Section 163(j) Proposed Regulations
S Corporations Committee/ABA Tax Section
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Agenda

• Overview of Section 163(j) Limitation
• Proposed Regulations, Comments, and Public Hearing
• Provisions for S Corporations and Partnerships
• Carryover of Disallowed Interest
• Other Implications for S Corporations
• Application of Section 382
• Closing-of-the-Books Elections
• Other Considerations
Section 163(j) Limitations

• A taxpayer’s deduction for business interest for a taxable year is limited to the sum of—
  —The business interest income for the taxable year;
  —30% of the adjusted taxable income of the taxpayer; and
  —The floor plan financing indebtedness of the taxpayer.

• Disallowed interest is carried forward indefinitely. An excess limitation is not carried forward.

• The limitation does not apply to—
  —The trade or business of performing services as an employee;
  —Any electing real property trade or business;
  —Any electing farming business; or
  —Certain regulated public utilities.
Section 163(j) Limitations (Cont’d)

• Adjusted taxable income is taxable income computed without regard to—
  —Any item of income, gain, deduction, or loss not properly allocable to a trade or business;
  —Any business interest or business interest income;
  —The amount of any net operating loss deduction under section 172;
  —The amount of any deduction allowed under section 199A;
  —For taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion; and
  —Such other adjustments as the Secretary may prescribe.

• Section 163(j), as amended, applies to taxable years beginning after December 31, 2017.
Small Business Exemption

• Section 163(j) does not apply to a taxpayer which meets the gross receipts test of section 448(c), except for a tax shelter precluded from using the cash method.

• The gross receipts test is satisfied if the taxpayer has three-year average annual gross receipts not exceeding $25 million, with special aggregation rules for commonly-controlled businesses.

• A “tax shelter” is any one of the following:
  — Any enterprise (other than a C corporation) if the offering of interests is required to be registered with any federal or state agency having the authority to regulate the offering;
  — Any syndicate (within the meaning of section 1256(e)(3)(B)); and
  — Any tax shelter (as defined in section 6662(d)(2)(C)(ii)).
Cost Recovery for Excepted Trades or Businesses

• Special cost recovery provisions apply to taxpayers receiving special treatment under section 163(j):
  — An electing real property trade or business;
  — An electing farming business;
  — A business with floor plan financing indebtedness; and
  — Certain regulated public utilities.

• Section 168(k) “bonus” depreciation may not be used for—
  — Property primarily used in a regulated public utility trade or business; and
  — Property used in a trade or business with floor plan financing indebtedness.

• The alternative depreciation system is required to be used for—
  — Nonresidential real property, residential rental property, and qualified improvement property of an electing real property trade or business; and
  — Property with a recovery period of ten years or more of an electing farming business.
Special Partnership/S Corporation Provisions

• In the case of a partnership, section 163(j) is applied with three basic principles (section 163(j)(4)):
  
  A. The limitation is applied at the partnership level, with any allowable deduction taken into account in determining the non-separately stated taxable income or loss of the partnership; and the adjusted taxable income of a partner excludes partnership items other than the partner’s share of excess taxable income of the partnership;
  
  B. Excess business interest of the partnership is allocated to partners currently, with immediate basis reduction, and may generally be deducted only when the partnership allocates excess taxable income to the partner in a subsequent taxable year; and
  
  C. The excess taxable income of a partnership (effectively) represents the amount of adjusted taxable income not needed to permit the partnership to deduct its business interest expense under the section 163(j) rules.

• Rules “similar to” the A and C rules apply to an S corporation and its shareholders, but the B rule does not apply.

• The proposed regulations’ rules pertaining to partnerships and partners reflect a mix of aggregate and entity concepts.
Proposed Section 163(j) Regulations


• Comments were due February 26, and the public hearing was held on February 27.

• Provisions relevant to S corporations include—
  —Prop. Reg. § 1.163(j)-1, Definitions
  —Prop. Reg. § 1.163(j)-2, Deduction for business expenses limited
  —Prop. Reg. § 1.163(j)-3, Relationship to other provisions limiting deductions
  —Prop. Reg. § 1.163(j)-6, Application of the business interest deduction limitation to partnerships and S corporations
  —Prop. Reg. § 1.382-2, -5, and -6, Application of section 382 to disallowed business interest of S corporations
Section 163(j) Comments/Hearing

• Comments by the ABA Section of Taxation were submitted in four parts:
  —Impact of the proposed regulations on corporate taxpayers and consolidated entities, submitted on February 26, 2019;
  —Definition of “interest” in the proposed regulations, submitted February 26, 2019;
  —Impact of the proposed regulations on real estate, submitted February 28, 2019; and
  —Impact of the proposed regulations on pass-through entities and their owners, submitted March 7, 2019.

• Tax Section comments related to S corporations include—
  —Model self-charged interest rules after the comparable section 469 provisions;
  —Support for retaining the treatment of disallowed business interest expense as a corporate attribute;
  —Limit the application of section 382 to those attributes carried forward at the corporate level; and
  —Apply section 163(j) separately to each short period for an actual or hypothetical short taxable year.
Section 163(j) Comments/Hearing (Cont’d)

• Principal topics covered at the public hearing include the following:
  — Definition of “tax shelter” for purposes of the section 163(j)(3) small business exception;
  — Confirm that affected taxpayers may effectively elect between bonus depreciation and a section 163(j) exception for floor plan financing indebtedness interest;
  — Scope of “motor vehicle” definition;
  — Treatment of certain items as “interest” for section 163(j) purposes;
  — Treatment of cost recovery allowances capitalized into inventory under section 263A;
  — Treatment of tiered partnerships;
  — Scope of the term “electing real property trade or business”; and
  — Allocation of items between excepted and non-excepted trades or businesses.
S Corporation Adjusted Taxable Income

- Section 1363(b) provides that the taxable income of an S corporation is determined in the same manner as an individual, except that:
  - The items described in section 1366(a)(1)(A) are separately stated;
  - The deductions referred to in section 703(a)(2) are not allowed;
  - Section 248 shall apply; and
  - Section 291 applies to the first three taxable years following S corporation status.

- The adjusted taxable income of an S corporation is generally determined under the following steps:
  - Determine taxable income pursuant to section 1363(b);
  - Take separately stated items (section 1366(a)(1)(A)) into account;
  - Exclude items not attributable to a non-excepted trade or business; and
  - Take into account other adjustments required by Prop. Reg. § 1.163(j)-1(b)(1).
Treatment of S Corporation Shareholders

• The adjusted taxable income of an S corporation shareholder (to the extent the shareholder is subject to a separate section 163(j) limitation) should be determined using the following additional steps:
  — Exclude the shareholder’s share of any item from the S corporation, except for excess taxable income;
  — Increase by the shareholder’s share of the corporation’s excess taxable income; and
  — Adjust for gain or loss on disposition of S corporation stock.

• The exclusion of the shareholder’s share of S corporation items precludes the double counting of certain items of the S corporation, i.e., first at the S corporation level and again at the shareholder level:
  — Business interest income;
  — Business interest expense;
  — Floor plan financing interest expense; and
  — Other items of business income and expense.
Example 16, Prop. Reg. § 1.163(j)-6(o)

<table>
<thead>
<tr>
<th>Item</th>
<th>Corporation X</th>
<th>Shareholder A</th>
<th>Shareholder B</th>
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</thead>
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<tr>
<td>Adjusted taxable income, Year 1*</td>
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<tr>
<td>Business interest expense</td>
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<td>Corporate limitation</td>
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<td>Corporate carryforward to Year 2</td>
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<td>Shareholder K-1 income</td>
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<td>Shareholder limitation</td>
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<td>-0-</td>
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<td>Shareholder carryforward to Year 2</td>
<td>-0-</td>
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<td>$ 20</td>
</tr>
</tbody>
</table>

*Shareholder amounts determined without regard to S corporation items.
Example 17, Prop. Reg. § 1.163(j)-6(o)

<table>
<thead>
<tr>
<th>Item</th>
<th>Corporation X</th>
<th>Shareholder A</th>
<th>Shareholder B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carryforwards from Year 1</td>
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<td>Excess taxable income</td>
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<td>Shareholder carryforward to Year 3</td>
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<td>-0-</td>
<td>$ 25</td>
</tr>
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</table>

*Shareholder amounts determined without regard to S corporation items.
Disposition of S Corporation Stock

• Section 163(j)(8)(B) provides the Secretary with regulatory authority to identify other adjustments in determining adjusted taxable income.

• If an S corporation owns only non-excepted trade or business assets, gain or loss on the disposition of S corporation stock is included in the shareholder’s adjusted taxable income.

• In the case of any other S corporation, an allocation of gain or loss on the disposition of S corporation stock is made to take into account the corporation’s ownership of—
  —Both non-excepted assets and excepted assets;
  —Investment assets; or
S Corporations Not Subject to Section 163(j)

• Where an S corporation is not subject to section 163(j) because of the small business exception (section 163(j)(3)), the following rules apply to the corporation and its shareholders:
  — The S corporation does not compute or apply a section 163(j) limitation;
  — If a shareholder is subject to section 163(j), the shareholder takes into account its share of S corporation items of business interest income or expense and other items of income, gain, deduction, and loss (including for the purpose of calculating the shareholder’s adjusted taxable income); and
  — Business interest expense of the corporation retains its character as such in the hands of the shareholders.

• Where an S corporation is not subject to section 163(j) because of its status as an excepted business (section 163(j)(7)(A)), the following rules apply to the corporation and its shareholders:
  — The S corporation does not compute or apply a section 163(j) limitation to the excepted business; and
  — The shareholder excludes the excepted section 163(j) items from the shareholder’s section 163(j) deduction calculation.
Termination of QSub Status

• Upon the termination of a qualified subchapter S subsidiary ("QSub") election, the federal income tax consequences of the termination are governed by two principal rules:
  — In general, the QSub is treated as a new corporation acquiring all of its assets (and assuming its liabilities) from the S corporation in exchange for the stock of the corporation (section 1361(b)(3)(C)(i)).
  — Where the termination occurs by reason of the sale of the QSub stock, the transaction is accorded treatment similar to that of Rev. Rul. 99-5, i.e., a sale of an undivided interest in the QSub assets followed by a transfer to a newly-formed corporation (section 1361(b)(3)(C)(ii)).

• Upon the termination of QSub status, disallowed business interest expense remains with the S corporation, and none of it is transferred to the corporation deemed to have been newly created. Prop. Reg. § 1.163(j)-6(l)(8).
• An S corporation shareholder’s stock basis is reduced, but not below zero, when a disallowed business interest expense carryforward becomes deductible. Prop. Reg. § 1.163(j)-6(l)(6).

• The accumulated adjustments account of an S corporation is adjusted to take into account business interest expense in the year in which the S corporation treats such business interest expense as deductible. Prop. Reg. § 1.163(j)-6(l)(7).

• In contrast, the earnings and profits of a C corporation are reduced for the taxable year in which the business interest expense is paid or accrued, regardless of the year in which it is deductible under section 163(j). Prop. Reg. § 1.163(j)-4(c)(1).
Carryover of Disallowed Business Interest

• Several provisions of the Code coordinate subchapter S with subchapter C, including the following:
  —Subchapter C applies to an S corporation and its shareholders, except as otherwise provided in the Code, and except to the extent inconsistent with a provision of subchapter S (section 1371(a)).
  —Section 1371(b) precludes a carryforward of tax attributes from a C corporation taxable year to an S corporation taxable year, or from one S corporation taxable year to another S corporation taxable year at the corporate level (section 1371(b)).

• Disallowed business interest expense of an S corporation is carried forward at the corporate level, and is subject to the same ordering rules as for a C corporation, as well as the application of section 382. Prop. Reg. § 1.163(j)-6(l)(5).

• New section 381(c)(20) authorizes the transfer of disallowed business interest in transactions otherwise subject to section 381(a).
Application of Section 382 to S Corporations

• Section 382 imposes limits on the ability of a loss corporation to use pre-changes losses to offset post-change taxable income following an ownership change.
  — An ownership change occurs when stock owned by one or more five-percent shareholders increases by more than 50 percentage points, compared with the lowest ownership by such shareholder, over a relevant testing period (section 382(g)(1)).
  — The annual section 382 limitation is generally the value of the stock, immediately before the ownership change, multiplied by the relevant long-term tax-exempt rate (section 382(b)(1)). Several adjustments to the limitation are required, including for redemptions, corporate contractions, failure to continue the business, recognized built-in gains and losses, and substantial non-business assets.
  — A corporation that has only disallowed business interest expense under section 163(j) has a pre-change loss, and is thus a “loss corporation” subject to the application of section 382 (section 382(d)(3)).

• Section 382 will apply to an S corporation, with respect to its disallowed business interest expense, under the following rules:
  — Current-year business interest is deemed to have been used first, followed by carryforward amounts in the order in which they arose (Prop. Reg. § 1.163(j)-5(b)(2)).
  — Any pre-change losses of the S corporation will be subject to the applicable section 382 limitations.
  — The current-year disallowed business interest expense for the year of the ownership change is allocated to the pre-change and post-change periods using ratable allocation, regardless of the method used for other items (Prop. Reg. § 1.382-6(b)(4)(i)).
Closing-of-the-Books Elections for S Corporations

• An S corporation may, with the consent of affected shareholders, elect to close the books to allocate its taxable income or loss between two periods in three cases:
  — The complete termination of a shareholder’s interest (section 1377(a)(2));
  — A qualifying disposition of its stock (Treas. Reg. § 1.1368-1(g)(2)); and
  — Subject to section 1362(e)(6)(D) (where closing of the books is mandatory), a termination of the S corporation election (section 1362(e)(3)).

• A short taxable year of an S corporation results from each of the following scenarios:
  — Termination of an S corporation election;
  — Deemed liquidation of an “old target” by reason of a section 336(e) or section 338(h)(10) election;
  — Acquisition of assets of an S corporation target in a transaction described in section 381(a); and
  — The S corporation joins a consolidated group.

• Under what circumstances should the daily allocation required by Prop. Reg. § 1.382-6(b)(4)(i) override the ability of an S corporation to elect to close its books to allocate taxable income or loss?
Application of Section 382 to Other Items of an S Corporation

• An S corporation is required to consider limitations under sections 382, 383, and 384 in determining the amount of its net unrealized built-in gain or loss. Treas. Reg. § 1.1374-3(a)(5).

• An S corporation arguably takes limitations under sections 382 and 383 into consideration when applying the following attributes from a C corporation taxable year to reduce a section 1374 built-in gains tax:
  — Capital losses;
  — Net operating losses; and
  — Unused business credits.

• Should the application of section 382 be extended to S corporations under other circumstances? Recognized built-in losses during an S corporation taxable year?
Miscellaneous Issues

• Section 163(j) is applied at the entity level for taxable years beginning after December 31, 2017. How will it apply to a fiscal-year S corporation with calendar-year shareholders?

• How would the self-charged interest (or re-characterization) rules apply to amounts loaned by or to an S corporation?

• How is the section 163(j) limitation applied to interest expense subject to Notice 89-35?
  — Debt-financed acquisitions
  — Debt-financed distributions
Specific Requests for Comments

- The preamble to the proposed regulations specifically requested comments on several areas of interest to S corporations:
  - The proposed approach to allocating gross receipts of an S corporation to its shareholders, and also whether other approaches to determining the gross receipts of S corporation shareholders for purposes of section 163(j) would more accurately measure the gross receipts of such shareholders;
  - The treatment of disallowed business interest expense carryforwards as an attribute of the S corporation, subject to section 382 limitations, as opposed to the shareholders, and the timing for any adjustments to shareholder basis and the S corporation’s accumulated adjustment account;
  - The integration of sections 163(j) and 382 and subchapter S (for example, comments regarding the interaction between sections 382 and 1362(e)(6)(D));
  - The application of section 382 to S corporations for purposes other than section 163(j);
  - The use of a re-characterization rule for self-charged lending transactions between an S corporation and its owners; and
  - The use of an alternative approach for S corporations and shareholders, requiring excess business interest expense to be allocated immediately to shareholders, with immediate implications for basis and the accumulated adjustments account.
Questions?
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