

# Preliminary highlights of the proposed regulations under Section 163(j)

November 27, 2018

## In brief

On November 26, Treasury released [proposed regulations](#) (the Proposed Regulations) concerning the Section 163(j) interest expense limitation rules. The [2017 tax reform act](#) (the Act) revised and broadened the existing interest expense limitation rules ('old Section 163(j)'). The IRS released prior guidance under Section 163(j) in Notice 2018-28. (For prior coverage on the Act, see the 'See also' section at the end of this document). Also on November 26, the IRS released Rev. Proc. 2018-59, which provides a safe harbor allowing taxpayers to treat certain infrastructure projects as real property trades or businesses solely for purposes of qualifying as an electing real property trade or business under Section 163(j)(7)(B).

Section 163(j), as modified for tax years beginning after December 31, 2017 ('new Section 163(j)'), generally limits business interest expense deductions. The Proposed Regulations provide needed guidance related to the mechanics of determining the interest expense limitation, and clarify the application of Section 163(j) to consolidated groups, RICs, REITs, partnerships, controlled foreign corporations (CFCs), and other foreign corporations.

The regulations are proposed to be effective for tax years ending after the date the regulations are published in final form in the Federal Register, although taxpayers may elect to apply the Proposed Regulations for tax years beginning after December 31, 2017, provided certain conditions are met. Some of the key highlights of the Proposed Regulations are set forth below. We will publish an in-depth Insight on the Proposed Regulations in the coming days. In addition, we will discuss the Section 163(j) guidance in an upcoming Tax Reform Readiness series webcast.

## In detail

### **New Section 163(j)**

New Section 163(j) 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 (see our previous [PwC](#)

[Insight](#) regarding new Section 163(j)). This new limitation broadly applies to the 'business interest' of any taxpayer (regardless of form) and regardless of whether the taxpayer is part of an 'inbound' group or an 'outbound' group. Unlike old Section 163(j), new Section 163(j) applies regardless of

whether the interest payment is made to a US or foreign person, or whether the recipient of interest is exempt from US tax.

For tax years beginning before January 1, 2022, ATI is roughly equivalent to EBITDA (similar to old Section 163(j)). However,

for tax years beginning on or after January 1, 2022, ATI will be roughly equivalent to EBIT. Similar to old Section 163(j), under new Section 163(j), a taxpayer may carry forward disallowed business interest expense indefinitely.

Notice 2018-28, released on April 2, 2018, (see our previous [PwC Insight](#) regarding the Notice) addressed several high-level issues. Those issues have generally been incorporated into the Proposed Regulations. The Proposed Regulations would withdraw the prior 1991 proposed regulations under old Section 163(j).

### **Highlights of the Proposed Regulations**

Treasury's release of the Proposed Regulations is the latest guidance relating to new Section 163(j). The following provides a high-level summary of the key rules set forth in the Proposed Regulations and the impact such rules have on the revised interest expense limitation.

#### **Definition of interest**

The Proposed Regulations provide a broad definition of 'interest' (income and expense) that includes: (a) 'interest' on indebtedness (including original issue discount, market discount, and acquisition discount); (b) amounts treated as interest under other provisions of the Code (including amounts treated as interest under Sections 483 (deferred payment contracts)); and (c) certain other amounts that are 'closely related to interest and that affect the economic yield or cost of funds of a transaction.' This last category of 'interest' is composed of items that are not otherwise deductible (or includible) as interest, including substituted interest payments, debt issuance costs, guaranteed payments, commitment fees (but only if some amount of financing is actually provided), and certain amounts that affect the

taxpayer's effective cost of borrowing (such as gain or loss on an interest rate or cross-currency swap).

Finally, the Proposed Regulations contain an anti-avoidance rule (applicable solely to the computation of interest expense) under which an otherwise deductible expense or loss incurred by a taxpayer in a transaction (or series of integrated or related transactions) pursuant to which a taxpayer secures the use of funds for a period of time is treated as interest expense if the expense or loss is 'predominantly incurred in consideration of the time value of money.'

#### **Adjusted taxable income**

The Proposed Regulations (like proposed regulations under old Section 163(j)) provide that in computing ATI, gain from the sale of property is reduced by depreciation, amortization, or depletion deductions with respect to the property for tax years beginning after 2017 and before 2022. Similar rules apply to gain recognized in connection with the sale of stock of a member of a consolidated group and partnership interests.

The Proposed Regulations provide that in computing ATI for purposes of new Section 163(j), the Section 250 deduction should be taken into account without regard to the taxable income limitation under Section 250(a)(2). For this purpose, the amount of the Section 250 deduction is determined without regard to Section 163(j). Special rules are provided with respect to a Section 250 deduction attributable to a GILTI inclusion.

#### **Treatment of disqualified interest carryforward**

Consistent with new Section 163(j)(2), the Proposed Regulations clarify that taxpayers may carry forward disqualified interest that was

disallowed under Section 163(j) to a succeeding tax year. In such case, any disqualified interest would be treated as business interest expense in the taxpayer's succeeding tax year. Consistent with Notice 2018-28, the Proposed Regulations generally apply the carryforward rules to disallowed interest under old Section 163(j).

#### **Small business exception**

Proposed Regulation sec. 1.163(j)-2(d) clarifies that the small business exception applies for a tax year to taxpayers with an annual average of \$25 million or less in gross receipts over the three prior tax years. Special rules apply to both partners in a partnership and shareholders of an S corporation.

#### **Anti-avoidance rule**

Proposed Regulation sec. 1.163(j)-2(h) provides a broad anti-avoidance rule that disregards an arrangement entered into with a principal purpose of avoiding Section 163(j) or the Proposed Regulations. Importantly, in the event the anti-avoidance rule applies, such an arrangement would be disregarded when calculating the interest expense limitation.

#### **Relationship to other interest expense limitations**

The Proposed Regulations provide that Section 163(j) generally applies only to business interest expense that would otherwise be deductible in the current year.

**Observation:** The Proposed Regulations reserve on coordination rules between Section 163(j) and the base erosion and anti-avoidance tax (BEAT). Such rules are expected to be addressed in upcoming BEAT proposed regulations.

*General rules applicable to C corporations and consolidated groups*

Proposed Regulation sec. 1.163(j)-4(b) provides that all items of income (including interest received or accrued), gain, deduction (including interest paid or accrued), or loss of a C corporation are properly allocable to a trade or business (as defined under Section 162) and thus treated as 'business' items (and not investment items) that are factored into a C corporation's calculation of its ATI (except to the extent such items are allocated to an trade or business excepted from the application of Section 163(j)). Generally, this is the case even for investment interest, investment expense, and investment income of a partnership that is allocated by the partnership to a C corporation partner.

Proposed Regulation sec. 1.163(j)-4(c) generally provides that the disallowance and carryforward of a deduction for a C corporation's business interest expense under Proposed Regulation sec. 1.163(j)-2 will not affect whether or when such business interest expense reduces the taxpayer's E&P. Accordingly, a C corporation's E&P is reduced by business interest expense in the year the expense is paid or accrued (without regard to the application of Section 163(j)). However, a taxpayer does not reduce its E&P in a tax year beginning after December 31, 2017 in order to reflect any carryforwards of disallowed interest to the extent the taxpayer previously reduced its E&P in order to reflect those interest payments in a prior tax year.

Proposed Regulation sec. 1.163(j)-4(d) generally provides that a consolidated group has a single Section 163(j) limitation. However, the Proposed Regulations do not aggregate members of an affiliated group that do

not file a consolidated return for purposes of applying the Section 163(j) limitation.

In determining consolidated ATI, Proposed Regulation sec. 1.163(j)-4(d) provides that all members of a consolidated group are treated as one corporation, and intercompany obligations and intercompany items and corresponding items from intercompany transactions are disregarded.

*Disallowed business interest expense carryforwards for C corporations*

Proposed Regulation sec. 1.163(j)-5(b) limits the amount of business interest expense for which a deduction is allowed in the tax year. The amount of any business interest expense not allowed as a deduction for any tax year as a result of the Section 163(j) limitation is carried forward to the succeeding tax year as a disallowed business interest expense carryforward.

Proposed Regulation sec. 1.163(j)-5(b)(2) provides that a C corporation's current year business interest expense is deducted in the current-year before any disallowed interest expense carryforwards from a prior tax year are deducted in that year. Thereafter, disallowed business interest expense carryforwards are deducted in the order of the tax years in which they arose, beginning with the earliest tax year, subject to, among other limitations, Section 382.

*S corporations*

Consistent with new Section 163(j)(4)(D), the Proposed Regulations provide rules for S corporations and their shareholders that are similar to the rules provided for partnerships and their partners. The Proposed Regulations also include rules that are specific to S corporations, including rules

regarding (i) the allocation of excess taxable income and excess business interest income, (ii) the effect of gain or loss recognition (due to disposition of stock) on a shareholder's ATI, and (iii) the treatment of disallowed business interest carry forwards.

*Partnerships*

Consistent with new Section 163(j)(4), the Proposed Regulations provide that the Section 163(j) limitation applies at the partnership level. If a partnership has deductible business interest expense, the deductible business interest expense is not subject to further Section 163(j) limitations at the partner level. However, deductible and excess business interest expense of the partnership retain their character at the partner level. Non-business interest expense and income of a partnership becomes business interest expense and income in the hands of a corporate partner.

A partnership's ATI takes into account Section 734(b) basis adjustments to partnership property, but partner-specific basis adjustments (such as Section 743(b) adjustments and Section 704(c)(1)(C)(i) built-in loss amounts) and remedial items of income or loss are taken into account at the partner level in determining a partner's ATI and separate Section 163(j) limitation. After a partnership has calculated its Section 163(j) limitation, the Proposed Regulations provide an 11-step process to allocate the partnership's ATI, deductible and excess business interest expense, and business interest income to its partners.

**Note:** An in depth PwC Insight will describe in more detail the 11-step process contained in the Proposed Regulations.

The 11-step process does not determine a partner's allocation of business interest expense, business

interest income, or items comprising ATI. Rather, the 11-step process determines each partner's amount of deductible business interest expense and amount of any Section 163(j) excess items.

The Proposed Regulations provide rules to prevent the double counting of business interest income and floor plan financing interest expense by a partner and the partnership. Excess business interest expense of a partnership is not carried forward by the partnership. Instead, the Proposed Regulations allocate the excess business interest expense to the partners.

**Observation:** The Proposed Regulations leave several key issues unaddressed, including lending transactions between a partnership and a partner (self-charged lending transactions), tiered partnerships, and partnership mergers and divisions. Comments are requested on these issues.

### *Application to CFCs*

The Proposed Regulations provide that new Section 163(j) applies to CFCs and certain partnerships in which an applicable CFC is a partner. In particular, Proposed Regulation sec. 1.163(j)-7 provides, in relevant part, that a CFC applies new Section 163(j) to interest expense in computing Subpart F income under Section 952, tested income for GILTI purposes under Section 951A(c)(2)(A), and ECI.

Modified rules under new Section 163(j) apply to determine the amount of a CFC's business interest expense subject to the limitation. Those rules would also modify the computation of a CFC's ATI and E&P. Similarly, modified rules are provided for computing a United States shareholder's ATI.

The Proposed Regulations provide a group of related CFCs (CFC groups) the option to elect an alternative method for computing members' interest expense that would limit the amount of business interest expense of a CFC group member subject to the Section 163(j) limitation by effectively not taking into account certain intra-group dealings. Partnerships may be treated as a CFC group member under certain circumstances. The election, which must be made by all members of the CFC group, is irrevocable once made.

A CFC's taxable income is computed under the principles of Reg. sec. 1.952-2 or the rules of Section 882 for ECI, and does not include dividends received from related persons. Under certain circumstances, CFC group members that directly own stock in one or more other CFC group members must include in their taxable income a portion of that CFC group member's excess taxable income.

To avoid double counting, US shareholders of applicable CFCs must subtract from taxable income any Subpart F, GILTI, and the Section 78 gross-up inclusions in computing their ATI. The subtracted amount does not include the portion of any Section 250 deduction allowed by reason of the inclusion, determined without regard to the Section 250 limitation to taxable income.

The disallowance and carryforward of a CFC's business interest expense deduction does not impact whether and when the expense reduces its E&P. It similarly does not affect the CFC's E&P limitation for Subpart F income under Section 952(c).

### *Application to foreign persons with ECI*

The Proposed Regulations provide that new Section 163(j) applies to foreign persons with ECI. For this

purpose, Proposed Regulation sec. 1.163(j)-8 modifies the definitions for ATI, business interest expense, business interest income, and floor plan financing interest expense for foreign persons to limit such amounts to ECI items and expenses properly allocable to ECI.

### *Excess amounts of partnership with foreign partners*

Where a partnership is engaged in a US trade or business, Proposed Regulation sec. 1.163(j)-8(c) modifies the application of the new Section 163(j) limitation for certain foreign partners that are nonresident alien individuals or non-CFC foreign corporations. The general allocation rules with regard to excess taxable income, excess business interest expense, and excess business interest income of the partnership (excess amounts of the partnership) are modified to take into account the fact that such foreign person is subject to US tax only in connection with its ECI. Such foreign partner can use the excess amounts of the partnership only to the extent of the partnership's income that would be ECI with respect to the foreign partner.

### *Coordination with Treas. Reg. sec. 1.882-5*

The Proposed Regulations incorporate rules coordinating new Section 163(j) and Treas. Reg. sec. 1.882-5. Proposed Regulation sec. 1.163(j)-8(e) provides that a foreign corporation must first determine its business interest expense allocable to ECI under Treas. Reg. sec. 1.882-5 before applying new Section 163(j) to determine if a portion of such business interest expense is disallowed.

Special rules apply where the foreign corporation is also a partner in a partnership that has ECI.

### *Coordination with branch profits tax under Section 884*

The Proposed Regulations clarify that the disallowance and carryforward of business interest expense do not have an impact on the determination of effectively connected earnings and profits or US net equity for purposes of the branch profits tax under Section 884.

### *Allocating interest expense and interest income*

Proposed Regulation sec. 1.163(j)-10(c) sets forth the general rule for allocating interest expense and income between excepted and non-excepted trades or business based (with certain exceptions) on the relative amounts of the taxpayer's adjusted basis in the assets used in its excepted and non-excepted trades or businesses.

### *Transition rules*

The Proposed Regulations incorporate rules for allocating disallowed disqualified interest carryforwards among members of an affiliated group that was treated as a single taxpayer under the provisions of old Section 163(j).

The transition rules also clarify the application of Section 382 to disallowed disqualified interest carryforwards and confirm that no amount of excess limitation under old Section 163(j) may be carried forward to tax years beginning in 2018.

### *Effective dates*

The provisions related to Section 163(j) are proposed to apply to tax years ending after final regulations are published in the Federal Register. Taxpayers may choose to apply the Proposed Regulations to tax years beginning after December 31, 2017, so long as the Proposed Regulations are applied on a consistent basis.

### *The takeaway*

The Proposed Regulations closely follow the previous administrative guidance provided under Notice 2018-28, provide additional guidance related to the mechanics of determining the interest expense limitation, and clarify the application of Section 163(j) to consolidated groups, partnerships, and CFCs. The Proposed Regulations, however, reserve on the interactions between Section 163(j) and the BEAT provisions under Section 59A. Such guidance is anticipated in forthcoming regulatory guidance.

Taxpayers should review and assess the impact of the provisions in the Proposed Regulations, and consider commenting on issues that Treasury should address before issuing final Section 163(j) guidance.

The above-mentioned highlights are not an exhaustive list of the provisions in the Proposed Regulations. Stay tuned for our in-depth Insight to be published in the coming days.

### **See also:**

- PwC Tax Insight: [First guidance under amended interest expense limitation clarifies high-profile issues](#)
- Tax reform readiness: [New US interest expense limitation](#)
- PwC Tax Insight: [Congress gives final approval to tax reform conference committee agreement](#)
- PwC Tax Insight: [Proposed revisions to US tax code would significantly impact inbound companies](#)
- PwC Tax Insight: [Republican tax bill will significantly impact US international tax rules](#)

## **Let's talk**

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