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IRS Releases Final Regulations on Deductibility of Business Interest Expense

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The IRS recently released long-awaited final regulations (Final Regulations) on the limitation on the deductibility of interest expenses under section 163(j), along with new proposed regulations (New Proposed Regulations) that address a variety of highly technical issues that are not covered by the Final Regulations and that provide guidance related to COVID-19 relief provisions in the *Coronavirus Aid, Relief, and Economic Security Act* (CARES Act).

The wait seems to have been justified: The Final Regulations and the New Proposed Regulations, which were released on July 28, 2020, are generally more taxpayer-favourable than expected and clear up some confusion created by the previous package of regulations (Prior Proposed Regulations) on which the Final Regulations are largely based. The provisions of the Final Regulations and the New Proposed Regulations apply broadly to U.S. businesses and the worldwide operations of U.S. multinationals, and include narrow statutory exclusions and some related irrevocable elections.

Section 163(j) generally limits a taxpayer's deduction for net business interest expense to 30% of the taxpayer's "adjusted taxable income," as defined under section 163(j). The provision provides significant exceptions for certain utility, real estate, energy and motor vehicle businesses, and provides complex rules for indebtedness owed by and business conducted through a partnership. In addition, section 163(j) does not apply to certain small taxpayers if the average of the taxpayer's gross annual receipts over the three prior years is \$25 million or less.

Currently, adjusted taxable income for the purposes of section 163(j) generally corresponds to a taxpayer's EBITDA, although for taxable years beginning in 2022 the definition of adjusted taxable income will be changed to correspond to a taxpayer's EBIT, which by definition is expected to result in the limitation becoming narrower in 2022 and later years.

The IRS has taken pains to incorporate taxpayers' comments on the Prior Proposed Regulations in drafting the Final Regulations. The preamble of the Final Regulations dedicates hundreds of pages to methodically describing and discussing the scores of comments received on the Prior Proposed Regulations. The good news is that, as noted above, many of the changes are taxpayer-favourable and reflect the IRS's continuing interest in providing practical solutions to interpretive issues relating to the *Tax Cuts and Jobs Act of 2017*.

The Final Regulations

Some significant provisions of the Final Regulations are described below:

Reduced Scope of Interest. The definition of "interest" in the Prior Proposed Regulations was widely criticized by the tax community as being overly broad. That definition of interest included certain items that were not controversial, such as original issue discount and accrued market discount, but also included certain hedges and swaps, substitute interest payments, debt issuance costs, commitment fees and guaranteed payments from partnerships. In addition, the Prior Proposed Regulations included an anti-avoidance rule that could subject almost any expense or loss incurred in consideration of the time value of money to the section 163(j) limitation.

The Final Regulations narrow this definition in several respects by (i) providing an exception from section 163(j) for certain swaps; (ii) limiting the application of section 163(j) to substitute interest payments only if the payment relates to a sale-repurchase or securities lending transaction that is not entered into by the taxpayer in the ordinary course of its business; and (iii) eliminating commitment fees, debt issuance costs, guaranteed payments from partnerships and hedges from the definition of interest for section 163(j) purposes, since

commentators raised convincing arguments that these types of payments are not always analogous to interest. However, the IRS left the door open to subjecting guaranteed payments and hedges to section 163(j) by including examples involving guaranteed payments and hedges under the anti-abuse rule.

Aggregation Rules. The Prior Proposed Regulations used an entity-based approach to affiliated groups and other groups of related taxpayers. Generally, under those rules, affiliated C corporations that do not file a consolidated tax return and partnerships owned by C corporations or groups of C corporations are required to determine their section 163(j) limitations on an entity-by-entity basis. The Final Regulations generally follow the Prior Proposed Regulations by permitting entities to be aggregated for the purposes of section 163(j) only if those entities are C corporations that file a consolidated tax return.

Partnerships. One notable feature of the Prior Proposed Regulations was the dizzying complexity of the rules applying section 163(j) in the partnership context. Notably, the Prior Proposed Regulations provided an 11-step calculation to allocate a partnership's section 163(j) excess items to each of its partners. Many commentators suggested simpler alternatives to the 11-step calculation, but the IRS retained the 11-step calculation in the Final Regulations because of its precision and because the IRS believes that the partnerships required to perform the 11-step calculation are already experienced in handling the complexities associated with other partnership-specific tax attributes, such as special allocations and section 704(c) allocations. The IRS did, however, provide an exception from the 11-step calculation for partnerships that allocate all items of income and expense among their partners on a pro rata basis.

On a disposition of a partnership interest, the Prior Proposed Regulations permitted the basis of the partnership interest to be increased to reflect any remaining business interest expense allocated to the disposing partner, but permitted this recovery only if the partner disposed of its entire partnership interest. The Final Regulations relax this rule by allowing a partner to recover a proportionate amount of that additional basis when the partner disposes of a portion of its partnership interest.

The IRS noted that many commentators asked for clarification on how the basis adjustment for remaining excess business expense should be applied in the context of an intercompany transfer of a partnership interest. The IRS reserved on this provision while it continues to study the issue.

Excepted Trades or Businesses. Section 163(j) does not apply to certain excepted trades or businesses, such as certain utility businesses or certain real estate businesses that file an election to be excluded from section 163(j). The Prior Proposed Regulations provided a variety of rules for allocating tax items relevant to section 163(j) between excepted and non-excepted businesses of a single taxpayer. The Final Regulations retain a number of these rules, including certain *de minimis* rules that simplify the allocation of tax items between excepted and non-excepted trades or businesses when most of a taxpayer's trade or business consists of a certain type of activity. For example, if 90% or more of a taxpayer's assets are allocated to an excepted or non-excepted trade or business, then all of the taxpayer's assets are treated as relating to such excepted or non-excepted trade or business, respectively. In addition, the Final Regulations provide some technical rules to clarify the operation of these *de minimis* rules, such as rules on the order in which the *de minimis* rules should be applied.

Discharge of Indebtedness. The IRS noted that the interaction of the discharge of indebtedness rules under section 108 and the section 163(j) limitation is complex, and accordingly the IRS is continuing to study the issue before releasing regulations.

The New Proposed Regulations

The IRS issued the New Proposed Regulations concurrently with the Final Regulations. The provisions of the New Proposed Regulations generally address specific technical details of the application of section 163(j). The New Proposed Regulations include provisions on the following issues:

- provisions that generally relax the compliance burden of section 163(j) with respect to groups of controlled foreign corporations;
- changes to the treatment of taxpayers who realize income effectively connected with a U.S. trade or business, generally intended to eliminate certain economic distortions;

- changes to the way that a publicly traded partnership determines the basis of its assets in order to preserve the fungibility of interests in the publicly traded partnership;
- rules to determine the tax treatment of interest expenses paid with respect to debt incurred to finance a distribution from a partnership;
- provisions to determine the excess business expense and excess business income allocated to a partner with respect to a loan from that partner to the partnership (i.e., self-charged interest);
- rules under which an allocation of excess business expense in a tiered partnership structure can affect the upper-tier partnership's basis in the lower-tier partnership, but not the basis of the upper-tier partnership's partners; and
- provisions on how to apply the increase in the percentage limitation to 50%, from 30%, under the CARES Act in the partnership context.

Effective Dates

The Final Regulations provide that they may generally be relied on by taxpayers for taxable years beginning after December 31, 2017, so long as the rules are applied consistently. Alternatively, taxpayers may generally rely on the Prior Proposed Regulations for taxable years beginning after December 31, 2017, and before the date that the Final Regulations are published in the *Federal Register*, so long as the rules are applied consistently.

Conclusion

The Final Regulations reflect the IRS's continuing interest in responding to taxpayers concerns throughout the process of providing regulatory guidance under the *Tax Cuts and Jobs Act of 2017*. Many of the finalized provisions are taxpayer-favourable and are intended to ease the burden of compliance with section 163(j).

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