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All in the Family

Applying the Business Interest Expense Limitation of Section 163(j) Within Groups

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Bios

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Agenda

1. Section 163(j) General Rule and Scope
2. Tiered Partnerships
3. Consolidated Groups
4. Controlled Foreign Corporations

Section 163(j) General Rule and Scope

Basic Elements of Section 163(j)

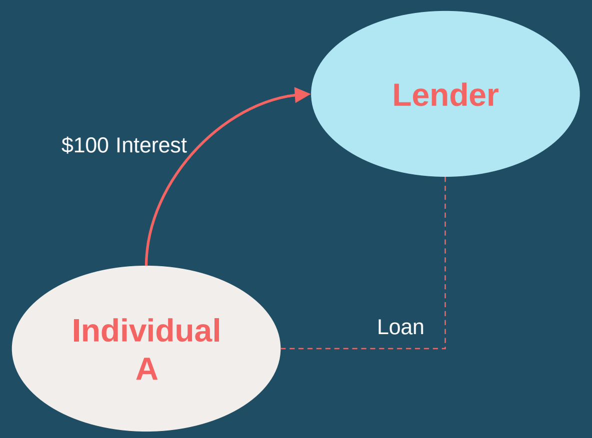
Key Formula*

- Limits the amount of business interest expense (“**BIE**”) that can be deducted to the sum of a taxpayer’s business interest income (“**BII**”) *plus* 30% of the taxpayer’s adjusted taxable income (“**ATI**”)

163(j) Limitation = .30(ATI) + BII

Key Terms

- Adjusted Taxable Income
- Business Interest Expense
- Business Interest Income
- Trade or Business
- Interest



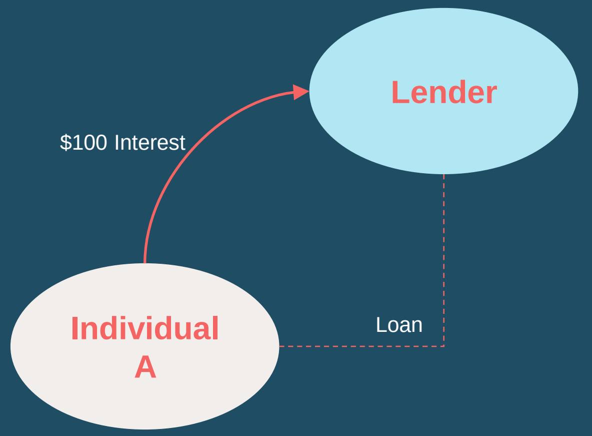
Individual A’s 163(j) Limitation	
BIE	$100
ATI	$100
BII	$0
163(j) Limitation	**$30**

**The presentation does not address rules related to floor plan financing.*

Adjusted Taxable Income

Adjusted Taxable Income

- “Tentative Taxable Income” with certain adjustments:
    - **<u>Increased by</u>** BIE, NOL deductions, 199A deductions, capital loss carryback/carryover deductions, deductions or losses not allocable to a non-excepted trade or business, and ***for taxable years beginning before 1/1/2022***, any deduction allowable for depreciation, amortization and depletion; and
    - **<u>Decreased by</u>** BII, income or gain that is not allocable to a non-excepted trade or business, and certain adjustments for sales or other dispositions of property, stock or partnership interests.
- Section 263A – Allowed as ATI addback for pre-2022 tax years



Individual A’s 163(j) Limitation	
BIE	$100
ATI	$100
BII	$0
163(j) Limitation	**$30**

Tiered Partnerships

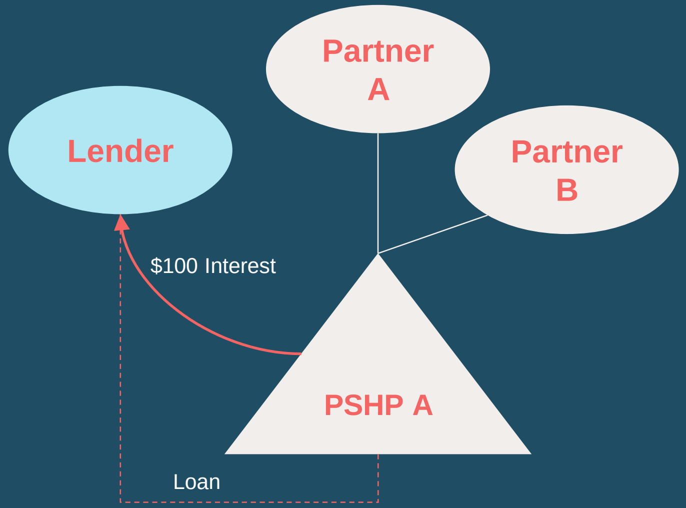
Treatment of Partnerships

General

- 163(j) limitation applies at ***partnership*** level

Additional Key Terms

- Deductible Business Interest Expense (DBIE)
- Excess Business Interest Income (EBII)
- Excess Business Interest Expense (EBIE)
- Excess Taxable Income (ETI)

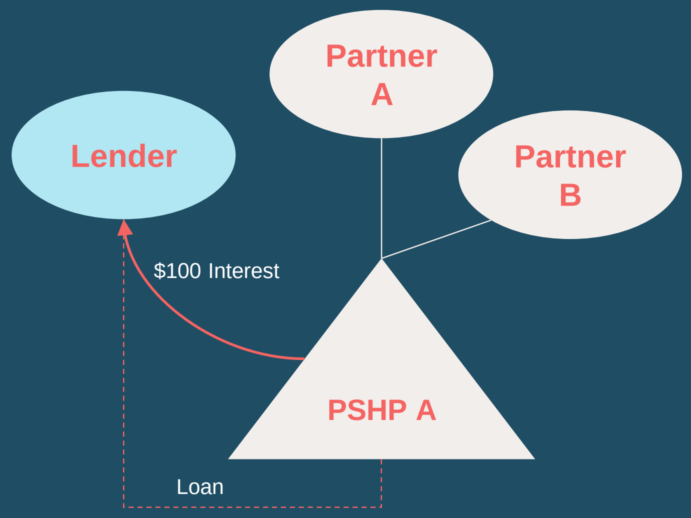


PSHP A's 163(j) Limitation	
BIE	$100
ATI	$100
BII	$0
163(j) Limitation	**$30**

Section 163(j) Excess Items

Allocation of DBIE and Excess 163(j) Items

- Excess items (i.e., EBIE, EBII and ETI) are dealt with at the ***partner*** level
- Partner's share of BIE, BII or items comprising ATI determined under section 704 of the Code and regulations thereunder
- 11-step computation applicable ***solely*** for the purpose of determining each partner's DBIE and section 163(j) excess items



PSHP A's 163(j) Limitation	
BIE	$100
ATI	$100
BII	$0
163(j) Limitation	**$30**

ATI of Partnership and Partner

ATI of a Partnership

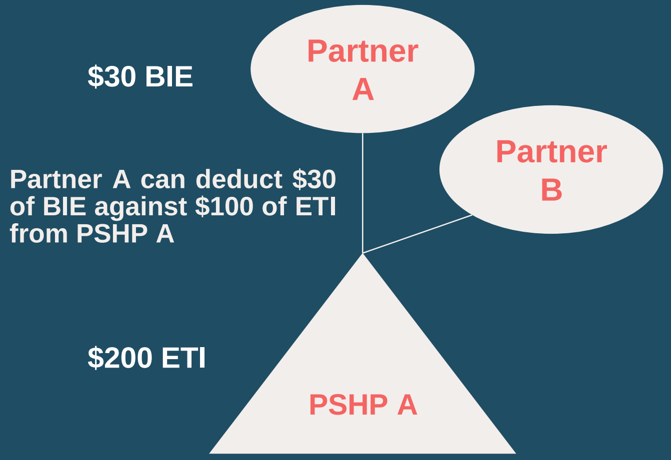
- Partnerships do not take into account "partner basis items" (i.e., adjustments pursuant to 743(b) or built-in loss property under 704(c)(1)(C) and remedial items)

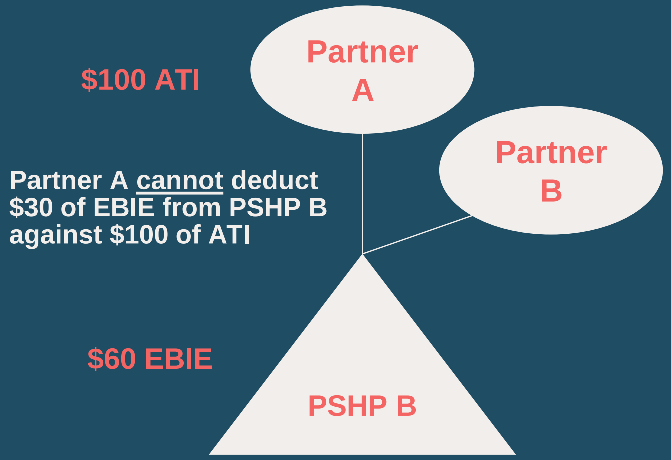
ATI of a Partner

- Determined without regard to distributive share of partnership items (but with regard to share of ETI)
- Takes into account partner basis items

Excess 163(j) Items

- ETI increases ATI
- EBII increases BII
- EBIE not immediately treated as BIE—must be allocated ETI/EBII in subsequent year from the same partnership
- EBIE basis adjustments





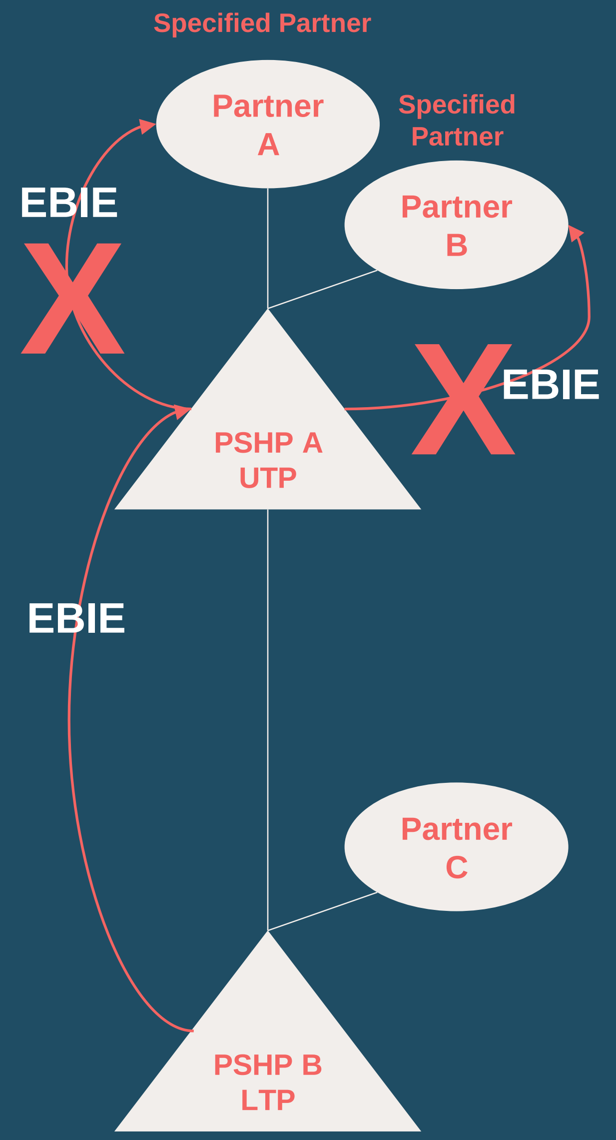
Intro to Tiered Partnerships

2020 Proposed Regulations

- Original Proposed Regulations reserved on entity versus aggregate approach
- 2020 Proposed Regulations adopt ***entity*** approach
- Basis and capital account adjustments

UTP EBIE

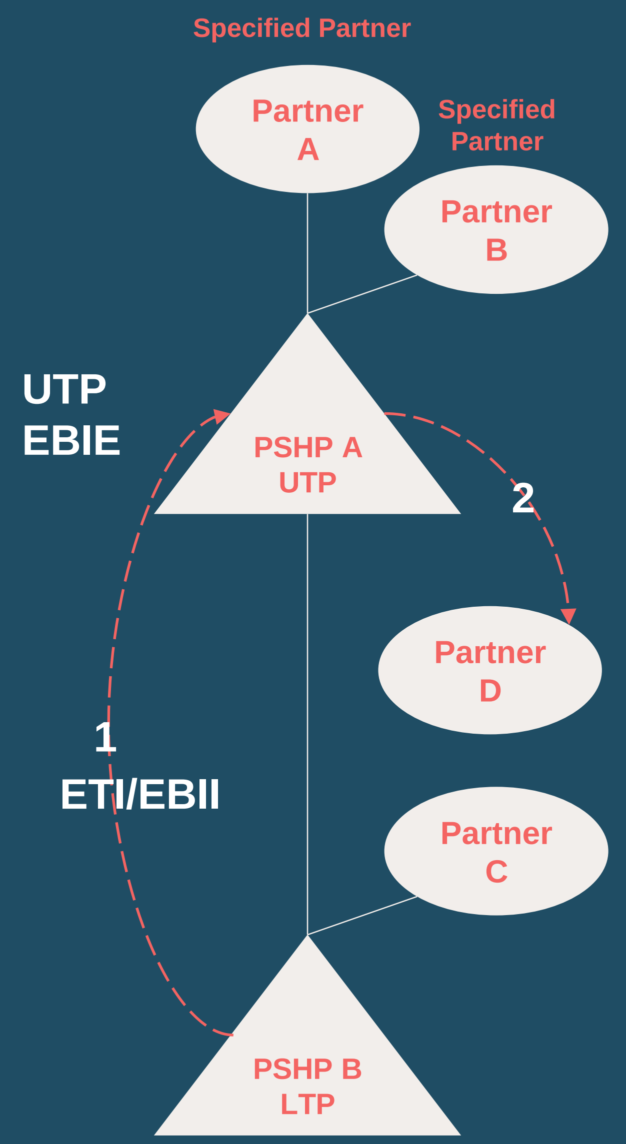
- Tracing of Specified Partners
  - Transferee Specified Partners – step into shoes
  - Redeemed Specified Partners – create special UTP account
- Basis and carryforward component



UTP EBIE Conversion Events

1. **LTP allocates ETI/EBII to UTP**
   - A. **Step 1:** Determine which UTP EBIE is treated as BIE
   - B. **Step 2:** Allocate BIE that was formerly UTP EBIE to the applicable specified partners
   - C. **Step 3:** Adjust for any negative basis adjustments under 734(b) previously made to such UTP EBIE and specified partners adjust for any negative 743(b) adjustments
2. **UTP disposes of its LTP Interest**
   - A. **Step 1:** Determine which UTP EBIE is reduced
   - B. **Step 2:** Increase basis in LTP interest by the total amount of UTP EBIE that is reduced
   - C. **Step 3:** Adjust for any negative 734(b)/743(b) adjustments previously made to such UTP EBIE
   - D. **Step 4:** Adjust basis in partnership property by the amount of basis increase in the same manner as positive 734(b) adjustment

Anti-Loss trafficking rules



Anti-Loss Trafficking Rules

- Determine whether UTP EBIE treated as BIE has a “Specified Partner”
  - ***Yes***, Determine whether the “Specified Partner” reduced its capital account upon initial allocation of EBIE from LTP to UTP
    - ***Yes***, Any deduction for such BIE or increase in basis upon disposition of LTP interest is ***not*** disallowed under anti-loss trafficking rules
    - ***No***, Determine whether Specified Partner is a “contributor transferee specified partner”
      - ***Yes***, Any deduction for such BIE or increase in basis upon disposition of LTP interest is ***not*** disallowed under anti-loss trafficking rules
      - ***No***, Any deduction for such BIE and any increase in basis upon disposition of LTP interest is ***disallowed*** under anti-loss trafficking rules
  - ***No***, In the case of the first conversion event, capitalize the basis (if any) of such BIE into the basis of UTP partnership property, and in the case of the second conversion event, no basis addback

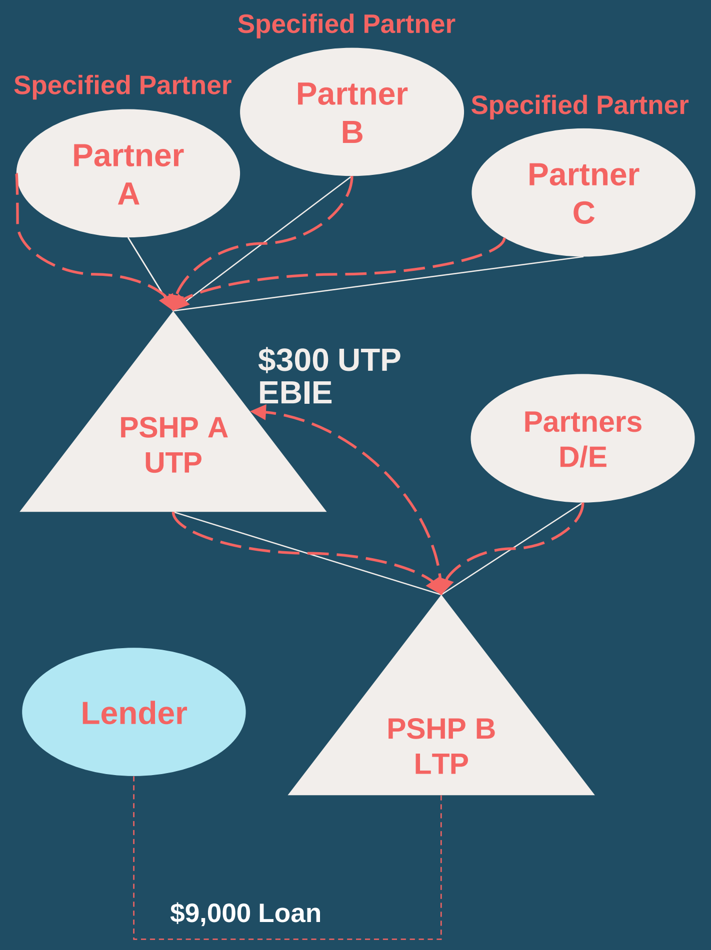
Example

Formation

- A, B and C form UTP by contributing $1,000 cash in exchange for a one-third interest
- UTP, D and E form LTP by each contributing $1,200 cash in exchange for a one-third interest
- LTP borrows $9,000, resulting in each LTP partner increasing its basis in LTP by $3,000
- Partners of UTP each increase their basis in UTP by $1,000 as a result of this borrowing

Year 1 Results

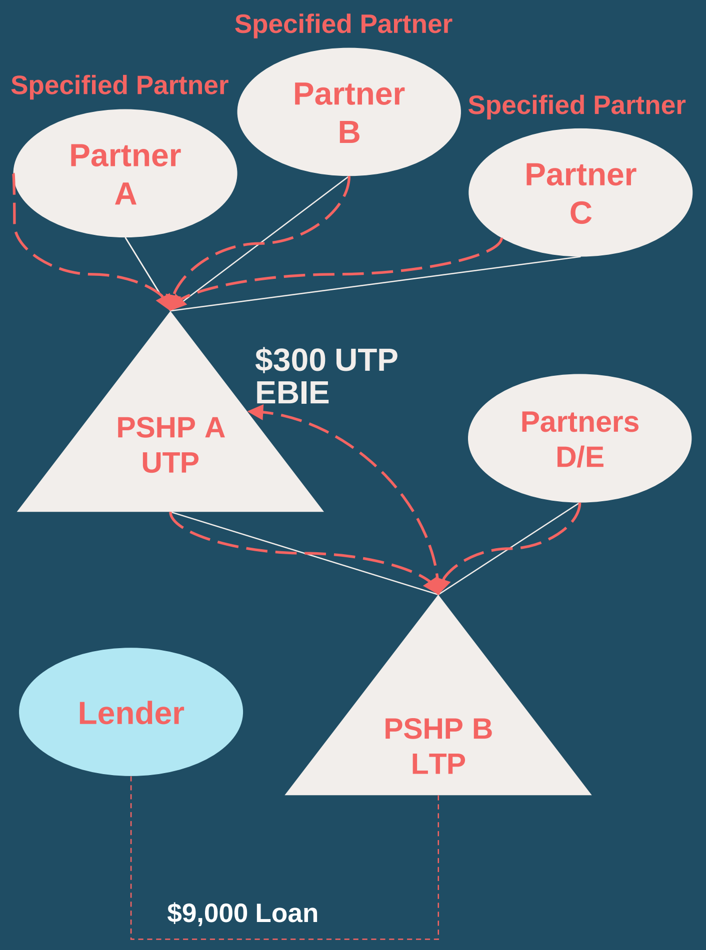
- LTP has $900 of BIE, $0 ATI and $0 BII (i.e., $900 EBIE)
- LTP allocates $300 of EBIE to each of its partners
- This results in A, B and C each being specified partners in respect of $100 of UTP EBIE
- While UTP, D and E reduced their basis in LTP by the amount of EBIE, the direct partners of UTP do **not** reduce the basis of their interests in UTP



Example

UTP Balance Sheet – End of Year 1						
	Assets			Liabilities and Capital		
	Tax	Book		Tax	Book	
Cash	$1,800	$1,800	**Liability**	$3,000	$3,000	
LTP	3,900	3,900	**Capital**			**Basis**
UTP EBIE	300	0	**A**	1,000	900	$2,000
			B	1,000	900	$2,000
			C	1,000	900	$2,000
TOTAL	**$6,000**	**$5,700**		**$6,000**	**$5,700**	**$6,000**

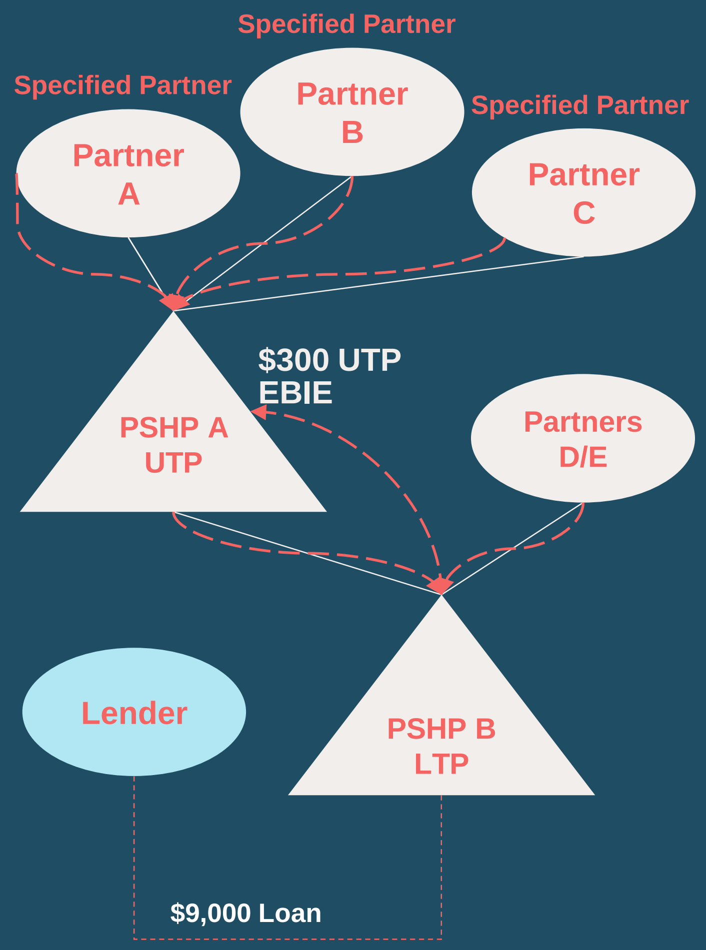
LTP Balance Sheet – End of Year 1						
	Assets			Liabilities and Capital		
	Tax	Book		Tax	Book	
Cash	$11,700	$11,700	**Liability**	$9,000	$9,000	
			Capital			**Basis**
			A	900	900	$3,900
			B	900	900	$3,900
			C	900	900	$3,900
TOTAL	**$11,700**	**$11,700**		**$11,700**	**$11,700**	**$11,700**



Tiered Partnerships

Example

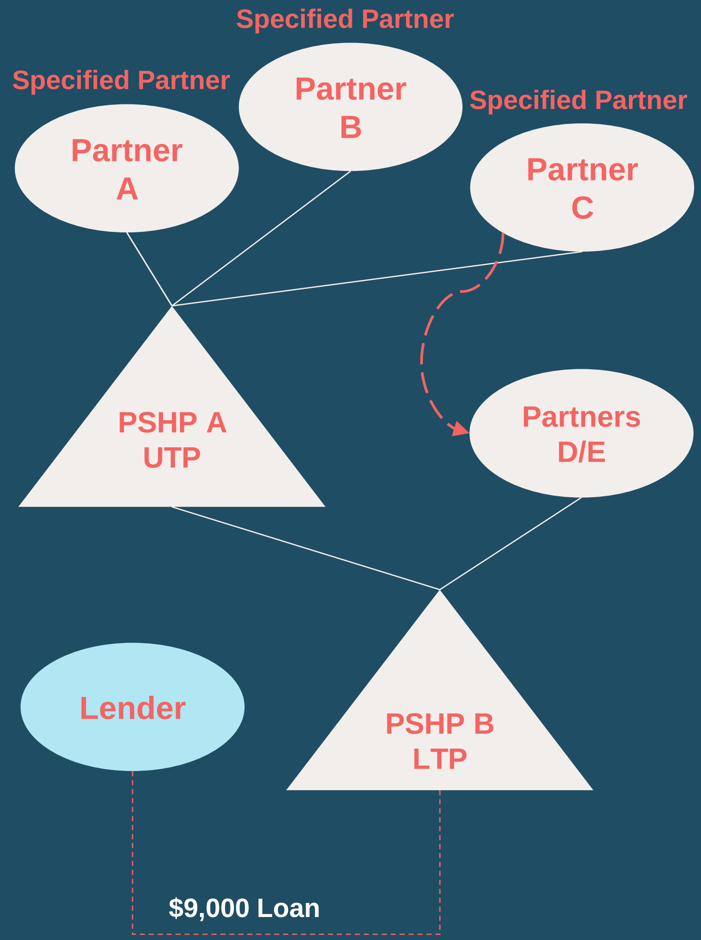
UTP EBIE – Year 1					
	Specified Partner			Partnership	
	Basis	Carryforward		Basis	Carryforward
A	$100	$100	**UTP**	$300	$300
B	100	100			
C	100	100			
TOTAL	**$300**	**$300**		**$300**	**$300**



Example

Year 2

- While a Section 754 election is in effect, C sells its UTP interest to D for $900
- Results in $100 741 loss
- D's initial basis in UTP is $1,900
- ($100) 743(b) basis adjustment allocated to UTP EBIE



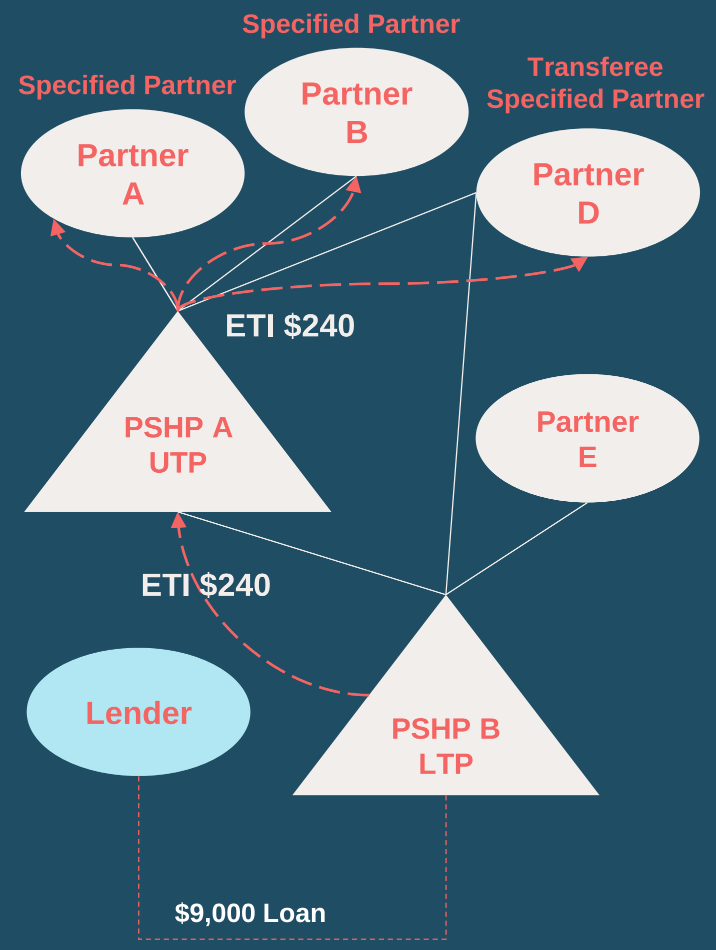
Example

Year 3

- LTP allocates $240 of its ETI to UTP, which allocates such ETI equally among its partners (assume no other 163(j) items)
- **Step 1:** UTP treats $80 of each partner's share of UTP EBIE as BIE
- **Step 2:** UTP allocates this BIE to its specified partners
    - A, B and D (a "transferee specified partner")
    - Each partner has $24 (i.e., 30% of $80) of deductible BIE and $56 of EBIE
- **Step 3:** D's share of $80 BIE was previously allocated ($80) negative 743(b) adjustment
    - Eliminates $24 deduction
    - D has $56 EBIE with a basis of $0

Anti-loss trafficking rules would have produced same result even if no Section 754 election

UTP EBIE – Year 3						
	Specified Partner				Partnership	
	Basis	743(b)	Carry forward		Basis	Carry forward
A	$20		$20	UTP	$60	$60
B	20		20			
D	20	(20)	20			
TOTAL	**$60**		**$60**		**$60**	**$60**

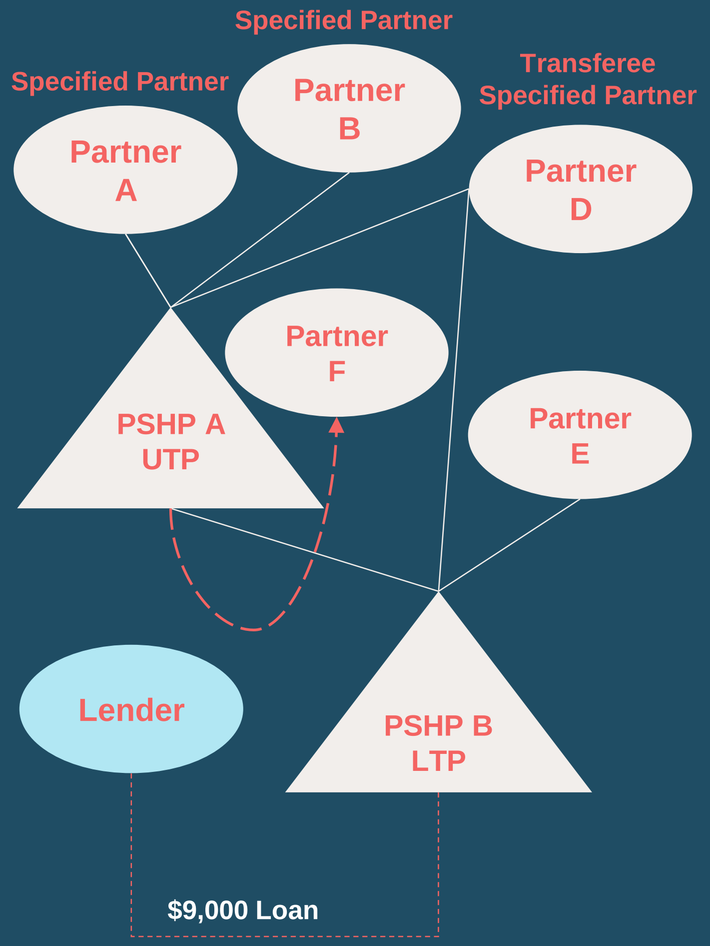


Example

Year 4

- UTP sells its LTP interest to Partner F for $1,140
- **Step 1:** UTP reduces its UTP EBIE by $60
- **Step 2:** UTP increases its adjusted basis in LTP by $60
- **Step 3:** UTP reduces its adjusted basis in LTP by $20 due to negative 743(b) adjustment
    - UTP recognizes $40 741 loss on sale
- **Step 4:** LTP has basis adjustment of $40

Anti-loss trafficking rules would have produced same result even if no Section 754 election



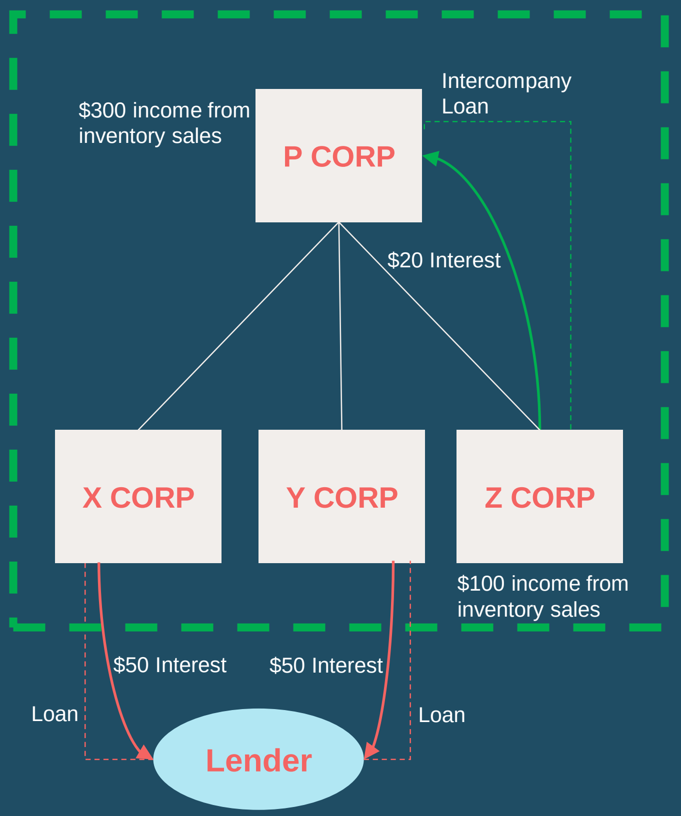
Consolidated Groups

Treatment of Consolidated Groups

General

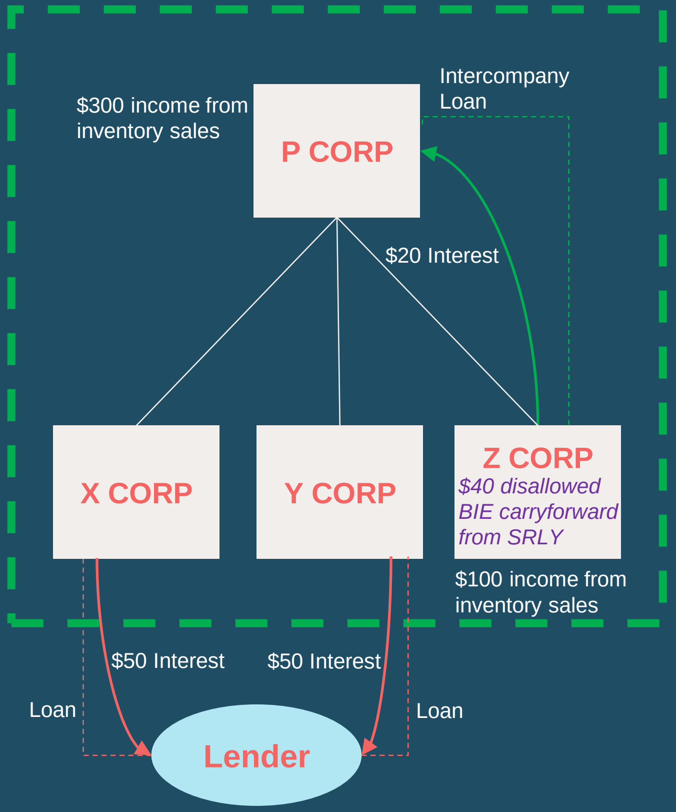
- ***Single*** 163(j) limitation for entire group
- Intercompany obligations are generally ***disregarded*** for 163(j) purposes
- No carryforward of excess limitation
- Disallowed BIE carried forward indefinitely

Note: Uncertainties/complexities for state tax purposes!



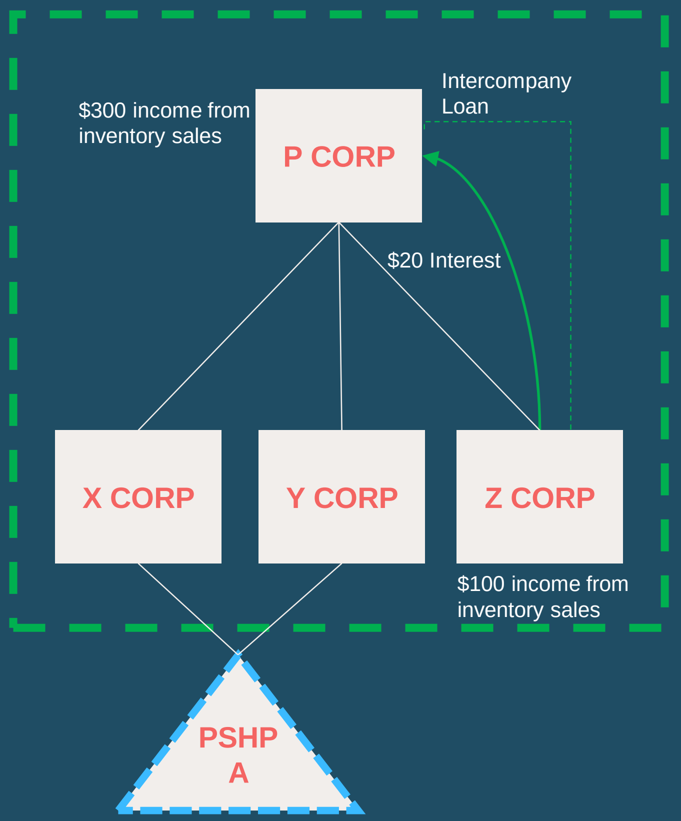
SRLY Rules

- Disallowed BIE carried forward from a SRLY is limited
- Cumulative SRLY register (similar to NOLs)
- Subgroup rules apply
- Use of disallowed BIE carryforwards is still subject to overall group 163(j) limitation



A Potential IRS Tactic?

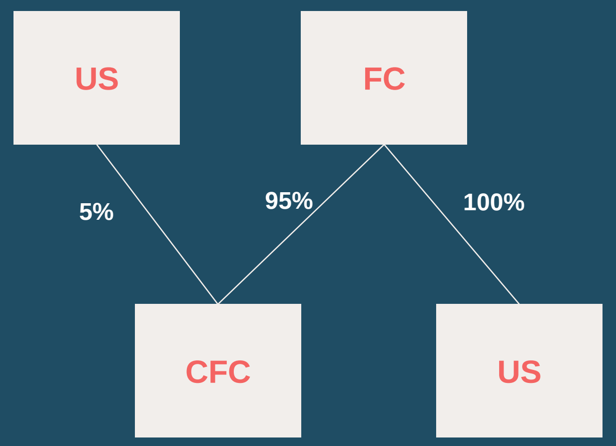
- Recall: 163(j) limitation applies at ***partnership*** level – even if all partners are consolidated group members
- Could IRS attempt to recast relationship between group members as constructive / de facto partnership?



Controlled Foreign Corporations (CFCs)

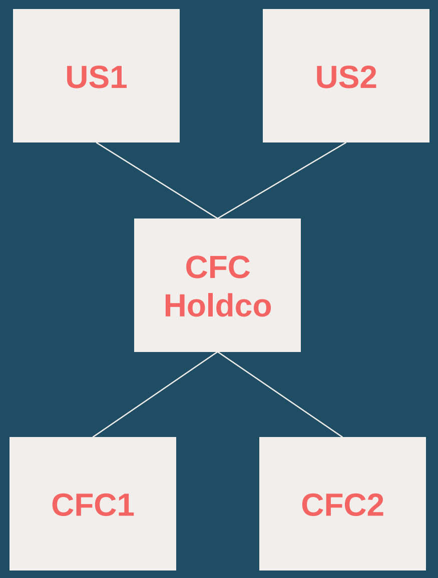
Controlled Foreign Corporations (CFCs)

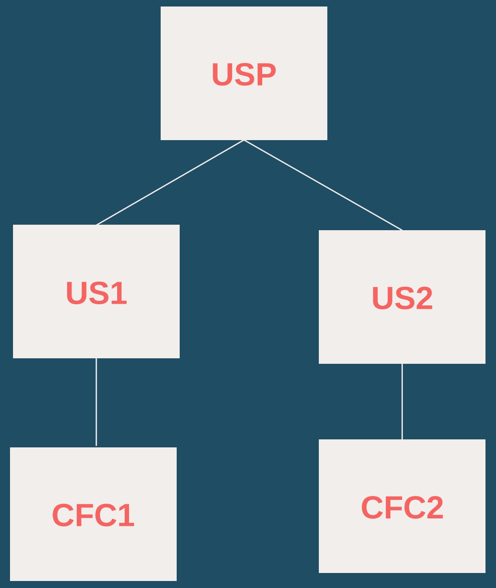
- Final Regulations make clear that section 163(j) applies to certain controlled foreign corporations and to foreign corporations with effectively connected income (ECI)
  - Relevant to computing subpart F income and tested income (*i.e.*, GILTI) of CFCs
- Section 163(j) applies to a CFC that has at least one U.S. shareholder that directly or indirectly owns stock in the CFC under section 958(a) (*i.e.*, not merely constructively under section 958(b))
- Also applies to other foreign corporations whose income is relevant for U.S. tax purposes



CFC Groups

- CFC group rules are included in the newly proposed regulations (prior proposed CFC group rules discarded)
- A CFC group is composed of CFCs with 80% direct or indirect stock ownership (by value) by a single CFC or by a single U.S. shareholder (the group parent)
  - Different from consolidated group rules:
    - Indirect ownership - looks through intervening partnerships
    - Only value (not vote) ownership taken into account





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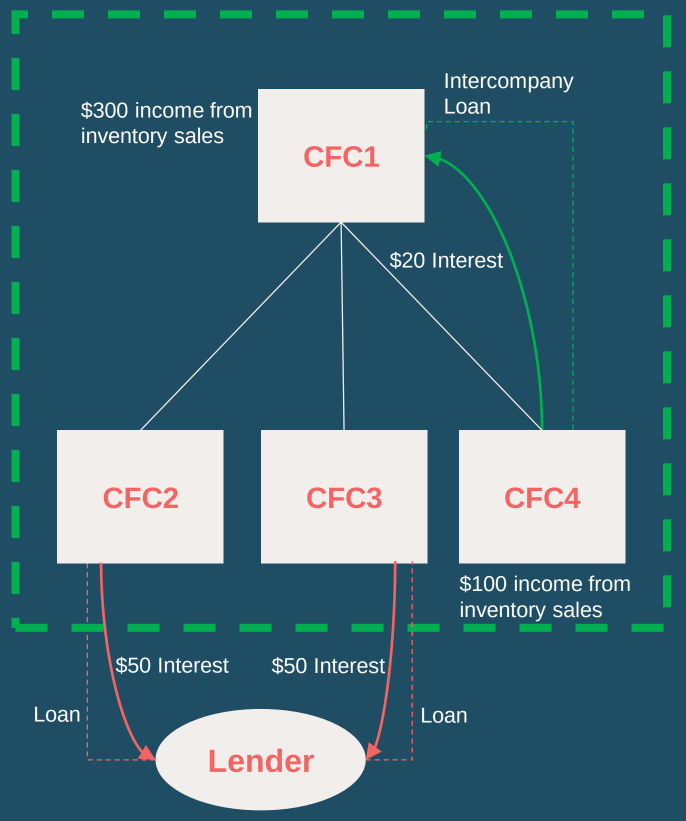
CFC Groups

- CFC grouping requires an election; otherwise, each CFC applies section 163(j) limitation separately
- The grouping election is made by a U.S. group parent or by the controlling U.S. shareholders of a CFC group parent
- CFC group election is revocable after 5 years; 5 year waiting period until election may be made again
    - SRLY-like rules applicable to BIE carryforwards of CFCs entering group
    - Subgroup rules apply (*i.e.*, SRLY subgroup concept)

CFC Group Limitation

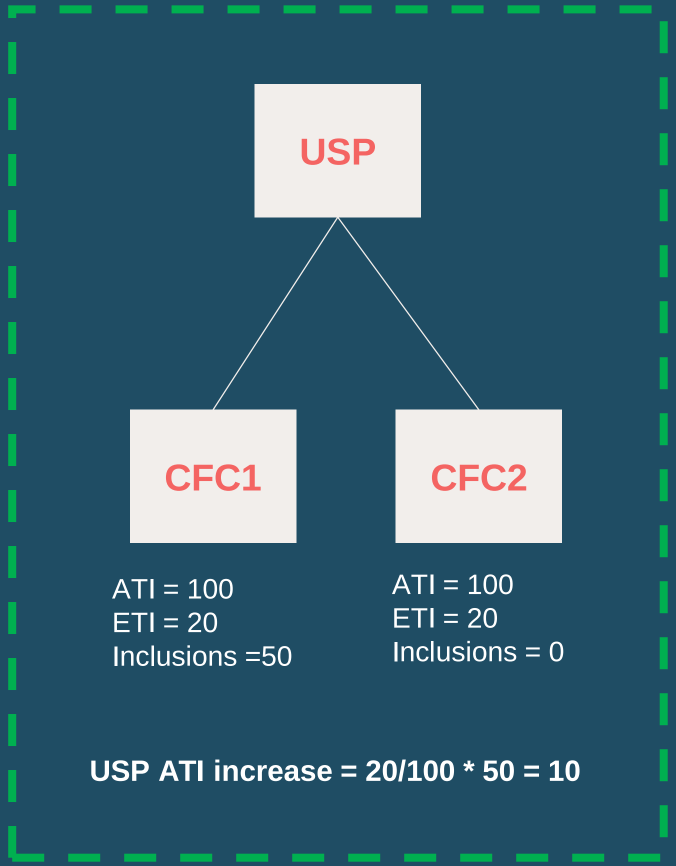
- ***Single*** 163(j) limitation for entire group
  - ATI, BII, BIE, BIE carryforward computed on a separate CFC basis
  - Amounts added together to compute group limitation
  - Group section 163(j) limitation =

    Aggregate BII plus 30% of aggregate ATI
- If BIE > group limitation
  - Each member deducts its BIE up to its BII
  - Remaining limitation is pro rated among members based on remaining BIE of each member
- Intercompany obligations are generally ***regarded*** for 163(j) purposes
- How does general rule that ATI cannot be less than zero affect CFC group computation?



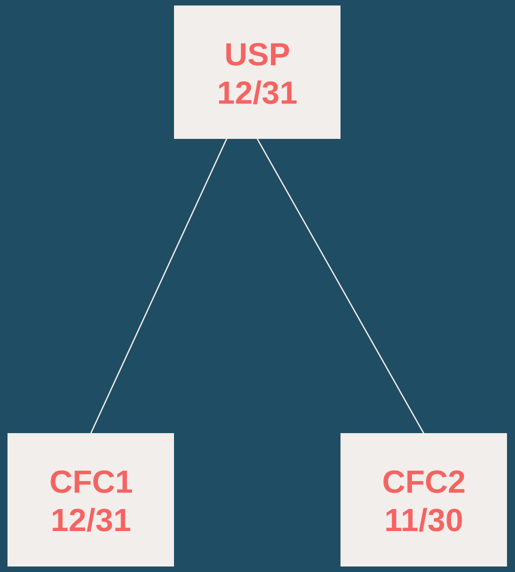
Excess Taxable Income

- ATI of U.S. shareholders may be increased by ETI of CFCs
  - ATI increase equals
    - ETI/ATI multiplied by
    - Total subpart F and GILTI inclusions
- Applies to standalone CFCs
- Applies to CFC groups only if there is CFC group election in place
  - Government concerned about manipulation of location of interest expense within CFC group in order to increase ETI



CFC Group Limitation

- U.S. parent and CFCs in a group may have different tax years
- CFC tax years that end with or within specified period are grouped
- ***Specified period*** of the CFC group is generally the taxable year of the group parent
    - For a parent that is a CFC, it is generally the majority US shareholder tax year (1 month deferral not taken into account)



Elective retroactive application of CFC group rules

- The proposed regulations may be retroactively applied for years beginning after 12/31/2017, provided that the section 163(j) regulations are applied consistently.
- A retroactive CFC group election (for tax years beginning after 12/31/2017) may be made on an amended tax return filed by the due date (with extensions) of the original Federal income tax return for the first tax year of each U.S. designated person ending after November 13, 2020.

THANK YOU

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