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Confusion Cubed: New Regulations Address Deductions of Business Interest Expense

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Tom Peters, the management guru, famously observed, "If you're not confused, you're not paying attention."[1] Truer words could not be imagined for taxpayers having to apply the limitation on the deduction for business interest expense imposed by §163(j).[2] The provision is mind-numbingly complex and raises more issues than it answers. Lucky for us, however, on July 28, 2020, the Department of the Treasury (the "Treasury") and the IRS sought to answer some of those questions by replacing prior proposed regulations with 575 pages of explanation and final regulations (the "Final Regulations") and 285 pages of new proposed regulations (the "2020 Proposed Regulations"). This article provides a selective overview of this new guidance.

At the outset, we note that planning for the application of §163(j) is very important because if a taxpayer has unused capacity to deduct business interest in a particular year, it cannot carry over such unused capacity to another tax year. Conversely, however, any business interest that is not currently deductible carries forward and is deemed to arise in subsequent years until it can be deducted. Thus, taxpayers are keenly incentivized not to generate more business interest income (BII) and adjusted taxable income (ATI) than business interest expense (BIE) in a year if they expect the situation to reverse in subsequent years. In addition, partnerships desiring to take advantage of the new regulations without having to seek IRS permission must act by September 30, 2020.[3]

BACKGROUND

A tax provision has resided in §163(j) for quite some time. The Tax Cut and Jobs Act, however, overwrote everything that had been in that I.R.C. section for tax years beginning after December 31, 2017. Under the revised provision before the CARES Act amendments, a taxpayer is limited in the amount of "business interest" that it can deduct to the sum of the taxpayer's BII plus 30% of its ATI.[4] Section 2306 of the CARES Act[5] amended and loosened these rules for a limited period of time. For tax years beginning in 2019 and 2020, taxpayers may elect to deduct business interest to the extent it does not exceed the sum of BII and 50% of the taxpayer's ATI.[6]

The ATI definition is key here. ATI does not include items of non-business income and expense and is not reduced by net operating loss (NOL) deductions. As originally written, ATI for years prior to 2022 was equal to taxable income after adding back deductions for depreciation, amortization, and depletion.[7] This limited time add-back provides a robust ATI base against which interest can be deducted. The Final Regulations make a significant change to the ATI definition (from the definition in the prior proposed regulations) by allowing taxpayers to add back depreciation and similar expenses that have been capitalized

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[1] Peters, *Thriving on Chaos: Handbook for a Management Revolution* (Harper Perennial 1991).

[2] All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[3] Rev. Proc. 2020-23.

[4] §163(j)(1). The provision also increases the taxpayer's ability to deduct business interest expense by the amount of its floor plan financing interest. This latter limitation will be ignored in text. Interest that must be capitalized is not subject to §163(j) limits. Reg. §1.163(j)-3(b)(5).

[5] Pub. L. No. 116-136.

[6] §163(j)(10)(A)(i). The election is made separately for each tax year.

[7] §163(j)(8).

into inventory. After these add-backs expire, however, §163(j) will severely limit interest deductions for many taxpayers.

The rules for taxpayers invested in partnerships are unique. A taxpayer does not simply aggregate her share of partnership income and expense and apply the §163(j) limit at the partner level. Instead, if a partnership generates BIE in excess of its BII and ATI limit, such excess interest is ring-fenced and is deductible only when that partnership generates sufficient income to enable the partner to deduct the suspended business interest.[8] Conversely, however, if the partnership generates BII and ATI that is not utilized to deduct business interest at the partnership level, the partner may add those items to its limitation in determining its business interest deduction.

The CARES Act also amended how §163(j) applies to partnerships. The amendments allow partnerships to elect to partially suspend the ''silo'' treatment for 2019. Under the temporary rule, the partnership first nets its 2019 BIE against BII and 30% of the partnership's ATI. Then, for 2020 only, 50% of any excess business interest expense (EBIE) is treated as paid or accrued by the partner, and that amount may be deducted without being subject to limitation under §163(j).[9] The remaining 50% remains subject to the ''silo'' rules for partnerships under §163(j). These revised rules are elective.

A taxpayer may elect to not apply this increased limitation, but once such an election is made it can only be revoked with IRS consent. This election is made by the partnership, not the partner. The ability granted by the CARES Act to stay within the current regime will be very helpful for taxpayers grappling with strategies to minimize their base erosion and anti-avoidance tax (BEAT) liability imposed by §59A. By keeping deductible interest expense paid to affiliates low, taxpayers subject to BEAT can avoid making base erosion payments and/or avoid having to waive the deduction to minimize their BEAT liability.

This CARES Act section also affords taxpayers the ability to elect to use their 2019 ATI for purposes of computing their 2020 taxable year interest expense limitation. The policy behind this election is that the Covid-19 pandemic is likely to cause taxpayers to derive less income in tax year 2020 than 2019. Accordingly, by permitting the use of 2019 ATI, taxpayers will have a greater §163(j) threshold, thereby increasing the amount of deductible interest. Again, the ability to elect not to use 2019 ATI may assist with BEAT planning and, because its use is elective, not disadvantage taxpayers with higher 2020 ATI than 2019 ATI.

[8] §163(j)(4).

[9] §163(j)(10)(A)(ii)(I).

In November 2018, the IRS issued proposed regulations to implement the rules contained in §163(j) (the ''2018 Proposed Regulations'').[10] These regulations are replaced by the Final Regulations. The Final Regulations will apply to tax years beginning on or after 60 days after they are published in the Federal Register.[11] Taxpayers may elect to apply the Final Regulations to all tax years beginning after December 31, 2017, or instead elect to apply the 2018 Proposed Regulations to tax years before the Final Regulations apply.

THE DEFINITION OF BUSINESS INTEREST INCOME AND EXPENSE

One of the most controversial aspects of the 2018 Proposed Regulations was the attempt by the IRS to sweep a substantial amount of deductions other than deductions for interest under the §163(j) limit. Although the IRS vigorously defended its right to issue regulations that subject non-interest deductions to the §163(j) limit, the Final Regulations reverse the most over-reaching positions taken in the 2018 Proposed Regulations. The 2018 Proposed Regulations created four categories of deductions that were proposed to be limited by the application of §163(j), and these categories remain, as revised, under the Final Regulations:

1. Any amount treated as interest under another provision of the I.R.C. (this rule was adopted without change in the Final Regulations);[12]

2. Embedded interest in over-the-counter (OTC) notional principal contract (swap) payments;

3. Amounts that the IRS deems to be for the time value of money but are not otherwise treated as interest for tax purposes (including substitute interest payments in securities lending transactions); and

4. Amounts treated as interest under an anti-abuse rule.

Swaps: The IRS retained the rule that treats OTC (but not exchange-cleared) swaps with significant payments as creating interest (income for the recipient and deduction for the payer), but made some tech-

[10] REG-106089-18. Please see *https://www.mayerbrown.com/en/perspectives-events/publications/2018/11/overview-of-the-new-proposed-regulations-on-intere* for Mayer Brown's coverage of the 2018 Proposed Regulations.

[11] As of the date of publication, the Final Regulations have not been published in the Federal Register despite being publicly released on July 28, 2020.

[12] Reg. §1.163(j)-1(b)(22)(i)(A)-§1.163(j)-1(b)(22)(i)(P).

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nical corrections to clarify the rule.[13] First, the interest component is ignored for swaps with significant payments if a federal regulator requires that the swap be collateralized. Second, unless the swap is entered into with a principal purpose of avoiding the application of §163(j), the rule that treats embedded interest in prepaid swaps is delayed for one year to allow financial institutions to develop systems to track the interest component.

Bond Premium: The Final Regulations retain the treatment of bond issuance premium as interest income to the bond issuer and, to the extent deductible, interest expense of the bond holder.[14]

Factoring Income: The Final Regulations retain the treatment of factoring income as interest income unless the purpose of the factoring transaction is to artificially increase the factor's interest income for §163(j) purposes.[15]

Securities Lending and Repos: When a person borrows (lends) a debt instrument in a securities lending transaction, the substitute interest payment that it makes (receives) is generally treated as rent.[16] The Final Regulations do not recharacterize substitute interest payments as interest if the securities lending transaction is entered into in the ordinary course of the taxpayer's trade or business.[17] For taxpayers not lending securities in an ordinary course business transaction, however, substitute interest payments are characterized as interest. Amounts paid or received in connection with repos treated as debt for tax purposes will constitute interest.

Commitment Fees: The Final Regulations reverse the position taken in the 2018 Proposed Regulations and do not treat commitment fees as interest for either the payer or the lender. The IRS has stated that it might issue additional guidance on this issue in the future.

Debt Issuance Costs: The Final Regulations reverse the position taken in the 2018 Proposed Regulations and do not treat debt issuance costs as interest expense for the borrower.

Partnership Guaranteed Payments: The Final Regulations reverse the position taken in the 2018 Proposed Regulations and do not treat guaranteed payments for the use of capital as interest for either the payer partnership or the recipient partner unless the guaranteed payment has been structured with a purpose to avoid the application of §163(j).

Debt Hedges: The Final Regulations reverse the position taken in the 2018 Proposed Regulations and do not treat hedge income, gain, deduction, or loss as interest for either holders or issuers of debt. This exception applies to foreign currency, interest rate, and other hedges. An anti-abuse rule, however, can cause such income or expense to be treated as interest if a purpose of the hedge is to avoid §163(j) limits.

RIC Dividends: Regulated Investment Companies (RICs) that hold over 50% of their assets in tax-exempt obligations can designate an appropriate portion of the dividends that they pay as ''exempt interest dividends.''[18] The 2020 Proposed Regulations expand this concept and allow RICs to designate the portion of their dividends attributable to business interest income as such.[19]

The Final Regulations provide a saving rule for interest expense allowable as a deduction under §163(j) but subject to disallowance under either the ''at risk'' or ''passive activity'' rules.[20] In general, §163(j) is applied before the at risk and passive activity rules are applied. When such interest deductions become allowable under the at risk or passive activity rules, as the case may be, in years after the year in which the interest expense is incurred, the deductions are not retested for deductibility under §163(j). Instead, such deductions are allowable without regard to the §163(j) limit in the carryforward year.[21]

CARRY-OVERS OF EXCESS BUSINESS INTEREST EXPENSE

Generally, the amount of any business interest not allowed as a deduction for any taxable year as a result of the §163(j) limitation is carried forward indefinitely and treated as business interest paid or accrued in the succeeding taxable year.[22] As noted above, the carryforward of excess limitation is not allowed.

For a taxpayer that is a C corporation, current-year BIE is deducted in the current taxable year before any disallowed BIE carryforwards from a prior taxable year are deducted in that year.[23] Disallowed BIE carryforwards are deducted in the order of the taxable years in which they arose, beginning with the earliest taxable year, subject to limitations under other sec-

[13] Reg. §1.163(j)-1(b)(22)(ii).

[14] Reg. §1.163(j)-1(b)(22)(iii).

[15] Reg. §1.163(j)-1(b)(22)(iii)(E).

[16] Prop. Reg. §1.1058-1(d).

[17] Reg. §1.163(j)-1(b)(22)(iii)(C).

[18] §852(b)(5).

[19] Prop. Reg. §1.163(j)-1(b)(22)(F), §1.163(j)-1(b)(35).

[20] The passive activity loss rules of §469 and the at risk rules of §465 provide limits on the amount of net losses incurred by non-corporate taxpayers and closely held C corporations in any particular year. When these limits apply, the disallowed deductions carry forward and become deductible in future years when the taxpayer has passive activity income or amounts at risk, respectively.

[21] Reg. §1.163(j)-1(b)(3).

[22] §163(j)(2).

[23] Reg. §1.163(j)-1(b)(2).

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tions of the I.R.C.[24] Special carryforward rules apply to consolidated groups[25] and partnerships[26] as discussed below.

The Final Regulations revise the definition of ''disallowed business interest expense'' in response to comments requesting clarification as to when disallowed BIE carryforwards are treated as ''paid or accrued.'' Solely for purposes of §163(j) and the §163(j) regulations, disallowed BIE is treated as paid or accrued in the taxable year in which the expense is taken into account for federal income tax purposes (without regard to §163(j)), or in a succeeding taxable year in which the expense can be deducted by the taxpayer under §163(j), as the context may require.[27] The preamble to the Final Regulations explains that applying the carryforward rule without regard to context would lead to results inconsistent with congressional intent. For example, if a disallowed BIE were treated as paid or accrued only in a future taxable year in which such expense could be deducted after the application of §163(j), §382 never would apply to such expense because disallowed BIE carryforwards never would be pre-change losses.

In addition, the IRS amends certain regulations under other I.R.C. sections in order to coordinate with the §163(j) regulations.

The IRS confirms that a ''loss corporation'' under §382 includes a corporation that is entitled to use a disallowed BIE carryforward.[28] The IRS clarifies that a ''pre-change loss'' includes disallowed BIE of the old loss corporation paid or accrued in the taxable year of the testing date that is attributable to the pre-change period, including the pre-change period in the current year.[29] In allocating the current-year pre-and post-change BIE, disallowed BIE and disallowed BIE carryforwards, taxpayers are permitted to make a closing-of-the-books election or otherwise follow the allocation rules provided in the Final Regulations.[30] Additionally, like other pre-change losses carried over under the bankruptcy exception of §382, certain BIE carryforwards must be recomputed upon the conversion of a debt into equity.

Lastly, the preamble to the Final Regulations confirms that the ordering rules for the utilization of pre-change losses and pre-change credits and for the absorption of the §382 limitation and the §383 credit limitation remain unchanged.[31] A taxpayer's §382 limitation would be absorbed by disallowed BIE carryforwards before being absorbed by NOLs.[32] The ordering rules have raised concerns as the pre-2018 NOLs may expire before being utilized.

THE DEFINITION OF ATI

Because §163(j) limits the deduction of interest expense to the sum of a taxpayer's BII plus 30% of the taxpayer's ATI, the definition and calculation of ATI is key to the application of §163(j). The Final Regulations define ATI as the ''tentative taxable income'' of the taxpayer for the tax year subject to certain specified adjustments.[33] Tentative taxable income is defined as the taxpayer's taxable income under §63 but, to avoid circularity issues, computed without regard to the §163(j) limitation and without regard to any disallowed BIE carryforwards.[34]

First, the Final Regulations set forth a list of items that shall be *added* to the taxpayer's tentative taxable income to determine ATI, including (i) business interest expense (other than disallowed business interest expense carryforwards, already backed out from tentative taxable income), (ii) the NOL deduction under §172 and deductions for capital loss carrybacks or carryovers, (iii) the pass-through deduction under §199A, and (iv) for tax years beginning before January 1, 2022, depreciation, amortization, and depletion deductions.[35]

In a change welcomed by many taxpayers, the Final Regulations extend the add-backs described in (iv) above to depreciation and amortization expense that, instead of being deducted, is required to be capitalized into inventory under §263A. Section 263A generally requires certain taxpayers that manufacture or produce inventory to capitalize depreciation or amortization into the basis of the manufactured inventory. The amount so capitalized is subsequently recovered in the form of cost of goods sold, which reduces the gross income of the manufacturer. Prior to the issuance of the 2018 Proposed Regulations, taxpayers had raised the concern that certain capital-intensive manufacturers would be at a disadvantage compared to taxpayers engaged in other businesses because the manufacturers would not get the benefit of an ATI add-back for depreciation and amortization expense they were required to capitalize under §263A. The Treasury declined to provide any relief in the 2018 Proposed Regulations and specifically indicated that deprecia-

[24] Reg. §1.163(j)-1(b)(2).

[25] Reg. §1.163(j)-5(b)(3).

[26] §163(j)(4)(B).

[27] Reg. §1.163(j)-1(b)(10).

[28] Reg. §1.382-2(a)(1)(i)(A).

[29] Reg. §1.382-2(a)(7).

[30] Reg. §1.382-6.

[31] Prop. Reg. §1.383-1(d).

[32] Prop. Reg. §1.383-1(d).

[33] Reg. §1.163(j)-1(b)(1).

[34] Reg. §1.163(j)-1(b)(43).

[35] Reg. §1.163(j)-1(b)(1)(i).

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tion or amortization expense capitalized into inventory shall not be treated as a depreciation or amortization deduction for purposes of the ATI adjustments. The Final Regulations now reverse course and provide that depreciation, amortization, or depletion capitalized into inventory under §263A in a tax year beginning before January 1, 2022, will be added back to tentative taxable income, regardless of the period in which the capitalized amount is recovered through cost of goods sold.[36] Taxpayers that had opted to apply the 2018 Proposed Regulations in their entirety for tax years beginning before the issuance of the Final Regulations can now choose to follow this rule in the Final Regulations for those tax years (which may necessitate the filing of amended returns).[37]

Second, the Final Regulations provide for certain items that shall be *subtracted* from the taxpayer's tentative taxable income to determine ATI, including (i) business interest income, (ii) floor plan financing interest expense, (iii) in the case of the sale or disposition of property, the greater of the allowed or allowable depreciation or amortization with respect to the property for tax years beginning after December 31, 2017, and before January 1, 2022, (iv) in the case of the sale or disposition of stock of a member of a consolidated group, the investment adjustment amounts with respect to such stock that are attributable to deductions described in (iii), (v) in the case of the sale or disposition of a partnership interest, the taxpayer's distributive share of the deductions described in (iii) to the extent such deductions were allowable under §704(d), and (vi) Subpart F, GILTI and §78 income inclusions, net of any related §250 deduction (see below for a discussion around the ability to roll-up excess controlled foreign corporation (CFC) group limitation under the 2020 Proposed Regulations).[38]

The claw-backs described in (iii), (iv), and (v) seek to prevent taxpayers from realizing a double benefit with respect to depreciation and amortization deductions. If a depreciation deduction is added back to ATI when claimed, the incremental gain that a taxpayer realizes upon disposition of the depreciated property by reason of having claimed such depreciation deduction should not increase the taxpayer's ATI again. To prevent similar double benefits, adjustments also apply in the case of sales of stock of consolidated group members and partnership interests where the taxpayer's basis in the stock or partnership interest had been reduced by reason of an amortization or depreciation deduction.

Responding to a concern raised by commenters, the Treasury included a new anti-duplication rule in the Final Regulations pursuant to which the aggregate of the subtractions from tentative taxable income of a consolidated group with respect to an item of property cannot exceed the aggregate amount of the consolidated group member's depreciation or amortization deductions with respect to such item of property.[39]

The 2020 Proposed Regulations would allow taxpayers to use an alternative computation method for the claw-back of depreciation and amortization deductions such that the adjustment amount is capped at the amount of gain realized on the sale or disposition of the property, the group member stock or the partnership interest, as applicable. Taxpayers that desire to apply this gain limitation rule must apply it consistently to all dispositions of assets, stock, or partnership interests.

Finally, it is worth noting that the 2018 Proposed Regulations included certain ordering rules in the calculation of §163(j) ATI and the taxable income limitations under §172 and §250 to avoid circularity problems. The Final Regulations do not incorporate these proposed ordering rules. The Treasury notes in the preamble to the Final Regulations that further study is required to determine the appropriate rules for coordinating these provisions and that, until further guidance is issued, taxpayers may choose any reasonable approach (which could include ordering rules like the ones in the 2018 Proposed Regulations or simultaneous equations) as long as such approach is applied consistently for all relevant tax years.

THE PARTNERSHIP RULES

The §163(j) limitation is generally 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. 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 Final Regulations generally adopt the 2018 Proposed Regulations with some taxpayer-favorable modifications, which are highlighted below. The 2020 Proposed Regulations address certain items that were reserved in the 2018 Proposed Regulations.

Partnership Level ATI

A partnership generally determines its ATI in the same manner as described above (taking into account

[36] Reg. §1.163(j)-1(b)(1)(iii).

[37] Reg. §1.163(j)-1(c)(1).

[38] Reg. §1.163(j)-1(b)(1)(ii).

[39] Reg. §1.163(j)-1(b)(1)(iv)(D). For example, if an adjustment was made when group member S sold depreciated property to an unrelated person, no further adjustment shall apply if a member of the group subsequently sells S's stock to a third party.

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both separately and nonseparately stated items). A 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, partner basis items including §743(b) 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 at the partner level.

Partner Level ATI and Business Interest Income

Partner level ATI 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 the 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 business interest expense (EBII). The determination of a partner's share of excess taxable income and EBII 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 Final 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 Section 163(j) Excess Items

The Final Regulations generally retain the complex 11-step process for allocating deductible business interest expense (''deductible BIE'') and excess items (i.e., excess taxable income, EBII and BIE that exceeds the §163(j) limitation at the partnership level). These steps are used solely for this purpose and do not affect the partnership's allocations under §704(b). As noted above, these allocations are necessary because deductible 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. At the conclusion of the 11 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 new exception allows partnerships to bypass the 11-step process when each partner has a pro rata share of allocable ATI, allocable BII, and allocable BIE.[40] In that case, the partnership allocates its §163(j) excess items in the same pro rata proportions. This change should be a welcome simplification for partnerships that are able to rely on the exception (e.g., partnership that allocate all items in proportion to relative percentage interests).

Carryforwards

If a partnership has BIE in excess of its §163(j) limitation, the EBIE is allocated to the partners in accordance with the process noted above and is not carried forward by the partnership.

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 EBII 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 EBII). 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.

Partner Basis Adjustments in General

A partner's basis in its partnership interest is reduced by its share of deductible BIE and EBIE as determined in accordance with the steps noted above, regardless of whether such BIE is deemed paid or ac-

[40] Prop. Reg. §1.163(j)-6(f)(2)(ii).

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crued by the partner. However, deductible BIE and EBIE 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 EBIE allocated to the partner. EBIE from a prior taxable year that is suspended under §704(d) (negative §163(j) expense) is not treated as EBIE 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 EBIE, which is subject to the general carryforward rules.

Partner Basis Step-Up Upon Disposition of Interest

The 2018 Proposed Regulations provided for an increase in outside basis immediately before a disposition of partnership interest, but only if the partner disposed of substantially all of its interest. The increase equaled the amount of any EBIE that had not been deemed paid or accrued by the partner. In response to comments addressing the possibility for mismatches in tax gain and economic gain under this approach and other distortive effects, the Final Regulations adopt a rule that permits a basis increase upon any disposition of a partnership interest. Specifically, the basis of the retained partnership interest is increased immediately before the disposition by the amount of EBIE that is proportionate to the disposed of interest (based on the ratio of the fair market value of the transferred interest to the total fair market value of the interest).[41] The Final Regulations also provide that a disposition for this purpose is deemed to occur upon (1) a distribution or money or property in complete liquidation of a partnership interest and (2) a termination of the partnership under §708(b)(1).

Rules for BIE from Exempt Partnerships

In a change from the 2018 Proposed Regulations, the Final Regulations provide that BIE allocated by a partnership that is an exempt entity (i.e., that satisfies the small business exception) is not subject to the §163(j) limitation at the partner level.[42] In other words, BIE of an exempt partnership generally is not limited at either the partnership or the partner level. Similar rules apply for BIE received from S corporations that are exempt entities.

If a partner is allocated BIE from a partnership in one year and in a succeeding year the partnership is an exempt entity, the previously-allocated BIE remains potentially subject to the §163(j) limitation at the partner level in the succeeding year.[43] In addition, if a partner is allocated EBIE from a partnership and in a later year the partnership engages in excepted trades or businesses, then the partner does not treat any of its EBIE that was previously allocated from the partnership as BIE in such succeeding year by reason of the partnership engaging in excepted trades or businesses.

Special Rules for Trading Partnerships

Investment interest of a non-corporate taxpayer is deductible only to the extent of its investment income pursuant to §163(d). In the partnership context, a partner that does not materially participate in the partnership's trade or business (a ''passive partner'') is required to treat its allocable share of the partnership's BIE as investment interest.[44] Since §163(j) also imposes limitations on the deductibility of BIE in the partnership context, the 2018 Proposed Regulations addressed the interplay of those two limitations by treating BIE at the partnership level as being subject to §163(j) limitations and treating the §163(j) carryover items allocated to passive partners as being subject to §163(d) limitations. This approach reflected the view that a partnership is a separate taxpayer from its partners and §163(j)(5) only requires that interest expense cannot be both BIE and investment interest expense in the hands of the same taxpayer.

In light of the comments that this interpretation is at odds with the statutory language and intent of §163(j)(5), the 2020 Proposed Regulations adopt a different approach to address this issue – BIE from a trading partnership is allocated between passive partners and non-passive partners and the portion of BIE allocated to non-passive partners is subject to §163(j) limitations pursuant to the general rules described above and the portion allocated to passive investors is

[41] Prop. Reg. §1.163(j)-6(h)(3).

[42] Prop. Reg. §1.163(j)-6(m)(2).

[43] Prop. Reg. §1.163(j)-6(m)(3).

[44] §163(d)(5)(A).

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subject to §163(d) limitations only at the partner level and is not subject to §163(j) limitations.[45]

However, a trading partnership may not necessarily have sufficient information to determine whether a partner is a passive partner or not, because the current rule does not prevent a partner from grouping its activity with respect to such partnership with other activities of such partner outside the partnership. Therefore, the 2020 Proposed Regulations revise §469 activity grouping rules so that any activities relating to an active trade or business in which a taxpayer does not materially participate may not be grouped with any other activities of the taxpayer.[46] The Treasury has invited comments whether other feasible approaches may be available, including requiring each partner to annually certify its material participation in the partnership's trading activities.

Partner's Loan to a Partnership

The 2018 Proposed Regulations reserved on the treatment of BII and BIE with respect to lending transactions between a partnership and a partner. The 2020 Proposed Regulations provide that, in the case of a loan by a partner to the partnership (a ''self-charged lending transaction''), any interest expense of the partnership attributable to such loan is treated as BIE of the partnership for §163(j) purposes.[47] To allow the lending partner to offset interest income from the self-charged lending transaction against its share of BIE, if the lending partner is allocated EBIE from the borrowing partnership in a taxable year and has interest income attributable to the self-charged lending transaction, the lending partner shall treat such interest income as an allocation of EBII from the partnership in such taxable year to the extent of the lending partner's allocable share of EBIE from the borrowing partnership in such taxable year.[48] In addition, to prevent the double counting of BII, the lending partner includes interest income that was recharacterized as EBII only once when calculating the lending partner's own §163(j) limitation.[49]

For non-corporate lending partner, to the extent any interest income from the self-charged lending transaction exceeds the lending partner's share of EBIE from the borrowing partnership for the taxable year, and such interest income otherwise would be properly treated as investment income of the lending partner, such excess will continue to be treated as investment income of the lending partner for that taxable year for §163(d) purposes.[50] This rule allows the interest income received by the lending partner in respect of the self-charged lending transaction to be treated as investment income when the lending partner is not otherwise engaged in a U.S. trade or business of loan origination, while the business income expense of the partnership with respect to such self-charged lending transaction is subject to §163(j) limitations and potentially limited at the partner level as EBIE. This rule also ensures that a partnership engaged in a self-charged lending transaction will be subject to the §163(j) limitations to the same extent regardless of the sources of its loans.

Treatment of Excess Business Interest Expense in Tiered Partnerships

The 2020 Proposed Regulations also provide special rules relating to tiered partnership which were reserved in the 2018 Proposed Regulations.[51] Adopting an entity approach, the 2020 Proposed Regulations provide that if the lower-tier partnership (the ''LTP'') allocates EBIE to the upper-tier partnership (the ''UTP''), such EBIE is taken into account at the UTP level instead of being reallocated to the partners of the UTP.[52] In other words, the EBIE is carried forward by the UTP and will be taken into account to the extent of any excess taxable income or EBII subsequently allocated from the LTP or when the UTP disposes of its interest in the LTP.[53] The UTP's EBIE is treated as a non-depreciable capital asset with the fair market value of zero, thereby potentially creating negative adjustments under §734 or §743 in connection with any distribution of UTP assets or any transfer of UTP interests.[54] The fair market value of the UTP's EBIE will not be adjusted by any book up or book down as required by §704(b) regulations.[55] The tax basis of the UTP's EBIE is equal to the amount by which the UTP reduced its adjusted tax basis in the LTP due to the allocation of such EBIE.[56]

In addition, the UTP's adjusted tax basis in the LTP is reduced as a result of such EBIE, but the UTP partners' adjusted bases in the UTP are not.[57] Instead, such EBIE is allocated to the UTP partners as nondeductible §705(a)(2)(B) expense items and reduces

[45] Prop. Reg. §1.163(j)-6(c)(1).

[46] Prop. Reg. §1.469-4(d)(6).

[47] Prop. Reg. §1.163(j)-6(n).

[48] Prop. Reg. §1.163(j)-6(n).

[49] Prop. Reg. §1.163(j)-6(n).

[50] Prop. Reg. §1.163(j)-6(n).

[51] Prop. Reg. §1.163(j)-6(j).

[52] Prop. Reg. §1.163(j)-6(j)(1).

[53] Prop. Reg. §1.163(j)-6(j)(5).

[54] Prop. Reg. §1.163(j)-6(j)(4).

[55] Prop. Reg. §1.163(j)-6(j)(4).

[56] Prop. Reg. §1.163(j)-6(j)(4).

[57] Prop. Reg. §1.163(j)-6(j)(3).

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their §704(b) capital accounts in the UTP,[58] and the UTP partners' outside tax basis will be reduced as and when the UTP treats such EBIE as taken into account as BIE.[59]

The 2020 Proposed Regulations also provide for complicated anti-loss trafficking rules to prevent the transfer of the upper-tier partnership's EBIE.[60]

CONSOLIDATED RETURN RULES

Single Limitation

The Final Regulations continue to provide that a consolidated group has a single, group-level §163(j) limitation. ATI is the group's taxable income. Offsetting intercompany items of income and expense, including intercompany interest income and interest expense from intercompany obligations, are disregarded. One limited exception is made for repurchase premium paid to acquire a member's debt from a third party.

Having a single, group-level limitation can work for or against a member. A member may have a sufficient limit on a stand-alone basis to deduct its interest, but lose the ability to deduct interest if its allocable share of the consolidated limit is less. Conversely, a member unable to deduct interest on a stand-alone basis because of a low limit could benefit by being part of a group with a high limit.

Despite the single, group-level limitation, it is still necessary to track each member's current-year business expense and disallowed BIE carryforwards for purposes of determining each member's carryforward to the next year. That carryforward is a member-level attribute, just like a net operating loss, that follows the member when it leaves the group. Indeed, the Final Regulations treat a member's disallowed BIE carryforward as a deferred deduction subject to attribute reduction under the unified loss rules in Reg. §1.1502-36.

Ordering Rules

To apply the group limit, the taxpayer first determines the group's aggregate BIE including disallowed BIE carryforwards). If the limit exceeds that aggregate amount, then §163(j) does not limit deductions of either current-year BIE or carryforwards of disallowed BIE.

On the other hand, if the aggregate BIE (including disallowed BIE carryforwards) exceeds the group's limit, certain ordering rules apply. First, each member with current-year BIE deducts such BIE up to the amount of its current-year BII. Second, each member deducts its remaining current-year BIE up to its allocable share of the group's §163(j) limit. Third, if there is a §163(j) limit remaining, disallowed BIE carryforwards are deducted by members in the order of taxable years in which they arose, beginning with the earliest taxable year. Where two or more members have disallowed BIE carryforwards from the same taxable year, each member deducts its disallowed BIE carryforwards up to its allocable share of the remaining limit. Any current-year BIE or disallowed BIE carryforwards of a member that are not deducted are carried forward to the next taxable year.

SRLY Restrictions

The Final Regulations continue to provide that, in the case of consolidated group members, disallowed BIE carryforwards from separate return years are subject to the separate return limitation year (SRLY) limitation. The SRLY limitation generally limits the amount of a member's SRLY deductions or losses that may be included in the consolidated group's return to the net income generated by that member. It applies only when the use of the member's SRLY deductions or losses are not otherwise restricted by the ''ownership change'' rules of §382. The SRLY limitation is modified to ensure that the member is not permitted to claim SRLY deductions or losses in excess of the lesser of its own limitation or the group's §163(j) limitation for the year.

While the SRLY limitation generally operates on a cumulative basis, e.g., for NOLs (that is, any unused SLRY limitation can be carried forward to the next year), the 2018 Proposed Regulations provided that the SLRY limitation would operate only on an annual basis with no carryforward of unused limits. The Treasury believes that was more consistent with the post-TCJA version of §163(j), which did not retain the excess limitation carryforward provisions from pre-TCJA §163(j). The Final Regulations, in response to comments, adopt the more favorable cumulative approach for calculating the SRLY limitation, on grounds it better serves the SRLY objective of permitting a member to use pre-group carryforwards as if it were still a stand-alone corporation.

Anti-Abuse Rule

Final Regulations continue to provide that the single §163(j) limitation applies only to corporate members of a consolidated group, and does not extend to partnerships whose only partners are members of a consolidated group, or to affiliated groups that have

[58] Prop. Reg. §1.163(j)-6(j)(2).

[59] Prop. Reg. §1.163(j)-6(j)(5).

[60] Prop. Reg. §1.163(j)-6(j)(8).

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not elected to file a consolidated return. Applying aggregation to partnerships conflicts with the clear mandate in §163(j)(4) that partnership interest expense is limited at the partnership level. Moreover, the Treasury stated in the preamble of the Final Regulations that there is no support in the legislative history for treating non-consolidated corporations as a single taxpayer. Nevertheless, if a taxpayer attempts to take advantage of these structures by moving an excepted trade or business into a controlled partnership or non-consolidated corporation, and then causes that entity to incur debt with a purpose to avoid §163(j) limits, the anti-avoidance rule could override the intended tax treatment.

INTERNATIONAL CONSIDERATIONS

Application of Section 163(j) to CFCs

The Treasury doubled down on its position in the 2018 Proposed Regulations that §163(j) applies to CFCs for purposes of computing Subpart F income and GILTI, amidst commenters' arguments that this position lacked authority.[61] For 26 years §163(j) applied only to U.S. corporations. The TCJA expanded §163(j) to also apply to non-corporates including partnerships and individuals, by providing that the ATI limitation now applies to any ''taxpayer.'' Section 7701(a)(14) defines ''taxpayer'' as ''any person subject to any internal revenue tax.'' Is a CFC without effectively connected income (ECI), and thus without any obligation to file a U.S. tax return, a ''taxpayer?'' The TCJA legislative history is silent on applying §163(j) to CFCs. Nevertheless, the Treasury has sidestepped the ''taxpayer'' requirement by relying on a Subpart F regulation (Reg. §1.952-2) issued well before the TCJA, the fact that Congress did not expressly prohibit applying §163(j) to CFCs, and its belief that §163(j) should apply to any CFC ''whose income is relevant for U.S. purposes.''

ATI Reduction

The Final Regulations continue to provide that a U.S. shareholder of a CFC must reduce ATI by the excess of any inclusions of Subpart F income, GILTI or §78 gross-ups that are allocable to a non-excepted trade or business, over the amount of any §250 deduction allowed by reason of GILTI and related §78 gross-ups.[62] While this negative ATI adjustment is not described in the statute, the Treasury believes it is necessary because of its decision to apply §163(j) to CFCs, since there would be a double counting of this income if it were included in ATI at both the CFC and U.S. shareholder levels. Notably, while the Final Regulations confirm the general rule that CFCs must apply §163(j) as if they were U.S. corporations, the detailed rules applying §163(j) to CFCs remain in proposed form. Yet this negative ATI adjustment at the U.S. shareholder level is currently required under the Final Regulations. The only path for reversing this negative adjustment is to tier up excess ATI limitation under either the 2018 Proposed Regulations (with a CFC Group election) or the 2020 Proposed Regulations (with either a stand-alone CFC or CFC Group election).

Application of Domestic C Corporation Rules

The mandate in the Final Regulations to treat CFCs for §163(j) purposes as if they are U.S. corporations may sound simple in concept, but questions likely will arise due to obvious differences between these two types of entities. For example, does this mean that CFCs operating solely outside the United States can take advantage of the exceptions for businesses engaged in real estate, farming or regulated utilities, or small businesses?[63] Does the special rule in §951A that reduces a CFC's ''net deemed tangible income return'' by the CFC's net interest expenses apply before or after the application of §163(j)?[64] Are CFCs covered by a high tax exclusion election from GILTI nevertheless subject to §163(j) and included in a CFC

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[61] Note that because the Final Regulations continue to provide that a CFC's earnings and profits are determined without regard to any disallowance of BIE under §163(j), the application of §163(j) has a much greater impact on the U.S. taxation of GILTI than the U.S. taxation of Subpart F income.

[62] Note that, as explained above, the Final Regulations, similar to recent final regulations under §250, do not address the ordering for the application of §250 and §163(j); the preamble to the Final Regulations provides that taxpayers may adopt any reasonable approach for coordinating these taxable income-based provisions.

[63] Reg. 1.163(j)-1(b)(1)(ii)(G) of the Final Regulations provides that ATI is reduced by inclusions of Subpart F income, GILTI and §78 gross-ups that are ''properly allocable to a non-excepted trade or business.'' Prop. Reg. §1.163(j)-7(h)(3)(ii) and §1.163(j)-7(j)(9)(ii) of the 2020 Proposed Regulations apply the safe harbor election and the tiering up of excess limitation, respectively, to amounts ''properly allocable to a non-excepted trade or business.'' Thus, it appears that those exceptions apply at the CFC level.

[64] Section 951A(b)(2)(B) provides that interest expense deducted in arriving at tested income is deducted from the U.S. shareholder's net deemed tangible income return. This rule effectively eliminates the benefit of the deduction. If the §163(j) limit were applied *after* applying §951A(b)(2)(B), there could be a double elimination of the interest deduction. Thus, presumably the §163(j) limit is applied *before* applying §951A(b)(2)(B).

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Group election?[65] Do the CARES Act changes apply if a CFC Group election is not made?

CFC Group Election

The main substantive change made in the 2020 Proposed Regulations relates to the tax effect of making a ''CFC Group'' election.[66] Under the 2018 Proposed Regulations, the election forced a netting of the CFC Group members' interest expense and interest income to arrive at the group's ''net BIE.'' Then, each member, using its own ATI, applied its own §163(j) limit to its allocable share of the group's net BIE to determine the amount of its current-year BIE deduction or disallowed BIE carryforwards. The 2020 Proposed Regulations determine a §163(j) limit at the CFC Group level by comparing the group's ATI to the group's aggregate items of BIE, BII, and disallowed BIE carryforwards. Then, each member applies its allocable share of group's §163(j) limit to its own current-year BIE and disallowed BIE carryforwards to determine what is deductible and what must be carried forward.

The new group-level §163(j) limit is allocated to CFC Group members using the same allocation rules used for consolidated groups. Generally, the consolidated group rules allocate the limit to support a member's deductions based on the ratio of the member's BIE or disallowed BIE carryforwards to, respectively, the group's BIE or disallowed BIE carryforwards for the same taxable year. The 2020 Proposed Regulations also impose limitations on the group's use of a CFC's disallowed BIE carryforwards that were generated prior to the CFC joining the CFC Group (pre-CFC Group carryforwards), similar to the SRLY limitation for consolidated groups.

There are limits, however, on the extent to which the CFC Group rules are similar to the consolidated group rules, adding to the complexity for CFCs. Unlike the rules for consolidated groups, interest income and expense from debt between CFC Group members are not disregarded. These items may effectively be netted when calculating the §163(j) limit group-level limit, but are otherwise respected when determining each CFC's ability to deduct its current-year BIE or disallowed BIE carryforwards. Further, interest deductions on intercompany loans may be denied if, for example, a purpose is to force a deduction in excess of the borrowers' §163(j) limit in a year in which the U.S. shareholder has excess GILTI foreign tax credits, in order to reduce the U.S. shareholder's federal income tax liability.[67] Special rules (e.g., ''specified year'' and ''specified period'') are also needed because CFC's can have a variety of different taxable years, unlike consolidated group members.

Tiering Up Excess ATI Limitation

The benefits of making a CFC Group election under the 2018 Proposed Regulations included not only the ability to effectively net one member's interest expense against another member's interest income, but also the ability to ''roll up'' a CFC's excess ATI limitation (that is, generally the excess of the CFC's §163(j) limit over its current-year BIE and disallowed BIE carryforwards) to the U.S. shareholder (to the extent of its Subpart F and GILTI inclusions) and increase the U.S. shareholder's §163(j) limit. The roll-up benefit, however, was available only after the bottom-tier CFC's excess ATI limitation moved up the CFC chain to the highest-tier CFC before moving to the U.S. shareholder, in a series of iterative calculations. The CFC Group Election under the 2020 Proposed Regulations is intended to achieve the same benefits, except that the roll-up of the excess ATI limitation does not tier up through the CFC chain but, rather, moves directly from a CFC Group member having the excess limitation to the U.S. shareholder. This CFC-by-CFC calculation of excess ATI limitation under the 2020 Proposed Regulations, while different, does not appear on its face to be much less complicated than the method used in the 2018 Proposed Regulations.

Favorable Changes

The Final Regulations do make several changes that clearly are taxpayer-favorable. First, the CFC Group election was a one-time, irrevocable election, in the 2018 Proposed Regulations, whereas the 2020 Proposed Regulations permit an election to be revoked after five years. If an election is revoked, a taxpayer must wait at least five years before making a new CFC Group election.

Second, as a way to mitigate the long-term effect of even a five-year election, a CFC Group may make a

[65] Within a CFC Group there may be one or more ''tested units'' (the new standard under the final high-tax exclusion regulations) that qualify for the high-tax exclusion. While there is no express coordination between the final high-tax exclusion regulations and either the Final Regulations or the 2020 Proposed Regulations, one option is to apply the CFC Group's §163(j) limit to all the CFCs within the CFC Group and tier up from all the CFCs in the CFC Group having an excess limitation, subject, however, to a reduced cap on the tier-up that results from decreasing GILTI and/or Subpart F income from the high-tax exclusion election.

[66] A CFC Group is one or more chains of CFCs connected by 80% stock ownership, using §1504(a)(2)(B) principles, except that the 80% test is applied only to value (rather than vote and value).

[67] Prop. Reg. §1.163(j)-7(g)(4) (anti-abuse rule).

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''safe-harbor'' election on an annual basis to be exempt from the §163(j) limitation if the group's current-year BIE and disallowed BIE carryforwards are below a certain threshold. This election is not available, however, if the CFC Group has any disallowed BIE carryforwards attributable to pre-CFC Group carryforwards. Also, if the election is made, the U.S. shareholder is not permitted to share in the excess ATI limitation of any CFC Group member.

Third, the 2020 Proposed Regulations are more favorable to a U.S. shareholder that owns only a single, stand-alone CFC. Under the 2018 Proposed Regulations, a CFC Group Election was available only if the U.S. shareholder owned two or more CFCs. As a result, a stand-alone CFC could not tier up its excess limitation to the U.S. shareholder. While the 2020 Proposed Regulations similarly restrict the CFC Group election to two or more CFCs, a stand-alone CFC may make use of the annual safe-harbor election. Also, a stand-alone CFC's s excess limitation tiers up to the U.S. shareholder, provided a safe harbor election is not made.

Fourth, the 2018 Proposed Regulations had an unfortunate ''cliff rule'' where a CFC Group with any amount of ECI (even if *de minimis*) in a year was excluded from the group, which effectively meant it was permanently excluded because of the restrictions on changing an election. The 2020 Proposed Regulations provide that a CFC is not precluded from being a CFC Group member just because it has ECI. Instead, the CFC Group member's ATI, current-year BIE, BII and disallowed BIE carryforwards that are not attributable to ECI are included in the CFC Group's §163(j) calculations. The ECI is treated as if it were contained in a hypothetical separate corporation with the same shareholders and taxable year as the actual CFC, with a separate §163(j) calculation required for the ECI.[68]

The CARES Act added §163(j)(10), which increases the ATI limit from 30% to 50% in 2019 and 2020 for a ''taxpayer,'' and provides separate elections to retain the 30% limit for either 2019 or 2020, and to apply 2019 ATI to the 2020 ATI limit. Rev. Proc. 2020-22, issued on April 10, 2020, implies that the CARES Act changes as well as the two elections apply to any CFC without regard to whether a CFC Group election is made.[69] The 2020 Proposed Regulations, however, confuse matters by implying that the CARES Act changes apply only if the CFC is either part of a CFC Group or is a stand-alone CFC.[70]

Effective Date Possibilities

Taxpayers are faced with a smorgasbord of choices of whether, and how, to make a CFC Group election for periods after the effective date of the TCJA and before the finalization of the 2020 Proposed Regulations. The provision in the Final Regulations mandating the application of §163(j) to CFCs applies to a CFC's taxable year beginning after a 60-day period following the publication of the Final Regulations in the Federal Register; however, a taxpayer may apply the Final Regulations to 2018, 2019, and 2020 periods so long as the taxpayer and its related parties apply them consistently. The 2020 Proposed Regulations apply to a CFC's taxable year beginning after a 60-day period following publication of these regulations as final regulations in the Federal Register. However, if a taxpayer elects to apply the Final Regulations to the 2018-2020 period, the taxpayer may rely on the provisions in the 2020 Proposed Regulations involving CFCs for those same taxable years so long as the taxpayer and its related parties apply them consistently. If the taxpayer does not elect to apply the Final Regulations retroactively, then the taxpayer may still choose to apply the provisions in the 2020 Proposed Regulations involving CFCs beginning in 2021 until these proposed regulations are finalized, so long as they are applied consistently for each year. Finally, if the taxpayer does not elect to apply the Final Regulations retroactively, the taxpayer may rely on the 2018 Proposed Regulations for the 2018-2020 period so long as they are applied consistently.

For example, assume a U.S. shareholder has several CFCs, all of which have a calendar tax year. The Final Regulations would not be effective until January 1, 2021. The parties would have at least the following options for applying §163(j) to the CFCs:

1. Apply §163(j) to CFCs for the period beginning in 2018 and until the 2020 Proposed Regulations are finalized, pursuant to the Final Regulations and the 2020 Proposed Regulations;

2. Apply §163(j) to CFCs for the 2018-2020 period pursuant to the 2018 Proposed Regulations,

[68] The 2020 Proposed Regulations revise and re-propose the provisions in the 2018 Proposed Regulations relating to the application of §163(j) to CFCs with ECI, but make a helpful change by taking into account only income and activities associated with ECI rather than the CFCs entire income and activities. Prop. Reg. §1.163(j)-8.

[69] Rev. Proc. 2020-22, §6.02(3).

[70] The CARES Act changes are addressed in three instances in the 2020 Proposed Regulations, first in Prop. Reg. §1.163(j)-7(c)(5) which provides rules for how CFC Groups may make the elections, next in Prop. Reg. §1.163(j)-7(h) relating to the annual safe harbor election, and finally in Prop. Reg. §1.163(j)-7(j)(4) relating to the tiering-up of excess limitation to the U.S. shareholder. None of these situations applies to a CFC for which there is no CFC Group election in effect.

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and then pursuant to the Final Regulations and the 2020 Proposed Regulations for the period beginning in 2021 and until the 2020 Proposed Regulations are finalized;[71] or

3. Choose not to apply either the Final Regulations or the 2018 Proposed Regulations for the 2018-2020 period and rely solely on a reasonable position under the statute and legislative history that §163(j) does not apply to CFCs in 2018, 2019, or 2020, and apply the Final Regulations (either with or without the 2020 Proposed Regulations) starting in 2021.[72]

EXCEPTED TRADES OR BUSINESSES

General Rule

Certain small business taxpayers are wholly exempt from applying §163(j) to their BIE, 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 (i) the trade or business of performing services as an employee, (ii) an electing real property trade or business, (iii) an electing farming business, and (iv) certain utility businesses. 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) (i.e., slower depreciation for certain assets than otherwise, and importantly, losing the benefit of immediate expensing for qualified property). Each election applies to the taxable year for which the election is made and all subsequent taxable years and is generally irrevocable.

As noted, the interest expense of excepted trades or businesses is not BIE and is thus not subject to the §163(j) limitation. Similarly, though, ATI that is properly allocated to an excepted trade or business is not applicable for purposes of §163(j). If all of a taxpayer's interest expense is allocated to excepted trades or businesses or to non-excepted trades or businesses, then it is not necessary to allocate interest expense among trades or businesses. The same goes for ATI.

However, if a taxpayer has interest expense, interest income or ATI associated with both excepted and non-excepted trades or businesses, then it is necessary to allocate between the trades or businesses. The application of these concepts is chiefly ensconced in allocation rules that generally require an allocation of interest, income, deduction, and assets between separate trades or businesses (within an entity). The Final Regulations stay the course of the 2018 Proposed Regulations in relying on §162 and associated case law and administrative guidance as the metric for making such determinations in the context of §163(j), and do not create any new rules or further guidance for this purpose.[73]

Asset-Based Allocations for Interest

While the IRS received comments highlighting some of the inequality that can result among different taxpayers by using an asset-based approach to allocating interest income and expense among excepted and non-excepted trades or businesses, the Final Regulations indeed adopt this approach.[74] The taxpayer determines the adjusted basis in its assets for the tax year based on either a quarterly determination method or, if available, an annual determination method (i.e. the annual method uses the average of adjusted asset basis based on the first and last day of the applicable tax year). The annual determination method is only available if the taxpayer has demonstrated that its total adjusted basis at the end of the year in its assets used in the its excepted trades or businesses, as a percentage of the total adjusted basis in its assets, does not differ by more than 20% from such percentage at the beginning of the year. As in the 2018 Proposed Regulations, 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. The taxpayer's interest expense and interest income is allocated among the excepted or non-excepted trades or businesses on the basis of the relative amounts of adjusted basis in the assets from the applicable excepted and non-excepted trades

[71] The 2020 Proposed Regulations provide in Prop. Reg. §1.163(j)-7(e)(v) that a CFC Group election may be made under the 2020 Proposed Regulations even if an irrevocable election has already been made under the 2018 Proposed Regulations.

[72] Taxpayers are not required to follow proposed regulations, as they have no legal effect unless and until they are adopted.

[73] The Final Regulations, like the 2018 Proposed Regulations, include the observation that maintaining separate books and records for all excepted and non-excepted trades or businesses is an indication of a particular asset being used in a particular trade or business.

[74] If an asset is used in two or more trades or businesses during a determination period, then the taxpayer's basis in the asset may be allocated based upon one of three permissible methods. Different assets can use different methods of the three permissible methods depending on the method that most reasonably reflects the use of the asset.

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or businesses.[75] If at least 90% of the taxpayer's basis in its assets for the tax year is allocable to either excepted and non-excepted trades or businesses, then all the taxpayer's interest expense and interest income for that year is properly allocable to the 90% or more trades or businesses.[76]

Exceptions to the Asset-Based Allocation

The Final Regulations retain from the 2018 Proposed Regulation the qualified nonrecourse indebtedness exception from this general asset basis based allocation of interest expense. A taxpayer must directly allocate interest expense on qualified nonrecourse indebtedness to the relevant assets associated with the borrowing. The Final Regulations clarify that the taxpayer disregards only an amount of basis in the assets encumbered by qualified nonrecourse indebtedness which does not exceed the amount of the obligation (rather than the full basis of such assets). In addition, the 2018 Proposed Regulations provided that 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. The Final Regulations drop this exception and do not include a special direct allocation rule for financial and insurance businesses. However, the Final Regulations do not require a financial services entity (within the meaning of Reg. §1.904-4(e)(3)) to disregard its basis in cash, cash equivalents, and customer receivables in determining §163(j) allocations with respect to the assets of its trades or businesses.

Allocation for ATI

In terms of the allocation of items relating to ATI, as in the 2018 Proposed Regulations, gross income other than dividends and interest income is allocated to the trade or business that generated the gross income. Dividends are subject to a variety of look-through rules that generally follow the interest income approach in being based on an adjusted asset basis method with the 90% or more asset basis in either excepted or non-excepted trades or businesses resulting in an allocation in entirety to the relevant trades or businesses. With reference to §861, the Final Regulations provide that expenses (other than interest expense), losses and other deductions that are definitely related to a trade or business are allocable to the trade or business to which they relate.

Anti-Abuse Rule

The 2018 Proposed Regulations provided 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. The Final Regulations retain this general anti-avoidance rule and its ''principal purpose'' standard. The preamble to the Final Regulations explicitly rejected a comment letter's proposed standard of a transaction subject to the anti-abuse provision as a transaction that does not have a ''substantial business purpose.''

Real Property Trades or Businesses

Interest expense that is allocable to an ''electing real property trade or business'' (an ''ERPTB'') is not subject to the §163(j) interest deduction limitation.[77] A taxpayer that is engaged in a qualifying real property trade or business may elect to treat that trade or business as an ERPTB. However, a taxpayer that makes an ERPTB election must use the less favorable alternative depreciation system (ADS) and cannot claim bonus depreciation with respect to property used in the electing trade or business.[78] A taxpayer may make an ERPTB election with respect to a qualifying real property trade or business even if such business would be exempt from §163(j) under the small business exemption.[79] The preamble to the Final Regulations notes that some businesses that may

[75] The Final Regulations 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. As in the 2018 Proposed Regulations, in allocating the basis of stock of a domestic non-consolidated C corporation or a CFC, the shareholder must look through to the assets of the corporation if the shareholder's direct and indirect interest in the corporation (determined under the constructive ownership rules of §318(a)) is at least 80% by vote and value, and in a change from the 2018 Proposed Regulations, the Final Regulations provide that a shareholder may choose to look through to the corporation's assets if it directly owns at least 80% of its stock by value.

[76] The various allocation rules under Reg. §1.163(j)-10 contain a number of *de minimis* rules that are mandatorily applied and based on a standard of ''at least 90%.'' In addition, in certain circumstances, the application of the *de minimis* rules include ordering rules to eliminate confusion and potential divergent outcomes among taxpayers. For example, first an asset used in excepted and non-excepted trades or businesses determines whether it is wholly allocated to a particular trade or business on account of a 90% *de minimis* rule, and next, a taxpayer determines whether at least 90% of all its assets are allocated to the excepted or non-excepted trades or businesses (in order to allocation all of its assets to an excepted or non-excepted trade or business).

[77] Reg. §1.163(j)-9(a).

[78] Reg. §1.163(j)-9(c)(3).

[79] Reg. §1.163(j)-9(b)(2)(i).

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qualify for the small business exemption may nonetheless choose to elect to be an ERPTB in order to avoid needing to determine whether the business meets the annual gross income test to qualify for the small business exemption. It should be noted that, unlike an ERPTB, a business that meets the small business exemption is not required to use ADS and may claim bonus depreciation. Furthermore, an election to be an ERPTB is irrevocable.[80] Consequently, eligible taxpayers should carefully consider whether to make an ERPTB election, especially if they may otherwise be exempt from §163(j) under the small business exemption.[81]

Any real property trade or business described in §469(c)(7)(C) may elect to be an ERPTB.[82] Section 469(c)(7)(C) defines a real property trade or business as ''any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.'' The Final Regulations include new regulations under §469 that clarify that ''real property'' includes land, buildings, and other inherently permanent structures that are permanently affixed to land, or any interest in such property, and excludes machines and equipment that serve an active function (even if permanently affixed to land). Property that is manufactured or produced for sale that is not real property in the hands of the manufacturer or producer, but that may be incorporated into real property after it is sold, like bricks and windowpanes, is not real property.[83] The Final Regulations also clarify that real property operation and management means handling day-to-day operations of a trade or business relating to the maintenance and occupancy of real property used by paying customers, where such customers are paying primarily for the use of real property. The provision of significant or extraordinary personal services in connection with the real property where the use of the real property is only incidental to such services is not a qualified real property activity for this purpose.[84]

The 2020 Proposed Regulations provide that a qualifying ''development'' business includes the maintenance and improvement of raw land to make it suitable for subdivision and the construction of residential or commercial buildings (including excavation, clearing, and installation of infrastructure), and that a qualifying ''redevelopment'' business includes the demolition and removal of existing buildings and infrastructure to return land to a raw condition or otherwise prepare the land for new development.[85]

The Final Regulations provide a safe harbor under which a real estate investment trust (a ''REIT'') may make an ERPTB election with respect to all or part of its assets if the REIT holds real property, interests in one or more partnerships that hold real property, or shares in one or more other REITs that hold real property.[86] The real property may be held directly or indirectly through tiers of partnership and/or REITs. For purposes of the safe harbor, ''real property'' has the more expansive definition found in the REIT rules. If the REIT owns ''real property financing assets'' (e.g., mortgages and REMIC regular interests) with a value that does not exceed 10% of the value of the REIT's total assets at the close of the taxable year, the REIT may include such assets part of its ERPTB. However, if the value of the REIT's real property financing assets represents more than 10% of the REIT's total assets, then such assets will not be part of the REIT's ERPTB and the REIT must allocate its income and expenses between its excepted and non-excepted trades or businesses. The REIT safe harbor also applies to a partnership if one or more REITs directly or indirectly own at least 50% of the partnership's capital and profits, the partnership meets the REIT asset and gross income tests (as if it were a REIT), and the partnership otherwise qualifies for the REIT safe harbor (as if it were a REIT).

On the same date that the Final Regulations were released the IRS issued Notice 2020-59, which contains a proposed Revenue Procedure that would provide a safe harbor under which the management or operation of a qualified residential living facility that provides supplemental assistive, nursing, or routine medical services to customers or patients may elect to be an ERPTB. A qualified residential living facility is a facility that consists of multiple rental dwelling units that generally serve as primary residences on a permanent or semi-permanent basis, with an average period of customer or patient use that is 90 days or more. Qualifying supplemental services are personal and professional services that are customarily and routinely provided to individual residential customers or patients of nursing homes, assisted living facilities, memory care residences, continuing care retirement communities, skilled nursing facilities, or similar facilities, as needed, on a day-to-day basis. Such ser-

[80] Reg. §1.163(j)-9(c)(2).

[81] In addition, the preamble to the Final Regulations clarifies that a corporate partner in a partnership that conducts a real property trade or business is not entitled to unilaterally treat its share of the partnership's trade or business as an excepted trade or business. Rather, the partnership's trade or business is only an excepted trade or business with respect to the corporate partner if the partnership makes the §163(j) election.

[82] Reg. §1.163(j)-9(b)(1).

[83] Reg. §1.469-9(b)(2)(i)(A).

[84] Reg. §1.469-9(b)(2)(ii)(H), §1.469-9(b)(2)(ii)(I).

[85] Prop. Reg. §1.469-9(b)(2)(ii)(A), §1.469-9(b)(2)(ii)(B).

[86] Reg. §1.163(j)-9(h).

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vices generally do not include surgical, radiological, or other intensive or specialized medical services that are usually only provided in emergency or short-term in-patient or out-patient hospital or surgical settings. It should be noted that this safe harbor applies solely for purposes of determining whether a business may elect to be an ERPTB under §163(j), and does not apply for purposes of determining whether a taxpayer is engaged in a real property trade or business for purposes of §469. Once published, the proposed Revenue Procedure will apply for tax years beginning after December 31, 2017. However, taxpayers may rely on the safe harbor now.

The IRS previously issued Rev. Proc. 2018-59, which created a safe harbor for taxpayers who have entered into certain ''public private partnerships'' relating to certain infrastructure projects to be eligible to elect to be an ERPTB.[87]

The Final Regulations include an anti-abuse rule under which a trade or business may not elect to be an ERPTB if 80% or more of the fair market rental value of a taxpayer's real property is leased to a commonly controlled lessee.[88] Common control means that at least 50% of the direct and indirect ownership of the lessor and lessee is held by related parties. However, there are three exceptions to this anti-abuse rule.[89] First, there is a ''*de minimis*'' exception to the anti-abuse rule if at least 90% of the fair market rental value of the taxpayer's real property is leased to a person that is not under common control with the taxpayer, a person that is under common control with the taxpayer if such person has elected to be an ERPTB (to the extent the leased property is used in such ERPTB) and/or a person that is under common control with the taxpayer if such person is an excepted regulated utility trade or business (to the extent the leased property is used in such excepted regulated utility trade or business). Second, there is a ''look through'' exception to the anti-abuse rule to the extent that the taxpayer's real property is leased to persons described in the prior sentence (but such leases represent less than 90% of the fair market rental value of the taxpayer's real property so that the *de minimis* exception does not apply) and to the extent that such persons sublease the property to persons described in the prior sentence. Note that neither the lease nor the sublease needs to take the form of a lease, and the examples in the Final Regulations make clear that providing rooms in a hotel to guests can qualify as a sublease for this purpose. The foregoing two exceptions do not apply if the lessor and the lessee are part of the same consolidated group. Finally, there is an exception to the anti-abuse rule for leases of qualified lodging facilities or qualified healthcare properties by REITs and partnerships that elect to apply the REIT safe harbor described above (REITs typically lease such properties to a taxable REIT subsidiary that is controlled by the REIT pursuant to special REIT rules for such properties).

A taxpayer may elect to treat a qualifying trade or business as an ERPTB by attaching an election statement to the taxpayer's timely filed original federal income return.[90] The election will apply for the tax year for which the election is made and for all subsequent tax years, and is irrevocable. Due to the retroactive changes made to §163(j) under the CARES Act, earlier this year the IRS released Rev. Proc. 2020-22, which provided an automatic extension for qualifying taxpayers to elect to treat a qualifying trade or business as an ERPTB for taxable years 2018, 2019, and 2020. Rev. Proc. 2020-22 also provided an opportunity for taxpayers to withdraw a previously filed ERPTB election.

THE SMALL BUSINESS EXEMPTION

Under §163(j)(3), taxpayers with average annual gross receipts of $25 million or less (adjusted for inflation) for the three tax years immediately preceding the current year are generally not subject to the §163(j) limitation.[91]

Certain aggregation rules apply for purposes of the gross receipts test under the small business exemption.[92] Together with the Final Regulations, the IRS released an FAQ addressing the operation of these aggregation rules.[93]

Under the 2018 Proposed Regulations, taxpayers that qualified for the small business exemption were not eligible to make an election for a trade or business to be an electing real property trade or business or an electing faming business. Commenters requested the elimination of this restriction, noting that it may be simpler for a taxpayer to make the real property or farming business election than to collect the gross re-

[87] Please see https://www.mayerbrown.com/en/perspectives-events/publications/2019/01/the-publicprivate-partnership-infrastructure-excep for Mayer Brown's coverage of Rev. Proc. 2018-59.

[88] Reg. §1.163(j)-9(j)(1).

[89] Reg. §1.163(j)-9(j)(2).

[90] Reg. §1.163(j)-9(d).

[91] *See* §448(c).

[92] Generally, the aggregation rules combine the gross receipts of multiple taxpayers if they are treated as a single employer under the controlled group rules of §52(a) or §52(b), under the affiliated service group rules of §414(m), or under the rules of §414(o).

[93] *See* https://www.irs.gov/newsroom/faqs-regarding-the-aggregation-rules-under-section-448c2-that-apply-to-the-section-163j-small-business-exemption.

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ceipts information necessary to determine whether it is already exempt as a small business. The Treasury agreed with this comment and provided in the Final Regulations that a taxpayer may make a ''protective election'' for a trade or business to be an electing real property business or an electing farming business, even if the gross receipts test may be satisfied for the year of the election.[94]

The Final Regulations provide that qualification for the small business exemption is tested at the partnership level for partnerships.[95]

EFFECTIVE DATE CONSIDERATIONS

Taxpayers at a minimum, for taxable years 2018 through 2020, must decide whether to apply the 2018 Proposed Regulations, the Final Regulations, or no regulations at all. Under a special exception, taxpayers applying the 2018 Proposed Regulations to taxable years 2018 through 2020 may nevertheless benefit from the rule in the Final Regulations that adds back capitalized depreciation, amortization, and depletion to ATI.[96] For those taxpayers having issues addressed by the 2020 Proposed Regulations (e.g., CFCs), they also must decide whether to apply the 2020 Proposed Regulations retroactively to taxable years 2018 through 2020, or to 2021 and any later period prior to finalization of these regulations, or to not apply them at all.

The Treasury has imposed two conditions on a taxpayer's ability to ''rely'' on either the Final Regulations prior to their effective date or the 2018 or 2020 Proposed Regulations prior to them being finalized. The rules must be applied ''in their entirety'' and ''consistently.'' The ''entirety'' condition is straightforward, that is, it means the regulations may not be applied on a piecemeal basis. The ''consistently'' requirement is less clear. Taxpayers have questioned, for example, whether they can rely on the 2018 Proposed Regulations for 2018 and the Final Regulations for 2019 and 2020. Given the ''entirety'' requirement, there would always be consistency within a single year; thus, unless the Treasury clarifies the language, it appears that the term ''consistently'' requires consistency over the three-year period. As such, the taxpayer in that situation must either amend its 2018 return to apply the Final Regulations, or risk having a lack of reliance for all three years.

Having a right to rely on the application of either the 2018 or 2020 Proposed Regulations may not be critical to a taxpayer. Taxpayers may affirmatively cite existing proposed regulations as ''substantial authority'' for penalty purposes.[97] Moreover, where there are no final or temporary regulations in force on the particular issue, the IRS views proposed regulations on the particular issue as the agency's position and will not take a position harsher to the taxpayer than the result under the proposed regulations.[98] Thus, a taxpayer could cite as substantial authority the 2018 Proposed Regulations in the 2018-2020 period, and the 2020 Proposed Regulations beginning in 2021 until they are finalized or withdrawn, without complying with the two reliance conditions. As for the Final Regulations, however, the only way for a taxpayer to apply them retroactively is to comply with the two conditions for reliance.

Another option for a taxpayer is to not apply any set of regulations, final or proposed, to taxable years 2018 through 2020 with respect to certain issues, and to cite the 2018 Proposed Regulations as substantial authority for other issues in taxable years 2018 through 2020.[99] The Final Regulations, obviously, do not apply to 2018 through 2020 unless the taxpayer properly elects to rely on them, and taxpayers are not required to follow proposed regulations. Further, the IRS may not enforce proposed regulations against taxpayers. In the absence of regulations, a taxpayer may have substantial authority for a position even where it is supported only by a well-reasoned construction of the pertinent statutory provision as applied to the relevant facts.[100] For example, it is conceivable that a taxpayer could take the position that interest expense includes only expenses treated as interest under the I.R.C., or that §163(j) does not apply to CFCs (with the corresponding result that ATI is not reduced by inclusions of Subpart F income, GILTI or §78 gross-ups), in taxable years 2018 through 2020, while at the same time cite the consolidated return provisions in the 2018 Proposed Regulations as substantial authority for taxable years 2018 through 2020.

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[94] Reg. §1.163(j)-9(b)(2). The look-through rules for allocation of interest would apply to a partnership, non-consolidated C corporation or S corporation that makes this protective election. As such, the protective election may be advantageous because it may allow partners in a partnership to characterize their partnership interest as attributable to an excepted business under the look-through rules (which would not be an option if the partnership were simply exempt as a small business).

[95] Reg. §1.163(j)-6(m)(1).

[96] Reg. §1.163(j)-1(c).

[97] Reg. §1.6662-4(d)(3)(iii).

[98] CC-2003-114.

[99] Note that neither the IRS's commitment in CC-2003-114 to abide by its proposed regulations, nor the ability of taxpayers to cite proposed regulations as substantial authority, is conditioned on taxpayers applying the proposed regulations in their entirety.

[100] Reg. §1.6662-4(d)(3)(i).

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