

Treasury Releases Guidance on Business Interest Deduction Limits

On Nov. 26, 2018, the Department of the Treasury and the Internal Revenue Service issued proposed regulations under Section 163(j) of the Internal Revenue Code regarding the limitation on the deduction for business interest expense.

Section 163(j) was amended by the *Tax Cuts and Jobs Act*, (P.L. 115-97) by removing prior Section 163(j)(1) through (9) and adding new Section 163(j)(1) through (10). In April 2018, Treasury released interim guidance on the interest deduction limitation through Notice 2018-28, but the proposed regulations are far more detailed and provide enhanced guidance.

Background

Congress amended Section 163(j) under the TCJA, in part, out of concern that prior law treated debt-financed investment more favorably than equity-financed investment. This debt bias generally encouraged taxpayers to utilize more leverage than would occur in the absence of the Code. Limiting the deduction of business interest is meant to reduce the relative favorability of debt and to encourage a more efficient capital structure for businesses. Congress also believed it necessary to apply the limit broadly across different types of taxpayers so as not to distort the choice of entity.

Thus, in accordance with Congress's goals, for tax years beginning after Dec. 31, 2017, Section 163(j) generally limits the amount of business interest expense that can be deducted in the current taxable year to the sum of (1) the taxpayer's business interest income for the taxable year; (2) 30 percent of the taxpayer's adjusted taxable income (ATI) for the taxable year; and (3) the taxpayer's floor plan financing interest expense for the taxable year. The limitation applies to all taxpayers except for certain small businesses that meet the gross receipts test in Section 448(c) and certain trades or businesses listed in Section 163(j)(7). Interest amounts disallowed for any taxable year as a result of the Section 163(j) limitation are carried forward and treated as business interest paid or accrued in the next taxable year.

The Proposed Regulations

The TCJA substantially changed the statutory rules of Section 163(j) to limit the amount of net business interest expense that can be deducted in the current taxable year of any taxpayer with only limited exceptions. Due to this considerable modification, Treasury set forth the proposed regulations to ensure that all taxpayers calculate the business interest expense limitation in a similar manner.

The proposed regulations are organized into 11 substantive sections, proposed §§1.163(j)-1 through 1.163(j)-11, and provide rules relevant to the calculation of the Section 163(j) limitation, including:

1. **Proposed §1.163(j)-1: Definitions:** The proposed rules provide definitions of terms used in Section 163(j), including (1) ATI, (2) interest, (3) trades or businesses and excepted trades or businesses, (4) electing real property trade or business, (5) electing farming business, (6) regulated utility trade or business, and (7) floor plan financing interest expense. This section includes an anti-avoidance rule, as well as adjustments to

prevent double counting and other distortions of items upon the sale or disposition of property.

2. **Proposed §1.163(j)-2:** Deduction for Business Interest Expense Limited. This section details the Section 448(c) gross receipts test exemption, clarifies when entities should be aggregated for purposes of the gross receipts test, and explains how disallowed business interest expense may be carried forward. It also specifies that tax-exempt organizations only include gross receipts from unrelated trades or businesses when determining whether or not the exemption is satisfied.
3. **Proposed §1.163(j)-3:** Relationship of Business Interest Deduction Limitation to Other Provisions Affecting Interest. The proposed regulations provide ordering and operating rules to control the interaction of the Section 163(j) limitation with other provisions of the Code (as the legislative history of the TCJA shows an intent for Section 163(j) to apply after other provisions that defer, capitalize, or disallow interest expense). However, Section 163(j) is not last in ordering, and the proposed regulations clarify that Section 163(j) would apply before the loss limitation rules in Sections 465 and 469 and before the application of Section 461(l).
4. **Proposed §1.163(j)-4:** General Rules Applicable to C Corporations (including REITs, RICs, and Members of Consolidated Groups) and Tax-Exempt Corporations. This section provides rules regarding the computation and characterization of items of income and expense under Section 163(j) for C corporations (including members of a consolidated group, REITs, and RICs) and tax-exempt corporations. It also provides that the disallowance and carryforward of a deduction for a C corporation's business interest expense will not affect whether or when such business interest expense reduces the taxpayer's E&P. Thus, C corporations generally should not wait to reduce their E&P for business interest expense until the taxable year in which a deduction for such expense is allowed under Section 163(j). The proposed regulations provide a special rule for RICs and REITs under which their E&P generally are not reduced by a disallowed business interest expense in the year it is disallowed. This section also clarifies that consolidated groups have a single Section 163(j) limitation but members of an affiliated group that does not file a consolidated return would not be aggregated for purposes of applying the Section 163(j) limitation.
5. **Proposed §1.163(j)-5:** General Rules Governing Disallowed Business Interest Expense Carryforwards for C Corporations. This section provides rules regarding disallowed business interest expense carryforwards for taxpayers that are C corporations, including members of a consolidated group. It addresses: (1) transactions to which Section 381(a) applies, (2) rules regarding limitations on disallowed business interest expense carryforwards from separate return limitation years (SRLYs), (3) cross references to rules regarding the application of Section 382, and (4) provides rules regarding the overlap of the SRLY limitation with Section 382.
6. **Proposed §1.163(j)-6:** Application of the Business Interest Expense Deduction Limitations to Partnerships and Subchapter S Corporations. This section provides guidance regarding partnership and S corporation deductions and carryforwards under Section 163(j). To the extent a partnership is subject to the limitation imposed by Section 163(j), the limitation shall be applied at the partnership level and any deduction for business interest expense not disallowed under Section 163(j) is taken into account in determining the nonseparately stated taxable income or loss of the partnership. Similar rules apply to S corporations. The proposed regulations also ensure that, for owners of partnerships and S corporations, business interest

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income is used only once, at the entity level, in offsetting business interest expenses. This eliminates the incentive to create tiered partnerships purely to double-count interest income in order to avoid the Section 163(j) limitation.

7. **Proposed §1.163(j)-7:** Application of Section 163(j) to Foreign Corporations and Their Shareholders. The proposed regulations clarify that Section 163(j) applies to determine the deductibility of a CFC's business interest expense, generally in the same manner applicable to the deductibility of a domestic C corporation's business interest expense (but specifies certain cases that will limit the amount of a CFC's business interest expense and modify computation of ATI, and rules for making such modifications). The proposed regulations also include rules for calculations of ATI by U.S. shareholders of CFCs.
8. **Proposed §1.163(j)-8:** Application of Section 163(j) to Foreign Persons with Effectively Connected Income. In general, nonresident alien individuals or foreign corporations are subject to net basis income taxation only with respect to their income that is or is effectively connected (ECI) with a U.S. trade or business. Nonresident aliens (that are not applicable CFCs) that have ECI are subject to Section 163(j). To reflect that foreign persons are only taxed on their ECI, the definitions of ATI, business interest expense, business interest income, and floor plan financing expense are modified to limit such amounts to income which is effectively ECI.
9. **Proposed §1.163(j)-9:** Elections for Excepted Trades or Businesses; Safe Harbor for Certain REITs. The proposed regulations (1) provide guidance in applying the rules for farming and real property trade or business elections, including the time and manner for electing real property trades or businesses and farming businesses, (2) provide a safe harbor for REITs to elect to be excepted real property trades or businesses, (3) define the conditions under which the election terminates (as the statute says the election is irrevocable), and (4) provide an anti-abuse rule that disallows an election to be an excepted real property trade or business for trades or businesses that lease substantially all of their real property to the owner of the real property trade or business, or to a related party of the owner.
10. **Proposed §1.163(j)-10:** Allocation of Expense and Income to an Excepted Trade or Business. This section provides rules for allocations of ATI, interest expense, and interest income between excepted and non-excepted trades or businesses based on the relative amounts of the taxpayer's adjusted tax basis in the assets used in its excepted and non-excepted trades or businesses. This section also provide rules for allocating tax items other than interest income and interest expense.
11. **Proposed §1.163(j)-11:** Transition Rules. This section specifies rules that apply if a corporation (that is subject to the Section 163(j) limitation) joins a consolidated group whose taxable year began before Jan. 1, 2018, and thus is not currently subject to the Section 163(j) limitation.

Next Steps

Treasury and the IRS are requesting comments on the proposed regulations. Comments are due within 60 days after the proposed regulations are published in the Federal Register. We anticipate that comments will be due in early February. A public hearing is scheduled for Feb. 25, 2019, at 10 a.m. If there is not sufficient time to discuss all of the topics on Feb. 25, 2019, the hearing will continue the following day at 10 a.m.

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Given that these rules will significantly impact the taxation for most businesses, we believe it is important for taxpayers to engage in the rulemaking process. By doing so, policymakers will have a better understanding of the impact these rules will have on businesses and the challenges businesses will face during the implementation process.

The Brownstein Federal Tax Policy team can assist you in assessing the impact that these rules will have on your business. In addition, we can help you determine whether to submit written comments to the proposed guidance. Our team has significant experience with the rulemaking process. To the extent questions are unanswered or the rules are not clear, our team can facilitate a dialogue with policymakers to help resolve your issues.

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