

XI. *Limitations on the Business Interest Deduction: The New I.R.C. § 163(j) under the Tax Cuts and Jobs Act*

A. Introduction

In 2017 the Tax Cuts and Jobs Act (TCJA) amended various sections of the Internal Revenue Code (IRC, Tax Code), including section 163(j).¹ This change included a stricter limit on the allowable deduction of business interest expense.² Before the TCJA, corporations could deduct interest paid on trade or business related debt subject to a few exceptions.³ The new section limits the amount of business interest that can be deducted. The business interest deduction limit does not apply to businesses meeting section 448(c)'s gross receipts test, which are businesses with less than \$25 million in average annual gross receipts over a period of three taxable years.⁴ At the end of 2017, the Joint Committee on Taxation estimated that this limitation would increase the United States' tax revenue by \$8.4 billion in 2018 alone, and around \$253 billion in total from the 2018 tax year through 2027.⁵

¹ See Tax Cuts and Jobs Act, Pub. L. 115-97, § 13301, 131 Stat. 20154, 2117 (2017) (amending the 1986 Internal Revenue Code) [hereinafter Tax Cuts and Jobs Act].

² *Id.* (providing a stricter limitation on the deductibility of business interest expense).

³ See I.R.C. § 163 (2012); Memorandum from Garvey Schubert Barer, P.C., Larry Brant & Steven Nofziger, Larry's Tax Law: Decoding the Tax Cuts and Jobs Act—Part V: Changes to IRC §163(j) and the Business Interest Deduction Rules (Feb. 2, 2018), <https://www.gsblaw.com/pp/blogpost-949.pdf?47009> [https://perma.cc/5MMG-TEPQ].

⁴ I.R.C. § 448(c) (2012) (“A corporation or partnership meets the gross receipts test . . . if the average annual gross receipts of such entity for the 3-taxable-year period ending with the taxable year which precedes such taxable year does not exceed \$25,000,000.”); Memorandum from Garvey Schubert Barer, P.C., *supra* note 3 (“In the case of any taxpayer . . . which meets the gross receipts test of section 448(c) for any taxable year, paragraph (1) shall not apply to such taxpayer for such taxable year.”).

⁵ JOINT COMM. ON TAXATION, JCX-67-17, ESTIMATED BUDGET EFFECTS OF THE CONFERENCE AGREEMENT FOR H.R. 1, THE “TAX CUTS AND JOBS ACT” at 3 (2017).

Unfortunately, the TCJA left open many issues surrounding the new rules on business interest deduction.⁶ Therefore, the Department of the Treasury (Treasury) issued proposed regulations regarding section 163(j) in November of 2018.⁷ The main issues covered by the proposed regulations include definitional issues, issues with the carryforward rules for disallowed business interest deductions, and the application of section 163(j) to consolidated groups, partnerships, S corporations, and controlled foreign corporations.⁸

Section B proceeds with a discussion of the prior iterations of section 163(j) and its historical significance. Section C then discusses the changes arising from the enactment of the TCJA, effects of the changes, and the expected impacts. Section D considers the proposed regulations and their likely effects on businesses moving forward. Finally, Section E provides a brief conclusion.

B. Background

1. Earnings Stripping

Prior to 1989, the Tax Code allowed corporations to deduct any and all interest related to its trade or business.⁹ Corporations quickly found a way to take advantage of this deduction using a

⁶ John A. Bogdanski, *Section 163(j)—Not Just About ‘Stripping’ any More*, 45 CORP. TAX’N 21, 27 (2018) (discussing “gaps in the statutory language” that existed upon enactment of the new 163(j)).

⁷ Client Alert Commentary from Latham & Watkins LLP, Eric Cho et al., *IRS Issues Proposed Regulations on Business Interest Deduction Limitations* (Dec. 19, 2018), <https://www.lw.com/thoughtLeadership/IRS-Issues-Proposed-Regulations-on-Business-Interest-Deduction-Limitations> [<https://perma.cc/P2GS-HC25>] (“On November 26, 2018, the Treasury and the Internal Revenue Service (IRS) released proposed regulations (Proposed Regulations) implementing the business interest expense limitation rules under new Section 163(j) . . .”).

⁸ *US Proposed Regulations Offer Much-Needed Guidance on Section 163(j) Business Interest Expense Limitation*, ERNST & YOUNG (Nov. 30, 2018), <https://www.ey.com/gl/en/services/tax/international-tax/alert--us-proposed-regulations-offer-much-needed-guidance-on-section-163j-business-interest-expense-limitation> [<https://perma.cc/V7PL-5HRU>].

⁹ Memorandum from Garvey Schubert Barer, P.C., *supra* note 3 (describing how, before the TCJA, interest related to a trade or business was generally deductible).

method known more generally as “earnings stripping.”¹⁰ One way to accomplish earnings stripping was to make deductible interest payments to a foreign affiliate that faced little to no U.S. tax on its interest income, effectively decreasing taxable income for the domestic corporation.¹¹

This practice has been mitigated in part by Subpart F income rules under section 954(a).¹² Additionally, in 1989, Congress enacted section 163(j) to reduce earnings stripping accomplished through business interest deductions.¹³ This section incorporated a limitation on a business’s interest deductions if a business’s disqualified interest exceeded fifty percent of its adjusted taxable income, and that business’s debt to equity ratio at the end of the taxable year exceeded 1.5 to 1.¹⁴ If the corporation’s ratio exceeded that amount and the corporation’s net interest expense exceeded fifty percent of adjusted taxable income, the deduction of this disqualified interest was disallowed, but could be carried forward indefinitely to future taxable years.¹⁵ Disqualified interest was defined in section 163 as “any interest paid or accrued by the taxpayer (directly or indirectly) to a related person if no tax is imposed by this subtitle with respect to such interest.”¹⁶ Thus, the section attempted to reduce the practice of earnings stripping through interest payments.¹⁷

2. Results and Effectiveness

In 1989 the Joint Committee on Taxation estimated that the limit on interest deductions meant to prevent earnings stripping would create a tax revenue increase of \$25 million in 1990, and a total

¹⁰ *Id.* (stating the allowance of the trade or business interest deduction resulted in the practice of earnings stripping to avoid tax).

¹¹ J. Clifton Fleming et al., *Getting Serious About Cross Border Earnings Stripping: Establishing an Analytical Framework*, 93 N.C. L. REV. 673, 675 (2015).

¹² *Id.* at 682.

¹³ Memorandum from Garvey Schubert Barer, P.C., *supra* note 3 (stating that the enactment of section 163(j) in 1989 was meant to reduce earnings stripping through a restriction on business interest deductions for certain qualifying businesses).

¹⁴ I.R.C. § 163 (2012); Fleming et al., *supra* note 11, at 693 (explaining the original section 163(j) enacted in 1989).

¹⁵ §§ 163(j)(1)(A), (j)(2)(B)(ii) (2012).

¹⁶ § 163(j)(3)(A).

¹⁷ *See* Fleming et al., *supra* note 11, at 693.

increase of \$183 million for tax years 1990–1994 (not adjusted for inflation).¹⁸ However, the question remains: was the section actually effective in preventing earnings stripping?

The section itself was criticized for several reasons.¹⁹ First, when the section was enacted it came into conflict with provisions of U.S. tax treaties, in particular the articles pertaining to associated enterprise and nondiscrimination.²⁰ The concern revolved around the effects on foreign relations and the threat of rebalancing, whereby the foreign country attempts to even the playing field by increasing its tax on U.S. corporations.²¹ Another criticism was that the earnings stripping rules were subject to abuse as “they disregarded the economics of corporate finance.”²² The general idea was that the section was far too mechanical and thus open to compliance by form but not substance.²³ Additionally, the section’s debt-to-equity threshold was criticized for being overly broad as it would catch not only “cases of abusive thin capitalization” but also those of “economically-justified high leverage” (there are many substantive business reasons to be highly leveraged), while at the same time missing many of the situations of earnings stripping where it was originally meant to apply.²⁴

A 2007 Treasury report to Congress recognized that many corporations continued to avoid substantial U.S. tax through earnings stripping despite the operation of section 163(j).²⁵ However, the Treasury concluded it was “not possible to determine with precision

¹⁸ JOINT COMM. ON TAXATION, *supra* note 5, at 2.

¹⁹ Robert J. Misey, Jr., *An Unsatisfactory Response to the International Problem of Thin Capitalization: Can Regulations Save the Earnings Stripping Provision?*, 8 BERKELEY J. INT’L L. 171, 192–97 (1991).

²⁰ *Id.* at 192 (“The clear and distinct conflict between the earnings stripping provision and two treaty articles—the associated enterprises article and the nondiscrimination article—shows that the earnings stripping provision overrides treaties.”)

²¹ *Id.* at 196.

²² *Id.* at 196–97.

²³ *Id.* (discussing the abuse of the mechanical test employed by 163(j)).

²⁴ *Id.* at 197.

²⁵ DEP’T OF THE TREASURY, REPORT TO THE CONGRESS ON EARNINGS STRIPPING, TRANSFER PRICING AND U.S. INCOME TAX TREATIES 8 (2007), <https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Earnings-Stripping-Transfer-Pricing-2007.pdf> [<https://perma.cc/FD4P-BSJV>] (“Evidence of earnings stripping by ICs suggests that in this context the current rules of section 163(j) are not effective at preventing the shifting of income inappropriately outside the United States.”).

whether section 163(j) is effective in preventing” earnings shifting by foreign controlled domestic corporations as it was unable to determine with accuracy the amount of income shifting that actually occurs.²⁶ But the Treasury stated there was “strong evidence,” based on a study of four inverted corporations, that these inverted corporations stripped “essentially 100 percent of their income out of the United States.”²⁷ These four corporations alone reduced tax revenue in 2002 and 2003 by at least \$700 million, and the revenue loss overall is estimated to be “considerably larger.”²⁸ Thus, it is difficult to say that the old section 163(j) was entirely effective—if at all—in stopping earnings stripping and preserving the tax base.²⁹

C. Current Regulation Under TCJA

This section examines the changes, criticisms, and possible impacts following the enactment of the new rules from the TCJA. As discussed above, the new section 163(j) limits the amount of business interest deducted by taxpayers to the sum of:

- (i) the business interest income of such taxpayer for such taxable year;
- (ii) thirty percent of the adjusted taxable income of such taxpayer for such taxable year; plus
- (iii) the floor plan financing interest of such taxpayer for such taxable year.³⁰

The floor plan financing interest refers to “indebtedness used to finance the acquisition of motor vehicles held for sale or lease” (including boats and farming equipment).³¹ The proposed regulations provide greater detail on what is included in adjusted taxable income

²⁶ *Id.* at 23.

²⁷ *Id.*

²⁸ *Id.*

²⁹ *See id.* (discussing the continuing practice of earnings stripping even after the enactment of section 163(j)).

³⁰ Tax Cuts and Jobs Act, Pub. L. 115-97, § 13301, 131 Stat. 2054, 2117 (2017).

³¹ *Id.*

as well as what constitutes business interest income and expense, discussed below.³²

1. *Exempt Parties*

Section 163(j) contains several exemptions for certain taxpayers.³³ The cap on business related interest deduction does not apply to businesses that meet the gross receipts test under I.R.C. section 448(c), meaning a business that has less than \$25 million in average annual gross receipts over a three-year-taxable period.³⁴ The section also exempts “trade or business of performing services as an employee” by not treating this activity as a trade or business for purposes of the limitation.³⁵ Narrowing its applicability, the section also exempts “any electing real property trade or business,” certain farming businesses, and certain public utilities.³⁶

2. *Earnings Stripping under the New Legislation*

The above concerns of earnings stripping have not disappeared entirely with the new legislation.³⁷ While the amendment of

³² See Limitation on Deduction for Business Interest Expense, 83 Fed. Reg. 67490, 67493 (Dec. 28, 2018).

³³ § 13301, 131 Stat. at 2117–19 (providing exemptions, with some exceptions, for small businesses, employee trade or businesses, farming businesses, real property businesses, and others).

³⁴ § 13301, 131 Stat. at 2117 (2017) (“In the case of any taxpayer . . . which meets the gross receipts test of section 448(c) for any taxable year, paragraph (1) shall not apply to such taxpayer for such taxable year.”); I.R.C. § 448(c) (2012) (“A corporation or partnership meets the gross receipts test . . . if the average annual gross receipts of such entity for the 3-taxable-year period ending with the taxable year which precedes such taxable year does not exceed \$25,000,000.”).

³⁵ See JOINT COMM. ON TAXATION, JCS-1-18, GENERAL EXPLANATION OF PUBLIC LAW 115-97 178 (2018) (“The trade or business of performing services as an employee is not treated as a trade or business for purposes of the limitation.”).

³⁶ See *id.* at 178–79.

³⁷ Bogdanski, *supra* note 6, at 30 (describing how the new 163(j) may still be in effect partly to stop earnings stripping even though it is now aimed more at adjusting capital structures, but the new BEAT provision is also aimed at preventing earnings stripping).

section 163(j) repealed the previous earnings stripping rules,³⁸ there is still a concern for preserving the U.S. tax base present in the amended tax code.³⁹ Congress's motivation to influence the amount of debt in a corporation's capital structure has eclipsed (but has not entirely done away with) the earnings stripping concern within 163(j).⁴⁰ A lower debt-to-equity ratio would be preferential to the IRS, as equity distributions are generally taxed twice.⁴¹ Additionally, the new amendments broadened the reach of 163(j) by imposing a restriction that applies to all trade and business related interest deductions, not just disqualified interest from related party transactions.⁴² In fact, it removed the idea of disqualified interest entirely.⁴³

The new section also continues to fight tax base erosion through its interaction with IRC section 59A, the Base Erosion and Anti-Abuse Tax (BEAT).⁴⁴ Generally, this section mitigates tax base erosion by imposing a minimum tax on large corporations based on their modified taxable income.⁴⁵ The amount of interest deduction disallowed under section 163(j) will be allocated "first to interest paid or accrued to persons who are not related parties with respect to the taxpayer."⁴⁶ The Treasury and the IRS have not issued guidance on the issue—despite questions and confusion—electing rather to "reserve on

³⁸ See § 13301, 131 Stat. at 2117 (2017); Andrew Betaque et al., *Tax Reform: Impact on Lending*, WINSTON & STRAWN LLP (Jan. 16, 2018), <https://www.winston.com/en/thought-leadership/tax-reform-impact-on-lending.html> [<https://perma.cc/6G9V-VY53>] ("The Act repeals the earnings stripping rules and imposes a new limitation on the deductibility of net business interest expense under new Code Section 163(j).")

³⁹ Bogdanski, *supra* note 6, at 30.

⁴⁰ Robert E. Holo et al., *Not So Fast: 163(j), 245A, and Leverage in the Post-TCJA World*, 128 YALE L.J. F. 383, 384 (2018).

⁴¹ GARY CLYDE HUFBAUER & ARIEL ASSA, PETERSON INST. FOR INT'L ECON., POLICY BRIEF 03-7, RULES AGAINST EARNINGS STRIPPING: WRONG ANSWER TO CORPORATE INVERSIONS 3 (2003), <https://piie.com/sites/default/files/publications/pb/pb03-7.pdf> [<https://perma.cc/LKN6-YU4Q>].

⁴² See Tax Cuts and Jobs Act, Pub. L. 115-97, § 13301, 131 Stat. 2054, 2117 (2017) (repealing previous provisions of section 163(j) that worked with the idea of disqualified interest).

⁴³ § 13301, 131 Stat. at 2117.

⁴⁴ Bogdanski, *supra* note 6, at 30 (explaining the interaction and purpose of 163(j) and BEAT).

⁴⁵ *Id.*

⁴⁶ Base Erosion and Anti-Abuse Tax, 83 Fed. Reg. 65956, 65964 (Dec. 21, 2018).

the interaction of these provisions” and to consider comments received on this topic “in conjunction with separate guidance under section 59A.”⁴⁷

3. *Expected Impacts*

c) Debt vs. Equity⁴⁸

Before the TCJA, the tax code favored debt over equity, which encouraged corporations to carry more debt because of the allowable deductions related to interest expense.⁴⁹ The previous iterations of 163(j) focused only on related party lending and highly leveraged corporations, but 163(j) under the TCJA has greatly expanded the scope.⁵⁰ The new limit imposed by the TCJA will cause debt to become more expensive for many taxpayers.⁵¹ Therefore, it is likely to have a significant impact on the capital structures of corporations, making them more equity-heavy, as well as impacting acquisition financing through debt—though the extent of this impact is yet unknown.⁵² There is also concern that this limit will push multinational corporations to move borrowing to foreign territories that allow the advantage of an unlimited or less limited interest expense deduction.⁵³

Multinational corporations also favored debt over equity—mostly in the form of dividends—for the repatriation of cash to the United States due to the tax offset allowed through interest expense

⁴⁷ Limitation on Deduction for Business Interest Expense, 83 Fed. Reg. 67490, 67497 (Dec. 28, 2018) (“The Treasury Department and the IRS have received comments on the interaction of sections 163(j) and 59A. . . . These proposed regulations reserve on the interaction of these provisions.”).

⁴⁸ For an in-depth discussion on the TCJA effect on debt and equity related decisions, see Holo et al., *supra* note 40.

⁴⁹ Holo et al., *supra* note 40, at 383 (“Under the TCJA, debt financing is now generally less favored by the Code, and so acquisition structures and capital structures will need to be rethought and remodeled to assess their relative tax efficiency going forward.”).

⁵⁰ *Id.* at 384 (“[D]isallowances under § 163(j) were generally aimed at reducing the use of related-party debt to engage in ‘earnings stripping.’”).

⁵¹ *Id.*

⁵² *Id.* (“The expanded scope of § 163(j) under the TCJA may significantly decrease the corporate appetite for relying on debt to finance future acquisition structures, including, notably, structures that did not raise any § 163(j) issues pre-TCJA.”).

⁵³ *Id.* at 390.

deductions pre-TCJA.⁵⁴ The new limit, combined with the effects of the new participation exemption under IRC section 199A, may move corporations towards equity routes when repatriating earnings.⁵⁵

d) Tax Budget

In late 2017, the Joint Committee on Taxation released its estimates of TCJA budget effects.⁵⁶ The estimates show that the limitation on business interest deductions will increase tax revenue in 2018 by \$8.4 billion and in 2019 by \$17.7 billion.⁵⁷ For tax years 2018–2022 (the years where depreciation, amortization, and depletion are not includable in adjusted taxable income⁵⁸), the limitation is expected to increase tax revenue by \$90.2 billion and cause a total increase over tax years 2018–2027 of \$253.4 billion.⁵⁹ This provision by itself will recoup around 18.8% of the expected tax losses flowing from the lowered corporate tax rate, which is expected to decrease tax revenues from 2018–2027 by \$1.35 trillion.⁶⁰

D. Proposed Regulations

The IRS was quick to recognize the need for additional guidance concerning section 163(j), and on April 2, 2018 announced its intent to issue proposed regulations along with issuing interim initial guidance on the section in Notice 2018-28.⁶¹ The proposed regulations were finally released on November 26, 2018, and will only apply to tax years following their adoption as final regulations unless taxpayers

⁵⁴ *Id.* at 384.

⁵⁵ *Id.* at 384–85.

⁵⁶ See JOINT COMM. ON TAXATION, *supra* note 5, at 3.

⁵⁷ *Id.*

⁵⁸ Tax Cuts and Jobs Act, Pub. L. 115-97, § 13301, 131 Stat. 2054, 2117 (2017) (“[T]he term ‘adjusted taxable income’ means the taxable income of the taxpayer computed without regard to . . . in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion”)

⁵⁹ See JOINT COMM. ON TAXATION, *supra* note 5, at 3.

⁶⁰ *Id.*

⁶¹ *Forthcoming Proposed Regulations will Offer Some Clarity on Section 163(j) Business Interest Expense Limitation*, ERNST & YOUNG (Apr. 6, 2018), <https://taxnews.ey.com/news/2018-0750-forthcoming-proposed-regulations-will-offer-some-clarity-on-section-163j-business-interest-expense-limitation> [<https://perma.cc/T7E6-9MLJ>].

choose to apply them to tax years following 2017.⁶² These regulations were open for comment until February 26, 2019.⁶³

The main topics the proposed regulations covered include resolving definitional issues, determining how the new section interacts with other sections in the tax code, addressing carryforward issues, addressing applicability to foreign corporations, and expanded guidance on how to apply the section to partnerships and S corporations.⁶⁴ The following is an overview of certain guidance that appears within the proposed regulations.

1. Significant Definitions

A taxpayer's adjusted taxable income (ATI) is essential for the calculation of the deduction limitation under section 163(j).⁶⁵ The section itself defines ATI as taxable income not including:

- (i) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business,
- (ii) any business interest or business interest income,
- (iii) the amount of any net operating loss deduction under section 172,
- (iv) the amount of any deduction allowed under section 199A, and
- (v) in the case of taxable year beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion⁶⁶

Additionally, the section allows for adjustments to ATI "as provided by the Secretary," allowing the Treasury to issue further rules on

⁶² *US Proposed Regulations Offer Much-Needed Guidance on Section 163(j) Business Interest Expense Limitation*, *supra* note 8, at 1 (stating that taxpayers may choose to apply the Regulations but by default the "Regulations would apply to tax years ending after the date the Treasury decision adopting the regulations as final regulations is published in the Federal Register").

⁶³ Limitation on Deduction for Business Interest Expense, 83 Fed. Reg. 67490, 67490 (Dec. 28, 2018).

⁶⁴ *See id.*

⁶⁵ *See* Tax Cuts and Jobs Act, Pub. L. 115-97, § 13301, 131 Stat. 2054, 2117 (2017) (stating the limitation is equal to the sum of business interest income, 30 percent of ATI, and the floor planning finance interest).

⁶⁶ *Id.* at 2120.

computing ATI.⁶⁷ The proposed regulations indeed added more adjustments to the computation.⁶⁸ These include the subtraction of the floor plan financing interest expense, adjustment for disposition of certain properties (only for tax years beginning before January 1, 2022), and adjustment for sale or disposition of stock from an interest in a consolidated group or partnership.⁶⁹ The smaller ATI is made, the more likely business interest will be subject to the new limitation.⁷⁰ Additionally, beginning in 2022 when depreciation, amortization, and depletion are deducted, ATI will decrease even further.⁷¹

The proposed regulations also define “interest” for section 163(j).⁷² The section itself merely defines business interest as “any interest paid or accrued on indebtedness properly allocable to a trade or business” not including investment interest.⁷³ The section fails to further elaborate on what exactly constitutes interest.⁷⁴ Thus, the Treasury decided to address this concern and defined interest in more detail under the proposed regulations.⁷⁵ Generally, interest under section 163(j) is to include interest on conventional debt and any transaction that is in substance indebtedness even if it is not indebtedness in form.⁷⁶ It will include items that are traditionally treated as

⁶⁷ *Id.* (“[T]he term ‘adjusted taxable income’ means the taxable income of the taxpayer . . . computed with such other adjustments as provided by the Secretary.”); *US Proposed Regulations Offer Much-Needed Guidance on Section 163(j) Business Interest Expense Limitation*, *supra* note 8, at 2 (“Section 163(j)(8)(B) authorizes the Treasury to provide for additional adjustments to ATI.”).

⁶⁸ *Limitation on Deduction for Business Interest Expense*, 83 Fed. Reg. at 67492.

⁶⁹ *Id.*; *US Proposed Regulations Offer Much-Needed Guidance on Section 163(j) Business Interest Expense Limitation*, *supra* note 8, at 2 (discussing the proposed adjustments made to the calculation of ATI).

⁷⁰ *See* § 13301, 131 Stat. at 2117 (2017) (basing the limitation of business interest deduction on ATI).

⁷¹ *Id.* at 2120 (providing for the inclusion of depreciation, amortization, and depletion in the calculation of ATI for taxable years 2022 and on).

⁷² *Limitation on Deduction for Business Interest Expense*, 83 Fed. Reg. at 67493.

⁷³ § 13301, 131 Stat. at 2117.

⁷⁴ *Id.*

⁷⁵ *Limitation on Deduction for Business Interest Expense*, 83 Fed. Reg. at 67493.

⁷⁶ *Id.*

interest under income tax principals as well as some that are not.⁷⁷ These include hedges on interest bearing assets or liabilities, debt issuance costs, income from factored receivables, and others “that the IRS and Treasury viewed as ‘closely related’ to interest and that ‘affect the economic yield or cost of funds of a transaction involving interest.’”⁷⁸ The regulations also impose

an anti-avoidance rule that treats as interest expense for purposes of section 163(j) an expense or loss predominantly incurred in consideration of the time value of money in a transaction or series of integrated or related transactions in which a taxpayer secures the use of funds for a period of time.⁷⁹

This is in order to prevent avoidance of the limit through transactions that are in substance financing transactions, a concern voiced in the prior version of 163(j).⁸⁰ Generally, the detailed but wide-reaching examples of interest, as well as the anti-avoidance rule appear to broaden the reach of 163(j) and close any gaps that make the limit vulnerable to manipulation.⁸¹

2. *Carryforward Rules*

Disallowed interest expense will generally be carried forward to each subsequent tax year, indefinitely.⁸² The regulations state that the carried forward amount will be applied after the current year’s

⁷⁷ *US Proposed Regulations Offer Much-Needed Guidance on Section 163(j) Business Interest Expense Limitation*, *supra* note 8, at 3 (discussing proposed changes to broaden what would qualify as business interest under section 163(j)).

⁷⁸ *Id.*; *See Limitation on Deduction for Business Interest Expense*, 83 Fed. Reg. at 67493.

⁷⁹ Prop. Treas. Reg. § 1.163(j)-1, 83 Fed. Reg. at 67493.

⁸⁰ *See id.*; *Misey*, *supra* note 19, at 197.

⁸¹ *See Limitation on Deduction for Business Interest Expense*, 83 Fed. Reg. at 67493.

⁸² Tax Cuts and Jobs Act, Pub. L. 115-97, § 13301, 131 Stat. 2054, 2117 (2017) (“The amount of any business interest not allowed as a deduction for any taxable year by reason of paragraph (1) shall be treated as business interest paid or accrued in the succeeding taxable year.”)

interest is accounted for.⁸³ This is out of concern over the interaction of 163(j) carryforward deductions and section 381.⁸⁴

3. Foreign Corporations⁸⁵

Proposed Treasury Regulation sections 1.163(j)-7 and 1.163(j)-8 provide the most useful guidance to foreign corporations.⁸⁶ Generally, section 163(j) will apply to controlled foreign corporations (CFC) the same way it applies to domestic corporations.⁸⁷ Thus, a CFC will apply section 163(j) when determining the amount of interest expense deductible in its calculations of subpart F income.⁸⁸ The proposed regulations also include an election for CFCs called the CFC group election, that provides for alternative calculations of certain amounts that may be advantageous for certain taxpayers.⁸⁹ The regulations also provide guidance for foreign taxpayers with effectively connected income.⁹⁰

⁸³ Limitation on Deduction for Business Interest Expense, 83 Fed. Reg. at 67500; *US Proposed Regulations Offer Much-Needed Guidance on Section 163(j) Business Interest Expense Limitation*, *supra* note 8, at 6 (discussing the mechanics of the carryforward for disallowed business interest deductions).

⁸⁴ Limitation on Deduction for Business Interest Expense, 83 Fed. Reg. at 67490; *US Proposed Regulations Offer Much-Needed Guidance on Section 163(j) Business Interest Expense Limitation*, *supra* note 8, at 6 (providing examples of interactions between 163(j) and other sections of the revenue code).

⁸⁵ For a more in-depth analysis, see *US Proposed 163(j) Regulations Have Implications for Financial Services Industry*, ERNST & YOUNG (Dec. 11, 2018), [https://taxinsights.ey.com/archive/archive-news/us-proposed-163\(j\)-regulations-have-implications.aspx](https://taxinsights.ey.com/archive/archive-news/us-proposed-163(j)-regulations-have-implications.aspx) [<https://perma.cc/76NB-BPR5>].

⁸⁶ *Id.* (explaining that sections 1.163(j)-7 and 1.163(j)-8 will “provide guidance on applying the new Section 163(j) rules to CFCs, their shareholders, and other foreign corporations with effectively connected income to a US trade or business”).

⁸⁷ Limitation on Deduction for Business Interest Expense, 83 Fed. Reg. at 67512–15.

⁸⁸ *Id.*

⁸⁹ Limitation on Deduction for Business Interest Expense, 83 Fed. Reg. at 67513–14; *US Proposed Regulations Offer Much-Needed Guidance on Section 163(j) Business Interest Expense Limitation*, *supra* note 8, at 8–9 (discussing the CFC group election and its effects on the taxpayer).

⁹⁰ Limitation on Deduction for Business Interest Expense, 83 Fed. Reg. at 67515.

4. Partnerships and S Corporations

The proposed regulations state that section 163(j) should be applied at the partnership level, making partnerships deduct the interest, not the individual taxpayers.⁹¹ However, the excess deduction over the limitation that is disallowed will be accounted for as excess business interest (EBI), which is allocated to the partners like profit or loss is allocated.⁹² Subsequently, the partner may only deduct the EBI against excess taxable income that is distributed by that same partnership.⁹³ The regulations provide detailed steps for the calculation of the partnership's ATI and the partner's.⁹⁴

5. Comments

During the time it was open for comments, the proposed regulation garnered 108 comments from various individuals, companies, and organizations.⁹⁵ The comments address a number of aspects of the proposed regulation including definitions, applicability to CFCs, interaction with other code sections.⁹⁶ However, the proposed regulation's definition of interest seemed to receive some of the most attention.⁹⁷

The American Institute of Certified Public Accountants (AICPA) submitted a lengthy comment concerning almost every part of the new regulations.⁹⁸ In it, the AICPA criticizes the Treasury's adoption of a broad and detailed definition of interest and instead suggests interest include "any amount generally treated as interest under

⁹¹ *Id.* § 1.163(j)-6; *US Proposed Regulations Offer Much-Needed Guidance on Section 163(j) Business Interest Expense Limitation*, *supra* note 8, at 6–7 (discussing the treatment of the business interest deduction for partnerships).

⁹² *Id.*

⁹³ *Id.*

⁹⁴ *Id.*

⁹⁵ *Limitation on Deduction for Business Interest Expense (REG-106089-18)*, REGULATIONS.GOV, <https://www.regulations.gov/docket?D=IRS-2019-0004> [<https://perma.cc/EJ99-X429>].

⁹⁶ *See id.*

⁹⁷ *See id.*

⁹⁸ *See* Annette Nellen, Chair, Am. Inst. of Certified Pub. Accountants, *Re: Notice of Proposed Rulemaking Regarding the Limitation on Deduction for Business Interest Expense [REG-106089-18]* (Feb. 21, 2019) <https://www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/20190221-aicpa-comments-sec-163j-prop-regs.pdf> [<https://perma.cc/ZBG4-PNAF>].

other provisions of the Code or regulations.”⁹⁹ The AICPA bases this suggestion on the congressional intent underlying section 163(j), claiming Congress had no intention of this section applying to any payments that do not involve indebtedness or those that are not traditionally considered interest.¹⁰⁰ It goes on to claim the Treasury does not have the authority to expand the definition of interest because Congress did not include a clause in 163(j) specifically allowing the Treasury to promulgate regulations.¹⁰¹ The comment also voices concerns over the administrative burden the broad definition will impose on the IRS.¹⁰² The U.S. Chamber of Commerce makes a similar argument in its comment, claiming this new definition of interest “goes far beyond the congressional intent.”¹⁰³ It is unclear if these comments will sway the Treasury to adjust the new regulations.

E. Conclusion

While the regulations covered a number of issues arising from the new 163(j), many concerns relating to both guidance needs and policy issues remain. The definition of interest—now broadened and not entirely definitive—may result in high compliance costs for taxpayers that have complex financing structures, and high administrative costs to the IRS to answer these questions as they arise.¹⁰⁴ Additionally, the partnership and CFC rules are complex and taxpayers

⁹⁹ *Id.* at 3–4.

¹⁰⁰ *See id.*

¹⁰¹ *See id.* (“If Congress intended to expand the definition of interest within the meaning of section 163(j), particularly to such a significant extent, Congress would have indicated as such, whether in the statute itself or in the relevant legislative history.”).

¹⁰² *Id.* at 5.

¹⁰³ U.S. Chamber of Commerce, *Feedback for REG-106089-18 (§163(j)) as of 2/25/2019*, 1 (Feb. 25, 2019), <https://www.uschamber.com/comment/us-chamber-comments-reg-106089-18-limitation-the-deduction-business-interest-expense> [<https://perma.cc/44XL-AGZ2>].

¹⁰⁴ *See generally* Limitation on Deduction for Business Interest Expense, 83 Fed. Reg. 67490 (Dec. 28, 2018); *US Proposed Regulations Offer Much-Needed Guidance on Section 163(j) Business Interest Expense Limitation*, *supra* note 8, at 14 (“As a consequence of the broad definition, taxpayers with complex financing structures . . . will face a substantial compliance burden to determine to what extent amounts not previously treated as interest may be subject to limitation under Section 163(j).”).

will face increased costs here.¹⁰⁵ Unfortunately, the new section may also cause more problems for businesses that are already in distress because the limitation is tied to that business's adjusted taxable income.¹⁰⁶ Further guidance on disallowed business interest deduction's interaction with section 59A is also awaited.¹⁰⁷

Moving forward, taxpayers should be aware of the exemptions under 163(j), the elections allowed under the section, and how the section specifically applies to the taxpayer, whether it is a partnership, C corporation, or CFC. The effective increase in the cost of debt will impact the financial industry and the capital structure of corporations, as well as the movement of debt financing abroad.¹⁰⁸

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¹⁰⁵ *Id.*

¹⁰⁶ Bogdanski, *supra* note 6, at 30 (“By tying the deductibility of interest to the taxpayer’s ‘adjusted taxable income,’ the revised Section 163(j) may exacerbate problems for businesses that encounter financial difficulty.”)

¹⁰⁷ Limitation on Deduction for Business Interest Expense, 83 Fed. Reg. 67490, 67497 (Dec. 28, 2018).

¹⁰⁸ Holo et al., *supra* note 40, at 384–90 (discussing consequences of the new section 163(j) and the increased cost of debt).

¹⁰⁹ Student, Boston University School of Law (J.D. 2020).