AICPA

February 21, 2019

CC:PA:LPD:PR (REG-106089-18)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Notice of Proposed Rulemaking Regarding the Limitation on Deduction for Business Interest Expense [REG-106089-18]

Dear Sir or Madam:

The American Institute of CPAs (AICPA) appreciates the efforts of the Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS) to address the need for guidance related to the changes to section 163(j)[1] as enacted under Pub. L. No. 115-97, commonly referred to as the Tax Cuts and Jobs Act (TCJA or "the Act").

On April 2, 2018, Treasury and the IRS issued Notice 2018-28 – Initial Guidance Under Section 163(j) as Applicable to Taxable Years Beginning After December 31, 2017 (the "Notice"). The AICPA submitted comments in response to the Notice, on July 9, 2018.[2] Subsequently, on November 26, 2018, Treasury and the IRS issued notice of proposed rulemaking REG-106089-18 (the "proposed regulations"). This letter is in response to the proposed regulations.

Specifically, the AICPA submits comments and recommendations in the following areas related to the proposed regulations:

I. Definition of Interest
   1. Overall Definition of Interest
      - Congressional Intent / IRS and Treasury Authority
      - Administrative Burden
      - Inconsistency of Promulgating Parallel Definitions of Interest
   2. Specific Items of Concern
      - Debt Issuance Costs
      - Commitment Fees
      - Guaranteed Payments
      - Foreign Exchange

[1] Unless otherwise indicated, hereinafter, all section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations promulgated thereunder.
[2] https://www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/20180709-aicpa-comments-notice-2018-28-sec-163j.pdf.

1455 Pennsylvania Ave. NW, Washington, DC 20004-1081
T: +1 202.737.6600 F: +1 202.638.4512
aicpaglobal.com | cimaglobal.com | aicpa.org | cgma.org

3. The Anti-avoidance Rule

II. Application of Section 163(j) to Consolidated Groups
1. The Section 163(j) Limitation of a Consolidated Group
2. Aggregate Business Interest Expense and Business Interest Income
3. Allocation of Interest and Other Items Between Excepted Trades or Businesses and Non-Excepted Trades or Businesses Conducted by a Consolidated Group
4. Disallowed Interest Incurred by a Partnership Allocated to a Subsidiary of a Group
5. Ordering Rules for Absorbing Disallowed Interest
6. Separate Return Limitation Year Rules

III. Allocation Rules
1. Adjusted Basis Attributed to the Stock of a Group Member
2. Indirect Interests for the Look-Through Rule in Prop. Reg. § 1.163(j)-10(c)(5)(ii)(B)
3. Allocation of Disallowed Disqualified Interest Carryforward

IV. Ordering and Operating Rules
1. Whether the Section 163(j) Limitation is a Method of Accounting under Sections 446 and 481
2. Determination of Adjusted Taxable Income

V. Interaction of Section 163(j) and Section 108
1. Interaction with Section 108(b)
2. Interaction with Section 108(e)(2)

VI. Partnership Related Items
1. Intercompany Transfer of a Partnership Interest in Nonrecognition Transactions
2. Tiered Partnerships Carryforward Allocation
3. Basis Adjustments Upon Disposition of Partnership Interests Pursuant to Section 163(j)(4)(B)(iii)(II)

VII. International Tax Items
1. Excess Adjusted Taxable Income Limitation within a Controlled Foreign Corporation Group
2. Excess Adjusted Taxable Income Limitation of a Single Controlled Foreign Corporation
3. Computing the Adjusted Taxable Income of an Applicable Controlled Foreign Corporation

VIII. Small Business Relief from Definition of Tax Shelter

These comments were developed by the AICPA Corporations and Shareholders Tax Technical Resource Panel, with assistance from the Partnership Tax Technical Resource Panel, the International Tax Technical Resource Panel, and the Tax Methods and Periods Technical Resource Panel, and approved by the Tax Executive Committee.

The AICPA is the world's largest member association representing the accounting profession with more than 431,000 members in 137 countries and a history of serving the public interest since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. If you have any questions, please contact Kristin Esposito, Senior Manager – AICPA Tax Policy & Advocacy, at (202) 434-9241, or kristin.esposito@aicpa-cima.com; or me at (408) 924-3508, or annette.nellen@sjsu.edu.

Sincerely,

Annette Nellen, CPA, CGMA, Esq.
Chair, AICPA Tax Executive Committee

cc: The Honorable David J. Kautter, Assistant Secretary for Tax Policy, Department of the Treasury
The Honorable Charles P. Rettig, Commissioner, Internal Revenue Service
Mr. William M. Paul, Acting Chief Counsel, Internal Revenue Service
Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation
Mr. Krishna Vallabhaneni, Deputy Tax Legislative Counsel, Office of Tax Policy, Department of the Treasury
Mr. Christopher W. Call, Attorney-Advisor (Tax Legislation), Office of Tax Policy, Department of the Treasury
Mr. Brett York, Attorney-Advisor, Office of Tax Policy, Department of the Treasury
Mr. Robert Wellen, Associate Chief Counsel (Corporate), Internal Revenue Service
Mr. Zachary King, Office of the Associate Chief Counsel (Income Tax and Accounting), Internal Revenue Service
Mr. Charles Gorham, Office of the Associate Chief Counsel (Income Tax and Accounting), Internal Revenue Service
Ms. Susie Bird, Office of the Associate Chief Counsel (Income Tax and Accounting), Internal Revenue Service
Ms. Jaime Park, Office of the Associate Chief Counsel (Income Tax and Accounting), Internal Revenue Service
Ms. Sophia Wang, Office of the Associate Chief Counsel (Income Tax and Accounting), Internal Revenue Service
Mr. Kevin Jacobs, Office of the Associate Chief Counsel (Corporate), Internal Revenue Service
Mr. Russell Jones, Office of the Associate Chief Counsel (Corporate), Internal Revenue Service
Mr. John Lovelace, Office of the Associate Chief Counsel (Corporate), Internal Revenue Service

Ms. Meghan Howard, Attorney, Office of the Associate Chief Counsel (Passthroughs and Special Industries), Internal Revenue Service
Mr. William Kostak, Office of the Associate Chief Counsel (Passthroughs and Special Industries), Internal Revenue Service
Mr. Anthony J. McQuillen, Attorney, Office of the Associate Chief Counsel (Passthroughs and Special Industries), Internal Revenue Service
Ms. Adrienne Mikolashek, Attorney, Office of the Associate Chief Counsel (Passthroughs and Special Industries), Internal Revenue Service
Mr. James Quinn, Attorney, Office of the Associate Chief Counsel (Passthroughs and Special Industries), Internal Revenue Service
Ms. Angela Holland, Attorney, Office of the Associate Chief Counsel (International), Internal Revenue Service
Mr. Steve Jensen, Senior Counsel, Office of the Associate Chief Counsel (International), Internal Revenue Service
Mr. Charles Rioux, Attorney, Office of the Associate Chief Counsel (International), Internal Revenue Service
Mr. Michael Chin, Office of the Associate Chief Counsel (Financial Instruments and Products), Internal Revenue Service
Ms. Regina Johnson, Publication Regulation Specialist, Internal Revenue Service

AMERICAN INSTITUTE OF CPAs

Proposed Regulations Regarding the Limitation on Deduction for Business Interest Expense [REG-106089-18]

February 21, 2019

BACKGROUND

Prior to the enactment of the Tax Cuts and Jobs Act (TCJA), under section 163(j) ("old section 163(j)"),[3] corporations were disallowed a deduction for disqualified interest paid or accrued in a taxable year if the following threshold tests were satisfied:

- The payor's debt-to-equity ratio exceeded 1.5 to 1.0 (also known as the safe harbor ratio); and
- The payor's net interest expense was in excess of 50% of its adjusted taxable income (ATI).

For purposes of old section 163(j), disqualified interest included interest paid or accrued to the following parties:

- Related parties if no federal income tax was imposed on the interest;
- Unrelated parties in certain instances when a related party guaranteed the debt; and
- A real estate investment trust (REIT) by a taxable REIT subsidiary of the REIT.

Any disallowed interest was treated as interest paid or accrued in the succeeding taxable year and eligible for carry forward indefinitely and any excess limitation was eligible for carry forward for three years.

The TCJA substantially amended section 163(j) by placing additional limitations on the deduction of business interest expense for taxpayers and expanding the group of taxpayers to which it applies. Under section 163(j) as amended by the TCJA ("new section 163(j)"),[4] beginning in taxable years after December 31, 2017, a taxpayer's deduction for business interest expense is limited to the sum of:

- Interest income;
- 30% of ATI; and
- Floor plan financing interest.

[3] For purposes of this letter, all references to "old section 163(j)" are to section 163(j) prior to the Tax Cuts and Jobs Act.

[4] For purposes of this letter, all references to "new section 163(j)" are to section 163(j) as amended by the Tax Cuts and Jobs Act.

In addition, new section 163(j) applies to all taxpayers except the following:

- Taxpayers with average annual gross receipts in the prior three-year period of $25 million or less (other than a tax shelter as defined under section 448);
- Certain regulated utilities trades or businesses;
- Certain real property trades or businesses that make an election; and
- Certain farming businesses that make an election.

Under new section 163(j), disallowed interest expense is eligible for carry forward indefinitely. However, there is no longer a carryforward available for any excess limitation.

COMMENTS

I. Definition of Interest

Background

Section 163(j)(5) defines the term "business interest" as any interest paid or accrued "on indebtedness" properly allocable to a trade or business. By contrast, "business interest income" is defined as the amount of interest includible in the gross income of the taxpayer for the taxable year which is properly allocable to a trade or business.[5] Thus, the statutory definition is potentially asymmetrical: business interest expense is limited to interest on "indebtedness," while the scope of business interest income is exceptionally broad. Although the term "indebtedness" is not defined, it appears to refer to traditional debt instruments.

The Preamble to the proposed regulations under section 163(j) (the Preamble and the proposed regulations, respectively) notes the absence of statutory and regulatory guidance as to when an instrument is treated as debt for tax purposes and when a payment is treated as interest. Consequently, the Internal Revenue Service (IRS) and Department of the Treasury ("Treasury") established debt-equity principles (as described in Notice 94-47)[6] and to the common law definition of interest as compensation for the use or forbearance of money.[7]

The Treasury and the IRS considered three options with respect to the definition of interest. The first option was not to define the term and instead rely on general tax principles for this purpose. However, the absence of a clear definition would have created uncertainty for the IRS and taxpayers in determining the scope of section 163(j). Alternately, the proposed regulations could have defined interest narrowly in order to cover amounts only associated with conventional debt instruments and amounts that are generally treated as interest for United States (U.S.) federal income tax purposes. This approach, however, in the view of the IRS and Treasury, would incentivize taxpayers to enter into distortive transactions that have the economic effect of indebtedness and interest without being labeled as such.

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[5] Section 163(j)(6).
[6] 1994-1 C.B. 357.
[7] *See Deputy v. du Pont*, 308 U.S. 488, 498 (1940).

Therefore, the proposed regulations incorporate a broad and highly detailed definition of interest that according to the Preamble, is designed to encompass all transactions that are commonly understood to generate interest income and expense. Notwithstanding the statutory definition, the proposed regulations explicitly define interest to include payments that are not made with respect to a debt instrument.

The definition of interest under the proposed regulations is divided into three broad categories. First, under the general rule, interest includes any amount paid, received, or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement (including a series of transactions) that is treated as a debt instrument for purposes of section 1275(a) and Treas. Reg. § 1.1275-1(d) or an amount that is treated as interest under other provisions of the Internal Revenue Code (IRC or "Code") or the regulations thereunder.[8]

Second, the definition of interest includes certain amounts that are closely related to interest and affect the economic yield or cost of funds of a transaction involving interest—even if such amounts do not constitute compensation for the use or forbearance of money—and even if such amounts are deductible under section 162 (rather than section 163).[9] This category includes such items as debt issuance costs, commitment fees (if any portion of the financing to which the fee relates is actually provided), and guaranteed payments for the use of capital under section 707(c).

The second category also includes a special rule for amounts that affect an issuer's effective cost of borrowing or a holder's effective yield with respect to a debt instrument.[10] Specifically, the proposed regulations provide that income, deduction, gain, or loss from a derivative (as defined in section 59A(h)(4)(A)) that alters a taxpayer's effective cost of borrowing with respect to a liability of the taxpayer is treated as an adjustment to the interest expense of the taxpayer.[11] Likewise, a derivative that alters a holder's effective yield with respect to a debt instrument is treated as an adjustment to the interest income by the taxpayer.

Finally, the proposed regulations provide an anti-avoidance rule for amounts predominantly associated with the time value of money.[12] The rule provides that any deductible expense or loss incurred by a taxpayer in a transaction or series of integrated or related transactions in which the taxpayer secures the use of funds for a period of time is treated as interest expense if it is

[8] Proposed Reg. § 1.163(j)-1(b)(20)(i). Payments with respect to a debt instrument that is treated as stock under Treas. Reg. § 1.385-3 are not characterized as interest under the general rule.
[9] Proposed Reg. § 1.163(j)-1(b)(20)(iii).
[10] Proposed Reg. § 1.163(j)-1(b)(20)(iii)(E)-(F).
[11] The proposed regulations provide an example in which a taxpayer that is obligated to pay interest at a floating rate on a note, enters into an interest rate swap that entitles the taxpayer to receive an amount that is equal to or that closely approximates the interest rate on the note in exchange for a fixed amount. Income, deduction, gain, or loss from the swap is treated as an adjustment to interest expense. Similarly, any gain or loss resulting from a termination or other disposition of the swap is an adjustment to interest expense, with the timing of gain or loss subject to the rules of Treas. Reg. § 1.446-4.
[12] Proposed Reg. § 1.163(j)-1(b)(20)(iv). The proposed regulations also contain a special rule that applies to certain swaps. A swap (other than a cleared swap) with significant nonperiodic payments is treated as two separate transactions consisting of an on-market, level payment swap and a loan. The loan is accounted for by the parties to the contract independently of the swap. The time value of money component associated with the loan (determined in accordance with Treas. Reg. § 1.446-3(f)(2)(iii)(A)) is recognized as interest expense to the payor and interest income to the recipient.

"predominantly incurred in consideration of the time value of money." There is no parallel rule that permits the recipient to treat such amounts as interest income (although the IRS and Treasury have requested comments on whether such a rule is appropriate). Further, the anti-avoidance rule applies irrespective of whether the taxpayer acted with a principal purpose of avoiding the interest expense limitation under section 163(j).

1. Overall Definition of Interest

Recommendation

We strongly recommend that Treasury and the IRS amend the proposed regulations to define interest for purposes of section 163(j) as any amount generally treated as interest under other provisions of the Code or regulations.

Analysis

Congressional Intent / IRS and Treasury Authority

The definition of interest in the proposed regulations is exceptionally broad. Section 7805(a) permits Treasury to "prescribe all needful rules and regulations for enforcement of [the tax laws]." Such a general grant of congressional authority gives Treasury the executive power to issue *interpretive* regulations. Interpretive regulations should interpret, explain, and apply the bills signed into law without expansion beyond the apparent statutory intent.

Based on the statutory text of section 163(j) and the legislative history underlying section 163(j), there is no indication that Congress intended for interest within the meaning of section 163(j) to apply to transactions that do not involve indebtedness, or payments that are not viewed as traditional interest. Further, there is no clause in section 163(j) specifically authorizing Treasury to promulgate regulations similar to section 1502. The Preamble references Treas. Reg. §§ 1.891-9T and 1.954-2 regarding treating amounts that are closely related to interest as interest income or expense. However, the underlying statute of each of these regulations has a different purpose than section 163(j) in which an expansive view of interest is more consistent with the intent and authority given by the statute. Therefore, the term "interest" as defined in the proposed regulations exceeds the scope of congressional intent regarding the definition of interest within the meaning of section 163(j). If Congress intended to expand the definition of interest within the meaning of section 163(j), particularly to such a significant extent, Congress would have indicated as such, whether in the statute itself or in the relevant legislative history.

Pursuant to the foregoing, Treasury and the IRS should amend the proposed regulations to define interest for purposes of section 163(j) as any amount generally treated as interest under other provisions of the Code or regulations. Alternatively, the final regulations should allow for an item-by-item analysis in order to determine if an item is interest within the meaning of section 163(j). Such an approach would consider the substance of each item, which is consistent with U.S. federal income tax policy. To the extent that Treasury and the IRS are concerned about addressing alleged abuses, they can address such issues by virtue of the substance over form principle, existing case law on the definition of debt, or permissible regulatory means, rather than via an overly broad and complex interpretation of interest.

Administrative Burden

The proposed regulations will impose substantial administrative burdens on taxpayers (and the IRS) as a result of the exceptionally broad definition of interest without meaningfully contributing to the sound administration of tax policy. The proposed regulations create a parallel as opposed to interpretive definition of interest. Therefore, taxpayers will need to engage in significant and comprehensive compliance activities in order to ensure that they are treating all the potential transactions in accordance with the proposed regulations. Furthermore, the IRS will need to utilize its limited resources to ensure that taxpayers are complying with the proposed regulations.

Inconsistency of Promulgating a Parallel Definition of Interest

It is inconsistent with other Code sections to establish a parallel definition of interest in the proposed regulations for purposes of section 163(j). Section 163(j) does not present any special or compelling federal tax policy that warrants defining interest more broadly than it is defined for purposes of other important federal income tax regimes in the Code (e.g., withholding and information reporting, section 59A, and foreign tax credit expense apportionment). To the extent section 163(j) presents a special or compelling tax policy that warrants defining interest broader than it is defined for purposes of other rules, Congress could have indicated as such.

In addition, while the term “indebtedness” is not defined in the statute or proposed regulations, the placement of the limitation in section 163 appears intended to refer to traditional debt instruments. Section 163(a) allows a deduction for all *interest* paid or accrued within the taxable year *on indebtedness*. Section 163(j) merely limits the application of section 163(a) by virtue of limiting the amount of business interest that a taxpayer may deduct for any taxable year. Because the proposed regulations would significantly broaden the definition of interest, they would apply section 163(j) to items that do not fall within the purview of section 163(a). The limitation (section 163(j)) applicable to a general rule (section 163(a)) would apply to items not governed by the general rule. The interaction between sections 163(a) and 163(j) further demonstrates that the term “interest” as defined in the proposed regulations not only exceeds the scope of congressional intent but creates inconsistency with other code sections.

2. Specific Items of Concern

If the IRS and Treasury, in the final regulations, do not reverse their overly broad definition of interest put forth in the proposed regulations, we suggest the final regulations allow for an item-by-item analysis (as discussed below) as to whether an item is considered interest within the meaning of section 163(j).

Debt Issuance Costs

Overview

The Preamble provides that the proposed regulations treat as interest, certain amounts that are closely related to interest and that also affect the economic yield or cost of funds of a transaction involving interest. At the same time, however, the Preamble expressly provides that such amounts may not fall within the purview of interest in the ordinary sense (i.e., compensation for the use or forbearance of money). Particularly, the Preamble provides that certain debt issuance costs are an example of amounts treated as interest expense under the proposed regulations.

The proposed regulations define "interest" as any amount described in Prop. Reg. § 1.163(j)-1(b)(20)(i), (ii), (iii), or (iv).[13] The proposed regulations provide that any debt issuance costs that are subject to Treas. Reg. § 1.446-5 are treated as interest expense of the issuer.[14] Generally, Treas. Reg. § 1.446-5 provides rules for allocating debt issuance costs over the term of the indebtedness. Under Treas. Reg. § 1.446-5, debt issuance costs are defined "as those transaction costs incurred by an issuer of debt (that is, a borrower) that are required to be capitalized under Treas. Reg. § 1.263(a)-5." Treasury Reg. § 1.263(a)-5(a) generally provides that a taxpayer is required to capitalize amounts paid to facilitate a borrowing. Included within the scope of a borrowing is the issuance of any indebtedness.[15]

Recommendation

We recommend that the final regulations do not include as interest expense, the costs associated with issuing indebtedness.

Analysis

Although we agree that certain costs for the use of capital closely resemble interest and could potentially affect the economic yield or cost of funds of a transaction involving interest, treating debt issuance costs for the use of capital as interest, (e.g., accounting, legal, and underwriting costs) is exceptionally broad and does not account for economic reality. Particularly, debt issuance costs are ancillary to facilitating the issuance of indebtedness. To the contrary, interest in the ordinary sense—as well as amounts that are reasonably related to interest and that also affect the economic yield or cost of funds of a transaction involving interest—are and traditionally have been integrally related to the cost of borrowing. Debt issuance costs are a related, but economically disparate cost of doing business.

Further, existing statutory and regulatory regimes arguably govern the deductibility of debt issuance costs adequately, such as Treas. Reg. § 1.263(a)-5. The proposed regulations create an additional layer of complexity to an already robust statutory and regulatory regime. Accordingly, costs associated with issuing indebtedness should not fall within the purview of interest as it relates to interest expense as defined in the proposed regulations.

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[13] Proposed Reg. § 1.163(j)-1(b)(20).
[14] Proposed Reg. § 1.163(j)-1(b)(20)(iii)(H).
[15] Treasury Reg. § 1.263(a)-5(a)(9).

Commitment Fees

Overview

The proposed regulations define "commitment fees" in part as "any fees in respect of a lender['s] commitment to provide financing . . . ." The proposed regulations treat commitment fees "as interest if any portion of such financing is actually provided."

Recommendation

We recommend that the final regulations not include as interest, income associated with commitment fees.

Analysis

Similar to debt issuance costs, commitment fees should not fall within the purview of "interest" as defined in the proposed regulations. Commitment fees are ancillary to facilitating the issuance of indebtedness and are not interest. While interest in the ordinary sense—as well as amounts that are reasonably related to interest and that also affect the economic yield or cost of funds of a transaction involving interest—are integrally related to the cost of borrowing, commitment fees are a related, but economically disparate cost of doing business. Accordingly, income associated with commitment fees should not fall within the purview of interest as defined in the proposed regulations.

Guaranteed Payments

Overview

The proposed regulations provide that amounts that are closely related to interest and that affect the economic yield or cost of funds of a transaction involving interest are treated as interest for purposes of section 163(j), and that such amounts include "guaranteed payments for the use of capital under section 707(c)."

Recommendation

The AICPA recommends that the final regulations do not treat all guaranteed payments for the use of capital as interest.

Analysis

While we agree that certain guaranteed payments for the use of capital closely resemble interest and likely affect the economic yield or cost of funds of a transaction involving interest, treating all guaranteed payments for the use of capital as interest is overly broad. Additionally, it creates uncertainty as to the treatment of certain partnership payment structures that were not historically treated as debt.

Example 1

Individuals A, B, and C form Partnership ABC. In Year 1, each of the partners contributes the following property to Partnership ABC in exchange for partnership interests: Partner A contributes cash (or cash-equivalent property); Partner B contributes real property; and Partner C contributes intellectual property.

Over the course of several years, each partner (i.e., A, B, and C) receives annual guaranteed payments for the use of capital under section 707(c). Partner A receives guaranteed payments for the use of the cash contributed; Partner B receives guaranteed payments for the use of the real property contributed; and Partner C receives guaranteed payments for the use of the intellectual property contributed.

While we agree that the guaranteed payments for the use of the cash contributed by Partner A closely resembles interest, the guaranteed payments made to Partner B and Partner C resemble rent payments and royalty payments, respectively. However, the proposed regulations do not make a distinction between guaranteed payments made for the use of cash and guaranteed payments made for the use of other capital (e.g., real property or intellectual property). Instead, the proposed regulations suggest that guaranteed payments for the use of any capital under section 707(c) is included in interest.

The statutory language in section 707(c) provides that guaranteed payments subject to section 707(c) are treated as trade or business expenses and, subject to the capitalization rules of section 263, are deductible under section 162, and not section 163. Accordingly, treating all guaranteed payments for the use of capital as interest is overly broad and creates uncertainty for certain partnership payment structures that were not historically treated as payments on debt.

Foreign Exchange

Overview

It is not clear in the proposed regulations if foreign exchange (FX) is included in the definition of interest for purposes of section 163(j).

Recommendation

We request that Treasury and the IRS clarify whether FX is included in interest for purposes of section 163(j). Additionally, we specifically suggest excluding an FX hedge of principal from the definition of interest for purposes of section 163(j).

Analysis

There is at least one example in the proposed regulations indicating that an FX swap altered a taxpayer's cost of borrowing. The example provides that FX swaps that hedge interest payments appear to fall within the purview of interest as defined in the proposed regulations. However, it is unclear whether the definition of interest set forth in the proposed regulations captures an FX hedge of principal (e.g., an FX forward). Since it would have a relatively marginal impact on the yield of indebtedness, an FX hedge of principal should not fall within the purview of interest.

3. The Anti-Avoidance Rule

Overview

Proposed Reg. § 1.163(j)-1(b)(20)(iv) provides an anti-avoidance rule which states that "[a]ny expense or loss, to the extent deductible, incurred by a taxpayer in a transaction or series of integrated or related transactions in which the 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."

Recommendations

The AICPA recommends that Treasury and the IRS withdraw the anti-avoidance rule in Prop. Reg. § 1.163(j)-1(b)(20)(iv).

To the extent the Treasury and the IRS do not withdraw the anti-avoidance rule, we recommend that the final regulations:

- Limit the rule to transactions that have a principal purpose of avoiding the rules of section 163(j) or the proposed regulations, akin to Prop. Reg. § 1.163(j)-2(h);
- Make the anti-avoidance rule bilateral in order that any income or gain predominantly received in the consideration of the time value of money is treated as interest income for purposes of section 163(j); and
- Clarify the meaning of the terms "secures the use of funds" and "predominantly incurred in consideration of the time value of money" as used for purposes of the anti-avoidance rule.

Analysis

The anti-avoidance rule in Prop. Reg. § 1.163(j)-1(b)(20)(iv) lacks both symmetry (i.e., it treats the payment of such amounts as interest expense, however, it does not treat the receipt of such amounts as interest income) and an element of intent (i.e., it applies whether or not the taxpayer acted with a principal purpose of avoiding the interest expense limitation under section 163(j)). Therefore, we suggest withdrawing the anti-avoidance rule because it is overbroad, prejudicial (it only treats amounts as interest expense, but not interest income) and it lacks an intent element. However, to the extent the Treasury and the IRS do not withdraw the anti-avoidance rule, we suggest limiting the rule to transactions that have a principal purpose of avoiding the rules of section 163(j) or the proposed regulations, akin to Prop. Reg. § 1.163(j)-2(h).

The lack of symmetry in the anti-avoidance rule is concerning because it could potentially increase a taxpayer's regulatory burden if it creates multiple characterizations of the same item (e.g., an item that is characterized as interest expense under section 163(j), but not characterized as interest for any other purpose, including interest income under section 163(j)). In this regard, certain taxpayers could also experience whipsaws when treating an expense item as an interest expense, but the corresponding income item is not treated as interest income. Thus, we recommend that Treasury and the IRS make the "anti-avoidance" rule in Prop. Reg. § 1.163(j)-1(b)(20)(iv) bilateral—namely, that any income or gain predominantly received in consideration of the time value of money is treated as interest income for purposes of section 163(j).

Moreover, it is not clear how the phrase "predominantly incurred in consideration of the time value of money" is interpreted. This ambiguity is particularly pronounced with respect to loans denominated in a nonfunctional currency and related FX hedging transactions (which is potentially treated as a derivative that adjusts the yield of a debt instrument). In addition, although many transactions have a component relating to the time value of money, the anti-avoidance rule should not apply unless, as part of the relevant transaction, the taxpayer secures the use of funds for a period of time. It is not entirely clear, however, what it means to "secure the use of funds" for this purpose. The IRS and the Treasury should clarify such terms with additional examples or guidance.

II. Application of Section 163(j) to Consolidated Groups

<u>Background</u>

The proposed regulations provide rules for: (i) computation of the consolidated group section 163(j) limitation; (ii) computation of consolidated business interest expense and business interest income; (iii) allocation of interest expense, interest income, and other items of income and expense, among excepted trades or businesses (ETBs) and non-excepted trade or businesses (NETBs) conducted by members of a consolidated group; (iv) taking into account disallowed interest incurred by a partnership that is allocated to a member of a consolidated group; (v) ordering rules for absorbing disallowed interest arising in different years; and (vi) computation of the separate return limitation year (SRLY) limitation on disallowed interest carryforwards arising in SRLYs.

1. The Section 163(j) Limitation of a Consolidated Group

Consolidated Groups

<u>Overview</u>

Under the proposed regulations, a consolidated group has a single limitation. This single limitation is based upon the consolidated taxable income (CTI) of the group, as adjusted to reflect ATI. Thus, the location of items of income or loss within the group generally does not impact the limitation, which furthers consolidated group single-entity principles that are articulated, among other places, in the intercompany transaction rules of Treas. Reg. § 1.1502-13. This approach allows consolidated groups to avoid the burdens that would otherwise have applied if they were required to determine each member's ATI separately, and restructure operations to ensure that the members generating ATI are the same members accruing business interest expense.

Recommendation / Observation

We commend the IRS and Treasury for adopting a single limitation approach with regards to consolidated groups.

Analysis

We commend Treasury for adopting a single limitation approach with regard to consolidated groups. It is impractical and administratively burdensome, without meaningfully furthering the policies behind section 163(j), to require a member of a consolidated group to calculate its limitation on a separate entity basis.

Example 1: Consolidated group's limitation based on CTI

P is the common parent of a consolidated group, and P owns 100% of the stock of S1 and S2, each a member of the P consolidated group. The P group's consolidated ATI is $100, solely attributable to S1's items. S2 accrues $40 of business interest expense to a bank. Notwithstanding that S2 did not generate any ATI or interest income on a separate company basis, the P group's consolidated ATI is $100, and thus its consolidated limitation is $30, all of which is available to S2, because S2 is the only member that paid or accrued business interest expense. S2 deducts $30 of business interest expense, and its remaining $10 is disallowed carryforward to the P group's subsequent consolidated return year.

If instead, S2 were required to generate its own ATI, all of S2's business interest expense is disallowed, which is an inappropriate result. Therefore, we agree with the approach of the proposed regulations to allow consolidated groups to have a single limitation.

Affiliated Groups that Do Not File a Consolidated Return

Overview

Affiliated groups that do not file a consolidated return (and other groups of related entities) do not determine ATI on a single-entity basis, except in the context of certain special rules for partnerships and controlled foreign corporations (CFCs) that effectively tier-up excess ATI in certain situations.

Recommendation / Observation

We agree with Treasury's approach of not aggregating the items of affiliated groups that do not file a consolidated return.

Analysis

The partnerships and CFCs that tier-up excess ATI are presumably more likely to consider restructuring operations that align business interest expense within the entities that generate ATI. We acknowledge that harsh consequences could result if, for example, one member of the group incurs the business interest expense and another member generates the ATI, however, these results flow from the taxpayer's decision not to file a consolidated return. Thus, we agree with Treasury's approach of not aggregating the items of affiliated groups that do not file a consolidated return, because sharing items among non-consolidated members (e.g., allocating limitation) is unjustifiably complex.

> *Example 2: Affiliated (but not consolidated) group's limitation based on separate member basis*
>
> Assume the same facts as Example 1, except that the P group does not file a consolidated return. Because S2 has no separate ATI or interest income, it has a zero limitation, and thus its entire business interest expense is disallowed and carried forward to its subsequent year.
>
> If S1 and S2 merge, the future ATI of the combined entity is available for the combined entity's future business interest expense. Assuming S1 and S2 combine in a section 381 transaction, any limitation of the combined entity remaining for a year (after first being applied to the current business interest expense incurred in such year) is available to allow deductions for disallowed carryforwards from prior years. There is a special limitation applicable to the year of the combination, based on the post-combination portion of the acquiring corporation's limitation.

We note that the "super-affiliation" concept in the withdrawn, former proposed regulations (1991-2 C.B. 1040) under former section 163(j)(6)(C) introduced in 1991, was not adopted by the proposed regulations. For the reasons stated above in the discussion of affiliated non-consolidated groups, we agree with this approach.

Intercompany Transactions

Overview

Extending single-entity principles, the proposed regulations provide that a group's consolidated ATI is determined without regard to intercompany items and corresponding items from intercompany transactions to the extent they offset. Thus, if one group member conducts solely an ETB (e.g., an electing real property business) and another member conducts solely an NETB, transactions between such members do not affect ATI.

Recommendation

We recommend that Treasury and the IRS revisit whether items from intercompany transactions (other than business interest expense and business interest income) can, in certain circumstances, affect the amount of ATI generated by ETBs and NETBs and reconsider the competing policies of section 163(j) and Treas. Reg. § 1.1502-13(a).

Analysis

There are alternative approaches to the method in the proposed regulations that better reflect the intent of Congress to provide an exemption from debt attributable to certain businesses. For example, other than business interest expense and business interest income which, as discussed below are generally allocated in proportion to relative asset basis by reason of the fungibility of money, Treasury could have provided that other items of income and expense are taken into account by the businesses to which they relate, regardless of whether the transactions giving rise to such items are intercompany transactions.

This approach would have more precisely identified the ATI attributable to ETBs and NETBs. However, such an approach would cause intercompany transactions to affect the tax liability of the consolidated group, a consequence that is inconsistent with the single entity principles of Treas. Reg. § 1.1502-13(a). Thus, it is necessary to weigh single entity principles against the policy of section 163(j) to exempt certain businesses. Although the approach of the proposed regulations is an acceptable one, Treasury should revisit whether items from intercompany transactions (other than business interest expense and business interest income) can, in certain circumstances, affect the amount of ATI generated by ETBs and NETBs, and reconsider the competing policies of section 163(j) and Treas. Reg. § 1.1502-13(a). For example, Treasury should consider whether engaging in an NETB or ETB is treated as a "special status" under Treas. Reg. §1.1502-13(c)(4).

Example 3: Consolidated ATI does not take into account offsetting items from intercompany transactions

P is the common parent of a consolidated group, and P owns 100% of the stock of S1 and S2, each a member of the P consolidated group. S1 conducts a real estate business that qualifies as an ETB, generally not subject to section 163(j). S2 conducts an NETB. S2 makes a $100 deductible payment to S1 for real estate management services, and S1 includes the amount in income. Notwithstanding that the items relating to the ETB conducted by S1 are not included in the P group's consolidated ATI and the items relating to S2's business are included in the consolidated ATI, under the proposed regulations the consolidated ATI is not reduced by S2's $100 deduction. In contrast, assume that S2 made a deductible payment to an unrelated party of $100 for comparable services, and S1 received an unrelated $100 payment from a different unrelated party for comparable services. In this case S2's expense would reduce the consolidated ATI by $100, reflecting S2's $100 deduction, and none of S1's items are reflected in ATI, by reason of S1's business being an ETB.

As described above, alternative approaches are possible, including giving effect to S2's $100 payment to S1, by increasing the CTI attributable to the ETB and decreasing the CTI attributable to the NETB, thus in aggregate decreasing the consolidated ATI.

Carryforward of Excess Limitation

Consistent with the statutory language of section 163(j), the proposed regulations provide for no carryforward of excess limitation to subsequent years. Thus, if a consolidated group's limitation for a year is not fully utilized to absorb business interest expense of its members, the excess is eliminated. While the merits of this "use it or lose it" mechanism are questionable, Treasury is bound by the statutory provisions on this issue, and thus if it wants to provide relief to taxpayers by allowing carryover of excess limitation, it should seek a legislative change.

2. Aggregate Business Interest Expense and Business Interest Income

<u>Overview</u>

A consolidated group's business interest expense and business interest income are the aggregate of each member's business interest expense and business interest income, intercompany obligations disregarded. Aggregate business interest expense and business interest income of the group thus looks only to external borrowing/lending (including borrowing/lending with nonconsolidated affiliates). Because, as discussed above, the consolidated limitation is determined by reference to CTI, disregarding intercompany obligations for purposes of determining business interest expense and business interest income generally should not impact the ability of the group to utilize its consolidated limitation. For example, as illustrated in Example 1 above, it is not necessary for a group member that is an external borrower to itself to generate ATI. Rather, it can use the consolidated ATI. Similarly, if an external borrower on-lends the proceeds to an income-producing group member, the fact that this on-lending is disregarded does not prevent the group from using the consolidated limitation attributable to the income-producing member to absorb the business interest expense of the external borrower.

<u>Recommendation</u>

We support the approach of the proposed regulations to not permit intercompany debt to create business interest expense or business interest income.

<u>Analysis</u>

Given single entity principles and the fungibility of money, we agree that intercompany obligations should not create business interest expense or business interest income. Such a result would allow for manipulation of such amounts simply by moving money around the consolidated group. In contrast with non-interest items of income and deduction, it is appropriate to take into account intercompany transactions with respect to interest. Therefore, we agree with the approach of the proposed regulations to ignore intercompany debt.

<u>*Example 1: Aggregate business interest expense and business interest income – do not take into account items from intercompany obligations*</u>

P is the common parent of a consolidated group, and P owns 100% of the stock of S1 and S2, each a member of the P consolidated group. For the year, P pays an

> unrelated bank $100 of business interest expense, S1 pays P $80 of interest, and S2 pays S1 $70 of interest. S2 earns $40 of business interest income from a different unrelated bank. The intercompany interest income of each of P and S1, and the corresponding interest expense of each of S1 and S2, are disregarded in determining the P group's aggregate business interest expense and business interest income, because such items are from intercompany obligations. The P group's aggregate business interest expense is $100, attributable to P's payment to a bank, and the P group's aggregate business interest income is $40, attributable to S2's receipt from a different bank.

We agree with these results since money is fungible and, more importantly, the approach employs consolidated group single entity principles.

3. Allocation of Interest and Other Items Between Excepted Trades or Businesses and Non-Excepted Trades or Businesses Conducted by a Consolidated Group

<u>Overview</u>

The proposed regulations determine whether trade or business activity is an ETB or an NETB by reference to the activities conducted by all members of a consolidated group, as if such activities were conducted by a single corporation. This method furthers the single-entity approach generally taken by the proposed regulations, with which we support.

After a consolidated group determines its aggregate percentage of business interest expense allocable to all of its ETBs (generally, by relative asset basis), that percentage applies to each member's business interest expense. Thus, a member conducting an ETB will not have a higher percentage (and a member conducting an NETB will not have a lower percentage) of its business interest expense treated as exempt from the rules of section 163(j).

Consistent with single-entity treatment of a consolidated group, the basis in the creditor position of an intercompany obligation is not considered an asset for purposes of allocating items between the group's ETBs and NETBs, and neither is the basis in member stock owned by another group member. In addition, member stock transferred to a nonmember is treated as a transfer by the consolidated group of a proportionate amount of the transferred member's underlying assets. Finally, basis does not include any amounts attributable to gain or loss realized on property transferred in an intercompany transaction (whether or not such gain or loss has been taken into account).

<u>Recommendation</u>

For purposes of determining asset basis, we recommend that the IRS and Treasury allow taxpayers to take into account basis from certain intercompany transactions, provided that adequate safeguards are put in place against abuse.

Analysis

As noted above, due to single entity principles and the fungibility of money, we agree with the allocation of the group's business interest expense to the members. Generally, it should not matter which member incurs the interest expense. However, there are competing considerations with respect to determining asset basis by disregarding intercompany transactions. We recognize that it is problematic if taxpayers can sell at a gain, in an intercompany transaction, assets used in an ETB, and thus allocate more interest expense to ETBs. However, requiring taxpayers to monitor a separate system of asset basis for section 163(j) purposes adds significant complexity. For example, assume that S sells an asset to B at a gain, and then S leaves the group. The asset basis step-up is from an intercompany transaction and thus disregarded for section 163(j) purposes. The gain is taken into account upon S leaving the group, and the group would no longer track the asset or the transaction as an intercompany transaction (i.e., the adjustments pursuant to Treas. Reg. § 1.1502-13 would have been made upon S leaving the group). Furthermore, is it possible that there are meaningful practical, legal, and commercial constraints on transferring assets attributable to an ETB from one member to another. Thus, Treasury should consider allowing taxpayers to include basis from certain intercompany transactions, provided that adequate safeguards are put in place against abuse.

> *Example 1: Members conduct ETBs and NETBs, and engage in intercompany transactions*
>
> P is the common parent of a consolidated group, and P owns 100% of the stock of S, a member of the P consolidated group. P conducts an ETB (which includes leasing buildings) and S conducts an NETB. P leases a 30% portion of a building to S for use in S's NETB, and P leases a 70% portion of the building to an unrelated customer as part of its own ETB. A 30% portion of P's basis is attributable to S's NETB, because S uses that portion in its business, notwithstanding that P owns the building. The 70% portion of the building leased to the unrelated customer is attributable to P's ETB. P's lease to S is disregarded for purposes of determining the nature of the business activity.

Intercompany transactions are also disregarded for purposes of determining whether an asset is used in an ETB or an NETB, and property is treated as not used in a trade or business for purposes of these allocation rules if the use derives from intercompany transactions.

4. Disallowed Interest Incurred by a Partnership Allocated to a Subsidiary of a Group

Overview

In general, section 163(j) applies to partnerships at the partnership level, and if the partnership does not have sufficient limitation, the partner carries forward its allocable share of disallowed partnership business interest expense until it is allocated excess taxable income (ETI) from the partnership. ETI generally is any excess of the partnership's ATI over the amount of ATI that would have been necessary to fully utilize all of the partnership's business interest expense for the year. The partner reduces its outside basis in the partnership interest in the year the business interest expense is disallowed, as opposed to waiting until the business interest expense is absorbed. Thereafter, if the partner disposes of the partnership interest (even in a nonrecognition transaction) before the business interest expense is taken into account, the business interest expense carryforward is eliminated. Immediately prior to the disposition, the partner increases its outside basis in the partnership interest to reverse the prior reduction.

When a subsidiary of a consolidated group is the partner in the partnership with disallowed business interest expense, the Treas. Reg. § 1.1502-32 system of investment adjustments to a higher-tier member's basis in the stock of a subsidiary member works differently than the basis adjustments to the subsidiary's basis in the partnership. In particular, there is no downward adjustment in member stock basis when the partnership's business interest expense is disallowed despite the subsidiary's reduction to its own partnership interest basis, and there is no upward adjustment in member stock basis immediately before the subsidiary disposes of the partnership interest despite the subsidiary's increase to its own partnership interest basis. Rather, the member's basis in subsidiary stock does not change by reason of the disallowance and subsequent elimination of business interest expense; it only is reduced if and when the subsidiary's business interest expense is absorbed by the group. This method creates temporary inside/outside basis disparity with respect to the member's basis in the subsidiary's stock and the subsidiary's basis in its own assets.

<u>Recommendation</u>

The AICPA recommends providing an example under Treas. Reg. § 1.1502-13 to illustrate how the matching and acceleration rules work in the case of an intercompany disposition of a partnership with disallowed business interest expense carryforwards. The approach should apply the principle that the intercompany disposition does not alter the amount of business interest expense that is effectively taken as a deduction by the consolidated group.

<u>Analysis</u>

The temporary inside/outside basis disparity is important in performing calculations that focus on basis in the group (e.g., consolidated built-in gain or loss under Treas. Reg. § 1.1502-91(g), and net inside attributes under Treas. Reg. § 1.1502-36(d)). The Preamble to the proposed regulations notes that the member partner is exchanging one attribute (outside basis in a partnership interest) with another (effectively a deferred deduction of business interest expense), which is reasonable, and is derived from how partnerships are treated under section 163(j). It may lead to anomalous results in certain cases when inside basis is relevant to a calculation and, therefore, attention to such cases and possible adjustments to obtain the correct result is warranted.

> <u>*Example 1: Member's disposition of interest in a partnership with disallowed business interest expense*</u>
>
> P is the common parent of a consolidated group. P owns 100% of the stock of S, a member of the P consolidated group, and S is a partner in PRS. P's basis in S stock is $100, and S's basis in its PRS interest is $100. PRS allocates $20 of disallowed business interest expense to S under section 704, and S carries forward this

disallowed business interest expense until it is allocated ETI from PRS. At the time the disallowed business interest expense is allocated under section 704, S's basis in PRS is reduced from $100 to $80. P's basis in S is not reduced and remains at $100. In a subsequent year, S sells its partnership interest to an unrelated party. Immediately before the disposition, S's basis in PRS is increased by $20 from $80 to $100. P's basis in S in not increased and remains at $100. (In each case, the adjustments assume there are no other interim adjustments.)

If S incurred the disallowed business interest expense directly instead of through PRS, P's basis in S stock similarly is not reduced upon the disallowance. Thus, there is parity in the basis results whether or not a partnership is used.

Example 2: Intercompany disposition of partnership interest to another member

Assume the same facts as Example 1, except S's disposition of its interest in PRS is to another member of the P consolidated group in an intercompany transaction (other than in a transaction in which the partnership terminates, a transaction with respect to which the proposed regulations reserve). The stock basis and partnership interest basis results are the same. The disposition of a partnership interest in an intercompany transaction is a disposition for purposes of the partnership basis adjustment rules described above. Following the intercompany transaction, the matching and acceleration rules of Treas. Reg. § 1.1502-13(c) and (d) govern the timing and attributes of S's items and the items of the member purchasing the PRS interest from S.

We suggest providing an example under Treas. Reg. § 1.1502-13 to illustrate how the matching and acceleration rules work in the case of an intercompany disposition of a partnership with disallowed business interest expense carryforwards. The approach should apply the principle that the intercompany disposition does not alter the amount of business interest expense that is effectively taken as a deduction by the consolidated group.

In contrast to an actual disposition of a partnership interest, if a consolidated group member that is a partner leaves the consolidated group while owning its partnership interest, that deconsolidation is not treated as an indirect disposition of the partnership interest. In such a case, the normal rules governing disallowed business interest expense incurred by a partnership continue to apply to the departing member.

5. Ordering Rules for Absorbing Disallowed Interest

Overview

A group's consolidated limitation includes not only its consolidated ATI but also the group's aggregate business interest income. If the aggregate of each member's business interest expense exceeds the group's consolidated limitation for a year, each member first deducts interest to the extent of its own business interest income. If there is remaining consolidated limitation, each member deducts its allocable share of the group's remaining consolidated limitation, in proportion to such member's net interest expense (i.e., each member's business interest expense reduced by its business interest income).

Recommendation

We support the approach in the proposed regulations for allocating a group's consolidated limitation among its members.

Analysis

While other approaches for allocating a group's consolidated limitation among its members are possible (e.g., allocating aggregate business interest income among members instead of first netting each member's business interest income against business interest expense on a separate company basis), we support the approach of the proposed regulations.

We provide the following examples for illustrative purposes:

> *Example 1: Allocation of a group's consolidated limitation among members*
>
> P is the common parent of a consolidated group. P owns 100% of the stock of S1 and S2, each a member of the P consolidated group. The P group's consolidated ATI is $100. S1 has business interest income of $10, and thus the P group's consolidated limitation is $40 ([$100 * 30%] + $10). In addition, each of S1 and S2 incurs $30 of business interest expense, and thus the P group's aggregate business interest expense is $60. Because the aggregate business interest expense of $60 exceeds the group's consolidated limitation of $40, S1 first deducts $10 of business interest expense, an amount equal to its own business interest income. Remaining is $20 of business interest expense for S1 and the entire $30 of business interest expense for S2, as well as $30 of remaining consolidated limitation. S1 and S2 deduct their respective remaining business interest expense to the extent of the remaining consolidated limitation, in proportion to their respective share of net interest expense, with such proportion equaling 40% for S1 ($20 out of the $50 aggregate) and 60% for S2 ($30 out of the $50 aggregate). Thus, of the remaining $30 limitation, S1 deducts $12 and carries $8 forward, and S2 deducts $18 and carries $12 forward.

An alternative approach to Example 1 is to allocate the entire limitation of $40, including S1's $10 of business interest income, in proportion to the member's business interest expense, which would result in $20 of deductible business interest expense for each of S1 and S2, and a $10 disallowed business interest expense carryforward for each of S1 and S2. This alternative approach has the benefit of further deemphasizing the location of interest income and interest expense among group members. The proposed regulations, by prioritizing S1's own business interest expense when using its business interest income, essentially increase the amount S1 can deduct from $20 to $22 and decrease the amount S2 can deduct from $20 to $18. The alternative approach is reasonable and has theoretical appeal as discussed above; the approach of the proposed regulations appears reasonable as well.

As illustrated above, the location of business interest income within a consolidated group can affect the allocation of the group's consolidated limitation by effectively permitting a member earning business interest income priority access to the consolidated limitation to the extent it contributed to the group's consolidated limitation with its business interest income. This method is in contrast to the contribution of each member to the group's consolidated ATI, for which no priority allocation of limitation is given. Generally, the location of items of income or loss among members of a group is not relevant for purposes of the amount or allocation of the consolidated group's limitation. However, other than to the extent of a member's business interest income as discussed above, the allocation of a group's consolidated limitation is calculated by relative business interest expense.

However, if a group's consolidated limitation for a year exceeds the aggregate of each member's business interest expense, the consolidated group can deduct all of the year's business interest expense, and any remaining consolidated limitation is available to deduct business interest expense carryforwards from prior years, beginning with the earliest year (i.e., a first-in, first-out (FIFO) approach). If there are carryforwards from the same year for different members, these carryforwards are deducted pro rata, in proportion to each such member's net business interest expense (similar to the allocation of insufficient limitation in the current year, described above). Presumably, in the original year that the business interest expense was incurred, section 163(j) would not have prohibited the member from deducting the business interest expense to the extent of such member's business interest income. Thus, in allocating excess current year limitation to prior year carryforwards, the appropriate proportion is determined by relative net business interest expense (as opposed to relative gross business interest expense, which would effectively double-count some or all of the business interest expense of a member with business interest income).

> *Example 2: Deducting carryforwards and allocation of deduction among members*
>
> P is the common parent, and P owns 100% of the stock of S1 and S2, each a member of the P consolidated group. The P group's consolidated ATI for Year 3 is $100, and thus the P group's consolidated limitation is $30 ($100 * 30%). S1 and S2 each incur $10 of business interest expense, resulting in P group aggregate business interest expense of $20. Section 163(j) does not disallow any of S1's or S2's business interest expense in Year 3, and there is $10 remaining limitation. In Year 1, S1 had $8 of disallowed business interest expense and in Year 2, S2 had $8 of disallowed business interest expense. The $10 of remaining limitation from Year 3 is used to deduct S1's and S2's prior year disallowed business interest expense, starting with the earliest year. Therefore all $8 of S1's Year 1 business interest expense is deductible, and $2 of S2's $8 Year 2 business interest expense is deductible.

6. Separate Return Limitation Year Rules

Overview

Proposed Reg. § 1.163(j)-5(d) provides a limitation on disallowed business interest expense carryforwards from separate return limitation years to align with the SRLY limitation on net operating loss (NOL) carryforwards provided for in Treas. Reg. § 1.1502-21. However, the proposed regulations provide that the calculation of the SRLY limitation for disallowed business interest expense carryforwards differs from the calculation of the SRLY limit for NOLs.

The Preamble explains that the SRLY limitation for NOL carryovers is cumulative. This result is based upon a member's aggregate contribution to CTI determined by reference to only the member's tax items, for all consolidated return years of the consolidated group in which the member was included in the group. As a result, a member may carry forward its unused SRLY limitation from one year to the next.

In contrast, the Preamble explains that the SRLY limitation for disallowed business interest expense carryforwards is calculated annually based upon a member's section 163(j) limitation, determined by reference only to the member's tax items for any given taxable year. As a result, a member may not carry forward its unused section 163(j) SRLY limitation from one year to the next. Treasury and the IRS have determined that this result is appropriate because Congress did not retain the excess limitation carryforward provisions from old section 163(j). Thus, allowing members to carry forward their unused section 163(j) SRLY limitation is inconsistent with congressional intent.

Furthermore, the proposed regulations provide for several additional limitations on a member's ability to use its disallowed interest expense carryforward arising in a SRLY as follows:

- Such items are only includable by the consolidated group in a taxable year to the extent the group has any remaining section 163(j) limitation for that year after applying the rules in Prop. Reg. § 1.163(j)-5(b);
- Such items are includable to the extent the SRLY member's section 163(j) limitation for that year exceeds the amount of the member's business interest expense already taken into account by the group in that year under the rules in Prop. Reg. § 1.163(j)-5(b); and
- SRLY-limited disallowed business interest expense carryforwards are deductible on a pro-rata basis with non-SRLY limited disallowed business interest expense carryforwards from taxable years ending on the same date.

Treasury and the IRS requested comments on the SRLY rules in Prop. Reg. §1.163(j)-5(d), including whether a member's SRLY-limited disallowed business interest expense carryforwards are no longer subject to a SRLY limitation (to the extent of the member's stand-alone section 163(j) limitation) in taxable years in which the member's stand-alone section 163(j) limitation exceeds the consolidated group's section 163(j) limitation.

<u>Recommendation</u>

The AICPA recommends that the final regulations include a provision which would provide that a member's SRLY-limited disallowed business interest expense carryforwards are no longer subject to a SRLY limitation (to the extent of the member's stand-alone section 163(j) limitation) in taxable years in which the member's stand-alone section 163(j) limitation exceeds the consolidated group's section 163(j) limitation.

Analysis

The AICPA provided written comments[16] in response to Notice 2018-28 – Initial Guidance Under Section 163(j) as Applicable to Taxable Years Beginning After December 31, 2017 on how the SRLY rules could apply to disallowed business interest expense carryforwards arising in a SRLY. In that letter, the AICPA recommended that a member's SRLY-limited disallowed business interest expense carryforwards are no longer subject to a SRLY limitation (to the extent of the member's stand-alone section 163(j) limitation) in taxable years in which the member's stand-alone section 163(j) limitation exceeds the consolidated group's section 163(j) limitation. The AICPA continues to make the same recommendation.

In making this recommendation, the AICPA provided examples to illustrate how this application would apply, which are included below for reference.

Example 1

S1 joins a consolidated group on day one of year 1. At the time S1 joins the group, it has $50 of disallowed interest deduction carryforwards. The consolidated group has no interest deduction carryforwards. Neither S1 nor the consolidated group has any business interest income or floor plan financing interest. In year 1, S1 has $30 of ATI and all other consolidated group members have ($40) of ATI. Therefore, the consolidated group has ($10) of ATI.

The $50 of disallowed interest deduction carryforward of S1 is all SRLY-limited. In year 1, the consolidated group's ability to utilize the SRLY interest is limited to the lesser of 30% of S1's ATI or the consolidated group's ATI. As a result, in year 1, the group cannot deduct any interest since consolidated ATI is ($10). On a stand-alone basis, S1 would have been able to deduct $9 ($30 * 30%) of its disallowed interest carryforward. As a result, $9 of S1's SRLY interest should lose its SRLY taint and become a disallowed interest deduction carryforward of the consolidated group.

Example 1(a) (Continuation of Example 1)

In year 2, S1 has $0 of ATI and the other members of the consolidated group have $40 of ATI. As a result, the consolidated group has $40 of ATI. No member of the consolidated group generated interest expense during year 2.

The consolidated group's interest deduction in year 2 is limited to $12 (30% x $40 consolidated ATI). The consolidated group is entitled to a deduction of $9 of disallowed interest which represents $9 of disallowed interest deduction of S1 that is no longer subject to SRLY. The consolidated group cannot deduct any additional interest in year 2 since S1's ATI during the year was $0. The $41 ($50 - $9) of disallowed interest deduction of S1 remains subject to SRLY.

[16] https://www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/20180709-aicpa-comments-notice-2018-28-sec-163j.pdf.

Example 1(b) (Continuation of Example 1 & 1a with alternate year 2 fact pattern)

> In year 2, Sub 1 has $0 of ATI and the other members of the consolidated group have $20 of ATI. As a result, the consolidated group has $20 of ATI. No member of the group generated interest expense during year 2.
>
> The consolidated group's interest deduction in year 2 is limited to $6 (30% x $20 consolidated ATI). The consolidated group can deduct $6 of the $9 of disallowed interest deduction that is no longer subject to SRLY. The remaining $3 of disallowed interest deduction that is no longer SRLY is carried forward. The $41 of disallowed interest deduction of Sub 1 remains subject to SRLY.

Allowing the SRLY-limited disallowed interest deduction carryover to lose its SRLY taint in years in which the consolidated group's ATI is less than the SRLY sub's (S1's) separate company ATI is consistent with the SRLY register construct of Treas. Reg. § 1.1502-21(c)(1)(i). However, the consolidated group's ability to deduct interest in future years remains subject to the overall section 163(j) limitations, which aligns with the concept that the section 163(j) limit is not cumulative as it is a year-by-year test. As illustrated in Example 1(b), while some of S1's SRLY limited disallowed interest deduction carryforward lost its SRLY taint in year 1, the ability of the consolidated group to take an interest deduction in subsequent years remains subject to the 30% of ATI limit.

III. Allocation Rules

1. Adjusted Basis Attributed to the Stock of a Group Member

Background

Proposed Reg. § 1.163(j)-10 provides the exclusive rules for allocating tax items that are properly allocable to a trade or business between ETBs and NETBs for the purposes of section 163(j) ("the allocation rules").

Under Prop. Reg. § 1.163(j)-10(c), the amount of a taxpayer's interest expense and interest income properly allocable to a trade or business is allocated to the taxpayer's ETBs or NETBs for purposes of section 163(j) based upon the relative amounts of the taxpayer's adjusted basis in the assets used in its ETBs or NETBs.[17] If 90% or more of a taxpayer's basis in its assets for the taxable year is allocable to either ETBs or NETBs, all of the taxpayer's interest expense and interest income for that year properly allocable to a trade or business is treated as allocable to either ETBs or NETBs.[18] Other items are also allocable to ETBs or NETBs based on the taxpayer's adjusted basis in assets.[19] The taxpayer's adjusted basis in assets for this purpose is determined under Prop. Reg. § 1.163(j)-

[17] Proposed Reg. § 1.163(j)-10(c)(1)(i). *But see* rules requiring the direct allocation of interest expense and interest income under Prop. Reg. § 1.163(j)-10(d).
[18] Proposed Reg. § 1.163(j)-10(c)(1)(ii).
[19] E.g., dividends under Prop. Reg. § 1.163(j)-10(b)(3) and certain expenses under Prop. Reg. § 1.163(j)-10(b)(5).

10(c)(5).[20] For non-depreciable property other than land, the adjusted basis for purposes of Prop. Reg. § 1.163(j)-10 is generally the adjusted basis for determining gain or loss from the sale or other disposition of that asset as provided in Treas. Reg. § 1.1011-1.[21] The adjusted basis of depreciable property for purposes of Prop. Reg. § 1.163(j)-10 is subject to depreciation methods specified in Prop. Reg. § 1.163(j)-10(c)(5).[22]

For purposes of applying the allocation rules:

- All members of a consolidated group (a group) are treated as one corporation;[23]
- Intercompany obligations (within the meaning of Treas. Reg. § 1.1502-13(g)(2)(ii)) are not considered an asset of the creditor member;[24]
- Intercompany transactions (within the meaning of Prop. Reg. § 1.1502-13(b)(1)(i)) and their offsetting items are disregarded;[25] and
- Property is not treated as used in a trade or business to the extent that the use of such property in a trade or business derives from an intercompany transaction.[26]

Stock of a group member that is owned by another member of the same group is not treated as an asset for purposes of the allocation rules.[27] Furthermore, for the purposes of the allocation rules, the transfer of the stock of a group member to a non-group member is treated by the group as a transfer of the member's assets proportionate to the amount of the member stock transferred.[28] In contrast, if a taxpayer owns stock in a corporation that is not a member of the taxpayer's consolidated group, the stock is treated as an asset of the taxpayer.[29]

Overview

We commend Treasury and the IRS for adopting an objective approach to allocating interest expense to ETBs that is reasonable. A significant consideration for the allocation of interest expense and interest income to ETBs is the adjusted basis of a taxpayer's assets used in such trade or business. However, the stock of a consolidated group member is not considered an asset for purposes of the allocation rules.

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[20] Proposed Reg. § 1.163(j)-10(c)(1)(i).
[21] Proposed Reg. § 1.163(j)-10(c)(5)(i)(A).
[22] Proposed Reg. § 1.163(j)-10(c)(5)(i).
[23] Proposed Reg. § 1.163(j)-10(a)(4).
[24] Proposed Reg. § 1.163(j)-10(a)(4).
[25] Proposed Reg. § 1.163(j)-10(a)(4).
[26] Proposed Reg. § 1.163(j)-10(a)(4).
[27] Proposed Reg. § 1.163(j)-10(a)(4).
[28] Proposed Reg. § 1.163(j)-10(a)(4).
[29] Proposed Reg. § 1.163(j)-10(a)(4) and Prop. Reg. § 1.163(j)-10(c)(5)(ii)(B)(1).

Recommendation

The AICPA recommends that the final regulations clarify that a purchase of a member's stock by another member of its consolidated group from a non-member is treated as a purchase of a proportionate amount of the member's assets for purposes of Prop. Reg. § 1.163(j)-10.[30]

Analysis

Because the stock of a consolidated group member is not treated as an asset for purposes of the allocation rules, Prop. Reg. § 1.163(j)-10(c) provides that the transfer of the stock of a group member to a non-group member is treated as a transfer of a proportionate amount of the member's assets. However, the proposed regulations do not specifically provide the treatment of a purchase of the stock of a group member, or a corporation that becomes a group member immediately thereafter. If Prop. Reg. § 1.163(j)-10(a)(4) is taken further, the purchase of the stock of a member is not treated as a purchase of stock of the member, but rather is treated as a purchase of a proportionate amount of the member's assets for purposes of the allocation rules (i.e., the transaction is treated not as a stock purchase but as an asset purchase). Without a clarification on this matter, taxpayers may interpret the regulations to imply such treatment.

The final regulations should clarify that the purchase of a group member's stock is treated as a purchase of a proportionate amount of the member's assets for this purpose. Without such treatment, the amount of adjusted basis attributed to an ETB or NETB may differ significantly depending on whether a shareholder and the underlying corporation are members of the same consolidated group.

The allocation of interest expense under Prop. Reg. § 1.163(j)-10 is affected by the adjusted basis attributed to ETBs or NETBs. Regardless of how much adjusted basis of assets is attributed to ETBs and NETBs, it is inappropriate for a consolidated group to have a different amount of adjusted basis that is subject to the allocation rules than a shareholder and a corporation that are not members of a consolidated group. Such disparate treatment could produce substantially different results under the allocation rules. While we recognize the legislative intent to treat a consolidated group as one corporation, there is no legislative history indicating the intent to treat a consolidated group different from a non-consolidated corporation in this manner.

The following examples illustrate our position:

Example 1 – No consolidated return filed

A corporation, Target, conducts an ETB. Target has assets with a fair market value of $100 and $0 adjusted basis. Target has $0 liabilities. Another corporation, Parent, solely conducts an NETB with an adjusted basis in its assets of $100. Parent purchases 100% of Target's stock for $100. Parent and Target do not file a consolidated tax return.

[30] The recommendation includes a purchase of stock of a corporation that would become a member of the purchaser's consolidated group immediately thereafter.

Parent's Target stock is treated as an asset for purposes of the allocation rules under Prop. Reg. § 1.163(j)-10(c)(5)(ii)(B). The adjusted basis of its Target stock, $100, would impact the allocation of interest expense and interest income of Parent between its ETB (conducted through Target) and its NETB under the allocation rules.[31]

Example 2 – Consolidated return filed

Example 2 assumes the same facts as Example 1, except that Parent and Target file a consolidated return.

Parent's Target stock is not treated as an asset for purposes of the allocation rules under Prop. Reg. § 1.163(j)-10(a)(4). The amount of adjusted basis that Parent's consolidated group may take into account for the purposes of the allocation rules is unclear. If the Target stock, and the amount paid by Parent to acquire the Target stock, is ignored entirely, the adjusted basis of Target's assets for purposes of Prop. Reg. § 1.163-10 is $0.

Parent should have the ability to take into account the amount paid for its Target stock, $100, for purposes of the allocation rules in both Examples 1 and 2. Furthermore, Parent should have the same amount of adjusted basis subject to the allocation rules in Example 1 and Example 2. We recognize that such treatment is not always beneficial for Parent, however, no disparity between Example 1 and Example 2 for this purpose is equitable.

Example 3

Same as Example 1, except that Target has assets with a fair market value of $100 and $1,000 adjusted basis and no liabilities.

Example 4

Same as Example 2, except that Target has assets with a fair market value of $100 and $1,000 adjusted basis and no liabilities.

If there is a disparity between Example 3 and Example 4, Parent will have more adjusted basis in the system for Example 4 than in Example 3 because the amount paid by Parent for Target's stock is disregarded. If Parent is treated as purchasing the assets of Target in Example 4, Example 3 and Example 4 will have similar results for purposes of the allocation rules.

2. Indirect Interests for the Look-Through Rule in Prop. Reg. § 1.163(j)-10(c)(5)(ii)(B)

Background

If a shareholder's direct and indirect interest in a non-consolidated domestic C corporation or a CFC satisfies the ownership requirements of section 1504(a)(2), the shareholder must look-

[31] Proposed Reg. § 1.163(j)-10(c)(5)(ii)(B).

through to the assets of such corporation for purposes of allocating the shareholder's basis in its stock between ETBs and NETBs (the "look-through rule").[32] Stock ownership meets the requirements of section 1504(a)(2) if it: (i) possesses at least 80% of the total voting power of the stock of such corporation; and (ii) has a value equal to at least 80% of the total value of the stock of such corporation.[33]

If a shareholder other than a C corporation or tax-exempt corporation does not satisfy the minimum ownership threshold, the shareholder will generally treat its entire basis in the corporation's stock as an asset held for investment.[34] If a shareholder that is a C corporation or a tax-exempt corporation does not satisfy the minimum ownership threshold, the shareholder must treat its entire basis in the corporation's stock as allocable to a NETB.[35]

Overview

The look-through rule in Prop. Reg. § 1.163(j)-10(c)(5)(ii)(B) applies if a shareholder's direct and indirect interest in a non-consolidated corporation or CFC meets the ownership test in section 1504(a)(2).

Recommendation

The AICPA recommends that the final regulations clarify the definition of an indirect interest for purposes of the ownership requirement in the look-through rule and provide for specific constructive ownership rules.

Analysis

A shareholder of a non-consolidated domestic C corporation or CFC must apply the look-through rule if such shareholder's direct and indirect interest in the corporation satisfies the ownership requirements of section 1504(a)(2).[36]

Section 1504(a)(2) does not contain constructive ownership rules governing when an indirect interest in a corporation is taken into account. Thus, it is unclear when a shareholder's indirect ownership in a corporation is counted for the purposes of the ownership requirement in the look-through rule. While the members of a consolidated group are treated as one corporation for purposes of the look-through rule, the final regulations should clarify if an indirect interest of a corporation that is not owned solely by members of a consolidated group is counted as well.

[32] Proposed Reg. § 1.163(j)-10(c)(7)(i).
[33] Section 1504(a)(2).
[34] Proposed Reg. § 1.163(j)-10(c)(5)(ii)(B)(2)(iii).
[35] Proposed Reg. § 1.163(j)-10(c)(5)(ii)(B)(2)(iii).
[36] Proposed Reg. § 1.163(j)-10(c)(7)(i).

We provide the following example for illustrative purposes:

> *Example 5*
>
> Domestic Parent directly wholly owns a CFC (CFC 1), and directly owns 50% of another CFC (CFC 2). The remaining 50% of CFC 2's stock is directly owned by CFC 1. Domestic Parent and CFC 1 both conduct an NETB, but CFC 2 conducts an ETB.

Because CFC 2 is not owned solely by members of a consolidated group, it is unclear under the proposed regulations whether Domestic Parent and CFC 1 may apply the look-through rule. The application of certain constructive ownership rules (e.g., sections 318(a)(2) and (3)) would attribute stock ownership to Domestic Parent and CFC 1 that is sufficient to apply the look-through rule for each corporation, however, the proposed regulations do not specifically reference section 318. Therefore, we recommend that the final regulations clarify the meaning of indirect interest for purposes of the ownership requirement in the look-through rule and provide specific constructive ownership rules that apply.

3. Allocation of Disallowed Disqualified Interest Carryforward

Background

Except to the extent it is properly allocable to an ETB under Prop. Reg. § 1.163-10, disallowed disqualified interest is carried forward to the taxpayer's first taxable year after December 31, 2017 and treated as a disallowed business interest expense carryforward under section 163(j) and Prop. Reg. § 1.163(j)-2.[37] The Preamble to the proposed regulations requested comments related to how the allocation rules in Prop. Reg. § 1.163(j)-10 should apply to disallowed disqualified interest under old section 163(j). Proposed Reg. § 1.163(j)-10(a)(6) is reserved for the application of Prop. Reg. § 1.163(j)-10 to disallowed disqualified interest carryforwards.

Overview

The proposed regulations contemplate that disallowed disqualified interest expense carryforward under old section 163(j) is possibly allocable to an ETB. However, the proposed regulations do not provide a specific methodology to determine disallowed disqualified interest carryforward that is properly allocable to an ETB or a NETB.

Recommendations

The AICPA recommends that the final regulations provide that taxpayers can use either the historical taxable year or the effective date taxable year as the reference taxable year for allocating disallowed disqualified business interest between ETBs and NETBs under Prop. Reg. § 1.163(j)-10.

[37] Proposed Reg. § 1.163(j)-11(b)(1).

The AICPA further recommends providing the effective date approach in the final regulations as a safe-harbor. This method would permit taxpayers to allocate disallowed disqualified interest to ETBs and NETBs under Prop. Reg. § 1.163(j)-10 based on the taxpayer's circumstances in its first taxable year beginning after December 31, 2017 as if the disallowed disqualified interest arose in such taxable year.

The AICPA also recommends that the final regulations provide that any reasonable methodology is acceptable in relation to allocating disallowed disqualified interest to ETBs and NETBs provided the method is applied consistently to disallowed disqualified interest that arose in the same taxable year.

Analysis

There are a number of possible methods that taxpayers can use to allocate disallowed disqualified interest to ETBs and NETBs under the allocation rules. One method would require a taxpayer to analyze the allocation rules with respect to disallowed disqualified interest for each taxable year in which the disallowed disqualified interest arose (the "historical approach"). However, the historical approach likely will prove administratively burdensome for many taxpayers. Another method would allocate disallowed disqualified interest to ETBs and NETBs under Prop. Reg. § 1.163(j)-10 based on the taxpayer's circumstances in its first taxable year beginning after December 31, 2017 as if the disallowed disqualified interest arose in such taxable year (the "effective date approach"). The effective date approach appears simpler for taxpayers to apply however, it may not accurately represent the taxpayer's circumstances.

Because any allocation methodology could present issues for taxpayers to apply, we suggest allowing taxpayers to use any reasonable method provided the same method is applied consistently to disallowed disqualified interest that arose in the same taxable year. Additionally, a disallowed disqualified interest expense carryforward may have been generated in many past taxable years. The final regulations should provide a safe-harbor for taxpayers to allocate disallowed disqualified interest expense carryforward to an ETB or NETB that is not administratively burdensome.

IV. Ordering and Operating Rules

Overview

The proposed regulations provide ordering and operating rules governing the interaction of the section 163(j) limitation with other provisions of the Code. Under these rules, the proposed regulations generally apply to interest expense that is deductible without regard to the section 163(j) limitation; interest expense disallowed, deferred, or capitalized in the current taxable year, or not yet accrued, is not taken into account for purposes of section 163(j). The proposed regulations apply after the operation of the loss limitation rules in sections 465 and 469 and before the application of the limitation on excess business losses of noncorporate taxpayers in section 461(l).

Recommendations

The AICPA recommends that the IRS and Treasury clarify that the 163(j) limitation applies after the application of all provisions that subject interest expense to capitalization and that sections 263A and 263(g) are nonexclusive examples of this general ordering rule.

The AICPA further recommends that the IRS and Treasury clarify the scope and operation of Prop. Reg. § 1.163(j)-3(b)(9) governing the interaction of the section 163(j) limitation with provisions that characterize interest expense as something other than business interest expense.

Analysis

Proposed Reg. § 1.163(j)-3(b)(1) provides, in part, that section 163(j) applies after the application of provisions that subject interest expense to disallowance, deferral, capitalization or other limitation. Provisions relating to the disallowance and deferral of interest are discussed in subsections (b)(2), (b)(3) and (b)(4), and nonexclusive examples of disallowance and deferral provisions are provided. Subsection (b)(5) addresses provisions requiring capitalization of interest but references only sections 263A and 263(g), without identifying them as nonexclusive examples.

The text of subsection (b)(5) thus implies that the ordering rule for interest capitalization applies only to sections 263A and 263(g), which is contrary to the legislative history of section 163(j). We suggest revising subsection (b)(5) to clarify that sections 263A and 263(g) are nonexclusive examples of the general ordering rule for interest capitalization, consistent with the treatment of ordering rules for disallowed and deferred interest in preceding subsections (b)(2), (b)(3) and (b)(4). The suggested revision is particularly appropriate because of the expansive concept of interest set forth in Prop. Reg. § 1.163(j)-3(b)(20), which increases the likelihood that capitalization of interest is possibly required by provisions other than sections 263A and 263(g).

Proposed Reg. § 1.163(j)-3(b)(9) provides that, except as otherwise provided, provisions that characterize interest expense as something other than business expense, such as section 163(d), govern the treatment of that interest expense and such interest expense is not treated as business interest expense for any purpose under section 163(j). By its terms, subsection (b)(9) applies to amounts that constitute interest expense under section 163(j) but are characterized as something other than business interest expense under any other provision. In general, business interest expense is defined as interest expense that is properly allocable to an NETB or that is classified as floor plan interest. Accordingly, it appears that subsection (b)(9) applies where a provision other than 163(j) provides that amounts otherwise qualifying as interest expense under section 163(j) are not properly allocable to an NETB and thus are not considered business interest expense under section 163(j).

The construction of subsection (b)(9) is not consistent with the example of section 163(d) provided in the subsection. Section 163(d) governs the characterization of certain interest as investment interest. This characterization is a different issue from whether an amount otherwise qualifying as interest expense under section 163(j) is properly allocable to an NETB, thus qualifying as business interest expense. Accordingly, it is unclear how subsection (b)(9) applies to an amount that qualifies as interest under section 163(j), is characterized as investment interest under section 163(d), but is properly allocable to an NETB.

1. Whether the Section 163(j) Limitation is a Method of Accounting under Sections 446 and 481

Overview

The proposed regulations provide that any business interest expense disallowed as a deduction under the section 163(j) limitation ("disallowed business interest expense") is carried forward to the succeeding tax year as business interest expense for purposes of section 163(j).[38] This carryforward rule also applies to interest, including carryforwards, that was disallowed under old section 163(j) in the taxpayer's last taxable year beginning before January 1, 2018 and was carried forward pursuant to old section 163(j) ("disallowed disqualified interest"). The proposed regulations place no time limits on the carryforward of disallowed business interest expense or disallowed disqualified interest.

Recommendation

The AICPA recommends that the IRS and Treasury clarify that a change in the calculation and application of the section 163(j) limitation on the deduction of business interest is not considered a change in the method of accounting within the meaning of sections 446 and 481.

Analysis

Methods of accounting used by taxpayers to compute taxable income are subject to special rules under sections 446 and 481. In particular, once a taxpayer has established a method of accounting for an item of income or expense, the taxpayer must obtain the consent of the Commissioner under section 446(e) before changing to a different method of accounting for that item. Accounting method changes are ordinarily on a prospective basis; a taxpayer generally may not make a retroactive change in a method of accounting by amending its returns. Finally, when the taxpayer changes its method of accounting or the IRS imposes a change in method of accounting, section 481(a) requires an appropriate adjustment to offset any duplications or omissions of income or deductions that result from the change.

The term "method of accounting" includes not only the overall method of accounting of the taxpayer (such as cash receipts and disbursements or accrual) but also the accounting treatment of any material item, which includes "any item that involves the proper time for the inclusion of the item in income or the taking of a deduction."[39] Thus, an accounting practice that involves the timing of when an item is included in income or when it is deducted is considered an accounting method.[40] In determining whether timing is involved, generally the pertinent inquiry is whether

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[38] Proposed Reg. §§ 1.163(j)-1(b)(8).
[39] Treasury Reg. §§ 1.446-1(a)(1), (e)(2)(ii)(a).
[40] FPL Group, Inc. v Commissioner, 115 T.C. 554, 562 (2000); General Motors Corp. v. Commissioner, 112 T.C. 270, 296 (1999); Color Arts, Inc. v. Commissioner, T.C. Memo. 2003-95.

the accounting practice permanently affects the taxpayer's lifetime taxable income or merely changes the tax year in which taxable income is reported.[41]

The proposed regulations allow the carryforward of disallowed business interest expense and disallowed disqualified interest indefinitely into successive taxable years. Section 163(j) thus operates to defer, rather than to permanently disallow, the deduction of interest to which the provision applies. As such, it is possible to view section 163(j) as a timing provision that qualifies as a method of accounting within the meaning of sections 446 and 481.

Alternatively, section 163(j) can ultimately create a permanent disallowance of interest where the limitations applicable in the subsequent years of its existence never allow the taxpayer to deduct all of its deferred interest. This possibility led the IRS to conclude that discontinuing the limitation of old section 163(j) did not constitute a change in method of accounting under section 446.[42]

2. Determination of Adjusted Taxable Income

Overview

To determine the ATI for a taxable year under the proposed regulations, deductions for depreciation under section 167 or 168, the amortization of intangibles and other amortized expenditures, and depletion under section 611 are added back to a taxpayer's taxable income for tax years beginning before January 1, 2022. The result is an increase in ATI, reducing the amount of interest expense potentially subject to the limitation. The Preamble and the text of Prop. Reg. § 1.163(j)-1(b)(iii) state that depreciation, amortization, and depletion capitalized to inventory under section 263A is not considered depreciation allowable as a deduction for purposes of section 163(j). Therefore, it is not added back to ATI which increases the amount of interest expense subject to the limitation.

Recommendation

The AICPA recommends that the IRS and Treasury provide that depreciation, amortization, and depletion allowances that are allocable to inventory, capitalized, and recovered through cost of goods sold (COGS) for the tax year retain their original character and are allowable as a deduction for purposes of section 163(j) and allowable for addback to ATI for tax years beginning before January 1, 2022.

Analysis

For taxable years beginning after December 31, 2017, ATI under section 163(j)(8) means the taxable income of the taxpayer computed without regard to the following items:

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[41] See Rev. Proc. 2002-18, section 2.01; Rev. Proc. 91-31, 1991-1 C.B. 566, Primo Pants Co. v. Commissioner, 78 T.C. 705, 723-724 (1982); Knight Ridder Newspapers, Inc. v. United States, 743 F.2d 781, 798 (11th Cir. 1984); Huffman v. Commissioner, 126 T.C. 322, 343 (2006) affd. 518 F.3d 357, 364-5 (6th Cir. 2008); Peoples Bank & Trust Co. v. Commissioner, 415 F.2d 1341, 1344 (7th Cir. 1969).
[42] CCA 201202021, 2012 WL 105617.

- Any item of income, gain, deduction, or loss that is not properly allocable to a trade or business;
- Any business interest or business interest income;
- The amount of any NOL deduction;
- The amount of any deduction allowed under section 199A; and
- For taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion.

For taxable years beginning after December 31, 2021, ATI is computed with regard to deductions allowable for depreciation, amortization, or depletion. Proposed Reg. § 1.163(j)-1(b)(1) would follow the statutory framework of section 163(j)(8) and define ATI to include the adjustments specified in section 163(j)(8)(A), as well as additional adjustments under the authority granted by the Secretary in section 163(j)(8)(B) to prevent double-counting and other distortions of items such as floor plan financing interest expense and certain deductions for depreciation, amortization, or depletion upon the sale or disposition of property.

Treasury Reg. § 1.61-3 defines gross income for manufacturing, merchandising, and mining businesses as total sales, less COGS, plus other income from investments and incidental or outside operations or sources. COGS is determined in accordance with the taxpayer's method of accounting and, therefore, is not accounted for earlier than the taxable year in which economic performance occurs. COGS is generally computed based on beginning inventory, plus capitalizable costs incurred during the taxable year, less ending inventory. Taxpayers subject to inventories recover, through COGS, inventoriable costs that are otherwise currently deductible when the related inventory items are sold.

Treasury Reg. § 1.263A-1(a)(3)(ii) requires producers to include in inventory costs: (1) all direct costs of producing the inventory; and (2) the inventory's allocable share of indirect costs. Treasury Reg. § 1.263A-1(e)(3)(i) provides that indirect costs are properly allocable to produced inventory when the costs directly benefit or are incurred by reason of the performance of production activities. Section 263A(c) provides exceptions for certain costs not includable in COGS since there is no requirement to capitalize them as inventoriable costs. Under Treas. Reg. § 1.263A-1(e)(3)(ii)(I), there is a requirement to capitalize as inventoriable indirect costs, depreciation, amortization, and cost recovery allowances on equipment and facilities (or self-constructed assets) related to assets used in the manufacturing process or resale activities. Depletion, whether or not in excess of cost, is properly allocable to property that has been sold for purposes of determining the gain or loss on sale of the property.

Neither the former proposed regulations[43] nor the Committee Reports to the TCJA indicate that Congress intended to exclude depreciation, amortization, and depletion that is allocable to COGS as an addition to ATI. COGS-allocable depreciation, amortization, and depletion allowances have

[43] According to the Preamble to the prior proposed regulations under the pre-amendment version of section 163(j), the adjustments to taxable income to arrive at ATI were intended to approximate income under a cash-flow approach. In permitting an add-back for deductions for depreciation under section 167 and section 168, if the goal is to arrive at a cash position, there is no reason to distinguish between depreciation or amortization claimed as a deduction or taken into account as a reduction in gross income through COGS as in neither case does the depreciation represent a cash outlay in the current period. See Prop. Reg. § 1.163(j)-2(f).

long been regarded as allowable deductions for purposes of the asset basis adjustment provisions in section 1016(a)(2) of the Code. Section 167(c)(1) generally provides that the basis for allowed deduction for exhaustion, wear and tear of any property is the adjusted basis used for the purpose of determining gain on the sale or other disposition of such property. Section 1016(a)(2) provides, in part, that proper adjustment with respect to the property is made for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent the amount is allowed as a deduction in computing taxable income and results (by reason of the deductions so allowed) in a reduction of tax for any taxable year, but no less than the amount allowable under the prevailing tax law. Essentially, section 1016(a)(2) provides that the basis of depreciable property is reduced by the greater of allowed or allowable depreciation, amortization, and depletion (regardless of whether it is included in COGS). Upon disposition of a given asset, a taxpayer can claim the appropriate amount of basis as an offset to proceeds (if any) in determining gain or loss.

If allowed depreciation (i.e., depreciation claimed and sustained on the taxpayer's federal income tax returns) exceeds allowable depreciation (i.e., depreciation properly claimed per statute), the taxpayer may not claim the excess depreciation twice: that is, once upon original cost recovery and a second time upon disposition of the asset. However, if allowable depreciation exceeds allowed depreciation, the taxpayer may under-recover basis over the life of the asset (i.e., the excess is recovered neither through cost recovery nor upon disposition). If allowed and allowable depreciation are equal (i.e., the taxpayer claimed the proper amount of depreciation), the correct amount of lifetime basis will have been recovered.

Section 1016(a)(2) provides that in calculating basis, adjustments are required for depreciation to the extent such amounts are allowed or allowable as deductions in computing taxable income. In determining whether a deduction is allowable under section 1016(a)(2), taxpayers must look to whether the deduction is permitted by the Code and whether it is otherwise limited or forbidden in the Code. While adjustments to basis are required to the extent of the amount of depreciation either allowed or allowable as a deduction, no adjustment is permitted or required to the extent of disallowed deductions. "[A] deduction is "allowable" under the Code if some provision of the Code permits it to be taken as a deduction and no other provision of the Code acts to limit or forbid it as a deduction."[44]

Based on the above, it appears the term "allowable" for purposes of the basis adjustment means not disallowed by a disallowance or exempt income provision. This meaning is consistent with the rationale applied by the Court of Federal Claims in *CBS Corporation & Subsidiaries v. United States*[45] in holding that a taxpayer's tax basis in its assets is not reduced by depreciation disallowed under the Foreign Sales Corporation rules. Also, it is implausible to read the regulation as not providing for a basis adjustment for depreciation that is allocable to COGS since it is not allowable as a deduction. Given that the same term is used to describe both the basis adjustments under section 1016 and the addback in section 163(j) to ATI, it is reasonable to allow depreciation allocable to COGS as a deduction for the addback to ATI under section 163(j)(8)(A)(v).

The proposed regulations provide for an ordering rule for the interaction of section 163(j) and section 263A(f), which provides that taxpayers must apply the interest capitalization rules of

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[44] *Sharp v. United States*, 14 F.3d, 583, 587-88 (Fed. Cir. 1993).
[45] 105 Fec. Cl. 74 (2012).

section 263A(f) prior to applying the limitation under section 163(j). In addition, the proposed regulations provide that any interest expense capitalized under section 263A(f) is not later treated as business interest expense potentially subject to disallowance under section 163(j). This ordering rule originated in the interest capitalization rules following the enactment of section 263A.[46] Since interest capitalized under section 263A(f) is not otherwise deductible for the tax year, the result of this ordering rule is appropriate in that the section 163(j) limit is based on taxable income that takes into account all allowable deductions. The ordering rule also obviates the need for taxpayers to apply a complex tracing rule to the interest capitalized and potentially recharacterizing it from depreciation to interest expense in a later year.

As the interest capitalization rules often apply to long-lived depreciable assets, the burdens associated with tracking such interest through later depreciation allowances likely outweigh the benefits of subjecting such interest to the disallowance provision in a later year, especially in the case of long-lived depreciable fixed assets. In contrast, (except in the case of the last-in, first-out (LIFO) inventory method) costs that are allocable to inventory are typically recovered either in the year incurred or in the immediately succeeding year. In addition, a number of businesses subject to 163(j) have no ending inventory (e.g., power generation, natural resource extraction). Therefore, the amount of depreciation, amortization, or depletion allocable to inventory is recovered in the same year. In the case of depreciation, amortization, and depletion, there is also no potential disallowance provision for which a special ordering rule is needed. The only issue is whether such depreciation, amortization, or depletion is considered allowable as a deduction. The flush language in section 263A(a) indicates that an amount is not taken into account through capitalization unless it is otherwise "allowable" as a deduction, and, in describing the items added back to taxable income in arriving at ATI, Prop. Reg. § 163(j)(8)(A)(5) states broadly that it is any deduction allowable for depreciation, amortization, and depletion. Depreciation that is allocable to and capitalized with respect to inventory and COGS must qualify as an allowable deduction for capitalization to occur. Accordingly, it should qualify as an allowable deduction for the add-back to ATI.

The IRS reached a similar conclusion in Advice Memorandum 2008-012 regarding the characterization of certain specified liabilities inventoried and recovered through COGS for purposes of determining whether such amounts were subject to a carryback provision for allowable deductions under former section 172(f). Former section 172(f) provided a 10-year carryback for specified liability losses, generally defined as any amount allowable as a deduction that is attributable to certain activities such as product liabilities, environmental remediation, or workers' compensation. In A.M. 2008-012, the IRS concluded that environmental remediation and workers' compensation costs allocable to inventory under section 263A and recovered through COGS are accounted for as specified liabilities to the extent taken into account in computing a NOL for the taxable year.

The Joint Committee of Taxation General Explanation of P.L. 115-97 (JCS-1-18) provides that for purposes of computing ATI before 2022, any deduction allowable for depreciation, amortization, or depletion includes any deduction allowable for any amount treated as depreciation, amortization, or depletion. Amounts included in COGS are still treated as allowable depreciation, amortization, or depletion deductions for purposes of reducing the basis of depreciable property

[46] Treasury Reg. § 1.263A-9(g)(1).

under section 1016(a)(2) in order to properly recover the entire cost basis of the property or properly compute gain or loss on disposition of the property. Accordingly, depreciation, amortization, and depletion capitalized and included in COGS should not lose the nature of the underlying costs for purposes of computing earnings before interest, tax, depreciation and amortization (EBITDA) under section 163(j)(8)(A)(v).

V. Interaction of Section 163(j) and Section 108

1. Interaction with Section 108(b)

Overview

Under the TCJA, taxpayers are allowed to carryover disallowed interest deductions indefinitely.[47] However, it is not clear if disallowed interest carryforwards under section 163(j) constitute an attribute that is subject to reduction under section 108(b).

Recommendation

The AICPA believes that disallowed interest carryforwards are not an attribute subject to reduction under section 108(b)(2) as currently drafted. If, consistent with the underlying policy section 108(b)(2), Treasury and the IRS expect taxpayers to treat disallowed interest carryforwards as attributes subject to section 108(b)(2), we recommend that Treasury and the IRS so clarify.

Analysis

Generally, income from the cancellation of indebtedness (CODI) is included in gross income under section 61(a)(11). However, section 108(a) permits certain taxpayers to exclude CODI from gross income to the extent of their insolvency or bankruptcy ("excluded CODI").[48] In exchange for avoiding CODI, section 108(b) requires that taxpayers reduce specified tax attributes to the extent of the excluded CODI. In particular, section 108(b)(2) provides that the following attributes are reduced in the following order:

- Any NOL for the year of the discharge and any NOL carryover to such year;
- Any carryover to or from the taxable year of a discharge of an amount allocable for purposes of determining the amount allowable as a general business credit under section 38;
- The amount of minimum tax credit available under section 53(b) as of the beginning of the taxable year immediately following the taxable year of the discharge;
- Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under section 1212;
- The basis of the property of the taxpayer;
- Any passive activity loss or credit carryover of the taxpayer under section 469(b) from the taxable year of the discharge; and

[47] Section 163(j)(2).
[48] Section 108(a)(1) and (3).

- Any carryover to or from the taxable year of the discharge for purpose of determining the amount of the credit allowable as a foreign tax credit under section 27.

The legislative history to section 108(b)(2) explains:

> In developing the rules of the bill, the committee recognized that the basis-reduction mechanism of present law fails to effectuate the Congressional intent of deferring, but eventually collecting tax on, ordinary income realized from debt discharge.
>
> Thus, present law permits both solvent and insolvent taxpayers to apply the amount of their discharged debt to reduce the basis of non-depreciable assets that may never be sold, such as stock in a subsidiary corporation or the land on which the company operates its business, thereby avoiding completely, rather than deferring, the tax consequences of debt discharge. . . .[49]
>
> Accordingly, the rules of the bill are intended to carry out the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge. Thus, in the case of a bankrupt or insolvent debtor, the debt discharge amount is applied to reduce the taxpayer's net operating loss and certain other tax attributes, unless the taxpayer elects to apply the amount first to reduce basis in depreciable assets.[50]

The legislative history also provides for the following:

> Any amount of debt discharge which is left after attribute reduction under these rules is disregarded (i.e., does not result in income or have other tax consequences).[51]

Over time, Congress has added attributes and removed attributes from the list in section 108(b)(2).[52] The TCJA did not add disallowed interest carryforwards to the list of attributes in section 108(b)(2).

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[49] Under the law at the time, "a debtor which would otherwise be required to report current income from debt cancellation under the preceding rules instead may elect to reduce the basis of its assets . . . ." H.R. Rep. No. 96-833, at 7 (Mar. 19, 1980) (House Report accompanying the Bankruptcy Tax Act of 198 (P.L. 96-589)).
[50] H.R. Rep. No. 96-833, at 9 (Mar. 19, 1980).
[51] S. Rep. No. 96-1035, at 13 (Nov. 23, 1980) (Senate Report accompanying the Bankruptcy Tax Act of 1980 (P.L. 96-589)).
[52] *See e.g.*, P.L. 103-66 (adding the minimum tax credit under section 53 to the list of attributes available for reduction under section 108(b)(2) as well as the passive activity loss under section 469(b)); P.L. 98-369 (removing credit carryovers under former section 38 (relating to investment in certain depreciable property), former section 40 (relating to expenses of work incentive programs), former section 44B (relating to credit for employment of certain new employees), former section 44E (relating to alcohol used as a fuel) and former section 44F (relating to credit for increasing research activities)).

In contrast, the TCJA added disallowed interest carryforwards to the list of attributes in section 381(c).[53] Similar to section 108(b)(2), section 381(c) sets forth a list of tax attributes (including NOLs), each of which carry over to the acquiring corporation in a liquidation qualifying under section 332 or an acquisitive asset reorganization under section 368.[54]

The TCJA also amended the definition of pre-change loss in section 382 to include disallowed interest carryforwards.[55] Generally, section 382 can limit a taxpayer's ability to use NOLs incurred before an ownership change ("pre-change losses") following an ownership change. Prior to the enactment of the TCJA, pre-change losses were limited to NOLs incurred before the ownership change.

Reducing disallowed interest carryforwards in the event of excluded CODI is consistent with the purpose of section 108(a) and (b)(2) (i.e., to defer CODI while subsequently collecting tax on an equivalent amount of income by reducing attributes that would reduce taxable income in subsequent years). However, the statute does not expressly include disallowed interest carryforwards in the list of attributes subject to reduction under section 108(b)(2). Furthermore, the legislative history to section 108(b)(2) indicates that the list of attributes in section 108(b)(2) is an exclusive list, and once exhausted, remaining excluded CODI is discharged without additional cost. Moreover, for purposes of sections 381 and 382, the TCJA provides express rules accounting for disallowed interest carryforwards; the fact that Congress omitted disallowed interest carryforwards from 108(b)(2) indicates that such omission was intentional.

Based on the foregoing, under current law, disallowed interest carryforwards are not subject to reduction under section 108(b)(2). As a result, if, consistent with the underlying policy of section 108(b)(2), Treasury and the IRS expect taxpayers to treat disallowed interest carryforwards as attributes subject to reduction in the event of excluded CODI, we recommend that Treasury and the IRS affirmatively state such treatment. However, if Treasury and the IRS do not agree that they have the authority to add disallowed interest carryforward to the list of attributes subject to reduction under section 108(b)(2), a statutory amendment is necessary.

2. Interaction with Section 108(e)(2)

<u>Overview</u>

Section 108(e)(2) provides that no income is realized from the discharge of indebtedness to the extent that payment of the liability would give rise to a deduction. It is unclear whether taxpayers can avoid CODI if accrued but unpaid interest on the cancelled debt is disallowed under section 163(j) (i.e., a disallowed interest deduction).

<u>Recommendations</u>

The AICPA recommends that Treasury and the IRS clarify whether section 108(e)(2) applies to the discharge of interest expense that is disallowed as an interest deduction if paid.

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[53] Section 381(c)(20).
[54] Section 381(a).
[55] Section 382(d)(3).

If Treasury and the IRS conclude that section 108(e)(2) should not apply to interest limited by section 163(j), we recommend that Treasury and the IRS provide rules that would treat such discharged interest expense as a disallowed interest deduction eligible for carryover under section 163(j)(2).

Analysis

As discussed above, CODI (including interest owed) is generally included in gross income. However, under section 108(e)(2), to the extent that payment of a liability would give rise to a deduction, no income is realized from the discharge of indebtedness and no attribute reduction is required.[56] For example, a cash-basis taxpayer will not recognize CODI to the extent discharged interest expense would have resulted in a deduction, if paid.[57]

As discussed above, section 163(j) can apply to limit a taxpayer's business interest expense deduction. It is unclear whether an interest deduction limited by section 163(j) is considered an amount that would have given rise to a deduction for purposes of section 108(e)(2). Neither section 108(e)(2) nor section 163(j) address this issue and the legislative history is similarly silent.

> *Example 1*
>
> In year 1, Taxpayer accrued $10 of business interest, which was disallowed under section 267(a)(3) (or section 163(e)(3)) until it was paid. In year 2, Taxpayer was discharged of the $10 of accrued interest from year 1 before it was paid. If the business interest had been paid in year 2, it would have been disallowed under section 163(j).

In Example 1, section 108(e)(2) should apply because the payment of the interest would *give rise* to a deduction even if such deduction is also subject to section 163(j). The fact that section 163(j) would have disallowed the business interest had it been paid should not alter whether section 108(e)(2) applies. The application of section 108(e)(2) in Example 1 appears to fall within the underlying purpose of section 108(e)(2). However, taxpayers require clear guidance that section 108(e)(2) would apply in this context.

Based on the foregoing, we recommend that Treasury and the IRS clarify that section 108(e)(2) applies to interest that, if paid, would be limited by section 163(j). Alternatively, if Treasury and

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[56] The legislative history of section 108(e)(2) provides that it was intended to allow cash-basis taxpayers who were discharged of a liability that would give rise to a deduction to utilize it. *See* S. Rep. No. 96-1035 (1980) at 20:

> The bill provides that if the payment of a liability would have given rise to a deduction, the discharge of that liability does not give rise to income or require reduction of tax attributes. For example, assume a cash-basis taxpayer owes $1,000 to its cash-basis employee as salary and has not actually paid such amount. If later the employee forgives the debt (whether or not as a contribution to capital), then the discharge does not give rise to income or require any reduction of tax attributes.

See also H.R. 96-833 at 16 (containing the same language).

[57] Section 108(e)(2) could also apply to interest accrued by an accrual basis taxpayer that is subject to section 267. Section 267(a)(2) provides that payments by an accrual method taxpayer to a related cash method taxpayer are not deductible until the payee includes the amount in income. Similarly, section 267(a)(3) requires accrual method taxpayers to use the cash method of accounting with respect to the deduction for amounts owed to a related foreign person (e.g., interest expense).

the IRS conclude that section 108(e)(2) should not apply to interest that would be limited by section 163(j), we recommend that Treasury and the IRS provide rules that would treat such discharged interest expense as a disallowed interest deduction eligible for carryover under section 163(j)(2) such that taxpayers are not required to include an amount in income without the corresponding deduction.

VI. Partnership Related Items

1. Intercompany Transfer of a Partnership Interest in Nonrecognition Transactions

Overview

Section 163(j)(4)(B)(iii)(I) generally provides that a partner's adjusted basis in its partnership interest is reduced (but not below zero) by the amount of excess business interest expense allocated to that partner. Section 163(j)(4)(B)(iii)(II) further provides that if a partner disposes of its partnership interest, the adjusted basis of the partner's interest is increased, immediately before the disposition, by the amount of the excess (if any) of this basis reduction over the amount of any excess interest expense that was treated as paid by the partner (i.e., excess interest expense that was deducted by the partner against ETI of the same partnership). By its terms, section 163(j)(4)(B)(iii)(II) applies to the transfer of a partnership interest in a transaction "in which gain is not recognized in whole or in part." In the Preamble to the proposed regulations, Treasury and the IRS requested comments on these rules with respect to the intercompany transfer of a partnership interest among consolidated group members.

Recommendation

The AICPA recommends that the intercompany transfer of a partnership interest in a nonrecognition transaction is treated as a disposition for purposes of section 163(j)(4)(B)(iii)(II).

Analysis

In the Preamble, Treasury and the IRS requested comments on whether the intercompany transfer of a partnership interest in a nonrecognition treatment is treated as a disposition for purposes of section 163(j)(4)(B)(iii)(II). As mentioned above, this provision clearly contemplates that a disposition of a partnership interest includes a transaction "in which gain is *not recognized* in whole or in part."[58] The legislative history, moreover, provides no indication otherwise.

2. Tiered Partnerships Carryforward Allocation

Overview

Treasury and the IRS have requested comments regarding whether, in a tiered partnership arrangement, carryforwards (i.e., excess business interest expense) are allocated through the upper-tier partnerships (UTP).

[58] Emphasis added.

Generally, the statute and the proposed regulations thereunder provide for an entity-level application of the section 163(j) limitation, and the excess business interest expense – or disallowed portion of a partnership's business interest expense – is allocated to the partners pursuant to the mechanics prescribed by Prop. Reg. § 1.163(j)-6(f)(2).

In addition, Treasury and the IRS have emphasized within the Preamble that the manner of allocating section 163(j) excess items (i.e. ETI, excess business interest expense, and excess business interest income) must consistently apply with five specific issues. One of these issues is that section 163(j) applies at the partnership level.[59]

<u>Recommendation</u>

The AICPA recommends that the IRS and Treasury issue final regulations clarifying that, in the context of a tiered partnership, the allocation of excess business interest expense to an UTP is not carried through the UTP. To maintain consistency and satisfy the guiding principles outlined by Treasury and the IRS in the Preamble, we recommend that any allocation of excess business interest expense to a UTP pursuant to Prop. Reg. § 1.163(j)-6(f)(2) remains suspended until the next taxable year in which the UTP is allocated ETI from such lower-tier partnership (LTP).[60]

<u>Analysis</u>

If the allocation of excess business interest expense to a UTP flows through to the partners of the UTP, the first of the five specific principles identified by Treasury and the IRS is not satisfied since there is not a true application of the section 163(j) rules at the partnership level of the UTP.

The following example modifies two examples from Prop. Reg. § 1.163(j)-6(o) to demonstrate the AICPA's recommended approach in the context of a tiered partnership structure. This example illustrates how the excess business interest expense allocated to an UTP is suspended at that UTP until ETI is later allocated (from the same lower tier partnership which allocated the excess business interest expense) in order to re-apply the 163(j) rules at that partnership entity level.

<u>Example</u>

The facts are the same as Examples 1[61] and 2,[62] except that Partner X is an UTP (referred to here as "UTP X") with respect to PRS partnership. In addition, UTP X

[59] See Section 6.D.i of the Preamble.
[60] Proposed Reg. § 1.163(j)-6(g)(2).
[61] "Example 1. (i) Facts. X and Y are equal partners in partnership PRS. In Year 1, PRS has $100 of ATI and $40 of business interest expense. PRS allocates the items comprising its $100 of ATI $50 to X and $50 to Y. PRS allocates its $40 of business interest expense $20 to X and $20 to Y. X has $100 of ATI and $20 of business interest expense from its sole proprietorship. Y has $0 of ATI and $20 of business interest expense from its sole proprietorship."
[62] "Example 2. (i) Facts. The facts are the same as in Example 1 of this paragraph (o). In Year 2, PRS has $200 of ATI, $0 of business interest income, and $30 of business interest expense. PRS allocates the items of its $200 of ATI $100 to X and $100 to Y. PRS allocates its $30 of business interest expense $15 to X and $15 to Y. X has $100 of ATI and $20 of business interest expense from its sole proprietorship. Y has $0 of ATI and $20 of business interest expense from its sole proprietorship."

has two partners, X1 and X2, who are equal partners in UTP X. The analysis below focuses on partner UTP X and its partners X1 and X2.

In Year 1, PRS allocated deductible business interest expense of $15 and excess business interest expense of $5 to each of UTP X and Y. At the level of UTP X, this partnership has ATI of $100 and business interest expense of $20 from its own operations.

In this modified example, applying the approach recommended by the AICPA, UTP X in Year 1 still has a section 163(j) limitation of $30 ($100 ATI * 30%), and deductible business interest expense of $20. The excess business interest expense of $5 is held at the level of UTP X until ETI is allocated from partnership PRS to release it. The $5 excess business interest expense does not flow through to partners X1 and X2. Note that since UTP X is itself a partnership in this modified example, UTP X also has ETI of $33.33 [(10/3) * ($30 Limitation - $20 deductible business interest expense)] in Year 1, which is allocated between its partners X1 and X2 pursuant to the mechanics prescribed by Prop. Reg. § 1.163(j)-6(f)(2).

In Year 2, PRS allocated deductible business interest expense of $15 and ETI of $50 to each of UTP X and Y. At the level of UTP X, this partnership has ATI of $100 and business interest expense of $20 from its own operations.

In this modified example, applying the approach recommended by the AICPA, UTP X in Year 2 still has a section 163(j) limitation of $45 ($150 ATI * 30%), and deductible business interest expense of $25. The ATI includes not only $100 from its sole proprietorship, but also $50 from the ETI allocated from PRS. The deductible business interest expense includes not only $20 of business interest expense from UTP X's sole proprietorship, but also $5 of excess business interest expense from PRS that was carried forward from Year 1. This $5 of excess business interest expense (previously allocated from PRS) becomes deductible in Year 2 because of the ETI allocated from PRS which releases it. Note that since UTP X is itself a partnership in this modified example, UTP X also has ETI of $66.67 [(10/3) * ($45 Limitation - $25 deductible business interest expense)] in Year 2, which is allocated between its partners X1 and X2 pursuant to the mechanics prescribed by Prop. Reg. § 1.163(j)-6(f)(2).

3. Basis Adjustments Upon Disposition of Partnership Interests Pursuant to Section 163(j)(4)(B)(iii)(II)

<u>Overview</u>

Treasury and the IRS requested comments on the issue of basis adjustments where a partner disposes of less than substantially all of its interest in a partnership. Proposed Reg. § 1.163(j)-6(h)(2) provides that a partner shall not increase its basis in its partnership by the amount of any excess business interest expense that the partner has not yet treated as paid or accrued in accordance with Prop. Reg. § 1.163(j)-6(g).

Recommendations

The AICPA recommends that Treasury and the IRS define "substantially all" as used in Prop. Reg. § 1.163(j)-6(h)(3) to mean 80% or more of a partner's interest in profits or capital of the partnership.

The AICPA also recommends that Treasury and the IRS replace the method described in Prop. Reg. § 1.163(j)-6(h)(3)(ii) with the second alternate approach discussed in the Preamble,[63] which would require a partner to track its basis in the partnership interest in a manner similar to that set forth in Rev. Rul. 84-53.

Analysis

The phrase "substantially all" appears in other areas of guidance including, but not limited to, section 41(d)(1)(C), section 368(a)(1)(C), and section 1400Z-2(d). Regulations or other guidance have each defined "substantially all" differently for purposes of the applicable code section. These references provide insight into a reasonable definition of "substantially all" in this context.

Under section 41(d)(1) in order for activities to constitute qualified research, substantially all of the activities must constitute elements of a process of experimentation that relates to a qualified purpose. Under Treas. Reg. § 1.41-4(a)(6), the substantially all requirement is satisfied if 80% or more of a taxpayer's research activities constitute elements of a process of experimentation that relates to a qualified purpose.

Under section 368(a), certain reorganizations require that substantially all of the assets are transferred or acquired. Under advance ruling guidelines found in Section 3.01 of Rev. Proc. 77-37, a transfer of assets that constitutes 90% of the value of the target's net assets (and 70% of the value of the target's gross assets) immediately prior to the transfer is considered substantially all of the assets.

Under section 1400Z-2(d)(3)(A), in order for a trade or business to qualify as a qualified opportunity zone business, substantially all of the tangible property owned or leased by the taxpayer must qualify as opportunity zone business property. Under Prop. Reg. § 1.1400Z-2(d)-1(c)(3), the substantially all requirement is satisfied if at least 70% of the tangible property owned or leased is qualified opportunity zone business property.

We recommend that Treasury and the IRS define "substantially all" of a partnership interest, for purposes of a partial disposition under section 163(j), to mean 80% or more of a partner's interest in profits or capital of the partnership. This definition would provide a consistent interpretation within the meaning of Prop. Reg. §1.163(j)-6(h)(3) and comparable to how the term is defined for other code sections.

[63] "A second approach would increase the partner's remaining basis in the partnership interest by the amount of excess business interest expense that is proportionate to the amount of the partner's adjusted basis in the partnership interest that was transferred or redeemed. This method would require a partner to track its basis in the partnership interest in a manner similar to that set forth in Rev. Rul. 84-53, 1984-15 I.R.B. 17, 1984-1 C.B. 159 (Apr. 9, 1984)." Limitation on Deduction for Business Interest Expense, 83 Fed. Reg. 248 (Dec. 28, 2018); page 67509.

Generally, in the case of a partial disposition of a partnership interest, Rev. Rul. 84-53 determines the amount of basis of the transferred portion based on the ratio of the fair market value of the portion sold over the fair market value of the entire partnership interest. Rev. Rul. 84-53 cites Treas. Reg. § 1.61-6(a), which provides that when a part of a larger property is sold, the cost or other basis of the entire property is equitably apportioned among the several parts for purposes of determining gain or loss on the part sold.

Other partnership provisions also address how to handle a partial or complete disposition of a partnership interest. For instance, Treas. Reg. § 1.704-1(b)(2)(iv)(l) provides that the capital account attributable to the transferred interest carries over to the transferee partner.

In the event of a partial disposition, Prop. Reg. § 1.163(j)-6(h)(3)(ii) appears to cause a mismatch between the amount of the capital account that transfers in a partial disposition of a partnership interest and the tracking of the excess business interest expense. For example, a transferor's capital account that includes a reduction for the excess business interest expense is carved up based on the portion attributable to the transferred interest and is carried over to the transferee partner but the transferor's basis under section 705 remains unaffected. Additionally, other tax attributes, such as section 704(c) built-in gains and losses (except section 704(c)(1)(C) amounts), may partially transfer over to a transferee partner and may result in unintended differences between a partner's capital account under section 704(b) and its outside basis (which still reflects a reduction for excess business interest expense) under section 705.

Because of this potential disparity, we recommend that Prop. Reg. § 1.163(j)-6(h)(3)(ii) instead adopts a method similar to that set forth in Rev. Rul. 84-53 to increase the transferor's basis in its partnership interest, by utilizing a ratio of the excess business interest expense equaling the same ratio of the transferor's basis in its partnership interest used in determining its gain or loss pursuant to Rev. Rul. 84-53. This method would cause the amount of excess business interest expense remaining with the transferor to better align with the transferor's expected future economic share. The following example illustrates the application of this procedure.

> <u>*Example 1*</u>
>
> On January 1, 2018, A and B each contribute $100 in exchange for an interest in newly-formed AB Partnership. A and B agree to allocate all items of income, gain, loss, and deduction generated by AB equally. On December 31, 2018, A has a basis in its partnership interest of $60 before taking into account any interest expense. A's distributive share of AB's excess business interest expense is $40, which is not yet treated as paid or accrued. On March 1, 2019, A sells one-fourth of its partnership interest (which is considered less than "substantially all" of A's partnership interest) to C, an unrelated party, for $25. A first calculates the portion of excess business interest expense attributable to the partial disposition, which is $10 ($40 times 25%). Next, A increases its basis immediately before the disposition by the portion of excess business interest expense attributable to the partial disposition. The result is a basis in A's partnership interest of $30 (($60 - $40) + $10). A then multiples its basis immediately before the disposition by the percentage of interest that is disposed. The result, $7.50 ($30 x 25%), is the amount

of basis used to calculate the $17.50 ($25 - $7.50) of gain A recognizes on the disposition of its partnership interest. Finally, A's basis in its remaining 37.5% (50% times (1- 25%)) interest in AB partnership is $22.50 ($30 - $7.50) and A will have $30 ($40 - $10) of remaining excess business interest expense.

VII. International Tax Items

1. Excess Adjusted Taxable Income Limitation within a Controlled Foreign Corporation Group

Overview

The proposed regulations allow any excess ATI limitation to flow from lower to higher tier CFCs, but do not allow the excess ATI limitation to flow from higher to lower tier CFCs.

Recommendation

The AICPA recommends that the final regulations provide that the excess ATI in any CFC with a CFC Group Election in place is available for utilization by any other CFC in that CFC group.

Analysis

Proposed Reg. § 1.163(j)-7(c) allows for upper tier CFCs to utilize the excess ATI of lower tier CFCs provided a CFC Group Election is in place. However, the proposed regulations do not allow for a lower tier CFC subject to the section 163(j) interest expense limitation to utilize excess ATI from an upper tier CFC.

The proposed approach of allowing CFCs within the CFC group to share excess ATI is reasonable due to the fungibility of money. However, the AICPA notes that money is fungible in all directions, not solely from lower-tier to higher-tier CFCs, and not allowing use of the excess ATI limitation to all members of the CFC group is inequitable. In addition, we are unaware of a policy reason to limit the excess ATI to flow only from lower to higher-tier CFCs, as taxpayers could restructure their CFC ownership structures to place entities with higher excess ATI below entities with lower or no excess ATI. Such restructurings would require substantial time and cost. To avoid imposing this burden on taxpayers, the AICPA recommends that the final regulations provide that all CFCs within a group covered by a CFC Group Election may share excess ATI limitation without the need to restructure.

2. Excess Adjusted Taxable Income limitation of a Single Controlled Foreign Corporation

Overview

The proposed regulations allow any excess ATI limitation from a group of CFCs that are part of a CFC Group Election to flow upward to the U.S. shareholder to the extent of income inclusions.

Recommendation

The AICPA recommends permitting U.S. shareholders with an interest in only a single CFC to utilize the CFC's excess ATI as if a CFC Group Election was made covering the single CFC.

Analysis

Proposed Reg. § 1.163(j)-7(d) allows the U.S. shareholder of a group of CFCs with a CFC Group Election to increase the U.S. shareholder's ATI by any excess ATI in the CFC group. The proposed regulations provide that the ability of U.S. shareholders to utilize the benefit of excess ATI in CFCs is only available for CFCs where a CFC Group Election is in place. Furthermore, Prop. Reg. § 1.163(j)-7(b) provides that only taxpayers that own multiple CFCs may make a CFC Group Election. The election and its benefits are not available to taxpayers owning a single CFC.

Taxpayers could avoid this limitation by forming a second CFC and making a CFC Group Election for the two CFCs. Forming and maintaining the second CFC, while carving out some business operations within the supply chain solely to operate this second CFC would impose additional costs and result in unnecessary inefficiencies to taxpayers. There is no reasonable policy basis for requiring a taxpayer to take these unnecessary steps to attain the ability to flow the excess ATI limitation up to the U.S. shareholders. As operations with only one CFC are often indicative of the operations of small businesses performing their first expansion offshore, denying this provision to them would put small businesses at a disadvantage over larger multinational operations. A U.S. shareholder of a single CFC should receive similar treatment for any excess ATI limitation from that CFC. Accordingly, we recommend permitting them to utilize the CFC's excess ATI.

3. Computing the Adjusted Taxable Income of an Applicable Controlled Foreign Corporation

Overview

Treasury and the IRS requested comments on whether the principles of Treas. Reg. § 1.952-2 should apply for determining a CFC's taxable income for purposes of section 163(j). As stated in the Preamble, "For example, questions have arisen as to whether a CFC should be allowed a dividends-received deduction under section 245A, even though section 245A by its terms applies only to dividends received by a domestic corporation."

Recommendation

The AICPA recommends that Treasury and the IRS apply the principles of Treas. Reg. § 1.952-2 for determining a CFC's taxable income for purposes of section 163(j). We specifically recommend that the dividends received deduction (DRD) under section 245A is allowed in determining a CFC's taxable income for purposes of section 163(j).

Analysis

In describing the availability of the DRD under section 245A, footnote 1486 on page 599 of the

Joint Explanatory Statement of the Committee of the Conference for the TCJA states:

> "Including a controlled foreign corporation treated as a domestic corporation for purposes of computing the taxable income thereof. See Treas. Reg. § 1.952–2(b)(1). Therefore, a CFC receiving a dividend from a 10-percent owned foreign corporation that constitutes subpart F income may be eligible for the DRD with respect to such income."

The AICPA agrees with the application of Treas. Reg. § 1.952-2(b)(1) in this context. Tax attributes of the foreign corporation are included in calculating the taxable income of the domestic corporation, and therefore, it is appropriate to apply the rules for determining taxable income of a domestic corporation to the CFC.

For example, under the CFC Group Election, the proportionate share of the excess ATI of each lower-tier CFC is "rolled up" to the upper-tier CFCs. In addition, the U.S. shareholder may generally add to its taxable income an amount equal to its proportionate share of the eligible CFC excess ATI of the highest-tier member(s). As the U.S. shareholder is including in taxable income an attribute (the excess ATI) from its upper-tier CFCs, it is appropriate to calculate this attribute under the rules for determining taxable income of a domestic corporation.

On the question of whether a CFC is entitled to a DRD under section 245A, footnote 1486 of the Conference Report quoted above clearly indicates that Congress anticipated that section 245A would apply to dividends received by a CFC in certain circumstances. The AICPA believes that the calculation of taxable income for purposes of section 163(j) is one of those circumstances.

VIII. Small Business Relief from Definition of Tax Shelter

The AICPA requests that Treasury and the IRS provide certain small businesses relief from the definition of a tax shelter to ensure that they will qualify for the small business simplifying provisions (including those in section 163(j)) available under the TCJA. Please see our detailed comments and recommendations on this issue in our letter to the IRS dated February 13, 2019. [64]

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[64] https://www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/20190213-small-business-relief-from-definition-of-tax-shelter-letter.pdf.