The New Section 163(j): Selected Issues

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Tax reform created new rules for limiting the deduction of business interest expense. This article explains the application of new section 163(j), compares the new rules with the prior rules, and discusses selected issues the new statute has created for taxpayers, with a focus on non-partnership entities. The issues addressed involve corporate investment interest, consolidated groups, electing real estate trade or business, and interest equivalents.

I. Introduction

On December 22, 2017, H.R. 1 (originally known as the Tax Cuts and Jobs Act of 2017) was signed into law (the "Act"). As part of the Act, Code section 163(j) was amended to create a broad deferral/disallowance regime with respect to the deductibility of “business interest expense.” Judging by the numerous drafting mistakes that the IRS has all but acknowledged, it appears that new section 163(j) was rushed into law without a full and careful review. Thus, it will be the job for years to come of the IRS, the courts, and tax practitioners to grapple with and work out the numerous problems and

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2 This article focuses on selected non-partnership issues arising under new section 163(j). For a discussion of various partnership issues with respect to new section 163(j), see our accompanying article The New Section 163(j): Partnership Issues, What’s News in Tax (Sept. 24, 2018).


4 Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the “Code”) or the applicable regulations promulgated pursuant to the Code (the “regulations”).

4 See Notice 2018-28 (issued Apr. 2, 2018), discussed below in the text.
mistakes of the new statute. Set forth below is a discussion of certain selected issues arising with respect to the new statute.

II. Selected Issues

A. General

Section 163(j) was amended by the Act to provide new rules limiting the deduction of “business interest expense” (“BIE”) for tax years beginning after December 31, 2017. Section 163(j) now provides that a taxpayer (including individuals and corporations) generally will be prohibited from deducting BIE in excess of the sum of its:

- Business interest income (“BII”),
- 30 percent of “adjusted taxable income” (“ATI”) from a trade or business, as further described below, and
- Floor plan financing interest\(^5\) for the tax year.\(^6\)

BIE is interest expense, and BII is interest income, that are properly allocable to a “trade or business,” but not investment interest expense or income under section 163(d). A “trade or business” does not include:

- The trade or business of performing services as an employee
- Any electing real property trade or business
- Any electing farming business
- The trade or business of the furnishing or sale\(^7\) of (1) electrical energy, water, or sewage disposal services, (2) gas or steam through a local distribution system, or (3) transportation of gas or steam by pipeline\(^8\)

For tax years beginning after December 31, 2017, and before January 1, 2022, ATI is defined as taxable income other than: (1) items not allocable to a “trade or business,” (2) BIE and BII, (3) net operating losses under section 172, (4) the 20 percent deduction for qualified business income.

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\(^5\) As floor plan financing interest applies to a very limited number of taxpayers, we will generally ignore this provision for purposes of this article.

\(^6\) Section 163(j)(1).

\(^7\) Provided that the rates for the furnishing or sale, as the case may be, have been established or approved by a state or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any state or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative.

\(^8\) Section 163(j)(7)(A).
pursuant to section 199A; and (5) depreciation, amortization, and depletion.9 For tax years beginning after December 31, 2021, depreciation, amortization, and depletion must be deducted in determining ATI.10 The exclusion of depreciation, amortization and depletion from ATI until such date (i.e., thereby increasing ATI, and consequently the 30 percent bucket of allowable BIE) should have the effect of putting off the day of reckoning with the new section 163(j) for many taxpayers.

Any disallowed interest may be carried forward indefinitely.11 However, unlike old section 163(j) (which allowed the carryforward of unused excess limitation, see below), unused ATI may not be carried forward to increase the ATI of the taxpayer in a subsequent tax year. For example, if a taxpayer has $200 of ATI and $30 of BIE in year 1, the taxpayer may use $100 out of the $200 of ATI to permit the deductibility of the BIE of $30. Nevertheless, the taxpayer may not carry forward the extra $100 of unused ATI to year 2 to permit the deductibility of another $30 of BIE in year 2. Section 163(j) applies after the rules for capitalizing interest under section 263A and after any other rules that otherwise disallow deductibility of interest, such as sections 265 and 279.12 The limitation on deductibility of interest applies to tax years beginning after December 31, 2017, and interest on existing debt instruments is not grandfathered.13

B. Carryforwards under Old Section 163(j)

Prior to the Act, section 163(j) disallowed a deduction for disqualified interest paid or accrued by a corporation in a tax year if two threshold tests were satisfied. The first threshold test was satisfied if the payor’s debt-to-equity ratio exceeded 1.5 to 1.0. The second threshold test was satisfied if the payor’s net interest expense exceeded 50 percent of its adjusted taxable income (generally, taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under section 199, depreciation, amortization, and depletion). Disqualified interest for this purpose included interest paid or accrued to: (1) related parties when no federal income tax was imposed with respect to such interest income; (2) unrelated parties in certain instances in which a related party guaranteed the debt; or (3) a real estate investment trust (“REIT”) by a taxable REIT subsidiary of that REIT. Interest amounts disallowed for any tax year under section 163(j) prior to the Act were treated as interest paid or accrued in the succeeding tax year and could be carried forward indefinitely. In addition, any excess limitation (i.e., the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor’s net interest expense) could be carried forward three years and offset against disqualified interest.

Clearly, new section 163(j) would not permit the use of any “excess limitation carryforwards” from pre-Act years to post-Act years as new section 163(j) expressly limits the use of BIE to 30 percent of the current ATI of the taxpayer. But upon enactment the question arose, what happens to the interest

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9 Section 163(j)(8)(A).
10 Section 163(j)(8)(A)(v).
11 Section 163(j)(2).
13 P.L. 115-97, § 13301(c).
expense carried forward under prior section 163(j) to post-Act years? Some practitioners even went so far as to suggest that such interest expense could be immediately deductible with no limitation at all.

However, on April 2, 2018, the IRS issued Notice 2018-28 (the “Notice”) which stated that Treasury and the IRS intend to issue regulations clarifying that taxpayers with disqualified interest disallowed under prior section 163(j) for the last tax year beginning before January 1, 2018, “may carry such interest forward as business interest to the taxpayer’s first tax year beginning after December 31, 2017.” Also, the regulations will clarify that the interest carried forward will be subject to potential disallowance under new section 163(j) “in the same manner as any other business interest otherwise paid or accrued” in a tax year beginning after December 31, 2017.

Thus, if read literally, it appears that if a taxpayer carries forward section 163(d) investment interest deferred under prior section 163(j), the interest would be transformed into BIE for purposes of new section 163(j) regardless of whether the taxpayer has any trade or business and any ATI or BII. Thus, the “deemed” BIE would not be deductible. Moreover, if a taxpayer elects in 2018 to be excluded from new section 163(j) as an electing real property trade or business (see further below), that taxpayer will not be treated as engaged in a “trade or business” and, hence, will not have ATI or earn any BII to use against the carried forward “deemed” BIE.

Both of these examples reach the wrong results. Instead, the carried forward old section 163(j) interest should be allocated in any given post-2017 year based on the relative values or adjusted bases of the taxpayer’s assets used in its trade or business or other types of activities in the current year. Thus, for example, in the case of a taxpayer that has two activities of equal sizes (i.e., based on either the fair market value or adjusted bases of the assets used in these activities), one being a section 163(j) active trade or business and one not (i.e., such as a pure investment activity or an electing real property trade or business), the carried forward old 163(j) interest should be equally allocated among the two activities such that 50 percent of the interest is treated as BIE, and 50 percent as non-BIE interest not subject to section 163(j). Hopefully, the quotation cited above from the Notice (“in the same manner as any other BIE otherwise paid or accrued”) will not be the approach adopted in the future regulations.

A related issue may arise where a taxpayer has disallowed business interest carryforwards pursuant to new section 163(j) and subsequently (e.g., in 2022) makes the electing real property trade or business election. In this situation, the taxpayer may never be able to deduct the disallowed business interest deductions because it is treated under section 163(j)(2) as business interest paid or accrued in the later carryforward year when the electing real property trade or business can no longer generate ATI (i.e., trade or business income.) Unlike the prior section 163(j) issue discussed above, which may be addressed by regulations or IRS guidance, this issue may need to be addressed with a technical correction because it results from the explicit mechanics of the statute.

C. Corporations

1. Investment Interest

Section 163(j) applies only to the deduction of “business interest,” which is defined as, “any interest paid or accrued on indebtedness properly allocable to a trade or business.” It does not include “investment interest (within the meaning of subsection (d)).” Section 163(d)(3)(A) defines “investment interest” as “any interest allowable as a deduction under this chapter…which is paid or accrued on indebtedness properly allocable to property held for investment.”

Consider a corporation that pays interest on indebtedness properly allocable to property held for investment. Should this interest be subject to the interest limitation rule of section 163(j) or would it escape the limitation, as it is not business interest? Although the limitations of section 163(d) on the deductibility of investment interest do not apply to corporations, section 163(d) makes no affirmative reference as to whether it is possible for corporate taxpayers to have “investment interest” and section 163(j) provides no express provision addressing this question. However, in a footnote in the 2017 conference report, Congress expressly provided the following:

Section 163(d) applies in the case of taxpayer other than a corporation. Thus, a corporation has neither investment interest nor investment income within the meaning of section 163(d). Thus, interest income and interest expense of a corporation is properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of the provision.

Similarly, Notice 2018-28 provides that consistent with congressional intent as reflected in the conference report (i.e., the above-cited footnote), Treasury and the IRS intend to issue regulations clarifying that, solely for purposes of section 163(j), for a taxpayer that is a C corporation, all interest paid or accrued by the C corporation on indebtedness of the C corporation will be business interest within the meaning of section 163(j)(5), and all interest on indebtedness held by the C corporation that is includible in gross income of the C corporation will be business interest income within the meaning of section 163(j)(6). Thus, the IRS’s position is clear: Corporations cannot have investment interest for purposes of section 163(j).

2. Consolidated Groups

The Notice states that Treasury and the IRS intend to issue regulations clarifying that the limitation in section 163(j)(1) on the amount allowed as a deduction for business interest applies at the level of the consolidated group and therefore, for example, it is the group’s ATI and the group’s interest expense...
and income (ignoring intercompany liabilities) that is used in applying section 163(j). Thus, although a particular corporate member of the group may have minority shareholders and may incur debt and interest expense for a business wholly different from that of other members of the group, nevertheless, the subsidiary’s interest expense, income, ATI, and so forth is aggregated with that of all the other members of the group. This is consistent with the approach adopted by the proposed regulations under old section 163(j) and recognizes that a consolidated group should be viewed as one taxpayer for this purpose. However, this seems at odds with the approach of the statute with respect to partnerships, as the provision is applied on a partnership-by-partnership entity basis in many respects, even though partnerships are flow-throughs and are generally not themselves taxpayers.

3. Earnings and Profits

The Notice also states that Treasury and the IRS intend to issue regulations clarifying that the disallowance and carryforward of a deduction for a C corporation’s BIE under section 163(j) will not affect whether or when the BIE reduces earnings and profits (E&P) of the payor C corporation. Indeed, this was the approach taken under proposed section 1.163(j)-1(e) and 1.163(j)-8(g) for prior section 163(j).

This creates an interesting consequence for controlled foreign corporations (“CFC”) not engaged in a U.S. trade or business that generate subpart F income and have BIE. Assuming new section 163(j) applies to such a CFC, any BIE so affected would still reduce the E&P of the CFC, and thereby may reduce its subpart F income as the latter is capped by the amount of that E&P. However, interestingly, new section 951A (“GILTI”) imposes a tax on non-subpart F income of a CFC, without any E&P cap. Instead, taxable income for GILTI purposes will apparently be determined based on the same U.S. tax principles applicable for domestic corporations. Thus, there may be an incentive for a highly leveraged CFC to organize its activities so that it generates subpart F income if it otherwise would be subject to BIE limitations under section 163(j) and a significant GILTI tax.

D. Electing Real Estate Trade or Business

A taxpayer may elect to be excluded from the interest deduction limitations of section 163(j) if the taxpayer is engaged in a “real property trade or business” under section 469(c)(7)(C). If the election is made it is irrevocable. While this election can yield significant benefits to a taxpayer, there is a price to pay for it—if a taxpayer makes the election, the taxpayer must depreciate nonresidential real property, residential rental property, and qualified improvement property under the ADS recovery period, i.e., longer lives and slower depreciation. For example, residential rental property placed in service before

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20 Section 952(c)(1)(A). It should be noted that if subpart F income is reduced for a year by reason of the E&P limitation, a “recapture account” must be created and non-subpart F income earned in future years must be recaptured as subpart F income.
21 See section 951A(c)(2).
22 Section 163(j)(7)(A), (B).
23 Section 163(j)(7)(B).
2018 would convert to an ADS life of 40 years. Thus, when determining whether to make the election, taxpayers engaged in a real property trade or business will have to weigh the benefit of no section 163(j) interest limitation versus the cost of slower depreciation deductions. In fact, given the exclusion of deductions for depreciation, amortization, and depletion in calculating the interest limitation amount, i.e., ATI, under section 163(j) through 2021, some may find that section 163(j) will not actually limit interest deductions for tax years prior to 2022. Accordingly, some taxpayers engaged in a real property trade or business may wait until 2022 to elect out of the section 163(j) interest limitation rules in order to take advantage of the more beneficial depreciable lives.

The term "real property trade or business" is defined as "any real property development, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business." The legislative history makes clear that the real property exception is not limited to rental businesses and indicates that it is "intended that a real property operation or a real property management trade or business includes the operation or management of a lodging facility."

The election to opt out of section 163(j) for taxpayers engaged in a real property trade or business may provide taxpayers with interesting planning alternatives, assuming there are sufficient business purposes to support the planning. For example, consider a taxpayer that is not engaged in a real estate trade or business, owns encumbered real property such as its own corporate headquarters, and whose BIE is limited under section 163(j). The taxpayer could form a private REIT or a controlled partnership and sell or contribute tax free the real property to the REIT/partnership. The taxpayer could then lease the property back from the REIT/controlled partnership and, in return, make lease payments to the REIT/partnership. (The taxpayer may raise additional financing by issuing or selling equity in the REIT/partnership to third parties as a non-tax purpose, for example.) As the REIT/partnership is engaged in a real property trade or business, i.e., the rental of real property, and section 163(j) is applied at the partnership level (and certainly at the REIT level in the case of a REIT), it could elect to opt out of the section 163(j) interest limitation rules and its interest expense on the loan encumbering the headquarters would be exempt from those limitations. At the same time and as a result of this restructuring, the taxpayer’s BIE amount would be correspondingly reduced by the amount of the

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24 Sections 163(j)(7)(B) and 469(c)(7)(C).
26 In the case of the REIT, the rent earned from the leaseback will not be REIT qualifying rent if the lease is to a corporation in which, after taking account certain attribution rules under section 318, the REIT owns, directly or indirectly, stock possessing 10 percent or more of the total combined voting power of all classes of stock entitled to vote, or 10 percent or more of the total value of shares of all classes of stock, or in the case of any person which is not a corporation, an interest of 10 percent or more in the assets or net profits of such person. However, a REIT should not be deemed to own its own shareholders and a lease to such a shareholder should produce REIT qualifying rent. See Rev. Rul. 74-605, 1974-2 C.B. 97 (sale of stock of a second tier subsidiary ("Sub2") by a first tier subsidiary ("Sub1") to its corporate parent ("Parent") was not a transaction subject to section 304(a)(1) since Sub1 could not be deemed to be in "control" of Parent under the constructive ownership rules of the Code as it would then be deemed to own its own shares).
27 Section 163(j)(4)(A)(i).
interest now accruing on the REIT/partnership’s tax return with respect to the corporate headquarters’ mortgage.

E. Interest Equivalents

Section 163(j) literally only applies to “interest,” thereby creating an opening for taxpayers to avoid the limitations of section 163(j) by incurring liabilities that accrue expense and deductions that are not literally interest. A simple example would be using a securities loan to generate cash proceeds, and to pay deductible “substitute payments” with respect to the securities loan. To illustrate, a taxpayer in need of $1 million to operate its business could borrow $1 million face value of five-year treasuries under a qualifying securities loan under section 1058,28 sell the treasuries, and use the cash in its business. The taxpayer would be required to pay to the securities lender as “substitute payments” amounts equal to the interest payments being paid on the five-year treasuries from time to time. These substitute payments are deductible currently and are not treated as interest under the Code.29 At the end of the term of the securities loan, the taxpayer would buy the five-year treasuries from the market and return them to the securities lender. It is possible that the taxpayer would have gain or loss on the closing of the securities loan, although it may choose a security (such as five-year treasuries) that have limited volatility. Note that under proposed section 1.163(j)-2(e)(3), under prior section 163(j), the issue of interest equivalents was reserved. However, proposed section 1.163(j)-2(e)(6) specifically provided that substitute payments under securities loans made between related parties would be deemed to be “interest expense” under prior section 163(j). The limitation of this rule to securities loans between related parties reflects the fact that prior section 163(j) only applied to interest payments made to a related party, and presumably any new regulations issued with respect to interest equivalents under new section 163(j) would not so limit its application.

Similarly, in Notice 2004-31,30 the IRS stated that the payment of guaranteed payments by a partnership to a partner that is a related party of the other partner(s) would be treated as interest for purposes of prior section 163(j) and that such a transaction would be a reportable transaction under section 6011. This raises an interesting issue as to whether using a similar structure to avoid new section 163(j), in which the partner receiving the guaranteed payments is not a related party to the other partners, would be a reportable transaction. Although Notice 2004-31 is limited to a situation in which the recipient is a related party, this is arguably only because the notice was issued under prior section 163(j), which only applied to interest payments made to related parties. Therefore, there may be a risk that the IRS could argue that such a non-related party guaranteed payment structure could also be

28 If not a qualifying securities loan, the IRS may view this transaction as a prepaid forward contract or a notional principal contract issued by the taxpayer, with either characterization possibly resulting in less beneficial tax consequences for the taxpayer.

29 Deputy v. Du Pont, 308 U.S. 488 (1940) (dividends paid for use of borrowed stock are not “interest,” despite “broader meaning” of term encompassing compensation for retention or use of property). See Commissioner v. Wiesler, 161 F.2d 997 (6th Cir., cert denied, 332 U.S. 842 (1947) (expense of borrowing stock to effect short sale “is not technically interest, yet it is an expense necessary to...obtaining and using stock”); deduction allowed under section 162).

treated as a reportable transaction under the notice, although the better answer is it should not, as the notice relates to a now-obsolete statute. If the notice would apply, care must be taken even when the intent is to allocate a preferred return to the “lender/partner” as opposed to a guaranteed payment, as preferred returns that are matched with gross income allocations of the partnership might be treated as guaranteed payments under partnership tax law. 31

See, e.g., Rev. Rul. 81-300, 1981-2 C.B. 143 (“Thus, and [in] view of the legislative history and the purpose underlying section 707 of the Code, the term “guaranteed payment” should not be limited to fixed amounts. A payment for services determined by reference to an item of gross income will be a guaranteed payment if, on the basis of all of the facts and circumstances, the payment is compensation rather than a share of partnership profits.”) Cf. Edward T. Pratt v. Commissioner, 64 T.C. 203 (1975). See also Mckee, Nelson & Whitmire, Federal Taxation of Partnerships and Partners ¶¶ 14.02(4), 14.03(1) (Thomson Reuters Tax & Accounting 4th ed. & Supp. 2018-3) (in determining the treatment of the preferred return holder in such case, one would focus on whether the gross income allocations impose entrepreneurial risk on the recipient).