Section 163(j) Proposed Regulations

ABA PANEL – NEW ORLEANS
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Introductions

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New 163(j)
New 163(j) – In General

• Limits business interest expense deductions to the sum of business interest income, 30% of adjusted taxable income (“ATI”), and the taxpayer’s floor plan financing interest for the tax year.

• Applies regardless of whether (i) the taxpayer is part of an ‘inbound’ group or an ‘outbound’ group, (ii) the interest payment is made to a US or foreign person, (iii) the interest recipient is related, or (iv) the interest recipient is exempt from US tax.

• ATI is taxable income computed without regard to:
  - (1) items not properly allocated to a trade or business;
  - (2) business interest expense or business interest income;
  - (3) net operating losses;
  - (4) the section 199A deduction; and
  - (5) for tax years beginning before January 1, 2022, deductions allowable for depreciation.

• Treasury released proposed regulations on November 26, 2018 that address new section 163(j) (the “Proposed Regulations”).
The Proposed Regulations provide a broad definition of interest.

The items described as interest can generally be broken down into two categories, amounts traditionally considered interest and interest equivalents.

Examples of amounts traditionally considered interest:
- OID
- Amounts treated as interest under section 483

Examples of interest equivalents:
- Guaranteed payments
- Loan commitment fees
- Substitute interest payments

The Proposed Regulations also contain an ‘anti-avoidance rule’ where amounts ‘predominantly incurred in consideration of the time value of money’ which would otherwise be deductible are treated as interest.
New 163(j) – Corporations

• The Proposed Regulations generally provide that the disallowance and carryforward of a deduction for a C corporation's business interest expense will not affect whether or when such business interest expense reduces the taxpayer's earnings and profits.

• If a member of a consolidated group has a current-year business interest expense for which a deduction is disallowed in the current tax year under section 163(j), basis in the stock of the member of the consolidated group is adjusted in a subsequent taxable year when the expense is absorbed by the consolidated group.

• The Proposed Regulations treat disallowed business interest expense as an attribute that can be eliminated under the unified loss rules of Treas. Reg. § 1.1502-36.

• The section 163(j) limitation on business interest expense does not apply to certain trades or businesses. The Proposed Regulations provide rules for both consolidated and non-consolidated, affiliated corporations to determine their allocation of interest between such trades or businesses.
Depreciation
Depreciation

- The Proposed Regulations contain a number of provisions modifying ATI to account for section 163(j)(8)(A)’s requirement that ATI be computed without regard to any deduction allowable for depreciation.

- For taxable years beginning before January 1, 2022, any deduction for depreciation under section 167 or section 168 is added to taxable income to determine ATI. Prop. Treas. Reg. § 1.163(j)-1(b)(1)(i)(D).

- With respect to the sale or other disposition of property, ATI is reduced by the lesser of (1) any gain recognized on the sale or other disposition of such property, and (2) any depreciation, amortization, or depletion deductions for the taxable years beginning after December 31, 2017, and before January 1, 2022, with respect to such property. Prop. Treas. Reg. § 1.163(j)-1(b)(1)(ii)(C).

- With respect to the sale or other disposition of stock of a member of a consolidated group that includes the selling member, ATI is reduced by the investment adjustments with respect to such stock that are attributable to deductions taken for depreciation. Prop. Treas. Reg. § 1.163(j)-1(b)(1)(ii)(D).

- Depreciation, amortization, and depletion capitalized to inventory under section 263A are not treated as deductions, and are not adjustments, in computing ATI. In some industries, most depreciation is converted to cost of goods sold, and the Proposed Regulations prohibit any benefit for the depreciation—even pre-2022.
Examples — Assumptions

• For purposes of the examples in this presentation we have made the following assumptions:
  • The items of income and deduction depicted are all the items of the taxpayer or consolidated group, as relevant.
  • None of the income and deductions depicted are for interest unless otherwise indicated.
  • All items other than interest would be applicable in determining adjusted taxable income.
Depreciation – Example 1

**Date 1:**

- **X** transfers $100 to **Y** in exchange for **Asset A**, a depreciable asset.
- **X** depreciates **Asset A**'s adjusted basis to $0 between Date 1 and Date 2.
- **X** transfers **Asset A** to **Z** in exchange for $40 on Date 2.

**Facts:**
1. On Date 1, **X** transfers $100 to **Y** in exchange for **Asset A**, a depreciable asset.
2. Between Date 1 and Date 2, **X** depreciates **Asset A**'s adjusted basis to $0.
3. On Date 2, **X** transfers **Asset A** to **Z** in exchange for $40.

**U.S. Federal Income Tax Considerations:**

For taxable years beginning before January 1, 2022, as **Asset A** is depreciated, the depreciation reduces **X**'s taxable income but does not impact **X**'s ATI for purposes of section 163(j).

On the disposition of **Asset A**, the Proposed Regulations would reduce ATI for the $40 of gain recognized on the sale of **Asset A**.
Depreciation – Example 2

Facts:
1. On Date 1, S transfers $100 to Y in exchange for Asset A, a depreciable asset.
2. Between Date 1 and Date 2, S depreciates Asset A’s adjusted basis to $0 and all deductions are absorbed by the P Group.
3. On Date 2, P transfers S to Z in exchange for $40.

U.S. Federal Income Tax Considerations:
For taxable years beginning before January 1, 2022, as Asset A is depreciated, the depreciation reduces P’s basis in S and reduces S’s taxable income but does not impact S’s ATI for purposes of section 163(j).

On the disposition of S, P would recognize $40 of gain. The $40 dollars of gain would increase P’s taxable income by $40. The Proposed Regulations would then reduce P’s ATI by the amount of investment adjustments P had in its S stock attributable to depreciation deductions (i.e., $100).

Effectively, this disregards P’s reductions in S’s basis for depreciation causing P to recognize a $60 loss on the sale of S for ATI purposes.

Query: Why is there a different result when selling stock vs. selling assets? Why does an asset transfer look to the lesser of gain or depreciation for ATI computation purposes while a sale of group member stock looks solely to depreciation for ATI computation purposes?
Depreciation – Example 3

**Facts:**
1. On Date 1, S transfers $100 to Y in exchange for Asset A, a depreciable asset.
2. Between Date 1 and Date 2, S depreciates Asset A’s adjusted basis to $0 and all deductions are absorbed by the P Group.
3. On Date 2, S transfers Asset A to W in exchange for $100.
4. On Date 3, P transfers S to Z in exchange for $100.

**U.S. Federal Income Tax Considerations:**

On the disposition of Asset A, S would recognize $100 of gain. The $100 dollars of gain would increase P group’s taxable income by $100. The Proposed Regulations would then reduce P’s ATI by the amount of depreciation taken with respect to Asset A (i.e., $100).

On the disposition of S, P would reduce its ATI by the amount of investment adjustments that are “attributable to” depreciation deductions. Is the positive investment adjustment for S’s Asset A gain “attributable to” depreciation deductions?

If not, the $100 of depreciation reduces ATI by a total of $200—a double recapture.

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Consolidated 163(j) Limitation
Consolidated 163(j) Limitation

- The Proposed Regulations provide a multi step process for determining how member’s business interest expense may be utilized.

1. First, the consolidated group determines if its section 163(j) limitation for the current year exceeds the member’s aggregate current-year business interest expense. If so, none of the current year business interest expense would be subject to disallowance.

2. If the members’ aggregate current year business interest expense exceeds the group’s section 163(j) limitation for the current year, each member can deduct its current-year business interest expense up to the amount of its business interest income.

3. If the group has any section 163(j) limitation remaining after the application of Step 2, each member with remaining current year business expense would deduct its current year expense pro rata.

4. If the group has any section 163(j) limitation remaining after deducting current year interest expense then carryforwards are permitted to be deducted in the order of the year in which they arose. For carryforwards from the same year, they are deducted on a pro rata basis.

Prop. Treas. Reg. § 1.163(j)-5(b)(3)
SRLY Limitations

- The Proposed Regulations set forth rules similar to those in Treas. Reg. § 1.1502-21(c) regarding disallowed business interest expense carryforwards from SRLYs.
  - Disallowed business interest expense carryforwards of a member arising in a SRLY that are included in the consolidated group’s business interest expense deduction may not exceed the group’s section 163(j) limit **for that year**, determined by reference only to the member’s items of income, gain, deduction and loss for that year.
  - Deduction of SRLY carryforward interest expense is only available if the group has any remaining section 163(j) limitation for the current year after the deduction of current year business interest expense and only to the extent that section 163(j) SRLY limitation for the current year exceeds the amount of the member’s business interest expense already deducted by the group.
  - SRLY limited disallowed business interest expense carryforwards are deducted on a pro rata basis with non-SRLY limited disallowed business interest expense carryforwards.

Prop. Treas. Reg. § 1.163(j)-5(d)
382 Overlap

- Prop. Treas. Reg. § 1.163(j)-5(f) applies the principles of Treas. Reg. § 1.1502-21(g) to disallowed business interest expense carryforwards when the application of the SRLY limitation results in an overlap with the application of section 382.
SRLY Limitation – Example 4

Facts:

1. In Year 1, S joins the P consolidated group with a $100 section 163(j) carryforward arising from before joining the group (i.e., a SRLY carryforward).

2. In Year 2, S has $100 of taxable income and P has $100 of taxable loss on a separate entity basis.

3. In Year 3, S has $0 of income or loss and P has $300 of taxable income.

U.S. Federal Income Tax Considerations:

Under the Proposed Regulations, S would not be able to use any of its section 163(j) carryforward in Year 3 because it did not have any taxable income, notwithstanding that it has contributed $100 to the group’s consolidated taxable income since joining.

Query: What is the policy behind a different result for a section 163(j) carryforward limitation compared to use of an NOL? S would have been able to use up to $100 of SRLY NOL in Year 3.
SRLY Limitation – Example 5

Facts:

1. In Year 1, S joins the P consolidated group with a $100 section 163(j) carryforward from before joining the group. P also has a section 163(j) carryforward of $100 from Year 1.

2. In Year 2, there is sufficient income and interest income such that there is $100 of section 163(j) interest limitation. S has $50 of section 163(j) limitation on a standalone basis.

U.S. Federal Income Tax Considerations:

S may only utilize its carryforward that is permitted to be absorbed on a pro rata basis with the group’s overall carryforward.

Accordingly, S uses $33 of its 163(j) carryforward ($100 x ($50 SRLY Limit/$150 total available carryforward)), and P uses $66 of its carryforward ($100 x ($100/$150)).

This limitation exacerbates the impact of the unavailability of a cumulative register going into the next year.
Cancellation of Debt Income
COD Income

- Generally a taxpayer has taxable gross income for amounts realized from the discharge of indebtedness ("COD Income").

- If a taxpayer is insolvent, it is not required to include COD Income in gross income to the extent of insolvency. Section 108(a). However, a taxpayer that excludes COD Income from gross income because it is insolvent is required to reduce certain tax attributes under section 108(b).

- Section 108(e)(2) provides that “no income shall be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction.”

- The Proposed Regulations do not contain a tracing principle for determining what interest expense has been allowed from a specific instrument and what interest expense has been carried forward.
COD Income – Example 6

Facts:
1. P and S are members of a consolidated group. P wholly owns F, a foreign corporation.
2. In Year 1, S accrues $100 of interest expense on a $1,000 debt obligation owed to F.
3. In Year 2, F forgives the $100 of S’s accrued interest. In Year 2, P and S have a section 163(j) limitation of $0.

U.S. Federal Income Tax Considerations:
S’s accrued interest on the debt to F is not deductible until paid. Section 267(a)(3).
Under section 61(a)(12), has S realized $100 of COD income?
• Does section 108(e)(2) apply to the accrued interest?
• What does it mean that a payment “would have given rise to a deduction” when taxpayer is in a 163(j) limitation position?
• If section 108(b) applies, is section 163(j) carryforward an attribute to reduce? Could this be addressed by regulation?
• If section 108(b) is not applicable to section 163(j) carryforward, could it still be eliminated under general tax principles if the interest won’t be paid because it is discharged before the 163(j) limitation becomes available?
• If section 108(e)(2) does not apply, what is the character of the COD Income (i.e. ordinary vs. interest income)? Under what authority?
COD Income – Example 7

Facts:

1. In Year 1, S, an accrual basis taxpayer, accrues $100 of interest expense on a $1,000 debt obligation owed to X.
2. In Year 2, X forgives the $100 of S’s accrued interest. In Year 2, P and S had a section 163(j) limitation of $0.

U.S. Federal Income Tax Considerations:

As an accrual basis taxpayer, S incurs the interest expense on the debt in Year 1 as it accrues for tax purposes, notwithstanding that the interest was not paid.

Under section 61(a)(12), has S realized $100 of COD income?

• What is the impact of having already accrued the interest expense for tax purposes compared to Example 1?
• What if $50 of interest is forgiven and S had a $50 163(j) limit for the year?
Intercompany Obligations
Repurchase Premium

- If a debt instrument is repurchased by the issuer for a price in excess of its adjusted issue price (as defined in Treas. Reg. § 1.1275-1(b)), the excess (repurchase premium) is generally deductible as interest for the taxable year in which the repurchase occurs. See Treas. Reg. § 1.163-7(c).

- Repurchase premium deductible under Treas. Reg. § 1.163-7(c) is interest for purposes of determining interest limitation under section 163(j). Prop. Treas. Reg. § 1.163(j)-1(b)(20)(i)(H).
Intercompany Obligations

Facts:

1. P wholly owns S. S owes $100 to A. The receivable has an adjusted issue price of $100.
2. A’s receivable has increased in value to $120 due to decreases in market rates.
3. S transfers $120 to A in exchange for the receivable owed from S.

U.S. Federal Income Tax Considerations:

Without regard to section 163(j), S would be entitled to deduct $20 of repurchase premium as interest expense on the acquisition of the receivable.

However, S must determine its interest expense under section 163(j), including the repurchase premium, and will only be able to take the deduction in the year of acquisition if enough limitation is available. Otherwise it will be required to carry forward the interest expense until sufficient limitation is available.
Deemed Satisfaction Reissuance

• Transactions involving intercompany obligations are generally governed by Treas. Reg. § 1.1502-13(g).

• An intercompany obligation is any obligation constituting indebtedness under general principles of federal income tax law between members of the same consolidated group. Treas. Reg. § 1.1502-13(g)(2)(i)-(ii).

• If debt of a member becomes an intercompany obligation, then the debt is treated, immediately after it becomes an intercompany obligation, as having been satisfied by the debtor for cash equal to the holder’s adjusted basis in the note and then as having been reissued as a new obligation for the same amount of cash (“Deemed Satisfaction Reissuance”). Treas. Reg. § 1.1502-13(g)(5)(ii)(A).

• In a Deemed Satisfaction Reissuance inbound transaction the attributes of each members items are taken into account on a separate entity basis. Treas. Reg. § 1.1502-13(g)(6)(i)(B).
163(j) - Intercompany Obligations

• For most purposes, intercompany obligations are treated as debt that generates either interest income or interest expense.

• Intercompany obligations impact each member’s separate taxable income or separate net operating loss for various purposes such as computing how much of a consolidated net operating loss is attributable to a member or a member’s SRLY limitation on using net operating loss carryforwards. See Treas. Reg. § 1.1502-21(b)(2)(iv)(B)(1); Treas. Reg. § 1.1502-21(c)(1).

• The purpose of Treas. Reg. § 1.1502-13 is “to provide rules to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability).”

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Intercompany Obligations

- Intercompany obligations under the Proposed Regulations:
  - Intercompany obligations are disregarded for purposes of determining the current-year business interest expense and business interest income of a member. Prop. Treas. Reg. § 1.163(j)-4(d)(2)(v);
  - Intercompany obligations are disregarded for purposes of calculating the ATI of a consolidated group. Prop. Treas. Reg. § 1.163(j)-4(d)(2)(v); and
  - Intercompany items and corresponding items are disregarded for purposes of calculating the ATI of a consolidated group to the extent those items offset in amount. Prop. Treas. Reg. § 1.163(j)-4(d)(2)(iv).

- However, intercompany obligations and items are not disregarded for other purposes under Treas. Reg. § 1.1502-21 purposes.

- These rules may be particularly difficult to apply in the context of separate state reporting for state tax purposes.
Facts:
1. P wholly owns S. S owes $100 to A. A’s receivable has increased in value to $120 due to decreases in market rates.
2. P transfers $120 to A in exchange for the receivable owed from S.

U.S. Federal Income Tax Considerations:
Immediately after the acquisition, P will have an adjusted basis of $120 in the receivable owed from S.

Under the Deemed Satisfaction Reissuance model, S will be treated as satisfying the debt for $120.

Attribute redetermination doesn’t apply so P has no gain or loss. S has $20 repurchase premium treated as interest expense.

Under the Proposed Regulations, intercompany obligations are disregarded for purposes of determining ATI, business interest income, and business interest expense.

The $20 of interest expense would not be included for purposes of determining P group’s ATI or “business interest expense.”

Query: Is S free to deduct the $20 repurchase premium because such amount is not business interest expense subject to section 163(j)?
Allocations of Interest
Allocation of Interest

• Prop. Treas. Reg. § 1.163(j)-10 sets forth rules for determining the amount of interest expense, interest income, and other tax items of a taxpayer that is properly allocable to excepted and non-excepted trades or businesses for purposes of Section 163(j).

• A taxpayer’s interest expense and interest income is generally allocated to a taxpayer’s excepted and non-excepted trades or businesses under the Proposed Regulations based on the relative amounts of the taxpayer’s adjusted basis in the assets.

• For purposes of Prop. Treas. Reg. § 1.163(j)-10, a consolidated group is treated as a single corporation. Consequently, the consolidated group, as opposed to a single member, is treated as engaged in excepted or non-excepted trades or businesses.

• A shareholder must look through to the assets of a non-consolidated domestic C corporation for purposes of allocating the shareholder's basis in its stock in the corporation between excepted and non-excepted trades or businesses if the shareholder's direct and indirect interest in the corporation satisfies the ownership requirements of section 1504(a)(2).
Facts:
P is a pure holding company that wholly owns both X and Y, but does not file a consolidated return with X or Y.

Assets A and C are used in excepted businesses by X and Y, respectively. Assets B and D are used in non-excepted businesses, by X and Y, respectively.

P has $100 of interest expense in Year 1.

U.S. Federal Income Tax Considerations:
25% ($25 basis in Asset A/$100 total asset basis) of the X stock owned by P is allocated to excepted businesses and 100% ($100 basis in Asset C/$100 total asset basis) of the Y stock owned by P is allocated to excepted businesses. The remaining 75% ($75 basis in Asset B/$100 total asset basis) of P’s X stock owned by P is allocated to non-excepted businesses.

62.5% ($125 excepted stock basis/$200 total stock basis) of P’s interest expense is therefore allocated to excepted businesses and 37.5% ($75 non-excepted stock basis/$200 total stock basis) of P’s interest expense is allocated to non-excepted businesses.

The result here is the same as it would be in consolidation, but it would be different if the stock basis in X or Y did not conform to inside asset basis or if there were liabilities at X or Y, such that one had higher stock basis than the other, even if there were conformity.
Partnership Sale
Partnerships

• Under the Proposed Regulations, a partnership determines its business interest expense, business interest income, ATI, and floor plan financing interest expense, and then calculates its section 163(j) limitation.

• Any deduction for business interest expense not disallowed under section 163(j) is taken into account in determining the non-separately stated taxable income or loss of the partnership.

• The adjusted basis of a partner in a partnership is reduced (but not below zero) by the amount of the excess business interest allocated to the partner.

• If a partner disposes of a partnership interest, the adjusted basis of the partner in the partnership interest shall be increased immediately before the disposition by the basis reduction for interest allocated from the partnership over the amount of excess interest already used by the partner. No deduction under is allowed to the transferor or transferee for any excess business interest expense resulting in a basis increase.

• Prop. Treas. Reg. § 1.163(j)-4(d) clarifies that a transfer of a partnership interest in an intercompany transaction that does not result in the termination of the partnership is treated as a disposition for purposes of section 163(j)(4)(B)(iii)(II).
Partnerships - Example 10

Facts:
1. In Year 1, Z has $100 of section 163(j) carryforward expense that is allocated pro rata to S1, S2, and S3.
2. In Year 2, S1 transfers its 33% interest in Z to S2 in exchange for cash.

U.S. Federal Income Tax Considerations:
In Year 1, S1 will reduce its basis in the Z partnership by the amount of excess business expense allocated to it.
In Year 2, immediately before S1 disposes of its interest in Z, its basis in Z will be increased by the amount of any excess business interest that has not yet been absorbed by S1.

No deduction is allowed to S1 or S2 for any excess business interest expense resulting in a basis increase.

Compare:
If Z were a member of the P consolidated group, interest expense subject to limitation under section 163(j) would not impact members’ bases in Z until absorbed by Z.
If S1 were to dispose of Z member stock in an intercompany transaction, S1 would not adjust its basis in Z immediately before the sale for disallowed interest expense.

Question: Was Treas. Reg. § 1.1502-13 not thought to be powerful enough to further delay any partnership basis adjustment and give a chance for the group to absorb the interest allocation as would happen for a single entity?
Partnerships - Example 11

Facts:
1. On Day 1 of Year 1, S transfers $100 to X in exchange for a 99.9 percent interest in the Z partnership.
2. In Year 1, Z generates $30 of interest expense, but has a $0 of section 163(j) limitation. S is allocated the $30 of suspended interest and reduces its partnership basis to $70.
3. At the beginning of Year 2, B transfers $50 to S in exchange for the 99.9 percent interest in the Z partnership.
4. In Year 2, the partnership generates $30 of income, which is taxed to B, increasing B’s basis in the Z partnership to $80.
5. On Day 1 of Year 3, Y transfers $20 to B in exchange for the interest in Z.

U.S. Federal Income Tax Considerations:
On the sale of Z to B, S will increase its basis in Z immediately before the sale by the amount of suspended interest and recognize a $50 capital loss that is deferred.

During Year 2, B will have $30 of taxable ordinary income from the partnership allocation.

On the sale of Z to Y, B will recognize a $60 capital loss that is not deferred. S’s previously deferred loss will be included in taxable income.
U.S. Federal Income Tax Considerations (continued):

If the attribute redetermination rules of Treas. Reg. § 1.1502-13(c)(1)(i) are inapplicable, the P group will have $30 of ordinary income and $110 of capital loss.

If S and B were divisions of a single corporation, the $30 of interest carryforward would have been deducted in year two, meaning that the entity would have had $30 of ordinary income, $30 of ordinary deduction, and $80 of capital loss when the entity sold the partnership interest with a basis of $100 for $20.

Query: Should $30 of S’s capital loss be recharacterized as ordinary?
163(j) & 382
A carryover of disallowed interest to a change year is a pre-change loss under section 382, but there is uncertainty over whether a carryover created by the losses in the year of change is also a pre-change loss.

For a carryover that arises in a year of an ownership change, the IRS may consider similar rules for other carryforwards—that is, allocate the disallowed business interest between pre-ownership change and post-ownership change periods—and limit the pre-ownership change portion. But do these rules apply?

A loss corporation’s taxable income is offset first by losses subject to a section 382 limitation, to the extent the section 382 limitation for the taxable year has not yet been absorbed, before being offset by losses of the same type from the same taxable year that are not subject to limitation. Prop. Treas. Reg. § 1.383-1(d).
Other Issues
Other Issues

- The interaction of the consolidated 163(j) regulations and the BEAT regulations.
- Section 163(j) implications with respect to GILTI
- The interaction of section 163(j) and the deduction under section 250.
Thank You