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# Tax reform readiness: Practical reactions to the Section 163(j) proposed regulations

December 20, 2018

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## In brief

The 2017 tax reform act (the Act) introduced to the Code new Section 163(j), which limits business interest expense deductions to the sum of business interest income, 30% of adjusted taxable income, and the taxpayer's floor plan financing interest for the tax year. The IRS on November 26 issued proposed regulations under new Section 163(j), effective for tax years ending after the date the final regulations are published in the Federal Register. The regulations state that taxpayers may elect to apply the regulations to tax years beginning after December 31, 2017, if certain conditions are met.

The proposed regulations raise a number of important issues. PwC on December 6 hosted a webcast featuring PwC specialists who discussed some of these issues. This Insight highlights those discussions. [Watch](#) the webcast replay and register for future webcasts in PwC's Tax Reform Readiness series, which addresses other areas affected by tax reform.

The next webcast — Tax reform readiness: Q4 financial reporting considerations — is scheduled for Thursday, January 3, 2019, from 2:00 PM - 3:00 PM (EDT).

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## In detail

### Key definitions and mechanics

'Business interest' means interest paid or accrued on indebtedness properly allocable to a trade or business. It does not include 'investment interest,' which is defined in Section 163(d) as interest allowable as a deduction under Chapter 1 of the Code that is paid or accrued on indebtedness properly allocable to property held for investment; it also

does not include qualified residence interest under Section 163(h)(3) or any interest taken into account under Section 469 in computing income or loss from passive activity.

The Section 163(j) definition of interest includes all manner of interest (stated and unstated) and items similar to interest, such as bond premium amortization and market discount. Section 163(j) broadens the definition

to include items not otherwise treated as interest for US federal income tax purposes, including: substitute interest payments, debt issuance costs, guaranteed payments, commitment fees (but only if some amount of financing actually is provided), certain amounts with respect to derivatives that affect the taxpayer's effective cost of borrowing (such as gain or loss on an interest rate swap), and certain amounts that alter a taxpayer's

effective yield with respect to a debt instrument held by the taxpayer.

Adjusted taxable income, for tax years beginning before January 1, 2022, is roughly equivalent to EBITDA. For tax years beginning on or after January 1, 2022, adjusted taxable income will be roughly equivalent to EBIT.

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 Section 250 deduction is determined without regard to Section 163(j). Special rules are provided with respect to the portion of the Section 250 deduction attributable to a global intangible low-taxed income (GILTI) inclusion.

**Observation:** The expansion of Section 163(j)'s scope to numerous types of expenses and losses that do not constitute interest under general tax principles (and may not be deductible under Section 163 in the first place) constitutes a significant variance from existing law. Many taxpayers likely have modeled the impact of Section 163(j) solely by reference to interest expense deductible under Section 163. The Section 163(j) proposed regulations, if finalized as proposed, will expand the impact of Section 163(j) to many types of expenses and losses that are, for example, deductible under Section 162.

**Observation:** Respondents to a polling question during the December 6 webcast were divided on whether, given the proposed regulations' broad definition of 'interest,' their companies will be Section 163(j) limited: 39% said their companies would be limited, 28% said their companies would not be limited, and 32% said they were unsure.

### *Prop. Reg. sec. 1.163(j)-2: General mechanics*

Taxpayers may carry forward disqualified interest that was disallowed under Section 163(j) to a succeeding tax year, if allocable to a non-excepted business. Consistent with Notice 2018-28, the proposed regulations generally apply the carryforward rules to interest disallowed under old Section 163(j). Any disqualified interest would be treated as business interest expense in the taxpayer's succeeding tax year.

A 'small business exception' for taxpayers with an annual average gross receipts of \$25 million or less over the three prior tax years is available. Special rules apply to both partners in a partnership and shareholders of an S corporation.

Under a broad anti-avoidance rule, arrangements entered into with a principal purpose of avoiding Section 163(j) or the proposed regulations will be disregarded.

### *Prop. Reg. sec. 1.163(j)-3: Interplay with other interest provisions*

Section 163(j) generally applies only to business interest expense that otherwise would be deductible in the current year. It applies after provisions that disallow, defer, capitalize, or otherwise limit an interest deduction.

There are three exceptions to the general ordering rule: Section 163(j) applies before the at-risk rules of Section 465, the passive activity loss provisions of Section 469, and Section 461(l).

The proposed regulations reserve on coordination between Section 163(j) and the base erosion and anti-avoidance tax (BEAT). These rules are found in the proposed BEAT regulations released December 13.

### **C corporations and consolidated groups**

#### *Prop. Reg. sec. 1.163(j)-4: General rules for C corporations and consolidated groups*

All items of income, gain, deduction, or loss of a C corporation are properly allocable to a trade or business and treated as 'business' items (and not investment items), except to the extent such items are allocated to a trade or business excepted from the application of Section 163(j).

Disallowance and carryforward have no impact on whether or when affected business interest expense reduces the taxpayer's earnings and profits (E&P).

A consolidated group has a single Section 163(j) limitation but aggregate members of an affiliated group that do not file a consolidated return do not. All members of a consolidated group are treated as one corporation. Intercompany obligations and intercompany items and corresponding items from intercompany transactions are disregarded.

#### *Prop. Reg. sec. 1.163(j)-5: General disallowance of carryforward for C corporations*

Current-year business interest expense is deducted in the current year before any disallowed interest expense carryforwards. Disallowed business interest expense carryforwards from prior separate-limitation years are subject to the SRLY limitation and provide limitations on the ability of a member of a consolidated group to utilize its disallowed business interest expense carryforwards arising in a SRLY.

*Prop. Reg. sec. 1.163(j)-10: Allocation to income of excepted trades or businesses*

Gross income, other than dividends and interest income, is allocated to the trade or business that generated such income. There is a look-through rule for dividends, although a de minimis rule also applies. Because a consolidated group is treated as a single corporation, the consolidated group is treated as engaged in excepted or non-excepted trades or businesses.

The general rule for allocating interest expense and income between excepted and non-excepted trades or businesses is 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. There are other permissible methods for allocating basis in an asset used in more than one trade or business. Under certain circumstances, a taxpayer may directly allocate interest expense to the taxpayer's assets.

**Partnerships**

*Prop. Reg. sec. 1.163(j)-6: Rules for partnerships*

- Consistent with Section 163(j)(4), the proposed regulations provide that the Section 163(j) limitation applies at the partnership level. It applies only to business interest expense, not to investment interest expense.
- A C corporation partner's distributive share of partnership investment interest income and expense converts to business interest income and expense at the C corporation partner level.
- Guaranteed payments for the use of capital are treated as interest expense.

- 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.
- Section 163 rules do not have any effect on the validity or effect of partnership Section 704 allocations.

There are special adjusted taxable income calculations at both the partnership and partner levels. At the partner level, Section 743(b), Section 704(c)(1)(C), and remedial items of income or loss are treated as arising at the partner level and do not enter into a partnership's Section 163(j) calculation. At the partnership level, Section 734(b) adjustments are treated as partnership basis and do enter into a partnership's Section 163(j) calculation. There are also special partner-level calculations for sales of partnership interests.

There is an 11-step process for allocating deductible business interest expense and excess Section 163(j) items. A mix of aggregate and entity approaches, the 11-step process generally requires that the partnership's business interest expense be tested at both the partnership and partner levels. Generally, retesting at the partner level (aggregate) will not cause business interest expense to be suspended if the partnership agreement does not contain special allocations and business interest expense was deductible when tested at the partnership level (entity).

Regarding business interest expense carryforwards, the proposed regulations appear to take a fairly generous approach. Excess business interest expense is allocated to the partner, which carries it forward at the partner level. First, excess business

interest expense is treated as paid or accrued by the partner, to the extent of ETI allocated to that partner. Second, excess business interest expense may be deducted to the extent of the partner's business interest income plus 30% of adjusted taxable income.

**Observation:** The proposed regulations leave several key issues unaddressed, including partnership mergers and divisions; self-charged lending transactions for loans between partners and the partnership; and tiered partnerships. The IRS and Treasury have requested comments on these issues.

**International**

*Prop. Reg. sec. 1.163(j)-7: Controlled foreign corporations (CFCs) and US shareholders (outbound issues)*

'Applicable CFCs' and certain partnerships in which an applicable CFC is a partner are subject to Section 163(j) and the proposed regulations. An 'applicable CFC' is a CFC that has at least one direct or indirect (not constructive) 'United States shareholder' (US Shareholder). Applicable CFCs are subject to new Section 163(j) in computing Subpart F income, GILTI tested income, and effectively connected income (ECI). The disallowance and carryforward of a CFC's business interest expense deduction has no impact on E&P. It generally is determined on a CFC-by-CFC basis following the rules applicable to US corporations.

An alternative method is available under a 'CFC group election,' under which the group's 'applicable net business interest expense' is first aggregated and allocated among the group members. The amount allocated then is analyzed under Section 163(j) at the group member level. The election also allows CFCs to tier up excess taxable income.

For US Shareholders of applicable CFCs, there are special 'double counting' and 'addback' rules for the Section 78 gross-up, Subpart F inclusions, and GILTI inclusions properly allocable to a trade or business.

The CFC group election thus can affect (increase) US Shareholder-level adjusted taxable income.

**Observation:** Although the CFC group election is intended to be taxpayer-favorable and can be beneficial in many cases, it is an irrevocable election, and there may be situations in which it is more beneficial not to make the election. Thus, taxpayers should model the potential Section 163(j) impact with and without the election before deciding whether to make the election.

*Prop. Reg. sec. 1.163(j)-8: Applicability to foreign persons with ECI (inbound issues)*

Section 163(j) applies to foreign persons with ECI. Adjusted taxable income, business interest expense, business interest income, and floor plan financing interest expense are limited to ECI items and expenses properly allocable to ECI for foreign persons. The limitation is modified for certain foreign partners that are nonresident alien individuals or non-CFC foreign corporations when a partnership is engaged in a US trade or business.

First, taxpayers must determine business interest expense allocable to ECI under Reg. sec. 1.882-5. Then they should apply Section 163(j) to determine if a portion of such business interest expense is disallowed.

Disallowance/carryforward do not have an impact on the determination of effectively connected E&P or US net equity for purposes of the Section 884 branch profits tax.

#### Transition rules

*Prop. Reg. sec. 1.163(j)-11: Transition rules*

Under Prop. Reg. sec. 1.163(j)-11, prior Section 163(j) disallowed interest expense is carried forward and subject to disallowance under new Section 163(j) and Prop. Reg. sec. 1.163(j)-2, except to the extent such interest is allocable to an excepted trade or business pursuant to Prop. Reg. sec. 1.163(j)-10.

No amount of excess limitation under previous Section 163(j)(2)(B) may be carried forward to tax years beginning after December 31, 2017.

The transition rules also include 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 rules clarify the application

of Section 382 to disallowed disqualified interest carryforwards. They also address situations in which a corporation that is subject to the Section 163(j) limitation joins a consolidated group whose tax year began before January 1, 2018. Finally, the rules address the Section 382(k)(1) impact.

#### The takeaway

The Section 163(j) regulations are complex and introduce a highly technical set of rules and computations. In addition to providing that Section 163(j) applies to applicable CFCs and foreign persons with ECI, the regulations cover how the rules apply at the partnership level. Because of the expanded definition of 'interest' and the entities subject to the rule, taxpayers should reexamine the the potential impact of Section 163(j) on their businesses.

**Observation:** When asked during the December 6 webcast which topic covered by the proposed Section 163(j) regulations they believe will have the biggest impact on their companies, respondents cited general mechanical issues and the broad definition of 'interest' (44%), but substantial percentages chose application to CFCs (30%) and effect on partnerships and partners (25%).

## Let's talk

For a deeper discussion of how this might affect your business, please contact:

### International Tax Services

Rebecca Lee  
(202) 414-4604  
[rebecca.e.lee@pwc.com](mailto:rebecca.e.lee@pwc.com)

Matthew Chen  
(202) 414-1415  
[matthew.m.chen@pwc.com](mailto:matthew.m.chen@pwc.com)

Susan Conklin  
(202) 312-7787  
[susan.j.conklin@pwc.com](mailto:susan.j.conklin@pwc.com)

### Mergers & Acquisitions

Karen Lohnes  
(202) 414-1759  
[karen.lohnes@pwc.com](mailto:karen.lohnes@pwc.com)

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