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Overview of the New Proposed Regulations on Interest Deduction Limitation Rules

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On November 26, 2018, the Department of Treasury (Treasury) and Internal Revenue Service (IRS) released proposed regulations (Proposed Regulations)[1] that flesh out new §163(j).[2] The §163(j) interest limitation rule was a cornerstone of the 2017 tax act enacted by Congress in December 2017.[3] It is a broad business interest limitation rule that applies to all taxpayers (subject to specified exceptions) reducing a taxpayer's ability to deduct interest expenses. It changes the landscape for how businesses will consider funding their operations. The Proposed Regulations are thoughtful, but they are long and complicated. Treasury appears to acknowledge this in the preamble by repeatedly inviting taxpayers to provide comments in order to help create a workable framework. It seems unlikely that any taxpayer can intuitively comply with these rules. In some instances they are substance-driven, and in other instances they are more form-driven. We set forth below a brief overview of certain portions of the Proposed Regulations.

In general, the Proposed Regulations apply to taxable years ending after the date the Proposed Regulations are adopted as final; however, taxpayers may apply rules set forth in the Proposed Regulations so long as those rules are consistently applied.

Under §163(j), on an annual basis, taxpayers can deduct net business interest expenses up to 30% of their adjusted taxable income (ATI), which does not include a reduction for depreciation and amortization for tax years beginning before January 1, 2022. After that, adjusted taxable income includes a reduction for depreciation and amortization, making taxpayers more likely to be subject to the limitation.

WHAT IS INTEREST?

Under the Proposed Regulations, interest expense is interest paid or accrued (or treated as paid or accrued) in the tax year, and interest income is interest included in gross income for the tax year. But what is interest? Tax advisors should be advised that the Proposed Regulations use a very broad brush in defining interest for purposes of §163(j) and do not limit the definition to items that are treated as interest under other provisions of the Code. The Proposed Regulations generally define interest based on the principle that interest for §163(j) should include any amounts associated with the time value of money or use of funds.

Examples of amounts that are treated as interest are original issue discount (including *de minimis* original issue discount), market discount, debt repurchase premium, certain amounts on a sale-repurchase agreement (repo) that is treated as debt for tax, certain amounts on the loan component of a swap with significant nonperiodic payments, an issuer's debt issuance costs that are capitalized into the debt (and treated as if they adjust the yield for purposes of amortizing the costs), amounts on certain derivatives that alter a taxpayer's effective cost of borrowing with respect to a liability, and certain amounts on a synthetic debt instrument created by an integrated hedging transaction. In addition, interest includes factoring income, lender commitment fees (as long as some amount of financing is provided), guaranteed payments to a partner for use of capital and substitute interest payments in a securities lending transaction.

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[1] REG-106089–18.

[2] Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended (Code), and the Treasury regulations promulgated thereunder.

[3] For an overview of the 2017 tax act, Pub. L. No. 115-97, (including §163(j)) and related IRS guidance implementing the same, see the Mayer Brown Tax Reform Roadmap.

The Proposed Regulations also provide an anti-avoidance rule that any deductible expense or loss incurred in a transaction in which the taxpayer secures the use of funds for a period of time is treated as interest expense if it is predominantly incurred in consideration of the time value of money.

The Proposed Regulations do not appear to alter situations where the payments are part of a transaction that is historically respected for tax as something other than a ''use of funds'' type of transaction. For example, rental payments on a true lease are not interest for purposes of §163(j). This is supported by the fact that the Proposed Regulations include as interest for purposes of §163(j) the amounts under a rental agreement treated as interest pursuant to §467. Similarly, while the Proposed Regulations provide that factoring income is interest income under §163(j) (and this is sensible under its principles), a taxpayer that factors its receivables to a buyer is engaging in a sale transaction of the receivables and so it would seem that no portion of the loss or discount on that transaction is interest expense subject to §163(j) (however, this is not entirely clear). Also consider that the Proposed Regulations include as interest the interest under §483 for deferred payments under certain contracts for the sale and exchange of property. Query whether any portion of a prepayment or deferred payment for services is intended to be interest for purposes of §163(j).

WHAT IS 'BUSINESS INTEREST'?

Business Interest Generally

Only ''business'' interest expense (BIE) is subject to the §163(j) limitations, and only ''business'' interest income (BII) is used to allow the deductibility of BIE outside of the 30% ATI limitation. Interest is BIE if it is properly allocable to a trade or business (that is not a trade or business specially excepted from §163(j)). ''Trade or business'' here means the general understanding of a trade or business pursuant to §162, which allows a deduction for ordinary and necessary expenses associated with carrying on a trade or business. The contours of this ''trade or business'' definition have produced floods of litigation, so it comes with an existing body of law and generally requires a bona fide profit motive.

BIE and BII are further distinguished from personal interest (defined in §163(h)(2)) and investment interest, which is addressed by §163(d) and generally relates to property held for investment and can include certain activities where the taxpayer does not participate materially in the venture.[4]

However, importantly, the Proposed Regulations provide that for purposes of §163(j) all interest expense and interest income of a C corporation is BIE and BII. In addition, where a C corporation is a partner in a partnership, all interest income and expense allocated by the partnership to the C corporation are BIE and BII in the hands of the C corporation irrespective of whether the partnership itself has a trade or business or is otherwise excepted from §163(j) (other than in the case of a partnership's subpart F or GILTI inclusions that are allocable to a non-trade or business). As mentioned below, a C corporation partner in a partnership may, or in certain circumstances must, look through the partnership for purposes of determining allocations of BIE and BII between businesses excepted from the §163(j) limitation and other businesses (unless the partnership is eligible for the small business exemption), and a partnership may have its own §163(j) limitation such that a C corporation partner will have to treat excess BIE in accordance with those rules. However, as an initial matter, the point is that a C corporation's interest items are virtually always BIE and BII subject to these rules.

Exceptions to §163(j) Limitation on Business Interest

The only taxpayers wholly exempt from applying §163(j) to their BIE are those taxpayers meeting the small business exemption. This exemption is available for taxpayers in a year where the taxpayer has average annual gross receipts of $25 million or less for the three preceding taxable years. The gross receipts of the taxpayer (whether a corporation, partnership or individual) are aggregated with gross receipts of any other person that is part of the commonly controlled group with the taxpayer (which generally uses a 50% or more test for control). The taxpayer also includes its distributive share of partnership gross receipts in its gross receipts calculation (if the partnership is not otherwise aggregated with the taxpayer). Arrangements entered into to avoid §163(j), including the use of multiple entities to avoid exceeding the minimum gross receipts threshold, may be disregarded and recharacterized by the IRS.

However, other taxpayers can avoid the §163(j) limitation with respect to interest that is properly allocable to an excepted trade or business. For purposes of §163(j), ''excepted trades or businesses'' are (1) the trade or business of performing services as an em-

[4] See Reg. §1.163-8T for rules for allocating interest expense to investment property or activity.

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ployee, (2) an electing real property trade or business, (3) an electing farming business, and (4) certain utility businesses. The interest expense of excepted trades or businesses is not BIE and is thus not subject to the §163(j) limitation. Similarly, ATI that is properly allocated to an excepted trade or business is not applicable for purposes of §163(j). The downside of being an excepted trade or business is that the assets of the business will be subject to an alternate depreciation schedule described in §168(g)(8) (generally, slower depreciation for certain assets than would otherwise be allowed, including, importantly, losing the benefit of immediate expensing for qualified property). A trade or business for these purposes does not include activities that do not involve the provision of services or products to a person other than the taxpayer. For example, if a taxpayer engaged in the provision of technology services to customers also has an asset management team managing the taxpayer-owned property that houses the technology business, the taxpayer does have a real property trade or business on account of the asset management team.

A taxpayer can elect excepted trade or business treatment for eligible businesses by attaching an election statement to the tax return with certain required information, including a principal business activity code. A taxpayer may make elections for multiple trades or businesses on a single election statement.

A consolidated group[5] is treated as a single corporation for purposes of making the election and applying the excepted trade or business concept to its §163(j) limitation. In other words, the group (rather than a particular member) is treated as engaged in excepted or non-excepted trades or businesses based on overall proportional split of excepted versus non-excepted trades or businesses operated in aggregate by the members. Intercompany obligations and transactions are disregarded for purposes of the determination. Once a consolidated group has determined its overall percentage of interest expense allocated to excepted trades or businesses and non-excepted trades or businesses, that percentage is applied to each member's interest expense (as allocable between an excepted and non-excepted trade or business) regardless of whether that member actually engaged in an excepted trade or business.

If a taxpayer (or consolidated group) has an excepted and non-excepted trade or business, the taxpayer must allocate BIE, BII and all other tax items (for purposes of ATI) between the businesses. BIE and BII is allocated among the businesses based on the relative amounts of the taxpayer's adjusted basis in the assets used in each of the businesses, with the calculation of adjusted basis performed on a quarterly basis with the average of the four quarters used for the taxable year determination. Under a de minimis exception, if 90% or more of the taxpayer's asset basis is allocable to either an excepted or non-excepted trade or business, then all BIE and BII for that year is allocable to that excepted or non-excepted trade or business.

The Proposed Regulations also provide certain methodologies for allocation where an asset is used in more than one trade or business, and provide detailed look through rules with respect to accounting for assets indirectly held by a taxpayer through its interests in partnerships, S corporations and non-consolidated C corporations.

The Proposed Regulations contain certain special rules for calculating adjusted basis for this purpose. For example, basis in land and similar inherently permanent structures is generally calculated on its unadjusted basis, basis in intangible property is calculated using ordinary §167 and §197 rules, and basis in tangible depreciable property is generally calculated under the §168(g) alternative depreciation system (a slower schedule than generally available). Self-created intangible assets, customer receivables and cash and cash equivalents are not taken into account for these calculations.

There are some important exceptions from the allocation of interest expense based on the adjusted basis of assets. A taxpayer must allocate interest expense on "qualified nonrecourse indebtedness" to the relevant assets associated with the borrowing. The Proposed Regulations incorporate the sourcing rules for interest expense on qualified nonrecourse indebtedness under Reg. §1.861-10T for purposes of making the applicable determinations here. In addition, a taxpayer engaged in certain banking, insurance, financing or similar business must directly allocate interest expense and income from that business to the taxpayer's assets used in that business.

Finally, the Proposed Regulations provide for a very broad anti-abuse rule. If a principal purpose, whether or not it is outweighed by other purposes, for any purchase, sale or change in use of an asset is to artificially shift basis allocable to excepted and non-excepted trades or businesses, the additional basis or change in use will not be taken into account for purposes of these allocation rules. A taxpayer making an allocation must attach a statement to its tax return including information regarding the allocation.

In addition to the allocation of interest among excepted and non-excepted trades or businesses, the Proposed Regulations provides rules for allocating the other tax items that comprise the relevant ATI for the trades or business. That is, a taxpayer must properly allocate income and expense among excepted and

[5] As defined in Reg. §1.1502-1(h).

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non-excepted trades or businesses so that it does not, for example, increase its ATI for the non-excepted trade or business with items properly allocable to the excepted trade or business. Gross income other than dividends and interest is allocated to the trade or business that generated the gross income. Dividends, and gain or loss from dispositions of entities, are subject to special look-through rules. The allocation of expenses, losses and other deductions is based on the sourcing rules under Reg. §1.861-8(b) and are allocable to the trade or business in which they are definitely related (and if a deduction is definitely related to both excepted trades or businesses and non-excepted trades or businesses, then the deduction is apportioned between the businesses based on the relative amounts of the taxpayer's adjusted basis in the assets used in those trades or businesses). Deductions not definitely related to a business are ratably apportioned to all gross income.

Electing Real Property Exception

Section 163(j)(7)(B) defines an electing real property trade or business by reference to §469(c)(7)(C), which provides "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business." The Proposed Regulations amend the regulations under §469 to provide more direction on the sort of businesses that are included in this category. In general, the Proposed Regulations define "real property" to include land, buildings, and other inherently permanent structures that are permanently affixed to land, or any interest in such property, and exclude machines and equipment that serve an active function (even if permanently affixed to land). On the other hand, property produced that is used in real property but is not real property in the hands of the producing taxpayer, like bricks and windowpanes, is not real property. In addition, real property activity for this rule is satisfied where the taxpayer is handling day-to-day operations of a trade or business relating to the maintenance and occupancy of the property that affect the availability and functionality of the property used by paying customers. The provision of significant or extraordinary personal services in connection with the real property where the use of the real property is incidental is not a qualified real property activity for this purpose.

The Proposed Regulations include an anti-abuse rule that applies if 80% or more of the value of a taxpayer's real property is leased to commonly controlled businesses.

The Proposed Regulations provide a safe harbor for a real estate investment trust (REIT) to qualify as an electing real property trade or business. The safe harbor, incorporating certain look through rules, generally allows a REIT to qualify its entire business as an electing real property trade or business if the REIT holds real property, shares in REITs holding real property and/or interests in partnerships holding real property (in each case, "real property" has the more expansive definition found in Reg. §1.856-10), and its "real property financing assets" (e.g., mortgages and REMIC regular interests) are equal to 10% or less of the value of the REIT's total assets at the close of the taxable year. However, if the real property financing assets represent more than 10% of the REIT's total assets, then the REIT must allocate items between its excepted and non-excepted trades or businesses, with any REIT-held asset that meets the Reg. §1.856-10 definition of real property treated as an asset of an excepted trade or business (to the extent the REIT makes an election for that trade or business).

Simultaneously with the Proposed Regulations, the IRS issued Rev. Proc. 2018-59 providing guidance on applying the §163(j) limitations to infrastructure arrangements between governmental entities and private persons, commonly known as public private partnerships, in which private persons maintain or provide services with respect to various types of infrastructure property. As noted above, §163(j) allows a taxpayer to elect to treat a trade or business described in §469(c)(7)(C) as an "electing real property trade or business," which will then not be subject to the §163(j) interest deduction limitation (but will be required to use an alternate depreciation schedule described in §168(g)(8) for the assets used in such trade or business). Rev. Proc. 2018-59, which becomes effective on December 10, 2018 (but may be applied for taxable years beginning after December 31, 2017), creates a safe harbor that allows taxpayers to designate a trade or business conducted in connection with a "specified infrastructure arrangement" as an electing real property trade or business, thereby allowing interest allocable to that trade or business to avoid the §163(j) limitation (although the alternate depreciation schedule will then apply). A "specified infrastructure arrangement" is a contract of more than five years between a government and a private trade or business under which the private trade or business is responsible for designing, building, constructing, reconstructing, developing, redeveloping, managing, operating or maintaining a "qualified public infrastructure property." A "qualified public infrastructure property" includes various types of infrastructure property available for the use or benefit of the general public, such as airports, docks, mass transit, waste facilities, water and electric facilities, qualified public educational facilities, rural broadband service facilities, and Brownfield/Superfund remediation if either owned by a government or subject to certain government regulation.

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MECHANICS OF §163(j)

Limitation and Carryforward

Consistent with §163(j)(1), the Proposed Regulations provide that the deduction of BIE cannot exceed the sum of current-year BII, 30% of the taxpayer's adjusted taxable income and current-year floor plan financing interest expense.

The Proposed Regulations generally would apply to BIE after other provisions that defer, capitalize or disallow interest expense. Therefore, BIE that has been disallowed, deferred, or capitalized in the current taxable year, or that has not yet been accrued, would not be taken into account for purposes of §163(j) (although §163(j) would apply before the loss limitation rules of §465 and §469). The Proposed Regulations reserve on the interaction of §163(j) with §108 (addressing income from discharge of indebtedness) and §59A (relating to the tax on the base erosion minimum tax amount).

To the extent a taxpayer's BIE is in excess of §163(j)'s annual limitation, the BIE is carried forward into the succeeding year and is treated as part of that year's BIE. Excess BII or excess ATI is not carried forward; those attributes are only relevant to the applicable current tax year. Section 163(j) applies to the total amount of BIE in a taxable year (including carryforwards of disallowed BIE from prior years) and does not directly trace to interest expense associated with any particular debt obligations. A carryforward BIE does change character and so a BIE will not become allocable to an excepted trade or business in a subsequent year even if the taxpayer only has an excepted trade or business in that later year.

A C corporation (or a consolidated group) must track its BIE in accordance with the year the BIE was generated and the Proposed Regulations' ordering rules. In a current tax year, a C corporation first deducts BIE from the current year to the extent available under §163(j), and disallowed BIE carried forward from prior years is deducted in the order of the taxable years in which they arose beginning with the earliest taxable year (subject to limitations such as §382). This tracking is intended to assist in the application of limitations such as §382 and the separate return limitation year (SRLY) rules.[6]

Definition of ATI

The Proposed Regulations define ATI as the taxable income of the taxpayer, computed in accordance with §63 but without regard to the §163(j) limitation, with certain adjustments. Specifically, the Proposed Regulations provide for the adjustments listed in the statute that are disregarded in computing ATI: income, gain, deduction or loss not properly allocable to a trade or business; BIE and BII; §172 net operating loss deductions; §199A qualified business income deductions; and deductions for depreciation, amortization and depletion with respect to taxable years beginning before January 1, 2022 (a capitalization into costs of goods is not a deduction for depreciation, amortization and depletion).

The Proposed Regulations also include special rules for defining the taxable income of RICs and REITs, consolidated groups, partnerships, S corporations and certain controlled foreign corporations, as well as adjustments to avoid double counting. For example, for sales or dispositions of certain property for taxable years beginning before January 1, 2022, deductions for depreciation and amortization (not to exceed the gain recognized on the sale or disposition) are subtracted from ATI. Without this subtraction, the taxpayer would have a double benefit because the depreciation would not reduce the taxpayer's ATI, but would reduce the taxpayer's tax basis in the property such that the taxpayer would have additional gain (and thus additional ATI) in the year of sale.

Only adjustments specifically required by the Proposed Regulations are allowed. For instance, a dividends received deduction under §243 for dividends received by a C corporation (that is neither a RIC nor a REIT) is not added back in computing ATI. Similarly, the new §250 deduction relating to foreign-derived intangible income and global intangible low-taxed income (GILTI) amounts will also generally reduce ATI (without the limitations in §250(a)(2) that could reduce the amount of the deduction). That said, as explained below, the taxpayer may be required to add back the §250 deduction to the extent it is attributable to a GILTI inclusion.

Consolidated Groups

The Proposed Regulations provide that a consolidated group (as defined in Reg. §1.1502-1(h)) generally has a single §163(j) limitation. This rule does not extend to non-consolidated entities (e.g., affiliated companies that do not file a consolidated return with the group) or to partnerships whose only partners are members of the consolidated group. For a consolidated group, intercompany obligations and intercompany items are disregarded for purposes of §163(j). The Proposed Regulations provide rules for basis adjustments, allocations of utilized and excess BEI and BII among the members of the consolidated group, and departures or additions to consolidated group members.

[6] *See* Reg. §1.1502-1(e), §1.1502-21).

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Other Miscellaneous Rules

The Proposed Regulations provide a number of ancillary rules to address various circumstances and taxpayers. For example, the Proposed Regulations requires that foreign and domestic C corporations that are not a RIC or REIT reduce their earnings and profits for their annual BIE, irrespective of whether or not it is disallowed under §163(j). In addition, there are rules regarding the application to excess of BIE of the SRLY rules, §381 (generally requiring an acquiring corporation to succeed to and take into account certain tax items of a distributor or transferor corporation in a tax-free reorganization or liquidation) and §382 (generally limiting a taxpayer's ability to reduce its income by the net operating losses of an acquired target corporation), as well as special rules for applying §163(j) to S corporations, utilities, tax-exempt corporations, RICs and REITs (for the last two, notably, the Proposed Regulations clarify that the dividends paid deduction is not taken into consideration when calculating ATI).

APPLICATION TO PARTNERSHIPS

Under §163(j)(4), the general rule is that the §163(j) limitation is imposed at the partnership level, and any deduction for BIE not disallowed under §163(j) is taken into account in determining income or loss of the partnership and the partners' distributive shares thereof. The amount of any BIE that is not disallowed is not subject to any further limitations at the partner level under §163(j).[7] The amount of any BIE that is disallowed at the partnership level is carried forward at the partner level. Similar rules apply to an S corporation. The complexity of the Proposed Regulations with respect to partnerships is largely an attempt to preserve the aggregate nature of partnerships while remaining consistent with the statutory scheme of applying §163(j) at the partnership level.

Partnership ATI

A partnership generally determines its ATI in the same manner as described above (taking into account both separately and nonseparately stated items). In addition, the partnership takes into account §734(b) basis adjustments (i.e., adjustments to the basis of partnership assets resulting from certain distributions made to partners) for purposes of calculating its ATI.

However, under the Proposed Regulations §743(b) basis adjustments (i.e., adjustments to the basis of partnership assets that apply solely to a transferee partner as a result of the transfer of a partnership interest), built-in loss amounts with respect to contributed property under §704(c), and §704(c) remedial allocations are not taken into account when computing the partnership's ATI. Instead, these adjustments are taken into account by the applicable partner in determining its own §163(j) limitation.

Partners' ATI and Business Interest Income

The ATI of a partner is generally determined in accordance with the rules described above. To prevent double counting of items already taken into account by the partnership with respect to its §163(j) limitation, a partner's ATI generally does not include such partner's distributive share of any of the partnership's items of income, gain, deduction or loss. However, to the extent that the partnership has ''excess taxable income'' (i.e., ATI in excess of the amount necessary to prevent the partnership's BIE for such year from being limited under §163(j)), each partner includes its allocable share of such excess taxable income in the partner's ATI. Similarly, in determining a partner's BII, the partner may include its allocable share of the partnership's BII only to the extent that such BII exceeds the partnership's BIE (excess BII). The determination of a partner's share of excess taxable income and excess BII is discussed below. As noted above, the partner's ATI is adjusted (upward or downward) to reflect the effects of §743(b) basis adjustments, built-in loss amounts with respect to §704(c) property and §704(c) remedial allocations.

In the event a partner sells a partnership interest and the partnership in which the interest is being sold owns only non-excepted trade or business assets (i.e., assets that are subject to the §163(j) limitation), the gain or loss on the sale of the partnership interest is included in the partner's ATI. The Proposed Regulations provide a method for allocating sale proceeds where the partnership in which the interest is being sold owns both excepted assets and non-excepted assets.

Allocation of Deductible Business Interest Expense and §163(j) Excess Items

The Proposed Regulations provide eleven steps for allocating deductible BIE and excess items (i.e., excess taxable income, excess BII and BIE that exceeds the §163(j) limitation at the partnership level). These steps are solely for this purpose and do not affect the partnership's allocations under §704(b). As noted above, these allocations are necessary because deduct-

[7] However, as explained in the Proposed Regulations, the BIE would retain its character as such at the partner level for other purposes of the Code, such as the passive activity loss limitations under §469.

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ible BIE is not subject to further limitation at the partner level, and only excess items are included in calculating a partner's §163(j) limitation. As noted above, these steps are intended to preserve the aggregate nature of partnerships while remaining consistent with the statutory scheme of applying §163(j) at the partnership level. At the conclusion of the eleven steps, the total amount of deductible BIE and excess items allocated to each partner will equal the partnership's total amount of deductible BIE and excess items.

A partner's allocable share of deductible BIE as determined by these steps is deductible by the partner and is not subject to any further partner-level limitation. The partner's share of excess BIE would be carried forward at the partner level as discussed immediately below.

Carryforwards

To the extent a partnership has BIE in excess of its §163(j) limitation, such excess BIE is allocated to the partners in accordance with the eleven steps noted above and is not carried forward by the partnership.

The BIE that is carried forward by a partner only becomes BIE that is treated as paid or accrued by the partner in the applicable subsequent year to the extent of the excess taxable income or excess BII that the partner is allocated from the partnership in that year. Deduction of such BIE is subject to partner-level limitations (e.g., 30% of the partner's ATI and partner's BII, including in the partner's §163(j) limitation determination any allocated excess taxable income and/or excess BII). However, any amount of BIE that is treated as paid or accrued in the applicable year as a result of excess taxable income that is not deducted because of a partner-level limitation is carried forward to succeeding years as partner-level BIE that may be used to offset income, irrespective of whether income arises from the partnership in any such succeeding year.

Basis Adjustments

A partner's basis in its partnership interest is reduced by its share of deductible BIE and excess BIE as determined in accordance with the eleven steps noted above, regardless of whether such BIE is deemed paid or accrued by the partner. However, deductible BIE and excess BIE are subject to the suspended loss rules under §704(d). Under §704(d), a loss is only allowed to the extent of the partner's adjusted basis in its partnership interest and any excess loss is suspended. Accordingly, the adjusted basis of a partner in a partnership interest is reduced, but not below zero, by the amount of any deductible BIE or excess BIE allocated to the partner. Under the Proposed Regulations, excess BIE from a prior taxable year that is suspended under §704(d) (''negative §163(j) expense'') is not treated as excess BIE in any subsequent year until such negative §163(j) expense is no longer suspended. Accordingly, negative §163(j) expense does not affect allocation of excess taxable income to the partner and the allocation of any such excess taxable income is included in the partner's ATI. Once the negative §163(j) expense is no longer suspended, it becomes excess BIE, which is subject to the general carryforward rules.

If a partner disposes of all or substantially all of its partnership interest, the partner's basis in its partnership interest is recovered by increasing such basis immediately before the disposition by the amount of any excess BIE that has not been deemed paid or accrued by the partner. However, no deduction is allowed for the excess BIE that resulted in the basis increase or any negative §163(j) expense.

In the event a partner disposes of less than substantially all of its interests, the partner's basis in its partnership is not increased by the amount of any excess BIE that has not been deemed paid or accrued by the partner and any such excess business interest expense would remain excess BIE in the hands of the transferor until the transferor is allocated an appropriate amount of excess taxable income or excess BII from the partnership (or added to the basis of its partnership interest upon a full disposition). In addition, any negative §163(j) expense remains the negative §163(j) expense of the transferor until such negative §163(j) expense is no longer suspended.

Reserved Matters

The Proposed Regulations have reserved on a few issues relating to partnerships. Importantly, Treasury has reserved on the treatment of excess BIE in tiered partnerships. Specifically, Treasury requests comments regarding whether, in a tiered partnership arrangement, carryforwards should be allocated through upper-tier partnerships and how and when an upper-tier partner's basis should be adjusted when a lower-tier partnership is subject to a §163(j) limitation. Treasury has also reserved on the application of §163(j) to a partnership merger or division, and Treasury noted its intent to adopt certain rules for lending transactions between a pass-through entity and one of its owners.

§163(j) IMPACT ON FOREIGN CORPORATIONS

Application to CFCs and Their Shareholders

In general, the Proposed Regulations clarify that §163(j) applies to the BIE of a controlled foreign cor-

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poration (CFC). Thus, a CFC with BIE would apply §163(j) for purposes of computing subpart F income (as defined under §952), tested income for GILTI purposes (as defined under §951A(c)(2)(A)), and income that is effectively connected with the conduct of a US trade or business (ECI).

The benefit of a CFC's interest expense deducted in arriving at tested income is effectively eliminated to the extent that the interest expense is deducted from the US shareholder's net deemed tangible income return under §951A(b)(2)(B). Thus, imposing a §163(j) limit on a CFC's interest deductions does not inflict any additional pain to the extent that the interest deductions would have, in any event, reduced the US shareholder's deemed tangible income return and, consequently, increased the US shareholder's GILTI. As a practical matter, the imposition of a §163(j) limit on a CFC's interest deductions causes an increase an GILTI when the interest expense deductions that otherwise would be allocable to tested income are in excess of the US shareholder's net deemed tangible income return.

CFC Group Election

The default method would require the §163(j) limitation to be calculated on a CFC-by-CFC basis with no netting of BII of one CFC against the BIE of another CFC. As a relief for taxpayers, the Proposed Regulations provide for an option to elect an alternative method (''CFC group election'') that generally disregards certain intragroup transactions and would limit the amount of BIE of a CFC group member to the amount of the member's allocable share of the group's net BIE. The applicable net BIE of a CFC group is the excess, if any, of the sum of the amounts of BIE of each CFC group member over the sum of the amounts of BII of each CFC group member. A CFC group member's allocable share is computed by multiplying the applicable net BIE of the CFC group by a fraction, the numerator of which is the CFC group member's net BIE (computed on a separate company basis), and the denominator of which is the sum of the amounts of the net BIE of each CFC group member with net BIE (computed on a separate company basis).

For this purpose, a CFC group means two or more CFCs, if at least 80% of the stock by value of each CFC is owned (within the meaning of §958(a)) by a single U.S. shareholder or, in aggregate, by related US shareholders that own stock of each member in the same proportion. If one or more CFC group members conduct a financial services business, typically highly leveraged with significant amounts of BIE and BII, the alternative method is applied by treating those entities as comprising a separate subgroup to separate those entities from other, non-financial services business CFC group members. Also, a controlled partnership (in general, a partnership in which CFC group members own, in aggregate, at least 80% of the interests) is treated as a CFC group member, and the interest in the controlled partnership is treated as stock.

A CFC with ECI may not compute its §163(j) limitation under the alternative method. The CFC group and any financial services subgroup must exclude such CFC from all group-level computations.

Rules for Computing ATI

To mitigate potential double-counting of income taken into account in the ATI of a CFC, any dividend received by an applicable CFC from a related person is subtracted from the distributee's taxable income, as the dividend represents income that could be part of the distributing corporation's ATI.

In the case of a U.S. shareholder of a CFC, to avoid double counting of the taxable income already included in ATI of a CFC, the US shareholder must subtract from ATI any gross income under subpart F, GILTI inclusion amounts and §78 gross-up inclusions in computing its ATI (subject to the ''addback rule'' discussed below when the ''CFC group election'' is in effect). Simultaneously, the US shareholder must add back to its ATI the §250 deduction that was attributable to the GILTI inclusion amount subtracted from the US shareholder's ATI (the §250 deduction would otherwise decrease the US shareholder's ATI given that it is factored into the general calculation of taxable income).

Where a CFC group election is in effect, there can be ''rolling up'' of excess taxable income to a higher-tier member. That is, an upper-tier CFC group member takes into account a proportionate share of the ''excess'' ATI of each lower-tier member in which it directly owns stock for purposes of computing the upper-tier member's ATI.

Further, if a U.S. shareholder owns, directly or indirectly through one or more foreign partnerships, stock of the specified highest-tier member for which a CFC group election is in effect and the specified highest-tier member has CFC excess taxable income attributable to taxable income of the CFC group that resulted in the US shareholder having specified income inclusions, the US shareholder may add to its taxable income an amount equal to its proportionate share of the ''eligible'' CFC excess taxable income of the specified highest-tier member and any other highest-tier members (addback rule). The ''eligible'' CFC excess taxable income under this addback rule shall be the portion of the CFC excess taxable income that is attributable to income that gave rise to subpart F or GILTI inclusions for the US shareholder (reduced by the portion of any §250 deduction that is allowable by reason of the GILTI inclusion). If a US shareholder

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of a CFC group member with a CFC group election is a domestic partnership, this addback rule does not apply. However, if a US shareholder partnership has a domestic C corporation partner (a US corporate partner), the addback rule is applied to the US corporate partner for purposes of computing the US corporate partner's ATI.

Application to Foreign Persons with ECI

Foreign persons are taxed only on ECI. To reflect this, the definitions for ATI, BIE, BII and floor plan financing interest expense are modified to limit such amounts to ECI items and expenses properly allocable to ECI.

In the case of a partnership engaged in a U.S. trade or business, the excess amounts of the partnership income can be used by a foreign partner (nonresident alien individual or non-CFC foreign corporation) only to the extent of the partnership's income that would be ECI. Thus, the amount of excess BII that can be used by such foreign partner is limited to effectively connected BII over allocable effectively connected BIE.

For a foreign corporation that has ECI, it must first determine its BIE allocable to ECI under Reg. §1.882-5 before applying §163(j) to determine if a portion of such BIE is disallowed. If the foreign corporation is also a partner in a partnership that has ECI, the foreign corporation must back out that portion of the BIE determined under Reg. §1.882-5 (because such BIE has already been subject to §163(j) at the partnership level) and the foreign corporation is then left with only the non-partnership BIE.

The Proposed Regulations also provide that disallowance and carryforwards of BIE will not affect the determination of effectively connected earnings and profits or US net equity for purposes of the branch profits tax under §884.

CERTAIN TRANSITION RULES

The Proposed Regulations provide for two transition rules: (a) a rule for corporations subject to the §163(j) limitation that join an acquiring consolidated group whose taxable year began before January 1, 2018 (which is therefore not yet subject to the new §163(j) limitation), and (b) a rule for taxpayers with carryforwards under §163(j) as it existed before the 2017 tax act (''Old §163(j)'').

First, the Proposed Regulations provide that, where a target corporation that is subject to the §163(j) limitation joins a consolidated group whose taxable year began before January 1, 2018, the status of the acquiring group will control the application of §163(j) to the target corporation for the period the target corporation is included in the acquiring consolidated group. For example, assume that on May 31, 2018, X, a standalone calendar year corporation is acquired by an acquiring consolidated group with a November 30 fiscal year. Beause the acquiring group has a taxable year that began before January 1, 2018, the acquiring group is not yet subject to new §163(j). The Proposed Regulations provide that X is subject to §163(j) for its short taxable year ended May 31, 2018 but is not subject to §163(j) for its taxable period beginning June 1, 2018 as a member of the acquiring consolidated group.

Second, the Proposed Regulations provide for two transition rules for certain carryforwards under Old §163(j). In some circumstances, Old §163(j) disallowed a deduction to a corporation for ''disqualified interest'' paid or accrued by the corporation during the taxable year if Old §163(j) applied to such year.[8] Further, Old §163(j) provided that any disallowed amount would be treated as disqualified interest paid or accrued in the succeeding taxable year. Consistent with the proposal in Notice 2018-28, the Proposed Regulations provide that a taxpayer's interest expense for which a deduction was disallowed under Old §163(j) is carried forward to the taxpayer's first taxable year beginning after December 31, 2017 (and is subject to disallowance under ''new'' §163(j) and, according to Notice 2018-28, to the new base erosion and antiabuse tax of §59A).

Old §163(j) allowed a corporation that was subject to limitation under Old §163(j) to add to its annual limitation any ''excess limitation carryforward'' from the prior taxable year.[9] Consistent with the proposal in Notice 2018-28, the Proposed Regulations state that, because new §163(j) does not include a provision for excess limitation carryforward, no amount of excess limitation left over under Old §163(j) from earlier taxable years can be carried forward to taxable years beginning after December 31, 2017.

LOOKING AHEAD

The Proposed Regulations are just one set among many sets of long and complex regulatory packages

[8] Old §163(j) generally defined ''disqualified interest'' as interest paid or accrued to a related wholly or partially tax-exempt party. Old §163(j) only disallowed interest expense up to a corporation's ''excess interest expense'' for a year, which was generally the corporation's ''net interest expense'' exceeding 50% of the corporation's adjusted taxable income.

[9] Under Old §163(j), a corporation's ''excess limitation'' for a taxable year was the excess of 50% of the corporation's adjusted taxable income over the corporation's net interest expense. The excess limitation was permitted to be carried forward into the corporation's three succeeding years. The excess limitation carryforward could then be used to reduce excess interest expense in the carryover year.

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implementing the 2017 tax act released in 2018. However, because §163(j) can impact both domestic and international business operations, tax advisors would do well to understand what it is the Proposed Regulations are attempting to accomplish. In the meantime, it is unclear whether the IRS will issue additional proposed regulations addressing certain items the Proposed Regulations reserve for (such as the application of §163(j) to tiered partnership structures) or whether those items will appear as a part of any final or temporary regulations.

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