Section 163(j) Update

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Agenda

Overview
Interest
Adjusted Taxable Income
Carryover of Disallowed BIE
Circular Basis
COD Income
Section 163(j) provides that the amount allowed as a deduction for business interest expense may not exceed the sum of:

- business interest income for such taxable year;
- floor plan financing interest for such taxable year; and
- 30 percent of "adjusted taxable income" for such taxable year.

Any disallowed business interest is carried forward and treated as business interest paid or accrued in the succeeding taxable year subject to section 163(j). Section 163(j)(2).

Certain excepted trades or businesses are not subject to the limitation under section 163(j) including certain “small businesses,” electing real property businesses, electing farming businesses and regulated utilities.

Section 163(j) may apply to any taxpayer with special rules for different types of taxpayer (e.g., C corporation, partnership, S corporation, etc.).
Overview

• On November 26, 2018, the IRS issued proposed regulations under section 163(j) and related provisions.

• The proposed regulations include 1.163(j)-1 through 1.163(j)-11 and proposed regulations under other sections.

• The proposed regulations are effective for taxable years ending after the date that final regulations are published in the Federal Register.

• However, taxpayers and their related parties (under sections 267(b) and 707(b)(1)) may apply the proposed regulations:

  "so long as the taxpayers and their related parties consistently apply the rules of the section 163(j) regulations, and if applicable, §§ 1.263A-9, 1.381(c)(20)-1, 1.382-6, 1.383-1, 1.469-9, 1.882-5, 1.1502-13, 1.1502-21, 1.1502-36, 1.1502-79, 1.1502-91 through 1.1502-99, (to the extent they effectuate the rules of §§ 1.382-6 and 1.383-1), and 1.1504-4 to those taxable years."

[Emphasis added] (Excerpt from Prop. Reg. § 1.163(j)-1(c)).
Administration Issues

- Timing of final regulations
- Changes from the current proposed regulations
- Effective date for final regulations
- Additional proposed regulations
- Other projects with section 163(j) implications
Interest

- The proposed regulations provide an expanded definition of interest.

- The definition under Prop. Reg. § 1.163(j)-1(b)(20) consists of 3 categories:
  1. **Compensation for the use or forbearance of money** includes OID, qualified stated interest, repurchase premium, market discount, and imputed interest.
  2. **Swaps with significant non-periodic payments** includes time-value component of non-cleared swaps with significant non-periodic payments.
  3. **Other amounts treated as interest** includes amounts that are “closely related to interest.”

- The category "**other amounts treated as interest**" includes:
  - Substitute interest payments;
  - Debt issuance costs;
  - Guaranteed payments for use of capital;
  - Commitment fees (but only if some amount of financing is actually provided);
  - Amounts with respect to a derivative that **alters a taxpayer's effective cost of borrowing** with respect to a liability of the taxpayer (such as gain or loss on an interest rate swap); and
  - Amounts with respect to a derivative that **alters a taxpayer's effective yield** with respect to a debt instrument held by the taxpayer.
The proposed regulations also provide an "anti-avoidance" rule under Prop. Reg. § 1.163(j)-1(b)(20)(iv) which states:

"Any expense or loss, to the extent deductible, incurred by a taxpayer in a transaction (or series of integrated or related transactions) in which a taxpayer secures the use of funds for a period of time is treated as interest expense of the taxpayer if such expense or loss is predominantly incurred in consideration of the time value of money."

• Query whether factoring loss or guarantor fees may be included by anti-avoidance rule.

• Other items that could be treated as interest under the anti-avoidance rule?
Adjusted Taxable Income (ATI)

• Under section 163(j)(8), Adjusted Taxable Income (ATI) is defined as the taxable income of a taxpayer computed without regard to:
  – income, gain, deduction, or loss not properly allocable to a trade or business;
  – business interest expense and business interest income;
  – net operating loss deduction under section 172;
  – the deduction under section 199A (for qualified business income); and
  – depreciation, amortization, or depletion for taxable years beginning before January 1, 2022.

• The Code provides the Secretary with the authority to make other adjustments to taxable income to arrive at ATI.
Adjusted Taxable Income (ATI)

• Under the Proposed Regulations, taxable income has the meaning provided in section 63, but for this purpose computed without regard to the application of section 163(j) and the section 163(j) regulations.

• Section 63 defines taxable income as gross income minus deductions allowed by chapter 1.

• The preamble acknowledges the need for ordering rules to coordinate the operation of other provisions that affect taxable income or include limitations based on taxable income.

• A deduction under section 250(a)(1) is determined without regard to the taxable income limitation in section 250(a)(2) and without regard to section 163(j).
Adjusted Taxable Income (ATI)

• Under Prop. Reg. § 1.163(j)-1(b)(37)(ii), “If for a taxable year a taxpayer is *allowed* a deduction under section 250(a)(1) that is properly allocable to a non-excepted trade or business, then taxable income for the taxable year is determined without regard to the limitation under section 250(a)(2).”

• Similarly under Prop. Reg. § 1.163(j)-4(d)(2)(iv), “if for a taxable year a member of a consolidated group is *allowed* a deduction under section 250(a)(1) that is properly allocable to a non-excepted trade or business, then, for purposes of calculating ATI, consolidated taxable income for the taxable year is determined as if the deduction were not subject to section 250(a)(2).”

• For the purposes of ATI, the deduction under section 250(a)(1) is determined without regard to section 163(j).

• Query whether a section 250 deduction is “allowed” if the actual section 250 deduction is $0? Is there a cliff effect for computing the section 250 deduction for ATI?
Additions to taxable income under Prop. Reg. § 1.163(j)-1(b)(1):

- business interest expense;
- net operating loss deduction;
- deduction under section 199A;
- deduction for capital loss carryback or carryover;
- deduction or loss not properly allocable to a non-excepted trade or business;
- excess taxable income from CFCs if there is a CFC group election; and
- for years beginning before January 1, 2022:
  - depreciation under sections 167 or 168;
  - amortization of intangibles under sections 167 or 197;
  - other amortized expenditures (section 195(b)(1)(B), 248, or 1245(a)(2)(C)); and
  - depletion under section 611.

Key Considerations:

*Expenses capitalized to inventory under section 263A are not a depreciation, amortization, or depletion deduction under the proposed regulations, and therefore are not an addition under the proposed regulations.*
Subtractions to taxable income under Prop. Reg. § 1.163(j)-1(b)(1):

- business interest income;
- floor plan financing interest expense;
- the lesser of: (1) any gain recognized on the sale or other disposition of property; and (2) depreciation, amortization, or depletion for taxable years after December 31, 2017 and before January 1, 2022, with respect to such property;
- certain investment adjustments under Reg. § 1.1502-32 attributable to depreciation, amortization, and depletion upon the sale or other disposition of the stock of a member of a consolidated group;
- the taxpayer's distributive share of certain deductions of depreciation, amortization, and depletion allowable under section 704(d) upon the sale or other disposition of a partnership interest;
- income or gain that is not properly allocable to a non-excepted trade or business; and
- deemed inclusions under sections 78, 951(a), and 951A less the deduction under section 250 as computed for section 163(j) purposes.

Key Considerations:

- Recapture provisions may operate similar to Sec. 1245, but taxpayers will need to allocate purchase price in detail to depreciable and amortizable assets.
- In the sale of a consolidated subsidiary, there is no look-through to the underlying assets.
Step 1:
- Parent forms NewCo and contributes Asset A, for which it took a deduction of $10 for depreciation in 2019, into NewCo in exchange for NewCo stock.
- NewCo joins Parent’s consolidated group upon formation.
- Parent recognizes no gain under section 351(a) and takes an exchanged basis in the NewCo stock equal to the basis in Asset A under section 358(a)(1).

Analysis:
- Parent must reduce ATI by the lesser of (i) gain on the transfer of Asset A or (ii) the depreciation deduction taken in 2019. Prop. Reg. § 1.163(j)-1(b)(ii)(C).
- Parent recognized no gain on the transaction, and ATI will not be reduced.

Question:
- Are all nontaxable exchanges considered other dispositions?
  - A nontaxable exchange of a partnership interest treated as a transfer by sale or exchange for purposes of section 743(b). See ILM 201726012.
Step 2:
• Parent contributes the stock of NewCo to a partnership in exchange for a partnership interest.
• Parent recognizes no gain under section 721(a) and takes an exchanged basis in the partnership interest.
• The partnership has a transferred basis of $90 in the NewCo Stock under section 723.
• Parent makes no investment adjustments with respect to its NewCo stock under Treas. Reg. § 1.1502-32 between the formation of NewCo and the transfer to the partnership.

Analysis:
• Parent must reduce its ATI by the amount of investment adjustments made under Treas. Reg. § 1.1502-32 that are attributable to deductions taken for depreciation. Prop. Reg. § 1.163(j)-1(b)(ii)(D).
• Because no investment adjustments have been made to the NewCo stock, Parent will not reduce its ATI.
Depreciation and Amortization Under 163(j)
Example – Transfer of Group Member

Question:
• Should the transfer of NewCo stock trigger a reduction of ATI under Prop. Reg. § 1.163(j)-1(b)?
  ▪ If NewCo had owned Asset A and taken a deduction of $10 for depreciation of the asset that was absorbed into the Parent consolidated return, then the NewCo stock would have had $10 of investment adjustments described in Prop. Reg. § 1.163(j)-1(b)(ii)(D).
  ▪ Should the $10 of depreciation deductions that are reflected in Parent’s reduced basis in NewCo stock in the section 351 exchange be treated as negative investment adjustments within the framework of section 163(j) and the proposed regulations?
Depreciation and Amortization Under 163(j)
Example – Partnership Sale of Stock

Step 3:
- Partnership sells the NewCo stock to a 3rd party for $100.
- Partnership recognizes gain on the sale of NewCo stock that is allocated to Parent under section 704(c).

Analysis:
- Prop. Reg. § 1.163(j)-1(b)(ii)(D) is not applicable because the transfer is not a disposition of stock of a member of a consolidated group by a selling member.
- There does not appear to be any other provisions in the proposed regulations that would otherwise require a reduction in ATI.

Question:
Is this transaction or series of transactions covered by the anti-abuse rule under Prop. Reg. § 1.163(j)-2(h) for agreements entered into with a principal purpose of avoiding the rules of section 163(j) or the regulations thereunder?
Adjusted Taxable Income (ATI)

- Business interest expense includes (i) any interest expense that is properly allocable to a non-excepted trade or business, (ii) floor plan financing interest, and (iii) disallowed business interest expense carryforwards. Prop. Reg. § 1.163(j)-1(b)(2)(i).

- Any business interest expense disallowed under section 163(j) is carried forward to the succeeding taxable year as business interest expense that is subject to such section (such carried forward interest makes up the “disallowed business interest expense carryforward”). Prop. Reg. § 1.163(j)-1(b)(9); Prop. Reg. § 1.163(j)-2(c).
Adjusted Taxable Income (ATI)

• The proposed regulations require that taxable income is computed without regard to section 163(j) and the section 163(j) regulations. As a result, current year interest expense would initially reduce a taxpayer’s taxable income for purposes of computing ATI.

• If the taxpayer has a disallowed business interest expense carryforward, such amount will be included in its business interest expense, which is added to taxable income when computing ATI.

• Applied literally, this would result in a net increase to the taxpayer’s ATI by the amount of disallowed business interest expense carryforward, creating a larger section 163(j) limitation for the taxpayer.

• If a taxpayer applies the regulation literally, is taxable income computed without regard to business interest as required under section 163(j)(8)?

• The instructions for Form 8990 direct a taxpayer to first compute taxable income “as though all of its business interest expense is otherwise allowable business interest expense” and then to “add to taxable income all business interest expense to the extent included in taxable income.”
Consolidated Groups

• A consolidated group has a single section 163(j) limitation.

• Intercompany items and corresponding items are disregarded to the extent that they offset in amount for purposes of calculating the consolidated group's ATI.

• All intercompany obligations, as defined in Treas. Reg. 1.1502-13(g)(2)(ii), are disregarded for purposes of calculating the consolidated group’s ATI. Prop. Reg. § 1.163(j)-4(d)(2)(v).

• All intercompany obligations, as defined in Treas. Reg. 1.1502-13(g)(2)(ii), are disregarded for purposes of determining a member’s business interest expense and business interest income. Prop. Reg. § 1.163(j)-4(d)(2)(v).
**Example 1 – Debt Becoming an Intercompany Obligation**

**Facts similar to Treas. Reg. § 1.1502-13(g)(7)(ii), Example 10(iii):**
- B owes debt to X with an adjusted issue price of $100. X's note receivable has increased in value to $130 due to a decrease in prevailing market interest rates.
- P transfers $130 to X in exchange for the note receivable owed from B.

**Analysis:**
- Immediately after the acquisition, P will have an adjusted basis of $130 in the note receivable owed from B.
- Under the Deemed Satisfaction Reissuance model in Treas. Reg. § 1.1502-13(g), B will be treated as satisfying the debt for $130.
- P has no gain or loss and B has $30 of 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.
- **Query** whether B may deduct the $30 repurchase premium without it being subject to section 163(j)? See PLR 201707006 for a similar fact pattern.
Example 2 – Debt Becoming an Intercompany Obligation

Variation of Treas. Reg. § 1.1502-13(g)(7)(ii), Example 10(iii):
- B owes debt to X with an adjusted issue price of $100. X’s note receivable has decreased in value to $70 due to an increase in prevailing market interest rates.
- P transfers $70 to X in exchange for the note receivable owed from B.

Analysis:
- Immediately after the acquisition, P will have an adjusted basis of $70 in the note receivable owed from B.
- Under the Deemed Satisfaction Reissuance model in Treas. Reg. 1.1502-13(g), B will be treated as satisfying the debt for $70.
- P has no gain or loss and B has $30 of COD income under section 61(a)(11).
- Under the Proposed Regulations, intercompany obligations are disregarded for purposes of determining ATI, business interest income, and business interest expense.
- Query whether B includes the $30 of COD income in its ATI?
C Corporations

- C corporations generally only have items that are properly allocable to a trade or business.
- **Business Interest Expense (BIE) and Business Interest Income (BII)**
  
  A C corporation can only have BIE and BII for purposes of section 163(j) (unless allocable to an excepted trade or business). Prop. Reg. § 1.163(j)-4(b)(1).

- **ATI**
  
  All items of income, gain, deduction, or loss of a taxpayer that is a C corporation are properly allocable to a trade or business for purposes of section 163(j) and, thus, taken into account in determining ATI (unless allocable to an excepted trade or business). Prop. Reg. § 1.163(j)-4(b)(2).

- **C Corporation Partners**
  
  Investment interest that a partnership pays or accrues and that is allocated to a C corporation partner is treated by the C corporation as properly allocable to a trade or business. Similar treatment for investment income and investment expenses. Prop. Reg. § 1.163(j)-4(b)(3)(i).
The proposed regulations reserved for “self-charged” interest. See Prop. Reg. § 1.163(j)-6(n).

If business interest expense is disallowed for PRS, Corp has business interest income with no deduction for business interest expense.

The preamble states that the IRS intends to adopt rules to re-characterize for the lender and the borrower.

One possible approach mentioned in the preamble is Treas. Reg. § 1.469-7.
Carryforward of Disallowed BIE

Carryforwards: In General

– Section 163(j)(2) provides that any BIE not allowed as a deduction under section 163(j)(1) is treated as BIE paid or accrued in the succeeding taxable year.

– BIE is interest expense that is properly allocable to a non-excepted trade or business or that is floor plan financing interest expense. Prop. Reg. § 1.163(j)-1(b)(2)(i).

– Disallowed business interest expense carryforwards (which are treated as allocable to a non-excepted trade or business in a prior year) are not re-allocated between non-excepted and excepted trade or businesses in a succeeding taxable year. Prop. Reg. § 1.163(j)-10(c)(4).
Carryforward of Disallowed BIE

Carryforwards: Ordering Rule for Absorption

– The Proposed Regulations provide that a C corporation’s current-year BIE (i.e., interest expense deductible in current year without regard to the section 163(j) limitation and carryforwards) is deducted before any carryforwards from a prior taxable year.

– Carryforwards deducted in the order in which they arose, with the earliest taxable year first.

– Carryforwards are subject to applicable limitations (e.g., section 382, SRLY).
Carryforward of Disallowed BIE

- Disallowed disqualified interest under the former section 163(j) is carried forward to the taxpayer's first taxable year beginning after December 31, 2017, under the proposed regulations, and is subject to disallowance as a disallowed business interest expense carryforward. Prop. Reg. § 1.163(j)-11(b).

- A taxpayer may not reduce its earnings and profits for disallowed disqualified interest carryforwards deducted in the current year if it reduced earnings and profits in a prior year.

- Each member of an affiliated group under the former section 163(j) is allocated an allocable share of the group's disallowed disqualified interest carryforward.

- Special rule to clarify application of section 382 before final regulations.

- See also proposed regulations under section 59A.
Hybrid Instruments and Pre-Reform Carryforward
Pre-Reform Carryforward Into TCJA Years

• Prior to the enactment of the TCJA, section 163(j) contained a different interest expense limitation and deferral regime that could result in a carryforward tax attribute referred to as disallowed disqualified interest.

• Under the proposed regulations, disallowed disqualified interest is carried forward to the taxpayer’s first taxable year beginning after December 31, 2017, and is subject to disallowance as a disallowed business interest expense carryforward under section 163(j) and Prop. Reg. § 1.163(j)-2. Prop. Reg. § 1.163(j)-11(b).

• Disallowed business interest expense carryforward is treated as a component of business interest expense under the proposed regulations.

• Section 163(j)(2) provides that any business interest not allowed as a deduction by section 163(j)(1) shall be treated as business interest paid or accrued in the succeeding taxable year.

• Consider whether such limitation is intended to apply only to section 163(j)(1) as enacted in the TCJA.
Hybrid Instruments and Pre-Reform Carryforward
Pre-Reform Carryforward Into TCJA Years

• The regulations are silent on the application of section 267A and section 163(j) to hybrid transactions involving disallowed disqualified interest that is carried from a taxable year beginning before December 31, 2017.

• Section 267A(a) “shall apply to taxable years beginning after December 31, 2017” and provides that no deduction shall be allowed for an amount paid or accrued pursuant to a hybrid transaction.

• The definition of hybrid transaction is not limited by the date that interest is accrued.

• Should disallowed disqualified interest that was accrued on an instrument that would have been a hybrid instrument under section 267A, had it been effective at the time of accrual, be subject to disallowance when it is carried to a year where section 267A is effective?

• Does section 163(j)(2) require that such disallowed disqualified interest is treated as paid or accrued in the current year for all purposes, including section 267A?

• The proposed regulations under section 59A are explicit that a base erosion payment does not include disallowed business interest that is carried from a taxable year beginning before January 1, 2018. Prop. Reg. § 1.59A-3(b)(3)(vii).
Excepted Trades or Businesses

• Certain specified trades or businesses (excepted trades or businesses) are not subject to section 163(j).

• The term "trade or business" does not include:
  – performing services as an employee;
  – certain regulated public utilities; and
  – any electing real property trade or business or any electing farming business.

• "Real Property Trade or Business" means any real property, development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. Section 469(c)(7)(C).
Excerpted Trades or Businesses

- The proposed regulations provide rules and procedures for the election for excepted real property trades or businesses or farming businesses. Prop. Reg. § 1.163(j)-9.

- The election is generally irrevocable. Prop. Reg. § 1.163(j)-9(b)(2).

- An election for a partnership must be made on the partnership’s return with respect to any trade or business that the partnership conducts. Prop. Reg. § 1.163(j)-9(c)(4).

- An election by a partnership does not apply to a trade or business conducted by a partner outside of the partnership. Prop. Reg. § 1.163(j)-9(c)(4).

- The Preamble states, “The Treasury Department and the IRS also have determined that small businesses that are exempt under section 163(j)(3) and Prop. Reg. § 1.163(j)-2(d)(1) may not make an election under proposed Prop. Reg. § 1.163(j)-9.”
Corp conducts a real property trade or business.

In year 1, Corp does not elect to be treated as an excepted trade or business under section 163(j)(7)(B) and has business interest expense disallowed under section 163(j) that carries forward to year 2.

In year 2, Corp elects to be treated as an excepted trade or business under section 163(j)(7)(B).

Does the Corp election in Year 2 have any impact on disallowed business interest carryforward from Year 1?
Corporate Partner with RPTB – Hypothetical 1

- PRS conducts a real property trade or business.

- PRS may elect to be treated as an excepted trade or business under section 163(j)(7)(B).

- Can Corp elect to be treated as an excepted trade or business?

- Query if Corp owns solely an interest in PRS.

- By analogy, see Theodore G. Arens (T.C. Memo 1990-241) stating, “Cases too numerous to cite have held that the business of a partnership is the business of its partners.”
Excepted Trades or Businesses

• To the extent that a partnership or S corporation is not subject to section 163(j) because it has an excepted trade or business, the entity does not apply its section 163(j) limitation to business interest expense that is allocable to such excepted trade or business. Prop. Reg. § 1.163(j)-6(m)(2).

• If a partner or S corporation shareholder is allocated an item allocable to an excepted trade or business, such excepted 163(j) item is excluded from the partner's or S corporation shareholder's section 163(j) deduction calculation. Prop. Reg. § 1.163(j)-6(m)(2).

• 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 section 163(j), the excess business interest expense from prior taxable years is treated as paid or accrued by the partner in such succeeding taxable year. Prop. Reg. § 1.163(j)-6(m)(3).

• If an S corporation has a disallowed business interest expense carryforward for a taxable year, and in the succeeding taxable year becomes not subject to section 163(j), then such disallowed business interest expense carryforward:
  – Continues to be carried forward at the S corporation level;
  – Is no longer subject to section 163(j); and
  – Is taken into account in determining the non-separately stated taxable income or loss the S corporation. Prop. Reg. § 1.163(j)-6(m)(4).
Corp is a C corporation and a partner in PRS.

PRS conducts a real property trade or business.

In year 1, PRS does not elect to be treated as an excepted trade or business under section 163(j)(7)(B) and allocates excess business interest expense to Corp, which is properly allocable to the RPTB.

In year 2, PRS elects to be treated as an excepted trade or business under section 163(j)(7)(B).

Does the PRS election in Year 2 have any impact on Corp’s EBIE from Year 1?
Departing Member of a Consolidated Group

- **Departing Members.** A departing member may retain its current-year BIE (through the date of departure) and carryforwards, to the extent not used by the consolidated group for the taxable year including the departure date, or otherwise reduced (e.g., under Treas. Reg. § 1.1502-36). The remaining attributes would be carried forward to the member’s first separate return year.

- **Basis Adjustments.** In general, stock basis adjustments apply under Treas. Reg. § 1.1502-32, at the time disallowed BIE is absorbed by the group.
  - Note that the preamble explicitly makes this point, but that Prop. Reg. § 1.163(j)-4(d)(3) simply includes a cross-reference to Treas. Reg. § 1.1502-32(b).

- **Treas. Reg. § 1.1502-36.** A disallowed BIE is treated as a deferred deduction under Treas. Reg. § 1.1502-36 and, thus, may be reduced or reattributed under Treas. Reg. § 1.1502-36(d) (addressing a duplicative loss in loss member stock and inside tax attributes, upon a transfer of such stock).

- Special rules apply to intercompany transfers of partnership interests.

- Special transition rules apply to members joining a consolidated group, for effective date purposes.
163(j) Limitation Impact on Circular Basis

The Circular Basis Rule

• Whenever stock of a member is sold Treas. Reg. § 1.1502-11(b) prevents the use of a departing subsidiary's losses from offsetting gains generated by other members of a consolidated group from the disposition of the subsidiary member's stock (the Circular Basis Rule).

• Generally, if one member (P) disposes of the stock of another member (S), the Circular Basis Rule limits the use of S's deductions and losses in the year of disposition and the carryback of items to prior years. Treas. Reg. § 1.1502-11(b)(1).

• The purpose of this limitation is to prevent P's income or gain from the disposition of S's stock from increasing the absorption of S's deductions and losses, because increased absorption would reduce P's basis in S's stock under Treas. Reg. § 1.1502-32 and that increased absorption would, in turn, increase P's income or gain.
163(j) Limitation Impact on Circular Basis
The Circular Basis Rule

• In determining the limitation imposed by the Circular Basis Rule, the consolidated group must first tentatively compute its consolidated taxable income (or loss) for the year of disposition (and any prior years to which the deductions or losses may be carried) without regard to P's income and gain from the disposition. Treas. Reg. § 1.1502-11(b)(2)(i).

• S's deductions and losses offset income and gain only to the extent of the consolidated taxable income (or loss) excluding any gain or loss from the disposition of S's stock.

• To the extent S's losses or deductions are currently absorbed or carried back to and absorbed in prior taxable years in the tentative CNOL calculations, such S losses and deductions absorbed have the effect of reducing P's basis in its S's stock reduced under Treas. Reg. § 1.1502-32(b).

• Prop. Reg. § 1.163(j)-4(d)(3) cross-references Treas. Reg. § 1.1502-32(b) related to investment adjustments. The preamble states, “Under those rules, if a member has current-year business interest expense for which a deduction is disallowed in the current taxable year under section 163(j), basis in the member’s stock would be adjusted in a later taxable year when the expense is absorbed by the group.”
Facts:
• P and S are members of consolidated group.
• In year 1, P has ordinary income of $30 and S has $80 of ordinary loss.
• P sells S's stock for $520 at the close of year 1.
• Only $30 of S's loss is absorbed in the determination of consolidated taxable income under Treas. Reg. § 1.1502-11(b).
• P's basis in S's stock is reduced from $500 to $470 immediately before the disposition.
• P recognizes a $50 gain from the sale of S's stock and the group has consolidated taxable income of $50 for year 1.
Facts:
• P and S are members of consolidated group.
• In year 1, P has ordinary income of $30 and S has $80 of BIE.
• P sells S’s stock for $520 at the close of year 1.
• For purposes of ATI, the relevant taxable income is the consolidated group’s consolidated taxable income. Prop. Reg. § 1.163(j)-4(d)(2)(iv).
• Should P’s gain from the sale of S’s stock be included in the P group’s ATI?
• If so, $15 of S’s BIE is deducted by the P group.
• P’s basis in S stock is reduced from $500 to $485 immediately before the disposition, thus, P has a revised gain of $35.
• Should the principles of Treas. Reg. § 1.1502-11(b) apply to determining the consolidated group’s ATI?
163(j) Limitation Impact on Circular Basis
Treas. Reg. § 1.1502-11(b)(2)(iii), Example 1, Variation

P sells S for $520

$30 Ordinary Income

$500 Basis

$80 BIE

Analysis:

• If Treas. Reg. § 1.1502-11(b) applies to limit ATI to $30, only $9 of S’s BIE is deducted by the P group (i.e., 30% of the P group ATI is $9 (30% of $30)).

• Thus, P’s basis in S stock is reduced from $500 to $491 immediately before the disposition, thus, P has a revised gain of $29.

• P’s gain on S stock does not give rise to further deduction of S’s BIE.
163(j) Limitation Impact on Circular Basis
Treas. Reg. § 1.1502-11(b)(2)(iii), Example 1, Variation 2

Facts:
• P and S are members of consolidated group.
• In year 1, P has ordinary income of $20 not including any interest expense or gain related to S.
• P also has $15 of BIE and S has $25 of NOL.
• At the end of the year, P sells S’s stock for $100 at the close of year 1.

Analysis:
• Under Treas. Reg. § 1.1502-11(b), P Corp must determine how much of S Corp’s $25 loss it will utilize in its consolidated taxable income.
• P Corp must tentatively compute its taxable income without taking into account P Corp’s income and gain from the disposition of S Corp.
• In order to determine P Corp’s taxable income for the year, it must determine its ATI to determine its deduction for business interest expense.
Analysis (continued):

- For purposes of computing ATI, does the tentative computation also require that P does not include gain from sale of the S stock?

- If the disposition is completely ignored, P would have ATI of $20, a section 163(j) limitation of $6 ($20 x .3), tentative taxable income of $14 and a limit of $14 of S's NOL in computing its taxable income.

- However, P when computing its actual ATI for purposes of section 163(j) would need to include gain from the sale of S stock. P's gain will be $10 plus whatever amount of S's NOL is used (as a result of the investment adjustment).

- The amount of NOL that is used by P is going to depend on how much interest P deducts in computing its taxable income for the year.
Analysis (continued):

Alternative 1:

- Ignoring any investment adjustments for purposes of ATI, P Corp would have ATI of $30 ($20 TI + $10 cap gain), section 163(j) limitation of $9 ($30 x .3), and utilize $14 (cap under -11(b)) of S Corp’s NOL.

- Given that P Corp had $20 of taxable income and $9 of interest deductions, it would have only been able to use $11 of S Corp’s NOL to offset its own income, and must be using some portion of the NOL to offset gain on the stock of S Corp, which -11(b) is intended to prevent.

- This result is driven by the fact that ATI is increased by the capital gain on S Corp stock but is not reduced by the use of S Corp’s NOL deduction.
163(j) Limitation Impact on Circular Basis
Treas. Reg. § 1.1502-11(b)(2)(iii), Example 1, Variation 2

Alternative 2:
- If the disposition is accounted for in the -11(b) computation but with no investment adjustments, P Corp would have ATI of $30 ($20 TI + $10 cap gain), a section 163(j) limitation of $9 ($30 x .3), tentative taxable income of $11 and would have a limit of $11 of S Corp’s NOL in computing its taxable income.
- When computing actual ATI, P Corp would have ATI of $41 ($20 TI + $21 cap gain), a section 163(j) limitation of $12.3 ($41 x .3), and would use $11 of S Corp’s NOL in computing taxable income.
- Given that P Corp had $20 of taxable income and $12.3 of interest deductions, it would have only been able to use $7.7 of S Corp’s NOL to offset its own income, and must be using some portion of the NOL to offset gain on the stock of S Corp, which -11(b) is intended to prevent.

P sells S for $100

- P: $20 Ordinary Income
  $15 BIE
  $90 Basis
- S: $25 NOL

Analysis (continued):
163(j) Limitation Impact on Circular Basis
Treas. Reg. § 1.1502-11(b)(2)(iii), Example 1, Variation 2

Analysis (continued):

Alternative 3:

- If the disposition is accounted for in the -11(b) computation but with an assumed investment adjustment of $8.461, P Corp would have ATI of $38.461 ($20 TI + $18.461 cap gain), a section 163(j) limitation of $11.539 ($38.461 x .3), tentative taxable income of $8.461 and would have a limit of $8.461 of S Corp’s NOL in computing its taxable income.

- When computing actual ATI, P Corp would have ATI of $38.461 ($20 TI + $18.461 cap gain), a section 163(j) limitation of $11.538 ($38.461 x .3), and would use $8.461 of S Corp’s NOL in computing taxable income.

- P Corp has $20 of taxable income and $11.538 of interest deductions, thus it has $8.461 of taxable income unrelated to the sale of S Corp. The $8.461 of S Corp’s NOL is only used to offset P Corp’s income and does not result in a violation of the principles of -11(b).
P sells S for $100

$20 Ordinary Income
$15 BIE

$90 Basis

S

$25 NOL

Analysis (continued):

Math:

NOL = TI – (NOL+TI+CG).3

NOL = TI - .3 NOL - .3TI - .3CG

NOL = .7TI -.3 NOL - .3CG

1.3NOL = .7TI -.3CG

NOL = .5384TI - .2307CG

NOL = 10.768 - 2.307 = 8.461

TI = Taxable income with no interest component

CG = Capital gain on disposition with no investment adjustment
163(j) Limitation Impact on Circular Basis
Treas. Reg. § 1.1502-11(b)(4)(iii), Example 2

Facts:

• P, S1, and S2 are members of consolidated group.
• At the close of year 1, P sells the stock of S1 and S2 for $100 each.

Analysis:

• The respective loss of S1 and S2 is not limited under Treas. Reg. § 1.1502-11(b) with respect to the disposition of the stock of the other.
• Each subsidiary’s loss may offset P’s gain from the disposition of the other subsidiary.
• Therefore, P’s aggregate gain is increased from $100 to $200 because P’s basis in S1 and S2 are decreased by $50 each under Treas. Reg. § 1.1502-32.

P sells S1 and S2 for $100

S1

$50 Basis

$50 NOL

P

$30 Ordinary Income

$50 Basis

S2

$50 Basis

$50 NOL
Facts:
- P, S1, and S2 are members of consolidated group.
- At the close of year 1, P sells the stock of S1 and S2 for $100 each.

Analysis:
- The respective loss of S1 and S2 is not limited under Treas. Reg. § 1.1502-11(b) with respect to the disposition of the stock of the other.
- Each subsidiary’s loss may offset P’s gain from the disposition of the other subsidiary.
- Should P’s gain from the sale of S1 and S2 be included in the P group’s ATI?
Facts:
- P, M, and S are members of consolidated group.
- During year 1, P has ordinary income of $1000, M has $100 of charitable contribution, S has $100 of charitable contribution and $200 of deductible expenses.
- At close of year 1, P sells S for $900.

Analysis:
- For purposes of the consolidated charitable contributions deduction, the P group’s deduction is limited to $80 (i.e., 10% of $800). Prop. Reg. §1.1502-11(b)(2)(iii)(D).
- Accordingly, S’s absorbed amount is $240.
- P’s basis in S’s stock is reduced from $1000 to $760 immediately before the disposition.
- P recognizes a $140 gain from the sale of S’s stock.
- Thus, the P group has CTI of $860 ($1000 less $40 from M less $240 from S plus $140).
Facts:
• P, M, and S are members of consolidated group.
• During year 1, P has ordinary income of $1000, M has $100 of BIE, S has $100 of BIE and $200 of deductible expenses that are included in the group’s ATI.
• At close of year 1, P sells S for $900.

Analysis:
• For purposes of the consolidated group, is the P group’s BIE deduction limited to $240 (i.e., 30% of $800)?
• Accordingly, S’s absorbed amount is $320.
• P’s basis in S’s stock is reduced from $1000 to $680 immediately before the disposition.
• P recognizes a $220 gain from the sale of S’s stock.
• Thus, the P group has CTI of $780 ($1000 less $120 from M less $320 from S plus $220).
P sells S for $900

Questions:

• Should P’s gain from S be included in the P group’s ATI? See Prop. Reg. § 1.1502-11(b)(2)(iii)(D).

• If not, the deduction of BIE with respect to M is arguably less than it should be.

• Is there a reason that charitable contributions are different than BIE?
COD Income

• Taxpayers will need to determine COD income when discharged of accrued interest that is, or would be, subject to section 163(j).

• COD income is generally equal to the excess of the adjusted issue price (AIP) of a debt over its repurchase price. Treas. Reg. § 1.61-12(c)(2)(ii).

• Because a debt's AIP references the holder’s includible OID, the AIP at the time of a discharge may include accrued OID that has not been deducted (e.g., disallowed business interest under section 163(j)).
COD Income
Example

Facts:
• P, S1, and S2 are members of consolidated group.
• P owes debt with an adjusted issue price of $110 to third party lenders, which includes $10 of business interest expense that has been disallowed under section 163(j).
• P is discharged of the $110 of debt and realizes COD income.

Issues:
• What is the appropriate amount of P’s COD income?
• Should P’s BIE impact attribute reduction under section 108(b) if the COD income may be excluded?
COD Income (cont.)

Potential Fixes

• COD income is not realized if it did not give rise to a tax benefit. Rev. Rul. 58-546, but see section 111(c).

• Disallowed business interest carryover is treated as NOL for purposes of section 108(b).

• Section 108(e)(2) principles apply to disallowed business interest.

• Other approaches?
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