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Updated Interest Deductibility Guidance Released by the IRS under Section 163(j)

Attorneys
Leo P. Arnaboldi III
Kat Saunders Gregor
Sara Clevering
Brian Harris
Hudson Todd
Lucas Caruso

On July 28, 2020, the Treasury Department and the IRS issued final and proposed regulations (the "Final Regulations" and "New Proposed Regulations") under Section 163(j) of the Internal Revenue Code (the "Code"). The Final Regulations and New Proposed Regulations amend prior proposed regulations issued on November 26, 2018 (the "Prior Proposed Regulations"). Section 163(j) of the Code generally limits business interest expense deductions and was substantially revised by the Tax Cuts and Jobs Act (the "TCJA"), which took effect on January 1, 2018. Section 163(j) was further revised by the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act"), which was enacted on March 27, 2020. Our coverage of the TCJA and the CARES Act can be found here and here, respectively. Certain key tax provisions of the CARES Act can be found here.

This client alert provides a high-level overview of some of the key guidance on Section 163(j) contained in the newly released regulations.

Key Takeaways

Final Regulations

- The Final Regulations remove items previously defined as "interest" from the definition of interest for Section 163(j) purposes, including debt issuance costs, a partnership's guaranteed payments for the use of capital and hedging transactions.

- The Final Regulations largely adopt the definition of adjusted taxable income (or "ATI") in the Prior Proposed Regulations, with one key exception: for taxable years beginning before January 1, 2022, the amount of any depreciation, amortization, or depletion expense that is capitalized into basis under Section 263A during taxable years beginning before January 1, 2022 is added back as a deduction for depreciation, amortization, or depletion when calculating ATI for that taxable year.
  - The Final Regulations also permit correlative adjustments to gain on the sale of property for purposes of ATI where depreciation or amortization on those items was previously denied.
  - The Final Regulations finalize, but do not substantively change, application of the Prior Proposed Regulations to members of affiliated groups. Members of an affiliated group aggregate for purposes of Section 163(j) only if they are members of a consolidated group.
  - In addition, the Final Regulations largely exempt intercompany loans from Section 163(j) between consolidated group members, except where one member acquires the existing debt of another member at a premium and the debt is considered reissued at a premium.

- The Final Regulations adopt a safe harbor allowing REITs to elect out of Section 163(j) as an electing real property trade or business if the value of the REIT's real estate financing assets, such as mortgages, represents less than 10% of the value of the REIT's assets and clarify that this safe harbor applies regardless of whether the REIT holds its assets indirectly or directly.

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- For Section 382 purposes, the rules permit corporate taxpayers to elect to prorate excess business interest expense ("EBIE") or close the books in the year of an ownership change. The Prior Proposed Regulations mandated a pro-rata approach—the Final Regulations provide more flexibility.
- The Final Regulations modify the anti-avoidance rules to provide that any expense or loss economically equivalent to interest is treated as interest for purposes of Section 163(j) if reducing interest expense subject to Section 163(j) was a principal purpose in structuring the transaction.
  - The Final Regulations also retain an embedded loan rule for swaps with significant non-periodic payments, while excluding certain cleared and non-cleared swaps with margin requirements.
  - Under the Final Regulations, all transactions with debt-like components will need to be analyzed under the anti-avoidance rules to determine whether any portion of the economics would be recharacterized as business interest expense.
  - Finally, where a counterparty receiving an item of income or gain is aware that an element of a transaction will be treated as business interest expense, the counter-party may elect to treat the business interest expense as interest income if certain requirements are met.

New Proposed Regulations

- The New Proposed Regulations contain several key provisions affecting partnerships:
  - A partnership is permitted to allocate EBIE from a lower-tier partnership to an upper-tier partnership, but not beyond the upper-tier partnership level.
  - Following the Prior Proposed Regulations, partnerships are treated separately from corporate owners—in effect, adopting an aggregate approach to the calculation of Section 163(j) limitations.
  - If a partnership is a small business entity exempt from Section 163(j) because it averages less than $25 million in revenues over last three years, partners are similarly exempt from Section 163(j) on EBIE allocated from that partnership.
  - If a partner lends to a partnership, that partner is allowed net interest income received from the partnership but such amount offsets the partner's EBIE that the partnership allocates to the partner.
  - In the case of trading partnerships where some partners materially participate in the trade or business and other do not, the New Proposed Regulations bifurcate the partnership's interest expense so that only the portion of the partnership's interest expense that is attributable to the participating partners is subject to the partnership's Section 163(j) limitation.

Background

The TCJA amended Section 163(j) to limit the deductibility of net interest expense paid or accrued on debt properly allocable to a trade or business to 30% of ATI, subject to certain exceptions. As further described below, ATI is generally defined as the taxable income of the taxpayer computed without regard to certain items, including any deduction allowable for depreciation, amortization, or depletion for taxable years beginning before January 1, 2022. Any deduction in excess of the limitation is carried forward and may be used in a subsequent year, subject to the 30% limitation.

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The CARES Act raises the limitation percentage under Section 163(j) for taxable years beginning in 2019 and 2020 (except for taxable years of partnerships beginning in 2019) from 30% to 50%, unless a taxpayer elects not to apply the greater limitation percentage. For taxable years of partnerships beginning in 2019, a partner treats 50% of its allocable share of the partnership's excess business interest expense (discussed more generally further below) as an interest deduction in the partner's first taxable year beginning in 2020 without limitation. The remaining 50% of such excess business interest expense remains subject to the Section 163(j) limitation applicable to excess business interest expense carried forward at the partner level.

Key Provisions in the Final Regulations

Definition of Interest

The Final Regulations narrow the definition of "interest" from what had been contemplated under the Prior Proposed Regulations. The items removed from the definition of interest include debt issuance costs, guaranteed payments for the use of capital provided by a partner to a partnership, and amounts paid pursuant to hedging transactions. Thus, the deductions associated with the removed items are not subject to limitation under Section 163(j). While the removal of these items provides welcome relief to taxpayers, these items can still be considered interest under the anti-avoidance rules, as further described below.

Anti-Avoidance Rules

The Final Regulations modify the anti-avoidance rules in the Prior Proposed Regulations and generally provide that any expense or loss economically equivalent to interest is treated as interest expense for purposes of Section 163(j) of the Code 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. Any expense or loss is economically equivalent to interest to the extent it is (1) deductible by the taxpayer; (2) incurred by the taxpayer in a transaction or series of integrated or related transactions in which the taxpayer secures the use of funds for a period of time; (3) substantially incurred in consideration of the time value of money; and (4) not otherwise defined as interest in the Final Regulations. The Final Regulations contain examples illustrating the application of the interest anti-avoidance rules in a number of situations, including a hedging transaction involving a foreign currency swap transaction, a forward contract involving gold, a loan guaranteed by a related party in which the related party receives guarantee fees, and guaranteed payments for the use of capital.

Definition of ATI

Section 163(j) provides that ATI of a taxpayer is computed without regard to certain items, including any deduction allowable for depreciation, amortization, or depletion for taxable years beginning before January 1, 2022. Thus, deductions for depreciation, amortization, and depletion are added back to taxable income for purposes of calculating ATI for taxable years beginning before January 1, 2022. The Prior Proposed Regulations provided that depreciation, amortization, or depletion expense capitalized into inventory under section 263A was not a depreciation, amortization or depletion deduction for purposes of the add-back. In a taxpayer- friendly reversal, the Final Regulations provide that the amount of any depreciation, amortization, or depletion that is capitalized into inventory under section 263A during taxable years beginning before January 1, 2022, is added back as a deduction for depreciation, amortization, or depletion when calculating ATI for that taxable year.

Consolidated Groups

Consistent with the Prior Proposed Regulations, members of a consolidated group are aggregated for purposes of Code Section 163(j), and the consolidated group has a single Section 163(j) limitation. Partnerships that are wholly owned by

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members of a consolidated group are not aggregated with the group for purposes of Section 163(j), as the IRS notes Congressional intent is for partnerships to be treated as entities rather than aggregates for purposes of Section 163(j). Members of an affiliated group that do not file a consolidated return are not aggregated with each other for purposes of Section 163(j). The Treasury Department and IRS declined to expand the aggregation rules to related taxpayers other than consolidated group members. In addition, consistent with the Prior Proposed Regulations, the Final Regulations do not apply Section 163(j) to business interest expense or business interest income incurred on intercompany obligations, with one limited exception related to repurchase premium on obligations that are deemed satisfied and reissued.

Real Estate Investment Trusts ("REITs")

The Final Regulations adopt the special safe harbor for REITs provided by the Prior Proposed Regulations. Specifically, if a REIT holds real property, interests in partnerships holding real property, or shares in other REITs holding real property, the REIT is eligible to make an election to be an electing real property trade or business for all or part of its assets. If a REIT makes such an election, and if the value of the REIT's real property financing assets, which include, among other items, interests or participation interests in mortgages, deeds of trust, interests in REMICs and debt instruments issued by publicly offered REITs, at the close of the taxable year is 10 percent or less of the value of the REIT's total assets at the close of the taxable year, then, under the safe harbor all of the REIT's assets are treated as assets of an excepted trade or business, and the REIT's interest expense is not subject to Section 163(j) limitations. In adopting this safe harbor, the Final Regulations clarify that a REIT may elect to be an electing real property trade or business if it holds real property directly as well as indirectly through interests in one or more partnerships or shares in one or more REITs. The Final Regulations also provide that a partnership may apply the REIT safe harbor election at the partnership level if one or more REITs own, directly or indirectly, at least 50 percent of the partnership's capital and profits, and the partnership would meet the income and asset value tests applicable to REITs if it were a REIT.

Section 382

Corporations are generally able to carry forward net operating losses ("NOLs") generated in a tax year to a future tax year, and use them to offset taxable income in the future year, subject to certain limitations. Section 382 of the Code generally imposes limitations on a loss corporation's ability to utilize NOL carryforwards from a year prior to an "ownership change." Following the promulgation of the TCJA, Section 163(j) business interest expense carryforwards were subject to similar limitations, such that a loss corporation would not be able to deduct business interest expense carryforwards from a year prior to an "ownership change." Diverging from the Prior Proposed Regulations, the Final Regulations permit loss corporations to elect to calculate the portion of business interest expense carryforwards that are disallowed under this rule using a closing of the books method for pre-change and post-change periods rather than applying a ratable allocation across the taxable year of the "ownership change."

Key Provisions in the New Proposed Regulations

Application to Partnerships

The Section 163(j) limitation for partnerships applies at the partnership level. The amount of business interest expense that is not deductible by the partnership due to the Section 163(j) limitation creates a partner-level tax attribute, or EBIE. A partner generally may deduct EBIE only when the partner is later allocated ATI that is not used to support a business interest expense deduction at the partnership level.

Consistent with the statute's approach of applying Section 163(j) at the partnership level, the New Proposed Regulations use an "entity approach" for the treatment of EBIE allocated by a lower-tier partnership to an upper-tier partnership. The rules provide that, following an allocation of EBIE to an upper-tier partnership, the upper-tier partnership would not

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further allocate such EBIE to its partners. The EBIE is instead carried forward by the upper-tier partnership, and the upper-tier partnership's basis in the lower-tier partnership is reduced by the amount of such EBIE.

In a favorable clarification to the Prior Proposed Regulations, the Final Regulations provide that business interest expense allocated by a small-business entity exempt from Section 163(j) to its partners will not further be subject to the Section 163(j) limitation at the partner level.

The New Proposed Regulations address the treatment of business interest expense on borrowing by a partnership from a partner by including the business interest expense of the borrowing partnership in 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 lending transaction, the partner would treat that interest income as an allocation of excess business interest income to the extent of the lending partner's allocation of EBIE from the borrowing partnership in that tax year. Thus, the partner's interest income from the partnership offsets the partner's EBIE from the partnership dollar for dollar.

The New Proposed Regulations provide that certain passthrough entities that are engaged in trades or businesses that are per se non-passive activities and in which one or more owners of the entities do not materially participate, or "trading partnerships," will bifurcate their 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. Only the portion of a partnership's interest expense that is allocable to the materially participating partners is treated as subject to the partnership's Section 163(j) limitation.

Controlled Foreign Corporations ("CFCs")

The Final Regulations clarify that Section 163(j) does in fact apply to controlled foreign corporations and other foreign corporations subject to certain exclusions (for example dividends received from related parties are excluded from the calculation of the CFC's ATI). The New Proposed Regulations made substantial changes to the applications of Section 163(j) to CFCs, largely in response to taxpayer concerns over the complexity and administrative burden that would be required to comply with the Prior Proposed Regulations. The New Proposed Regulations also include an anti-abuse rule that would increase the amount of ATI calculated under certain circumstances (for example if a taxpayer's interest deduction limitation creates an increase in tested income, but it does not result in increased U.S. tax liability because of excess GILTI foreign tax credits offsetting the increase, then the anti-abuse rule could be used to prevent the taxpayer from carrying forward business interest expense to future periods).

The New Proposed Regulations modified the "CFC group" election which now allows the Section 163(j) limitations to be calculated and applied on a group basis. The New Proposed Regulations also contain robust rules for determining which entities qualify as members in the CFC group. Members of the CFC group are generally required to calculate business interest expense, ATI and the amount of disallowed carryforwards separately in the first instance, and then the limitation imposed under Section 163(j) is generally applied to the CFC group in the aggregate (although for certain calculations, the separate CFCs are allocated amounts of the aggregate items). This aggregate approach eliminates the need for lower-tier CFCs to be able to roll up excess taxable income to higher-tier CFCs. The New Proposed Regulations continue to allow for CFCs to roll up excess taxable income to U.S. Shareholders, although the formula for calculating the amounts that roll up has changed. CFCs can also join or leave a CFC group. The New Proposed Regulations contain rules for limiting the use of interest expense carryforwards with respect to a CFC from periods before the CFC joined the CFC group. These rules operate similarly to the rules that apply with respect to carryforwards of a consolidated group arising in a separate return limitation year (as defined in Treas. Reg. Sec. 1.1502-1(f)). Unlike the Prior Proposed Regulations, under the New Proposed Regulations a CFC group election requires that an election be formally made, and such election is irrevocable for five years. The election applies to each specified group member.

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Certain CFCs (that are either stand-alone or that have elected to be a part of a CFC group) are exempt from the limitations under Section 163(j) if they qualify for a new safe harbor under the New Proposed Regulations. The safe harbor is available on a year-by-year basis. To elect the safe harbor, the applicable CFC must have business interest expense that does not exceed 30% (or 50% for years 2019 and 2020) of the lesser of "qualified tentative taxable income" or the sum of "eligible amounts" of the applicable CFC for its taxable year. "Eligible amounts" are the combined subpart F income and GILTI inclusions the CFC or CFC group would have if it were wholly owned by domestic corporations without tested losses and without regard to the Section 250(a)(2) limitation.

Effectively Connected Income ("ECI")

The New Proposed Regulations further provide modifications to the definitions used in calculating the Section 163(j) limitation in the case of a specified foreign person (that is not an applicable CFC) that has effectively connected income with a trade or business in the United States. Only ECI items and assets that are U.S. assets are taken into account for purposes of applying 163(j) to a specified foreign person under the New Proposed Regulations. The mechanics are different in the context of a foreign partnership as opposed to a foreign corporation. Section 163(j) generally is applied at the partnership level, and the New Proposed Regulations specify how to calculate a foreign partner's allocable share of Section 163(j) attributes that are ECI to subsequently calculate the limitation. The rules also include a separate set of mechanics for calculating the amount of disallowed business interest expense of a foreign corporation. In each case, the New Proposed Regulations require an apportionment between items that are treated as ECI and those which are non-ECI in order to calculate the appropriate interest expense limitation that applies to the foreign person.

Applicability and Effective Date

The Final Regulations and the New Proposed Regulations are generally applicable 60 days after publication of final rules in the federal register. Taxpayers may apply the Final Regulations, certain aspects of the New Proposed Regulations or the Prior Proposed regulations, each in their entirety, to taxable years beginning after December 31, 2017 if the taxpayer and its related parties apply such rules consistently.

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