Final Regulations Narrow Limits on Interest Deductions but Retain Partnership and International Rules

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Treasury and the IRS released Final Regulations under Section 163(j) of the Code clarifying certain limitations on the deduction of business interest expense, along with Proposed Regulations on issues not addressed by the Final Regulations, including updates related to the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act"). As compared to the Initial Proposed Regulations released in 2018, the Final Regulations include a more limited definition of interest, thereby limiting the scope of the rules.

Section 163(j) was significantly revised by the Tax Cuts and Jobs Act ("TCJA") in December 2017. Under current Section 163(j), a taxpayer generally cannot deduct business interest expense for a taxable year to the extent that such business interest exceeds the sum the taxpayer's business interest income ("BII") and 30% of the taxpayer's adjusted taxable income ("ATI") for the taxable year. The CARES Act further modified Section 163(j), allowing taxpayers to elect to use 50% (instead of 30%) of ATI for taxable years 2019 and 2020 and use their 2019 ATI to calculate their 2020 business interest expense deduction limit. In the case of partnerships, the 30% limitation continues to apply to taxable year 2019 but 50% of any business interest of the partnership that is disallowed to the partners in 2019 will not be subject to any Section 163(j) limitation in 2020.

The business interest expense deduction limitation does not apply to small businesses with gross receipts of $26 million (inflation-adjusted) or less, electing real property trades or businesses, electing farming businesses, and certain regulated public utilities. The Final Regulations will apply to all taxable years beginning on or after 60 days from the date the Final Regulations are published. The Proposed Regulations will not be effective until issued in final form; however, taxpayers may generally rely on the Proposed Regulations in the interim.

Our summary highlights important aspects of the Final and Proposed Regulations, with a focus on items that have changed since the Initial Proposed Regulations.

Definition of Interest

- In a taxpayer-friendly change, the Final Regulations remove a number of items from the extremely broad definition of interest in the Initial Proposed Regulations, which means such amounts are not categorically subject to the Section 163(j) limitation.

- Key items removed from the definition of interest include debt issuance costs, commitment fees (though such amounts are subject to more comprehensive IRS guidance projects), guaranteed payments of partnerships for the use of capital, and certain hedging expenses.

- The Final Regulations replace the longer list of items that are deemed to be interest with more robust anti-avoidance rules. These rules characterize a deductible expense as interest for Section 163(j) purposes if it is economically equivalent to interest and if a principal purpose for structuring the relevant transactions was to reduce the amount of interest incurred by a taxpayer that is subject to Section 163(j).

  Comment: Examples in the Final Regulations make clear that certain standard commercial arrangements, including the issuance of debt-like equity within a partnership or the payment of guaranty fees, can give rise to interest expense pursuant to the anti-avoidance rules if motivated by a principal purpose to avoid generating interest expense that is subject to Section 163(j). The anti-abuse rule can apply even if those transactions have a lower pre-tax cost of capital than a standard debt financing structure.

- If a taxpayer recognizes an item of non-interest income and is aware that the payor is treating the payment as interest expense pursuant to the anti-avoidance rule, such taxpayer can treat the income as interest income, potentially offsetting other business interest expense.

  Comment: Parties to transactions that might be re-characterized under the anti-avoidance rule, such as the issuance of preferred equity in a partnership, should consider the treatment of payments under Section 163(j).

- A similar anti-avoidance rule addresses transactions designed to increase a taxpayer's BII.

- The Final Regulations require taxpayers to impute interest subject to Section 163(j) to certain swaps with significant, non-periodic payments. The Final Regulations add exceptions for cleared swaps and for non-cleared swaps that meet federal regulatory (or similar) margin or collateral requirements.

- The Proposed Regulations would allow taxpayers to include certain distributions by a regulated investment company as interest income for purposes of Section 163(j) to the extent such distributions relate to interest income earned by the regulated investment company. This look-through treatment does not extend to foreign money market funds or other passive foreign investment companies.

Partnerships

- The Section 163(j) limitations apply separately at the partnership level. A partnership computes the amount of business interest expense that is deductible by its partners based on the partnership's BII and ATI. Excess business interest expense allocated to partners is generally suspended at the partner level. Suspended expense is freed only from subsequent allocations to such partner of excess BII (that is, BII to the extent it exceeds business interest expense) or excess ATI (that is, ATI in excess of the amount necessary to allow business interest expense to be deductible) from that partnership, or upon a disposition of such partnership interest.

- A partner similarly computes its own ATI, BII and deductible business interest expense without regard to any items from the partnership except to the extent that the partnership allocates excess BII or excess ATI not used to offset prior excess business interest expense.

- The Final Regulations retain the 11-step computational system introduced in the Initial Proposed Regulations to allocate deductible business interest expense and excess items among partners. This system is designed to match, to the extent feasible, allocation of the partnership's deductible business interest expense to the partners that are allocated ATI and BII under the partnership agreement that were used to determine the partnership's deductible interest.

  Comment: Notwithstanding that Section 163(j) views a partnership as an entity, the Final Regulations do not allow the partnership to allocate these items under other reasonable approaches, instead forcing the allocation under the 11-step system. In a simple example, if a partnership only has BII of $100 that is allocated 100% to partner A and business interest expense of $150 that is allocated 50% to partner A and 50% to partner B (such that $100 of the interest is allowed and $50 suspended), the 11-step system will force the partnership to allocate $75 of allowed interest to partner A and $25 of allowed interest, and $50 of the suspended interest, to partner B. This outcome is premised on the notion that the interest deduction allowed was based on the BII and therefore should first be allocated to the partner that is allocated the BII. Note that partner B is still allocated $25 of allowed interest because

partner A is economically allocated only $75 of interest expense under the 50/50 sharing arrangement.

- The Final Regulations permit a partnership that allocates all items relevant to the Section 163(j) analysis on a pro rata basis to bypass the 11-step system.

- The Final Regulations allow a selling partner to increase its basis in its partnership interest sold by the portion of any excess business interest expenses based on the portion of the partnership interest sold. This rule is also available for a liquidating distribution but not for partial redemptions. To avoid causing inside/outside basis discrepancies, the Proposed Regulations provide for an equal increase to the partnership's asset basis.

  Comment: The Initial Proposed Regulations required a partner to sell all or substantially all of such partner's partnership interest in order to utilize this basis increase. The Final Regulations benefit taxpayers that make partial sales of interests in partnerships that are subject to the Section 163(j) limitation by reducing the amount of capital gain or increasing the amount of capital loss recognized on the sale. However, a partner that is anticipating allocations of excess BII or ATI that would release suspended interest expense and create an ordinary deduction should consider the effects of this change.

- The Proposed Regulations provide that a trading partnership with an individual partner that is a passive investor and subject to the limitation under Section 163(d) on investment interest is not subject to the Section 163(j) limitations with respect to the interest expense allocable to such individual. However, to avoid whipsaw, the Proposed Regulations will no longer allow an individual partner to group activities outside of the partnership in determining whether he or she is a passive investor or material participant. The IRS is considering alternatives where partners may annually certify their status to the partnership.

- The Proposed Regulations provide a taxpayer-friendly rule that may mitigate the Section 163(j) limitation in the context of a loan provided to a partnership by one of its partners. Specifically, interest income earned by such partner from a loan provided to the partnership is treated as excess BII to the extent necessary to free up any excess business interest expense allocated to the partner from that partnership in that taxable year.

  Comment: The self-charged interest rule applies even where the interest income earned by the partner is investment income subject to Section 163(d) rather than BII subject to Section 163(j). Note that the self-charged exception only applies to direct

partners—amounts lent by related parties or to a lower-tier partnership do not enjoy this exception.

- The Proposed Regulations adopt an entity approach to tiered partnerships, with the Section 163(j) test determined at the lower-tier partnership ("LTP") level that paid or accrued the interest and the regular partnership rules applying to the upper-tier partnership ("UTP") in respect of the LTP's excess items. The Proposed Regulations create a complex set of rules aimed at preventing taxpayers from NOL-type trafficking of excess business interest expense by effectively mandating that only the beneficial owner of the UTP that economically bears (indirectly through the UTP) the interest expense when paid or accrued by the LTP may benefit from any excess business interest expense that is freed to the UTP in subsequent years.

Consolidated Groups

- The Final Regulations generally adopt the approach of the Initial Proposed Regulations for consolidated groups and provide for a single group-wide limitation that disregards affiliate transactions. The Final Regulations also have rules for apportioning utilized and disallowed interest deductions among members, which are relevant if members join or leave the group.

- Treasury indicated that it expects to issue future guidance regarding the interaction of Section 163(j) and the rules for consolidated groups that include both life insurance companies and other members ("life-nonlife groups").

  Comment: It would be helpful for any future guidance to confirm that a single Section 163(j) limitation applies to a life-nonlife group. For regulatory reasons, life-nonlife groups often issue debt from nonlife holding companies while deriving substantial interest income in their life insurance companies. The ability of a life subgroup to use nonlife subgroup interest deductions is already limited by the current life-nonlife consolidated return rules, and therefore additional subgroup limitations under Section 163(j) are unnecessary.

Crossborder

- The Final Regulations confirm that Section 163(j) applies to controlled foreign corporations ("CFCs"). Consistent with the Initial Proposed Regulations, disallowed interest may increase GILTI and Subpart F inclusions. However, the interest will

reduce earnings and profits, which may limit a U.S. shareholder's overall Subpart F income.

- Many of the special rules and elections proposed by the Initial Proposed Regulations were not adopted by the Final Regulations, and were instead reinserted, often with meaningful changes, in the Proposed Regulations.

  Comment: Comments to the Initial Proposed Regulations requested that Section 163(j) simply not apply in the CFC context. Treasury generally rejected these comments, though the Proposed Regulations do offer some practical improvements.

- The Proposed Regulations allow certain related CFCs to elect to form a "CFC Group." The CFC Group would then calculate a single, group-wide Section 163(j) limit, which is allocated among the members of the group.

  Comment: The Initial Proposed Regulations also included a concept of a "CFC Group." The original CFC Group rules allocated group business interest expense among its members, who then each calculated a separate Section 163(j) limit. Treasury intends the new CFC Group approach to be less burdensome, but the rules remain complex.

- The Proposed Regulations include two helpful rules. First, U.S. shareholders of CFCs will be allowed to include a portion of GILTI and Subpart F in ATI (based on the CFC's unused Section 163(j) limitation). Second, the Proposed Regulations include a "safe harbor" election, under which certain CFCs would not be subject to Section 163(j). This safe harbor election is targeted at CFCs that would clearly not be limited under Section 163(j) and allows such CFCs to avoid potentially burdensome compliance and reporting obligations related to Section 163(j).

Real Property

- Taxpayers can elect out of the application of Section 163(j) with respect to a real property trade or business (the "Real Property Election"), though doing so generally requires the taxpayer to forego accelerated depreciation on assets used in such trade or business.

- The Final Regulations broaden the ability of certain taxpayers to avail themselves of the Real Property Election, even if their real estate activities do not necessarily rise to the level of a trade or business, and simplify the ability of real estate investment

trusts to make the Real Property Election, including with respect to activities undertaken via partnerships or other real estate investment trusts.

- The Initial Proposed Regulations contained an anti-abuse rule that provides that a taxpayer cannot make the Real Property Election if more than 80% of its property by value is leased to related parties. The Final Regulations provide an exception to this anti-abuse rule for certain situations in which the property is leased to a related party that is itself in a real property trade or business.

  Comment: The anti-abuse rule in the Initial Proposed Regulations was overly broad, and captured scenarios where a group of companies are in the real property business, but split their assets into an Operating Company/Property Company structure and therefore utilize inter-company leases. Such structure is used in various industries, including hospitality and assisted living.

Multiple Trades and/or Businesses

- The Final Regulations generally adopt the approach in the Initial Proposed Regulations for allocating interest income and expense to excepted and non-excepted trades or businesses based on the relative amounts of a taxpayer's adjusted basis in the assets used in such trades or businesses (other than cash and cash equivalents). The Final Regulations provide that such calculation disregards the amount of basis in assets encumbered by qualified nonrecourse indebtedness, which does not exceed the amount of such obligation (rather than the full basis of such assets, as was the case under the Initial Proposed Regulations).

  Comment: Comments to the Initial Proposed Regulations requested that taxpayers be permitted to allocate interest expense and income between excepted and non-excepted trades or businesses based on the earnings or gross income of each trade or business. Although Treasury notes in the Preamble to the Final Regulations that such an approach could allow taxpayers to time income recognition in a manner that create distortions, they also note that they will continue to study these comments and may provide future guidance on this issue.

  Comment: The Final Regulations generally retain the tracing approach for purposes of allocating interest expense and income between non-trades or businesses (resulting, in the case of individuals, in investment interest subject to the limitations of Section 163(d)) and trades or businesses (resulting in business interest subject to the limitations of Section 163(j)), by tracing disbursements of debt proceeds to specific expenditures, rather than using an apportionment approach as is used to

allocate business interest income and expense between excepted and non-excepted trades or businesses.

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Please do not hesitate to contact us with any questions.

NEW YORK

Michael Bolotin
mbolotin@debevoise.com

Rafael Kariyev
rkariyev@debevoise.com

Daniel Priest
dpriest@debevoise.com

Peter F.G. Schuur
pfgschuur@debevoise.com

Samuel M. Duncan
smduncan@debevoise.com

Molly Bailey Klinghoffer
mbklingh@debevoise.com

Lena E. Smith
lesmith@debevoise.com