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US: New final regulations address application of Section 163(j) limitation to CFCs and partnerships, while reserving on certain provisions

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Executive summary

New final regulations (TD 9943, the 2021 Final Regulations), released 5 January 2021, provide guidance on applying the limitations on the deductibility of business interest expense under the United States (US) Internal Revenue Code[1] Section 163(j) (the Section 163(j) limitation), which was significantly modified by the *Tax Cuts and Jobs Act* (TCJA), and further modified by the *Coronavirus Aid, Relief, and Economic Security Act* (CARES Act). The 2021 Final Regulations retain the same basic structure as the proposed regulations released in July 2020 (the 2020 Proposed Regulations) and include certain definitions and rules for applying the Section 163(j) limitation to controlled foreign corporations (CFCs) and partnerships.

While the 2021 Final Regulations adopt much of the 2020 Proposed Regulations, they also include significant revisions and clarifications as discussed in more detail below. Additionally, the 2021 Final Regulations reserve on certain important provisions of the 2021 Proposed Regulations that the US Internal Revenue Service (IRS) continues to study, including: (i) the treatment of interest expense from debt-financed acquisitions of, and distributions from, passthrough entities; (ii) rules on partnership and partner basis adjustments upon partner dispositions; (iii) rules on the treatment of excess business interest expense in tiered partnerships; (iv) the computation of a US shareholder's adjusted taxable income (ATI) when a CFC group election is in place; and (v) the treatment of foreign persons with effectively connected income (ECI).

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Detailed discussion

Background

Section 163(j) limits the deduction for business interest expense (BIE) 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 ATI, and (3) the taxpayer's floor plan financing interest. 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.

In July 2020, the IRS released final regulations under Section 163(j) (the 2020 Final Regulations) addressing what constitutes interest for purposes of the limitation, how to calculate the Section 163(j) limitation, which taxpayers and trades or business are subject to the limitation, and how the limitation applies in certain contexts (e.g., consolidated groups). The 2020 Final Regulations generally apply to tax years beginning on or after 13 November 2020. Concurrently with the 2020 Final Regulations, the IRS issued the 2020 Proposed Regulations, setting forth the provisions that are now substantially adopted in the 2021 Final Regulations. For a discussion of the 2020 Final Regulations and 2020 Proposed Regulations, see EY 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*, dated 4 August 2020.

Applicability dates

The 2021 Final Regulations apply to tax years beginning on or after the date that is 60 days after the regulations are published in the Federal Register (applicability date). Except as otherwise provided, taxpayers may apply the Final 2021 Regulations to a tax year beginning after 31 December 2017, and before 60 days after the applicability date, provided that they consistently apply the 2021 Final Regulations and the 2020 Final Regulations to that tax year and each subsequent tax year. For tax years for which the 2021 Final Regulations do not apply, taxpayers may rely on the rules in the 2020 Proposed Regulations to the extent provided in the 2020 Proposed Regulations. Whether the incoming Biden Administration seeks to halt or suspend the application of the 2021 Final Regulations (for example, pending review of the regulations) remains to be seen.

The 2021 Final Regulations reserve on several provisions contained in the 2020 Proposed Regulations. To the extent that a rule in the 2020 Proposed Regulations is reserved, taxpayers may rely on that rule in the 2020 Proposed Regulations for a tax year beginning on or after 60 days after the 2021 Final Regulations are published in the Federal Register; to do so, however, the taxpayer must consistently follow all rules in the 2020 Proposed Regulations that are not finalized for that tax year and each subsequent tax year beginning on or before the date the Treasury decision adopting that rule as final applies or other guidance on continued reliance is issued.

2021 Final Regulations

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

The 2020 Final Regulations allow taxpayers to make positive adjustments to tentative taxable income (TTI) for certain items of depletion, depreciation and amortization (DDA). Conversely, the 2020 Final Regulations also require taxpayers to make negative adjustments to TTI upon the sale or disposition of certain property, a consolidated group member's stock and certain partnership interests. The 2020 Proposed Regulations permitted taxpayers to compute these negative adjustments as equal to the lesser of (i) the gain on the sale or disposition of the property, or (ii) the amount of allowed or allowable DDA deductions for the property during the tax years beginning after 31 December 2017, and before 1 January 2022 (the EBITDA[2] Period). The negative adjustments apply to consolidated member stock and partnership interests because the "outside basis" in such stock or interests reflects the DDA deductions taken by the member or partnership. The 2021 Final Regulations generally adopt the provisions of the 2020 Proposed Regulations regarding negative adjustments to TTI, provide clarifications to the ATI computation and offer new examples illustrating their application. Significant changes include the following:

- The only stock gain relevant for purposes of applying the "lesser of" standard to dispositions of member stock is the gain that is deemed recognized on the stock of the member holding the item of property (or the stock of a successor) for which DDA deductions were allowed or allowable during the EBITDA Period.

- Taxpayers may reduce negative adjustments to TTI to the extent they can demonstrate that prior-year additions to TTI during the EBITDA Period resulting from DDA deductions for such property did not increase the deductible BIE for those years (e.g., the increase in TTI in the prior year by reason of adding back DDA deductions did not in fact result in greater BIE deductions because the taxpayer had sufficient Section 163(j) limitation even without the add-back, or because the taxpayer did not incur BIE in the prior year).
- Negative adjustments are required upon the sale or disposition of property for which DDA capitalized under Section 263A is included in the computation of TTI during the EBITDA Period. The rule applies even when taxpayers did not elect to apply the 2020 Final Regulations retroactively, in which case capitalized DDA may or may not have been added back to TTI.
- Amounts taken into account by a consolidated group upon a "sale or other disposition" include the net gain the group would take into account, including as a result of intercompany transactions. According to the Preamble, this change ensures that gain taken into account by a consolidated group for purposes of certain negative adjustments is the same regardless of whether the property is sold in an intercompany transaction before leaving the group (i.e., to ensure that the consolidated group benefitting from the TTI add-back for DDA deductions has the same total TTI reduction in the year of disposition).
- An acquiring corporation in a Section 381 transaction described in Treas. Reg. Section 1.1502-13(j)(5)(i) is treated as a successor to the transferor corporation for purposes of certain negative adjustments required under the 2020 Final Regulations.
- Any transaction in which a member leaves a consolidated group is treated as a taxable disposition of all stock of the departing member held by any member of the consolidated group, unless the transaction is described in Treas. Reg. Section 1.1502-13(j)(5)(i) (correcting a previously incomplete cross-reference that omitted "reverse acquisitions" when a smaller consolidated group acquires a larger consolidated group).
- The disposition of property, member stock or partnership interests in a nonrecognition transaction (other than a deconsolidation, which is addressed elsewhere, and a Section 381 transaction, for which an exception exists) is treated as a taxable disposition for purposes of the gain prong of the "lesser of" computation (e.g., a Section 351 or Section 721 transaction is treated as a taxable disposition for this purpose, notwithstanding that no gain or loss is recognized).

The 2021 Final Regulations provide examples illustrating some of these rules (including application of the successor asset rules in Treas. Reg. Section 1.163(j)-1(b)(1)(iv)(C) and the anti-duplication rule in Treas. Reg. Section 1.163(j)-1(b)(1)(iv)(D)). The Treasury Department indicated it continues to study other aspects of the 2020 Final and Proposed Regulations, including alternatives to the "lesser of" standard proposed by commenters for potential future guidance.

Treas. Reg. Section 1.163(j)-2: Deduction for BIE limited

To coordinate with modifications made to Section 163(j) by the CARES Act, the 2020 Final Regulations allowed taxpayers to elect to use their ATI from the last tax year beginning in 2019 (2019 ATI) for any tax year beginning in 2020. For purposes of this election, the 2021 Final Regulations provide that the 2019 ATI of an acquiring corporation in a transaction to which Section 381 applies equals the amount of the acquiring corporation's ATI for its last tax year beginning in 2019. The 2021 Final Regulations also provide, for purposes of this election, that the 2019 ATI of a consolidated group equals the consolidated group's ATI for its last tax year beginning in 2019.

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

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 2021 Final Regulations adopt some of the rules from the 2020 Proposed Regulations and reserve on others.

The Final Regulations adopted, with some modifications and clarifications, the proposed rules addressing:

- Election to substitute 2019 ATI for the partnership's 2020 ATI
- Treatment of excess business interest expense (EBIE) allocated to a partner in a tax year beginning in 2019
- Application of Section 163(j) to partnership self-charged lending transactions
- Application of Section 163(j) to trading partnerships and publicly traded partnerships (PTPs)

Election to substitute 2019 ATI for partnership's 2020 ATI

For tax years beginning in 2020, Section 163(j)(10)(B)(i) allows a partnership to elect to determine its Section 163(j) limitation for that year using its ATI for the last tax year beginning in 2019. This elective provision may cause a partnership to have ATI in tax year 2020 that does not match the partnership's net amount of tax items that comprise ATI for that tax year. The 2021 Final Regulations require an electing partnership to determine each partner's allocable ATI by using the partnership's tax year 2019 Section 704 income, gain, loss and deduction as though those amounts were recognized by the partnership in tax year 2020.

The rule under the 2021 Final Regulations is a change from the 2020 Proposed Regulations. The 2020 Proposed Regulations modified 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 reference to a similar rule that applies to tiered partnerships under Prop. Reg. Section 1.163(j)-6(j)(9).

Given that the tiered-partnership rules were not finalized as part of the 2021 Final Regulations, the 2021 Final Regulations provide an alternate method for determining the partners' allocable shares of ATI in tax year 2020.

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 statute further requires the remaining 50% of the partner's allocable share of the partnership's 2019 EBIE to remain subject to the Section 163(j) Limitation applicable to EBIE carried forward at the partner level. If a partner disposes of a partnership interest in the partnership's 2019 or 2020 tax year, the 2021 Final Regulations allow the partner to deduct -6(g)(4) BIE in tax year 2020 so no basis increase results to that extent under the general rules immediately before the disposition; under Treas. Reg. Section 1.163(j)-6(h)(3), the remaining 50% of the partner's remaining EBIE increases the partner's basis in its partnership interest immediately before the disposition.

While the 2021 Final Regulations adopt the rule from the 2020 Proposed Regulations without substantive changes, the 2020 Proposed Regulations include two clarifications. If a partner disposes of its partnership interest in the partnership's 2019 or 2020 tax year, the 2021 Final Regulations clarify that the disposing partner can deduct -6(g)(4) BIE in tax year 2020, but only to the extent (i) that deduction would not have been limited under Section 704(d) immediately before the disposition, and (ii) that amount does not result in a basis increase under Treas. Reg. Section 1.163(j)-6(h)(3). The 2021 Final Regulations also clarify that partners may elect out of the 50-percent EBIE rule for each partnership interest held by the partner on a partnership-by-partnership basis.

Partnership self-charged lending transactions

The 2021 Final Regulations adopt the self-charged lending rule from the 2020 Proposed Regulations without substantive changes. 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 2021 Final Regulations treat the 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 is allocated EBIE from the borrowing partnership and has interest income attributable to the self-charged lending transaction, the 2021 Final Regulations provide that the lending partner shall treat that interest income as an allocation of excess business interest income (EBII) from the borrowing partnership in that tax year, but 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, is treated as investment income of the lending partner under Section 163(d) if it would otherwise properly be treated as such, unless the lending partner is a C corporation.

The Preamble to the 2021 Final Regulations states that the Treasury and IRS will not broaden the self-charged lending rule to allow partners in upper-tier partnerships that make loans to lower-tier partnerships to offset EBIE that may be suspended in those lower-tier partnerships, given the added complexity and administrative difficulties; they will, however, consider broadening the rule to include loans to partnerships by other members of the same consolidated group as a corporate partner.

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

The 2021 Final Regulations largely adopt the 2020 Proposed Regulations in requiring 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 2021 Final Regulations treat only the portion of the partnership's interest expense that is allocable to the materially participating partners as being subject to the partnership's Section 163(j) limitation. In addition, the 2021 Final Regulations require a trading partnership to bifurcate all its other items of income, gain, loss and deduction from its trading activity between passive-investor partners and all other partners. All partnership items properly allocable to passive investors are treated as investment items subject to Section 163(d).

In addition, the 2021 Final Regulations provide a transition rule permitting non-materially-participating partners in a trading partnership to deduct EBIE allocated to them from that partnership in any tax year ending before the effective date of the 2021 Final Regulations (without regard to the amount of excess taxable income or EBII that may be allocated by the partnership to the partner) in the first tax year ending on or after the effective date of the 2021 Final Regulations. EBIE that is no longer subject to the Section 163(j) limitation solely as a result of this transition rule will also not be subject to the limitation under Section 163(d). For example, assume a non-materially-participating individual partner has a carryforward of US$20[3] of EBIE from a trading partnership from tax year 2018 that previously reduced his tax basis in the partnership and that EBIE has not been freed up since 2018 through allocations of ETI or EBII. Under the transition rule, the partner can deduct the $20 as interest expense in tax year 2022 without considering any limitation under Section 163(d).

To be fungible, 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 2021 Final Regulations adopt substantially all of the provisions for PTPs set forth under the 2020 Proposed Regulations. These rules include allowing a PTP 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 2021 Final Regulations treat a 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. For example, assume there are two sellers in a PTP, L and M, where the units held by L would receive an allocation of $500 of annual remedial income and the units held by M would receive an allocation of $500 of annual remedial deductions. A purchaser of the L units would step into the shoes of the seller for $500 of annual remedial income and would have an annual Section 743(b) deduction of $1,000 (net $500 of deductions). Under this rule, a purchaser of the L units would offset its Section 743(b) deduction against its remedial income and only consider net deductions of $500 for the purchaser's ATI purposes. This puts a purchaser of L units in the same position as a purchaser of M units.

Proposed partnership rules not finalized with the 2021 Final Regulations

The 2021 Final Regulations did not finalize some of the more complex rules introduced with the 2020 Proposed Regulations. Specifically, Treasury and the IRS continue to study and analyze the debt-financed distribution rules under Prop. Reg. Section 1.163-14, the tiered-partnership rules, and the partnership and partner basis adjustments under Prop. Reg. Section 1.163(j)-6, which would require numerous mechanical calculations for partnerships and their partners. These rules remain proposed; taxpayers and their related parties may rely on the 2020 Proposed Regulations rules that were not finalized, subject to the associated applicability provisions under the 2020 Proposed Regulations. The 2020 Proposed Regulations would require early adopters to apply all of Prop. Reg. Section 1.163(j)-6; consequently, taxpayers interested in adopting the taxpayer-friendly self-charged lending rule or the rule for non-materially participating partners in a trading partnership would also have to adopt Prop. Reg. Section 1.163(j)-6's rules for tiered partnerships and for partnership and partner basis adjustments. Thus, it is welcomed relief that the 2021 Final Regulations give taxpayers an option to early adopt the favorable provisions without the need to adopt the more complex rules in the 2020 Proposed Regulations.

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

The Final Regulations adopt the CFC group election regime introduced by the 2020 Proposed Regulations, with certain modifications. The 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 and determining the amount of BIE each member can deduct. Accordingly, if a 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.

Generally, a taxpayer's ATI cannot be less than zero (the no-negative ATI rule). In a change from the 2020 Proposed Regulations, the 2021 Final Regulations modify the no-negative ATI rule in the context of a CFC group. If a CFC group member's ATI is limited to zero under the no-negative ATI rule, the CFC group's ATI would arguably be overstated because CFC group's ATI would include all positive CFC ATI but exclude all negative CFC ATI. Under the 2021 Final Regulations, the no-negative ATI rule is modified so that the ATI of CFC group members takes into account amounts less than zero for purposes of determining the ATI of a CFC group. The ATI of a CFC group, however, cannot be less than zero.

In another significant change from the 2020 Proposed Regulations, the deduction for foreign income taxes (under Treas. Reg. Section 1.960-1(b)) is not taken into account when computing CFC ATI under the 2021 Final Regulations. This provides parity between CFCs and domestic corporations, which do not deduct federal income taxes in determining ATI.

Unlike the consolidated group rules, intercompany obligations among members of the same CFC group are still generally respected in determining the relevant amounts for each member and the CFC group. Anti-abuse provisions disregard any transaction that is between members of a CFC group and entered with the principal purpose of affecting a CFC group's (or group member's) Section 163(j) limitation by (i) increasing or decreasing a CFC group's (or group member's) ATI or (ii) increasing a CFC group's (or group member's) BII. The application of the anti-abuse rule to intragroup transactions that increase BII is a new provision introduced in the 2021 Final Regulations.

Effect of the 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 exceeds the CFC group's Section 163(j) limitation, then current-year BIE is deducted first. If the CFC group's current-year BIE exceeds the CFC group's Section 163(j) limitation, then each CFC group member deducts its current-year BIE that does 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 deducts a pro rata portion thereof.

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

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 year ending with or within that specified period (a specified tax 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 generally consists of one or more chains of applicable CFCs connected by stock ownership under a "specified group parent." The 2021 Final Regulations clarify, however, that a specified group may also exist when a US shareholder directly owns all its applicable CFCs (rather than owning applicable CFCs through one or more "chains"). Further, there must be at least two applicable CFCs in a specified group for an applicable CFC to be a specified group member and for a CFC group election to be available.

A specified group parent may be (i) an applicable CFC (in which case it is a member of the CFC group), or (ii) a US corporation (treating a US consolidated group as a single corporation) or a US individual citizen or resident (each a qualified US person).

The specified group parent must 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 must 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) is taken into account in determining whether the 80% ownership thresholds are met. Notwithstanding comments requesting a lower ownership threshold (e.g., 50%), the 2021 Final Regulations maintain the 80% threshold. US consolidated return principles generally apply for purposes of determining when a specified group ceases to exist, such as when the specified group parent no longer exists.

If a CFC group member has ECI, then the items, disallowed BIE carryforwards, and other attributes of the CFC group member that are ECI are treated, for purposes of Section 163(j), as those of a separate applicable CFC that is not treated as a specified group member for the specified tax year (an ECI deemed corporation). Thus, items and attributes of an ECI deemed corporation are not included when calculating the CFC group's Section 163(j) limitation or allocating the limitation among CFC group members. The Treasury Department and IRS continue to study the proper method for allocating assets between a CFC group member and an ECI deemed corporation, which is relevant to the allocation of BII and BIE to an excepted trade or business under Treas. Reg. Section 1.163(j)-10 (as discussed in greater detail later). Until guidance is issued, taxpayers may use a reasonable method, consistently applied, for allocating assets between a CFC group member and an ECI deemed corporation.

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

Making the CFC group election

The CFC group election is made for a specified period of a specified group, such that the CFC group election applies to each specified group member for its entire specified tax year ending with or within the specified period. A CFC group election must generally 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. A limited exception applies under which a CFC group election may be made on an amended return for a specified period ending with or within a designated US person's tax year ending before 13 November 2020. The amended return must be filed on or before the due date (including extensions) of the original return for the designated US person's first tax year ending on or after 13 November 2020. For example, for calendar-year taxpayers, a CFC group election may be made on an amended return filed for tax years 2018 or 2019, so long as the amended return is filed on or before the due date (including extensions) for filing the original 2020 income tax return.

The 2020 Proposed Regulations required taxpayers making a CFC group election to attach a statement with their return for the year in which the CFC Group election is made or revoked. The 2021 Final Regulations retain this requirement, but additionally require taxpayers to attach a statement to their return for each year for which a CFC group election is in effect.

The CFC group election remains in effect for each specified group's specified period that begins during the 60-month period following the last day of the first specified period for which the election was made. Notwithstanding comments requesting that taxpayers be permitted to make or revoke the election on an annual basis, the 2021 Final Regulations allow the election to be revoked only after the 60-month period has passed. If an election is revoked, a new election cannot be made for a specified period of the specified group if the specified period begins during the 60-month period following the last day of the first specified period for which the election was revoked.

The CFC group election rules impose a separate-return-limitation-year (SRLY) limitation on a CFC group member's pre-group disallowed BIE carryforwards from a tax year preceding its CFC group membership (pre-group disallowed BIE carryforwards). The SRLY concept is similar to rules that limit a consolidated group from utilizing pre-existing attributes of a domestic corporation that joins the consolidated group. The desired effect of the SRLY limitation is to allow utilization of the attributes of a joining member (in this case, a CFC's disallowed BIE carryforwards) only to the extent that the member could have used the attributes if it had remained a separate entity as opposed to joining the group (i.e., to prevent a corporation from achieving a better result by joining a group). As applied here, a CFC group member cannot deduct any pre-group disallowed BIE carryforwards exceeding the CFC's cumulative Section 163(j) limitation, computed without taking into account the income of any other CFC group members.

When a CFC group election is first made, all CFC group members are treated as having been separate CFCs that join the CFC group, just as if the CFC group had acquired each CFC. Thus, the SRLY limitation applies to the disallowed BIE carryforwards from prior years before the first year in which a CFC group election is in effect. Consequently, disallowed BIE carryforwards that exist before an initial CFC group election can generally only be utilized by a CFC group member to the extent the CFC has sufficient Section 163(j) limitation on a standalone basis.

The 2021 Final Regulations provide a limited transition rule under which members of a CFC group for which a CFC group election was made under the Section 163(j) regulations proposed in 2018 (the 2018 Proposed Regulations) may be treated as a "pre-group subgroup." Under the pre-group subgroup rule, CFC group members may take into account the items of income of other CFC group members when computing their SRLY limitation if the other CFC group members are part of the same pre-group subgroup. Thus, the transition rule may increase the amount of pre-group disallowed BIE carryforward, if any, that can be deducted by a CFC group for which a CFC group election was made under the 2018 Proposed Regulations. For example, the transition rule allows the Section 163(j) limitation of one member of the CFC group to support the SRLY-limited disallowed BIE carryforward of another member of the CFC group, instead of the otherwise applicable member-by-member approach.

The 2021 Final Regulations do not state explicitly whether Section 382 applies to the acquisition of a CFC with disallowed BIE carryforwards that constitutes an "ownership change" of the CFC, although the Preamble indicates that Section 382, by its terms, appears to apply. The Preamble notes that Treasury will study, when Section 382 does apply, whether an "overlap rule" will turn off the SRLY limitation for a Section 382 ownership change, similar to the overlap rule in the consolidated return SRLY concept.

Subpart F and Global Intangible Low-Taxed Income (GILTI) inclusions in ATI of US shareholder

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 2020 Proposed Regulations, however, would allow a US shareholder of certain stand-alone CFCs or CFCs for which a CFC group election is made to include in its ATI a portion of its specified deemed inclusions (other than the Section 78 gross-up).

The 2021 Final Regulations reserve on the computation of a US shareholder's ATI with respect to such CFCs, as Treasury and the IRS continue to study the method for determining the amount by which the ATI of a US shareholder should be increased by its specified deemed inclusions. Consequently, for tax years beginning on or after 13 November 2020 (the effective date of the 2020 Final Regulations), a US shareholder (and its related parties) will have to apply the provisions of the 2020 Proposed Regulations to take into account in its ATI the specified deemed inclusions with respect to its CFCs (see the prior discussion of applicability dates and reliance on certain provisions of the 2020 Proposed Regulations).

Expansion of annual safe harbor election

The 2021 Final Regulations provide an annual safe harbor election if a CFC group's BIE does 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 safe harbor election is also available if a CFC group's BII is greater than or equal to its BIE, an expansion of the election provided in the 2020 Proposed Regulations.

The eligible amount of a CFC group member is the sum of the CFC's (i) subpart F income, and (ii) the approximate GILTI inclusion amount, net of the associated Section 250 deduction (all determined as if the CFC were wholly-owned by a domestic corporation and accounting for any elections made with respect to the CFCs, such as the subpart F high-tax exception or GILTI high-tax exclusion). The eligible amount of a CFC group member is also computed without regard to Section 163(j). A CFC's qualified tentative taxable income is its TTI (taking into account only items properly allocable to a non-excepted trade or business).

If the safe harbor election is made for a CFC group meeting either the 30% or BII requirement, then none of the CFC group's BIE is disallowed under Section 163(j). If a safe harbor election is made, however, no portion of the CFC group's specified deemed inclusions are included in a US shareholder's ATI. Taxpayers therefore must weigh the loss of specified deemed inclusions from US shareholder's ATI against the benefits of the safe harbor election.

The safe harbor election is 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. Moreover, the safe harbor election is not available if any member of the CFC group has a pre-group disallowed BIE carryforward.

Finally, the safe harbor election must 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. The same limited exception available for CFC group elections applies, whereby the election can be made via the filing of an amended return for certain periods ending before 13 November 2020.

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

Prop. Treas. Reg. Section 1.163(j)-8 provides rules for applying Section 163(j) to a nonresident alien individual or foreign corporation with ECI. These rules are designed to ensure that only ECI items are included in the Section 163(j) limitation. Specifically, Prop. Treas. Reg. Section 1.163(j)-8 modifies the definitions of ATI, BIE, BII and floor plan financing interest expense of a specified foreign person to limit those amounts to ECI and expenses properly allocable to ECI. The proposed regulation also provides rules for determining the ECI and non-ECI portions of a specified foreign partner's allocable share of ETI, EBIE, and EBII and the ECI and non-ECI portions of a relevant foreign corporation's deductible and disallowed BIE.

The Treasury Department and the IRS continue to study methods of determining the amount of deductible BIE and disallowed BIE carryforwards that are allocable to ECI and anticipate addressing these issues in future guidance. As a result, the 2021 Final Regulations reserve on Treas. Reg. Section 1.163(j)-8.

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

In general, the 2020 Final Regulations allocate BIE and BII between excepted and non-excepted trades or business based upon the relative amounts of the taxpayer's adjusted basis in the assets used in its trades or businesses. Look-through rules apply to taxpayers that own an interest in certain partnerships or certain 80%-owned corporations that are not part of the taxpayer's consolidated group. To prevent the inappropriate double counting of basis in excepted trade or business assets, the 2020 Proposed Regulations contained a rule preventing a C corporation from looking through the stock of its subsidiary for purposes of basis allocation between excepted and non-excepted trades or businesses if that subsidiary itself looked through the stock of its subsidiaries (i.e., to prevent excepted trade or business assets of a lower-tier subsidiary from inappropriately supporting interest expense incurred by multiple ties of corporations above the lower-tier subsidiary). The 2021 Final Regulations replace the bright-line limited look-through rule with an anti-abuse rule; that rule limits a C corporation's ability to look through the stock of a nonconsolidated subsidiary only if a principal purpose for borrowing funds at an upper-tier entity level or adding an upper-tier or lower-tier entity to the ownership structure is increasing the amount of the taxpayers' basis allocable to excepted trades or businesses.

Treas. Reg. Section 1.469-9: Definition of real property trade or business

Section 163(j) does not apply to any "electing real property trade or business" (electing RPTB) (Section 163(j)(7)(A)(ii)). An electing RPTB includes any trade or business that is described in Section 469(c)(7)(C) and makes an election under Section 163(j)(7)(B). A trade or business described in Section 469(c)(7)(C) includes any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. The 2021 Final Regulations adopt the 2020 Proposed Regulations definitions for "real property development" and "real property redevelopment" to include business activities that involve the preservation, maintenance and improvement of forest-covered areas (timberland).

Implications

The 2021 Final Regulations adopt the general structure of the 2020 Proposed Regulations, while making several important modifications, and clarify various provisions within the 2020 Proposed Regulations, while also reserving on several important items. In particular, the 2021 Final Regulations modify various definitions regarding the computation of TTI and clarify that the computation of a CFC group member's ATI may be negative and is computed without regard to foreign taxes. These clarifications will ease taxpayer uncertainty when computing the Section 163(j) limitation.

The 2021 Final Regulations explicitly provide that taxpayers are not required to make the CFC grouping election within the first 60 days after the regulations are published as final but may make the election in subsequent years. This will allow taxpayers time to model out the implications of making such an election. The 2021 Final Regulations largely reject comments seeking to modify the safe-harbor election, though the safe-harbor election was modified to apply to CFCs with net BII. Although a transition rule is provided that may be beneficial in certain circumstances, Treasury rejected comments seeking to modify SRLY rules as applicable to pre-group disallowed BIE carryforwards. As a result, taxpayers must carefully examine the attributes of each potential CFC group member before making a CFC group election to avoid unintended consequences.

Interestingly, Treasury reserved on several important aspects of the 2020 Proposed Regulations as it continues to study comments for potential future guidance, including the computation of a US shareholder's ATI and the treatment of foreign persons with ECI. Until then, taxpayers may continue to rely on those provisions from the 2020 Proposed Regulations, provided they apply those provisions consistently.

Finally, Treasury simplified certain effective date rules while providing taxpayers with flexibility in applying the various regulatory regimes before the effective dates of the 2020 and 2021 Final Regulations. Early application of any version of the regulations, however, requires consistent application in subsequent tax years. Thus, taxpayers should begin carefully modeling the various methodologies and options under the differing regulatory regimes to determine the most optimal choice in pre-effective date tax years.

Endnotes

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
2. EBITDA: earnings before interest, taxes, depreciation and amortization.
3. Currency references in this Alert are to the US$.

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