Topics of “Interest”
Under Section 163(j)

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Disclaimer: The views expressed herein are not a statement of the views of the panelists representing the IRS and the Treasury Department.
Definition of Business Interest

Introduction

• For taxable years beginning after December 31, 2017, with limited exceptions, a taxpayer’s deduction for “business interest” expense for any year is limited to the sum of:
  – The taxpayer’s “business interest income”;
  – 30 percent of the taxpayer’s “adjusted taxable income”; and
  – The taxpayer’s “floor plan financing interest” expense.

• Proposed regulations under section 163(j) and related provisions (the “Proposed Regulations”) were released on November 26, 2018.

• Except as otherwise provided, the Proposed Regulations are proposed to be effective for taxable years ending after the date that the Treasury decision adopting the regulations as final is published in the Federal Register.

• In general, taxpayers are permitted to apply the Proposed Regulations to taxable years beginning after December 31, 2017, provided that the taxpayer (and related parties) consistently apply all of the rules in the Proposed Regulations to those taxable years.
Definition of Business Interest

Statutory Definition and Legislative History

**Statutory Definition**

- For purposes of section 163(j), the term “business interest” means any interest paid or accrued on indebtedness properly allocable to a trade or business. Such term shall not include investment interest (within the meaning of subsection (d))

**Legislative History**

- Conference report states that any amounts treated as interest for purposes of the Code are interest for purposes of section 163(j)
- In contrast, the Conference report under old section 163(j) goes further by stating:
  - “the conferees understand that Treasury might choose to increase net interest expense, under regulations, by all or a portion of expense items not denominated interest but appropriately characterized as equivalent to interest expense.”
Definition of Business Interest
Approaches Considered in Proposed Regulations

• The Treasury Department and IRS considered three options with respect to defining “interest” for purposes of section 163(j):
  
  (1) Not provide a definition and rely on general tax principles and case law
  
  (2) Adopt a definition of interest and limit the scope to items generally considered interest under the Code or regulations
  
  (3) Provide an expansive definition of interest income and expense
      
      
      – Amounts previously deductible under section 162 without limitation would be tested as business interest expense under section 163(j)
      
      – The Treasury Department and IRS asked for comments on this approach
Definition of Business Interest
Four Regulatory Categories

• Interest – In general
• Swaps with significant nonperiodic payments
• Other amounts treated as interest
• Anti-avoidance rule
Definition of Business Interest
Category #1 – In General

• Defines interest as “an amount paid, received, or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement, including a series of transactions, that is treated as a debt instrument for purposes of section 1275(a) and §1.1275-1(d), and not treated as stock under §1.385-3, or an amount that is treated as interest under other provisions of the Internal Revenue Code (Code) or the regulations thereunder.”

Includes:
• Original issue discount (OID)
  – Including amounts treated as OID, OID on synthetic debt instruments, and de minimis OID
• Market discount
• Acquisition discount
• Repurchase premium
• Interest on deferred payments under section 483
• Amounts paid or received in connection with a sale-repurchase agreement (i.e., a repo)
• Amounts treated as interest under section 988
Definition of Business Interest
Category #2 – Swaps with Significant Nonperiodic Payments

- Swaps other than cleared swaps with significant nonperiodic payments are treated as 2 separate transactions consisting of:
  - An on-market swap and;
  - A loan

- Time value of money component associated with the loan determined in accordance with Treas. Reg. § 1.446-3(f)(2)(iii)(A)
  - Would apply in the same manner as Treas. Reg. § 1.446-3(g)(4) before amended by T.D. 9719 (80 FR 26437, as corrected by 80 FR 61308))

- Would not apply to collateralized/cleared swaps
  - Proposed Regulations reserve on such treatment
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Category #3 – Other Amounts Treated As Interest

Ten Specific Items:

i. Issuance premium within the meaning of Treas. Reg. § 1.163-13 and amortizable bond premium deductible under section 171(a)(1)

ii. Ordinary income or loss with respect to certain debt, including contingent payment debt instruments

iii. Substitute interest payments made pursuant to securities lending or repo transactions

iv. Guaranteed payments for the use of capital under section 707(c)

v. Cost of borrowing

vi. Yield Adjustments

vii. Loan commitment fees if any portion of the commitment is drawn

viii. Debt issuance costs subject to Treas. Reg. § 1.446-5

ix. Any gain treated as ordinary under section 1258 (i.e., a conversion transaction)

x. Income from factored receivables
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Substitute Interest Payments

• Generally, substitute interest payments are not treated as interest for tax purposes. See *Deputy v. Du Pont*, 308 U.S. 488 (1940).

• Example 1 relates to a securities borrowing whereby a taxpayer makes substitute interest payments and uses the proceeds from selling the borrowed securities to purchase a debt portfolio.

• From a policy perspective, should all substitute interest payments be considered the same?
  - Consider the role of collateral
  - Consider borrowing Treasuries as opposed to borrowing corporate debt.
  - Consider whether the borrowing of debt instruments is part of the taxpayer’s ordinary business
  - Consider whether the securities borrowing is maintained for all or substantially all of the term of the debt instrument
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Treatment of Derivatives Altering Borrowing Costs and Yield

• Income, deduction, gain, or loss from a derivative (as defined in section 59A(h)(4)(A)) is treated as interest if the derivative alters (i) the borrower’s cost of borrowing with respect to a liability of the borrower or (ii) the taxpayer’s effective yield with respect to a debt instrument held by the taxpayer

• Consider how to apply the standard of when a derivative alters the cost of borrowing or effective yield

• Consider situations where the “offsetting” item is not interest, such as where a taxpayer recognizes capital gain on a debt investment and loss on the hedge (or vice versa) or situations where interest on debt is not deductible

• Consider the application in the case of aggregate hedges in a situation where the taxpayer engages in both excepted and non-excepted trades or business
Definition of Business Interest
Perceived concerns on FX-denominated debt instruments

• Taxpayer borrows at a low interest rate in a strong currency and synthetically converts the interest rate into a higher interest rate in a weaker currency to reduce the amount of interest expense.

• Taxpayer borrows at a high interest rate in a weak currency and synthetically converts the interest rate into a lower interest rate in a stronger currency to increase the amount of interest expense.

• Section 988(d) was enacted to deal with these situations. Treasury promulgated Treas. Reg. § 1.988-5(a) to implement the statute.

• Treas. Reg. § 1.988-5(a) only applies in limited circumstances when the yield to maturity of the synthetic debt instrument can be computed.

• If a transaction is not captured under section 988(d), section 988(b)(3) provides that the amount of currency gain or loss on any foreign currency derivative is not bifurcated between the time vale component (i.e., forward points) and the currency component. This was a conscious decision. Treas. Reg. § 1.988-2(d)(4) implemented this Congressional intent.

• Bottom line – unless a foreign currency derivative is integrated under Treas. Reg. § 1.988-5(a), the time value component of such derivative is treated as FX gain/loss and NOT as interest income/expense.
Definition of Business Interest

Foreign currency hedging considerations – Prop. Reg. § 1.163(j)-1(b)(20)(iii)(E)&(F)

• Unclear how this rule works outside of cross currency swaps or a series of forward contracts that, when integrated with the debt instrument, can produce a yield to maturity

• Example 2 of Prop. Reg. § 1.163(j)-1(b)(20)(v) raises many important questions

• What if a taxpayer hedges with currency forward contracts where a yield to maturity cannot be determined on day 1?
  - For example, a taxpayer may hedge a nonfunctional currency denominated debt instrument utilizing 30-day rolling forward contracts. Taxpayer would have to wait until the debt matures and all the hedges are settled to determine its yield to maturity. How does the taxpayer determine its section 163(j) limitation for a particular taxable year?

• What is the interaction between the straddle rules, section 1256, the hedge timing rules, and the 163(j) rules?
  - If a taxpayer did not properly identify a series of forward contracts as hedging transactions under section 1221, the interaction of the above rules is extremely complicated and unclear

• What happens if the FX-denominated debt instrument is not perfectly hedged?

• What happens if the taxpayer hedges on an aggregate basis that nets interest-bearing assets and liabilities?

• What happens if a taxpayer hedges with foreign currency options? How does one bifurcate the interest differential from volatility and currency?

• Compliance burden and reportable transaction considerations
Cross-currency swap Example

- On January 1, 2019, when USD:JPY = 1:100, A borrows JPY200,000 from Bank (the “JPY Loan”)
- The USD/JPY exchange rate does not fluctuate throughout the entire duration of the JPY Loan
- The JPY Loan bears an interest rate of 1 percent and has a maturity date of December 31, 2021
- At the issuance of the JPY Loan, the USD equivalent interest rate on a loan of $2,000 is 5 percent
- On the same date, A entered into a cross-currency swap transaction (“Currency Swap”) with Bank. Under the Currency Swap, A is obligated to swap the amounts with the Bank based on the table to the left
- A’s total USD cost of borrowing is $300. If the transaction is integrated under Treas. Reg. § 1.988-5(a), A’s treated as borrowing $2,000 with a 5% interest rate

<table>
<thead>
<tr>
<th>Date</th>
<th>A pays USD under the FX Swap</th>
<th>A receives JPY under the FX Swap</th>
<th>A receives in USD terms</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/2019</td>
<td>$100</td>
<td>¥2,000</td>
<td>$20</td>
</tr>
<tr>
<td>12/31/2020</td>
<td>$100</td>
<td>¥2,000</td>
<td>$20</td>
</tr>
<tr>
<td>12/31/2021</td>
<td>$100</td>
<td>¥2,000</td>
<td>$20</td>
</tr>
<tr>
<td>12/31/2021</td>
<td>$2,000</td>
<td>¥200,000</td>
<td>$2,000</td>
</tr>
</tbody>
</table>
Definition of Business Interest
Forward contract example

What is the correct amount of yield adjustment if the taxpayer uses a series of forward contracts?

• Same facts as above, except instead of entering into a cross-currency swap, A entered into a series of forward contracts on January 1, 2019 to buy JPY and sell USD on each date the interest payment and the principal payment on the JPY Loan is due.

• The below table demonstrates the approximate forward rates (in a perfectly efficient foreign exchange market) for such a series of forward contracts.

<table>
<thead>
<tr>
<th>Date</th>
<th>USD A pays under the forwards</th>
<th>JPY A receives under the forwards</th>
<th>JPY/USD Forward rate</th>
<th>Forward points</th>
<th>JPY A receives in USD terms</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/2019</td>
<td>$20.79</td>
<td>¥2,000</td>
<td>96.19</td>
<td>-3.81</td>
<td>$20</td>
</tr>
<tr>
<td>12/31/2020</td>
<td>$21.57</td>
<td>¥2,000</td>
<td>92.73</td>
<td>-7.27</td>
<td>$20</td>
</tr>
<tr>
<td>12/31/2021</td>
<td>$22.33</td>
<td>¥2,000</td>
<td>89.57</td>
<td>-10.43</td>
<td>$20</td>
</tr>
<tr>
<td>12/31/2021</td>
<td>$2,233.01</td>
<td>¥200,000</td>
<td>89.57</td>
<td>-10.43</td>
<td>$2000</td>
</tr>
</tbody>
</table>

• The total amount of interest and OID A pays on the combined instrument is approximately $300 throughout the term of the JPY Loan (combined with the forward contracts), which equals what A pays in the Currency Swap example above.

• Because the example assumes that the USD/JPY exchange rates did not fluctuate over the duration of the JPY Loan, the entire difference between what A pays under the forward contracts in USD and what A receives under the forward contracts in USD terms represents the forward points.

• Like in the Currency Swap example, A’s synthetic USD cost of borrowing is $300 at 5 percent.

• If the USD/JPY exchange rate fluctuated during this period, A would have additional gain or loss on each forward contract that is related solely to currency movement.
Commitment Fees

• Any fees in respect of a lender commitment to provide financing
  – Only subject to section 163(j) limitation if such commitment is drawn upon
  – If small portion of commitment is drawn, is full expense limited?
• Proposed Regulations reserve on a second provision for certain amounts labeled as fees
• Treasury Department and the IRS seek comments on whether other types of lending transaction fees, not otherwise treated as interest for federal income tax purposes, should be treated as interest for purposes of section 163(j)
• Historically, the treatment of fees paid by borrowers to lenders have been subject to uncertainty, including whether such fees simply result in a reduced issue price of debt under the rules of section 1273
Definition of Business Interest
Debt Issuance Costs

• Any debt issuance costs subject to Treas. Reg. § 1.446-5 are treated as interest expense of the issuer
• These items are typically deductible under section 162
• This is a very broad category, including items such as:
  – Arranger fees
  – Credit rating fees
  – Legal fees
  – Accounting fees
Definition of Business Interest
Category #4 – Anti-avoidance Rule

• Any deductible expense or loss incurred by a taxpayer in a transaction or series of integrated or related transactions in which the taxpayer secures funds for a period of time is treated as interest expense if the expense or loss is predominantly incurred in consideration of the time value of money
  – Note that this rule pertains to expense items only
  – Although the title indicates this is an “anti-avoidance” rule, the provision does not provide an intent test and could potentially be viewed as a general rule (in addition to all of the items discussed above)
  – Consider how to apply the standard of whether an expense or loss is “predominantly” incurred in consideration of the time value of money
Allocation of Interest Expense

• Taxpayers with both non-excepted and excepted trades or businesses are required to allocate interest expense and other items between such trades or businesses.

• Generally, the Proposed Regulations look to the relative amount of tax basis for the assets used in each business, measured quarterly, for purposes of allocating interest.
  – If 90 percent or more of the taxpayer’s adjusted basis is allocable either to a non-excepted or excepted trade or business, all of the taxpayer’s interest expense and income is allocable to such trade or business.
  – Interest from qualified nonrecourse indebtedness must be allocated directly to the relevant trade or business.
  – Detailed look-through rules and special rules for consolidated groups are set forth to determine tax basis for this purpose.

• The Proposed Regulations also provide detailed rules for allocating items other than interest for purposes of calculating ATI.
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