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Proposed Regulations Would Implement U.S. Interest Stripping Rules After Tax Reform

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As we have noted previously, the *Tax Cuts and Jobs Act of 2017* dramatically changed the limitation on the deductibility of interest expense under section 163(j).[1] Under the revised provision, the limitation applies to all taxpayers (not just to corporations) and to business interest paid to unrelated (as well as related) parties, but not to investment interest. Amended section 163(j) reduces the percentage limitation on interest expense deductions to 30% of the borrower's EBITDA (and further restricts it to 30% of EBIT after 2021) and introduces more restrictive rules relating to the interest expense of partnerships. Finally, the new provision permits certain real property, farming and utility businesses to avoid the limitation.

On November 26, 2018, the IRS released proposed regulations that provide more detail on how section 163(j) will be applied. The new rules are proposed to be effective for taxable years ending after the date that the final version of the proposed regulations are published in the *Federal Register*, although a taxpayer may generally apply the rules to taxable years beginning after December 31, 2017, provided that the parties related to the taxpayer also apply those rules.[2]

Among the more important provisions in the proposed regulations are the following:

Definition of Interest. In the preamble to the proposed regulations, the IRS notes that there is no generally applicable definition of interest under federal tax law. Nevertheless, the regulations define "interest" for the purposes of section 163(j) broadly, and explicitly include items such as original issue discount, accrued market discount, certain hedges, substitute interest payments, commitment fees, debt issuance costs and certain terms in connection with a swap.

Definition of Trade or Business. The proposed regulations apply section 163(j) separately to each trade or business conducted by a taxpayer and provide rules for allocating interest income and expense between trades and businesses that are subject to section 163(j) and those that are excepted from the new rules.

Ordering Rules. The proposed regulations provide that the limitation under section 163(j) is applied after other provisions of the Code that defer, capitalize or disallow interest expense, except for the limitations on passive activity losses and at-risk amounts and certain other provisions. The IRS reserved on the interaction between section 163(j) and the BEAT. Special ordering rules are also provided for suspended interest carryforwards from previous years. The proposed regulations provide that business interest expense is deducted in the current taxable year before any disallowed business interest expense carryforwards are deducted in that year. These ordering rules are necessary, in part, to prevent section 163(j) carryforwards from using up all of a corporations section 382 limitation, if applicable.

C Corporations. The IRS confirmed that all interest income and expense of a C corporation is considered business interest income and expense (and not investment interest and expense, which, as noted above, is not subject to the section 163(j) limitation). Accordingly, the proposed regulations provide that any allocations of investment interest income or expense from a partnership to a partner that is a C corporation are recharacterized as business interest income or expense at the partner level.

Detailed rules are provided regarding the effect of section 163(j) on a C corporation's earnings and profits. Under these rules, a C corporation should generally reduce its earnings and profits for the full amount of its business interest expense immediately, regardless of whether that expense is limited by section 163(j). Exceptions are provided for RICs and REITs, carryovers from the previous version of

section 163(j) that were already reflected in the C corporation's earnings and profits, and excess business interest expense allocated from a partnership.

The proposed regulations provide – consistently with the amended statute – that a corporation that acquires the assets of another corporation in certain tax-free reorganizations and liquidations succeeds to disallowed business interest expense carryforwards of the corporation whose assets were acquired.

Consolidated Groups. The proposed regulations provide that a consolidated group (but not an affiliated group that does not file a consolidated return) has a single section 163(j) limitation. Specific rules are provided regarding the calculation of the limitation and adjusted taxable income in the context of such groups. The proposed regulations provide that the SRLY limitation applies to disallowed business interest expense.

Partnerships. The proposed regulations provide a long series of technical rules for applying section 163(j) in the context of passthrough entities. But the IRS reserved on some of the more difficult topics in this area, such as self-charged lending transactions, tiered passthrough structures and partnership mergers and divisions. The proposed regulations provide several rules intended to prevent double-counting that may have unintended results.

International Issues. The proposed regulations include rules on applying section 163(j) to CFCs, including a new election to apply section 163(j) to multiple CFCs on an aggregate basis. The proposed regulations also provide rules to ensure that, for a foreign person engaged in a trade or business in the United States, section 163(j) takes into account only income and expense effectively connected to that trade or business.

Exception for Electing Real Property Trade or Business. Under the statute, a taxpayer engaged in a real property trade or business may elect out of section 163(j). The proposed regulations provide some detail on how this election applies. For instance, the proposed regulations provide that the election does not terminate when a taxpayer transfers all the assets of the real property trade or business to a related party.

The new rules provide a special safe harbour for REITs intending to elect out of section 163(j). The definition of "real property trade or business" used for the purposes of the electing real property trade or business exception generally does not include real property financing. Under the safe harbour, if the real property financing assets of a REIT make up 10% or less of the REIT's assets, then all of the REIT's assets are treated as real property trade or business assets.

As noted above, the proposed regulations otherwise provide allocation rules for exempt and non-exempt businesses, focusing generally on asset basis as the allocation method.

Regulated Utilities. Business interest expenses associated with regulated utilities are exempt from section 163(j) without a special election being made. If more than 10% of the business is associated with non-rate-regulated sales, however, an allocation between exempt and non-exempt businesses is required.

Summary

The new earnings stripping rules in the Code will apply broadly to taxable businesses in the United States, particularly if an election out is not available. The proposed regulations provide a sensible if somewhat cumbersome series of rules for applying the new statute. Even though the proposed regulations exceed 400 pages in length, the IRS has reserved or requested comments on many issues.

Interestingly, the preamble to the proposed regulations closes with a detailed defence of its approach, including a discussion of certain alternatives that were considered and rejected (such as adopting a tracing-of-proceeds approach instead of an asset-basis allocation method to allocate business interest income and expense between exempt and non-exempt trades or businesses). The preamble claims that over 80,000 taxpayers are likely to elect out of the new rules and a large number of small taxpayers will be exempt because they have average annual gross receipts of under $25 million; consequently, the IRS expects that fewer than 92,500 taxpayers will be subject to the new section 163(j) limitation.

[1] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (Code).

[2] "Related" for the purposes of the effective date provision looks to sections 267(b) and 707(b)(1), which generally treat persons as related if one owns more than 50% of the other or the same persons own more than 50% of both.

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