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Section 163(j) Regulations Are Finally Final

Introduction

The Tax Cuts and Jobs Act of 2017 (Public Law 115-97) (TCJA) made significant changes to Section 163(j) effective for tax years beginning after December 31, 2017. On December 28, 2018, Treasury and the Internal Revenue Service (IRS) published proposed regulations ("**Proposed Regulations**") implementing the amendments to Section 163(j) made by the TCJA. The details surrounding the Proposed Regulations are set forth in a client alert dated February 14, 2019.

On July 28, 2020, Treasury and the IRS issued final regulations under Section 163(j), which were slightly modified upon publication in the Federal Register on September 14, 2020 and will be effective on November 13, 2020 ("**Final Regulations**"). Taxpayers may apply these Final Regulations to taxable years beginning after December 31, 2017, provided that taxpayers and their related parties apply them consistently.

Treas. Reg. §1.163(j)-1 (Definitions)

Prior to the TCJA, Section 163(j) ("**Old Section 163(j)**") only applied to limit the deduction of interest paid or accrued on debt owed to or guaranteed by related parties. Interestingly, the proposed regulations issued in 1991 ("**1991 Proposed Regulations**") under Old Section 163(j) were never finalized. Section 163(j), as amended by the TCJA, applies more broadly to all business interest expense (BIE) even if it is between unrelated parties. Here, the general limitation (for most taxpayers) allows a deduction for BIE for a taxable year when interest exceeds the sum of: (i) business interest income (BII); and (ii) 30% of adjusted taxable income (ATI) for each taxable year.

Note: The increased ATI threshold for 2019 and 2020 is discussed below.

The excess of the BIE may be carried forward to succeeding taxable years; however, any excess limitation may not be carried forward. The excess current limitation exists when the current actual interest expense is less than the applicable limitations. Small business taxpayers, namely taxpayers with annual gross receipts of less than USD 25 million for the three succeeding taxable years (subject to inflation), are not subject to the Section 163(j) limitations.

The Final Regulations generally confirm the calculation of the business interest deduction as set out in the Proposed Regulations.

Section 163(j) applies a broad-based definition to all business interest that expands beyond related-party transactions, corporate taxpayers and the taxpayer's debt-to-equity ratio. The Proposed Regulations addressed this issue by deeming as interest all transactions that are indebtedness in substance even if not in form. Three basic categories were addressed: (i) compensation for the

forbearance of money; (ii) the time value component of swaps with significant non-periodic payments; and (iii) amounts closely related to interest. The Proposed Regulations also included an anti-avoidance rule, which was adopted in the Final Regulations.

The anti-avoidance rule generally treats as interest expense any amounts that are predominately associated with the time value of money or a series of transactions where a taxpayer receives the use of funds for a period of time (not included in the three basic categories). The rule essentially recharacterizes an amount as interest expense and does not recharacterize it as interest income. In short, it would only worsen a taxpayer's limitation under Section 163(j).

Compensation for the forbearance of money includes, but is not limited to, the following: qualified stated interest; original issue discount (OID) amounts; amounts treated as OID; acquisition discount to the extent included in income by a holder of such debt; deferred payments treated as interest under Section 483; amounts treated as interest under a Section 467 rental agreement; amounts treated as interest under Section 988; foregone interest under Section 7872; redeemable ground rent treated as interest under Section 163(c); and amounts treated as interest under Section 636.

Interest treated as a time value component of swap with significant and periodic payments may be treated as two separate transactions — one as a market level payment swap and the other as a loan independent of the swap.

Amounts closely related to interest are those that fall into the categories of a transaction that affects the economic yield or cost of funds involving interest, although not necessarily compensation for the forbearance of money or otherwise treated as interest under general principles. This category may include certain hedging transactions, substitute interest payments, gain treated as income under Section 1258, yield adjustments for derivatives under Section 59A(b)(4)(A), commitment fees, debt issuance costs, guaranteed payments or factoring costs.

Key takeaways from the Final Regulations include:

- The Final Regulations make the definition of interest more compatible with other parts of the Internal Revenue Code (the **"Code"**).

- The Final Regulations, while retaining the embedded loan rule with significant non-periodic payments, added certain exceptions for cleared swaps and non-cleared swaps that require the parties to meet margin or collateral requirements that are substantially similar to those of a federal regulator.

- The Final Regulations delay for one year the application date of the embedded loan rule to allow taxpayers added time to develop systems to track the amount of embedded interest accrued for a swap, except for the application of the anti-avoidance rules.

- Commitment fees and other fees paid in connection with a lending transaction are removed from the definition of interest under the Final

Regulations. Similarly, debt issuance costs, guaranteed payments for the use of capital and hedging income and expense are excluded.

- The Final Regulations provide that a substitute interest payment is treated as interest expense only if the payment relates to a sale-repurchase or securities lending transaction that is not entered into by the taxpayer in the ordinary course of its business.

- The Final Regulations provide that upon the sale or disposition of property that has a basis affected by amortization, depreciation or depletion during the earnings before interest, tax, depreciation and amortization (EBITDA) period, ATI must be reduced by the full amount of basis adjustments in the property for amortization, depreciation or depletion amounts even if the taxpayer recognized gain on the disposition.

- The Final Regulations further require ATI to be decreased by the amount of a taxpayer's subpart F and global intangible low-taxed income (GILTI) income inclusions that are allocable to a non-excepted trade or business.

- The Final Regulations did not address floor plan financing expenses and the ordering implied under Section 168(k)(9)(B) in the calculation of ATI despite many comments received. Treasury and the IRS believe the statutory requirements were clear and unambiguous.

- Despite commenters' concerns, the Final Regulations continue to define a "trade or business" as set forth within Section 162 and established case law and require taxpayers to properly allocate interest expense, interest income and other items of a trade or business accordingly.

The Proposed Regulations provided that the starting point for computing taxable income is the ATI. Section 163(j)(8)(A)(v) defines "ATI" as the taxable income of the taxpayer computed without regard to certain items, including any deduction allowable for depreciation, amortization or depletion for taxable years beginning before January 1, 2022. Further, the Proposed Regulations also excluded adjustments for sales or dispositions of property with an adjusted basis that reflects depreciation, amortization or depletion deducted in taxable years beginning between January 1, 2018 and December 31, 2021. These adjustments presumably were intended to preclude taxpayers from increasing their ATI by these amounts and any gain recognized from a reduced basis in the property sold — a likely double benefit. Thus, the Proposed Regulations provided that depreciation, amortization or depletion expense capitalized under Section 263A is recovered through cost of goods sold as an offset to gross receipts in computing gross income and may not be added back to taxable income in computing ATI.

Treasury and the IRS also reconsidered their position on the above provisions of the Proposed Regulations following the many comments and questions received. Thus, the Final Regulations provide that any amounts of depreciation, amortization or depletion that is capitalized into inventory under Section 263A during the taxable years beginning before January 1, 2022 is added back to Tentative Taxable Income (TTI) as a deduction for depreciation, amortization or depletion when calculating ATI for that taxable year, even if the capitalized amount is recovered

through cost of goods sold. TTI is generally determined in the same manner as taxable income under Section 63, but is computed without the application of the Section 163(j) limitation. The underlying rationale for this change in the Final Regulations appears to be because Treasury and the IRS did not believe the Proposed Regulations reflected congressional intent, which was to determine ATI using EBITDA.

Treas. Reg. §1.163(j)-2 (Application of the Limitation)

As stated above, the Final Regulations do not substantially alter the basic calculations contained in the Proposed Regulations or those contained in the statute. However, the Final Regulations incorporate several changes from the Coronavirus Aid, Relief, and Economic Security Act, P.L. 116-136 ("**CARES Act**").

The basic rule under Treas. Reg. §1.163(j)-2(b) is that the amount allowed as a deduction for BIE for the taxable year cannot exceed the sum of: (i) the taxpayer's BII for the taxable year; (ii) 30% of the taxpayer's ATI for the taxable year (or zero if the taxpayer's ATI for the taxable year is less than zero); and (iii) the taxpayer's floor plan financing interest expense for the taxable year. While the Proposed Regulations were not explicit, the Final Regulations make clear that the Section 163(j) limitation applies to tax-exempt organizations for purposes of computing their unrelated business taxable income (UBTI) under Section 512. The Final Regulations also clarify the application of the Section 163(j) limitation to trusts and estates.

The Final Regulations implement changes made by the CARES Act. Under the CARES Act, for any taxable year beginning in 2019 or 2020, the percentage of ATI component of the limitation is applied by substituting 50% for 30%. Apart from these two taxable years, the 30% limitation of ATI is applicable. However, the 50% ATI limitation does not apply to partnerships for taxable years beginning in 2019.

A taxpayer may elect to not have the 50% limitation, but rather the 30% limitation, apply in either of 2019 or 2020, thus making excess deductible business expense (if any) in those years a carryforward to a future year. In addition, under the Final Regulations (which implement the CARES Act), a taxpayer may elect to use the taxpayer's ATI for the last taxable year beginning in 2019 ("**2019 ATI**") as the ATI for any taxable year beginning in 2020. The specific time and manner of making (or revoking) these elections is described in detail in Rev. Proc. 2020-22, Section 6, 2020-18 I.R.B. 745. However, in general, the election is made simply by filing an original or amended US federal income tax return reflecting the elections made (i.e., application of the 30% limitation rather than the 50% limitation and/or use of the 2019 ATI).

As indicated in the Proposed Regulations and Section 163(j)(2), any disallowed BIE (or disallowed disqualified interest as defined in Treas. Reg. §1.163(j)-1(b)(12) under Section 163(j) as it existed prior to the TCJA) is carried forward to the succeeding taxable year as a disallowed BIE carryforward and, again potentially subject to limitation. No disallowed BIE carryforwards can be reallocated between non-excepted and excepted trades or businesses in any succeeding taxable year. However, under Treas. Reg. §1.163(j)-3(b)(8), disallowed BIE carryforwards are items to which an acquiring corporation succeeds under Section 381(a).

Treas. Reg. §1.163(j)-2 also provides for certain exemptions and mechanical rules in applying the limitation of Section 163(j). For example, Treasury and the IRS state in the preamble to the Final Regulations that they don't believe that the Section 163(j) limitation is a method of accounting under Treas. Reg. §1.446-1(e)(2)(ii)(a). Therefore, consent for application of the Section 163(j) limitation and related rules from Treasury and the IRS are unnecessary.

Treasury and the IRS also received multiple comments on the application of the small business exemption from the Section 163(j) limitation in Treas. Reg. §1.163(j)-2(d), but they declined to adopt most of these suggestions, while providing a few clarifications in the concurrently issued Proposed Regulations ("**2020 Proposed Regulations**"). Thus, except for a tax shelter as defined in Section 448(d)(3), the limitation on interest deductibility contained in Treas. Reg. §1.163(j)-2(b) does not apply to a taxpayer that meets the gross receipts test of Section 448(c) and the regulations related thereto. The gross receipts of an individual include all amounts specified as gross receipts under Section 448(c) (except for inherently personal amounts).

The Final Regulations provide that, for partnerships, and where the aggregation rules of Section 448(c) apply, a partner must include a distributive share of the gross receipts of the partnership (as determined under Section 703) in determining whether the small business exemption applies. Similarly, except where the aggregation rules of Section 448(c) apply, an S corporation shareholder must include in its gross receipts a proportionate share of the S corporation's gross receipts in determining whether the small business exemption applies. Finally, in applying the small business exemption to tax-exempt organizations, the only gross receipts taken into account are those taken into account in determining its UBTI.

Treas. Reg. §1.163(j)-3 (Coordination with Other Code Sections)

Treas. Reg. §1.163(j)-3 provides certain coordination rules between the Section 163(j) limitation and other provisions of the Code that defer, capitalize or disallow interest expense. The Final Regulations provide that Section 163(j) applies after the application of other provisions that subject interest expense to disallowance, deferral, capitalization or other limitation. For example, Treas. Reg. §1.163(j)-3(b)(2) provides that "business interest expense does not include interest expense that is permanently disallowed as a deduction under another provision of the Code, such as in Section 163(e)(5)(A)(i), (f), (l), or (m), or Sections 264(a), 265, 267A, or 279." The Code provisions that defer the deductibility of interest expense apply before the application of Section 163(j). In addition, capitalized interest expense under Sections 263A and 263(g) is not treated as BIE for purposes of Section 163(j). While Section 163(j) generally applies to limit the deduction for BIE before the application of Sections 461(l), 465 and 469, in determining TTI for purposes of computing ATI, Sections 461(l), 465 and 469 are taken into account. Further, any reduction in the dividends received deduction under Section 246A reduces the amount of interest expense taken into account under Section 163(j).

In the preamble to the Proposed Regulations, Treasury and the IRS solicited comments on the interaction between Section 163(j) and the rules addressing income from the discharge of indebtedness under Section 108. However, after

receiving comments on the cancellation of indebtedness income, disallowed BIE carryforward, exclusions or any tax benefit principles, Treasury and the IRS indicated that these novel and complex issues require further consideration. Therefore, they declined to issue guidance.

Treas. Reg. §1.163(j)-4 (C Corporations and Tax-Exempt Corporations)

Treas. Reg. §1.163(j)-4 provides rules regarding the computation of items of income and expense under Section 163(j) of taxpayers that are C corporations (including members of a consolidated group, real estate investment trusts (REITs) and regulated investment companies) and tax-exempt corporations. The Final Regulations largely mirror the Proposed Regulations, with certain clarifications.

Section 163(j) limits taxpayers' ability to deduct BIE, as contrasted, for example, with investment interest expense, which is separately limited by Section 163(d). Section 163(d), by its explicit terms, does not limit investment interest expense of corporate taxpayers (other than S corporations). The Final Regulations follow the rules set out in the Proposed Regulations to treat all interest expense of a C corporation as BIE and all interest income that is includible in gross income of a C corporation as BII, even in situations where investment interest income or expense are properly allocated to the C corporation from an underlying partnership. Additionally, the Final Regulations provide that the rules governing earnings and profits (E&P) of a corporation generally are not affected by Section 163(j) even if interest expense is disallowed. In other words, in determining a C corporation's E&P, interest otherwise deductible when paid or accrued generally reduces E&P as it is paid or accrued regardless of whether all or part of the payment or accrual is disallowed by Section 163(j).

For purposes of Section 163(j), all items of interest income and interest expense taken into account by a C corporation are generally treated as allocated to a trade or business under Treas. Reg. §1.163(j)-4(b)(1). Similarly, in determining a C corporation's ATI, all items of income, gain, deduction and loss are treated as allocated to a trade or business under Treas. Reg. §1.163(j)-4(b)(2) (citing Treas. Reg. §1.163(j)-10 for rules allocating the items between excepted and non-excepted trades or businesses). As a result, all of a C corporation's interest expense would be subject to limitation under Section 163(j), and all of a C corporation's interest income would increase the C corporation's Section 163(j) limitation. In other words, these "investment" items would be included in the calculation of the corporation's ATI with certain exceptions relating to "excepted trade or business," as discussed below. An increase in interest income (as well as increases in ATI and floor plan financing interest expenses, to the extent applicable) will increase the Section 163(j) limitation, thus potentially allowing the taxpayers a greater BIE deduction.

Although a C corporation cannot have investment interest, investment expense or investment income, within the meaning of Section 163(d), for purposes of Section 163(j), a partnership in which a C corporation is a partner may have those items. When the partnership allocates the investment items to the C corporation partner, those items would be recharacterized as business items and, accordingly, would affect the calculation of deductible BIE. Treas. Reg. §1.163(j)-4(b)(3)(i) provides

that items of investment interest, investment income or investment expense (within the meaning of Section 163(d)) of a partnership, and all other tax items of a partnership that are neither properly allocable to a trade or business of the partnership nor described in Section 163(d), that are allocated to a C corporation partner as separately stated items are treated by the C corporation partner as properly allocable to a trade or business of that partner. This rule does not affect characterization at the partnership level. Thus, under Treas. Reg. §1.163(j)-4(b)(3)(iii), investment interest expense and other interest expense of a partnership that is treated as BIE by a C corporation partner is not treated as excess BIE of the partnership, and investment interest income and other interest income of a partnership that is treated as BIE by a C corporation partner is not treated as excess taxable income of the partnership. See below for a discussion of Treas. Reg. §1.163(j)-6 and the rules governing excess BIE and excess taxable income.

The Final Regulations also expand Prop. Treas. Reg. §1.163(j)-4(b)(3)(i) 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 not subject to Section 163(j) or Section 163(d). These items might include tax items allocable to rental activities that do not rise to the level of a Section 162 trade or business but that otherwise give rise to allowable deductions (i.e., as under Section 212 as it existed under prior law) that are subject to Section 469. Thus, these items are also treated as properly allocable to a trade or business of a C corporation partner.

Under the Final Regulations (and consistent with the Proposed Regulations), if a domestic partnership includes amounts in gross income under Sections 951(a) and 951A(a) for an applicable controlled foreign corporation (CFC) and these amounts are investment income to the partnership, then a domestic C corporation partner's distributive share of these amounts that are properly allocable to a non-excepted trade or business of the domestic C corporation by reason of Treas. Reg. §1.163(j)-4(b)(3) and §1.163(j)-10(c) are excluded from the domestic C corporation partner's ATI. Treas. Reg. §1.163(j)-4(b)(3)(iv) provides that the allocation rule of Treas. Reg. §1.163(j)-4(b)(3)(i) does not apply to a C corporation's distributive share of a domestic partnership's inclusion under Sections 951 or 951A if the inclusion is not allocable to a partnership trade or business.

For a domestic or foreign C Corporation, the disallowance and carryforward under Section 163(j) of a deduction for BIE of the taxpayer or of a partnership in which the taxpayer is a partner generally does not affect whether or when the BIE reduces the taxpayer's E&P. In other words, even if the interest expense of a C corporation is disallowed as a deduction under Section 163(j) in any given year, the C corporation should nonetheless reduce its E&P by the full amount of interest expense in that year, including any disallowed portion, even though the disallowed portion is carried forward and may be deducted in one or more future tax years. Treas. Reg. §1.163(j)-4(c)(1).

The Final Regulations clarify that, because a C corporation that is a partner in a partnership reduces its E&P when it is allocated EBIT from the partnership, the corporation cannot reduce its E&P a second time when the C corporation is later permitted to deduct such EBIT. If a taxpayer that is a C corporation is allocated any excess BIE from a partnership, and if all or a portion of the excess BIE has not

yet been treated as BIE by the taxpayer at the time of the taxpayer's disposition of all or a portion of its interest in the partnership, Treas. Reg. §1.163(j)-4(c)(3) provides that the taxpayer must increase its E&P immediately prior to the disposition by an amount equal to the amount of the basis adjustment required under Section 163(j)(4)(B)(iii)(II) and Treas. Reg. §1.163(j)-6(h)(3).

Generally, the Proposed Regulations adopt rules for members of consolidated groups that are similar to the rules applicable to C corporations that are not members of consolidated groups.

Under the Final 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. Treasury and the IRS rejected the comments to aggregate non-consolidated entities for purposes of applying the Section 163(j) limitation consistent with the treatment under the Proposed Regulations because nothing in Section 163(j) or the legislative history of Section 163(j) suggests that Congress intended non-consolidated entities to be treated as a single taxpayer for purposes of Section 163(j). The Proposed Regulations, however, included a proposed exception to this general rule for CFCs.

By 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 rejected comments requesting to treat partnerships as an aggregate rather than an entity because Section 163(j) clearly applies at the partnership level (see Section 163(j)(4)).

However, 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. Relying on the anti-avoidance rule in Treas. Reg. §1.163(j)-2(j) and the anti-abuse rule in Treas. Reg. §1.163(j)-10(c)(8) carried over from the Proposed Regulations, they also added examples under the anti-avoidance rule.

Treas. Reg. §1.163(j)-4(d)(2) contains rules governing the calculation of the Section 163(j) limitation for members of a consolidated group. In determining whether items (other than intercompany items, corresponding items or items attributable to intercompany obligations) are interest for purposes of Section 163(j), the group is treated as a single taxpayer. The group's current-year BIE and BII are the sum of each member's current-year BIE and BII, respectively.

For purposes of calculating the ATI of a consolidated group, TTI is the consolidated group's consolidated taxable income, determined under Treas. Reg. §1.1502-11 notwithstanding any carryforwards or disallowances under Section 163(j). Treasury and the IRS explained in the preamble to the Final Regulations that a consolidated group's ATI would not take into account any net operating loss (NOL) deductions resulting from the carryback or carryforward of NOLs and that no change in the Final Regulations was needed to effectuate this result. Further, for purposes of calculating the ATI of the group, intercompany items and corresponding items are disregarded to the extent that they offset in amount. To

illustrate this concept, Treas. Reg. §1.163(j)-4(d)(2)(iv), for example, provides that "certain portions of the intercompany items and corresponding items of a group member engaged in a non-excepted trade or business will not be included in ATI to the extent that the counterparties to the relevant intercompany transactions are engaged in one or more excepted trades or businesses."

In determining a member's BIE and BII and in calculating the group's ATI, generally, all intercompany obligations, as defined in Treas. Reg. §1.1502-13(g)(2)(ii), are disregarded. This is consistent with the application of the rules contained in Treas. Reg. §1.1502-13 regarding consolidated groups. An exception applies only if a member of a group purchases an obligation of another member of the same group in a transaction where Treas. Reg. §1.1502-13(g)(5) applies and, as a result of the deemed satisfaction of the obligation under Treas. Reg. §1.1502-13(g)(5)(ii), the debtor member has repurchase premium that is deductible under Treas. Reg. §1.163-7(c). Accordingly, the repurchase premium is treated as interest subject to Section 163(j) and Treas. Reg. §1.163(j)-4(d)(2)(v).

Treas. Reg. §1.163(j)-4(e) contains additional rules related to the ownership of partnership interests by members of a consolidated group. The Proposed Regulations provided that intercompany transfers of partnership interests were to be treated as dispositions for purposes of Section 163(j). Commenters posed various questions and comments about the treatment of intercompany transfers of partnership interests as dispositions for purposes of Section 163(j). Acknowledging the concerns raised by these commenters, Treasury and the IRS reserved on issues relating to intercompany partnership interest transfers in the Final Regulations and are continuing to study the proper treatment of intercompany transfers of partnership interests that do not result in the termination of the partnership (intercompany partnership interest transfers), including whether such transfers should be treated as dispositions for purposes of Section 163(j)(4)(B)(iii)(II). Treasury and the IRS suggested a possible approach to intercompany partnership interest transfers and requested comments on possible approaches.

The Final Regulations otherwise mirror the Proposed Regulations on the treatment of the ownership of partnership interests by members of a consolidated group. Treas. Reg. §1.163(j)-4(e)(2) provides that a change in status of a member (becoming or ceasing to be a member of the group) is not treated as a disposition of a partnership interest owned by the member for purposes of Section 163(j)(4)(B)(iii)(II) and Treas. Reg. §1.163(j)-6(h)(3). In other words, if a corporation becomes or ceases to be a member of a consolidated group, and if that corporation is a partner in a partnership, that corporation's entry into or departure from a consolidated group does not trigger basis adjustments under Section 163(j)(4)(B)(iii)(II).

In the preamble to the Proposed Regulations, however, Treasury and the IRS requested comments as to whether additional rules are needed to prevent loss duplication upon the disposition of stock of a subsidiary member holding partnership interests. Treasury and the IRS agreed with the comments that excess BIE should be treated as an attribute that is taken into account in determining the net inside attribute amount for purposes of Treas. Reg. §1.1502-36(c) and (d). However, Treasury and the IRS determined that excess BIE is more akin to basis

(a Category D attribute) than to deferred deductions (a Category C attribute) (see Treas. Reg. §1.1502-36(d)(4)(i)). Accordingly, Treas. Reg. §1.163(j)-4(e)(4) provides that, for purposes of the unified loss rules set forth in Treas. Reg. §1.1502-36, excess BIE will be treated as a Category D asset within the meaning of Treas. Reg. §1.1502-36(d)(4)(i).

In addition, Treas. Reg. §1.163(j)-4(e)(3) provides that a member's allocation of excess BIE from a partnership and the resulting decrease in basis in the partnership interest under Section 163(j)(4)(B)(iii)(I) is not a noncapital, nondeductible expense for purposes of Treas. Reg. §1.1502-32(b)(3)(iii). Similarly, an increase in a member's basis in a partnership interest under Section 163(j)(4)(B)(iii)(II) to reflect excess BIE not deducted by the consolidated group is not tax-exempt income for purposes of Treas. Reg. §1.1502-32(b)(3)(ii). Investment adjustments are made under Treas. Reg. §1.1502-32(b)(3)(i) when the excess BIE from the partnership is converted into BIE deducted by the consolidated group.

Treas. Reg. §1.163(j)-5 (Disallowed Business Interest Expense Carryforwards)

Treas. Reg. §1.163(j)-5 provides general rules governing disallowed BIE carryforwards for C corporations. These rules largely mirror those that were included in the Proposed Regulations. Treas. Reg. §1.163(j)-5(b) provides that any interest expense of a C corporation that is disallowed under Section 163(j)(1) is carried forward to the next year as a disallowed interest expense carryforward and that current-year deductible BIE is deducted before any carryforwards from prior years. If carryforwards are available to be used, they must be deducted in the order of the taxable years in which they arose, beginning with the earliest taxable year.

As in the Proposed Regulations, the ability to carry forward interest expense under Section 163(j) effectively creates a new tax attribute for a C corporation. Section 381(c)(2) provides that Section 163(j) carryforwards can be acquired by successor corporations in certain tax-free liquidations and reorganizations and references Treas. Reg. §1.381(c)(20)-1 for rules governing the application of Section 381(c)(2) to disallowed BIE carryforwards.

Treas. Reg. §1.163(j)-5(e) cross-references regulations under Section 382 for rules addressing the interaction of Section 382 with disallowed interest expense carryforwards under Section 163(j). Generally, under Treas. Reg. §1.382-2(a), a carryforward of disallowed BIE is treated, for purposes of Section 382, as a separate attribute, and a C corporation can be a "loss corporation" even if its only attribute is one or more disallowed BIE carryforwards.

The rules applicable to consolidated groups are generally similar to those applicable to C corporations that are not members of consolidated groups. A consolidated group's disallowed BIE carryforwards for the current consolidated return year are the carryforwards form the group's prior consolidated return years plus any carryforwards from separate return years. As with the rules applicable to C corporations, all current-year BIE of members of a consolidated group is deducted in the current year before any disallowed BIE carryforwards from prior taxable years. Disallowed BIE carryforwards from prior taxable years are to be

deducted in the order of the taxable years in which they arose, beginning with the earliest taxable year, subject to certain limitations.

Treas. Reg. §1.163(j)-5(d) provides rules addressing the treatment of disallowed interest expense carryforwards of a consolidated group member that arose in a separate return limitation year (SRLY). Generally, a SRLY is any year during which the member was not part of the consolidated group. The Proposed Regulations took an annual calculation approach for the Section 163(j) SRLY limitation and several comments were received questioning why the SRLY limitation was not calculated on an aggregate or cumulative basis, as it is for NOLs. After considering the comments received, Treasury and the IRS determined that it would be more appropriate to use a cumulative Section 163(j) SRLY register.

Treas. Reg. §1.163(j)-5(d)(1) defines the "cumulative Section 163(j) SRLY limitation" and provides that the amount of disallowed BIE carryforwards of a member arising in a SRLY that are included in the consolidated group's BIE deduction for any taxable year may not exceed the aggregate Section 163(j) limitation for all consolidated return years of the group determined by reference to the member's items of income, gain, deduction and loss, reduced (including below zero) by the member's BIE (including disallowed carryforwards) absorbed by the group in all consolidated return years. For purposes of computing the member's cumulative SRLY limitation, intercompany items (that are otherwise excluded by Treas. Reg. §1.163(j)-4(d)(2)(iv)) are considered, with the exception of interest items attributable to intercompany obligations. Any disallowed BIE carryforwards of a member arising in a SRLY are available for deduction by the consolidated group in the current year only to the extent the group has remaining Section 163(j) limitation for the current year after the deduction of current-year BIE and disallowed BIE carryforwards from earlier taxable years that are permitted to be deducted in the current year. SRLY-limited disallowed BIE carryforwards are deducted on a pro rata basis with non-SRLY limited disallowed BIE carryforwards from tax years ending on the same date.

Treas. Reg. §1.163(j)-6 (Application to Partnerships and S Corporations)

Treas. Reg. §1.163(j)-6 contains rules regarding the application of Section 163(j) to partnerships and their partners, as well as S corporations and their shareholders. It sets forth the manner in which the Section 163(j) limitation applies to the interest expense of a partnership and the manner in which a partnership's deductible BIE and Section 163(j) excess items are allocated among its partners. These rules largely mirror those included in the Proposed Regulations. Several notable amendments and clarifying exceptions are summarized below:

The Final Regulations adopt the Proposed Regulations' 11-step calculation for determining the Section 163(j) excess items of a partnership that are allocable to its partners. This approach attempts to preserve the entity-level calculation required in Section 163(j)(4) while also preserving the economics of the partnership, including respecting any special allocations made in accordance with Section 704(b) and the regulations thereunder. However, the Final Regulations provide an exception from steps 3 through 11 of the 11-step calculation for partnerships that allocate all items of income and expense on a pro rata basis.

Instead, pro rata partnerships allocate all Section 163(j) items in step 2 proportionately.

Treas. Reg. §1.163(j)-6 also confirms that allocations under the 11-step calculation must satisfy the requirements of Section 704(b). Specifically, Treas. Reg. §1.704-1(b)(4)(xi) was added to confirm that the allocation of Section 163(j) excess items will be deemed in accordance with the partners' interests in the partnership.

The Final Regulations provide that BIE allocated by a partnership or an S corporation that qualifies for the small business exception is not retested by Section 163(j) at the partner or S corporation shareholder level. This is a taxpayer-friendly change in the Final Regulations, which required such amounts to be tested at the partner or S corporation shareholder level.

To the extent a partnership or an S corporation is engaged in an excepted trade or business, the Final Regulations do not apply the Section 163(j) limitation to BIE allocable to excepted trade or business. If a partner or S corporation shareholder is allocated any Section 163(j) item that is attributable to an excepted trade or business of the partnership or S corporation, those Section 163(j) items are excluded from the partner's or shareholder's Section 163(j) deduction calculation.

Pursuant to Section 163(j)(4)(B)(iii)(I), a partner's adjusted basis in its partnership interest is reduced (but not below zero) by the amount of excess BIE allocated to the partner. If a partner disposes of its partnership interest, Section 163(j)(4)(B)(iii)(II) generally allows an increase in outside basis for excess BIE that has not been deducted and has been carried forward.

The Final Regulations adopt a proportionate approach to dispositions of partnership interests, providing for a partial increase to a partner's adjusted basis in the partnership interest being disposed based on the relative value of the portion of the partner's interest being disposed compared to the value of the partner's interest immediately before the disposition. The basis increase occurs immediately before the disposition and equals the excess BIE allocated to that portion. This is a departure from the approach taken in the Proposed Regulations, which applied only upon the disposition of "all or substantially all" of a partner's interest in a partnership.

Treas. Reg. §1.163(j)-7 (application to foreign corporations and US shareholders)

The Final Regulations maintain the same general framework for applying Section 163(j) to CFCs, with a few important modifications.

Despite receiving numerous comments that Treasury had exceeded its regulatory authority, Treasury has maintained its position that Section 163(j), as amended by the TCJA, should apply to CFCs. As taxpayers will recall, Treasury regulations promulgated under the Old Section 163(j) specifically exempted CFCs from the limitation on interest deductions. Former Prop. Treas. Reg. §1.163(j)-1(a)(1) would have limited the scope of Old Section 163(j) to domestic corporations and foreign corporations with income effectively connected with a US trade or business. Although Congress had considered a global interest expense limitation, the

provision was omitted from the TCJA. Many commenters argued that Congress' decision to forgo a global interest expense limitation should have prohibited Treasury from expanding the amended Section 163(j) to CFCs.

Treasury rejected this argument, stating in the preamble to the Final Regulations that "as a general matter, application of U.S. tax principles to a foreign corporation for purposes of determining its income for U.S. tax purposes is within the authority of the Treasury Department and the IRS," and that "the exclusion of CFCs from the application of Old Section 163(j) under the 1991 Proposed Regulations is not determinative as to whether applicable CFCs and other foreign corporations should be excluded from the application of Section 163(j)." According to Treasury, because Congress "repealed and replaced Old Section 163(j)," its position in prior regulations should not bind it under the post-TCJA Section 163(j). Further, Treasury took the dearth of discussion of the application of Section 163(j) to CFCs in the legislative history — in contrast to specific exemptions for certain small businesses — to mean that Congress did not intend to exclude applicable CFCs from Section 163(j).

Treasury did yield to commentators regarding certain aspects of the group election in issuing the 2020 Proposed Regulations. Perhaps most importantly, Treasury has abandoned the "bottom-up" approach for determining the group's limitation. Under Prop. Treas. Reg. §1.163(j)-7(c)(2), a CFC group will have a single Section 163(j) limitation based on the sum of each group member's current-year BIE, disallowed BIE carryforwards, BII and ATI. Each amount is first determined on a separate entity basis. For this purpose, transactions between members of the CFC group are disregarded if the relevant group members executed the transaction with a principal purpose of affecting the group's or member's Section 163(j) limitation. Otherwise, loans between group members are respected and taken into account for purposes of determining the group limitation. In addition, the CFC group is treated as a single corporation for purposes of allocating items to an excepted trade or business, and the CFC group is treated as a single taxpayer for purposes of determining interest.

In response to comments that the requirements to be a member of the CFC group were overly restrictive, the 2020 Proposed Regulations create a new group regime based on the consolidated return rules. The group election is available to highly related CFCs, meaning those directly or indirectly related with 80% or greater ownership by value. A stand-alone entity that does not have a single 80% or greater shareholder, or is otherwise not part of a specified group, must compute its Section 163(j) limitation individually. Once the group limitation is determined, the limitation is allocated to particular group members based on the consolidated return rules in Treas. Reg. §1.163(j)-5, with certain modifications.

Further, in response to requests for the group election to be revocable, Treasury aligned the election with the consolidated return rules. The election can be revoked, but only for a specified period beginning 60 months after the last day of the specified period for which the election was made. Once a group election has been revoked, the group cannot make a new election for additional 60 months after the last day of the specified period of revocation. The election must be made no later than the due date, taking into account relevant extensions, of the original return for the taxable year of each "designated US person" (i.e., the US person

that is the parent of the specified group or each controlling domestic shareholder of the specified group).

Prop. Treas. Reg. §1.163(j)-7(h) provides an annual safe harbor election both for stand-alone CFCs and CFC groups. The election is not available to CFCs that are members of a specified group if a CFC group election is not in effect. For stand-alone CFCs, the safe harbor applies if the CFC's BIE does not exceed 30% of the lesser of: (i) its TTI; and (ii) its "eligible amount" for the taxable year. For a CFC group member, the safe harbor can apply where the CFC group's BIE does not exceed 30% of the lesser of: (i) the sum of the qualified TTI of each CFC group member; and (ii) the sum of the eligible amounts of each CFC group member. The "eligible amount" is the sum of the applicable CFC's subpart F income plus the approximate amount of GILTI inclusions its US shareholders would have were the applicable CFC wholly owned by domestic corporations that had no tested losses and that were not subject to the Section 250(a)(2) limitation on the Section 250(a)(1) deduction. This calculation is done at the individual CFC level.

For additional information concerning these rules, see Julia Skubis Weber, Stewart Lipeles and Joshua Odintz, New Final and Proposed Regulations under Section 163(j) and Their Application to Controlled Foreign Corporations, *Taxes: The Tax Magazine*, Vol. 98, Issue 11 (Oct. 6, 2020).

Treas. Reg. §1.163(j)-8 (Foreign Persons with ECI)

The Final Regulations reserve on the application of Section 163(j) to foreign persons with effectively connected income (ECI). Citing distorted results arising from the Proposed Regulations, Treasury and the IRS indicated that they need more time to study the methods of determining the amount of deductible BIE and disallowed BIE carryforwards that are allocable to ECI. The 2020 Proposed Regulations provide some additional guidance and clarity on the manner in which these rules apply to specified foreign partners and CFCs with ECI.

The 2020 Proposed Regulations include rules for calculating the amount of disallowed BIE of a foreign corporation. Under Prop. Treas. Reg. §1.163(j)-8, these calculations vary depending upon whether the foreign corporation is a foreign corporation with ECI that is not an applicable CFC; a foreign corporation with ECI that is an applicable CFC; a foreign corporation with ECI that is a specified foreign partner and that is not an applicable CFC; or a foreign corporation with ECI that is a specified foreign partner and that is an applicable CFC.

Treas. Reg. §1.163(j)-9 (Elections for Excepted Trades or Businesses; Safe Harbor for Certain REITs)

The limitation in Section 163(j) applies to business interest, which is defined as interest properly allocable to a trade or business. The term trade or business does not include any "electing real property trade or business" (ERPTB) or any "electing farming business" (EFB). Treas. Reg. §1.163(j)-9 provides general rules and procedures for making such elections.

Section 163(j)(3) provides a "small business exemption," whereby the Section 163(j) limitation does not apply to taxpayers that meet the gross receipts test of Section 448(c) (i.e., the average amount of annual gross receipts for the three

preceding taxable years does not exceed USD 25 million). This exemption requires an election, unless certain requirements are met.

The Final Regulations provide that taxpayers may make an election for a trade or business to be an ERPTB or EFB, provided that they so qualify to make that election, even if the gross receipts test under Section 448(c) is satisfied by the electing trades or businesses in the taxable year in which the election is made. This is a departure from the Proposed Regulations, which provided that a taxpayer that qualifies for the small business exemption was not eligible to make an ERPTB or EFB election. Treasury and the IRS agreed with commenters that making an annual gross receipts determination, to determine whether a taxpayer should make these elections or is already exempt from the limitation, could be burdensome.

The Final Regulations also provide an election to treat rental real estate activities as an ERPTB even if the taxpayer making the election is engaged in a trade or business within the meaning of Section 162. Generally, 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. However, commenters stated that taxpayers engaged in rental real estate activities who are not certain whether their rental real estate activities rise to the level of a Section 162 trade or business should be given the ability to obtain certainty by making a protective election to treat their rental real estate activities as an ERPTB. Treasury and the IRS agreed with their recommendation, but warned that, as with all other ERPTBs, once the protective election is made, all other consequences apply, including the irrevocability of the election and the required use of the alternative depreciation system for certain assets.

Rev. Proc. 2020-22, issued on April 10, 2020, provides additional guidance for the ERPTB and EFB elections, allowing certain taxpayers to make a late election or to withdraw an election previously made to be an ERPTB or EFB for taxable years beginning in 2018, 2019 or 2020.

Treas. Reg. §1.163(j)-9(j) provides an anti-abuse rule that prohibits an otherwise qualifying real property trade or business from making an ERPTB election 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 with the real property trade or business. The Final Regulations include two additional exceptions to this 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 (i) unrelated parties, and/or (ii) related parties that operate an excepted trade or business, the lessor is eligible to make an election to be an ERPTB for its entire trade or business (the "*de minimis* exception"). The *de minimis* exception accommodates taxpayers that, by law or for valid business reasons, divide their real property holding and leasing activities from their operating trade or business that qualifies as an excepted trade or business, while still maintaining an anti-abuse rule to prevent structures designed to circumvent the Section 163(j) limitation.

The second exception is a look-through rule that allows taxpayers to make an election for a certain portion of their real property trade or business (the "look-through exception"). Under the look-through exception, if a lessor trade or business leases to a trade or business under common control, the lessor is eligible

to make an election to be an ERPTB to the extent that (i) the lessor leases to an unrelated party, or (ii) the lessor leases to an electing trade or business under common control, and the latter subleases (or licenses) to unrelated third parties and/or related parties that operate an excepted trade or business. Accordingly, the lessor can make an election for the portion of its trade or business that is equivalent to the portion of the real property that is ultimately leased to unrelated parties and/or related parties that operate an excepted trade or business. A lessor that makes an election under this look-through exception must allocate the basis of assets used in its trades or businesses based on the relative fair market rental value of the real property that is attributable to the excepted and non-excepted portions of the trade or business.

Treas. Reg. §1.163(j)-9(h) provides a special safe harbor for REITs, whereby a REIT that holds real property, interests in partnerships holding real property or shares in other REITs holding real property is eligible to make an election to be an ERPTB for all or part of its assets. In response to comments, the Final Regulations clarify that neither a REIT that owns an interest in a single partnership or shares in a single REIT nor a REIT that holds an indirect interest in a REIT that holds real property is precluded from applying the safe harbor. Treasury and the IRS further agreed that a partnership that is controlled by a REIT or REITs and that would meet the REIT gross income and asset tests, if the partnership were a REIT, is sufficiently similar to a REIT for purposes of the REIT safe harbor. Thus, the Final Regulations provide that such a partnership may apply the REIT safe harbor election at the partnership level if one or more REITs own, directly or indirectly, at least 50% of the partnership's capital and profits and the partnership otherwise satisfies the safe harbor requirements.

Treas. Reg. §1.163(j)-10 (Allocation of Interest Expense, Interest Income and Other Items of Expense and Gross Income to an Excepted Trade or Business)

Treas. Reg. §1.163(j)-10 provides rules on the allocation of tax assets and interest income and expenses to excepted and non-excepted businesses. The Final Regulations broadly follow the Proposed Regulations, but they account for the ERPTB and EFB elections. The main changes compared to the Proposed Regulations contain the following.

Under Treas. Reg. §1.163(j)-10(a)(6), a taxpayer has to make an election whether to apply the allocation rules under Treas. Reg. §1.163(j)-10 either as if the interest were paid or accrued in the taxpayer's first taxable year beginning after December 31, 2017 (the effective date approach) or under the historic approach in the taxable years in which the interest was paid or accrued. The historic approach makes particular sense if the disqualified interest was accrued by an excepted business, but the taxpayer maintained an excepted and non-excepted business after December 31, 2017. Under the historic approach, 100% of the interest can be allocated to the excepted business and would not be covered by the interest limitation in Section 163(j).

While the Proposed Regulations contained a *de minimis* rule, but not for all allocation rules, the Final Regulations contain a *de minimis* rule for all allocation rules. Under this *de minimis* rule, an allocation of either the tax asset or the interest

income or expense does not need to occur, if 90% or more of the adjusted basis in the assets as determined under Treas. Reg. §1.163(j)-10(c)(5) are allocable to either excepted trades or businesses or non-excepted trades or businesses. In this case, 100% of the applicable adjusted basis of the relevant assets is attributed to either business. The applicable adjusted basis depends on whether the business is the taxpayer's business or a look through approach to a partnership, S corporation's or nonconsolidated C corporation's assets applies. The Final Regulations also remove a *de minimis* rule contained in Treas. Reg. §1.163(j)-10(c)(3)(iii)(B). Here, the entire adjusted basis in a tax asset is allocated to either the excepted or non-excepted business, if at least 90% of the gross income this asset generates, has generated, or may reasonably be expected to generate is attributable to either business.

The Final Regulations did not change the permissible allocation methodologies for allocating the asset basis between one or more trades or businesses, which are:

- The relative amount of gross income an asset generates, generated, or may reasonably be expected to generate;
- The relative amounts of physical space used if the asset is land or an inherently permanent structure; or
- The relative amounts of output of the trades or businesses provided they produce the same unit of output.

The Final Regulations stipulate, however, that a taxpayer may not change the allocation methodology chosen within a period of five years without the consent of the Commissioner to be obtained in a letter ruling, which will be granted only in extraordinary circumstances. If the taxpayer has used the same allocation method for at least five taxable years, the taxpayer may change it without the consent. Treas. Reg. §1.163(j)-10(c)(3)(iii)(A)(2).

The Final Regulations adopt the same look through approach as the Proposed Regulations, and expand the look-through rule to partnerships, S corporations or non-consolidated C corporations eligible for the small business exception, provided the trade or business is an ERPTB or EFB. Treas. Reg. §1.163(j)-10(c)(5)(D). Further, under Treas. Reg. §1.163(j)-10(c)(5)(B)(2)(ii), a shareholder in a domestic nonconsolidated C corporation must look through to the assets of the C corporation if the shareholder holds at least 80% in vote and value (Treas. Reg. §1.163(j) -10(c)(7)) and may look through if the shareholder holds at least 80% by value. Where the look-through approach applies, either mandatory or by choice, the shareholder may, for purposes of allocating the asset basis described in the aforementioned paragraph, look-through to the shareholder's pro rata share of the C corporation's basis in its assets adjusted under Treas. Reg. §1.163(j)-10(c)(5)(i) and -10(d)(4). If the shareholder decides to use the inside basis, the shareholder must do so for all domestic non-consolidated C corporations for which the shareholder is eligible to use this approach.

Under Treas. Reg. §1.163(j)-10(d)(2), a taxpayer with qualified nonrecourse debt must directly allocate interest expense from that debt to the taxpayer's assets under Treas. Reg. §1.861-10T(b). Different from Treas. Reg. §1.861-10T(b)(3),

and solely for purposes of the allocation of the interest expense relating to qualified nonrecourse debt under Section 163(j), the term "cash-flow from the property" includes revenue derived from the sale or lease of inventory or similar property for an excepted or non-excepted regulated utility trade or business. When calculating its basis in the assets of the excepted or non-excepted businesses, a taxpayer must make adjustments for qualified nonrecourse indebtedness, reducing its basis in the assets by the amount the qualified nonrecourse debt is secured by these assets. Treas. Reg. §1.163(j)-10(d)(4). The Final Regulations improve upon the Proposed Regulations, which stipulated a reduction in the amount of the full basis of the asset.

Treas. Reg. Section §1.163(j)-11 (Effective Dates and Transition Rules)

Treas. Reg. §1.163(j)-11 provides transition rules for the Final Regulations (including Old Section 163(j) and the regulations proposed thereunder to post-TCJA Section 163(j) and the Final Regulations). The Final Regulations are generally applicable to taxable years beginning on or after November 13, 2020. However, taxpayers and their related parties (within the meaning of Sections 267(b) and 707(b)(1)) may choose to apply the Final Regulations to taxable years beginning after December 31, 2017, provided that the taxpayers and their related parties consistently apply the Final Regulations to those taxable years.

If a corporation joins a consolidated group during a taxable year of the group beginning before January 1, 2018, and is subject to the Section 163(j) limitation at the time of its change in status, Section 163(j) will apply to the corporation's short taxable year ending when it becomes a member of the consolidated group. However, Section 163(j) does not apply to that corporation's short taxable year that begins the next day (when it becomes a member of the acquiring consolidated group). Any BIE paid or accrued by the corporation in its short taxable year ending on the day of its change in status for which a deduction is disallowed under Section 163(j) is carried forward to the acquiring group's first taxable year beginning after December 31, 2017 (and may be subject to limitations at that time).

Treas. Reg. §1.163(j)-11(c)(1) provides that disallowed disqualified interest under Old Section 163(j) is carried forward to the taxpayer's first taxable year beginning after December 31, 2017. Consistent with the Proposed Regulations, Treas. Reg. §1.163(j)-11(c)(3) provides detailed rules to allocate disallowed disqualified interest carryforwards of an affiliated group treated as a single taxpayer under Old Section 163(j)(6)(C) to each member of that affiliated group for purposes of post-TCJA Section 163(j). To the extent disallowed disqualified interest carryforward is properly allocable to a non-excepted trade or business under Treas. Reg. §1.163(j)-10, it is carried forward and potentially subject to disallowance under post-TCJA Section 163(j) (while interest allocable to an excepted trade or business is carried forward but is not subject to disallowance). However, a taxpayer may not reduce its E&P in a taxable year beginning after December 31, 2017 to reflect any disallowed disqualified interest carryforwards to the extent such amounts previously reduced its E&P under Old Section 163(j). As in the Proposed Regulations, no excess limitation under Old Section 163(j)(2)(B) may be carried forward to taxable years beginning after December 31, 2017.

The Final Regulations largely reflect the Proposed Regulations in terms of how the limitation under Section 382 applies to interest disallowed under post-TCJA Section 163(j) and Old Section 163(j). In general, the term "pre-change loss" under Section 382 includes any disallowed interest described in post-TCJA Section 163(j)(2). The Final Regulations retain the rule of the Proposed Regulations that, for purposes of Sections 382(d)(3) and 382(k)(1), and except as provided in Treas. Reg. §1.382-2(a)(7), with respect to any ownership change on a change date occurring before 13 November 2020, disallowed disqualified interest is not a pre-change loss under Treas. Reg. §1.382-2(a) and is not a carryforward of disallowed interest described in Section 381(c)(20). For ownership changes occurring on or after November 13, 2020, the treatment of disallowed disqualified interest is governed by Treas. Reg. §1.382-2(a)(1)(i)(A), §1.382-2(a)(2) and §1.382-6(c)(3).

State and Local Tax Implications of the Final Regulations

The Final Regulations bring back to light several state tax issues that were presented when Section 163(j) was first enacted as part of the TCJA, and they raise some new issues post-CARES Act. For the latter, taxpayers will need to be mindful of the modifications to Section 163(j) brought about by the CARES Acts (certain provisions of which are addressed by the Final Regulations) and the extent to which state and local governments have conformed to, or decoupled from, those modifications. In addition, while the Final Regulations have confirmed that members of a consolidated group are aggregated for purposes of computing the limitation under Section 163(j), the question of how the Section 163(j) limitation is computed at the state level remains unanswered in several jurisdictions. Finally, now that the Final Regulations have been issued, taxpayers are in need of guidance from state taxing authorities on how the interest expense limitation under Section 163(j) interacts with other deduction disallowance provisions, such as related-party interest expense add-back provisions. These issues are discussed in turn below.

In assessing the state tax impact of the Final Regulations, the first step is to determine whether Section 163(j) applies at the state level at all, and the key to understanding whether the interest expense limitation of Section 163(j) is incorporated into the state tax law is the state's conformity to the Code. Although approaches differ, each state with a corporate income tax draws upon the Code in some way and most states conform to federal taxable income as a starting point for computing state taxable income. As a general matter, a state may conform to the Code on either a static or a rolling basis. States that conform to the Code on a static basis do so as of a fixed date, which may or may not be the most recent version of the Code, rolling conformity states conform to the version of the Code that is currently in effect and some states conform to only specific Code sections (selective conformity) on either a static or a rolling basis. In addition to how a particular state conforms to the Code provisions, an equally important issue is whether that state conforms to federal interpretations of those provisions (e.g., Treasury regulations, rulings, etc.). With the release of the Final Regulations, an additional threshold question exists as to whether these Final Regulations will apply at the state and local level. Thus, taxpayers should pay particular attention to the language of a state's conformity statute to determine whether Treasury regulations apply in that state.

As applied to Section 163(j) and the Final Regulations, this conformity analysis is further complicated by the enactment of the CARES Act, which, among other changes, modified the Section 163(j) limitation by increasing the amount of deductible interest expense from 30% of ATI to 50% of ATI, thereby allowing taxpayers to deduct more BIE in 2019 and 2020 than previously allowed under the original TCJA provision. However, conformity to the CARES Act has been anything but consistent at the state and local level, even among rolling conformity states. For example, among the rolling conformity states (i.e., where Section 163(j) was automatically incorporated into the state's tax code by virtue of the passage of the TCJA), some states have expressly decoupled from the CARES Act provisions impacting Section 163(j), while others have conformed to those changes by virtue of their rolling conformity statutes.

Furthermore, in the states that have decoupled from the CARES Act provisions impacting Section 163(j), some states have selectively decoupled only from certain Section 163(j) provisions (while conforming to others), decoupled from the CARES Act provisions only for certain tax types (while conforming to those provisions for other tax types) or a combination of both. In static conformity states that have updated their conformity statutes to a tax year post-TCJA, but pre-CARES Act, those states will conform to Section 163(j) but should not conform to the CARES Act modification absent express legislative action. Because the Final Regulations make corresponding changes to reflect the modifications brought about by the CARES Act, taxpayers will need to determine which version of Section 163(j) applies in each state (assuming the state even conforms to Section 163(j) in the first instance) to determine the extent to which the Final Regulations apply.

This patchwork of conformity and non-conformity provisions among the various states is sure to be a source of confusion and frustration for many taxpayers.

Nonetheless, conformity is only the first step in analyzing the state tax impact of Section 163(j). There are other consistency concerns originally raised by the TCJA and the Proposed Regulations that warrant a renewed discussion in light of the Final Regulations.

For example, guidance is still needed to address concerns previously raised by taxpayers in the aftermath of the TCJA about how the differences in state tax filing methodologies may affect the computation of the Section 163(j) limitation at the state level. The Final Regulations confirm that members of a consolidated group are aggregated for purposes of Section 163(j) and the consolidated group has a single Section 163(j) limitation. However, states do not generally conform to the consolidated return method of reporting, but instead require either separate entity reporting or some version of combined reporting (e.g., unitary combined reporting) that does not necessarily equate to the federal consolidated return reporting group. In addition, many states have yet to issue guidance addressing many unanswered questions, including how to integrate the federal consolidated group limitation into the calculation of state taxable income. That said, at least one state — Michigan — has taken legislative action to clarify how the Section 163(j) limitation applies to the state unitary group, seemingly in response to the Final Regulations. The recently introduced bill, if enacted, would amend Michigan's Income Tax Act to equate "any reference to a federal consolidated return group" with "a reference to a unitary business group." Currently, the Michigan Income Tax Act treats each

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corporation included in a unitary business group or in a combined return as a single person.

Another area of uncertainty that continues to be an issue, but that has only been addressed by a handful of states since the TCJA's enactment, relates to the interaction between Section 163(j) with other state limitations on the deductibility of interest expenses. For example, unless an exception applies, several states require taxpayers to add back to federal taxable income the amount of any interest expense paid or accrued in connection with one or more transactions with a related member (in unitary combined reporting states, this add-back requirement generally applies when the related member is not included in the unitary combined reporting group). A crucial question since the enactment of Section 163(j) is one of timing, namely, does the interest expense limitation of Section 163(j) apply before or after applying the related party add-back? The answer to that question could affect state tax compliance in future years and it could require taxpayers to separately track interest expense deductions disallowed by Section 163(j) and carried forward to future years.

While the Final Regulations bring with them a renewed urgency to address these issues, the overall prospect of comprehensive state tax guidance being issued in the near term seems unlikely given the current state of affairs. State governments are facing severe budget shortfalls as a result of the COVID-19 crisis and, therefore, issuing guidance of this nature is unlikely to be a top priority for many commissioners of revenue. However, we are hopeful that the Final Regulations will push state taxing authorities to reconsider and provide some certainty surrounding these issues.

Conclusion

The Final Regulations largely adopt the Proposed Regulations without significant changes. Treasury and the IRS standardized the definition of "interest" for purposes of Section 163(j), thus alleviating many taxpayer headaches. However, while simplifying the rules, Treasury and the IRS largely disregarded many of the most significant comments provided by taxpayers including whether CFCs should be subject to Section 163(j) at all. It remains to be seen how the Final Regulations will be implemented from a state and local tax point of view.

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