Hon. Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on the Proposed Regulations under Section 163(j) and its interaction with Section 108

Dear Commissioner Rettig:

Enclosed please find comments on the proposed regulations under section 163(j) and its interaction with section 108. These comments are submitted on behalf of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

Eric Solomon
Chair, Section of Taxation

Enclosure

cc: Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury
Hon. Michael J. Desmond, Chief Counsel, Internal Revenue Service
Lafayette G. "Chip" Harter III, Deputy Assistant Secretary (International Tax Affairs), Department of the Treasury
Krishna P. Vallabhaneni, Acting Tax Legislative Counsel, Department of the Treasury
Doug Poms, International Tax Counsel, Department of the Treasury
Brett York, Associate International Tax Counsel, Department of the Treasury
Colin Campbell, Attorney-Advisor, Department of the Treasury
Ellen Martin, Tax Policy Advisor, Department of the Treasury
Bryan A. Rimmke, Attorney-Advisor, Department of the Treasury
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Daniel M. McCall, Deputy Associate Chief Counsel (International), Internal Revenue Service
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AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

Comments Concerning Proposed Regulations under
Section 163(j) and its Interaction with Section 108

These comments (the “Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Jason Dexter, Joshua Tompkins, and Anthony Sexton. Substantial contributions were made by Richard Blumenreich, Erik Corwin, Maury Passman, and Mark Schneider. These Comments have been reviewed by Lisa Zarlenega of the Section’s Committee on Government Submissions and Eric Sloan, Vice Chair of Government Relations for the Section.

Although members of the Section may have clients who might be affected by the federal tax principles addressed by these Comments, no member who has been engaged by a client (or who is a member of a firm or other organization that has been engaged by a client) to make a government submission with respect to, or otherwise to influence the development or outcome of one or more specific issues addressed by, these Comments has participated in the preparation of the portion (or portions) of these Comments addressing those issues. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

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Date: May 13, 2019
EXECUTIVE SUMMARY

These Comments are in response to Proposed Regulations issued on December 28, 2018,1 under section 163(j)2 with respect to changes made by Public Law 115-97 (the “Act”)3 (the “Proposed Regulations”). The Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) requested comments “regarding the interaction between section 163(j) and the rules addressing income from discharge of indebtedness under section 108,”4 which was not addressed in the Proposed Regulations. These Comments address the issues at the intersection of section 163(j) and the rules regarding cancellation of indebtedness income (“CODI”) under section 108.

Any rules in this area will necessarily require policy decisions to be made. In our view, there are not always clear rules mandated by the statutory language, and, absent guidance on certain of the issues discussed below, taxpayers incurring CODI will be faced with significant uncertainty. Indeed, practitioners are already seeing the effects of this uncertainty in active restructuring matters. For example, taxpayers are being forced to confront the possibility of having excess loss account (“ELA”) inclusions, reduction in the tax basis of assets such as inventory, and the loss of valuable net operating losses (“NOLs”) as a result of CODI that is attributable to interest expense for which these distressed taxpayers received a benefit only in the form of a Section 163(j) Carryforward (defined below). Had the interest expense not been incurred in the first place, there would be no loss of these more favorable attributes and no Section 163(j) Carryforward. And, although a Section 163(j) Carryforward is, in fact, an attribute that might be used in the future, just as a taxpayer does not have CODI on the forgiveness of accrued but unpaid interest whose prior deduction did not result in a tax benefit, nor should a taxpayer have CODI for discharged interest that was not previously deducted by reason of section 163(j) if the future tax benefit of the Section 163(j) Carryforward is eliminated in exchange. However, Treasury and the Service will need to grapple with countervailing factors—including potentially limited regulatory authority under section 108 and certain policy issues—when determining whether and how to address these issues.

Issues regarding the CODI and section 163(j) overlap potentially touch on all taxpayers, but these rules will necessarily be more complex in the Subchapter K5 context than elsewhere, driven largely by the dual-layered nature of section 163(j) in Subchapter K. These Comments attempt to construct a framework that works for all taxpayers. However, the Section would be pleased to submit comments in the future that address the overlap of CODI and section 163(j) in the Subchapter K context if that would be helpful to Treasury and the Service.

2 Unless otherwise indicated, all “section” references are to the Internal Revenue Code of 1986, as amended (the “Code”), and all “Reg.” references are to the Treasury Regulations promulgated under the Code, all as in effect on the date of these Comments.
5 References to “Subchapters” are to Chapter 1, Subtitle A of the Code.
As discussed in greater detail below, we believe that it would be inappropriate to require immediate taxation of forgiveness of section 163(j)-limited interest, while deferring the tax benefit of the associated Section 163(j) Carryforward. Accordingly, we make the following recommendations:

1. We recommend adoption of the Section 111 Approach (defined and discussed below) to address inappropriate outcomes resulting from the cancellation of interest expense that has given rise to a Section 163(j) Carryforward but no other tax benefit. Although we discuss various potential approaches below, we believe the Section 111 Approach better addresses a wider range of scenarios, while raising less concern about the scope of regulatory authority than some alternatives, and being more administrable than other alternatives. Although we believe that the Section 108(e)(2) Approach (defined and discussed below) is viable, we understand there may be reluctance to interpret the statute contrary to dicta in a Tax Court opinion. Accordingly, we recommend the Section 111 Approach, as there is both common law authority for it, and it avoids some of the difficult issues that arise in the context of the BII Approach (defined and discussed below).

2. We recommend adoption of the Pro-Ration Approach (defined and discussed below) for interest tracing to the extent our recommendations necessitate interest tracing. However, consideration should be given to the Presumption Approach (defined and discussed below), given the simplicity it provides and the fact that sound policy argues in favor of providing taxpayer-favorable rules in circumstances involving distressed taxpayers.

3. Where, in accordance with section 163(j)’s ordering rules, other Code provisions defer the deduction of interest expense before the limitation in section 163(j) applies, we recommend that Treasury and the Service adopt a rule to coordinate these other Code provisions with section 163(j), such that taxpayers are neither better nor worse off where two or more interest expense deferral provisions apply instead of one.

4. We recommend that CODI from the discharge of unpaid interest should be characterized as income from a non-excepted or excepted trade or business depending on the character of that business when the taxpayer became liable for the interest under the terms of the debt instrument.

5. Although we believe that any rule applying section 108(e)(2) to interest-related CODI could be relevant to section 357(c)(3)(A)(i), Treasury and the Service could expressly provide a non-reliance rule if that result is not intended or desired (i.e., by expressly providing that any Regulations adopted for purposes of section 163(j) cannot be relied on for applying section 357(c)).

I. BACKGROUND

A. Section 163(j) Generally

Section 163(j) limits a taxpayer’s deduction for business interest expense
Each taxable year to an amount equal to the sum of (i) the business interest income ("BII") of the taxpayer for the taxable year; (ii) 30% of the ATI of the taxpayer for the taxable year; and (iii) the “floor plan financing interest” of the taxpayer for the taxable year. The amount of a taxpayer’s BIE that is limited by section 163(j) is carried forward indefinitely as a “disallowed business interest expense carryforward.”

Section 163(j)(8)(A) defines ATI as the taxable income of the taxpayer computed without regard to—

(i) any item of income, gain, deduction, or loss that is not properly allocable to a trade or business,

(ii) any BIE or BII,

(iii) the amount of any NOL deduction under section 172,

(iv) the amount of any deduction allowed under section 199A, and

(v) in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion.

The Secretary is granted authority in section 163(j)(8)(B) to make any “other adjustments” to ATI. Treasury and the Service exercised this authority in the Proposed Regulations to adopt certain adjustments to ATI, including an adjustment to prevent double inclusion of depreciation in ATI before 2022 upon the sale of the asset or stock in a member or an interest in a partnership holding such asset.

If a taxpayer is an “excepted entity” because it operates an “excepted trade or business,” the excepted entity does not calculate a section 163(j) limitation. Also, an excepted trade or business does not generate ATI.

Disallowed business interest expense carryforwards appear to retain their character as BIE, regardless of whether they would otherwise be considered properly allocable to an excepted trade or business if they arose at a later time (e.g., the taxpayer

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6 BIE does not include “investment interest expense” within the meaning of section 163(d). I.R.C. § 163(j)(5). The Proposed Regulations provide that a C corporation can have only BIE and BII (and not investment interest income or investment interest expense) for purposes of section 163(j). Prop. Reg. § 1.163(j)-4(b). This treatment extends to items allocated to a C corporation partner from a partnership, even if the items constitute investment items at the partnership level; as such, a partnership’s allocation of “investment interest expense” within the meaning of section 163(d) to a C corporation partner is treated as BIE at the partner level. Prop. Reg. § 1.163(j)-4(b)(3).

7 I.R.C. § 163(j)(1).


10 An excepted trade or business includes the trade or business of performing services as an employee, an electing real property trade or business, an electing farming business, or an excepted regulated utility trade or business. I.R.C. § 163(j)(7)(A); Prop. Reg. § 1.163(j)-2(b)(38)(ii).

11 Prop. Reg. § 1.163(j)-6(m)(2).

had initially opted out of, but later elected to be, an electing real property trade or business). Thus, disallowed business interest expense carryforwards seemingly remain subject to the section 163(j) limitation, even if the taxpayer no longer conducts a non-excepted trade or business under section 163(j).

In the case of a partnership, section 163(j) is applied at the partnership level, and any deduction for BIE is taken into account in determining the non-separately stated taxable income or loss of the partnership. In addition, each partner’s ATI is (i) determined without regard to such partner’s distributive share of any items of income, gain, deduction, or loss of such partnership, and (ii) increased by such partner’s distributive share of such partnership’s excess taxable income (“ETI”). Each partner’s BII (for purposes of calculating that partner’s own section 163(j) limitation at the partner level) does not include BII from a partnership that is subject to section 163(j), except to the extent that partner is allocated excess business interest income (“EBII”) from that partnership.

Unlike in the case of an individual, corporation, or other taxpayer, the amount of any BIE not allowed as a deduction to a partnership for any taxable year is not automatically treated as BIE paid or accrued by the partnership in the succeeding taxable year. Rather, subject to the rules in the next paragraph, that disallowed BIE is treated as excess business interest expense (“EBIE”), which is allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership.

If a partner is allocated any EBIE from a partnership for any taxable year, (i) such EBIE is treated as BIE paid or accrued by the partner in the next succeeding taxable year in which the partner is allocated ETI or EBII from such partnership, but only to the extent of such ETI and EBII. Any portion of such EBIE remaining after applying the limitation above is treated as BIE paid or accrued by the partner in succeeding taxable years. In addition, once all such EBIE for all preceding taxable years has been treated as paid or accrued by a partner as a result of the partnership allocating ETI or EBII to that partner, any remaining ETI that the partnership has allocated to that partner may be taken

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13 Prop. Reg. § 1.163(j)-1(b)(2)(ii), -2(c)(1), -10(c)(4). But see Prop. Reg. § 1.163(j)-6(m)(3) (“If a partnership allocates excess business interest expense to one or more of its partners, and in a succeeding taxable year becomes not subject to the requirements of section 163(j), the excess business interest expense from the prior taxable years is treated as paid or accrued by the partner in such succeeding taxable year.”). The Section previously commented that the treatment of disallowed business interest carryforwards from a business that subsequently elects to become an electing real property trade or business (within the meaning of section 163(j)(7)(A)(ii)) or electing farming businesses (within the meaning of section 163(j)(7)(A)(iii)) is unclear. American Bar Association Section of Taxation, COMMENTS ON PROPOSED REGULATIONS UNDER SECTION 163(J) REGARDING ISSUES AFFECTING REAL ESTATE § V.B.1 (2019).

14 However, disallowed business interest expense carryforwards that are carried forward to a taxable year in which the taxpayer qualifies for the small business exemption are not subject to the section 163(j) limitation. Prop. Reg. § 1.163(j)-2(c)(2).


17 Prop. Reg. § 1.163(j)-6(e)(4)(i).


into account by that partner in computing that partner’s own ATI with respect to any other BIE that the partner incurred at the partner level.\(^{21}\) Similar to disallowed business interest expense carryovers, EBIE seemingly retains its character as BIE at the partner level, notwithstanding whether the partnership that generated the EBIE continues to be subject to section 163(j) in a later taxable year\(^{22}\) (hereinafter, disallowed business interest expense carryovers and EBIE will collectively be referred to as “Section 163(j) Carryforwards”).

Section 163(j)(4)(C) defines ETI with respect to any partnership as the amount that bears the same ratio to the partnership’s ATI as the excess (if any) of (i) 30% of the partnership’s ATI for the taxable year, over (ii) the amount (if any) by which the BIE of the partnership, reduced by the floor plan financing interest expense, exceeds the BII of the partnership, bears to 30% of the partnership’s ATI for the taxable year.\(^{23}\)

B. CODI Generally

When the liability to pay a debt is forgiven, the debtor generally has CODI in the year the debt is discharged unless one of several exceptions or exclusions applies.\(^{24}\) This rule historically was premised on a “freeing of assets” theory.\(^{25}\) When the liability existed, the debtor’s assets were tied up by the obligation to repay the debt. When the debt was forgiven, the reduction in the liability freed up a corresponding amount of assets, and the positive adjustment in the debtor’s balance sheet is an “accession to wealth” that should be included in the debtor’s gross income and subject to tax.\(^{26}\) CODI includes both forgiven principal and interest.\(^{27}\)

C. Section 108 Generally

Section 108 contains several exceptions to the general rule that CODI gives rise to taxable income. For example, a bankrupt or insolvent debtor generally is not required to pay immediately a tax in the year in which CODI is recognized.\(^{28}\) In this way, Congress sought to provide the debtor with a “fresh start” from a federal income tax perspective.\(^{29}\) If the debtor had to include the discharged debt in gross income when the debtor did not

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\(^{21}\) I.R.C. § 163(j)(4)(B)(ii); Prop. Reg. § 1.163(j)-6(g)(3).

\(^{22}\) See supra note 13 and accompanying text.

\(^{23}\) See also Prop. Reg. § 1.163(j)-1(b)(15).

\(^{24}\) I.R.C. § 61(a)(11); Reg. § 1.61-12(a).

\(^{25}\) United States v. Kirby Lumber Co., 284 U.S. 1, 3 (1931). In some cases involving relief from liabilities, the “freeing of assets” theory has been discounted if so-called “Tufts gain” is at stake. See Gershowitz v. Commissioner, 88 T.C. 984, 1011–12 (1987) (citing Commissioner v. Tufts, 461 U.S. 300, 310, n.11 (1983)) (noting that recognition of gain tied to the total amount of indebtedness in the context of a foreclosure does not rely on a “freeing of assets” theory).


\(^{28}\) I.R.C. § 108(a)(1)(A), (B). In the case of insolvent, but not bankrupt, taxpayers, this exclusion applies only to the extent of the taxpayer’s insolvency. There are various less commonly relied-upon exclusions under section 108(a); these Comments will focus on the bankruptcy exclusion as the prototypical case.

have the means to pay the tax, the Code would have the effect of placing the debtor back in debt (with the federal government as creditor).

The “price” of the income exclusion under section 108(a) is that the debtor must reduce tax attributes by the amount of excluded CODI. Section 108(b) sets forth a specific list of attributes that are subject to reduction as a result of excluded CODI, that list was not amended by the Act, and Section 163(j) Carryforwards are not in that list.

If a partnership is the debtor, the amount of CODI is calculated at the partnership level, where it is then allocated to the partners consistent with the general allocation of taxable income. However, eligibility for the section 108(a) exclusion is determined on a partner-by-partner basis, and any attribute reduction similarly is determined at the partner level.

Cash-method taxpayers and accrual-method taxpayers subject to certain interest deferral provisions are unable to deduct interest expense until it has been paid. To prevent the recognition of CODI followed by a possible permanent disallowance of interest expense when such unpaid interest is forgiven, section 108(e)(2) provides an exception to CODI recognition “to the extent that payment of the liability would have given rise to a deduction.”

II. DISCUSSION

A. Potential Distortions

As illustrated by the examples in Section II.A.1 and 2, immediately below, the forgiveness of interest that has been limited by section 163(j) creates distortions that are at odds with both the “freeing of assets” principle underlying cancellation of debt taxation and transactional parity. More specifically, the premise for the deduction of the interest expense (i.e., the payment or accrual of the interest) is gone: (i) the interest is

31 I.R.C. § 108(b).
32 In the context of consolidated groups, these rules are expanded upon in Regulation section 1.1502-28 and numerous other provisions that interact with that section.
33 H.R. REP. No. 96-833, at 274 (1980); S. REP. No. 96-1035, at 68 (1980). This rule is subject to modifications for, among other things, any special allocation of CODI, or any special allocations required under the partnership minimum gain rules, which may be prevalent in the context of so-called partnership exculpatory liabilities that are recourse to the partnership under state law principles, but are partnership non-recourse liabilities under section 752 principles.
34 I.R.C. § 108(d)(6).
35 For example, when a corporation issues a debt obligation subject to the AHYDO rules under sections 163(e)(5) and 163(i).
36 While there is no authority on point, it seems that the section 108(e)(2) exception may properly apply at either the partnership or partner level, depending on the character of the deductible expenditure. Under section 702, certain deductions are netted against income at the partnership level, while other items are passed through and deducted as separately stated items on the partner’s return. Logically, section 108(e)(2) should apply with respect to a liability at the level where the deduction would be taken, consistent with section 702. Sowell, supra note 30, at 355–65.
discharged and will never be repaid; and (ii) the accrual of the interest (i.e., the point at which the liability is taken into account for federal income tax purposes) has been deferred by section 163(j)(2) and may not occur until a year long after the interest has been discharged, at which point, taxpayers would be accruing an expense for an item that no longer exists (i.e., the interest would be deductible even though there was no longer a fixed liability to pay). Yet, as things stand, it appears that taxpayers would nevertheless be required to include the forgiven interest in income as CODI in the year of the discharge. And the only “compensation” for this upfront taxable income inclusion is a Section 163(j) Carryforward (i.e., a future deduction for a previously forgiven interest expense), which may not provide an offsetting cash tax benefit in the year of the discharge, if at all.

1. CODI as ATI Generally

The calculation of ATI starts with taxable income.\(^37\) And, generally speaking, CODI gives rise to taxable income under section 61(a)(11) unless an exception applies, such as one of those contained in section 108. Although some items of income or gain are excluded from the definition of ATI, CODI is not mentioned as one of them.\(^38\)

This can result in somewhat counterintuitive tax consequences. For example, if previously deducted interest expense subsequently is cancelled, a taxpayer may be better off from a cash tax perspective than it would have been had the debt on which the interest was forgiven never existed. This is demonstrated in Example 1, below.

*Example 1—Cancellation of Interest Previously Deducted*

In Year 1, taxpayer, who uses the accrual method, became liable to pay $50 of interest expense on Debt A and $50 of interest expense on Debt B (although taxpayer paid neither). Taxpayer had $400 of taxable income from operations (before any interest expense deductions) and ATI. Accordingly, taxpayer was able to deduct all $100 of the interest expense that it became liable for in Year 1,\(^39\) and taxpayer had $300 of taxable income after accounting for allowed interest expense deductions.\(^40\)

In Year 2, the $50 of Year 1/Debt A interest expense (which remains unpaid) was cancelled; no further interest under Debt A is due. Also, taxpayer became liable for another $50 of interest expense on Debt B (which was neither paid nor cancelled), and taxpayer had $100 of taxable income and ATI (before any interest

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\(^{37}\) I.R.C. § 163(j)(8); Prop. Reg. § 1.163(j)-1(b)(1).

\(^{38}\) I.R.C. § 163(j)(8)(A); Prop. Reg. § 1.163(j)-1(b)(1)(ii). We do not believe there is a question whether taxable CODI attributable to the forgiveness of loan principal is treated as ATI, as that amount is unaffected by section 163(j) (which applies only to interest).

\(^{39}\) Taxpayer’s section 163(j) limitation of $120 ($400 of ATI times 30% equals $120) exceeded the $100 of interest expense that taxpayer became liable for in Year 1 ($50 of interest expense on Debt A plus $50 of interest expense on Debt B).

\(^{40}\) Taxpayer’s taxable income at the end of Year 1 (before any interest expense deductions) of $400 minus the $100 of allowed interest expense deductions equals $300 of net taxable income for Year 1.
expense deductions and without regard to any CODI in respect of the cancellation of the $50 of Year 1/Debt A interest expense).

If the CODI attributable to the $50 of forgiven Year 1/Debt A interest expense is included in taxpayer’s ATI in Year 2, then, in Year 2, taxpayer would have $150 of taxable income and ATI ($100 of income from operations and $50 from taxable CODI), resulting in the ability to deduct $45/$50 of the Year 2/Debt B interest expense that became due in Year 2. Of that $45 deduction, $15 would be available as a result of the $50 of CODI arising from the forgiven Year 1/Debt A interest expense, while the remaining $30 would be as a result of the $100 of income from operations earned by taxpayer during Year 2. In this way, the CODI (which is effectively the reversal of the prior year $50 deduction on the Year 1/Debt A interest expense) is used to supplement ATI in Year 2 and thus allow for a greater deduction of the Year 2/Debt B interest expense than otherwise would have been available based on income from operations in Year 2 alone ($45 as opposed to $30).

Accordingly, the final outcome after Year 2 in this example is $550 of cumulative taxable income (before any interest expense deductions) minus $145 of cumulative interest expense deductions, for net taxable income of $405 and a Section 163(j) Carryforward of $5 (relating to the $50 of Year 2/Debt B interest expense, the deduction for which was limited by section 163(j)).

On the other hand, if the $50 of CODI in Year 2 is not taken into account for purposes of computing taxpayer’s ATI, but is taken into account for purposes of computing taxpayer’s taxable income, taxpayer would have $550 of cumulative taxable income (before any interest expense deductions) minus $130 of cumulative interest expense deductions, for net taxable income of $420 and a Section 163(j) Carryforward of $20 (relating to the $50 of Year 2/Debt B interest expense, the deduction for which was limited by section 163(j)).

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41 Taxpayer’s section 163(j) limitation of $45 ($150 of ATI times 30% equals $45) is less than the $50 of interest expense that taxpayer became liable for in Year 2 with respect to Debt B, so taxpayer’s ability to deduct the $50 of Year 2/Debt B interest expense is limited to $45 under section 163(j)(1)(B).
42 The $50 of CODI, as ATI, produces a section 163(j) limitation of $15 ($50 times 30% equals $15).
43 The $100 of income from operations, as ATI, produces a section 163(j) limitation of $30 ($100 times 30% equals $30).
44 Year 1 income from operations of $400 plus Year 2 income from operations of $100 plus Year 2 CODI of $50 from the forgiveness of the Year 1/Debt A interest expense equals $550 of cumulative taxable income (before any interest expense deductions).
45 The $50 deduction in Year 1 for the Year 1/Debt A interest expense plus the $50 deduction in Year 1 for the Year 1/Debt B interest expense plus the $45 deduction in Year 2 for the Year 2/Debt B interest expense equals $145 of cumulative interest expense deductions.
46 Year 1 income from operations of $400 plus Year 2 income from operations of $100 plus Year 2 CODI of $50 from the forgiveness of the Year 1/Debt A interest expense equals $550 of cumulative taxable income (before any interest expense deductions).
47 The $50 deduction in Year 1 for the Year 1/Debt A interest expense plus the $50 deduction in Year 1 for the Year 1/Debt B interest expense plus a $30 (as opposed to $45) deduction for the Year 2/Debt B interest expense equals $130 of cumulative interest expense deductions. The deduction for the Year 2/Debt B interest expense is reduced because, if the $50 of CODI is not included in ATI, taxpayer’s section 163(j) limitation for Year 2 is only $30 ($100 of ATI/income from operations times 30% equals $30), as opposed to $45 (($100 of ATI/income from operations plus $50 of ATI/CODI) times 30% equals $45).
By contrast, if Debt A had not existed, taxpayer would have been permitted to
deduct $50/$50 of the Year 1/Debt B interest expense\(^{48}\) and $30/$50 of the
Year 2/Debt B interest expense.\(^{49}\) Taxpayer would have $500 of cumulative
taxable income (before any interest expense deductions)\(^{50}\) minus $80 of
cumulative interest expense deductions,\(^{51}\) for net taxable income of $420 and a
Section 163(j) Carryforward of $20 (the same as if Debt A existed but the CODI
from the forgiveness of such interest was not taken into account for purposes of
ATI, as discussed immediately above).

Therefore, in this example, if the CODI is taken into account for purposes of ATI,
taxpayer would better off at the end of Year 2 from a net taxable income ($405 versus
$420) and Section 163(j) Carryforward ($5 versus $20) perspective by having incurred
interest expense in Year 1 that was forgiven in Year 2, than taxpayer would have been
had the interest expense (\(i.e.,\) Debt A) not been incurred at all.

Although this result seems counterintuitive, we do not believe this outcome
necessarily is inappropriate in the context of our tax system, which is constrained by
annual accounting.\(^{52}\) A number of provisions are already keyed off of taxable income
(which includes CODI) and are already affected by the fact that CODI attributable to
forgiven interest arises in a year after such forgiven interest is accrued. CODI’s impact on
section 163(j) would not seem especially troubling given section 163(j)’s status as a
temporary deferral provision. Moreover, we do not believe that the situation described
above presents a significant opportunity for abuse—third-party creditors would be
expected to enforce aggressively their rights under a loan agreement, and implementing
related-party loans with an eye to forgiving them in the future would raise significant
concerns as to the bona fide nature of the debt.

\(^{48}\) In Year 1, taxpayer had $400 of income from operations/ATI, so taxpayer’s section 163(j) limitation was
$120 ($400 of ATI times 30% equals $120). Taxpayer’s section 163(j) limitation exceeded the $50 of
Debt B interest expense that taxpayer became liable for in Year 1. Thus, all $50 of the Year 1/Debt B
interest expense was deductible.

\(^{49}\) In Year 2, taxpayer had $100 of income from operations/ATI, so taxpayer’s section 163(j) limitation
would be $30 ($100 of ATI times 30% equals $30). In this case, taxpayer’s section 163(j) limitation would
be $20 less than the $50 of Debt B interest expense that taxpayer became liable for in Year 2. Thus, only
$30 of the Year 2/Debt B interest expense would be deductible, and the remaining $20 would be a
Section 163(j) Carryforward.

\(^{50}\) Year 1 income from operations of $400 plus Year 2 income from operations of $100 equals $500 of
cumulative taxable income (before any interest expense deductions).

\(^{51}\) The $50 deduction in Year 1 for the Year 1/Debt B interest expense plus the $30 deduction in Year 2 for
the Year 2/Debt B interest expense equals $80 of cumulative interest expense deductions.

\(^{52}\) *Hillsboro National Bank v. Commissioner*, 460 U.S. 370, 378 n. 10 (1983) (noting that “Congress has
enacted an annual accounting system under which income is counted up at the end of each year.”).
In addition, the deduction and subsequent cancellation of interest does not always (and frequently would not) produce a net benefit because all income, including any CODI related to interest, is reduced by 70% when determining the amount of deductible interest expense. For instance, consider the results if the interest expense deduction in Year 1 were limited.

Example 2—Cancellation of Section 163(j)-Limited Interest

Same facts as Example 1, above, except that in Year 1 taxpayer has $100 (as opposed to $400) of taxable income from operations (before any interest expense deductions) and ATI. Accordingly, in Year 1, taxpayer is able to deduct only $30 of its $100 of total incurred interest expense, and taxpayer has $70 of Section 163(j) Carryforward.53 Assuming that our recommendation below to adopt a Pro-Ration Approach to allocate section 163(j)-limited interest expense to particular debt is adopted, taxpayer would have deducted $15 of interest expense with respect to each of Debt A and Debt B (for a total of $30 of allowed interest expense deductions), and $35 of taxpayer’s $70 Section 163(j) Carryforward would be allocable to each of Debt A and Debt B.

Thus, at the end of Year 2, if the $50 of CODI attributable to the forgiven Year 1/Debt A interest expense is included in ATI (such that, like above, taxpayer would have $100 of taxable income from operations and $50 from taxable CODI for a total ATI in Year 2 of $150), taxpayer would be able to deduct $45/$50 of the Year 2/Debt B interest expense.54 Taxpayer would have $250 of cumulative taxable income (before any interest expense deductions)55 minus $75 of cumulative interest expense deductions,56 for net taxable income of $175 and a Section 163(j) Carryforward of $75.57

If the $50 of CODI in Year 2 is not taken into account for purposes of ATI, but is taken into account for taxable income purposes, taxpayer would have $250 of cumulative taxable income before interest expense deductions (same as above) minus $60 (as opposed to $75) of cumulative interest expense deductions,58 for a

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53 Taxpayer’s section 163(j) limitation of $30 ($100 of ATI times 30% equals $30) exceeded the $100 of interest expense that taxpayer became liable for in Year 1 ($50 of interest expense on Debt A plus $50 of interest expense on Debt B). Taxpayer’s section 163(j) limitation of $30 was $70 less than the $100 of total interest expense that taxpayer became liable for in Year 1. Thus, only $30 of this interest expense was deductible, and the remaining $70 became a Section 163(j) Carryforward.

54 Taxpayer’s section 163(j) limitation of $45 ($150 of ATI times 30% equals $45) is less than the $50 of interest expense that taxpayer became liable for in Year 2 with respect to Debt B, so taxpayer’s ability to deduct the $50 of Year 2/Debt B interest expense is limited to $45 under section 163(j)(1)(B), and the remaining $5 is a Section 163(j) Carryforward.

55 Taxpayer had $100 of income from operations in Year 1 plus $150 of income in Year 2 ($100 of income from operations plus $50 of CODI).

56 Taxpayer deducted $60 of interest expense on Debt B ($15 in Year 1 and $45 in Year 2) plus $15 of interest expense on Debt A (all in Year 1).

57 Taxpayer’s Section 163(j) Carryforward from Year 1 of $70 (divided equally between Debt A ($35) and Debt B ($35)) plus a Section 163(j) Carryforward from Year 2 of $5 (attributable to the $50 of Year 2/Debt B interest expense, of which only $45 was allowed as a deduction due to taxpayer’s section 163(j) limitation).

58 Taxpayer had $30 of interest expense deductions in Year 1 ($15 for each of Debt A and Debt B) plus $30 (as opposed to $45) of interest expense deductions in Year 2 (all in respect of Debt B), with the shortfall of
net taxable income of $190 (as opposed to $175) and a Section 163(j) Carryforward of $90 (as opposed to $75).\(^{59}\)

By contrast, had Debt A not existed, taxpayer would have been permitted to deduct $30/$50 of the interest expense on Debt B in each of Year 1 and Year 2.\(^{60}\) Taxpayer would have $200 of cumulative taxable income (before any interest expense deductions)\(^{61}\) minus $60 of cumulative interest expense deductions,\(^{62}\) for a net taxable income of $140 and a Section 163(j) Carryforward of $40 (relating to the $50 of Year 1/Debt B interest expense and the $50 of Year 2/Debt B interest expense, the deduction for which was limited by section 163(j) to $30 in each of those years).

Accordingly, in Example 2, taxpayer would have (i) net taxable income of $190 and a Section 163(j) Carryforward of $90 if the CODI is excluded from ATI, (ii) net taxable income of $175 and a Section 163(j) Carryforward of $75 if the CODI is included in ATI, or (iii) net taxable income of $140 and a Section 163(j) Carryforward of $40 if Debt A never existed. In Example 1, recall that taxpayer was better off with Debt A having been incurred but then cancelled, whereas in Example 2, taxpayer is advantaged if Debt A never enters the equation.

Thus, as these examples show, what may seem like a simple solution to any perceived problem—that is, excluding interest-related CODI from ATI—also creates distortions. In the examples above, if interest-related CODI was excluded from ATI, the taxpayer’s cash taxes during Year 1 and Year 2 would be the same as, or, in the case of Example 2, higher than, they would have been had Debt A never been incurred. The only compensation for these higher cash taxes is a larger Section 163(j) Carryforward. This result is, in our view, not required by the Code and is inappropriate as a matter of tax policy because it would put distressed taxpayers (i.e., the typical taxpayer with realized CODI) in a disadvantaged position vis-à-vis a non-distressed taxpayer.

2. Attribute Reduction Under Section 108(b)

As noted above, as section 108(b) is currently formulated, Section 163(j) Carryforwards are not in the list of tax attributes subject to reduction as part of the price

\(^{59}\) Taxpayer’s Section 163(j) Carryforward from Year 1 of $70 (divided equally between Debt A ($35) and Debt B ($35)) plus a Section 163(j) Carryforward from Year 2 of $20 (attributable to the $50 of Year 2/Debt B interest expense, of which only $30 was allowed as a deduction due to taxpayer’s section 163(j) limitation, as reduced by the exclusion of CODI from ATI).

\(^{60}\) In each of Year 1 and Year 2, taxpayer had $100 of income from operations/ATI, so taxpayer’s section 163(j) limitation for each of Year 1 and Year 2 would be $30 ($100 of ATI times 30% equals $30). Thus, in each of Year 1 and Year 2, taxpayer’s section 163(j) limitation would be $20 less than the $50 of Debt B interest expense that taxpayer became liable for in each of those years. As a result, only $30/$50 of the Year 1/Debt B interest expense would be deductible, and only $30/$50 of the Year 2/Debt B interest expense would be deductible.

\(^{61}\) Year 1 income from operations of $100 plus Year 2 income from operations of $100 equals $200 of cumulative taxable income (before any interest expense deductions).

\(^{62}\) The $30 deduction in Year 1 for the Debt B interest expense plus the $30 deduction in Year 2 for the Debt B interest expense equals $60 of cumulative interest expense deductions.
for excluding CODI under section 108(a). As a result, absent regulatory action, taxpayers that recognize CODI, including CODI attributable to interest that gave rise to a Section 163(j) Carryforward, will apply the rules of section 108(a) and (b) without reducing Section 163(j) Carryforwards, which can lead to distortions. Whether the result is favorable will depend on the context, as illustrated below.

**Taxpayer A—Standalone Corporation with No Attributes or Tax Basis Other Than Section 163(j) Carryforwards**

In Year 1, Taxpayer A earns no income and owes $10 of interest expense, the deduction for which is disallowed by section 163(j). In Year 2, A files for bankruptcy, and the interest outstanding from Year 1 is discharged without payment. 63 Under the current rules with no changes to the Regulations, A will incur $10 of “black hole” CODI attributable to the forgiven interest that will not reduce any attribute, and A will be able to utilize the Section 163(j) Carryforward from Year 1 to the extent it has sufficient ATI in future years (and subject to any other limitations, including section 382).

One might argue that this imparts an inappropriate benefit to A. The interest expense that gave rise to the Section 163(j) Carryforward was never paid, yet A was permitted to keep the Section 163(j) Carryforward. Absent section 163(j), the interest would have given rise to a $10 NOL in Year 1 that would have been eliminated under section 108(b) in Year 2—it would be bizarre for A to be in a better position because of section 163(j).

However, there is another side to this argument. If A had earned $10 of gross income (and ATI) in Year 1, then, absent section 163(j), the $10 of accrued interest would have offset this $10 of income in full, A would owe no tax in Year 1, and all of the CODI in Year 2 would again be “black hole” CODI. Even with section 163(j), the same result would occur if A had $33.34 of gross income (and ATI), allowing the deduction of $10 of interest expense. Accordingly, where A has $0 of gross income (and ATI) in Year 1, eliminating the Section 163(j) Carryforward transforms a deferral provision into a permanent disallowance provision because the interest expense deduction and “black hole” CODI may well have arisen in different fact patterns.

The policy question is whether this “transformation” is justifiable in light of the fact that the interest was never paid. That is, of course, what happens to deductions that are deferred under the applicable high-yield discount obligation (“AHYDO”) rules—cancellation of the relevant interest expense results in a permanent elimination of any deduction. But, of course, in the AHYDO context, the common view is that the section 108(e)(2) exception applies to also eliminate the corresponding CODI. 64

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63 To simplify these examples, CODI with respect to the underlying debt is not being addressed.
64 See discussion infra Section II.B.2 on the applicability of section 108(e)(2) to section 163(j)-limited interest.
Taxpayer B—Standalone Corporation with Section 163(j) Carryforwards and Other Attributes, or Member of a Consolidated Group with an Excess Loss Account.

Same facts as Taxpayer A, above, but Taxpayer B, in addition to having $10 of Section 163(j) Carryforward, has a $10 NOL from operating losses not attributable to interest expense deductions. In this situation, B loses its $10 NOL under section 108(b), even though all of the CODI is attributable to interest expense that gave rise to the Section 163(j) Carryforward.

This is a highly unfavorable, and arguably unjustifiable, result, because of the significant limitations on the ability to utilize Section 163(j) Carryforwards in the future. Critically, this issue may be magnified if it is not a carryforward attribute, but rather tax basis that is subject to reduction, particularly if the tax basis subject to reduction is a short-lived asset, such as inventory or accounts receivable (“A/R”). Reduction of A/R tax basis is a potential “death knell” for restructuring companies because such reduction will produce taxable income almost immediately following a restructuring—potentially eviscerating the “fresh start” purpose of section 108. That problem goes beyond section 163(j), of course, but is exacerbated by the exclusion of Section 163(j) Carryforwards from section 108(b).

A similar issue is faced by members of a consolidated group where there is an ELA in the stock of such member. “Black hole” CODI incurred directly by a subsidiary is an ELA inclusion event, and, like a reduction in inventory and A/R tax basis, an ELA-inclusion event can be a significant roadblock to restructuring a troubled company.

B. Options to Address Potential Distortions

As illustrated above, excludable CODI would result in attribute reduction that would “skip” any Section 163(j) Carryforward. Further, if non-excludable CODI attributable to section 163(j)-limited interest is taken into account as ATI, or, even if it is not, taxpayers could be subject to immediate tax for CODI attributable to interest expense that is not currently deductible, and whose future deductibility is tied to a Section 163(j) Carryforward that may never be utilized, while the associated interest expense is long since forgiven. As a policy matter, we believe these results improperly decouple the source of CODI from the tax benefit, if any, that purportedly was obtained from the interest expense (namely, the allowance of a deduction for the payment or accrual of that interest expense).

65 Tax basis generally is further down the section 108(b) hierarchy, unless taxpayers make an election to reduce depreciable tax basis first. I.R.C. § 108(b)(2)(E), (b)(5). Additionally, there is a “liability floor” rule that prevents the reduction of aggregate tax basis below a debtor’s aggregate liabilities immediately after a transaction. This simplified example does not address those nuances.

66 CODI included in ATI would only provide BIE capacity equal to 30% of the CODI amount. Thus, if a taxpayer realized and recognized $100 of CODI, the taxpayer would be able to deduct an incremental $30 of BIE but would have a net taxable income increase of $70.

67 No real tax benefit will obtained by taxpayers that are subject to a “structural” section 163(j) limitation (i.e., taxpayers that will never have sufficient capacity to deduct all current-year interest expense). In other cases, the cash tax benefit may be obtained far into the future and will be eroded on a present-value basis by the passage of time.
interest), at odds with basic tax benefit and “freeing of assets” principles. Below we address options for addressing these distortions.68

1. **Adding Section 163(j) Carryforwards to Section 108(b) List**

To address the concern that excludable CODI results in attribute reduction that “skips” any Section 163(j) Carryforward, future Regulations could include Section 163(j) Carryforwards in the list of attributes subject to reduction under section 108(b) (the “Section 108(b) Approach”). This would allow taxpayers to reduce Section 163(j) Carryforwards before reducing more favorable tax assets, such as NOLs and asset basis.

These Regulations could take several different approaches. As one possibility, the Regulations could provide that a Section 163(j) Carryforward of any particular annual “vintage” is reduced before NOLs. This approach would be similar to the ordering rule adopted with respect to the application of section 382 to Section 163(j) Carryforwards. Alternatively, the Regulations could provide that Section 163(j) Carryforwards of any particular annual “vintage” are reduced on a proportionate, pro-rata basis with NOLs of the same year. Section 163(j) Carryforwards could also simply be located as a separate item in the list, either before or after NOLs. Finally, Regulations could require that Section 163(j) Carryforwards are reduced before other attributes to the extent CODI is attributable to forgiven interest. Any of these approaches would address the problem.

It is not clear, however, whether Treasury and the Service have the regulatory authority to make such a change. As noted above, section 108(b) sets forth a specific list of tax attributes subject to reduction, it does not contain a regulatory grant of authority to expand that list, and there was no specific regulatory grant of authority to coordinate section 163(j) with section 108. Moreover, as noted immediately above, a decision would need to be made regarding the proper placement of Section 163(j) Carryforwards in the list if this approach was adopted. Additionally, Section 163(j) Carryforwards are not the only attribute that is missing from section 108(b), so this is not an issue that is new to section 163(j).69

Nonetheless, Treasury and the Service have general interpretive regulatory authority under section 163(j), which they exercised, for example, to adopt ordering rules under the Proposed Regulations for the application of section 163(j) vis-à-vis other

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68 We are concerned that taxpayers are likely to take the position that certain of the approaches described below can be utilized in some form, even in the absence of regulatory authority specifically permitting these approaches. Accordingly, we urge Treasury and the Service to provide guidance in this area to achieve consistency among taxpayers.

69 Without purporting to be an exhaustive list, investment interest carryforwards under section 163(d), recognized built-in losses (“RBIL”) subject to the annual limitation under section 382 by virtue of section 382(h) and the Regulations promulgated thereunder, and overall domestic losses are also not in the list. These items do not all present the same issues—in particular, practitioners differ on whether RBILs should be subject to reduction under section 108(b) because of the statutory language that provides that RBILs are carried forward “under rules similar to the rules for the carrying forward of net operating losses [and capital losses].” I.R.C. § 382(h)(4)(A).
Code sections 70 and for the use of Section 163(j) Carryforwards that effectively preserves section 382 limitation to utilize against NOLs instead of Section 163(j) Carryforwards. 71

Even if Treasury and the Service conclude they have the authority to add Section 163(j) Carryforwards to the attributes to be reduced under section 108(b), we note that this approach does not address non-excludable CODI, and so a separate solution to avoid distortion would be necessary for non-excludable CODI.

2. Application of Section 108(e)(2)

Section 108(e)(2) generally provides an exception to CODI recognition “to the extent that payment of the liability would have given rise to a deduction.” If section 108(e)(2) applies to CODI related to section 163(j)-limited interest (the “Section 108(e)(2) Approach”), the forgiveness of such interest would not result in CODI, or ATI.

Although interest that is subject to a section 163(j) limitation has not yet given rise to a deduction, notably, a Section 163(j) Carryforward is, in fact, under section 163(j)(2), a deemed re-payment (or re-accrual) of the relevant interest in each year until there is sufficient ATI to claim the deduction. Accordingly, there is a statutory basis for this approach, if one believes that section 108(e)(2) should be interpreted to apply to certain situations involving accrual where the ability to claim a deduction is deferred.

In addition, although the ability to deduct interest expense under section 163(j) is not attributable to payment or accrual per se, one could argue that, from a policy perspective, deferral of a deduction under section 163(j) is not meaningfully different from deferral under a provision that is tied specifically to payment, such as the AHYDO rules, and it seems reasonably clear that section 108(e)(2) applies to interest expense deductions that are deferred under the AHYDO rules. 72

However, it bears noting that the Tax Court previously has considered, although in dicta, whether another temporary interest expense deferral provision—specifically, the investment interest expense limitation in section 163(d)—can negate the application of section 108(e)(2). In Brooks v. Commissioner, 73 the Tax Court held that forgiven interest was not traced to investment expenditures, and, therefore, was not eligible for a section 212 deduction. Going further, the court held that even if the debt was traced to an investment expenditure, the deduction for such investment interest expense would have

70 Prop. Reg. § 1.163(j)-3.
72 It is possible to distinguish AHYDO deferral from section 163(j) deferral on the basis that “payment” is the express key that unlocks deductions that have been deferred under AHYDO. However, “payment” may—and often does—take the form of equity or debt, in which case deduction may be permanently disallowed or again deferred, respectively, under section 163(e)(5)(A) and (i)(3)(B). In other words, there is no assurance that payment of the liability would have given rise to a deduction, as required by section 108(e)(2), because AHYDO payments sometimes are made in debt or equity that would not give rise to an immediate deduction. So, the distinction is not as strong as some practitioners believe it is.
73 103 T.C.M. (CCH) 1160, 2012 T.C.M. (RIA) ¶ 2012-025.
been disallowed under section 163(d) because the taxpayer did not prove that he had enough investment income to satisfy that section’s limitation on deducting investment interest expense (unlike section 163(j), section 163(d) provides for a dollar-for-dollar, as opposed to a 30-cents-on-the-dollar, deduction of investment interest expense against investment income). For these reasons, the court held that section 108(e)(2) did not apply. Section 163(d) has a similar carryover provision as section 163(j). Therefore, Brooks calls into question whether section 108(e)(2) could apply in cases where a taxpayer’s ability to deduct interest expense is subject to deferral, such as section 163(j).

We do not believe Brooks forecloses the application of section 108(e)(2) for a number of reasons. As an initial matter, Brooks addressed the fairly narrow situation of a cash-method taxpayer. By its terms, section 163(j) does not apply to cash-method taxpayers. Second, had the debt been properly traceable to investment expenditures, the taxpayer ought to have asserted that its CODI should have been treated as investment income under section 163(d)—it is unclear from the opinion whether that issue was raised, but it was not addressed. If so, because section 163(d) provides for a dollar-for-dollar deduction of investment interest expense against investment income, the CODI, if treated as investment income for purposes of section 163(d), ought to have permitted a full deduction of the forgiven interest expense and, thus, trigger the application of section 108(e)(2) to exclude the associated CODI from income. In addition, the discussion of section 108(e)(2) in Brooks was dicta. And, most importantly, the Tax Court did not evaluate or address what we believe is the fundamental issue under section 108(e)(2): should that provision be turned off permanently with respect to an item of CODI based on a provision that temporarily defers a deduction. The context of the Brooks decision makes the Tax Court’s conclusion fairly unsurprising because Brooks, a cash-method taxpayer, did not actually pay the interest, and so he did not actually have a section 163(d) carryforward of investment interest expense.

Fundamentally, there are two reasonably administrable ways to answer this question. One could take the view that because the deduction would be deferred at the moment the CODI arises, section 108(e)(2) can never apply to such CODI. Alternatively, one could take the view that a deferral provision is just that—a deferral provision—and the default assumption should be that the deferred deduction eventually could be claimed at some point in the future, such that section 108(e)(2) should apply when the debt giving

74 I.R.C. § 163(d)(1).
75 I.R.C. § 163(d)(2).
76 I.R.C. § 163(j)(3).
77 P.L.R. 200952018 (Sept. 17, 2009) (ruling that CODI is characterized as investment income for purposes of the section 163(d) limitation on deducting investment interest expense if the debt was incurred to acquire investment property); P.L.R. 9522008 (Feb. 22, 1995) (same).
78 Brooks v. Commissioner, 103 T.C.M. (CCH) 1160, 2012 T.C.M. (RIA) ¶ 2012-025 (“But if interest on the loan was investment interest, Brooks would've been entitled to a deduction for that interest only to the extent his investment income exceeded his investment interest and other investment expenses for 2003. Brooks has not, however, shown or argued that his investment income exceeded his investment expenses for 2003. His 2003 return reports that he had net investment income of only $25 and makes no mention of the forgiven interest. We therefore agree with the Commissioner that if Brooks had used the proceeds of the loan to purchase stocks or securities, he still wouldn't have been entitled to deduct the interest for 2003.”) (emphasis added).
rise to such deduction is cancelled.79 We believe the second approach is more in line with
the basic tax benefit principle that underlies section 108(e)(2)—that is, a taxpayer should
not be required to include CODI in taxable income if the forgiven amounts that gave rise
to the CODI did not provide a tax benefit in a prior year, especially if the premise for the
future deduction of those amounts no longer exists.

For these reasons, we believe that Treasury and the Service could adopt
Regulations that apply section 108(e)(2) (or its underlying principles) to interest expense
deductions that are deferred under section 163(j).80 If such an approach were adopted,
Treasury and the Service should require taxpayers to reduce their Section 163(j)
Carryforward by the amount of CODI excluded to foreclose a double benefit in the form
of future interest expense deductions for the excluded amounts. In addition, the
Section 108(e)(2) Approach should apply only to the extent that the relevant CODI can
be associated with a Section 163(j) Carryforward.81

For example, in Year 1, taxpayer has $100 of BIE and $100 of ATI, so taxpayer is
permitted to deduct $30 of interest expense and has a $70 Section 163(j) Carryforward. In
Year 2, the $100 of interest expense from Year 1 is forgiven. We would suggest that only
$70 of CODI could be excluded under the Section 108(e)(2) Approach in this
circumstance because $30 of the forgiven interest expense gave rise to a clear tax benefit
in Year 1 (i.e., a current-year deduction), and permitting taxpayer to exclude all $100 of
CODI in Year 2 would be inappropriate. This same principle can be applied where a
taxpayer becomes liable for interest expense that ultimately is forgiven in the same
taxable year: determine to what extent such interest expense gave rise to a Section 163(j)
Carryforward rather than a current-year deduction, and exclude such CODI under the
Section 108(e)(2) Approach.82

For the sake of completeness, and to assist Treasury and the Service in their
consideration of these issues, we consider additional options below.83

79 There is a potential third alternative, which is to adopt “open transaction” treatment with respect to the
cancellation. But we rejected such an approach as too difficult to administer.
80 Commentators agree with this approach. See Gordon D. Henderson & Stuart J. Goldring, TAX PLANNING
FOR TROUBLED CORPORATIONS § 404.1.1 (2019) (noting that a net taxable income increase from the
forgiveness of interest, the deduction for which would otherwise be subject to a temporary deferral
provision “would convert a mere deferral of a deduction event into a total destruction of [the
section 108(e)(2)] exception to COD[I], which does not seem consistent with the purpose of this
provision”).
81 We acknowledge that such an approach may require adopting a tracing regime, which may raise its own
set of issues, as discussed below.
82 This issue raises a fundamental question regarding the proper treatment of interest expense accruals
within the same taxable year that the interest is cancelled. The historical position of the Service appears to
be that this is a “nothing” for federal income tax purposes. McConway & Torley Corp. v. Commissioner,
2 T.C. 593, 595 (1943); C.C.A. 200801039 (Sept. 24, 2007). However, uncertainty continues in this area, in
significant part, because, for other reasons, interest expense typically is viewed as accruing on a constant
basis, rather than annually.
83 There are significant complexities regarding the application of section 108(e)(2) in the partnership
context, which are beyond the scope of these Comments. In particular, because interest expense deductions
that are limited by section 163(j) are suspended at the partner level, but the CODI that results if that interest
3. Section 111 Tax Benefit Principles

Alternatively, tax benefit principles could be utilized to provide an avenue to avoid immediate taxable income from interest-related CODI. Section 111(a) generally permits an exclusion from income to the extent no tax benefit was derived from a prior deduction (e.g., a deduction of interest expense). On the face of the statute, section 111 arguably does not apply to forgiven interest “trapped” in a Section 163(j) Carryforward because the Code has yet to treat such interest as deducted.\footnote{See I.R.C. §§ 111(a) (“gross income does not include income attributable to the recovery during the taxable year of any amount \textit{deducted} in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by this chapter”) (emphasis added), 163(j)(1) (“the amount \textit{allowed as a deduction} under this chapter for any taxable year shall not exceed. . . .”) (emphasis added), 163(j)(2) (“the amount of any \{BIE\} \textit{not allowed as a deduction} for any taxable year by reason of paragraph (1) shall be treated as \{BIE\} paid or accrued in the succeeding taxable year) (emphasis added); see also H.R. Rep. No. 96-833, at 264 (1980) (“cancellation of a previously \textit{accrued and deducted} expense does not give rise to taxable income if the \textit{deduction} did not result in a reduction of tax (sec. 111).”) (emphasis added); S. Rep. No. 96-1035, at 55 (1980) (same); Rev. Rul. 67-200, 1967-1 C.B. 15, \textit{clarified by} Rev. Rul. 70-406, 1970-2 C.B. 16 (taxpayer discharged from accrued interest allowed an exclusion under section 111 to the extent prior interest expense \textit{deductions} resulted in no tax benefit).}

However, section 111 is only a partial codification of the tax benefit rule.\footnote{The tax benefit rule originated in the courts and was only later codified under section 111. Inclusion of income under the tax benefit rule has been suggested by the courts as a necessary balancing entry because the taxpayer's income over the entire period would otherwise have been underrepresented. \textit{Barnett v. Commissioner}, 39 B.T.A. 864, 867 (1939); \textit{South Dakota Concrete Prods. Co. v. Commissioner}, 26 B.T.A. 1429, 1432 (1932). Courts have also described the tax benefit rule as "a necessary counterweight to the consequences of the annual accounting principle." \textit{Estate of Munter v. Commissioner}, 63 T.C. 663, 678 (1975).} That is, the tax benefit rule is both a rule of inclusion and exclusion: recovery of an item previously deducted must be included in income; that portion of the recovery not resulting in a prior tax benefit is excluded.\footnote{Putoma Corp. v. Commissioner, 66 T.C. 652, 664 n. 10 (1976), aff’d, 601 F.2d 734 (5th Cir. 1979).} Section 111 states only the exclusionary aspect of the rule, which permits a taxpayer to exclude from income the amount of a prior deduction that did not give rise to a tax benefit. Nevertheless, the judicial tax benefit rule continues to apply, even if section 111, by its terms, does not.\footnote{See, e.g., \textit{Hillsboro National Bank}, 460 U.S. at 388 (citing \textit{Dobson v. Commissioner}, 320 U.S. 489, 505–506 (1943)) (Section 111 "does not \textit{limit} the application of the exclusionary aspect of the tax benefit rule. On the contrary, it lists a few applications and represents a general endorsement of the exclusionary aspect of the tax benefit rule to other situations within the inclusionary part of the rule. The failure to mention inconsistent events in § 111 no more suggests that they do not trigger the application of the tax benefit rule than the failure to mention the recovery of a capital loss suggests that it does not.").} In this context, we believe that the tax benefit principles that underlie section 111 equally are applicable to forgiven interest comprised in a Section 163(j) Carryforward.

Directly relevant here, the courts have applied the tax benefit rule to hold that recovery of a previous amount that was not deductible in a prior year is not taxable income in the year of receipt on the theory that, without a federal tax benefit in year 1,
taxpayer ought not have to bear a federal tax burden on a refund it receives in year 2.\footnote{See, e.g., \textit{California & Hawaiian Sugar Refining Corp. v. United States}, 311 F.2d 235 (Ct. Cl. 1962) (no income on recovery of an amount that was not deductible when paid because the taxpayer was then an exempt organization); \textit{Tempel v. Commissioner}, 136 T.C. 341, 351 n. 19 (2011) (stating that state tax refunds are not income unless the taxpayer claimed a deduction for them—\textit{e.g.}, by itemizing for the previous year); \textit{Clark v. Commissioner}, 40 B.T.A. 333, 335 (1939) (holding that so long as “petitioner neither could nor did take a deduction in a prior year,” any amount he receives the next year “is not then includable in his gross income.”).}

That same fundamental premise applies to interest “trapped” in a Section 163(j) Carryforward: it has not, by express application of the statute, been previously deducted; without a prior deduction, the taxpayer has not received a tax benefit; and without a tax benefit, no inclusion ought to be required.

In the context of forgiven interest, there is instructive legislative history from the Bankruptcy Tax Act of 1980—which provided rules under section 108 governing the federal income tax treatment of discharge of indebtedness and the tax benefit rule of section 111—that supports the Section 111 Approach. Specifically, Congress included an example that provides “there is no debt-discharge amount [as determined under section 108] \textit{if either the [taxpayer] had not previously deducted the accrued interest or else the prior deduction had not resulted in a ‘tax benefit’ under section 111.”\footnote{H.R. Rep. No. 96-833, at 290 n. 9 (1980) (emphasis added). The purpose of section 111 and section 108(e)(2) is plain enough; taxpayers ought not suffer a tax detriment in the form of CODI for forgiven interest if (i) it does not reverse the benefit of an earlier deduction when the interest became due that eventually turns out not to be a deduction because the interest is discharged or (ii) it cannot be offset by a later deduction when paid because the liability to pay the interest is cancelled. Additionally, as discussed in these Comments, although a Section 163(j) Carryforward may become deductible sometime in the future, we believe that it is inappropriate as a matter of tax policy to decouple the source of interest-related CODI from the tax benefit by requiring immediate taxation of forgiveness of section 163(j)-limited interest and preserving the benefit in the Section 163(j) Carryforward, especially when, as is the case here, there is no longer a fixed liability to pay the interest—and, contrary to the “freeing of assets” principles that may apply in the context of forgiven loan principal, here, no benefit was received in the form of untaxed cash that was available to produce interim tax benefits, such as depreciation deductions for assets acquired with the debt. \textit{See also Hillsboro National Bank}, 460 U.S. at 378 n.11 (“While annual accounting precludes reopening the earlier year, it does not prevent a less precise correction—far superior to none—in the current year, analogous to the practice of financial accountants.”)). In this respect, we believe that such a current-year “correction” is, for the taxpayer, that the forgiven interest be a wash: the taxpayer should not recognize the amount of the forgiven interest as CODI, and the taxpayer would not get to keep a Section 163(j) Carryforward as an offsetting deduction for the tax.}

A potential setback to this line of thought, however, is that a carryforward may generally constitute a tax benefit, albeit an uncertain one because the ultimate utilization of the carryforward will often be in doubt in the case of Section 163(j) Carryforwards where interest is being forgiven. More specifically, section 111(c) turns off the benefit of section 111 to the extent a carryforward, such as an NOL, is generated by a prior deduction. And the statutory language does not appear to permit revisiting the application of section 111 if the carryforward ultimately expires without being used, although that is not free from doubt. Of course, Section 163(j) Carryforwards never expire. We note, however, that the section 111(c) exception to the general benefit of the section 111(a) exclusion appears to apply only if the carryforward exists as a result of a prior
As discussed in these Comments, a Section 163(j) Carryforward exists not because of a prior deduction, but rather due to the lack thereof.

To this end, although it is true that a carryforward may generally be considered a tax benefit, we note that unlike typical “accrued but unpaid” interest of an accrual-method taxpayer, interest that makes up a Section 163(j) Carryforward has never entered the “tax system” — section 163(j) specifically eliminates the ability to claim the deduction. Further, because the premise for the future deduction now no longer exists (i.e., the taxpayer no longer owes, nor will pay, that un-deducted interest), making the taxpayer include that forgiven interest in income as CODI in the year of the discharge, while forcing the taxpayer to carry the Section 163(j) Carryforward that offsets that income into the future indefinitely, and without even a future obligation to pay the debt, would appear counter to the goal of clearly reflecting a taxpayer’s income.

We are therefore of the view that Treasury and the Service could adopt the tax benefit principles underlying section 111 (the “Section 111 Approach”) in future Regulations by providing that a taxpayer may exclude CODI attributable to forgiven interest to the extent that interest expense has not given (and will not give) rise to a tax benefit. Similar to the Section 108(e)(2) Approach, the Section 111 Approach should apply only to the extent that the relevant CODI can be associated with a Section 163(j) Carryforward and the Section 163(j) Carryforward should be eliminated to the extent the interest expense to which the Section 163(j) Carryforward is attributable is forgiven.

4. BII Approach

Another potential alternative involves characterizing CODI that is attributable to interest as BII, but only to the extent of CODI (the “BII Approach”). The BII Approach differs from the options discussed above, because instead of simply eliminating the relevant CODI and Section 163(j) Carryforward, the BII Approach would preserve the CODI, but increase the ability to utilize the Section 163(j) Carryforward on a dollar-for-dollar basis, thus permitting the Section 163(j) Carryforward to offset, as opposed to eliminate, the CODI. The BII Approach would fall within Treasury and the Service’s authority to define BII within the meaning of section 163(j)(6) and would respect the basic character of the CODI consistent with the business activity that underlies the incurrence of the debt. The BII Approach would derive further support from the fact that the character of CODI currently is characterized as income from a passive activity to the extent the debt is allocated to passive activity expenditures when the debt is discharged or as investment income to extent the debt was incurred to acquire investment property.

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90 See H.R. REP. NO. 96-833, at 274 (1980) (“The bill clarifies present law by providing that in applying the tax benefit rule of section 111 of the Code in order to determine if the recovery of an item is taxable, a deduction will be treated as having a produced a reduction in tax if the deduction increased a carryover that had not expired at the end of the taxable year in which the recovery occurs.”) (emphasis added); S. REP. NO. 96-1035, at 67 (1980) (same).
91 I.R.C. § 163(j)(2) (flush language).
92 Id.
The BII Approach would extend these principles to treat the CODI as BII in the context of section 163(j).

The BII Approach could be quite taxpayer-favorable in certain circumstances, perhaps inappropriately so, as is illustrated by the discussion below.

**BII Approach—Situation 1**

Taxpayer has $10 of BIE and $15 of ATI in Year 1, and $10 of CODI attributable to that interest in Year 2. In Year 1, taxpayer is permitted to deduct $4.50 of its BIE ($15 of ATI times 30% equals $4.50), lowering its current taxable income to $10.50, and taxpayer has a Section 163(j) Carryover of $5.50: Under the BII Approach, in Year 2, all $10 of CODI is BII, permitting taxpayer to deduct all $5.50 of the Section 163(j) Carryforward to offset immediately $5.50 of the taxable CODI.

This result may seem overly beneficial, because if the $10 of CODI were merely ATI, rather than BII, only $3 of the Section 163(j) Carryforward could be utilized. However, we respectfully submit that the CODI event is a proper time to recapture the full tax benefit attributable to that BIE, and that this is not, in fact, an inappropriate outcome.

**BII Approach—Situation 2**

Same facts as Situation 1, above, but in Year 2, after the BIE accrued in Year 1 is forgiven, taxpayer incurs an additional $5 of BIE. Taxpayer has no other taxable items for Year 2, such that taxpayer’s only items for Year 2 are $10 of CODI and $5 of BIE, and taxpayer also has the $5.50 of Section 163(j) Carryforward from Year 1. In this situation, if the $10 of CODI is merely ATI, then, again, taxpayer is only able to claim $3 of BIE deduction in Year 2, and taxpayer would have a $7.50 Section 163(j) Carryforward. By contrast, if the full $10 of CODI is treated as BII, then taxpayer would be able to utilize the $5 of current-year BIE as well as $5 of the Section 163(j) Carryforward from Year 1.

This would appear to be an inappropriately beneficial result. As such, the BII approach should be limited to an amount equal to the Section 163(j) Carryforward attributable to the interest being forgiven.

As illustrated by Situations 1 and 2, above, the BII Approach serves to unlock interest “trapped” in a Section 163(j) Carryforward to offset CODI attributable to that interest. However, as illustrated below, the BII Approach arguably is overly taxpayer-favorable in cases in which CODI is realized but excluded from income, and a taxpayer does not have any attributes subject to reduction.
BII Approach—Situation 3—Excluded CODI Without Attributes Available to Reduce

Same facts as Situation 1, but instead of taxpayer having no other items of taxable income in Year 2, taxpayer has $10 of gross income in addition to the CODI.\(^{95}\) Also, assume that the realized CODI qualifies for exclusion under section 108(a), and that taxpayer has no attributes subject to reduction under section 108(b). Only $5.50 of the CODI is treated as BII in order to unlock the Section 163(j) Carryforward from Year 1. In this situation, taxpayer would be able to utilize the Section 163(j) Carryforward from Year 1 to offset taxable income generated in Year 2, but taxpayer would not suffer any consequences from the associated CODI because taxpayer has no attributes subject to reduction.

The simplest solution to the problem presented by Situation 3 is to provide that the BII Approach does not apply to CODI that is excludable by virtue of section 108(a). If combined with the adoption of the Section 108(b) Approach, discussed above, then this solution would be appropriate. If not, however, then the taxpayer would be in the quandary previously discussed: a taxpayer with no other attributes will arguably be better off than the taxpayer should be, and other taxpayers with “better” attributes will be forced to reduce those superior attributes and retain a Section 163(j) Carryforward. If the Section 108(b) Approach (or either the Section 111 Approach or Section 108(e)(2) Approach) cannot be adopted, the BII Approach could still be workable in this situation.

However, in addition to the cap discussed in Situation 2, an additional limitation would need to be put into place that would prevent the BII Approach from unlocking the Section 163(j) Carryforward from Year 1 to offset non-CODI taxable income in Year 2. Because of these complexities, we believe the BII Approach is inferior to the Section 111 Approach.

5. Recommendation

Although we acknowledge the various policy considerations and difficulties inherent in implementing certain of the proposals set forth above, we believe that it is inappropriate to decouple the source of interest-related CODI from the tax benefit by requiring immediate taxation of forgiveness of section 163(j)-limited interest and preserving the benefit in the Section 163(j) Carryforward. Accordingly, we recommend the adoption of one of the alternative approaches described above. Because we believe that a comprehensive solution that addresses both excludable and non-excludable CODI is most appropriate, we would not recommend the Section 108(b) Approach.\(^{96}\) Although we believe that the Section 108(e)(2) Approach is viable, we understand there may be reluctance to interpret the statute contrary to dicta in a Tax Court opinion. Accordingly, we recommend the Section 111 Approach, as there is both common law authority for it, and it avoids some of the difficult issues that arise in the context of the BII Approach.

\(^{95}\) This could occur if, for example, the taxpayer disposed of significant assets in the year of the CODI event, which is not abnormal in restructuring transactions.

\(^{96}\) This also avoids the authority concerns noted above. See discussion supra Sections II.A.2 and II.B.1.
C. Tracing and Allocation Considerations

1. Issue

The Section 108(e)(2), Section 111, and BII Approaches discussed above each rely on the existence of CODI attributable to interest that gave rise to a Section 163(j) Carryforward for its implementation. This raises two issues.

The first issue, which arguably is “harder,” but need not be addressed to adopt the Section 108(e)(2), Section 111, or BII Approaches, is whether there is CODI attributable to interest at all in any particular case. For example, assume the principal amount of a debt is $100, there is $10 of unpaid interest, and creditors receive $50 of recovery. Is there $10 of CODI attributable to interest and $50 of CODI attributable to principal, or is there $60 of CODI attributable to principal and no CODI attributable to interest? This presents an issue that arguably is beyond the scope of the Proposed Regulations, and, rather, speaks to long-standing uncertainty regarding the application of the payment ordering rules of Regulation sections 1.1275-2(a) and 1.446-2(e) (the “Payment Ordering Regulations”), which generally provide that a payment on a debt instrument is allocable first to original interest discount or interest. There is significant controversy regarding the application of the Payment Ordering Regulations to retirements of distressed debt instruments, and, particularly in the bankruptcy context, it is common practice for bankruptcy plans of reorganization to provide specifically that recoveries on debt instruments will be allocable to principal first for all relevant tax purposes. These Comments will not address this controversy, and we believe that Regulations in this area need not address the issue—it is enough to make any rule in this area turn on there being CODI allocable to interest that gave rise to a Section 163(j) Carryforward.

The second issue, which does need to be addressed for the Section 108(e)(2), Section 111, or BII Approaches to work, is whether CODI is attributable to interest that gave rise to a Section 163(j) Carryforward. Section 163(j) and the Proposed Regulations do not currently contain any mechanic to trace a Section 163(j) Carryforward to any particular debt instrument. There are two factual situations where this tracing mechanic would be meaningful: (a) some, but not all, of a debtor’s interest expense is forgiven; or (b) a Section 163(j) Carryforward is attributable, in part, to debt that the debtor is no longer obligated on, either because the debt has been repaid or because the debt has been assumed by another taxpayer. In either case, of course, a portion of a taxpayer’s Section 163(j) Carryforward would be attributable to interest that did not give rise to CODI. As a result, applying the Section 111 Approach or BII Approach in such

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97 An alternative could be to pro-rata a payment between interest and principal, but that is not a position commonly taken outside of the pro-rata prepayment context, where bifurcation is mandated.

98 This position generally is supported by case law that predates the Payment Ordering Regulations and by the legislative history of the Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 4 94 Stat. 3389, 3401–05 (1980). See H.R. REP. NO. 96-833, at 290 (1980) (“If the plan of reorganization allocates the value of the stock or other property received by the creditor between the principal amount of the creditor’s security and the accrued interest, both the corporate debtor and the creditor must utilize that allocation for Federal income tax purposes.”).

99 To avoid any doubt, we recommend that Treasury and the Service clarify (in separate guidance) the application, if any, of the Payment Ordering Regulations in the context of distressed debt instruments.
circumstance to the entire amount of CODI attributable to forgiven interest could be overly favorable to taxpayers.

2. Recommendation and Explanation

We recommend a pro-ration approach (the “Pro-Ration Approach”) to address this second issue, which involves allocating CODI pro rata among debt instruments. Although such an approach is not as difficult to administer as a tracing approach, if administrability is a concern, an alternative simplified approach could be adopted in the context of the Section 111 Approach (the “Presumption Approach”), which presumes that the Section 163(j) Carryforward arises first from interest on indebtedness that was forgiven.

To illustrate the Pro-Ration Approach, assume in Year 1, taxpayer incurs $300 of debt, split into three instruments, each of which accrues interest at 10% per year. In Years 1, 2, and 3, taxpayer has $30 of ATI, such that taxpayer can deduct $9 of interest in each year, and generates a Section 163(j) Carryforward of $21 in each year. Under the Pro-Ration Approach, at the end of Year 3, taxpayer has $63 of Section 163(j) Carryforward, split evenly among the three debt instruments. Taxpayer does not make interest payments in Years 1 through 3. In Year 4, interest is forgiven with respect to two of the three debt instruments. Because only $42 of Section 163(j) Carryforward can be attributed to the interest that was forgiven, the Section 111 Approach or BII Approach, as discussed above, would apply to only $42 of the CODI.

We understand that the Pro-Ration Approach is not as accurate as tracing, but Treasury and the Service have chosen not to apply tracing for other purposes in section 163(j), in part, because it could result in increased administrative burden for taxpayers and the Service. We believe that similar administrability concerns are presented by the use of a more specific tracing regime here, but acknowledge that factors that counseled against tracing in other circumstances (e.g., non-economic allocation of interest expense to subsidiaries) do not apply here.

If the Pro-Ration Approach still reflects too much complexity, a simplified method is available for the Section 111 Approach. To the extent a taxpayer has any Section 163(j) Carryforward and CODI attributable to any interest, the Section 163(j) Carryforward could be presumed to be attributable to the forgiven interest, and such CODI can be excluded and a corresponding amount of Section 163(j) Carryforward can be eliminated.100 This Presumption Approach has the benefit of simplicity and ease of administration, but undoubtedly would result in outcomes that are overly favorable to taxpayers in certain circumstances. However, overly favorable outcomes may represent a

100 A similar approach has been applied in other contexts. See, e.g., Prop. Reg. § 1.59A-3(c)(4) (presuming that Section 163(j) Carryforward is treated as being first composed of unrelated party interest and thus not a base erosion payment, contrary the presumption of interest paid in the year of disallowance); Reg. § 1.1502-36(d)(6)(iv)(A) (presuming an order and amount for reattribution elections).
lesser policy concern in the context of a distressed taxpayer (i.e., the typical taxpayer with CODI) than in other contexts.

D. Miscellaneous Issues

1. Interaction Between Section 163(j) and Section 108(e)(2) Where Interest Deduction Is Also Limited By Another Code Provision

a) Issue

The proper coordination of various interest expense limitations is implicated when BIE previously subjected to a non-section 163(j) limitation is forgiven. Thus, to the extent one of our recommendations described above is adopted, Regulations should describe the interaction of those rules with other rules that temporarily defer interest expense and are applied before section 163(j).

In addition, if one of our recommendations is not adopted, the interaction of section 163(j) and section 108(e)(2) will raise complex issues when taxpayers are subject to an interest deferral provision that defers the deduction of accrued interest until it is paid (e.g., AHYDO, section 163(e)(3), section 267). For example, under one interpretation, the interaction of these provisions raises the possibility of a taxpayer being advantaged by having two limitations on interest expense rather than one. Other interpretations could lead to highly technical, iterative calculations. Both of these possibilities and our thoughts regarding the appropriate policy results are set forth below.

b) Recommendation

If either the Section 108(e)(2) Approach, Section 111 Approach, or BII Approach, as discussed above, is adopted, we recommend that future Regulations make clear that the chosen approach applies not only when there is an existing Section 163(j) Carryforward, but also where interest expense previously has been disallowed by another temporary interest expense deferral provision. This could be accomplished either by regulatory mandate or through a rule that deems a payment of unpaid interest at the time such interest is forgiven. This deemed payment would create a Section 163(j) Carryforward that could then be offset—using one of the approaches described above—against the CODI realized upon the forgiveness of the interest.

Alternatively, if Treasury and the Service do not adopt either the Section 108(e)(2) Approach, Section 111 Approach, or BII Approach, as discussed above, we recommend that Treasury and the Service clarify whether section 108(e)(2) or section 111 apply to interest expense that previously has been deferred by a non-section 163(j) deferral provision and that would be limited by section 163(j) in the year of forgiveness. If Treasury and the Service determine that neither section 108(e)(2) nor section 111 apply as a general matter, then we recommend that a deemed payment rule be adopted.
c) **Explanation**

The fundamental issue discussed below is a consequence of the fact that other Code provisions limiting a deduction for interest expense are applied before section 163(j). Thus, to the extent another interest deferral provision applies, a taxpayer will not have interest expense disallowed under section 163(j), and, by extension, will not have a Section 163(j) Carryforward.

Before the promulgation of section 163(j), section 108(e)(2) would, in most situations, have excluded from CODI forgiven interest that was previously deferred because that interest would have been deductible had it been paid (assuming no permanent AHYDO disallowance). The broader applicability of the newly amended section 163(j) has created some uncertainty as to whether this will continue to be the case. More specifically, in *Brooks*, the Tax Court noted, in dicta, that CODI was not excludable under section 108(e)(2), in part, because the interest expense to which the CODI related (if investment interest) would be subject to deferral by section 163(d) if paid based on the facts argued. Section 163(d) operates in a similar fashion to section 163(j), which raises the possibility that a similar logic could be applied in the context of section 163(j). Although we do not believe that such an approach should be adopted in the section 163(j) context, we acknowledge that the applicability of *Brooks* is harder to dismiss in the context of sections 163(e)(3), (5), and 267 because these provisions act as a de facto cash method of accounting with respect to certain interest expense.

If section 108(e)(2) does not apply, another possibility is that, because the relevant interest expense has not resulted in a tax attribute (since no Section 163(j) Carryforward has arisen yet), the taxpayer has not received a “tax benefit” and ought to be able to exclude the CODI under section 111 principles. If one of the various approaches described above was not adopted (e.g., because Treasury and the Service determined that the existence of a Section 163(j) Carryforward represented a tax benefit that precluded the adoption of the Section 111 Approach), this interpretation (or the interpretation that section 108(e)(2) applies, as discussed previously) would have the odd effect of putting a taxpayer that is subject to two limitations in a better position than a taxpayer subject only to section 163(j)—this is, perhaps, another factor weighing in favor of our principal recommendations described above.

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101 If section 108(e)(2) only applies to the extent the forgiven interest would not have been limited by section 163(j) had it been paid or accrued, circular calculations conceivably could result. More specifically, CODI realized on the discharge of indebtedness should increase ATI (consistent with our recommendations above), and an increase in ATI would allow the taxpayer to deduct additional BIE. Thus, determining the extent to which section 163(j) would have applied to forgiven interest would be both (i) necessary to determine the amount of recognized CODI and (ii) affected by the amount of CODI so determined (because CODI is included in ATI). Consequently, certain taxpayers might arguably be required to perform an iterative calculation to determine the amount of CODI that may be excluded under section 108(e)(2).

102 Although the discussion in *Brooks* appeared to contemplate a permanent taxable income increase attributable to the forgiven interest, we believe this was a result of the facts at hand—in particular, that the interest expense was not reported as investment interest—rather than the application of broader tax principles.
If Treasury and the Service determines that neither section 108(e)(2) nor section 111 apply in cases where more than one limitation is applied to BIE, taxpayers may be forced to include CODI in taxable income but would not have an offsetting Section 163(j) Carryforward to compensate for this taxable income inclusion. Thus, taken to its most extreme interpretation, the application of multiple interest disallowance provisions could result in highly taxpayer-unfavorable consequences without any apparent policy consideration that would argue in favor of such a result. Therefore, our principal recommendation is that Treasury and the Service adopt the Section 108(e)(2) Approach, Section 111 Approach, or BII Approach, and provide a rule that deems a payment of unpaid interest at the time such interest is forgiven, as this would create a Section 163(j) Carryforward that could be offset against the realized CODI under one of those approaches.

If this recommendation is not adopted, we recommend that Treasury and the Service nevertheless clarify whether section 108(e)(2) or section 111 apply as a general matter to interest previously disallowed by another temporary interest expense deferral provision that would be disallowed under section 163(j) in the year of forgiveness if the interest expense had been paid or accrued. If Treasury and the Service determine that section 108(e)(2) and section 111 do not apply as a technical matter to interest expense previously disallowed under a temporary deferral provision that would be subject to section 163(j) had it been paid or accrued in the year of forgiveness, we recommend that a deemed payment rule be adopted. Under this rule, the other interest deferral provisions would no longer be applicable and section 163(j) would be applied. This would have the effect of at least allowing a taxpayer a Section 163(j) Carryforward equal to the CODI recognized.

2. **CODI Realized by Excepted, But Previously Non-Excepted Trades or Businesses**

   a) **Issue**

   As described above, Section 163(j) Carryforwards appear to retain their character as BIE, regardless of whether they would otherwise be considered properly allocable to an excepted trade or business if they arose at a later time (e.g., the taxpayer subsequently opts out of the section 163(j) limitation as an electing real property trade or business). Thus, Section 163(j) Carryforwards seemingly remain subject to the section 163(j) limitation, even if the taxpayer no longer conducts a non-excepted trade or business under section 163(j).\(^{105}\)

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\(^{103}\) In the related party context, this approach may already have support. See F.S.A. 199922034 (June 4, 1999); F.S.A. 199926018 (July 2, 1999); F.S.A. 200006003 (Feb. 11, 2000). Notably, limitations under section 163(e)(3) only apply to related parties.

\(^{104}\) See supra note 13 and accompanying text.

\(^{105}\) However, disallowed business interest expense carryforwards that are carried forward to a taxable year in which the taxpayer qualifies for the small business exemption are not subject to the section 163(j) limitation. Prop. Reg. § 1.163(j)-2(c)(2).
As a general matter, in calculating their ATI, taxpayers other than C corporations may include only taxable income properly allocable to a trade or business.\textsuperscript{106} An excepted trade or business, such as an electing real property trade or business, does not generate ATI\textsuperscript{107} or BII.\textsuperscript{108} As a result, if a taxpayer is engaged in a real property trade or business that produces Section 163(j) Carryforwards and later elects to treat that business as an electing real property trade or business, those Section 163(j) Carryforwards may never be deductible because the business no longer gives rise to the types of income (\textit{i.e.}, ATI or BII) that can offset the interest expense.

\textbf{b) Recommendation}

We recommend that CODI from the discharge of unpaid interest should be characterized as income from a non-excepted or excepted trade or business depending on the character of that business when the taxpayer became liable for that interest (\textit{i.e.}, if unpaid interest is attributable to a non-excepted trade or business when it becomes a Section 163(j) Carryforward, the corresponding CODI on the forgiveness of that interest also ought to be treated as attributable to a non-excepted trade or business when the interest is discharged, even if the underlying business is no longer a non-excepted trade or businesses at that time—for instance, because the business since became an electing real property trade or business).

\textbf{c) Explanation}

If our recommendations above are not adopted and CODI is included in ATI, any income or gain that is not properly allocable to a non-excepted trade or business is not included in ATI.\textsuperscript{109} Thus, if CODI is attributable to investment interest expense under section 163(d) or to an excepted trade or business under section 163(j), it would appear not to be included in ATI.

Generally, the character of CODI follows the underlying debt to which the CODI relates. For purposes of section 469, the Service has held that CODI is characterized as income from a passive activity to the extent the debt is allocated to passive activity expenditures when the debt is discharged.\textsuperscript{110} Likewise, the Service has ruled that CODI is characterized as investment income for purposes of the section 163(d) limitation on deducting investment interest expense if the debt was allocated to investment expenditures when the debt is discharged.\textsuperscript{111}

In determining whether interest expense is properly allocable to a non-excepted trade or business, tracing principles are used first to allocate the interest between


\textsuperscript{107} Id.


\textsuperscript{111} P.L.R. 200952018 (Sept. 17, 2009); P.L.R. 9522008 (Feb. 22, 1995). Consistent with established authority, we believe that CODI from forgiven loan principal should be characterized as income that is properly allocable to a non-excepted trade or business, or ATI, if the proceeds of the debt were used in a business that was a non-excepted trade or business at the time the proceeds were \textit{used}.
“business” and “investment,” for instance. Business interest expense—that is, interest expense that is allocated to section 162 trades or businesses—is then allocated between non-excepted and excepted trades or businesses generally using asset basis. Only business interest expense that is allocated to non-excepted trades or businesses is treated as BIE subject to the section 163(j) limitation.

As discussed above, this seems to be a one-time allocation, with Section 163(j) Carryforwards retaining their character as BIE in later years, regardless of any future changes to the business’s qualification as an excepted or non-excepted trade or business. Thus, the allocation of interest expense to what would have been a non-excepted trade or business in an earlier year would be unaffected by the later qualification of the business as an excepted trade or business, even if interest expense on debt incurred after the qualification of the business as an excepted trade or business would otherwise be considered properly allocable to an excepted trade or business.

As a result of such a one-time allocation of interest expense, one would expect that the characterization of CODI from forgiven interest would mirror that of the interest to which it relates to ensure that there is not a character disconnect between two related sources of tax items. Therefore, CODI from the discharge of unpaid interest should be characterized as income from a non-excepted trade or business if the CODI is attributable to interest that was incurred when the trade or business was non-excepted. From there, the approaches discussed above should be applied to avoid a situation in which a taxpayer is allocated current CODI that is “trapped” in a Section 163(j) Carryforward.

3. Gain Recognition Under Sections 357(c), 1001, and Other Transfer-Related Provisions

a) Issue

Contributions of property to a corporation are often tax-free under section 351(a), subject to various exceptions. One of those exceptions is section 357(c), which, subject to certain exceptions of its own, provides that a person contributing property to a corporation will recognize gain to the extent liabilities assumed by the transferee corporation exceed the transferor’s tax basis in the transferred assets. Section 357(c)(3)(A)(i) provides that, for purposes of section 357(c), liabilities do not include “a liability the payment of which [] would give rise to a deduction,” which is substantially the same language as section 108(e)(2).

Separate, but related, issues are (a) whether section 357(c)(3)(A)(i) applies where gain might otherwise be recognized that is attributable to interest that was accrued but not

113 Prop. Reg. § 1.163(j)-1(b)(38), -10(c)(1)(i).
115 See supra note 13 and accompanying text.
116 See Arrowsmith v. Commissioner, 344 U.S. 6, 8–9 (1952) (Under the Arrowsmith doctrine, when a later transaction is sufficiently related to an earlier transaction, the later transaction will be treated as having the same character as the earlier transaction).
deducted as a result of section 163(j) (which, in essence, poses the same question as whether section 108(e)(2) applies to CODI recognized in respect of forgiven interest that could not be deducted because of section 163(j)); and (b) if section 357(c)(3)(A)(i) does not exclude such amount, whether a transferor recognizing gain under section 357(c) should be able to rely on the Section 111 Approach or BII Approach to the extent such gain can be attributed to interest that gave rise to a Section 163(j) Carryforward.

b) Recommendation

In the event there is a desire to avoid Regulations in the section 163(j) context being interpreted as being relevant to section 357(c)(3)(A)(i), then that can be accomplished by adopting an approach other than the Section 108(e)(2) Approach (as the Section 108(e)(2) Approach is most directly related to the relevant language in section 357(c)(3)(A)(i)), or by expressly providing that any Regulations adopted for purposes of section 163(j) cannot be relied on for applying section 357(c). However, as noted below, we believe that Regulations promulgated under section 163(j) provide an appropriate opportunity to address uncertainty under section 357(c), and, accordingly, we would recommend that any approach taken with respect to CODI interaction with section 163(j) should be expanded to apply to section 357(c).

c) Explanation

In general, we believe the Section 111 Approach and BII Approach apply with equal force to gain recognition transactions as to transactions that give rise to CODI. In both cases, taxpayers are, under basic principles underlying the recognition of CODI as a general matter, recognizing taxable income because they received some tax benefit as a result of the liability. Recognition of additional gain attributable to a liability when the property is transferred subject to a liability is essentially a “claw back” of the tax benefit derived from the liability at issue. If that tax benefit is limited to a Section 163(j) Carryforward that may not ever be able to be utilized, current recognition of taxable income with respect to such liability is inappropriate. Accordingly, we believe the better conclusion is that a taxpayer should be entitled to exclude gain attributable to interest that gave rise to a Section 163(j) Carryforward that was not previously utilized. However, we understand that Treasury and the Service may wish to give additional consideration to this issue, and limiting the Section 111 Approach or BII Approach to situations involving CODI would be a relatively straightforward regulatory limitation, which is why we acknowledge that it may be appropriate to limit the ability to rely on Regulations adopted under section 163(j) for this purpose.

117 Indeed, this is the premise that underlies Crane v. Commissioner, 331 U.S. 1 (1947), the foundational case that gives rise to the idea that assumed liabilities are included in amount realized, and Tufts v. Commissioner, 461 U.S. 300 (1983), which expanded Crane to situations involving non-recourse debt in excess of the fair market value of transferred assets.