-step process. This will help minimize the potential administrative burdens created by the Section 163(j) reporting requirement.

Basis Adjustments Upon Disposition of Partnership Interests

Under the 2018 proposed regulations, when a partner disposes of its interest in a partnership, any basis adjustments attributable to previously allocated EBIE are reversed. Consequently, the partner will increase the basis in its partnership interest immediately before the disposition. This treatment will effectively cause the previously suspended interest expense allocated to the disposing partner to recognize less capital gain (or more capital loss) on the disposition. Importantly, the 2018 proposed regulations provided this rule applies only in situations involving the disposition of all or substantially all of the partner's interest in the partnership.

In response to numerous comments, Treasury and the IRS modified this rule in the final regulations to adopt a proportionate approach to partial dispositions of partnership interests. Under the adopted proportionate approach, Treasury and the IRS changed course and agreed that the basis add-back should be allocated to the disposed interest rather than the retained interest.

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The 2020 proposed regulations provide that if a partner (transferor) disposes of its partnership interest, the partnership shall increase the adjusted basis of partnership property by an amount equal to the amount of the increase required under §1.163(j)-6(h)(3), if any, to the adjusted basis of the partnership interest being disposed of by the transferor. Such increase in the adjusted basis of partnership property (§1.163(j)-6(h)(5) basis adjustment) shall be allocated among partnership properties in the same manner as a positive Section 734(b) adjustment. Because a §1.163(j)-6(h)(5) basis adjustment is taken into account when determining the gain or loss upon a sale of the asset, a §1.163(j)-6(h)(5) basis adjustment prevents the shifting of built-in gain to the remaining partners.

These proposed regulations would adopt an approach that treats the increase in the adjusted basis of any partnership property resulting from a §1.163(j)-6(h)(5) basis adjustment as not depreciable or amortizable under any section of the code, regardless of whether the partnership property allocated such §1.163(j)-6(h)(5) basis adjustment is otherwise generally depreciable or amortizable. This approach perceives EBIE as a deduction that was disallowed to the partnership (consistent with Section 163(j)(4)(B)(iii)(II)), and thus should not result in a depreciable Section 734(b) basis adjustment.

EXAMPLE

Consider the following example as included in the 2020 proposed regulations:

In Year 1, A, B and C formed partnership PRS by each contributing $1,000 cash. PRS borrowed $900, causing each partner's basis in PRS to increase by $300 under Section 752. Also in Year 1, PRS purchased Capital Asset X for $200. In Year 2, PRS pays $300 of business interest expense, all of which is disallowed and treated as EBIE. PRS allocated the $300 of EBIE to its partners, $100 each. Each partner reduced its adjusted basis in its PRS interest by its $100 allocation of EBIE to $1,200. In Year 3, when the fair market value of Capital Asset X is $3,200 and no partner's basis in PRS has changed, PRS distributed $1,900 to C in complete liquidation of C's partnership interest in a distribution to which Section 737 does not apply. PRS had a Section 754 election in effect in Year 3.

Consequences to selling partner. Pursuant to §1.163(j)-6(h)(3), C increases the adjusted basis of its interest in PRS by $100 immediately before the disposition. Thus, C's Section 731(a)(1) gain recognized on the disposition of its interest in PRS is $900 (($1,900 cash + $300 relief of liabilities) — ($1,200 outside basis + $100 EBIE add-back)).

Partnership basis. Pursuant to §1.163(j)-6(h)(5), PRS has a $100 increase to the basis of its assets immediately before C's disposition. Under Section 755, the entire $100 adjustment is allocated to Capital Asset X. Pursuant to §1.163(j)-6(h)(5), regardless of whether Capital Asset X is a depreciable or amortizable asset, none of the $100 of basis increase allocated to Capital Asset X is depreciable or amortizable. PRS has a Section 734(b) increase to the basis of its assets of $900 (the amount of Section 731(a)(1) gain recognized by C). Under Section 755, the entire $900 adjustment is allocated to Capital Asset X. As a result, PRS's basis in Capital Asset X is $1,200 ($200 + $100 basis increase + $900 Section 734(b) adjustment). Following the liquidation of C, PRS's basis in its assets ($1,500 cash + $1,200 Capital Asset X – $900 liability) equals the aggregate adjusted tax basis capital of partners A and B in PRS ($1,800).

BDO Insight: Adoption of a proportionate approach to partial dispositions with basis add-back to the disposed interest will allow taxpayers to recoup suspended interest more quickly than under the 2018 proposed regulations. It's worth noting, however, that this approach also eliminates the ability to potentially utilize the suspended interest against ordinary income taxed at higher rates.

Debt-Financed Partnership Distributions

In 1987, Treasury regulations were issued providing guidance to taxpayers about how to allocate interest expense among expenditures (see Treas. Reg. § 1.163-8T). The guidance classified interest expense into five categories: trade or business, passive activity, investment, personal, and portfolio. Notably, the regulations reserved guidance as to how debt was to be allocated to distributions by passthrough entities.

In a series of notices, Treasury and the IRS provided further guidance with respect to the allocation of interest expense in connection with certain transactions involving passthrough entities and owners of passthrough entities (see Notice 88-20, 1988-1 C.B. 487, Notice 88-37, 1988-1 C.B. 522, and Notice 89-35, 1989-1 C.B. 675). Specifically, Notice 89-35 provides, in part, rules addressing the treatment of (1) passthrough entity debt allocated to distributions by the entity to its owners (debt-financed distributions), and (2) a passthrough entity owner's debt allocated to contributions to, or purchases of, interests in a passthrough entity (debt-financed contributions or acquisitions).

In the case of debt-financed distributions, Notice 89-35 provides a general allocation rule and an optional allocation rule. The optional allocation rule applicable to debt-financed distributions allows a passthrough entity to allocate distributed debt proceeds and the associated interest expense to one or more expenditures, other than distributions, of the entity that are made during the same taxable year of the entity as the distribution, to the extent that debt proceeds, including other distributed debt proceeds, are not otherwise allocated to such expenditures. Under the optional allocation rule, distributed debt proceeds are traced to the owner's use of the borrowed funds to the extent that such distributed debt proceeds exceed the entity's expenditures, not including distributions, for the taxable year to which debt proceeds are not otherwise allocated.

Treasury and the IRS have determined that additional rules, specific to passthrough entities and their owners, are needed to clarify how the rules under §1.163-8T work when applied to a passthrough entity and to account for the partnership entity-level limitation under Section 163(j).

To more accurately account for the types of expenditures made by passthrough entities, the 2020 proposed regulations would provide rules tailored to passthrough entities. The framework that the 2020 proposed regulations provides is needed for a passthrough entity to determine how much of its interest expense is allocable to a trade or business for purposes of applying Section 163(j). These 2020 proposed regulations would apply before a passthrough entity applies any of the rules in Section 163(j).

The 2020 proposed regulations provide that when debt proceeds of a passthrough entity are allocated under §1.163-8T to distributions to owners of the entity, the debt proceeds distributed to any owner and the associated interest expense shall be allocated under the newly proposed regulations. In general, the 2020 proposed regulations adopt a rule similar to Notice 89-35, but with the following modifications. First, instead of providing that passthrough entities may use the optional allocation rule, the 2020 proposed regulations generally provide that passthrough entities are required to apply a rule that is similar to the optional allocation rule. Second, instead of providing that the passthrough entity may allocate excess interest expense using any reasonable method, the 2020 proposed regulations generally provide that the passthrough entity must allocate excess interest expense based on the adjusted tax basis of the passthrough entity's assets.

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EXAMPLE 1

A (an individual) and B (an individual) are partners in partnership PRS. PRS conducts two businesses; a manufacturing business, which is a trade or business within the meaning of Section 162 (manufacturing), and a separate commercial real estate leasing business (leasing). In Year 1, PRS borrowed $100,000 from an unrelated third-party lender (the loan). Other than the loan, PRS does not have any outstanding debt. During Year 1, PRS paid $80,000 in manufacturing expenses, $120,000 in leasing expenses, and made a $100,000 distribution to A, the proceeds of which A used to make a personal expenditure. Under §1.163-8T, PRS treated the $100,000 of loan proceeds as having been distributed to A. As a result, in Year 1 PRS had $200,000 of available expenditures and $100,000 of distributed debt proceeds. PRS paid $10,000 in interest expense that accrued during Year 1 on the loan and allocated such interest expense under Section 704(b) equally to A and B ($5,000 each). Thus, A and B each had $5,000 of allocable interest expense.

Because PRS treated all $100,000 of the loan proceeds as having been distributed under §1.163-8T, PRS allocated all $10,000 of the interest expense associated with the loan to the distribution. Thus, PRS must determine the tax treatment of such $10,000 of interest expense.

To the extent PRS has available expenditures, it must allocate any distributed debt proceeds to such available expenditures. Here, PRS has distributed debt proceeds of $100,000 and available expenditures of $200,000 (manufacturing expenditures of $80,000, plus leasing expenditures of $120,000). Thus, PRS allocates all $100,000 of the distributed debt proceeds to available expenditures as follows: $40,000 to manufacturing expenditures ($100,000 x ($80,000/$200,000)) and $60,000 to leasing expenditures ($100,000 x ($120,000/$200,000)). Because the amount of PRS's distributed debt proceeds is less than its available expenditures, none of the distributed debt proceeds are allocated to debt-financed distributions.

Because PRS's distributed debt proceeds are allocated to available expenditures (pursuant to paragraph (d)(1)(i) of this section), A and B each treat all $5,000 of their allocable interest expense as expenditure interest expense.

Each partner treats its expenditure interest expense in the same manner as the distributed debt proceeds that were allocated to available expenditures. Thus, A's $5,000 of expenditure interest expense comprises of $2,000 of business interest expense ($5,000 x ($40,000/$100,000)) and $3,000 of interest expense allocated to rental expenditures ($5,000 x ($60,000/$100,000)). B's $5,000 of expenditure interest expense similarly comprises of $2,000 of business interest expense and $3,000 of interest expense allocated to rental expenditures. As a result, $4,000 of interest expense associated with the distributed debt proceeds (A's $2,000 plus B's $2,000 of expenditure interest expense treated as business interest expense) is business interest expense of PRS, subject to Section 163(j) at the PRS level.

EXAMPLE 2

The facts are the same as in Example 1, except PRS did not have any rental expenditures in Year 1. As a result, in Year 1 PRS had $80,000 of available expenditures and $100,000 of distributed debt proceeds.

Because PRS treated all $100,000 of the loan proceeds as having been distributed to A under §1.163-8T, PRS allocated all $10,000 of the interest expense associated with the loan to the distribution. Thus, PRS must determine the tax treatment of such $10,000 of interest expense.

To the extent PRS has available expenditures, it must allocate any distributed debt proceeds to such available expenditures. Here, PRS has distributed debt proceeds of $100,000 and available expenditures of $80,000. Thus, $80,000 of the distributed debt proceeds are allocated to such available expenditures. PRS allocates the remaining $20,000 of the distributed debt proceeds to debt financed distributions.

A treats $2,000 of its allocable interest expense as debt financed distribution interest expense, which is the lesser of $5,000 or $2,000 ((A) the portion of debt proceeds distributed to A ($100,000), multiplied by (B) a fraction, the numerator of which is the portion of PRS's distributed debt proceeds allocated to debt financed distributions ($20,000), and the denominator of which is PRS's total amount of distributed debt proceeds ($100,000), multiplied by (C) the distributed debt proceeds interest rate of 10% (the amount of interest expense associated with distributed debt proceeds ($10,000), divided by the amount of distributed debt proceeds ($100,000))) and B treats $0 of its allocable interest expense as debt financed distribution interest expense, which is the lesser of $5,000 or $0 ((A) $0 x (B) 20% x (C) 10%).

Neither partner treats any of its allocable interest expense as excess interest expense.

Each partner determines the tax treatment of its debt-financed distribution interest expense based on its use of the distributed debt proceeds. Because A used its $100,000 of distributed debt proceeds on a personal expenditure, A's $2,000 of debt financed distribution interest expense is personal interest subject to Section 163(h) at A's level. Each partner treats its expenditure interest expense in the same manner as the distributed debt proceeds that were allocated to available expenditures. Thus, all $3,000 of A's expenditure interest expense and all $5,000 of B's expenditure interest expense is business interest expense. As a result, $8,000 interest expense associated with the distributed debt proceeds (A's $3,000 plus B's $5,000 of expenditure interest expense treated as business interest expense) is business interest expense of PRS, subject to Section 163(j) at the PRS level.

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Self-Charged Lending Transactions

The 2018 proposed regulations reserved on the treatment of BII and BIE with respect to lending transactions between a partnership and a partner (self-charged lending transactions). The 2020 proposed regulations would add a rule to 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 the self-charged lending transaction is BIE of the borrowing partnership for purposes of §1.163(j)-6.

Further, 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 will treat such interest income as an allocation of EBII (EBII) 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 EBII pursuant to proposed §1.163(j)-6(n) 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).

Passive Investors in Trading Partnerships

The preamble to the 2018 proposed regulations states that business interest expense of certain passthrough entities, including S corporations, allocable to trade or business activities that are per se passive under Section 469 and activities with respect to which the taxpayer does not materially participate will be subject to Section 163(j) at the entity level, even if the interest expense is later subject to limitation under Section 163(d) at the individual partner or shareholder level. To the extent that interest expense from a trading activity is limited under Section 163(j) and becomes a carryover item of partners who do not materially participate in the trading activity, the interest expense will be treated as investment interest in the hands of those partners for purposes of Section 163(d) once the interest expense is no longer limited under Section 163(j). This approach would effectively create a double-layered limitation for partners subject to the Section 163(d) limitation.

Commentators noted that creating a system whereby partners could see interest expense subject to both Section 163(j) and Section 163(d) was not consistent with rules under Section 163(j)(5). Pursuant to Section 163(j)(5), business interest expense does not include investment interest within the meaning of Section 163(d).

Under the 2020 proposed regulations, a trading partnership would be required to bifurcate its interest expense from a trading activity between partners that materially participate in the trading activity and partners that are passive investors. The Section 163(j) limitation would then be applied solely to the portion of the interest expense that is allocable to the materially participating partners. The portion of interest expense from a trading activity allocable to passive investors will be subject to limitation under Section 163(d) at the partner level, as provided in Section 163(d)(5)(A)(ii). In addition to the bifurcation of interest expense, the 2020 proposed regulations would also require the separate allocation of other items of income, gain, loss and deduction from trading activities to materially participating partners and passive partners.

BDO Insight: Under the 2020 proposed regulations, interest expense from trading partnerships may be subject to 163(j) or 163(d), but not both, with respect to a specific partner. While creating what appears to be an equitable result and one that is consistent with Section 163(j)(5), the 2020 proposed regulations may create significant administrative burden on trading partnerships. In order to comply with these rules, trading partnerships will be required to conclude on passive vs. non-passive status of each partner and then specially allocate relevant items to each group of partners.

Treatment of Excess Business Interest Expense in Tiered Partnerships

General Rule

While Section 163(j) clearly applies at the partnership level, less clear is how the limitation should impact partners in a tiered partnership structure. The 2018 proposed regulations specifically reserved on providing guidance and instead the preamble requested comments regarding whether, in a tiered partnership arrangement, carryforwards should be allocated through upper-tier partnerships. Additionally, Treasury and the IRS requested comments regarding how and when an upper-tier partner's basis should be adjusted when a lower-tier partnership is subject to Section 163(j). Comments submitted generally described three approaches to resolving the issues surrounding application of Section 163(j) in tiered partnership structures. These approaches include:

- **Entity Approach:** In applying the Entity Approach, Section 163(j) would be applied independently to each partnership. At each tier, EBIE that is not treated as paid or accrued or that has not given rise to a basis adjustment by a partnership would not be further allocated up the chain of ownership.
- **Aggregate Approach:** Under the Aggregate Approach, Section 163(j) would be applied only by the borrowing partnership. Partners in the borrowing partnership that are partnerships would pass through EBIE amounts and basis adjustments to their partners. Only direct and indirect partners that are not partnerships would apply the carryover rules in Section 163(j)(4) and would account for indirect shares of EBIE from a lower tier partnership or partnerships.
- **Blended Approach:** As a final option, a Blended Approach would require partners that are partnerships to apply the Section 163(j)(4) carryover rules but would also pass through EBIE amounts and basis adjustments to upper tier partners.

In the 2020 proposed regulations, Treasury and the IRS have adopted the Entity Approach in applying Section 163(j) in tiered partnership structures. Under these rules, if a lower-tier partnership allocates EBIE to an upper-tier partnership, then the upper-tier partnership reduces basis in its interest in the lower-tier partnership. However, partners of the upper-tier partnership do not reduce the basis of their upper-tier partnership interests until the upper-tier partnership treats such EBIE as business interest expense paid or accrued.

Notwithstanding the rule that partners of the upper-tier partnerships do not reduce tax basis by allocated EBIE, the expense does reflect an actual economic outlay and reduction in inherent partnership value. Consequently, the 2020 proposed regulations provide that if the lower-tier partnership pays or accrues business interest expense and allocates such business interest expense to an upper-tier partnership, then both the upper-tier partnership and any direct or indirect partners of the upper-tier partnership treat such expense as a reduction to the partner's Section 704(b) capital account, i.e., the expense is treated as a Section 705(a)(2)(B) expenditure.

BDO Insight: While application of the Entity Approach should generally be administratively easier than the Aggregate or Blended Approaches, care will need to be taken to ensure accurate maintenance of Section 704(b) capital. Further, the 2020 proposed regulations do not appear to provide guidance on the implications of a partnership that may have previously applied the Aggregate or Blended Approaches.

Basis and Carryforward Component of EBIE

A concern raised in connection with application of the Entity Approach is the apparent variance between inside and outside basis as it relates to the partners in the upper-tier partnership. Treasury and the IRS, however, explained in the preamble to the 2020 proposed regulations that there is no basis variance. While the upper-tier partnership reduces its basis in its interest in the lower-tier partnership, the reduction is not a permanent cost. Rather, the upper-tier partnership has basis in the EBIE.

Accordingly, the 2020 proposed regulations provide that if the lower-tier partnership allocates EBIE to the upper-tier partnership and such EBIE is not suspended under Section 704(d), then the upper-tier partnership treats the EBIE (UTP EBIE) as a nondepreciable capital asset, with a fair market value of zero and basis equal to the amount by which upper-tier partnership reduced its basis in the lower-tier partnership. Further, the fair market value of UTP EBIE, described in the preceding sentence, is not adjusted by any Section 704(b) capital account revaluations.

The 2020 proposed regulations provide that the upper-tier partnership treats the EBIE allocated from a lower-tier partnership as UTP EBIE until a "conversion event." The 2020 proposed regulations describe two conversion events to include (1) when the EBIE is treated as business interest expense paid or accrued under the Section 163(j) regulations and (2) there is a disposition of the interest in the lower-tier partnership.

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Anti-Loss Trafficking Rules

As described above, the Entity Approach relies on the creation of a built-in loss asset presumably under either Section 734(b) or Section 743(b). This approach is intended to prevent a partner from deducting business interest expense that was formerly a UTP EBIE if the partner did not bear the economic cost of the interest expense payment. The anti-loss trafficking rule under the 2020 proposed regulations would prohibit the trafficking of business interest expense by providing that no deduction is allowed to any transferee specified partner for any business interest expense derived from a transferor's share of UTP EBIE.

Partnership or S Corporation Not Subject to Section 163(j)

Under the 2018 proposed regulations, if a partner or S corporation shareholder is allocated business interest expense from an exempt entity, that allocated business interest expense will be subject to the partner's or S corporation shareholder's Section 163(j) limitations. After considering comments received, Treasury and the IRS decided to withdraw this rule and provide that business interest expense of an exempt partnership, or exempt S corporation, pursuant to Section 163(j)(3) does not retain its character as business interest expense and, as a result, is not subject to the Section 163(j) limitation at the partner or S corporation shareholder level.

Additionally, if a partner is allocated excess business interest expense from a partnership and, in a succeeding taxable year, such partnership engages in excepted trades or businesses, then the partner shall not treat any of its excess business interest expense that was previously allocated from such partnership as business interest expense paid or accrued by the partner in such succeeding taxable year by reason of the partnership engaging in excepted trades or businesses. Rather, such excess business interest expense shall remain as excess business interest expense until such time as it is treated as business interest expense paid or accrued by the partner pursuant to §1.163(j)-6(g)(2) or by reason of the partnership becoming an exempt entity (relating to the small business exemption). The final regulations provide a similar clarification for S corporations in §1.163(j)-6(m)(4).

APPLICATION TO S CORPORATIONS

Separate Application of Section 163(j) Limitation to Short Taxable Years of S Corporations

An S corporation's items of income and loss generally are allocated on a pro rata, per-day basis to all shareholders that hold the corporation's stock during the corporation's taxable year. However, subchapter S provides limited exceptions to that general allocation rule. For example, in the event that a shareholder completely terminates its interest, the S corporation and affected shareholders can elect to treat its taxable year "as if the taxable year consisted of two taxable years the first of which ends on the date of the termination" (each, a hypothetical short taxable year). In addition, an S corporation may make such an election if a shareholder has made a qualifying disposition. With regard to each of these instances, the S corporation may elect to "close the books" even though the corporation will file one federal income tax return for the taxable year covering both separate taxable periods. If an S corporation (1) has an actual short taxable year, or (2) determines its taxable income or loss as if its taxable year consisted of separate taxable years (that is, hypothetical short taxable years), the final regulations clarify that a separate Section 163(j) limitation should be calculated for, and applied to, each actual or hypothetical short taxable year.

APPLICATION TO FOREIGN CORPORATIONS AND U.S. SHAREHOLDERS

Section 1.163(j)-7 provides general rules regarding the application of the Section 163(j) limitation to foreign corporations and U.S. shareholders. The 2018 proposed regulations generally apply Section 163(j) and the Section 163(j) regulations to determine the deductibility of an applicable CFC's business interest expense in the same manner as these provisions apply to determine the deductibility of a domestic C corporation's business interest expense. Thus, under the 2018 proposed regulations, an applicable CFC with business interest expense applies Section 163(j) to determine the extent to which that expense is deductible for purposes of computing subpart F income as defined under Section 952, tested income as defined under Section 951A(c)(2)(A), and income that is effectively connected with the conduct of a U.S. trade or business (ECI), as applicable.

Although comments requested Section 163(j) not be applied to foreign corporations or be applied to foreign corporations in a limited capacity, Treasury and the IRS have determined in the final regulations that, under current law, Section 163(j) applies to applicable CFCs and other foreign corporations whose income is relevant for U.S. tax purposes. Furthermore, no comments were received on the application of §1.952-2 or Section 882 for purposes of determining the income, including ECI, of an applicable CFC or on the reduction of an applicable CFC's taxable income by the amount of any dividend received from a related person for purposes of determining ATI. In addition to clarifying that these rules apply to all relevant foreign corporations, the final regulations otherwise adopt these rules unchanged.

However, Treasury and the IRS have developed new rules, taking into account comments received, that substantially modify the rules contained in proposed §1.163(j)-7. Treasury and the IRS anticipate that, in many cases, these modifications will significantly reduce the compliance and administrative burdens of applying Section 163(j) to applicable CFCs. Because the operation of these new rules is sufficiently different from the operation of the rules in former proposed §1.163(j)-7, Treasury and the IRS determined that these rules should be proposed in order to provide taxpayers the opportunity to comment before their finalization. For a summary discussion of new proposed §1.163(j)-7, see our **August tax alert**.

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APPLICATION TO FOREIGN PERSONS WITH EFFECTIVELY CONNECTED TAXABLE INCOME

Proposed §1.163(j)-8 provides rules for applying Section 163(j) to a nonresident alien individual or foreign corporation with ECI. Although no comments were received on proposed §1.163(j)-8, Treasury and the IRS continue to study methods of determining the amount of deductible business interest expense and disallowed business interest expense carryforwards that are allocable to ECI. Accordingly, the final regulations reserve on the application of the business interest expense deduction limitation under Section 163(j) to foreign persons with ECI. In the 2020 proposed regulations, Treasury and the IRS are proposing rules for determining the amount of deductible business interest expense and disallowed business interest expense carryforward of a nonresident alien, foreign corporation, or partnership that is properly allocable to ECI. For a summary discussion of new proposed §1.163(j)-8, see our **August tax alert**.

ALLOCATION OF INTEREST EXPENSE, INTEREST INCOME, AND OTHER ITEMS OF EXPENSE AND GROSS INCOME TO AN EXCEPTED TRADE OR BUSINESS

General Method of Allocation: Asset Basis

In the final regulations, Treasury and the IRS continue to provide that interest expense and interest income are allocated between excepted and non-excepted trades or businesses based upon the relative amounts of the taxpayer's adjusted basis in the assets used in its trades or businesses.

Allocation Between Trades or Businesses and Non-Trades or Businesses

In the final regulations, Treasury and the IRS continue to provide that, before a taxpayer may determine the amount of interest expense, interest income, or other tax items that are properly allocable to excepted or non-excepted trades or businesses, the taxpayer first must apply §1.163-8T to determine which tax items are allocable to non-trades or businesses rather than to trades or businesses.

Consolidated Groups

With respect to property use that derives from an intercompany transaction in a consolidated group, the final regulations provide that when one member of a consolidated group (S) leases property to another member of the group (B), which uses the property in its trade or business, B's use of the property is not disregarded for purposes of the allocation rules in proposed §1.163(j)-10. If S and B were treated as disregarded entities owned by the same corporation, the lease would be ignored, and the leased property would be treated as an asset used in B's trade or business.

Quarterly Asset Testing

Under proposed §1.163(j)-10(c)(6), a taxpayer must determine the adjusted basis in its assets on a quarterly basis and average those amounts to determine the relative amounts of asset basis for its excepted and non-excepted trades or businesses for a taxable year. Treasury and the IRS acknowledge that determining asset basis on a quarterly basis would impose an administrative burden and agree that a safeguard is needed to account for episodic events, such as acquisitions, dispositions, or changes in business, that could affect average values. Thus, the final regulations permit a taxpayer to compute asset basis in its excepted and non-excepted trades or businesses by averaging asset basis at the beginning and end of the year, so long as the taxpayer falls under a 20% de minimis threshold.

De Minimis Rules

The final regulations clarify the application of the de minimis rules that simplify the application of §1.163(j)-10 should be applied in a specific order. A taxpayer first should determine the extent to which its utility businesses are excepted regulated utility trades or businesses. The taxpayer then should determine the extent to which the basis of any assets used in both excepted and non-excepted trades or businesses should be wholly allocated to either excepted or non-excepted trades or businesses. Only then should the taxpayer determine whether all its interest expense and interest income should be wholly allocated to either excepted or non-excepted trades or businesses.

Assets Used in More than One Trade or Business

In general, the 2018 proposed regulations provide that if an asset is used in more than one trade or business during a determination period, the taxpayer's adjusted basis in the asset must be allocated to each trade or business using one of three permissible methodologies provided in the regulations, depending on which methodology most reasonably reflects the use of the asset in each trade or business during that determination period. The final regulations have clarified that the consistency requirement in proposed §1.163(j)-10(c)(3)(iii)(A) does not require a taxpayer to use a single methodology for different categories of assets, because a methodology that is reasonable for one type of asset (for example, office buildings) may not be reasonable for another (for example, intangibles). Additionally, the final regulations permit a taxpayer to change its allocation methodology after a period of five taxable years without obtaining consent from the Commissioner. A taxpayer that seeks to change its allocation methodology more frequently must obtain consent from the Commissioner.

APPLICABILITY DATES

With limited exceptions (affecting the interplay of Section 163(j) with Section 382 and Section 1502), the final regulations are effective for taxable years beginning on or after November 13, 2020. However, taxpayers may apply the final regulations retroactively to a taxable year beginning after December 31, 2017, and before November 13, 2020, subject to certain consistency requirements. As an alternative, taxpayers may apply the 2018 proposed regulations to a taxable year beginning after December 31, 2017, and before November 13, 2020, so long as the 2018 proposed regulations are applied consistently by the taxpayers and their related parties for that taxable year. The revised language implies that taxpayers may choose which set of regulations to rely upon for each applicable year.

The 2020 proposed regulations would apply to taxable years beginning on or after 60 days after they have been adopted as final regulations and published in the Federal Register. However, taxpayers may rely on the 2020 proposed regulations to taxable years beginning after December 31, 2017, subject to certain consistency requirements.

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