July 9, 2018

The Honorable David J. Kautter
Assistant Secretary for Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable William M. Paul
Acting Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Mr. John Lovelace
Office Chief Counsel (Corporate)
Internal Revenue Service
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Mr. Russell Jones
Office Chief Counsel (Corporate)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Notice 2018 – 28 – Initial Guidance Under Section 163(j) as Applicable to Taxable Years Beginning After December 31, 2017

Dear Messrs. Kautter, Paul, Lovelace and Jones:

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"). This letter is in response to the IRS and Treasury's request for feedback on the rules described in the Notice as well as certain other issues related to section 163(j) that the IRS and Treasury should address in proposed regulations. We also intend to submit a second letter with our comments related to issues not addressed in this letter (e.g., the interaction of section 163(j) with international tax provisions).

Specifically, the AICPA offers feedback and recommendations in the following areas related to section 163(j):

I. Treatment of Disallowed Disqualified Interest from Last Taxable Year Beginning Before January 1, 2018

[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.

1. Rules for the allocation of business interest from a group treated as affiliated under the super-affiliation rules applicable to old section 163(j) to taxpayers under new section 163(j)

II. C Corporation Business Interest Expense and Income

1. Treatment of interest expense and income as business interest

2. Treatment of a partnership's investment interest expense with respect to its corporate partners

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

1. Allocation of the limitation among group members

2. Treatment of disallowed interest deduction carryforwards when a member leaves the group

3. Treatment of disallowed interest deduction carryforwards of a member that joins the group, including whether the carryforwards are subject to a separate return limitation year

4. Application of Treas. Reg. § 1.1502-32 to disallowed interest deductions

5. Application of section 163(j) to a consolidated group with one or more members that conduct a trade or business described in section 163(j)(7)(A)(ii), (iii), or (iv), as amended by the TCJA, or whose members hold an interest in a non-corporate entity such as a partnership that conducts such a trade or business

IV. Impact of Section 163(j) on Earnings and Profits

V. Other - The Application of the Section 163(j) Limitation on Partnerships

1. Treatment of excess business interest carryforwards by partners

2. Impact of section 743(b) adjustments

3. Real property trade or business election

4. Application of section 704(c) methods

5. Allocation of items between exempt and non-exempt businesses

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

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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, Acting Commissioner, Internal Revenue Service
Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation
Mr. Christopher W. Call, Attorney-Advisor (Tax Legislation), Office of Tax Policy, Department of the Treasury
Ms. Ellen Martin, Tax Policy Advisor, Department of the Treasury
Mr. Robert Wellen, Associate Chief Counsel (Corporate), Internal Revenue Service
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AMERICAN INSTITUTE OF CPAs

Notice 2018 – 28 – Initial Guidance Under Section 163(j) as Applicable to Taxable Years Beginning After December 31, 2017

July 9, 2018

BACKGROUND

Prior to the enactment of the TCJA, under section 163(j) ("old section 163(j)"),[2] 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)"),[3] 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.

[2] 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.

[3] 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;
- 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 for any excess limitation.

For purposes of new section 163(j), "business interest" is defined as any interest paid or accrued on indebtedness properly allocable to a trade or business. Business interest expense does not include investment interest expense (within the meaning of section 163(d)). Similarly, "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 business. Business interest income does not include investment income (within the meaning of section 163(d)).

Section 163(d)(3) provides that, with certain exceptions, "investment interest" is defined as any interest allowable as a deduction under Chapter 1 of the Internal Revenue Code (IRC or "Code") which is paid or accrued on indebtedness properly allocable to property held for investment. However, under section 163(d)(1), the limitation on the deduction of investment interest applies only in the case of a taxpayer other than a corporation.

Proposed regulations under old section 163(j) treated all members of an affiliated group (as defined in section 1504(a)) as one taxpayer, regardless of whether the group filed a consolidated return.[4] In addition, the proposed regulations applied a "super-affiliation" rule, in which certain corporations which were not members of the same affiliated group were also treated as one corporation. Under this rule, the scope of the affiliated group is generally expanded by applying section 318(a) attribution rules in determining whether the stock ownership requirements of section 1504(a)(2) are satisfied.

The proposed regulations provided that, in the case of an affiliated group filing a consolidated return, old section 163(j) was generally applied on a consolidated basis. In essence, the group was treated as one taxpayer. However, because of the super-affiliation rules, proposed regulations under old section 163(j) treated, as one taxpayer, certain corporations that may not have filed a single corporate tax return. In order to allocate the components of old section 163(j) among members of the super-affiliated group that did not join in the filing of a consolidated return, the proposed regulations established a four-step approach. This approach allocated the old section 163(j) limitation to the members of the group as well as the carryforwards of excess interest and excess limitation to such members.

[4] Proposed Reg. § 1.163(j)-5.

COMMENTS

I. Treatment of Disallowed Disqualified Interest from Last Taxable Year Beginning Before January 1, 2018

1. Rules for the allocation of business interest from a group treated as affiliated under the super-affiliation rules applicable to old section 163(j) to taxpayers under new section 163(j)

Overview

The Notice provides that new section 163(j) is applied at the level of the consolidated group. Thus, in effect, the limitations are determined by treating an affiliated group of corporations as one taxpayer only if a consolidated return is filed by the group. The stock ownership requirements of section 1504(a)(2) are not modified for purposes of applying the section 163(j) limitations to post-2017 taxable years. The Notice further states that the regulations will provide rules for the allocation of business interest from a group treated as affiliated under the super-affiliation rules described in the proposed regulations of old section 163(j) to taxpayers that are subject to new section 163(j).

Recommendation

The AICPA recommends that Treasury and the IRS utilize the rules in existing Prop. Reg. § 1.163(j)-5(c)(2) to allow taxpayers to allocate business interest from a group treated as affiliated under the super-affiliation rules of old section 163(j) to taxpayers under new section 163(j).

Analysis

Generally, in applying old section 163(j), taxpayers have followed the proposed regulations which remained in proposed format for nearly three decades. The proposed regulations are currently slated for withdrawal, however; it is not necessary to develop a new or different approach solely for the purpose of making the one-time transition from old section 163(j) to new section 163(j). We suggest that the new regulations allow taxpayers to utilize the same rules as Prop. Reg. § 1.163(j)-5(c)(2) to allow taxpayers to allocate business interest from a group treated as affiliated under the super-affiliation rules of old section 163(j) to taxpayers under new section 163(j).

The portion of the existing proposed regulations related to the allocation and carryforward of any excess limitation requires removal since it does not apply to any post-2017 taxable year.

II. C Corporation Business Interest Expense and Income

1. Treatment of interest expense and income as business interest

Overview

The Notice provides that regulations under section 163(j) will clarify that, solely for purposes of section 163(j), in the case of a C corporation, all interest paid or accrued on indebtedness of the taxpayer is business interest, and all interest on indebtedness that is includible in gross income of the corporation is business interest income.

Recommendations

The AICPA agrees with the IRS and Treasury that all interest expense paid or accrued by a C corporation is treated as "business interest" within the meaning of section 163(j)(5) and that all interest includible in the gross income of the corporation is treated as "business interest income" within the meaning of section 163(j)(6).

Subject to the provisions for certain activities excluded from the definition of trade or business for this purpose, we also recommend treating all items of income, gain, deduction, and loss of a C corporation as properly allocable to a trade or business.

Analysis

The proposed treatment of interest expense and income of a C corporation as business interest is consistent with congressional intent.[5] The Conference Report concludes that a corporation has neither investment interest nor investment income within the meaning of section 163(d). An alternative reading of the statute could conclude that, while a C corporation can have investment interest within the meaning of section 163(d)(4), it is not subject to the limitations set forth in section 163(d).

We agree that a C corporation should not avoid the section 163(j) limitations by claiming that some or all of its interest expense is investment interest. In general, section 163(j) is the primary limitation applicable to interest paid or accrued by a C corporation, and this limitation should apply broadly to all such interest.[6] Consistent with this approach, all includible interest income of a C corporation is treated as business interest income.

The Notice does not clarify how other items of income, gain, deduction, or loss of a C corporation are treated in determining ATI. Section 163(j)(8)(A)(i) provides that ATI is computed without regard to any item of income, gain, deduction, or loss which is not properly allocable to a trade or business. Consistent with the proposed treatment of interest expense and income of a C corporation, we suggest treating the ATI of such a corporation as all-encompassing. This

[5] Joint Explanatory Statement of the Committee of Conference footnote 688, at 386.

[6] We do not suggest subjecting interest expense to section 163(j) if an exception is otherwise available to a corporation, e.g., floor plan financing interest, electing farming businesses, electing real property trades or businesses, or regulated utilities.

methodology will ensure that affected taxpayers are not subject to the adverse consequences of treating all interest expense as subject to a limitation while having to exclude certain items from the computation of that limitation.[7] To the extent that Treasury and the IRS identify specific items of income, gain, deduction, or loss to exclude from the term "adjusted taxable income" for policy reasons specific to such item, it is reasonable that the adjustments are promulgated pursuant to the authority granted by section 163(j)(8)(B).

The term "trade or business," for purposes of section 163(j), excludes any 1) electing real property trade or business; 2) electing farming business; and 3) any regulated public utilities described in section 163(j)(7)(A)(iv). Therefore, a rule treating any activity of a C corporation falling within any of these three categories as a trade or business for this purpose, or to treat any item of income, gain, deduction, or loss of a C corporation from such activity as allocable to a section 163(j) trade or business is not required.

We also agree that this rule should not apply to an S corporation. Section 1363(b) provides that, with certain exceptions, the taxable income of an S corporation is computed in the same manner as an individual. Thus, it is clear that an S corporation can have investment interest income and expense and that its shareholders are generally subject to the limitations imposed by section 163(d).

2. Treatment of a partnership's investment interest expense with respect to its corporate partners

Overview

Unlike corporations, partnerships may have investment interest income and expense. These items retain their character when allocated to individual partners and become subject to the limitations of section 163(d) at the individual level. Further, these items retain their character at the partnership level and are, therefore, not considered in calculating the partnership's business interest limitation.

New section 163(j)(4) provides that, in the case of a partnership, section 163(j) is applied at the partnership level. Thus, a partnership must identify its business interest and business interest income, as well as its adjusted taxable income, and determine whether any section 163(j) limitation applies to the partnership's deductions for business interest. The business interest of a partnership is not subject to a separate limitation under section 163(j) at the partner level. To achieve this objective, a partner's ATI does not include the partner's share of any items of income, gain, deduction, or loss of the partnership. However, section 163(j)(4)(A)(ii) provides that, at the partner level, the partner's ATI is increased by any "excess taxable income" (ETI) allocated to the partner from the partnership.

A partnership may have investment interest and investment interest income that is separately stated and allocated to its partners. Because investment interest is not business interest to a partnership for purposes of section 163(j), such interest is not limited at the partnership level. Any limitations on investment interest of a partnership are applied (if at all) at the partner level. These items retain

[7] This recommendation is also consistent with the treatment of C corporations under sections 162 and 212.

their character when allocated to individual partners and become subject to the limitations of section 163(d) to the individual.

The Notice provides that regulations will identify whether and to what extent interest paid, accrued, or is includible in gross income by a non-corporate entity (such as, a partnership in which a C corporation holds an interest) is properly characterized to the C corporation partner, as business interest or business interest income.

Recommendation

The AICPA recommends that the IRS issue guidance to provide that a corporate partner's distributive share of both investment interest income and expense are recharacterized as business interest and netted against each other. A net negative amount (excess of expense over income) is added to the corporate partner's excess business interest (EBI) carryforward amount from the allocating partnership. A net positive amount (excess of income over expense) is added to any business interest income earned directly by the corporate partner and is available for use under section 163(j)(1)(A) in determining the corporate partner's interest expense limitation.

Analysis

Partnerships can incur investment interest expense for purposes of section 163(j). Congress indicated this conclusion with the language of section 163(d)(1), which states that, "in the case of a taxpayer other than a corporation, the amount allowed as a deduction under this chapter for investment interest for any taxable year shall not exceed the net investment income of the taxpayer for the taxable year." Since a partnership is a taxpayer other than a corporation, section 163(d)(1), by its terms, provides that a partnership can incur investment interest expense.

Consistent with the proposed treatment of interest paid or accrued by, and interest income includible in the gross income of a C corporation, we believe that investment interest expense and income allocated by a partnership to a C corporation partner is properly treated as business interest expense and income for purposes of applying section 163(j) to the partner. Any other treatment could provide an inappropriate incentive for C corporations to structure their operations and investments in partnership form to circumvent the section 163(j) limitations on business interest.

In the case of a partnership, Congress intended to adopt an "entity" approach to the application of the section 163(j) limitation. However, a pure "aggregate" approach is easier to apply, especially in the case of a C corporation partner of a partnership. In view of the clearly-expressed congressional intent, we believe that the best approach is to adopt a hybrid approach, consisting of an entity approach for business interest of a partnership and an aggregate approach for investment interest.

We think a hybrid approach is supported by the language of both the Conference Report and the statute itself. The Conference Report states in footnote 688 on page 238:

> *Section 163(d) applies in the case of a 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.

The statutory language of section 163(j) reads:

> *(5) Business interest. -- For purposes of this subsection, the term "business interest" means any interest paid or accrued on indebtedness properly allocable to a trade or business.* ***Such term shall not include investment interest (within the meaning of subsection (d)).***
>
> *(6) Business interest income. -- For purposes of this subsection, the term "business interest income" means 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.* ***Such term shall not include investment income (within the meaning of subsection (d)).***

Under our recommendation, the investment interest expense allocated from a partnership to a corporate partner is recharacterized as business interest expense. The amount is then netted against any investment interest income (which is recharacterized as business interest income) allocated from the same partnership to the corporate partner. If the net amount is negative (excess of expense over income), the net amount is added to the corporate partner's EBI carryforward amount from that partnership. If the net amount is positive (excess of income over expense), that amount is added to any business interest income earned directly by the corporate partner and is included in the amount under section 163(j)(1)(A).

The following examples show the application of our recommendation.

<u>*Example 1*</u>

Partnership XY consists of two equal partners – X, an individual and Y, a corporation. In 2020, XY has $30 of business interest expense, $50 of investment interest income, $60 of investment interest expense and adjusted taxable income of $100 for purposes of section 163(j). The entire $30 (30% limitation * $100 of adjusted taxable income = $30) of business interest expense is allowable as a deduction at the partnership entity level. Y has $15 of excess business interest related to XY carried forward from 2019.

Y is allocated $15 of deductible business interest expense, $25 of investment interest income and $30 of investment interest expense on the K-1 issued by XY. The investment interest income and expense are recharacterized as business interest and netted, resulting in a negative amount of $5. The $5 is considered excess business interest passed through from XY and added to Y's excess business interest carryforward related to XY. Y will carryforward $20 of excess business interest from XY to 2021.

Example 2

Partnership XY consists of two equal partners – X, an individual and Y, a corporation. In 2020, XY has $30 of business interest expense, $50 of investment interest income, $40 of investment interest expense and adjusted taxable income of $100 for purposes of section 163(j). The entire $30 (30% limitation * $100 of adjusted taxable income = $30) of business interest expense is allowable as a deduction at the partnership entity level. Y has business interest income of $10.

Y is allocated $15 of deductible business interest expense, $25 of investment interest income and $20 of investment interest expense on the K-1 issued by XY. The investment interest income and expense are recharacterized as business interest and netted, resulting in a positive amount of $5. The $5 is considered business interest income to Y and is added to Y's direct business interest income of $10. Thus, in calculating Y's partner level limitation on its direct business interest expense, the amount used in section 163(j)(1)(A) is $15.

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

1. Allocation of the limitation among group members

Overview

The Notice provides that the 30% limitation on business interest expense is computed on a consolidated basis. However, the Notice does not provide a methodology for allocating the limitation and deductible business interest expense among the members of the affiliated group.

Recommendation

The AICPA recommends that the IRS and Treasury provide a methodology for allocating the section 163(j) limitation using the principles of the net operating loss (NOL) rules of Treas. Reg. § 1.1502-21.

Analysis

Using the principles of Treas. Reg. § 1.1502-21, the ATI of a consolidated group and related business interest expense is computed on a consolidated basis. If the business interest expense of the consolidated group is less than 30% of ATI, each member of the group with business interest expense is eligible to deduct its business interest expense for the year. If the business interest expense of the consolidated group exceeds 30% of ATI, the amount allowable to the group members is similar to the NOL apportionment rules of Treas. Reg. § 1.1502-21(b)(2)(iv)(A) and (B).

Per Treas. Reg. § 1.1502-21(b)(2)(iv)(A) and (B), the percentage of the consolidated NOL attributable to a member equals the separate NOL of the member for the year of the loss divided by the sum of the separate NOLs for that year of all members having such losses. The denominator is determined by computing the NOL by reference to only the member's items of income, gain, deduction, and loss, including the member's losses and deductions absorbed by the group in the taxable year (whether or not absorbed by the member).

Using similar principles for the 30% business interest, each member of the group would compute its share of the deduction as follows:

$$\frac{\text{Business Interest Expense of the Member before Limitation}}{\text{Consolidated Business Interest Expense before Limitation}} \text{ X 30\% of Adjusted Taxable Income}$$

Using the methodology above, each member’s carryforward would equal its business interest expense less the amount allowed as a deduction.

2. Treatment of disallowed interest deduction carryforwards when a member leaves the group

Overview

As a general rule, when a member leaves an affiliated group, any attributes attributable to the departing subsidiary are allocated and apportioned to the member based on its relative contribution of those items. A methodology for determining each member’s share of the 163(j) deduction is provided above. Additionally, the circular basis rule of Treas. Reg. § 1.1502-11 limits the use of loss carryforwards of a member in certain situations in which the target member leaves the affiliated group in a taxable sale.

Recommendations

The AICPA recommends that the IRS and Treasury confirm that when a member leaves a consolidated group, the member’s share of the interest expense carryforward will leave with it.

The AICPA also recommends that the IRS and Treasury treat the section 163(j) carryforward in a manner similar to NOL and other loss carryforwards for purposes of the circular basis adjustment rules of Treas. Reg. § 1.1502-11.

Analysis

Using the principles of Treas. Reg. § 1.1502-21, when a member leaves the group, the apportioned excess business interest expense is carried to a separate return year and the member’s share of section 163(j) interest expense carryforward would leave with it. The amount of each member’s share of the section 163(j) carryforward would equal the amount computed under the method above.

The purpose of the circular basis rules is to prevent the consolidated group’s income or gain from the disposition of stock of a member from increasing the absorption of the member’s deductions and losses. The increased absorption would reduce the owner’s basis (or increase its excess loss account) in the subsidiary's stock under Treas. Reg. §1.1502-32 and, increases the seller's income or gain. We suggest that the proposed regulations clarify that the section 163(j) carryforward is treated in the same manner as an NOL carryforward.

3. Treatment of disallowed interest deduction carryforwards of a member that joins the group, including whether the carryforwards are subject to a separate return limitation year

Overview

Under the TCJA, any disallowed interest deduction is carried forward as a tax attribute subject to the limitation rules of section 382. In general, NOLs and other tax attributes are subject to the section 382 limitations, and in the case of the consolidated return regulations, the separate return limitation year (SRLY) rules of Treas. Reg. § 1.1502-21(c). The SRLY rules apply when a new member joins a consolidated group to limit the consolidated group's ability to utilize the NOLs and other tax attributes of the joining member. They generally limit the aggregate NOL carryovers and carrybacks of a member arising in SRLYs that are included in the NOL deduction of the group to the extent that they exceed such member's cumulative contribution to consolidated taxable income.

When a SRLY event occurs within six months of a section 382 ownership change, the "overlap" rules provide that the section 382 limitation controls and the SRLY rules do not apply. The TCJA provides that section 382 applies to disallowed interest deduction carryforwards, however, it does not specify whether principles similar to the SRLY limitation apply. Furthermore, it does not address the "overlap" rules and their applicability to disallowed interest deduction carryforwards.

Recommendation

In the event that Treasury and the IRS determine that the SRLY rules apply to disallowed interest deduction carryforwards, we suggest that they apply in their totality, including having the section 382-SRLY overlap rules apply to disallowed interest deduction carryforwards.

We also recommend that since the section 163(j) limitation applies on an annual basis, if the SRLY rules apply to disallowed interest deduction carryforwards, we request that they also apply on an annual basis.

Analysis

Certain NOLs are subject to the limitations under both section 382 and the SRLY rules under Treas. Reg. § 1.1502-21. The TCJA disallowed interest deduction carryforwards are a tax attribute subject to section 382. As a result, when there is a section 382 change of ownership, the use of the disallowed interest deduction carryforward is limited in the post-change period.

We recommend treating disallowed interest deduction carryforwards similar to NOLs, subject to both section 382 and the SRLY limitations, as well as any rules governing the overlap of these provisions. This suggestion will provide consistency in the treatment of NOL and disallowed interest deduction carryforwards in the stand-alone and consolidated return regimes.

Under section 163(j)(1), the annual deduction for business interest is limited and any carryover of disallowed business interest is taken into account for corporate acquisitions under section 381,[8] and is subject to limitation under section 382.[9]

If the SRLY rules apply, they should apply when a new member joins a consolidated group with a disallowed interest deduction carryforward, and section 382 does not apply. When determining the amount of the disallowed interest deduction carryforward to utilize in a post-SRLY year, we suggest computing it based on the lesser of the following:

- the sum of the joining member's (or SRLY subgroup's) business interest income, 30% of that member's (or subgroup's) ATI and the floor plan financing interest, or
- the sum of the same for the consolidated group.

When the sum of the consolidated group's business interest income, 30% of ATI and the floor plan financing interest is less than that of the SRLY member, we recommend that the amount of interest that would have been deductible to that SRLY member on a stand-alone basis lose its SRLY taint and become a disallowed interest deduction carryforward of the consolidated group.

The following example illustrates this point:

Example 1

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

The $50 of disallowed interest deduction carryforward of Sub 1 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 Sub 1's adjusted taxable income or the consolidated group's adjusted taxable income. As a result, in year 1, the group cannot deduct any interest since consolidated adjusted taxable income is ($10). On a stand-alone basis, Sub 1 would have been able to deduct $9 ($30 * 30%) of its disallowed interest carryforward. As a result, $9 of Sub 1'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, Sub 1 has $0 of adjusted taxable income and the other members of the consolidated group have $40 of adjusted taxable income. As a result, the

[8] IRC section 381(c)(20).
[9] IRC section 382(d)(3).

consolidated group has $40 of adjusted taxable income. 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 adjusted taxable income). The consolidated group is entitled to a deduction of $9 of disallowed interest which represents $9 of disallowed interest deduction of Sub 1 that is no longer subject to SRLY. The consolidated group cannot deduct any additional interest in year 2 since Sub 1's adjusted taxable income during the year was $0. The $41 ($50 - $9) of disallowed interest deduction of Sub 1 remains subject to SRLY.

Example 1(b) (Continuation of Example 1 & 1a with Alternate Year 2 Fact Pattern)

In year 2, Sub 1 has $0 of adjusted taxable income and the other members of the consolidated group have $20 of adjusted taxable income. As a result, the consolidated group has $20 of adjusted taxable income. 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 adjusted taxable income). 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 where the consolidated group's ATI is less than the SRLY sub'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 Sub 1's SRLY limited disallowed interest deduction carryforward lost its SRLY taint in year 1, the ability for the consolidated group to take an interest deduction in subsequent years remains subject to the 30% of ATI limit.

4. Application of Treas. Reg. § 1.1502-32 to disallowed interest deductions

Overview

Under the TCJA, disallowed interest deductions are carried forward indefinitely and treated as paid or accrued in each succeeding year.[10]

The Notice provides that, consistent with legislative history, Treasury and the IRS intend to issue regulations clarifying that the limitation under section 163(j) applies at the level of the consolidated

[10] IRC section 163(j).

group. The regulations also intend to address related issues including, without limitation, the application of Treas. Reg. § 1.1502-32 to disallowed interest deductions.

Treas. Reg. § 1.1502-32 generally provides for adjustments to the basis of the stock of a subsidiary S owned by another member M. In general, M will increase its basis in S stock for S's taxable income and reduce such basis for S's taxable loss. S's taxable income refers to consolidated taxable income taking into account only S's items and with deductions and losses taken into account only to the extent they are absorbed by S or another member of the consolidated group.[11] For this purpose, S's deductions or losses that are absorbed in the current year or carried forward and absorbed in a subsequent year are taken into account under Treas. Reg. § 1.1502-32 in the year of absorption (and not in the year the deduction or loss arises).[12]

Recommendation

The AICPA recommends that forthcoming guidance confirms that a disallowed interest deduction under section 163(j) is not taken into account under Treas. Reg. § 1.1502-32 until such deduction is absorbed by the member or another member of the consolidated group.

Analysis

Treasury Reg. § 1.1502-32 provides rules governing basis adjustments and contains a general rule that would reduce basis for the amount of S's deductions and losses that are absorbed. This rule generally governs the treatment of deferred deductions or losses including NOLs, and we believe it provides for an administrable framework for disallowed interest deductions under section 163(j).

The disallowance under section 163(j) is temporary with the ultimate tax effect of the disallowed interest deduction not yet realized. Further, maintaining consistent treatment with similar deductions–e.g., NOLs—would reduce complexity and uncertainty as compared to creating a separate and divergent set of rules to address a specific attribute. Finally, as with NOLs, there are rules limiting the potential to achieve a duplicate loss for the same disallowed interest expense, (e.g., in the stock of S and when S's deduction is absorbed and Treas. Reg. § 1.1502-36(d) limiting the ability to recognize a duplicate loss on S stock and when S's deduction is absorbed).

5. **Application of section 163(j) to a consolidated group with members that conduct a trade or business described in section 163(j)(7)(A)(ii), (iii), or (iv), as amended by the TCJA, or whose members hold an interest in a non-corporate entity that conducts such trade or business**

Overview

The Notice states that forthcoming regulations will address issues concerning the application of section 163(j) to consolidated groups including the application of section 163(j) to a consolidated group with one or more members that conduct a trade or business described in section

[11] Treasury Reg. §§ 1.1502-32(b)(2)(i) and -32(b)(3)(i).

[12] Treasury Reg. § 1.1502-32(b)(3)(i)(A). In contrast, if S's deduction or loss is carried back and absorbed in a prior tax year, the deduction or loss is taken into account under Treas. Reg. § 1.1502-32 in the year in which it arises.

163(j)(7)(A)(ii), (iii), or (iv), or whose members hold an interest in a non-corporate entity such as a partnership that conducts such a trade or business.

Section 163(j)(7) provides an exception (the "exempt business exception") that a "trade or business" does not include the following "exempt businesses" for purposes of section 163(j):

- the trade or business of performing services as an employee under section 163(j)(7)(A)(i);
- an electing real property trade or business under section 163(j)(7)(A)(ii);
- an electing farming business under section 163(j)(7)(A)(iii); and
- the trade or business of certain regulated public utilities described in section 163(j)(7)(A)(iv).

An electing real property trade or business is defined as any trade or business described in section 469(c)(7)(C) which makes an election under section 163(j)(7)(B).

An electing farming business is defined as:

- a farming business as defined in section 263A(e)(4) which makes an election under section 163(j)(7)(C); or
- any trade or business of a specified agricultural or horticultural cooperative as defined in section 199A which makes an election under section 163(j)(7)(C).

Both elections under sections 163(j)(7)(B) and (C) are irrevocable. Upon making either election, a taxpayer must use the alternative depreciation system (ADS) for certain property held by the electing exempt business (section 168(g)(1)(F) and (G)).

Recommendations

We recommend that Treasury and the IRS confirm in regulations that a C corporation may have interest expense that is not business interest under section 163(j) because it is paid or accrued indebtedness that is properly allocable to an exempt business.

We also recommend that Treasury and the IRS provide that the determination of whether a consolidated group has an exempt business is consistent with the determination of whether a division in a single corporation has an exempt business.

Finally, we recommend that Treasury and the IRS provide one or more safe harbors to determine the extent to which indebtedness is properly allocable to a trade or business for purposes of section 163(j). We suggest providing that taxpayers may use alternative methodologies if a safe harbor produces distortive results.

Analysis

The term "business interest" is defined as any interest paid or accrued on indebtedness properly allocable to a trade or business, however, the term "trade or business" does not include an exempt business. Thus, interest paid or accrued on indebtedness properly allocable to an exempt business does not constitute business interest.

As stated in the Notice, Treasury and the IRS intend to issue regulations clarifying that all interest paid or accrued by a C corporation is business interest within the meaning section 163(j)(5). Based on the language, this statement implies that the exempt business exception will not apply to C corporations. We recommend that the regulations clarify that a C corporation does not have business interest to the extent that its interest paid or accrued is properly allocable to an exempt business under sections 163(j)(7)(A)(ii), (iii), or (iv).

The statute does not exclude C corporations from the exempt business exception, and there is no stated congressional intent in the legislative history to exclude C corporations. Furthermore, the Conference Report specifically contemplates that a C corporation is not subject to section 163(j) to the extent that business interest is properly allocable to an exempt business.[13]

Once it is established that a C corporation is eligible for the exempt business exception, a determination is made as to whether an activity that otherwise qualifies as an exempt business is regarded as a trade or business. Existing regulations provide requirements for when a separate trade or business is recognized. For example, for purposes of section 446, a trade or business is not considered separate and distinct unless a complete and separable set of books and records is kept for such trade or business.[14] Alternatively, regulations under section 355 provide that a trade or business is actively conducted notwithstanding that it is conducted as a division of a single corporation.[15]

The limitation under section 163(j)(1) applies at the level of the consolidated group, which has caused an additional lack of clarity in determining the extent that the exempt business exception is applied to a consolidated group. One issue is whether a pure holding company is respected as its own separate trade or business. In Rev. Rul. 85-197, the IRS ruled that the historic business of

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[13] Joint Explanatory Statement of the Committee of Conference states at Footnote 688, "Section 163(d) applies in the case of a taxpayer other than a corporation. 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* [emphasis added]."

Joint Explanatory Statement of the Committee of Conference states at Footnote 697, "It is intended that any such real property trade or business, including such a trade or business *conducted by a corporation or real estate investment trust*, be included [emphasis added]. Because this description of a real property trade or business refers only to the section 469(c)(7) description, and not to other rules of section 469 (such as the rule of section 469(c)(2) that passive activities include rental activities or the rule of section 469(a) that a passive activity loss is limited under section 469), the other rules of section 469 are not made applicable by this reference."

[14] Treasury Reg. § 1.446-1(d)(2).

[15] IRC section 355(b) provides a requirement that certain corporations are engaged in the active conduct of a trade or business for section 355(a) to apply. Under section 355(b)(2), a corporation is treated as engaged in an active trade or business only if such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution. The regulations under section 355 provide the following example:

> For the past six years, corporation X has processed and sold meat products. X derives income from no other source. X separates the sales function from the processing function by transferring the business assets related to the sales function and cash for working capital to new subsidiary Y. X then distributes the stock of Y to X's shareholders. After the distribution, Y purchases for resale the meat products processed by X. X and Y both satisfied section 355(b). Treas. Reg. § 1.355-3(c), *Example 10*.

a holding company whose only asset consisted of all of the stock of an operating subsidiary was the business of the operating subsidiary.[16] Thus, it is unclear how to analyze the following fact pattern.

> *Example 1*
>
> Parent is a holding company whose only asset consists of all of the stock of an operating subsidiary corporation, Subsidiary. Parent and Subsidiary are the only members of a consolidated group. Parent has $100 of interest expense. Subsidiary has no debt of its own, and Subsidiary's sole trade or business constitutes an exempt business for purposes of section 163(j).

In the example, if Parent has a trade or business separate from Subsidiary, Parent may need to properly allocate at least a portion of its interest expense to its trade or business. However, if Subsidiary's exempt business is the only trade or business of the consolidated group, the entire interest expense is likely allocable to the exempt business because there is no other trade or business within the consolidated group.

It is also unclear whether intercompany transactions are regarded in determining whether a member of a group has an exempt business. Specifically, the regulations governing intercompany transactions contemplate a member of a consolidated group renting real estate from another member, which could give rise to a real property trade or business as defined in section 469(c)(7).[17]

The Notice states that a consolidated group's taxable income related to calculating its ATI (as defined in section 163(j)(8)) is its consolidated taxable income per Treas. Reg. § 1.1502-11, and intercompany obligations (as defined in Treas. Reg. § 1.1502-13(g)(2)(ii)) are disregarded for purposes of determining the limitation under section 163(j)(1). The Notice does not state that a consolidated group is treated as a single taxpayer. [18] Thus, it is unclear whether, and to what extent, an exempt business is regarded differently for the purposes of section 163(j) in the following scenarios:

> *Scenario 1*
>
> A member of a consolidated group conducts an exempt business as a division and has no separate taxable income derived from the exempt business.

[16] Revenue Rul. 85-197 (1985-2 C.B. 120).

[17] The regulations under Treas. Reg. § 1.1502-13(c)(7)(ii) provide:

> B operates a ranch that requires grazing land for its cattle. S owns undeveloped land adjoin B's ranch. On January 1 of Year 1, S leases grazing rights to B for Year 1. B's $100 rent expense is deductible for Year 1 under it separate entity accounting method. Under [Treas. Reg. § 1.1502-13(b)(1)], the rental transaction is an intercompany transaction, S is the selling member, and B is the buying member. Treas. Reg. § 1.1502-13(c)(7)(ii), *Example 8*.

[18] *Cf.* section 163(j)(6)(C) before the TCJA.

Scenario 2

A member of a consolidated group conducts an exempt business and has separate taxable income under Treas. Reg. § 1.1502-12 derived solely from customers that are not members of its consolidated group.

Scenario 3

A member of a consolidated group conducts an exempt business and has separate taxable income under Treas. Reg. § 1.1502-12 derived solely from customers that are members of its consolidated group (i.e., all transactions are intercompany transactions under Treas. Reg. § 1.1502-13 and reflected on the consolidated tax return with respective offsetting intercompany items or corresponding items).

We recommend consistent application of the exempt business exception in Scenario 1 and Scenario 3. These scenarios are economically indistinguishable and a distinction in the regulations could incentivize taxpayers to form entities that lack substance to qualify for the exempt business exception.

While the Notice states that all interest paid or accrued by a C corporation is business interest, consolidated groups with more than one trade or business will need to determine whether interest is properly allocable to an exempt business, and thus, *not* properly allocable to a trade or business as defined in section 163(j)(7).

Other commentators have elaborated on different methodologies to allocate interest expense of a taxpayer among more than one trade or business. Specifically, the New York State Bar Association has recommended basing the allocation of a corporation's interest expense for this purpose on: (i) the relative amount of assets used in a trade or business; or (ii) the relative amounts of income generated by a trade or business.[19]

A mandatory methodology is not the optimal solution for every taxpayer since there is the potential for any particular methodology to produce distortive results for a taxpayer. Therefore, we recommend providing one or more safe harbors in the regulations and allowing a taxpayer to use alternative methodologies if a safe-harbor produces distortive results.

IV. Impact of Section 163(j) on Earnings and Profits

Overview

It is not clear under new section 163(j) when business interest expense reduces earnings and profits (E&P) of the payor C corporation. The amended subsection provides for an indefinite carryforward for any business interest expense that is disallowed as a result of the limitation[20] which raises the issue as to whether E&P is reduced at the time of the interest accrual or payment or when the deduction is allowed. The Notice indicates that the IRS and Treasury intend to issue

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[19] New York State Bar Association, "Report No. 1393 on Section 163(j)," 2018 Tax Notes 61-11 (2018).
[20] IRC section 163(j)(2).

regulations clarifying that "the disallowance and carryforward of a deduction for a C corporation's business interest expense under section 163(j), as amended by the Act, will not affect whether or when such business interest expense reduces earnings and profits of the payor C corporation."[21]

Recommendation

We agree that the IRS and Treasury should issue regulations to confirm that the disallowance and carryforward of a deduction for a C corporation's business interest expense will not affect if or when the payor C corporation will reduce its earnings and profits.

Analysis

E&P should serve as an economic measure of a corporation's ability to pay dividends without distributing capital. Although that principle is not enumerated in the IRC, the courts and Treasury have established guidance for taxpayers to measure their E&P using that philosophy. For example, the United States Court of Appeals for the Seventh Circuit provided a description of the concept of E&P in *Luckman*:

> "[T]his concept [of E&P] represents an attempt to separate those corporate distributions with respect to stock which represent returns of capital contributed by stockholders from those distributions which represent gain derived from the initial investment by virtue of the conduct of the business. The crucial issue is whether a given transaction has a real effect upon the portion of corporate net worth which is not representative of contributed capital and which results from its conduct of business."[22]

Taxpayers measure E&P by real economic increases and decreases (e.g., operating income, overhead expenses, depreciation expenses, capital gains from the sale of stock, etc.). Thus, only income and expenses that affect a corporation's ability to pay dividends are reflected in E&P.[23]

Interest expense is an actual economic outlay and generally reduces a corporation's E&P in the year the interest is paid or accrued even if the expense is disallowed—in full or in part—as a deduction for federal income tax purposes. This treatment is consistent with Treas. Reg. § 1.312-7(b)(1), which provides that "A loss . . . may be recognized though not allowed as a deduction... but the mere fact that it is not allowed does not prevent decrease in earnings and profits by the amount of such disallowed loss." Any disallowed business interest expense under section 163(j) should fall under this general rule. In cases where a taxpayer is not permitted to take a deduction at the time of the expense, the interest payment or accrual reduces the ability of the corporation to pay dividends at that time and in the future. In addition, prior to the enactment of the TCJA,

[21] Notice 2018-28, I.R.B. 2018-16.
[22] *Luckman v. Comm'r*, 418 F.2d 381, 383 (7th Cir. 1969).
[23] For example, the new dividends received deduction under section 245A should not decrease E&P because it does not represent an economic expenditure of a corporation or an impairment of its ability to pay a dividend. *See* Treas. Reg. § 1.312-6(b) ("Among the items entering into the computation of corporate earnings and profits for a particular period are all income exempted by statute").

Treasury previously considered the impact of a business expense limitation on E&P under old section 163(j) and concluded that such a limitation does not affect the timing of the E&P reduction.

V. Other – The Application of the Section 163(j) Limitation on Partnerships

1. Treatment of excess business interest carryforwards by partners

Overview

Old section 163(j) applied only to corporations, while new section 163(j) applies to other entities including partnerships. Section 163(j)(4) provides rules specific to partnerships as follows:

- The 30% limitation on business interest expense is applied at the partnership, not the partner, level.
- A partner's ATI "shall be determined without regard to such partner's distributive share of any items of income, gain, deduction, or loss of such partnership." However, a partner's ATI "shall be increased by such partner's distributive share of such partnership's excess taxable income." The concept of excess taxable income (ETI) enables partners to utilize a partnership's unused business interest limitation in a given tax year. To the extent a partner does not utilize ETI in the year in which it arises, the statute does not provide a carryforward provision and the benefit of the ETI is lost.
- There are specific carryforward rules for a partnership's disallowed business interest expense. Each partner is allocated EBI "in the same manner as the non-separately stated taxable income or loss of the partnership."

Section 163(j)(4)(B)(ii) provides for the treatment of EBI. Specifically, it provides—

> *"Treatment of excess business interest allocated to partners. If a partner is allocated any excess business interest from a partnership under clause (i) for any taxable year—*
>
> > *(I) such excess business interest shall be treated as business interest paid or accrued by the partner in the next succeeding taxable year in which the partner is allocated excess taxable income from such partnership, but only to the extent of such excess taxable income, and*
> > *(II) any portion of such excess business interest remaining after the application of subclause (I) shall, subject to the limitations of subclause (I), be treated as business interest paid or accrued in succeeding taxable years.*
>
> *For purposes of applying this paragraph, excess taxable income allocated to a partner from a partnership for any taxable year shall not be taken into account under paragraph (1)(A) with respect to any business interest other than excess business interest from the partnership until all such excess business interest for such taxable year and all preceding taxable years has been treated as paid or accrued under clause (ii)."*

Recommendations

The AICPA recommends that the IRS issue regulations implementing section 163(j)(4(B)(ii) in the following manner:

1) Provide that ETI releases EBI from prior year(s) at the partner level on a dollar for dollar basis.

2) Calculate the current year deductible amount of the partner's released EBI from step 1 as 30% of ETI.

3) Add any ETI remaining after all partnership specific EBI is released which is also unused in step 2 to the ATI of the partner.

4) Add any non-deductible amount of the partner's released EBI to the partner's direct business interest expense before calculating the partner level limitation.

5) Carryforward any unreleased EBI in a silo for the specific partnership from which it was generated.

Analysis

The mechanics of the business interest carryforward rules are unclear in the statute as denoted in the following example:

> *Example 1*
>
> X and Y are equal partners in XY partnership and agree to allocate items of XY pro rata. In year 1, X and Y are each allocated $8 of excess business interest from XY. In year 2, X and Y have adjusted taxable income of $100 and $0, respectively. The adjusted taxable income of XY in year 2 is $80 and its business interest expense is $10. In year 2, the excess business interest of XY is $0 (business interest limit of $24 [$80 x 30%] exceeds business interest expense of $10). X and Y are each allocated $23.33 of excess taxable income from XY ([$80 x ($24 - $10)/$24]/2).

X and Y each have $8 of EBI from year 1 which does not exceed their share of ETI in year 2 of $23.33. Under section 163(j)(4)(B)(ii)(I), it appears that X and Y are each treated as having paid or accrued $8 of interest expense in year 2.

Under one interpretation of the statute, both X and Y must determine the portion of the $8 of EBI that is deductible based on their respective business interest limits for year 2. X's business interest limit is $37 ($123.33 [ATI of $100 + ETI of $23.33] x 30%). Consequently, the deduction to X is $8 of business interest expense in year 2 since the business interest expense does not exceed its business interest limit. Y's business interest limit is $7 ($23.33 [ATI of $0 + ETI of $23.33] x 30%). Y is only able to deduct $7 of the business interest expense in year 2 and treat $1 ($8 - $7) of the business interest expense as business interest paid or accrued in succeeding tax years under section 163(j)(2).

However, some commentators believe that under the statutory language, X and Y are automatically allowed a deduction of $8 in year 2 since each of X's and Y's share of ETI in year 2 of $23.33 exceeds their EBI of $8 from the same partnership.

We believe that neither of the approaches described above are fully reflective of the statutory intent to silo the determination of when business interest expense from a partnership is considered paid or accrued, as well as when such expense is deductible.
The following examples demonstrate the application of our recommended method of calculating the business interest carryforward:

Example 1

X and Y are equal partners in XY and agree to allocate items of XY pro rata. In year 1, X and Y are each allocated $8 of excess business interest from XY. In year 2, the adjusted taxable income of X and Y is $100 and $0, respectively. In year 2, the business interest expense of X and Y is $20 each. XY's adjusted taxable income in year 2 is $80 and it has business interest expense of $10. In year 2, XY's excess business interest is $0 (business interest limit of $24 [$80 x 30%] exceeds business interest expense of $10). X and Y are each allocated $23.33 of excess taxable income from XY ([$80 x ($24 - $10)/$24]/2).

Calculations for Partner X

1) The excess taxable income of $23.33 releases X's entire excess business interest of $8.
2) Only $7 of the released excess business interest B is deductible in year 2 (excess taxable income of $23.33 x 30%).
3) The entire amount of excess business interest was released, and all excess taxable income was used in step 2, therefore, $0 is added to the adjusted taxable income of X.
4) The remaining $1 of released excess business interest is added to X's business interest expense of $20. The entire $21 is deductible business interest expense since X's business interest limitation is $30 (adjusted taxable income of $100 x 30%).
5) There is $0 unreleased excess business interest remaining for carryforward.

Calculations for Partner Y

1) The excess taxable interest of $23.33 releases Y's entire excess business income of $8.
2) Only $7 of the released excess business interest is deductible in year 2 (excess taxable income of $23.33 x 30%).
3) The entire amount of excess business interest was released, and all excess taxable income was used in step 2, therefore, $0 is added to the adjusted taxable

income of Y.

4) The remaining $1 of released excess business interest is added to Y's business interest expense of $20. $0 of the $21 is deductible business interest expense since Y's business interest limitation is $0 (adjusted taxable income of $0 x 30%). Business interest expense of $21 is carried forward by partner Y to year 3.
5) There is $0 unreleased excess business interest remaining for carryforward.

Example 2

X and Y are equal partners in XY partnership and agree to allocate items of XY pro rata. In year 1, X and Y are each allocated $8 of excess business income from XY. In year 2, the adjusted taxable income of X and Y is $100 and $0, respectively. In year 2 the business interest expense of X and Y is $20 each. XY's adjusted taxable income in year 2 is $80 and it has business interest expense of $0. In year 2, XY's EBI is $0 (business interest limit of $24 [$80 x 30%] exceeds business interest expense of $0). X and Y are each allocated $40 of excess taxable income from XY ([$80 x ($24 - $0)/$24]/2).

Calculations for Partner X

1) The excess taxable income of $40 releases X's entire excess business interest of $8.
2) X's business expense limitation for the released excess business interest is $12 (excess taxable income of $40 x 30%) therefore, the entire $8 is deductible.
3) The entire amount of excess business interest was released and only a portion of excess taxable income was used in step 2. Therefore, $13.33 ($40 x ($12 - $8)/$12) is added to X's adjusted taxable income.
4) There is no nondeductible released excess business interest remaining. X's entire $20 of business interest expense is deductible since X business interest limitation is $34 ([adjusted taxable income of $100 + excess taxable interest of $13.33] x 30%).
5) There is $0 unreleased excess business interest remaining for carryforward.

Calculations for Partner Y

1) The excess taxable interest of $40 releases Y's entire excess business interest of $8.
2) Y's business expense limitation for the release excess business interest is $12 (excess taxable interest of $40 x 30%) therefore, the entire $8 is deductible
3) The entire amount of excess business interest was released and only a portion of excess taxable interest was used in step 2. Therefore, $13.33 ($40 x ($12 - $8)/$12) is added to Y's adjusted taxable income.
4) There is no nondeductible released excess business interest remaining. Only $4 of Y's business interest expense is deductible since Y's business interest limitation is $4 ([adjusted taxable income of $0 + excess taxable income of

$13.33] x 30%. $16 of business interest expense is carried forward by the partner to year 3.
5) There is $0 unreleased excess business interest remaining for carryforward.

Example 3

X and Y are equal partners in XY partnership and agree to allocate items of XY pro rata. In year 1 X and Y are each allocated $8 of excess business interest from XY. In year 2, the ATI of X and Y is $100 and $0, respectively. In year 2, the business interest expense of X and Y is $20 each. In year 2 XY's adjusted taxable income is $40 and its business interest expense is $10.

In year 2, XY's excess business interest is $0 (business interest limit of $12 [$40 x 30%] exceeds business interest expense of $10). Each of X and Y is allocated $3.33 of excess taxable income from XY ([$40 x ($12 - $10)/$12]/2).

Calculations for Partner X

1) The excess taxable income of $3.33 releases $3.33 of X's excess business interest carryforward of $8
2) Only $1 of the released excess business interest is deductible in year 2 (excess taxable income of $3.33 x 30%).
3) Since only a portion of X's excess business interest was released, $0 of excess taxable income is added to X's adjusted taxable income.
4) The remaining $2.33 of released excess business interest is added to X's business interest expense of $20. The entire $22.33 of X's business interest expense is deductible since X's business interest limitation is $30 (adjusted taxable income of $100 x 30%).
5) X has an excess business interest carryforward from XY of $4.67 to year 3.

Calculations for Partner Y

1) The excess taxable income of $3.33 releases $3.33 of Y's excess business interest carryforward of $8
2) Only $1 of the released excess business interest is deductible in year 2 (excess taxable income of $3.33 x 30%).
3) Since only a portion of Y's "excess business interest" was released, $0 excess taxable income is added to Y's adjusted taxable income.
4) The remaining $2.33 of released excess business interest is added to Y's business interest expense of $20. $0 of the $22.33 is deductible business interest expense since partner's business interest limitation is $0 (adjusted taxable income of $0 x 30%). Business interest expense of $22.33 is carried forward by the partner to year 3.
5) Y has an excess business interest carryforward from XY of $4.67 to year 3.

2. Impact of section 743(b) adjustments

Overview

In general, the tax basis of partnership property is not adjusted when a partnership interest is sold, exchanged or in the case of the death of a partner. However, if a partnership makes a valid section 754 election, or has a substantial built-in loss, then a special basis adjustment is available to the transferee for the tax basis of the transferee's share of partnership property. Corresponding depreciation or amortization deductions are subsequently available to the transferee partner.

Recommendation

The AICPA recommends that a partnership first calculate its section 163(j) limitation including the section 743(b) adjustments of a partnership's partner and then recalculates it without the section 743(b) adjustment to determine each partner's amount of deductible interest expense and EBI.

Analysis

Under Treas. Reg. 1.743-1(j), section 743(b) adjustments affect the transferee partner's basis in the applicable partnership property. Further, this regulation clarifies that a section 743(b) adjustment does not impact the partnership level determination of any item under section 703. If the depreciation or amortization deductions associated with section 743(b) adjustments were included in the partnership determination of ATI, then a specific partner's section 743(b) adjustment could impact the deductibility of interest for other partners of the same partnership. However, a partner's section 743(b) adjustment impacts the amount of taxable income the partner recognizes from the partnership on its own tax return. Given section 163(j)(4)(A)(i) requires that the annual limitation on the deduction of business interest expense is applied at the partnership level, we recommend the partnership first determine its section 163(j) interest limitation without regard to section 743 adjustments and determine each partner's share of deductible interest expense, EBI and ETI. In a subsequent step, we recommend that the partnership recalculate its ATI in regards only to the partner(s) that have section 743(b) adjustments to determine that partner's amount of deductible interest expense, EBI and ETI.

Example 1

X and Y are equal partners in XY partnership and agree to allocate all items pro rata. XY has $130 of ATI before taking into account any depreciation and amortization deductions, $10 of business interest expense, and no partnership-level depreciation or amortization deductions. X has a section 743(b) adjustment resulting in $100 of depreciation/amortization per year (attributable to X's purchase of its partnership interest from Z when XY had a valid section 754 election in effect).

XY calculates its adjusted taxable income without regard to X's section 743(b) adjustment. XY's adjusted taxable income is $130 and its section 163(j) limitation is $39 ($130 x 30%). Y's $5 distributive share of XY interest expense is included as part of Y's non-separately stated income and thus deductible by XY. Y is allocated $48.33 of excess taxable income ($130 x [$39 - $10]/$39)/2).

XY then recalculates its adjusted taxable income solely for X, taking into account its section 743(b) adjustment. In this step, XY has a tentative adjusted taxable income of $65 ($130 x 50%) for a loss of ($35) after the section 743(b) amortization and depreciation are taken into account. As a result, X's $5 distributive share of the interest expense of XY is disallowed and is allocated to X as excess business interest.

The example above demonstrates the impact of section 743(b) adjustments on amortization and depreciation. Although amortization and depreciation do not impact the partnership's calculation of ATI until 2022[24], other section 743(b) adjustments also impact the amount of income, gain and loss that flows through to a partner when there is a sale or exchange of property subject to the adjustment as shown in the following example.

Example 2

X and Y are equal partners in XY partnership and agree to allocate all items pro rata. XY has $130 of adjusted taxable income before taking into account any section 743(b) items. XY has $10 of business interest expense, and no partnership-level depreciation or amortization deductions. XY sells inventory for which X has a section 743(b) adjustment of $100 (attributable to X's purchase of its partnership interest from Z when XY had a valid section 754 election in effect).

XY first determines its adjusted taxable income without regard to X's section 743(b) adjustment. XY's adjusted taxable income is $130 and its section 163(j) limitation is $39 ($130 x 30%). Y's $5 distributive share of XY interest expense is included as part of Y's non-separately stated income and thus deductible by XY, and Y is allocated $48.33 of excess taxable income ($130 x [$39 - $10]/$39)/2).

Next, XY recalculates its adjusted taxable income solely for X, taking into account its section 743(b) adjustment. In this step XY has a tentative adjusted taxable income of $65 ($130 x 50%) for a loss of ($35) after the section 743(b) adjustment for the sold inventory is taken into account. As a result, X's $5 distributive share of XY interest expense is disallowed and is allocated to X as excess business interest.

There is precedent under Treas. Reg. § 1.1245-1(e)(3) and (4) for using this approach to take into account the partner's section 743(b) adjustment for purposes of determining the respective partner's share of ATI to calculate the section 163(j) limitation. This approach is analogous to the determination of the amount of gain recognized under section 1245(a)(1) by a partner who has a special basis adjustment under section 743(b) with respect to the section 1245 property that is

[24] IRC section 163(j)(8)(A)(v).

disposed of by the partnership. Treasury Reg. § 1.1245-1(e)(3) and (4) provide that the partner's share of section 1245(a)(1) gain on the disposal of an asset must take into account the partner's section 743 basis adjustment.

3. Real property trade or business election

Overview

Real estate businesses that satisfy the definitional standards under section 469(c)(7)(C) are eligible to irrevocably elect out of the interest limitation rules of section 163(j) (the real property trade or business election). Section 469(c)(7)(C) defines a real estate trade or business as including any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

Recommendation

The AICPA recommends that Treasury and the IRS clarify that a partnership, rather than its partners, makes the section 163(j)(7)(B) real property trade or business election.

Analysis

Generally, under section 703(b), any election affecting the computation of taxable income of the partnership is made at the partnership level. The rules under new section 163(j)(4) specifically provide that the limitation must apply at the partnership level.

An election for the real property trade or business at the partner level would significantly complicate the mechanics of determining each partner's share of depreciation deductions because an electing real property trade or business would need to use the ADS. In effect, different depreciation schedules are potentially required if certain partners elect out and other partners do not.

4. Application of section 704(c) methods

Overview

Partnerships holding section 704(c) property must take into account, for purposes of allocating items with respect to such property, the difference between the fair market value and adjusted tax basis at the respective time of contribution into the partnership or revaluation of the partnership. The methods used to determine such allocations affect how a distributive item of taxable income of the partnership is allocated among the partners, however, it has a net zero effect on taxable income at the partnership level.

Recommendations

The AICPA recommends that Treasury and the IRS clarify that section 704(c) methods are not taken into account in applying the section 163(j) limitation at the partnership level as they do not impact the amount of income or loss at the partnership level.

Analysis

In general, if the basis of contributed property differs from its value, section 704(c)(1)(A) requires the allocation of income, gain, loss, and deduction with respect to the contributed property among the partners "so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution." In addition, if a partnership revalues its property, increasing or decreasing the capital accounts of the partners to reflect a revaluation on the partnership's books, the regulations under section 704(b) require that the partners' distributive shares of depreciation, depletion, amortization, and gain or loss, computed for tax purposes, take into account the variation between the tax basis and section 704(b) book value of such property in the same manner as under section 704(c).

Treasury Reg. § 1.704(c)-3(a) provides that a partnership must account for the difference between the basis and value of contributed property "using a reasonable method that is consistent with the purpose of section 704(c)." However, there are three generally permissible methods for making section 704(c) allocations outlined in the regulations:

- the traditional method;
- the traditional method with curative allocations; and
- the remedial allocation method.

Although section 704(c) impacts how items of tax depreciation, depletion, amortization, and gain or loss are allocated among the partners in the partnership, it does not impact the amount of the partnership's taxable income or loss. Section 163(j)(4)(A)(i) requires that the annual limitation on the deduction of business interest expense is applied at the partnership level. Since section 704(c) does not impact the amount of the partnership's taxable income or loss, it should apply at the partnership level without regard to section 704(c).

5. Allocation of items between exempt and non-exempt businesses

Overview

Section 163(j)(7)(A) provides for the exclusion of certain businesses from the term "trade or business" for purposes of applying the section 163(j) limitation. The excluded businesses include the trade or business of performing services as an employee; any electing real property trade or business; any electing farming business; and the trade or business of the furnishing or sale of certain electrical energy, water, or sewage disposal services, gas or steam through a local distribution system, or transportation of gas or steam by pipeline. It is unclear how to allocate a partnership's interest expense between exempt and non-exempt businesses of the partnership in the situation where a partnership has both types of businesses.

Recommendation

The AICPA recommends that Treasury and the IRS provide alternative methods to allocate interest expense between exempt and non-exempt businesses including (1) apportionment based on assets, (e.g. principles similar to the principles under section 861 based on tax basis or fair market value), and (2) tracing principles as described under Treas. Reg. § 1.163-8T.

Analysis

In order to comply with the changes to the interest limitation rules under section 163(j) that exempt certain businesses, guidance is requested to determine the method of allocating interest expense apportioned to such exempt business versus a non-exempt business. Guidance providing a choice of allocation methodologies will provide certainty to the taxpayer as to the permissible approaches.