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Global Tax Alert

US final and proposed regulations under Section 163(j) narrow definition of business interest expense, expand anti-avoidance rules and substantially revise rules for foreign corporations

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On 28 July 2020, the United States (US) Treasury Department released final regulations (TD 9905) with guidance on applying the limitations on the deductibility of business interest expense (BIE) under Internal Revenue Code[1] Section 163(j) (the Final Regulations), which was significantly modified by the *Tax Cuts and Jobs Act* (TCJA) and then temporarily modified by the *Coronavirus Aid, Relief, and Economic Security Act* (CARES Act). The Final Regulations provide guidance on what constitutes interest for purposes of the limitation, how to calculate the limitation, which taxpayers and trades or business are subject to the limitation, and how the limitation applies in certain contexts (e.g., consolidated groups).

Accompanying proposed regulations (REG-107911-18) (the Proposed Regulations) would provide additional guidance on several other aspects of the limitation, including (i) substantially revised rules for applying the limitation to US shareholders of controlled foreign corporations (CFCs), (ii) rules for foreign persons with effectively connected income (ECI), and (iii) specific aspects of the limitation as applied to partnerships, including partnerships engaged in the trade or business of trading personal property.

Simultaneously, the Internal Revenue Service (IRS) also issued Notice 2020-59, which creates a safe harbor allowing taxpayers that manage or operate qualified residential living facilities to be treated as a real property trade or business

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solely for purposes of qualifying as an electing real property trade or business. The IRS also released Frequently Asked Questions (FAQs) on the aggregation rules that apply for purposes of the gross receipts test and determining whether a taxpayer is a small business exempt from the Section 163(j) limitation. The FAQs provide a brief summary of existing authorities but do not shed any new light on the aggregation rules.

The Final Regulations generally are effective and generally apply to tax years beginning 60 days on or after the date the regulations are published in the Federal Register, with special effective dates for certain provisions. The Proposed Regulations would generally apply to tax years beginning 60 days after the date the Proposed Regulations are published as final. Subject to certain requirements, taxpayers generally may apply the Final and Proposed Regulations before their applicability date or may apply the proposed regulations released in 2018 (2018 Proposed Regulations), but generally must apply any set of regulations in their entirety. As a result, taxpayers should immediately begin to model and assess any benefits and adverse consequences resulting from this choice, along with its impact on historic, existing, and future tax attributes and planning (in particular for the 2019 tax year for calendar-year taxpayers).

This Alert highlights the significant changes to the 2018 Proposed Regulations and describes the key aspects of the Proposed Regulations applicable to partnerships, foreign corporations and foreign persons with effectively connected income (ECI).

Section 163(j) Final Regulations

Background

Section 163(j) limits the deduction for business interest expense for tax years beginning after 31 December 2017, to the sum of (1) the taxpayer's business interest income (BII), (2) 30% of the taxpayer's adjusted taxable income (ATI), and (3) the taxpayer's floor plan financing interest. Business interest expense (BIE) is interest that is paid or accrued on indebtedness that is properly allocable to a trade or business. The Section 163(j) limitation does not apply to certain trades or businesses, such as an electing real property trade or business, an electing farming business and certain activities of regulated utilities. Certain activities, such as performing services as an employee, are excluded from being a trade or business.

Treas. Reg. Section 1.163(j) -1: Narrowed definition of interest, but expanded anti-abuse rule

Treas. Reg. Section 1.163(j)-1 contains definitions used throughout the Final Regulations. Significant modifications to the 2018 Proposed Regulations include the following:

1. Definition of "interest"

The Final Regulations narrow the scope of items of income or expense that are specifically defined as interest by excluding:

- Certain substitute interest payments that are made or received in the ordinary course of a taxpayer's business (such as securities lending transactions conducted in the ordinary course of a taxpayer's business with a broker dealer)
- Commitment fees, the treatment of which will be addressed in future guidance, along with other fees paid in connection with lending transactions
- Debt issuance costs
- Guaranteed payments for the use of capital, though expanded anti-avoidance rules (discussed later) may apply
- Income, deduction, gain or loss from hedging transactions, though the expanded anti-avoidance rules may apply

A swap with significant non-periodic payments is generally treated as an on-market swap and a loan that generates interest subject to Section 163(j) (the embedded loan rule). The Final Regulations extend their applicability date for these swaps to one year after the Final Regulations are published in the Federal Register. In addition, the Final Regulations exclude cleared swaps, or non-cleared swaps that require parties to meet certain margin or collateral requirements, from the embedded loan rule. Accordingly, these swaps do not give rise to interest expense or interest income.

The modifications in the Final Regulations are welcomed. Additionally, the exclusion of items such as debt issuance costs and commitment fees places enhanced importance on distinguishing debt-related expenses such as those from original issue discount. As explained later, however, taxpayers must be wary of the potential for uncertain application of a broadened anti-avoidance rule.

2. Expanded anti-avoidance rules

The Final Regulations treat any expense or loss economically equivalent to interest as interest expense if a principal purpose of structuring the transaction(s) is to reduce an amount incurred by the taxpayer that otherwise would have been interest expense or treated as interest expense.

An expense or loss is economically equivalent to interest if the item is (1) deductible by the taxpayer, (2) incurred by the taxpayer in a transaction(s) (or series of integrated or related transactions) in which the taxpayer secures the use of funds for a period , (3) substantially incurred in consideration of the time-value of money, and (4) not otherwise described in Treas. Reg. Section 1.163(j)-1(b). Whether a taxpayer enters into a transaction(s) with a principal purpose to reduce an amount that would otherwise be characterized as interest expense depends on all facts and circumstances of the transaction(s). The taxpayer's business purpose and pre-tax cost of funds, however, are ignored.

In certain circumstances, items of income arising from transaction(s) subject to the anti-avoidance rule will be characterized as interest income. In addition, the Final Regulations contain anti-avoidance rules that prohibit taxpayers from artificially increasing interest income and largely mirror those previously described.

The Final Regulations contain examples that illustrate the application of the anti-avoidance rule and result in non-interest expenses or losses being treated as interest expense for purposes of Section 163(j), including examples of a hedging transaction involving a foreign currency swap, and a loan guaranteed by a related party.

The anti-avoidance rules apply to transactions executed on or after the date the Final Regulations are published in the Federal Register. Given their breadth, taxpayers need to be aware of potentially foot-faulting into interest treatment (such as through ordinary hedging transactions) and must be wary of arrangements that are not explicitly described in the Final Regulations and may be subject to the anti-avoidance rules.

3. *Tentative taxable income and adjustments to ATI, including addbacks for amortization of Section 263A capitalized expenses*

The Final Regulations use a taxpayer's "tentative taxable income" (TTI) (which is computed without regard to Section 163(j)) as the starting point for determining ATI.

In a significant change from the 2018 Proposed Regulations, the Final Regulations permit depreciation, amortization or depletion that is capitalized into inventory under Section 263A to be added back to TTI when calculating ATI for that tax year. In this regard, the Final Regulations allow taxpayers that previously chose to follow the 2018 Proposed Regulations to follow the Final Regulations.

The ability to add back all tax depreciation, amortization or depletion incurred in the tax year, regardless of whether it is in fact deducted or capitalized into inventory under Section 263A and recovered through cost of goods sold, is a welcome change in the Final Regulations. In addition to allowing the addback for capitalized depreciation, depletion and amortization, the Treasury Department appears to understand the complexity that would be associated with identifying when cost recovery allowances are recovered after they are capitalized to inventory. Accordingly, the Final Regulations allow these deductions to be added back to TTI when calculating ATI in the year the depreciation expense is allowed. This is significant because it simplifies the computation and eases the administrative burden associated with tracking when the inventory to which the cost recovery allowance is capitalized is sold and the tax basis of the inventory, including the capitalized depreciation, amortization or depletion, is recovered as cost of goods sold.

The Final Regulations modify the rules on adjusting ATI upon the sale or other disposition of depreciable property, stock of a consolidated group or interests in a partnership. The Final Regulations also modify rules for transactions within a consolidated group to avoid inappropriate double inclusions, and generally do not treat the transfer of depreciable assets in a Section 381 transaction as a "sale or other disposition" for purposes of adjusting ATI.

Finally, Treasury determined that further study is needed to coordinate Section 163(j) with other rules limiting the availability of deductions based on a taxpayer's taxable income (such as income-based deductions under Sections 250(a)(2), 170(b)(2), and 172(a)(2)). Until such guidance is effective, taxpayers may choose any reasonable approach for coordinating these provisions, so long as they apply the approach consistently for all relevant tax years. Treasury applied a similar approach to this issue in recently released regulations issued under Section 250. See EY Global Tax Alert, *US final GILTI/FDII regulations under Section 250 include guidance on Section 962 elections, pass-through FDII reporting*, dated 22 July 2020 for details.

Treas. Reg. Section 1.163(j)-2: Operative rules and coordination with CARES Act

Treas. Reg. Section 1.163(j)-2 makes corresponding changes to reflect modifications to Section 163(j) made by the CARES Act and adjusts the ATI limitation to 50% for tax years beginning in 2019 and 2020 (though taxpayers

may elect out). The 50% ATI limitation does not apply to partnerships for tax years beginning in 2019. Similarly, Treas. Reg. Section 1.163(j)-2(b)(3) allows taxpayers to elect to use ATI for the last tax year beginning in 2019 as the ATI for any tax year beginning in 2020. The provision addresses short tax years in 2020 by allowing the ATI in the last tax year beginning in 2019 to be prorated based on the number of months in the short 2020 year.

Treas. Reg. Section 1.163(j)-3: Relationship to other provisions affecting interest

The Final Regulations confirm that Section 163(j) applies after the application of other provisions subjecting the interest expense to disallowance, deferral, capitalization or other limitation. The Final Regulations clarify that an item characterized as something other than interest under another provision (such as Section 163(d)) is not subject to the Section 163(j) limitation. Although Section 163(j) generally applies before Sections 461(l), 465, and 469, the Final Regulations consider these provisions in determining TTI for purposes of computing ATI.

Unfortunately, the Final Regulations do not address the interaction between the Section 163(j) limitation and the cancellation of indebtedness (COD) income rules of Section 108. Instead, the IRS and Treasury determined that such coordination requires further consideration and may be the subject of future guidance. Without clarification, it is unclear whether disallowed interest carryforwards are subject to reduction under Section 108(b)(2), and whether a taxpayer could avoid COD under Section 108(e)(2) if the accrued but unpaid interest on the cancelled debt is disallowed under Section 163(j).

Treas. Reg. Section 1.163(j)-4: Application to C corporations and tax-exempt corporations

1. Corporate items are per se trade or business items

Consistent with the 2018 Proposed Regulations, all of a C corporation's interest expense and interest income, as well as all items of income, gain, deduction or loss, is allocated to a trade or business (either excepted or non-excepted, as discussed later), regardless of the nature of the corporation's activity. For a corporate partner of a partnership, Section 163(d) items (investment interest, investment income, investment expense) that the partnership allocates to the corporate partner as separately stated items are allocable to a trade or business of the corporate partner. The same treatment applies to items that are neither trade or business items nor Section 163(d) items and that the partnership allocates to the corporate partner as separately stated items. This does not affect characterization of such items at the partnership level.

Investment interest expense (or investment interest income) of a partnership that is allocated to a corporate partner is treated as BIE (or BII) of the corporate partner, and not excess business interest expense (EBIE) (or excess taxable income, (ETI)) of the partnership. Thus, if the allocated expense is disallowed, the corporate partner does not have to wait for ETI allocated to it by the partnership in future years to free up the expense (a favorable result). Similarly, the allocated income does not free up prior- year disallowed business interest allocated by the partnership to the corporate partner (an unfavorable result). Rather, the corporation's own items can allow the expense to be deducted.

2. Effect of interest disallowance on earnings and profits

The Final Regulations retain the general rule from the 2018 Proposed Regulations that the disallowance and carryforward of disallowed BIE does not affect whether or when that expense reduces the earnings and profits (E&P) of a corporation. If a corporate partner has been allocated EBIE by the partnership, has not yet been able to treat that interest expense as its own BIE (i.e., because the partnership has insufficient excess taxable income to free up the expense at the partner level) and then disposes of all or a portion of its partnership interest, the corporation increases its E&P before the disposition by its positive basis adjustment in the partnership interest. This ensures that the positive basis adjustment in the partnership before disposition (which would reduce gain or increase loss and thus negatively affect E&P) does not duplicate the E&P reduction when the interest was originally paid or accrued and allocated to the corporate partner. This rule has been adjusted in the Final Regulations to take into account that these partnership basis adjustments no longer require a disposition of substantially all of a partnership interest, but rather follow a proportionate approach.

3. Consolidated group Section 163(j) limitation and business interest

A consolidated group has a single Section 163(j) limitation. The Final Regulations' new concept of TTI is defined for a consolidated group as the group's consolidated taxable income, disregarding Section 163(j) BIE carryforwards and disallowance. For determining a consolidated group's ATI, intercompany items and corresponding items from intercompany transactions are disregarded to the extent

they offset in amount. Thus, such items are not included in the group's ATI even if one member, on a standalone basis, is engaged in a non-excepted trade or business and the other is engaged in an excepted trade or business.

A consolidated group's current-year BIE and BII are the sum of each member's amounts. Interest on an intercompany obligation under Treas. Reg. Section 1.1502-13(g) is disregarded for this purpose. In a notable change to the 2018 Proposed Regulations, however, the Final Regulations treat "inbound" transactions as giving rise to BIE when a member of a consolidated group buys the creditor position of another member's debt from a non-member at a premium. This overrides the general rule for intercompany obligations, because the deemed satisfaction of the debt instrument immediately after the acquisition is an item with respect to an intercompany obligation, and such items are generally excluded from BIE. This is an unfavorable change, because inbound transactions for which debt was valued at a premium above issue price appeared to be outside the scope of Section 163(j). Taxpayers wishing to take advantage of such transactions in tax years before the Final Regulations are effective should consider the advantages and disadvantages of relying on the 2018 Proposed Regulations for those years.

Treas. Reg. Section 1.163(j)-5: Disallowed business interest expense carryforwards

1. Disallowed business interest expense carryforwards

Consistent with the treatment of non-corporate taxpayers, current-year BIE is deducted before disallowed BIE carryforwards; carryforwards are then deducted on a first-in-first-out (FIFO) basis. For a corporation, this ordering is subject to Section 382; for a member joining a consolidated group, the ordering is subject to the separate return limitation year (SRLY) rules.

If a consolidated group has insufficient Section 163(j) limitation to completely deduct its current-year BIE, then each member first deducts interest to the extent of its own BII, and then deducts any remaining interest expense based on its proportion of the entire group's remaining interest expense. Any member with remaining interest expense not allowed in the current year carries it forward to the next year.

If a corporation ceases to be a member of a consolidated group during a year, the member's current year BIE, and its carryforwards arising during its years in the group, are first made available for the consolidated group in that year to the extent allowed. The amount not deducted by the group that year can then be carried forward to the departing member's separate return year. The carryforward would be subject to reduction under the loss duplication rule of Treas. Reg. Section 1.1502-36(d). The Final Regulations clarify that BIE carryforwards are generally "Category C" attributes for purposes of the loss duplication rule, meaning that they can be reattributed by election back to the group. EBIE allocated by a partnership is a "Category D" attribute, however, and thus cannot be reattributed. Taxpayers disposing of a consolidated subsidiary with disallowed BIE should consider the application of Treas. Reg. Section 1.1502-36 and should explore whether or not to elect to reattribute attributes of the subsidiary back to the group.

2. Separate return limitation year rules

The SRLY rules apply to disallowed BIE carryforwards arising in a SRLY (generally meaning a tax year other than a consolidated return year). The SRLY rules do not apply if there is a contemporaneous (or within six months) Section 382 ownership change with respect to the corporation with the carryforward, in which case the overlap rule turns off the SRLY rules.

The amount of a SRLY carryforward that can be included in the consolidated group's BIE for any year cannot exceed the group's aggregate Section 163(j) limitation for all consolidated years, only taking into account the member's items, reduced (including below zero) by the member's BIE that was absorbed by the group in all consolidated years (including expense that was disallowed and then carried forward). This is an important, and positive, change from the Proposed Regulations, which would have applied a "year by year" approach to the SRLY limitation, meaning that a member's ATI or BIE for a consolidated year that did not get utilized would have been lost. The Final Regulations change this approach and apply a "cumulative register" concept, consistent with the manner in which SRLY rules apply to NOL and capital loss carryforwards.

The Final Regulations also changed the way that intercompany transactions among group members affect a member's register. Whereas the 2018 Proposed Regulations would generally have disregarded items from intercompany transactions to the extent they offset, the Final Regulations include items from intercompany transactions in the SRLY calculations, other than interest income and interest expense from intercompany obligations (which remain disregarded for this purpose). Again, this is more consistent with the way that the SRLY rules apply to NOL and capital loss carryforwards.

Taxpayers that own a subsidiary with a SRLY-limited BIE carryforward should consider the impact of intercompany transactions to help (or hurt) the SRLY cumulative register.

Treas. Reg. Section 1.163(j)-6: Partnerships and S corporations

1. Overview

For partnerships, Section 163(j) applies both at the partnership and partner level. As a result, partnerships deduct the BIE arising at the partnership level to the extent allowed by Section 163(j) and the disallowed amount creates a partner-level tax attribute, EBIE. A partner may deduct that EBIE only if and when, in a subsequent year, the same partnership allocates the partner excess taxable income ETI. ETI is generally a partnership's ATI that is not used to support a partnership-level BIE deduction.

Treas. Reg. Section 1.163(j)-6 generally provides rules on applying Section 163(j) to partnerships and their partners, including rules on how to calculate the limitation and how to allocate a partnership's deductible BIE and Section 163(j) excess items to its partners. The Final Regulations largely adopt the 2018 Proposed Regulations. Key changes or clarifications of the rules applicable to partnerships and their partners immediately follow.

2. Allocation of EBIE and ETI (11-step process)

Section 163(j)(4) generally allocates partnership EBIE and partnership ETI to each partner "in the same manner as" the "non-separately stated taxable income or loss of the partnership." These terms are not defined by statute or regulations. As a result, it was unclear how to apply the rule to special allocations. The 2018 Proposed Regulations provided an 11-step approach for determining the Section 163(j) excess items of a partnership allocable to its partners.

The Final Regulations adopt the 11-step approach. Although complex, this approach attempts to preserve the entity-level calculation required in Section 163(j)(4) while also preserving the economics of the partnership, including respecting any special allocations made in accordance with Section 704(b) and its regulations. For partnerships that allocate all items of income and expense on a pro rata basis (pro rata exception), the Final Regulations provide an exception from steps 3 through 11 of the 11-step approach because these partnerships by nature "do not make the kinds of allocations the 11-step calculation is designed to address." Instead, these partnerships would allocate all Section 163(j) items in step 2 proportionately.

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

3. Partnerships not subject to Section 163(j)

Under Treas. Reg. Section 1.163(j)-6(m)(1), BIE allocated by an exempt small-business entity to its partners is not subject to Section 163(j) at the partner level. This is a favorable change from the 2018 Proposed Regulations, which required such amounts to be tested at the partner level.

To the extent a partnership is engaged in an excepted trade or business, Treas. Reg. Section 1.163(j)-6(m)(2) does not apply the Section 163(j) limitation for BIE allocable to such excepted trade or business. If a partner is allocated any Section 163(j) item that is allocable to an excepted trade or business of the partnership, those excepted Section 163(j) items are excluded from the partner's Section 163(j) deduction calculation.

If a partner is allocated EBIE from a partnership and, in a succeeding tax year, the partnership becomes an exempt entity (by meeting the small-business exception), then the partner treats any of its previously-allocated EBIE from that partnership as BIE paid or accrued by the partner in that succeeding tax year (potentially subject to the Section 163(j) limitation at the partner level). This rule, however, applies only to exempt entities. If a partnership is no longer subject to Section 163(j) by reason of becoming an excepted business (e.g., by making a real property trade or business election), the previously allocated EBIE does not get treated as paid or accrued at the partner level and instead carries forward as EBIE.

4. Basis adjustments upon partial disposition of partnership interest under Section 163(j)(4)(B)(iii)(II)

Under Section 163(j)(4)(B)(iii)(I), a partner's adjusted basis in its partnership interest is reduced (but not below zero) by the amount of EBIE allocated to the partner. If a partner disposes of a partnership interest, Section 163(j)(4)(B)(iii)(II) generally allows an increase in outside basis for unused carried-forward EBIE.

The Final Regulations adopt a proportionate approach to partnership dispositions, allowing for a partial increase to a partner's adjusted basis in its partnership interest being disposed. The basis increase occurs immediately before the

disposition and equals the EBIE allocated to that portion (applying principles similar to Revenue Ruling 84-53). This is a change from the "all-or-nothing" approach taken in the 2018 Proposed Regulations, which applied only upon the disposition of "all or substantially all" of the partner's interest in the partnership.

For purposes of Treas. Reg. Section 1.163(j)-6(h)(3), a disposition includes a distribution of money or other property by a partnership to a partner in complete liquidation of the partner's interest. The Final Regulations also clarify that each partner is considered to have disposed of its partnership interest under Treas. Reg. Section 1.163(j)-6(h)(3) if the partnership terminates under Section 708(b)(1). The Treasury and IRS requested further comments on whether a current distribution of money or other property by the partnership to a continuing partner as consideration for an interest in the partnership should also trigger an addback and, if so, how to determine the appropriate amount of the addback.

5. Partnership mergers and divisions

The 2018 Proposed Regulations reserve on guidance regarding the application of Section 163(j) to partnership mergers and divisions. According to the Final Regulations, the Treasury and IRS will not, at this time, provide special rules analyzing the consequences of a partnership merger or division in the context of Section 163(j) because, in most situations, a partnership merger or division can be appropriately analyzed under the rules of Treas. Reg. Section 1.708-1(c) and (d).

The Final Regulations adopt substantially all of the provisions under Prop. Reg. Section 1.163(j)-6, with certain clarifying exceptions and amendments; some of the amendments and changes made under the Final Regulations are welcome changes for partnership taxpayers.

Treas. Reg. Section 1.163(j)-7: Foreign corporations

Relying in part on Treas. Reg. Section 1.952-2, the Final Regulations confirm that Section 163(j) applies to any foreign corporation whose income is relevant for US tax purposes and has applied since the effective date of Section 163(j). The Proposed Regulations, however, would substantially modify the rules applicable to foreign corporations. See below for a discussion of those rules.

Treas. Reg. Section 1.163(j)-8: Foreign persons with ECI

The IRS and Treasury Department reserved on final rules on foreign persons with ECI. As discussed later, proposed regulations provide additional guidance on this topic.

Treas. Reg. Section 1.163(j)-9: Elections for certain trades or business and REIT safe harbors

Section 163(j)(7) provides general rules for certain types of business, such as a real property or farming trade or business, to elect to not be treated as a trade or business for purposes of Section 163(j).

Treas. Reg. Section 1.163(j)-10: Allocation rules

1. General rule

In general, interest expense and interest income are allocated between excepted and non-excepted trades or businesses based upon the relative amounts of the taxpayer's adjusted basis in the assets used in its trades or businesses. The Final Regulations modify the methodology for computing asset basis from the 2018 Proposed Regulations and permit taxpayers to compute asset basis by averaging basis amounts at the beginning and end of the year, so long as the taxpayer falls within a specified 20% de minimis threshold. Look-through rules apply to taxpayers that own interests in partnerships or corporations that are not part of the taxpayer's consolidated group. For non-corporate taxpayers that hold interests in partnerships, the Final Regulations refine the calculation of a partner's share of partnership investment assets in arriving at the partner's basis in its partnership interest for purposes of Treas. Reg. Section 1.163(j)-10.

Special rules apply for assets that are used in more than one trade or business. The Final Regulations allow taxpayers to use one of three specified methodologies to allocate interest income and expense among such trades or businesses, so long as the methodology is consistently applied. The Final Regulations clarify that taxpayers are not required to use the same methodology for different classes of assets. The IRS and Treasury Department determined that the choice of methodology is not a method of accounting and permit a taxpayer to change its methodology after five years without obtaining IRS consent.

2. Application to consolidated groups

Consistent with the general rule for non-corporate taxpayers, interest expense and interest income are allocated between an excepted trade or business and non-excepted trade or business based on the relative asset basis used in each trade or business. For this purpose, consolidated group members are treated as a single corporation, so the group (and not each member) is treated as engaged in excepted and non-excepted businesses.

For purposes of allocating by relative asset basis, basis arising from intercompany transactions are disregarded. This adds significant complexity, as taxpayers will have to monitor actual tax basis, as well as tax basis ignoring intercompany transactions. Also, property is not treated as used in a trade or business to the extent the use derives from an intercompany transaction. For example, if member S leases a manufacturing plant to member B, a manufacturer, the property is not considered used in a leasing business. Rather, the consolidated group (and not S or B individually) is treated as engaged in a manufacturing business.

Member stock is not an asset for allocation purposes, and the transfer of member stock to a non-member treated as a transfer of a proportionate amount of the member's assets (but no similar rule exists for the acquisition from a non-member of stock of a corporation that is or becomes a member). The same percentage of interest paid to any lender is allocated to excepted and non-excepted business, so which member pays the interest and whether that member individually engages in a particular business is generally irrelevant (except for a limited tracing rule for certain nonrecourse debt and certain financial companies).

A robust set of special rules apply to 80% ownership of domestic non-consolidated stock. This situation is not very common, as generally, taxpayers would file a consolidated return in such a situation. In some cases, the shareholder may look through to the non-consolidated subsidiary's assets; in other cases, the taxpayer must look through to the corporation's assets.

Treas. Reg. Section 1.163(j)-11: Transition rules

Treas. Reg. Section 1.163(j)-11 provides rules on applying Section 163(j) to a corporation when it joins a consolidated group whose tax year began before 1 January 2018, and on the treatment of carryforwards of disqualified interest. The Final Regulations adopt the transition rules of the 2018 Proposed Regulations without substantive changes. For a discussion of those rules, see EY Global Tax Alert, *US proposed regulations offer much-needed guidance on Section 163(j) business interest expense limitation*, 30 November 2018.

Section 163(j) Proposed Regulations

Prop. Treas. Reg. Section 1.163(j)-1(b): Definitions

The Final Regulations removed the "lesser of" approach for adjusting ATI for sales or dispositions of depreciable property. The Proposed Regulations would permit taxpayers to use this standard and extend its application to dispositions of partnership interests and member stock. Taxpayers choosing to use the "lesser of" standard must do so for all sales or other dispositions otherwise subject to Treas. Reg. Section 1.163(j)-1(b)(1)(ii)(C), (D) or (E).

In addition, the Proposed Regulations would permit a RIC to report a dividend as Section 163(j) interest income (an interest dividend). As a result, a RIC shareholder may report interest dividends as interest income under Section 163(j), subject to certain requirements. Certain RICs and the shareholders receiving interest dividends may rely on the Proposed Regulations for tax years ending on or after the date the Proposed Regulations were published in the Federal Register.

Prop. Treas. Reg. Section 1.163(j)-2: Deduction for business interest expense limited

The Proposed Regulations provide rules for electing under the Final Regulations to use ATI for the last tax year beginning in 2019 as ATI for any tax year beginning in 2020. For transactions to which Section 381 applies, the 2019 ATI of the acquiring corporation in a Section 381 transaction equals the amount of the acquiring corporation's ATI for its last tax year beginning in 2019. For consolidated groups, the 2019 ATI of a consolidated group would equal the consolidated group's ATI for its last tax year beginning in 2019.

Treasury requested comments on these proposed rules and on (1) whether the 2019 ATI of an acquired corporation in a transaction to which Section 381 applies should be included in the acquiring corporation's 2019 ATI for purposes of Section 163(j)(10)(B)(i), and (2) how such a rule would address more complex fact patterns.

Prop. Treas. Reg. Section 1.163(j)-6: Partnerships

The Proposed Regulations include certain modifications to Reg. Section 1.163(j)-6 on the applicability of the Section 163(j) limitation to partnerships, including proposed rules addressing:

- Election to substitute 2019 ATI for the partnership's 2020 ATI
- EBIE allocated to a partner in a tax year beginning in 2019
- Partnership basis adjustments upon partner dispositions
- EBIE treatment in tiered partnerships
- Application of Section 163(j) to partnership self-charged lending transactions
- Application of Section 163(j) to trading partnerships and publicly traded partnerships

1. Prop. Reg. Section 1.163(j)-6(d)(5) — Election to substitute 2019 ATI for partnership's 2020 ATI

For any tax year beginning in 2020, a partnership could elect under Section 163(j)(10)(B)(i) to determine its Section 163(j) limitation using its ATI for the last tax year beginning in 2019. This elective provision could cause a partnership to have ATI in tax year 2020 that does not match its net tax items comprising ATI for that tax year. Accordingly, the Proposed Regulations would modify the rules for determining the partners' allocable shares of ATI under the "11-step approach" in Treas. Reg. Section 1.163(j)-6(f) by referencing a similar rule that applies to tiered partnerships under Prop. Reg. Section 1.163(j)-6(j)(9).

2. Prop. Reg. Section 1.163(j)-6(g)(4) — EBIE allocated in a tax year beginning in 2019

Unless an opt-out election is made, Section 163(j)(10)(A)(ii)(II) requires a partner to treat 50% of its allocable share of a partnership's EBIE for 2019 as BIE in the partner's first tax year, beginning in 2020, that is not subject to the Section 163(j) limitation ("-6(g)(4) BIE"). The Proposed Regulations clarify that the remaining 50% of the partner's allocable share of the partnership's 2019 EBIE remains subject to the Section 163(j) limitation applicable to EBIE carried forward at the partner level. The Proposed Regulations would permit a partner disposing of a partnership interest in the partnership's 2019 or 2020 tax year to deduct -6(g)(4) BIE in tax year 2020; consequently, a basis increase would not immediately result before such disposition under these rules. Under Treas. Reg. Section 1.163(j)-6(h)(3), however, the remaining 50% of the partner's remaining EBIE increases the partner's basis in its partnership interest immediately before the disposition. Moreover, the Proposed Regulations clarify that a partner may elect out of applying this rule.

3. Prop. Reg. Section 1.163(j)-6(h)(5) — Partnership basis adjustments upon partner dispositions

As noted, Section 163(j)(4)(B)(iii)(II) increases a partner's adjusted basis in its partnership interest (the outside basis) immediately before the disposition by the partner of its interest by any remaining unused EBIE. The statute does not indicate whether there is a corresponding increase to the basis of the partnership's assets (the inside basis), the absence of which would create disparities between inside basis and outside basis that, according to Treasury and IRS, are inconsistent with the intent of Section 163(j) and subchapter K.

To eliminate potential disparities, the Proposed Regulations would require the partnership to increase its basis in its assets (inside basis) if a partner disposes of its partnership interest. The inside basis increase would equal the increase, if any, to the partner's outside basis in the partnership interest being disposed of by the transferor partner. The Proposed Regulations provide a method for allocating the increase to the inside basis of partnership property similar to the rules under Section 734(b) but would not permit the basis increase to be depreciated or amortized.

4. Prop Reg. Section 1.163(j)-6(j) — Proposed rules on the treatment of EBIE in tiered partnerships

Consistent with the approach taken under the statute, which applies and computes Section 163(j) at the partnership level, the Proposed Regulations provide an "entity approach" to the treatment of EBIE allocated by a lower-tier partnership (LTP) to an upper-tier partnership (UTP). Specifically, the proposed rules would provide that, when LTP allocates EBIE to UTP, UTP does not further allocate such EBIE to its partners.

The Proposed Regulations also include rules designed to ensure that a reduction in UTP's outside basis in its LTP interest when LTP allocates EBIE to UTP does not create a disparity between UTP's partners' outside basis in their partnership interests and their ' respective shares of the adjusted basis of UTP's property following that reduction. These rules would effectively create a capital loss asset (UTP EBIE) with tax basis equal to the amount by which UTP reduced its basis in its LTP interest and a fair market value of zero.

When UTP's outside basis in its LTP interest is reduced due to LTP's allocation of EBIE to UTP, the Proposed Regulations would decrease the Section 704(b) capital accounts of UTP's partners by an equal amount, as if it were an expenditure item under Section 705(a)(2)(B).

5. Prop Reg. Section 1.163(j)-6(n) -Partnership self-charged lending transactions

For lending transactions between a partner (lending partner) and partnership (borrowing partnership) in which the lending partner owns a direct interest (self-charged lending transaction), the Proposed Regulations would treat BIE of the borrowing partnership attributable to the self-charged lending transaction as BIE of the borrowing partnership for purposes of determining the partnership's Section 163(j) limitation. To the extent the lending partner was allocated EBIE from the borrowing partnership and had interest income attributable to the self-charged lending transaction, the

Proposed Regulations would require the lending partner to treat that interest income as an allocation of excess business interest income (EBII) from the borrowing partnership in that tax year; this treatment, however, would apply only to the extent of the lending partner's allocation of EBIE from the borrowing partnership in that tax year. The remaining interest income, if any, would be treated as investment income of the lending partner under Section 163(d) (as appropriate), unless the lending partner is a C corporation.

6. Application of Section 163(j) to trading partnerships and publicly traded partnerships

a. Trading partnerships

Proposed Regulations would require a trading partnership to bifurcate its interest expense and all other items of income, gain, loss and deduction from a trading activity between partners that materially participate in the trading activity and partners that are passive investors. The Proposed Regulations would treat only the portion of the partnership's interest expense that is allocable to the materially participating partners as subject to the partnership's Section 163(j) limitation; all other items would generally be treated as investment items subject to Section 163(d).

b. Publicly traded partnerships

To ensure the fungibility of traded units of a publicly-traded partnership (PTP), traded PTP units must have identical economic and tax characteristics. This is generally accomplished by coupling the remedial method for allocating Section 704(c) items with basis adjustments under Section 743(b). Consistent with ensuring the fungibility of a PTP's traded units, the Proposed Regulations would require a PTP, solely for purposes of Section 163(j), to allocate Section 163(j) excess items and items attributable to the PTP's inside basis (gain or loss, and depreciation or amortization) based on each partner's share of Section 704(b) items. In addition, the Proposed Regulations would treat any Section 743(b) adjustment of a purchaser of a traded PTP unit that relates to a remedial item that the purchaser inherits from the seller as an offset to the related Section 704(c) remedial item.

The Proposed Regulations continue to add to the complexity of applying Section 163(j) at the partnership level. The debt-financed distribution rules under Prop. Reg. Section 1.163-14 (described later) and the "entity approach" under Prop. Reg. Section 1.163(j)-6 would require numerous mechanical calculations for partnership taxpayers and their partners, adding to the Final Regulations' already complex 11-step process for allocating excess Section 163(j) items.

Prop. Treas. Reg. Section 1.163(j)-7: Foreign corporations

1. New CFC group election regime

As noted, Section 163(j) applies to a CFC as if it were a domestic corporation and on a CFC-by-CFC basis. The 2018 Proposed Regulations allowed certain CFCs to make a CFC group election (the old CFC group election) and be treated as part of a CFC group for purposes of Section 163(j). Importantly, the Final Regulations do not adopt the rules of the old CFC group election. Treasury instead proposed an entirely new Section 163(j) CFC group election regime (new CFC group election) as part of the 2020 Proposed Regulations.

The new CFC group election is largely based on rules under Treas. Reg. Section 1.163(j)-5 governing the application of a single Section 163(j) limitation to a US consolidated group determining the amount of BIE each member can deduct. Accordingly, if the new CFC group election is made, a "CFC group" (discussed later) computes a single Section 163(j) limitation for the group's current "specified period" (generally the period matching the tax year of the CFC group's "specified group parent," as discussed later).

The computation and application of the Section 163(j) group limitation to a specified period of a CFC group is based on the sum of each CFC group member's BIE, disallowed BIE carryforward, BII, and ATI (each determined generally on a separate-company basis) for the member's tax year ending with or within that specified period of the CFC group. Items of a CFC group member are translated into a single currency of the CFC group, which is either the US dollar or the functional currency of most of the CFC group members.

The 2018 Proposed Regulations did not specifically address whether CFC taxable income should be computed on a pre- or post-tax basis for purposes of Section 163(j). In a significant clarification of the 2018 Proposed Regulations, the Proposed Regulations would require a CFC's TTI to be computed on an after-foreign tax basis. This contrasts with the computation of TTI for domestic corporations, which generally is computed before taxes.

Unlike the consolidated group rules, intercompany obligations among members of the same CFC group are still generally respected in determining these relevant amounts for each member and the CFC group. Anti-abuse provisions would disregard any transaction that is between members of a CFC group and entered into with the principal purpose of

affecting a CFC group's (or group member's) Section 163(j) limitation by increasing or decreasing a CFC group's (or group member's) ATI under the CFC group election.

2. Effect of the new CFC group election

The extent to which a CFC group's Section 163(j) limitation is allocated to a particular CFC group member's current-year BIE and disallowed BIE carryforwards is determined using rules that apply to consolidated groups under Treas. Reg. Section 1.163(j)-5. If the sum of the CFC group's current-year BIE and disallowed BIE carryforwards exceeded the CFC group's Section 163(j) limitation, then current-year BIE would be deducted first. If the CFC group's current-year BIE exceeded the CFC group's Section 163(j) limitation, then each CFC group member would deduct its current-year BIE that did not exceed the sum of its BII and floor plan financing interest. If the CFC group has any Section 163(j) limitation remaining for the current year, each applicable CFC with remaining current-year BIE would deduct a pro rata portion thereof.

A CFC member's allocable share is the ratio of the member's BIE to the sum of the BIE for all members. If the CFC group Section 163(j) limitation for the specified period equaled or exceeded the aggregate amount of the members' BIE (and disallowed BIE carryforwards " "), then none of the members' BIE (and disallowed BIE carryforwards) could be disallowed under Section 163(j).

Example:

CFC1 is the specified group parent of a CFC group and owns 100% of the stock of CFC2 and CFC3, each a member of the CFC group. The CFC group's ATI is $100, CFC2 has BII of $10, so the CFC group's Section 163(j) limitation is $40 ([$100 * 30%] + $10). In addition, CFC2 and CFC3 each incurs $30 of BIE, so the CFC group's aggregate BIE is $60. Because the aggregate BIE of $60 exceeds the group limitation of $40, CFC2 first deducts $10 of BIE, which equals its own BII. Of the $20 of remaining BIE for CFC2 and the $30 of BIE for CFC3, CFC2 and CFC3 deduct their respective remaining BIE to the extent of the remaining group limitation ($30), in proportion to their respective share of net interest expense, with that proportion equaling 40% for CFC2 ($20 out of the $50 aggregate) and 60% for CFC3 ($30 out of the $50 aggregate). Thus, of the remaining $30 of group limitation, CFC2 deducts $12 and carries $8 forward, and CFC3 deducts $18 and carries $12 forward.

If the CFC group's Section 163(j) limitation for the specified period exceeded the aggregate of each member's current-year BIE, then all of the member's BIE could be deducted. Disallowed BIE carryforwards not in excess of the remaining CFC group's Section 163(j) limitation could be deducted in the order of the tax years in which they arose (i.e., a FIFO approach), and disallowed BIE carryforwards that arose in the same tax year could be deducted on a pro rata basis.

As described, the location of BII within the CFC group can affect the allocation of the CFC Group's Section 163(j) limitation under the new grouping rules, because the member with BII is first allocated the CFC Group's Section 163(j) limitation before the remaining limitation is allocated to each member, according to its relative BIE. The new CFC group election, however, would avoid the distortions inherent with the old 2018 CFC group election. The old CFC group election generally computed a single CFC group net BIE that was allocated to each member as the amount of interest expense subject to Section 163(j) at the member-level, and rolling up any CFC "excess taxable income" from a lower-tier CFC to upper-tier CFC that was included in the ATI of the upper-tier CFC. The roll-up nature of CFC excess taxable income favored ownership chains with CFCs with higher ATI and low BIE at the bottom, and CFCs with lower ATI and high BIE at the top. By following the consolidated group rules, the new CFC group election would generally avoid (apart from prioritizing the allocation of group limitation against BII) locational distortions.

3. Determining the CFC group

The rules for determining a CFC group employ technical definitions to identify members of the group and determine the "specified period" of the group in relation to each member tax years ending with or within that specified period (a specified taxable year).

The first step is to identify the "specified group" of "applicable CFCs" whose tax years end with or within the "specified period" of the group. An applicable CFC is a CFC with at least one US shareholder that directly or indirectly owns the CFC's stock. A specified group consists of one or more chains of applicable CFCs connected by stock ownership under a "specified group parent." A specified group parent may be (i) an applicable CFC (in which case it is a member of the CFC group), (ii) or a US corporation (treating a US consolidated group as a single corporation) or a US individual citizen or resident (each a qualified US

person). An applicable CFC that derives ECI would still be taken into account, although the ECI items of the applicable CFC would be excluded.

The specified group parent would be required to own directly (or indirectly) at least 80% of the total stock by value of at least one applicable CFC. Furthermore, one or more of the other applicable CFCs or the specified group parent would be required to own directly (or indirectly) at least 80% of the total stock by value in each applicable CFC (other than the specified group parent). Unlike the consolidated return context, indirect ownership through a partnership (or trust or estate) would be taken into account in determining whether the 80% ownership thresholds are met.

The specified period of the specified group is generally the tax year of the specified group parent. If the specified group parent is an applicable CFC, the group's specified period would be determined by reference to the required tax year of the CFC under Section 898(c)(1), without regard to the one-month deferral year allowed under Section 898(c)(2). If an applicable CFC were in a specified group on the last day of its tax year ending with or within a specified period, the CFC would be considered a group member for that specified period for that entire tax year.

4. Making the new CFC group election

The new CFC group election would be made for a specified period of a specified group so that the CFC group election applied to each specified group member for its entire specified taxable year ending with or within the specified period. A CFC group election would have to be made or revoked for a specified period of a specified group no later than the due date (including extensions) of the original federal income tax return for the tax year of each designated US person in which or with which the specified period ends.

Each "designated US person" would have to make the CFC group election no later than the due date of its original US income tax return (including extensions) for the tax year in which or with which the CFC group's specified period ends. For a specified group whose specified group parent is a qualified US person, the qualified US person would be the designated US person who makes the election. If the specified group has a parent that is an applicable CFC, then the designated US person would be each controlling domestic shareholder (as provided in Treas. Reg. Section 1.964-1(c)(5)). The Preamble to the Proposed Regulations requests comments on whether a specified group that does not make a CFC group election when it first comes into existence should be prohibited from making the election for 60 months.

Once made for a specified period of a specified group, the new CFC group election would remain in effect for each specified period of the specified group for a 60-month period. Only after the 60-month period has passed can the election be revoked; if an election were revoked, a new election could not be made for any specified period of the specified group that begins during the 60-month period following the last day of the first specified period for which the election was revoked.

An applicable CFC that becomes a member of a specified group as of the last day of its tax year ending with or within the specified period of the specified group for which a CFC group election is in effect would be subject to the CFC group election and become a group member. The new CFC group election rules would impose a SRLY limitation on pre-group disallowed BIE carryforwards of an applicable CFC joining a specified group. An applicable CFC that ceases to be a member of a specified group before the last day of its tax year causes the CFC group election to terminate solely for that CFC.

5. Annual safe harbor election

To reduce compliance burdens, the 2020 Proposed Regulations provide an annual safe harbor election. The safe harbor election could be made if the CFC group's BIE did not exceed 30% of the lesser of (i) the sum of the "eligible amounts" of each CFC group member, and (ii) the sum of the "qualified tentative taxable income" of each CFC group member. The eligible amount of a CFC group member would be the sum of the CFC's (i) subpart F income, and (ii) the approximate GILTI inclusion amounts that the CFC would have (determined as if the CFC were wholly-owned by domestic corporations, without any tested losses and without regard to the Section 250(a)(2) taxable income limitation).

The eligible amount of a CFC group member would also be computed without regard to Section 163(j). A CFC's qualified tentative taxable income is its TII (determined according to items only properly allocable to a non-excepted trade or business). Taxpayers should consider the potential applicability of the safe harbor, given that the components of the eligible amount (i.e., subpart F and GILTI) would be determined after interest expense, which is computed without regard to Section 163(j) and its regulations.

The IRS and Treasury Department expressed concern that a single, overleveraged CFC could potentially reduce or eliminate tested income from all CFCs owned by a US shareholder. The design of the safe harbor election,

which cannot be made if a CFC group's BIE exceeds 30% of subpart F income and the US shareholder's approximate GILTI inclusion, is consistent with this concern.

If the safe harbor election were made, then none of the BIE of each CFC group member would be disallowed under Section 163(j). No portion of CFC excess taxable income, however, would be included in a US shareholder's ATI (as discussed later) if the election were made. Taxpayers therefore should weigh the loss of including CFC excess taxable income in a US shareholder's ATI against the benefits of the safe harbor election.

The safe harbor election would be limited to "stand-alone" applicable CFCs (i.e., an applicable CFC that is not a member of a specified group) and applicable CFCs that are members of a CFC group. Thus, the safe harbor election would not be available to an applicable CFC that is a member of a specified group for which the CFC group election is not in effect. The safe harbor election also could not be made for a CFC group that has pre-group disallowed BIE carryforward. This is due to concerns that the deduction of a carryforward of pre-group disallowed business interest under the safe harbor election would circumvent the SRLY-limitations otherwise imposed on those amounts under the CFC group election rules.

Like the CFC group election, the safe harbor election would have to be made by the due date of each designated US person's original US income tax return (including extensions) for the tax year in which or with which the CFC group's specified period ends.

6. CFC excess taxable income and ATI of US shareholder

Under the Final Regulations, a US shareholder excludes from ATI its subpart F inclusions, GILTI inclusion (reduced by any Section 250(a) deduction allowed for the GILTI inclusion), and Section 78 gross-up on deemed paid taxes (specified deemed inclusions). The Proposed Regulations would allow a US shareholder with a CFC group election to effectively include in its ATI a portion of its specified deemed inclusions (other than the Section 78 gross-up) for a CFC that is attributable to the CFC's excess taxable income.

More specifically, Prop. Reg. Section 1.163(j)-7(j) would allow the US shareholder to include in ATI the portion of the specified deemed inclusions (other than the Section 78 gross-up) equal the ratio of the CFC's "excess taxable income" over its ATI. In turn, the CFC's excess taxable income would be its allocable share of the CFC group's excess taxable income that is allocated to the CFC pro rata according to its relative ATI.

Example:

USP wholly-owns CFC1 and CFC2, which constitute a CFC group with respect to which a CFC group election is in effect. CFC1 has $60 of subpart F foreign base company sales income and $40 of business interest expense (and thus $100 of ATI). CFC2 has $100 of subpart F foreign base company services income and has not incurred any business interest expense (and thus $100 of ATI). These are the only amounts of income of the CFCs, and neither CFC earns any business interest income. USP's subpart F income inclusion is $60 from CFC1 and $100 from CFC2.

Under the CFC group election, CFC1 can deduct the full $40 of business interest expense (CFC group's Section 163(j) limitation is $60 ($200 x 30%). The CFC group ETI is $67 (i.e., the amount of ATI that would support the deduction of an additional $20 of business interest expense under the CFC group's Section 163(j) limitation of $60).

Both CFC1 and CFC2's allocable share of the CFC group excess taxable income is $33.5. The amount of the subpart F income inclusion that USP can include in ATI with respect to CFC1 is $20 ($60 x ($33.5 / $100). The amount of the subpart F income inclusion that USP can include in ATI with respect to CFC2 is $33.5 ($100 x ($33.5 / $100).

7. Applicability date

Prop. Treas. Reg. 1.163(j)-7 would generally apply to tax years beginning on or after 60 days after the date the Proposed Regulations are published as final regulations. For any tax year beginning on or after 60 days after publication of the Final Regulations, taxpayers and their related parties may apply Prop. Treas. Reg. 1.163(j)-7 to the extent they consistently follow all the rules of Prop. Reg. Sections 1.163(j)-7 and -8 for that tax year and each subsequent tax year. For tax years beginning after 31 December 2017 and beginning before the applicability date of the Final Regulations, however, taxpayers may not apply Prop. Treas. Reg. 1.163(j)-7 unless they also choose to apply the Final Regulations and Prop. Reg. 1.163(j)-8 to those tax years.

Although Prop. Reg. 1.163(j)-7 may be applied retroactively, there is no apparent exception to the more specific requirement to make the new CFC group election (and annual safe harbor election) no later than the original return due date (including extensions). Thus, it is unclear whether a calendar-year taxpayer may file an amended return for its 2018 tax year to apply the new CFC group election to that year. Subsequent guidance by Treasury resolving this apparent inconsistency would be welcome.

In addition, the Preamble to the Final Regulations clarifies that taxpayers could only make a grouping election under the 2018 Proposed Regulations for tax years in which the taxpayer relies on the 2018 Proposed Regulations. Taxpayers may still rely on the 2018 Proposed Regulations until required to apply the Proposed Regulations.

Prop. Treas. Reg. Section 1.163(j)-8: Foreign persons with ECI

Although the 2018 Proposed Regulations included certain rules on how the Section 163(j) limitation applied to nonresident alien individuals and foreign corporations that are not applicable CFCs (specified foreign persons) with ECI, those rules were not finalized. Instead, Prop. Reg. Section 1.163(j)-8 re-proposes rules for determining deductible BIE and disallowed BIE carryforwards of a nonresident alien, foreign corporation or partnership that is properly allocable to ECI.

1. Application to specified foreign person with ECI

Similar to the 2018 Proposed Regulations, Prop. Reg. Sections 1.163(j)-8(b)(1)-(5) would modify ATI, BII, BIE, and floor plan financing to consider only ECI items for purposes of applying the Section 163(j) limitation to specified foreign persons. Specified foreign person refers to a nonresident alien individual, as defined in Section 7701(b), or a foreign corporation other than a relevant foreign corporation. Prop. Reg. Section 1.163(j)-8(b)(6) would consider only ECI items and assets that are US assets in determining the amount of interest income and interest expense allocable to a trade or business under the Final Regulations.

2. Rules for specified foreign partner

Prop. Reg. Section 1.163(j)-8(c) would modify the 2018 Proposed Regulations to determine the portion of a specified foreign partner's allocable share of ETI, EBIE and EBII that is treated as ECI and non-ECI. To determine the portion of ETI that is allocated to a specified foreign partner from a partnership and is ECI, the specified foreign partner's allocation of ETI from the partnership would be multiplied by its specified ATI ratio (which compares the specified foreign partner's distributive share of the partnership's ECI to its distributive share of the partnership's total income. For EBII, a similar rule would apply using the BII ratio (which compares the specified foreign partner's allocable share of BII that is ECI to its allocable share of total BII). For EBIE, the ECI portion would be determined by subtracting the portion of the specified foreign partner's allocable share of deductible BIE that is characterized as ECI from the specified foreign partner's allocable share of BIE that is characterized as ECI. To allocate between deductible BIE that is characterized ECI or not ECI, the Proposed Regulations provide for a hypothetical partnership approach, with certain limitations.

3. Characterization of disallowed business interest expense

The portion of deductible and disallowed BIE of a relevant foreign corporation that is characterized as ECI or not ECI would be determined under Prop. Reg. Section 1.163(j)-8(d), which is similar to Prop. Reg. Section 1.163(j)-8(c). This rule calculates the hypothetical Section 163(j) limitation for two hypothetical foreign corporations (i.e., a foreign corporation with ECI and one without ECI) and allocates the deductible BIE between the two hypothetical limitations. The disallowed BIE that is ECI would be determined by subtracting the portion of the relevant foreign corporation's deductible BIE that is characterized as ECI from the relevant foreign corporation's BIE that is ECI.

4. Rules for disallowed business interest expense

Disallowed BIE would be characterized as ECI or not ECI in the year in which it arises and would retain its characterization in subsequent years. Prop. Reg. Section 1.163(j)-8(e) also provides an ordering rule to determine the EBIE that is treated as paid or accrued by a specified foreign partner in a subsequent year. For purposes of characterizing deductible BIE and EBIE as ECI or not ECI, a specified foreign partner's BIE would be deemed to include its allocable share of EBIE of partnerships in which it is a direct or indirect partner. Accordingly, EBIE of both top-tier partnerships and lower-tier partnerships would be characterized as ECI or not ECI in the year it arises, even if not included in a specified foreign partner's allocable share of EBIE.

5. Coordination rules, definitions and examples

Prop. Reg. Section 1.163(j)-8(f) provides rules coordinating the application of Section 163(j) with Treas. Reg. Section 1.882-5. Generally, the foreign corporation must first determine its BIE allocable to ECI under Treas. Reg. Section 1.882-5 before applying the Section 163(j) limitation. Prop. Reg. Section 1.163(j)-8(f)(1)(ii) provides rules for determining the portion of a specified foreign partner's BIE that is ECI that is treated as attributable to a partner's allocable share of interest expense of a partnership. As a general matter, the partnership would determine whether its items of income and expense are allocable to ECI, but the partner would determine the amount of interest

expense that is allocable to ECI. Because Section 163(j) applies separately to partnerships and their partners, a determination must be made as to the source of Treas. Reg. Section 1.882-5 interest expense. Prop. Reg. Section 1.163(j)-8(f)(1)(iii) provides rules on how to attribute the Treas. Reg. Section 1.882-5 interest expense among the foreign corporation and its partnership interests. These rules, however, merely characterize interest expense of the foreign corporation and its partnership interests as ECI or not ECI. They do not change the amount of interest expense.

Prop. Treas. Reg. Section 1.163(j)-14: Allocation of interest expense among expenditures for pass-through entities

Prop. Reg. Section 1.163-14 would require taxpayers to apply a set of complex and mechanical rules in determining the Section 163(j) limitation on interest expense associated with debt-financed distributions made by a pass-through entity and debt-financed acquisitions of an interest in a pass-through entity. Prop. Reg. Section 1.163-14 would augment and modify the proceeds tracing rules under Temp. Reg. Section 1.163-8T and make the application of certain aspects of Notice 89-35 mandatory. A more detailed Alert on this guidance is forthcoming.

Implications

In general, the Final Regulations retain the same basic structure as the 2018 Proposed Regulations, with taxpayer favorable and unfavorable modifications. Favorable modifications include a narrowed definition of interest expense and the Section 263A addback; unfavorable modifications include expanded anti-avoidance rules and treatment of premiums upon deemed satisfaction/reissuance of debt as interest. Implications specific to each of the Final Regulations appear at the end of the regulation summary.

The Proposed Regulations would both increase (for partnerships) and simplify (for CFCs) administrative and compliance burdens under Section 163(j). In particular, the consolidated group approach to CFCs arguably places less importance on a group's legal structure (in turn, reducing the need for legal restructuring to maximize interest deductions), and may eliminate locational distortions inherent in the 2018 Proposed Regulations' ATI roll-up provisions. Computing CFC TTI on an after-foreign tax basis, however, may cause some confusion based on the disparate treatment in this regard between domestic and foreign corporations.

Treasury has requested comments on various aspects of the Final and Proposed Regulations. Taxpayers should consider submitting comments on those and other issues needing additional guidance.

Subject to certain requirements, taxpayers generally may elect to apply aspects of the 2018 Proposed Regulations, or some or all of the Final and Proposed Regulations, before their applicability dates. Accordingly, taxpayers should immediately begin to consider and model the potential benefits and adverse consequences of the myriad ways in which this choice can impact historic, existing and future tax attributes, and existing and future planning. The need for immediate modeling and consideration is particularly acute for prior years with fast-approaching filing deadlines, such as the 2019 tax year for calendar-year taxpayers. Such considerations must be balanced, however, against the (in some cases) uncertain manner in which taxpayers may retroactively apply such rules.

Endnote

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.

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