Section 163(j)- Overview and 2021 Updates

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Overview

- On January 5, 2021, the IRS issued additional final regulations (TD 9943) under Section 163(j).
- Purpose of the final regulations:
  - Expand on final regulations released in July 2020
  - Adopt proposed regulations
  - Modify and clarify 163(j)
- Notable changes:
  - Further clarification on determining adjusted taxable income (“ATI”)
  - Additional guidance on the application of Section 163(j) to partnerships, controlled foreign corporations (“CFCs”), and foreign persons and shareholders of a regulated investment company (“RIC”)

General Rule

Taxpayers are entitled to a deduction for all interest paid or accrued within the tax year on debt. (Section 163(a))

When does 163(j) apply?

- **First question:**
  - Is the interest expense at issue "investment interest" or "business interest" (the deductibility of which is limited by Section 163(j))?
  - "Investment interest" means any interest paid or accrued with respect to debt allocated to "property held for investment." Section 163(d)(3)(A).
  - Conclusion: investment interest does not trigger 163(j)

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When does 163(j) apply?

- If the interest is classified as “business interest,” then its deductibility must be analyzed under Section 163(j).
- Business Interest — any interest paid or accrued on indebtedness properly allocated to a trade or business. Such term shall not include investment interest (within the meaning of subsection (d)). (163(j)(5))

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163(j) limitations

- What happens if 163(j) applies?
- The amount of deductible business interest expense in a taxable year cannot exceed the sum of:
  - the taxpayer's business interest income for the year;
  - 30% of the taxpayer's adjusted taxable income ("ATI") for the year (** adjusted to 50% by the CARES Act for tax years beginning in 2019 and 2020, (partnerships have special rules)); and
  - the taxpayer's floor plan financing interest expense for the year.

Who is subject to 163(j)?

- For tax years beginning after 2017, the limitation applies to all taxpayers who have business interest expense, other than certain small business that meet the gross receipts test in section 448(c) and it also does not apply to certain excepted trades or businesses.

2021 Updates

Adjusted Taxable Income

Adjusted Taxable Income

- New regulations clarify how taxpayers determine their ATI
- Generally, taxpayers determine their ATI by starting with "tentative taxable income" and applying additions and subtractions as specified in the existing final regulations consistent with the statute.

- **NEW in 2021**: *Addition* for depreciation, depletion and amortization for taxable years beginning after December 31, 2017, but before January 1, 2022 (the "EBITDA Period DD&A").

ATI: Recapture Subtraction

- To prevent a double benefit in ATI, the existing final regulations provide a subtraction to tentative taxable income upon the sale or disposition of depreciable property that is equal to the greater of EBITDA Period DD&A allowed or allowable with respect to the property (the "Recapture Subtraction").

Example

- Assume company X owns asset Y and uses asset Y in its business. Asset Y is depreciable or amortizable, and generates $500,000 of DD&A for company X during the EBITDA period. Company X then sells asset Y.

- Regulations require company X to apply the Recapture Subtraction concept, subtracting from its ATI for the year it sells asset Y all or a portion of the $500,000 DD&A asset Y generated.

ATI: Partnership Interest Recapture Subtraction

- The existing final regulations also provide a subtraction to tentative taxable income related to:

1) investment adjustments (under Treas. Reg. Sec. 1.1502-32) attributable to EBITDA Period DD&A upon the sale or disposition of the stock of a member of a consolidated group (a "Stock Recapture Subtraction"); and
2) the taxpayer's distributive share attributable to EBITDA Period DD&A upon the sale or disposition of a partnership interest (to the extent such deductions were allowable under Section 704(d)) (a "Partnership Interest Recapture Subtraction").

ATI: New Regulations

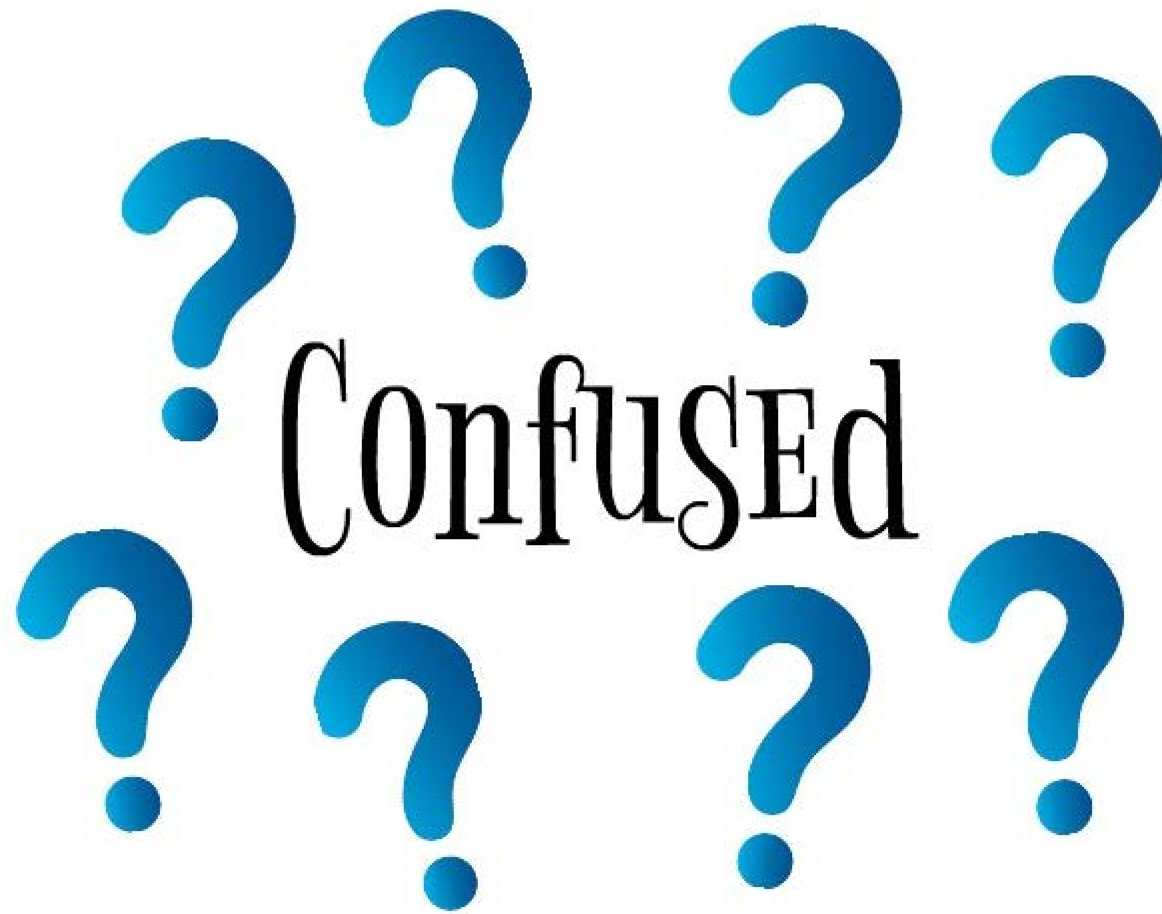
- Alternative method in determining Recapture Subtraction:

- The Recapture Subtraction may be computed as the lesser of:
  1. Any gain recognized on the sale or disposition of such property
  2. Any EBITDA Period DD&A with respect to such property
- Method is also available for the Stock Recapture Subtraction and the Partnership Interest Recapture Subtraction.
- **If the taxpayer uses this alternative method, they must use it for all dispositions for which there is a Recapture Subtraction, Stock Recapture Subtraction, or Partnership Interest Recapture Subtraction.

ATI: Negative Adjustment Cap

- Cap on the Recapture Subtraction, Stock Recapture Subtraction, and Partnership Interest Recapture Subtraction (the "Negative Adjustment Cap").

- The Negative Adjustment Cap provides that the subtraction is required only to the extent that the positive adjustment for EBITDA Period DD&A resulted in an increase in the amount allowed as a deduction for business interest expense in the year of the EBITDA Period DD&A.


Confused

Example

Allen is a calendar-year individual taxpayer with no disallowed business interest expense carryforward.

2021:
- Allen has:
  - $100 of business interest expense, no business interest income or floor-plan financing interest expense
  - $400 of tentative taxable income.

After taking into account all adjustments to tentative taxable income (other than the adjustments relating to EBITDA Period DD&A)

Allen has tentative taxable income of $450.

Allen increases tentative taxable income by $30 (from $450 to $480) for EBITDA Period DD&A.

Allen would have a Section 163(j) limitation of $135 ($450 x 30%) without regard to the adjustments due to EBITDA Period DD&A, and a 163(j) limitation of $144 ($480 x 30%) after factoring in the adjustments due to EBITDA Period DD&A

Example Continued

- In 2022, Allen sells the asset that gave rise to the $30 EBITDA Period DD&A adjustment for a gain of $50.

- Conclusion: Allen is not required to reduce his 2022 tentative taxable income due to the sale because the $30 addition to tentative taxable income in 2021 resulted in no increase in the amount allowed as a deduction for business interest expense (Allen's business interest expense of $100 was less than the $135 limitation calculated without regard to the adjustments due to EBITDA Period DD&A).

Election to Use 2019 ATI

- The new regulations clarify that the amount of 2019 ATI of an acquiring corporation in a Section 381 transaction is the amount of the acquiring corporation's ATI for its last taxable year beginning in 2019.

- The new regulations also provide the 2019 ATI of a consolidated group is the amount of the consolidated group's ATI for its last taxable year beginning in 2019 notwithstanding whether any members departed the group.

Example

- T corporation- 2019 ATI of $100
- A corporation-2019 ATI of $200

- If T merged into A during A's 2020 taxable year, and A makes the election under Section 163(j)(10)(B)(i) to use its 2019 ATI for 2020, A's 2019 ATI for purposes of the election is $200.

Partnerships

Partnerships- Regulations to look for in the Future

- The new regulations provide additional guidance on the application of Section 163(j) to partnerships, although they reserved on several key issues. Specifically, the new regulations did not provide further guidance on the Section 163(j) treatment of:
  - Partnership deductions capitalized by a partner
  - Partner basis adjustments upon liquidating distributions or dispositions of partnership interests
  - Tiered partnerships
- The IRS indicated they will continue to study these issues.

Trading Partnerships

- A trading partnership must bifurcate its interest expense from the trading activity between the portion allocated to its passive partners (partners that do not materially participate in the activity for purposes of Section 469) and its non-passive partners.
- Only the portion of the interest expense from the trading activity that is allocated to the non-passive partners is subject to Section 163(j) at the partnership level
- The portion allocated to passive partners is evaluated at the partner level under the investment interest rules of Section 163(d) instead.

Active v. Passive Partners

- The new regulations modify the grouping rules to prohibit taxpayers from grouping a partnership's trading activity with any other activity.

- Purpose of this regulation?
  - In order to allow a trading partnership to more easily determine which of its partners are active participants in its trading activity
  - To prevent potential abuse of the grouping rules under the Section 469 passive activity loss

Trading Partnerships-2018 to Now

- 2018: Some trading partnerships that relied on the 2018 proposed regulations may have previously allocated excess business interest expense ("EBIE") to their passive partners.
- 2021: Trading partnerships will **not** allocate passive partners any excess taxable income ("ETI") or excess business interest income ("EBII"), which could have *potentially* allowed such partners to deduct their share of EBIE at the partner level.
- IRS allowance: the final regulations provide a transition rule to permit passive partners in a trading partnership to deduct the EBIE allocated to them from the partnership, in the first taxable year ending on or after the effective date of the final regulations without regard to the amount of ETI or EBII that may be allocated to the partner.

Partner Loans- Self-Charged Lending Rule

- A partner that lends money to a partnership may treat interest income from the loan as EBII from the partnership to the extent of the lending partner’s allocation of EBIE.

- This “self-charged lending” rule can provide relief to lending partners where Section 163(j) disallows the borrowing partnership’s deduction for interest paid or accrued on the partner’s loans.

Partner Loans- Self-Charged Lending Rule

- NOTE: This rule *only* applies to situations in which the lending partner holds a direct interest in the borrower partnership

- The new regulations declined to expand the scope of the self-charged lending rule to include situations in which a partnership's creditor is a related party to a partner, or where a creditor holds an indirect interest in a partnership through another entity.

- NOTE: not applied to S-corporations

CARES Act and Partnerships

- New regulations include provisions concerning CARES Act provisions to partnerships.

- Regarding the CARES Act provision permitting 50% of any EBIE allocated to a partner for any taxable year beginning in 2019 being treated as BIE paid or accrued by the partner in the partner's first taxable year beginning in 2020, the new regulations clarify that partners may elect out of the 50% EBIE rule on a partnership-by-partnership basis.

Example

- Partner is allocated EBIE in 2018 and 2019
- Partner sells its partnership interest in 2019

Result

- Fifty percent of the 2019 EBIE is treated as paid or accrued by Partner in 2020 and is not subject to the Section 163(j) limitation at the partner’s level.

- Immediately before the partnership interest sale, Partner’s basis in its partnership interest is increased by the amount of EBIE from 2018 and the portion of the 2019 EBIE that is not applied in 2020.

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Example Continued

- The new regulations clarify that the 2019 EBIE can be deducted by the disposing partner only to the extent such deduction would not have been limited under Section 704(d) immediately before the disposition.

Controlled Foreign Corporations ("CFC") and Foreign Persons

CFCs and Foreign Persons

- General Rule: Section 163(j) is applicable to most foreign corporations with direct or indirect U.S. shareholders.

- The rules function to determine the deductibility of business interest expense when determining the foreign corporation's income under U.S. tax principles.

- This is relevant to the calculations of Subpart F, tested income and other CFC related items.

CFCs- Specified Group Members

- The proposed regulations introduced the concept of Section 163(j) on a group basis with respect to applicable CFCs that are "specified group members" of a "specified group."

- Specified group treatment is elective for the taxpayer.

CFCs- Specified Group Members

- A “specified group” calculates a single Section 163(j) limitation for a specified period of a CFC group based on the sum of the current-year business interest expense, disallowed BIE carryforwards, BII, floor plan financing interest expense and ATI of each CFC group member.

- In order to compute these amounts, the taxpayer started at a separate-entity basis and then combined all amounts.

CFCs- Specified Group Members

- Under this approach, there was ambiguity as to whether the ATI of a group member could be less than zero.

- General Rule: Section 163(j) has a "no-negative" ATI rule.

- Clarification: the ATI of CFC group members should take into account amounts less than zero for purposes of determining the ATI of a CFC group.

- This approach required taxpayers to include a CFC group member's negative ATI, if any when determining the ATI of the CFC group.

Anti-Abuse Rule

- An anti-abuse rule was put into place regarding certain intragroup transactions that affect ATI.
- This rule is expanded so that it may also apply to intragroup transactions entered into with a principal purpose of affecting a CFC group or a CFC group member's Section 163(j) limitation by increasing the CFC group or a CFC group member's BII.
- The expansion is intended to prevent artificial inflation of BII or BIE with a CFC group for a specified period in order to shift disallowed BIE from one CFC group member to another or change the timing of deductions of BIE.

Who can be in a Specified Group?

When determining a specified group and specified group members, the new regulations make three modifications to rules for clarification:

1. The definition of a specified group includes a qualified U.S. person's direct ownership in all applicable CFCs rather than just owning one or more chains of CFCs.
2. In order for an applicable CFC to be considered a specified group member and be eligible for the election, the new regulations modify the definition and state that there must be at least two applicable CFCs in a specified group.
3. When a specified group ceases to exist the rule is modified to clarify that references to the common parent are treated as references to the specified group parent.

CFC Group Election Waiting Period

- CFC group election made > cannot be revoked for a 60-month period following the last day of the first period for which the election was made
- Revoked> cannot be made again for 60 months following the last day of the period for which the election was revoked.
- Clarification 1: 60-month waiting period is not imposed on a specified group for which a CFC group election is not made for the *first* specified period in which a specified group exists.
- Clarification 2: Each designated U.S. person must attach a statement regarding the CFC group election for every year the CFC group election is in effect to its relevant federal income tax or information return. However, even if the required statement is not filed the CFC group election will remain in effect.

No Deduction for Foreign Income Taxes

- Unlike the proposed regulations, the new regulations determined that for purposes of computing ATI of a relevant foreign corporation it does <u>not</u> take into account a deduction for foreign income taxes that are creditable foreign taxes.

- Thus, foreign income taxes do not reduce ATI regardless of whether an election is made to claim a foreign tax credit.

CFC Safe Harbor

- The proposed regulations provided a new, annual “safe-harbor election” that exempts certain applicable CFCs from the application of Section 163(j). The new regulations expand this election to also include an applicable CFC or CFC group if its BIE does not exceed its BII.

- This means an applicable CFC or CFC group is eligible for the safe harbor election if its BIE does not exceed either its BII or 30% of the lesser of its “qualified tentative taxable income” or “eligible amount.”

Regulated Investment Company ("RIC") Shares

RIC Shares

- A "Section 163(j) interest dividend" paid by a RIC is treated as interest income for purposes of Section 163(j) subject to certain limitations. A RIC shareholder that receives a Section 163(j) interest dividend may treat such dividend as interest income for purposes of Section 163(j) subject to holding period requirements and other limitations.

- The IRS will continue to consider whether similar treatment should be extended to shareholders in real estate investment trusts ("REITs").

When can the new regs be applied?

- General Rule: effective to tax years beginning on or after 60 days after the date of their publication in the federal register

- BUT taxpayers may choose to apply the new regulations to earlier taxable years (beginning after 12/31/2017) as long as they (and their related parties) apply both the 2020 and 2021 final regulations under 163(j) consistently to that taxable year and all subsequent taxable years.

Next Steps

- The new regulations finalize rules that could have a significant impact on taxpayers depending on their circumstances. Because the new regulations may be applied retroactively and before they become effective, taxpayers should assess their positions under Section 163(j) considering the new regulations in tandem with existing guidance.

- Continue to be on the lookout for additional final regulations in the future as the IRS indicated that many proposed regulations are still under review.