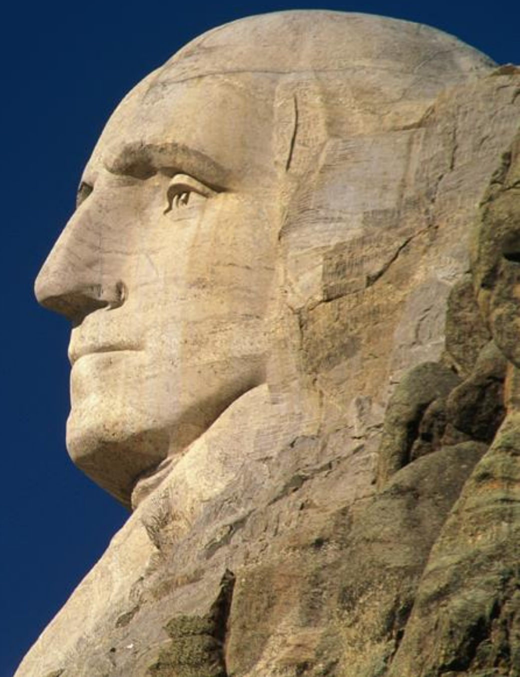
KPMG report: Initial analysis of regulations, guidance under section 163(j)

August 4, 2020



The U.S. Treasury Department and IRS (collectively "Treasury") on July 28, 2020, released two sets of regulations, as well as other administrative guidance, relating to section 163(j) as amended by:

- The 2017 U.S. tax law (Pub. L. No. 115-97, enacted December 22, 2017, and often referred to as the "Tax Cuts and Jobs Act")
- The Coronavirus Aid, Relief, and Economic Security Act (Pub. L. No. 116-136, enacted March 27, 2020, and often referred to as the "CARES Act")

The Treasury and IRS release (collectively, the "163(j) Package") included:

- Final regulations (T.D. 9905) (575 pages as issued in advance by the IRS) relating to section 163(j) (the "Final Regulations")—read the **Final Regulations** [PDF 898 KB] as published in the Federal Register.
- Proposed regulations (REG-107911-18) (285 pages as issued in advance by the IRS) relating to section 163(j) (the "2020 Proposed Regulations")—read the **2020 Proposed Regulations** [PDF 774 KB] as published in the Federal Register.
- **Notice 2020-59** [PDF 126], which provides a safe harbor allowing certain businesses that manage or operate "qualified residential living facilities" to qualify as "electing real property trades or businesses" under section 163(j)(7)(B)
- A list of **"frequently asked questions" (FAQs)** regarding the aggregation rules under section 448(c)(2) that apply to the section 163(j) small business exemption

Treasury on September 3, 2020, issued revised "official" versions of the Final Regulations and 2020 Proposed Regulations, which were published in the Federal Register on September 14, 2020. The official versions generally update and clarify the effective date language that was contained in the July 28 versions of the regulations.

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Background and applicability dates

Background

Section 163(j) was significantly altered, and its applicability was greatly expanded by, the Tax Cuts and Jobs Act. Finalization of regulations proposed by Treasury in late 2018 had been expected in early 2020 but with the enactment of the CARES Act, the scope and timing of the section 163(j) rules were revised. Now, with the release of this 163(j) Package, Treasury has provided final rules on many aspects of section 163(j), but, as will be discussed in this report, new proposed rules have once again changed significant parts of the regime and added complexity for many taxpayers. Before addressing the new guidance, a quick timeline of relevant developments to date is helpful in orienting the discussion.

The Tax Cuts and Jobs Act amended section 163(j) to disallow a deduction for business interest to the extent net business interest expense exceeds 30% of adjusted taxable income ("ATI") plus floor plan financing interest for taxable years beginning after December 31, 2017. For this purpose, ATI equals a taxpayer's taxable income computed without regard to (i) any item of income, gain, deduction, or loss that is not properly allocable to a trade or business, (ii) business interest expense or business interest income, (iii) the amount of any net operating loss ("NOL") deduction, (iv) the 20% deduction for certain passthrough income under section 199A, and (v) in the case of tax years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion. Business interest expense that is disallowed under section 163(j) is treated as paid or accrued in the succeeding taxable year and may be carried forward indefinitely. However, unlike under the old statute, to the extent a taxpayer has excess capacity to deduct interest in a given year but does not have sufficient interest expense, section 163(j) as amended does not permit such excess limitation to be carried forward.

Treasury issued Notice 2018-28 on April 6, 2018, in which it confirmed, among other things, that the section 163(j) limitation would be applied on a consolidated group basis.

Treasury released proposed regulations (REG-106089-18) relating to section 163(j) on November 26, 2018 (the "2018 Proposed Regulations"). Read ***TaxNewsFlash***

As indicated below, in March 2020 the CARES Act legislation made several temporary changes to section 163(j). These amendments apply to tax years beginning after December 31, 2018.

- **50% of ATI:** For tax years beginning in 2019 and 2020, the 30% limit on ATI is increased to 50%.
- **Partnerships:** The 50%-instead-of-30% ATI rule does not apply to a partnership tax year beginning in 2019, but (unless a partner otherwise elects out) for any of the partnership's 2019 excess business interest expense that is allocated to a partner under section 163(j)(4)(B)(i)(II):
  - 50% of that excess business interest expense will be treated as business interest that is paid or accrued by the partner in its first tax year beginning in 2020 and will not subject to the limits of section 163(j)(1) and is thus deductible in such tax year (subject to any other limitations that may apply), and
  - The other 50% will be subject to the limitations of section 163(j)(4)(B)(ii) in the same manner as any other excess business interest so allocated.

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- **Electing out of the 50%-of-ATI rule:** Taxpayers can elect not to have the 50%-of-ATI rule apply to any tax year. Such an election will need the Secretary's consent to be revoked. This is a partnership-level election and may be made only for tax years beginning in 2020.

- **Using 2019's ATI in 2020:** For any tax year beginning in 2020, taxpayers can elect to use their ATI from their last tax year beginning in 2019 for their ATI in the 2020 tax year. If such an election is made for a short tax year, the taxpayer's 2019 ATI will be prorated.

Treasury issued Revenue Procedure 2020-22 on April 10, 2020, in which it addressed the mechanics of the elections under section 163(j)(7)(B) (to be an electing real property trade or business) and section 163(j)(7)(C) (to be an electing farming business) for taxable years beginning in 2018, 2019, or 2020, as well as the mechanics for electing out of the CARES Act changes described above.

The Final Regulations and the 2020 Proposed Regulations were published on the IRS website on July 28, 2020, which has become a common practice by Treasury of late. The relevance of the publication venue is that effective dates and other administrative law matters are generally based on the display or publication of regulations by the Federal Register, so the effective dates of the rules will not be tied to the July 28 date.

Effective dates

Final Regulations

The Final Regulations generally will be applicable to taxable years beginning on or after November 13, 2020.

KPMG observation

The Final Regulations do not apply to tax years beginning in 2019 and there is no requirement for taxpayers to adopt or apply any of the new rules for 2019 (and even 2020 in many cases). Nonetheless, taxpayers do have the option to apply the Final Regulations retroactively and in some instances such application could prove to be a net benefit to taxpayers.

2020 Proposed Regulations

The 2020 Proposed Regulations generally are proposed to apply to taxable years beginning on or after the date 60 days after the date the Treasury Decision adopting the 2020 Proposed Regulations as final regulations is published in the Federal Register.

Retroactive application and reliance

Final Regulations

Taxpayers and related parties (determined under sections 267(b) and 707(b)(1)) generally will have the discretion to apply the Final Regulations in their entirety retroactively to a taxable year beginning after December 31, 2017, and before November 13, 2020.

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Notwithstanding the foregoing, the interest anti-avoidance rules in Reg. § 1.163(j)-1(b)(22)(iv) of the Final Regulations will be applicable to transactions entered into on or after November 13, 2020.

In addition, the rules for swaps with significant nonperiodic payments provided in Reg. § 1.163(j)-1(b)(22)(ii) will have a delayed applicability date, applying to notional principal contracts entered into on or after November 13, 2021 (although taxpayers and related parties may choose to apply such rules to notional principal contracts entered into before that date).

Alternatively, taxpayers may choose to rely on the 2018 Proposed Regulations for tax years beginning before the Final Regulations are applicable but must apply the 2018 Proposed Regulations in their entirety on a consistent basis. Taxpayers who choose to rely on the 2018 Proposed Regulations may nonetheless choose to apply Reg. § 1.163(j)-1(b)(1)(iii) in the Final Regulations (relating to depreciation, amortization, or depletion capitalized under section 263A) to taxable years beginning after December 31, 2017.

2020 Proposed Regulations

With certain exceptions and caveats as noted below, taxpayers and their related parties (determined under sections 267(b) and 707(b)(1)) may rely on the proposed rules in the 2020 Proposed Regulations for any taxable year beginning after December 31, 2017, and before the date 60 days after the date of publication of the Treasury Decision adopting the 2020 Proposed Regulations as final regulations in the Federal Register.

The 2020 Proposed Regulations provide that taxpayers who choose to apply the proposed rules to a taxable year before they are finalized must (along with their related parties) apply them and the Final Regulations consistently (and in certain cases consistent with other related regulations) to that taxable year and each subsequent taxable year. The following 2020 Proposed Regulations have such requirements:

- Prop. Reg. § 1.163(j)-1(b)(1)(iv)(B) and (E);
- Prop. Reg. § 1.163(j)-1(b)(22)(iii)(F) and (b)(35);
- Prop. Reg. § 1.163(j)-2(b)(3)(iii)-(iv) and (d)(3);
- Prop. Reg. § 1.163(j)-10(c)(5)(ii)(D)(2);
- Prop. Reg. § 1.469-4(d)(6);
- Prop. Reg. § 1.469-9(b)(2)(ii)(A) and (B); and
- Prop. Reg. § 1.1256(e)-2.

The following 2020 Proposed Regulations have the same consistency requirement as above, expect that taxpayers are not also required apply the Final Regulations:

- Prop. Reg. § 1.163-14;
- Prop. Reg. § 1.163-15; and
- Prop. Reg. § 1.163(j)-6 (however, must file consistently with § 1.163(j)-6 of the Final Regulations).

The rules with respect to the applicability of and reliance on Prop. Reg. §§ 1.163(j)-7 and -8 (relating to international provisions) are complex. Taxpayers who apply the Final Regulations to a taxable year beginning after December 31, 2017, and before November 13, 2020, may rely on §§1.163(j)-7 and 1.163(j)-8 of the 2020 Proposed Regulations for that taxable year. Taxpayers who choose not to apply the Final Regulations to such year(s) may not rely on either §1.163(j)-7 or 1.163(j)-8 of the 2020 Proposed Regulations for that taxable year(s).

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Comment period and hearing

Written comments or requests for a public hearing must be submitted by November 13, 2020.

Key concepts: Interest and adjusted taxable income

Interest

The Final Regulations narrow the definition of "interest" from the 2018 Proposed Regulations.
The Final Regulations maintain the structure of the 2018 Proposed Regulations in that the term "interest" means any amount described in one of four categories:

- Amounts generally accepted as the traditional meaning of "interest," that is, amounts paid, received, or accrued as compensation for the use or forbearance of money
- Amounts treated as interest on swaps with significant nonperiodic payments
- Amounts that affect the economic yield of a borrowing but that may not be compensation for the use or forbearance of money
- Amounts covered by an interest anti-avoidance rule

The Final Regulations do not change the first category, which includes amounts treated as interest (compensation for use or forbearance of money) under the Code or regulations, such as stated interest and original issue discount.

In the second category, for significant nonperiodic payments on swaps, the Final Regulations finalize the embedded loan rule, which requires a bifurcation of these contracts into a loan and an on-market, level-payment swap. The Final Regulations add exceptions for cleared swaps and for non-cleared swaps that require the parties to meet the margin or collateral requirements of a federal regulator (or requirements that are substantially similar to a federal regulator). The Final Regulations do not provide guidance to determine if a nonperiodic payment is significant. For purposes of section 163(j), the applicability date of the embedded loan rule is delayed for one year (unless the taxpayer chooses otherwise). Read ***TaxNewsFlash***

In the third category, the Final Regulations exclude several items that were included in the 2018 Proposed Regulations and narrow the rule for substitute interest payments. Debt issuance costs and commitment fees are now excluded from the definition of interest. (The Preamble says that "[t]he treatment of commitment fees and other fees paid in connection with lending transactions will be addressed in future guidance that applies for all purposes of the Code.")

The definition of interest also now excludes income, deduction, gain, or loss with respect to derivative contracts that alter a taxpayer's effective cost of borrowing or the effective yield of a debt instrument held by the taxpayer (the "hedging rules").

The rule for substitute interest is less inclusive than what had been proposed: A substitute interest payment is treated as interest expense by the payor only if the payment relates to a sale-repurchase or securities lending transaction that is **not** entered into by the payor in the payor's ordinary course of

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business. Likewise, a substitute interest payment is treated as interest income to the recipient only if the payment relates to a sale-repurchase or securities lending transaction that is **not** entered into by the recipient in the recipient's ordinary course of business.

Although the Final Regulations do not explicitly include guaranteed payments for the use of capital under section 707(c) in the definition of interest, the interest anti-avoidance rule (discussed next) includes an example in which such a guaranteed payment is treated as interest expense and interest income.

The Final Regulations substantially modify the fourth category: those amounts falling within the interest anti-avoidance rule. Importantly, the Final Regulations add a principal purpose requirement to this anti-avoidance rule, even while retaining a broad definition of "any expense or loss economically equivalent to interest." Specifically, any expense or loss is economically equivalent to interest to the extent that the expense or loss is deductible by the payor, is incurred in a transaction in which the taxpayer secures the use of funds for a period of time, is substantially incurred in consideration of the time value of money, and is not described in one of the other three categories.

For the anti-avoidance rule to apply, a taxpayer must have structured the transaction with a principal purpose of reducing an amount incurred by the taxpayer that otherwise would have been treated as interest under one of the other three categories. The taxpayer's business purpose for acquiring the funds is not relevant to the principal purpose inquiry, nor is the fact that the taxpayer has obtained funds at a lower pre-tax cost based on the structure of the transaction. Moreover, a holder must treat as interest income an amount received from a payor that the holder knows is treating as interest expense and that is compensation paid in consideration of the time value of money. Also, a transaction that is structured with a principal purpose of artificially increasing a taxpayer's business interest income ("BII") is ignored, such as a factoring transaction. For this purpose, the fact that a taxpayer has a business purpose for holding interest-generating assets is not taken into consideration. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately). The Final Regulations include several examples applying this anti-avoidance rule, including examples involving a foreign currency swap, a forward contract for the delivery of gold, a loan guaranteed by a related party in which the related party receives guarantee fees, and guaranteed payments for the use of capital of a partner.

Negative income

Although commenters had requested clarification on the treatment of negative interest, Treasury declined to do so, stating that the issue is beyond the scope of the Final Regulations.

Floor plan financing interest expense

The Final Regulations do not address the interaction between sections 163(j) and 168(k)(9) regarding floor plan financing interest expense. The Final Regulations do not exclude commercial financing liabilities from the section 163(j) limitation as requested by commenters.

Section 163(j) interest dividends

The 2020 Proposed Regulations would provide rules under which a regulated investment company ("RIC") that earns business interest income BII may pay "section 163(j) interest dividends," and rules under which a RIC's shareholder that receives a section 163(j) interest dividend may treat the dividend as interest income solely for purposes of section 163(j). The total amount of a RIC's section 163(j) interest dividends for a tax year would be limited to the excess of the RIC's BII over the RIC's business interest expense ("BIE") and other deductions that are properly allocable to the RIC's BII for the tax year. The

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amount of a section 163(j) interest dividend that a shareholder may treat as interest income for purposes of section 163(j) would be limited to the excess of the amount of the RIC dividend that includes the section 163(j) interest dividend over the sum of the "conduit amounts" other than interest-related dividends under section 871(k)(a)(C) and section 163(j) interest dividends (for example, capital gain dividends, exempt-interest dividends, and dividends eligible for the dividends received deduction). The Preamble to the 2020 Proposed Regulations explains that, absent this reduction for conduit amounts, a RIC shareholder could obtain an "inappropriate" benefit by treating a portion of a RIC dividend as interest income for purposes of section 163(j), while treating the same portion of the dividend as another non-interest type of income.

In addition, a shareholder generally would not be able to treat a section 163(j) interest dividend as interest income unless it meets certain holding period requirements. However, such holding period requirements would not apply to dividends paid by a money market fund or certain regular dividends paid by a RIC that declares section 163(j) interest dividends on a daily basis and distributes such dividends on a monthly or more frequent basis.

Only a RIC paying dividends that would be exempt from the holding period requirements and shareholders receiving such dividends may rely on the 2020 Proposed Regulations pertaining to section 163(j) interest dividends for tax years ending on or after the date of publication of the 2020 Proposed Regulations in the Federal Register.

Disallowed business interest expense

The Final Regulations revise the definition of "disallowed business interest expense" to reflect that for purposes of section 163(j), disallowed business interest expense is treated as "paid or accrued" in the tax year in which the expense is taken into account for Federal income tax purposes (without regard to section 163(j)), or in a succeeding tax year in which the expense can be deducted by the taxpayer under section 163(j), as the context may require.

The Preamble explains that the term "paid or accrued" as used in section 163(j)(2) is to provide a mechanism for disallowed business interest expense to be carried forward to and deducted in a subsequent tax year; it is not intended that interest be treated as paid or accrued in a later tax year for all purposes because that would be inconsistent with the purposes of other Code provisions. One example discussed in the Preamble is the interaction with section 382: If a disallowed business interest expense were treated as paid or accrued only in a future tax year in which such expense could be deducted after the application of section 163(j), then section 382 never would apply to such expense because disallowed business interest expense carryforwards never would be pre-change losses. The Preamble also says if a disallowed business interest expense were treated as paid or accrued in a future tax year for purposes of section 163(j)(8)(A)(ii), then such expense would be added back to tentative taxable income in determining ATI for that tax year (and for all future tax years to which such expense is carried forward under section 163(j)(2)), thereby artificially increasing the taxpayer's section 163(j) limitation.

Section 108 and cancellation of debt income

In the Preamble to the 2018 Proposed Regulations, Treasury requested comments on the interaction between section 163(j) and rules governing income from the discharge of indebtedness ("CODI"). In response, commenters sought clarification on whether CODI arises under section 61(a)(11) when a taxpayer receives a benefit only in the form of disallowed interest expense carryforwards, and how section 108(e)(2), section 111, and tax benefit principles apply. The Preamble states that "[i]n light of the complex and novel issues" raised in the comments, this interaction "requires further consideration and

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may be the subject of future guidance."

KPMG observation

The lack of guidance leaves taxpayers with an interpretative challenge. In general, section 108(e)(2) provides that no CODI arises to the extent that payment of the cancelled liability would have given rise to a deduction. The application of this provision to the cancellation of a liability for accrued, unpaid interest is unclear. The uncertainty is compounded where the deduction for the underlying accrued interest has been deferred as a result of the section 163(j) limitation, and because, as noted earlier, the tax year in which disallowed business interest expense is treated as paid or accrued can depend on the meaning of the phrase "as the context may require" in the definition of disallowed business interest expense. The potential consequence of CODI with respect to a liability for accrued interest can be unexpected, given that disallowed business interest expense carryovers are not among the tax attributes that can be reduced under section 108(b) in the case of excluded CODI (i.e., CODI excluded from income due to the debtor's insolvency).

Adjusted taxable income

General rules

The Final Regulations define adjusted taxable income ("ATI") as the "tentative taxable income" of the taxpayer for the tax year with certain adjustments.

Tentative taxable income, a new term added in the Final Regulations, is computed in accordance with section 63, but without regard to the application of the section 163(j) limitation and without regard to disallowed business interest expense carryforwards (i.e., all current-year business interest expense is treated as deductible for purposes of calculating tentative taxable income).

KPMG observation

The use of the new term *tentative taxable income* and the exclusion of disallowed business interest expense carryforwards are intended to correct an "unintended" aspect of the 2018 Proposed Regulations. Under the 2018 Proposed Regulations, disallowed business interest expense carryforwards would have resulted in a net positive adjustment to ATI. For example, a corporation that generated no net taxable income in 2019 and that had no other ATI adjustments for the year (i.e., no depreciation deductions or current-year interest expense), and that had a carryover of $100 in disallowed business interest expense from 2018, would have had ATI of $100 in 2019, thus allowing $30 of the 2018 disallowed business interest expense carryforward to be deducted in 2019 (and creating a $30 net operating loss ("NOL")).

KPMG observation

Ordering rules had been included in the 2018 Proposed Regulations to mitigate a circularity problem between the ATI determination and the section 250 deduction for foreign-derived intangible income ("FDII") and global intangible low-taxed income ("GILTI"). Circularity issues arise

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because (i) the section 163(j) limitation is based on taxable income after giving effect to the section 250 deduction, (ii) the section 250 deduction is itself subject to a taxable income limitation based on taxable income after the section 163 deduction for interest and the section 172 deduction for NOLs, and (iii) under the Tax Cuts and Jobs Act, as amended by the CARES Act, the deduction under section 172 for post-2017 NOLs will be subject to an 80% of taxable income limitation in tax years beginning after 2020, with taxable income determined after the section 163 deduction for interest (but before the section 250 deduction). In addition, the Code contains other non-coordinated taxable income limitations, such as those in sections 170(b)(2) (corporate charitable contributions), 246(b) (dividends received deductions), and 613(a) and 613A(d) (percentage depletion), each of which can present a circularity issue.

The proposed ordering rules are not included in the Final Regulations. The Preamble to the Final Regulations states that "further study is required to determine the appropriate rule for coordinating" these provisions. This dovetails with a similar comment made recently in the preamble to the final regulations under section 250. Both preambles state that until further guidance is provided, taxpayers may choose any reasonable approach (including simultaneous equations) for coordinating taxable income-based provisions, provided the approach is applied consistently for all relevant tax years.

ATI is then adjusted by adding the following to tentative taxable income:

- Any business interest expense (other than disallowed business interest expense carryforwards);
- Any NOL deduction under section 172 (including NOLs arising in tax years before the Final Regulations and carried forward);
- Any deductions under section 199A;
- For tax years beginning before January 1, 2022, any deduction for depreciation, amortization (and amortized expenditures), and depletion (including special allowances under section 168(k));
- Any deduction for a capital loss carryback or carryover; and
- Any deduction or loss that is not properly allocable to a non-excepted trade or business.

ATI would also be adjusted by subtracting the following:

- Any business interest income included in the tentative taxable income;
- Any floor plan financing interest expense for the tax year included in the tentative taxable income; and
- Any income or gain that is not properly allocable to a non-excepted trade or business.
- Any specified deemed inclusions with respect to an applicable controlled foreign corporation ("CFC"), as adjusted to reflect deductions under section 250 and other amounts.

Section 263A—depreciation, amortization, and depletion

The 2018 Proposed Regulations provided that depreciation, amortization, or depletion allocated to and capitalized with respect to inventory property under section 263A and included in cost of goods sold, was not a deduction for depreciation, amortization, or depletion for purposes of determining ATI. Thus, under the Proposed Regulations, ATI was not increased by such amounts, resulting in a lower section 163(j) limitation.

Under the Final Regulations, Treasury reverses course and permits depreciation, amortization, or depletion that is capitalized into inventory under section 263A to be added back to tentative taxable income during tax years beginning before January 1, 2022. The Final Regulations clarify that any depreciation, amortization, or depletion allocable to inventory is added back, regardless of the period in

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which the capitalized amount is recovered through cost of goods sold.

A taxpayer that relied on the 2018 Proposed Regulations in their entirety for tax years beginning before the Final Regulations are effective can choose to follow the Final Regulations' section 263A rule rather than the 2018 Proposed Regulations' section 263A rule. Thus, if a calendar year taxpayer did not increase its tentative taxable income for 2018 or 2019 in the amount of any depreciation, amortization, or depletion allocable under section 263A, the taxpayer may amend its returns for those years, but only if the taxpayer also applies the 2018 Proposed Regulations in their entirety. A taxpayer that applied the more favorable rule for depreciation in the Final Regulations before 2020 but did not adopt the 2018 Proposed Regulations in their entirety will have to consider whether to defend its position as an acceptable interpretation of the statute.

Capitalization of interest expense

The 2018 Proposed Regulations provided that sections 263(g) and 263A apply to interest required to be capitalized under those sections before section 163(j). The Final Regulations expand this rule to apply to all interest required to be capitalized, now listing sections 263(g) and 263A as examples of the general rule. The Final Regulations retain the rule that such capitalized interest is not treated as business interest expense for purposes of section 163(j).

Section 263A(f)

The Final Regulations generally apply only to business interest expense that would be deductible in the current tax year without regard to section 163(j). Thus, subject to certain exceptions, the section 163(j) limit applies after interest is capitalized interest under sections 263A and 263(g). Under the Final Regulations, capitalized interest expense is not treated as business interest expense for purposes of section 163(j). In capitalizing interest under the avoided cost method, the Final Regulations require a taxpayer to capitalize all interest that is neither investment interest under section 163(d), business interest expense under section 163(j), nor passive interest under section 469 before capitalizing any interest that is either investment interest, business interest expense, or passive interest.

Subtractions to reverse prior depreciation, amortization, and depletion adjustments

Furthermore, the Final Regulations impose an ATI "claw back" adjustment for sales and dispositions of certain property to reverse prior ATI adjustments for depreciation, amortization, and depletion. In particular, because deductions for depreciation, amortization, and depletion for tax years beginning after December 31, 2017 and before January 1, 2022 (the "Potential Double Counted Deductions") are added back to taxable income in computing ATI, the Final Regulations provide that with respect to the sale or other disposition of property, any Potential Double Counted Deductions with respect to such property must be subtracted from ATI, even in tax years after 2021.

KPMG observation

The Preamble to the Final Regulations states that Congress intended the ATI add-back for depreciation, amortization, and depletion from 2018-2021 "to be a timing provision that delays the inclusion of depreciation deductions in calculating a taxpayer's section 163(j) limitation." The rule requiring an ATI reduction upon a sale or other disposition of the property is intended to "ensure that the positive adjustment for depreciation deductions during the [2018-2021] EBITDA period

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merely defers (rather than permanently excludes) depreciation deductions from a taxpayer's calculation of the section 163(j) limitation."

KPMG observation

The phrase "sale or other disposition" is intended to have a broad meaning and includes certain section 351 exchanges and transactions in which a member of a consolidated group leaves the group (other than in a whole group acquisition). However, the Final Regulations contain an exception for non-deconsolidating transfers to acquiring corporations in section 381 transactions (generally, asset reorganizations and tax-free subsidiary liquidations). There is also an exception for transfers between members of the same consolidated group, although successor asset rules will apply.

KPMG observation

In response to comments regarding the administrative burden of tracking dispositions of relevant assets, the Preamble to the Final Regulations states that members of consolidated groups are already required to track depreciation deductions to calculate separate taxable income and preserve the location of tax items, and that all taxpayers are required to track depreciation deductions on an asset-by-asset basis for purposes of the recapture provisions of section 1245. Thus, the Preamble asserts, the ATI claw-back rule "should not impose a significant administration burden in many situations."

KPMG observation

The Final Regulations do not include the provision from the 2018 Proposed Regulations that would have limited the ATI reduction adjustment with respect to the sale or other disposition of an asset to the lesser of (i) the amount of gain realized on the sale or other disposition of the asset or (ii) the amount of the Potential Double Counted Deductions. The Preamble states that the gain limitation rule was eliminated on the basis of administrability and to harmonize the rule that applies to direct sales or other dispositions of property with the application of the rule to sales or other dispositions of stock of consolidated subsidiaries.

However, the 2020 Proposed Regulations would allow taxpayers to use an "alternative computation method" to determine ATI, under which taxpayers can apply the gain limitation rule not only to sales or other dispositions of assets (as provided by the 2018 Proposed Regulations), but also to sales or other dispositions of interests in certain consolidated subsidiaries or partnerships. As a condition to using the alternative computation method, a taxpayer would be required to apply the gain limitation rule to all dispositions of assets, stock of consolidated subsidiaries, and partnership interests for which an adjustment is required. (The ability to rely on the 2020 Proposed Regulations is addressed elsewhere in ***TaxNewsFlash***).

A similar rule would apply to claw back the benefit of Potential Double Counted Deductions in the context of a sale or other disposition of stock of a member of a consolidated group. This is necessary because under the investment adjustment rules of Reg. § 1.1502-32, a group member's tax basis in the stock of a subsidiary member generally is reduced to reflect deductions claimed by that member (an

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adjustment that can "tier-up" and result in adjustments to the stock basis of higher-tier members). Thus, basis in member stock can indirectly reflect Potential Double Counted Deductions.

In addition, a similar rule would apply to claw back the benefit of Potential Double Counted Deductions in the context of a sale or other disposition of an interest in a partnership with respect to the taxpayer's distributive share of any Potential Double Counted Deductions with respect to property held by the partnership at the time of sale or other disposition, to the extent such Potential Double Counted Deductions were allowable under section 704(d).

The Final Regulations also include a new Anti-Duplication rule to preclude multiple ATI reductions with respect to the same Potential Double Counted Deduction.

KPMG observation

The addition of a requested Anti-Duplication rule in the Final Regulations is expected to reduce or eliminate the likelihood of multiple ATI reductions in the context of consolidated taxpayers, and thus is welcomed. However, it is not expected to reduce the potential for complexity in the determination of consolidated ATI. For example, due to the consolidated rules that cause a tier-up of investment adjustments in the stock of higher-tier members, the restructurings or transfers of stock in lower-tier subsidiaries can result in the replication of stock basis adjustments that were originally attributable to 2018-2021 depreciation, amortization, and depletion deductions, and that may be difficult to track. In addition, with respect to a corporation departing a consolidated group, because (i) the group's ATI is reduced in the year of departure to claw back the departing member's Potential Double Counted Deductions in that group and no further ATI reductions are required with respect to the departing member, (ii) the group should model the reduction to its ATI and any resulting deferral of interest deductions in determining the economic cost of selling the departing member (and in evaluating whether to pursue or consent to a section 338(h)(10) election, if otherwise available).

KPMG observation

The application of the consolidated ATI claw-back and Anti-Duplication rules in certain circumstances appears uncertain. The Final Regulations contain an example in which a member of a group generates $100 of depreciation deductions in 2021 and has 50% of its stock sold to an unrelated person in 2024 while it continues to hold the depreciated item of property. (The sale of a 50% interest in the member results in the member's departure from the selling group at the end of the day of the sale.) The ATI claw-back rule provides that a transaction in which a member leaves a group is treated as a sale or disposition. However, it is unclear whether the deemed sale or disposition is of the depreciated asset, or of the member stock that reflects investment adjustments attributable to the depreciation deduction. The regulatory example concludes that the selling group's ATI is reduced by $50 in 2024 because of the 2021 depreciation deduction. The example implies that the reduction is with respect to the investment adjustment in the stock of the member (and only with respect to the shares actually sold). At the same time, it appears that the Anti-Duplication rule is intended to provide that deductions in a consolidated return year of a group are to be disregarded in separate return years of the corporation, and thus no further ATI claw-back is to be applied to a corporation after its departure from the selling group. This suggests that only $50 of the 2021 depreciation deduction would be subjected to an ATI claw-back under the facts of the example.

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Calculating ATI for cooperatives

The Final Regulations address the rules for calculating ATI for cooperatives. As explained in the Preamble to the Final Regulations, Prop. Reg. § 1.163(j)-1(b)(1) defines ATI as the taxable income of the taxpayer for the tax year, with certain adjustments. Prop. Reg. § 1.163(j)-4(b)(4) provides a special rule for calculating the ATI of a RIC or REIT, allowing the RIC or REIT not to reduce its taxable income by the amount of any deduction for dividends paid. The Preamble to the 2018 Proposed Regulations also requested comments on whether additional special rules are needed for specific types of taxpayers, including cooperatives.

A commenter asked that the Final Regulations include a special rule for calculating the ATI of cooperatives subject to taxation under subchapter T ("sections 1381 through 1388") of the Code. Under this special rule, taxable income would not be reduced by amounts deducted under section 1382(b)(1) (patronage dividends), section 1382(b)(2) (amounts paid in redemption of nonqualified written notices of allocation distributed as patronage dividends), or section 1382(c) (certain amounts incurred by farm cooperatives described in sections 521 and 1381(a)(1)). The commenter reasoned that such amounts are earnings passed on to members and are therefore analogous to dividends paid by a RIC or REIT to its investor.

Treasury agreed that, for purposes of section 163(j), amounts deducted by cooperatives under sections 1382(b)(1), (b)(2), and (c) are similar to amounts deducted by RICs and REITs for dividends paid to their investors. The Final Regulations therefore adopt a rule providing that, for purposes of calculating ATI, the tentative taxable income of a cooperative subject to taxation under subchapter T of the Code is not reduced by such amounts. In order to provide similar treatment to similarly situated taxpayers, the Final Regulations also provide that, for purposes of calculating ATI, the tentative taxable income of cooperatives not subject to taxation under subchapter T of the Code is not reduced by the amount of deductions equivalent to the amounts deducted by cooperatives under sections 1382(b)(1), (b)(2), and (c).

KPMG observation

The Final Regulations' new rule applies to both Subchapter T and non-Subchapter T cooperatives. With respect to Subchapter T cooperatives, the rule applies to both non-exempt cooperatives and section 521 farmers' cooperatives. The Final Regulations' new rule does not modify the determination of tentative taxable income of a cooperative with respect to deductions for cooperative per-unit retain allocations to patrons of the cooperative pursuant to sections 1382(b)(3) and (b)(4). This result is consistent with the flush language of section 1382(b), which treats amounts described in sections 1382(b)(3) and (b)(4) as a deduction in arriving at gross income (e.g. such payments are typically viewed as analogous to a non-cooperative's purchase of inventory, the cost of which ultimately is deducted as cost of goods sold).

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Implications for domestic corporations

Treatment of corporations and consolidated groups: Sections 1.163(j)-4, -5

General C corporation rules

The Final Regulations maintain the position provided by the 2018 Proposed Regulations that for purposes of the section 163(j) limitation, all interest expense and interest income of a C corporation *per se* is business interest expense ("BIE") and business interest income ("BII") and allocable to a trade or business. Consistent with the 2018 Proposed Regulations, the Final Regulations generally recharacterize investment interest income and expense of a partnership that is allocable to a C corporation partner as business interest income or expense that is properly allocable to a trade or business of the C corporation (though this latter rule would not apply to the extent a C corporation partner is allocated a share of a domestic partnership's subpart F or global intangible low-taxed income ("GILTI") gross income inclusions that are treated as investment income at the partnership level).

KPMG observation

The definition of *business interest* in section 163(j)(5) specifically excludes "investment interest (within the meaning of [section 163(d)]," and section 163(d)(3) defines *investment interest* as interest paid or accrued on debt that is properly allocable to property held for investment. Notwithstanding these statutory provisions, the Final Regulations categorically provide that all interest expense of a corporation is treated as properly allocable to a trade or business to ensure that all interest expense of a C corporation is within the reach of the section 163(j) limitation. The Preamble to the Final Regulations justifies this position by reference to a footnote in the TCJA's legislative history.

The Final Regulations provide that a C corporation deducts its current-year BIE before it can deduct any disallowed BIE carried forward from an earlier year. When the C corporation has sufficient capacity to deduct disallowed BIE carryforwards, the carryforwards generally are deducted based on the chronological order in which they arose, with the earliest carryforwards deducted first (though subject to limitations, such as section 382).

Under the Final Regulations, a C corporation's earnings and profits ("E&P") for a tax year would be calculated without regard to any disallowance of interest expense under section 163(j). Thus, a C corporation with disallowed interest expense for a particular year would calculate its current E&P by subtracting only its current year interest expense, regardless of whether a deduction for some portion or all of that expense is deferred under section 163(j) or whether the corporation can also deduct disallowed interest expense carried forward from an earlier year. The Final Regulations clarify that this rule also generally applies with respect to foreign corporations and with respect to the interest expense of a partnership in which the corporation is a partner (though a special rule applies with respect to excess BIE).

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KPMG observation

The Final Regulations retain the same E&P rule as the 2018 Proposed Regulations. This rule will complicate tax attribute calculations, because adjustments to starting numbers for a particular year will have to be made to include nondeductible interest and to remove deductions for previously deferred interest for determining E&P (in contrast, investment adjustments to the stock basis in a consolidated subsidiary are made when the interest is deducted). While this rule is consistent with the rule in the 1991 Proposed Regulations under former section 163(j), it will apply to a substantially larger number of corporations.

Special E&P rules, in lieu of these general rules, apply to RICs and REITs, and with respect to excess BIE allocated from a partnership to a C corporation partner. In the case of RICs and REITs for the tax year in which a deduction for the taxpayer's BIE is disallowed, or in which the RIC or REIT is allocated any excess BIE from a partnership, the taxpayer's E&P are adjusted in the tax year or years in which the BIE is actually deductible or, if earlier, in the first tax year for which the taxpayer no longer is a RIC or a REIT. For a C corporation partner that is allocated any excess BIE from a partnership, if all or a portion of the excess BIE has not yet been treated as BIE of the C corporation partner, the corporation must increase its E&P at such time as it disposes of all or a portion of its interest in the partnership by an amount equal to the amount of the basis adjustment required under section 163(j)(4)(B)(iii)(II).

For further discussion of the application of the 163(j) Package to REITs, read the **Passthrough Focus Report**

Consolidated return rules

Consistent with the 2018 Proposed Regulations, the Final Regulations generally take a broad, single-entity approach and apply a single section 163(j) limitation to a consolidated group. The Final Regulations also require a group's adjusted taxable income ("ATI") to be calculated on a consolidated basis. Thus, the group's current-year BIE and BII is the sum of the current-year interest items of the members. However, intercompany obligations (indebtedness between members of the same consolidated group) are generally disregarded for purposes of determining the group's BIE and BII, as well as its consolidated ATI. The Final Regulations create an exception to this rule for repurchase premium arising pursuant to the deemed satisfaction and reissuance rule of Reg. § 1.1502-13(g)(5) when an obligation becomes an intercompany obligation, and treat the repurchase premium as interest expense subject to the section 163(j) limitation although it is paid on an intercompany obligation.

Also consistent with the 2018 Proposed Regulations, the Final Regulations provide that intercompany items and corresponding items (within the meaning of Reg. § 1.1502-13) are disregarded for purposes of calculating consolidated adjusted taxable income ("ATI") to the extent they offset in amount.

KPMG observation

The Final Regulations impose additional complexity by requiring new, additional consolidated adjustments for purposes of determining the consolidated section 163(j) limitation, calculations that were not required prior to the TCJA. Consolidated corporations with U.S. state tax filing requirements will encounter further compliance complexity. Read the **State and Local Tax Focus Report**

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KPMG observation

Despite receiving comments arguing that interest income and expense on intercompany obligations should be taken into account for purposes of section 163(j), Treasury believed that the simplicity and perceived administrability of the adopted approach outweighed the potential distortive consequences of generally ignoring intercompany obligations. Under this approach, the allocation of BII and expense generally will be driven by which consolidated members receive or pay interest, respectively, to third parties, and thus can be influenced by on-lending arrangements within the group.

Furthermore, consistent with the 2018 Proposed Regulations, the Final Regulations do not aggregate affiliated but non-consolidated entities. For example, a partnership wholly owned by members of a consolidated group is not aggregated with its consolidated partners but generally is regarded as an entity and is subject to the partnership rules described elsewhere [Link to passthroughs focus piece]. The Final Regulations also retain the anti-avoidance rules included in the 2018 Proposed Regulations that are intended to preclude taxpayers from using controlled affiliates to avoid the section 163(j) limitation.

In general, the Final Regulations adopt the five-step approach provided in the 2018 Proposed Regulations to determine a consolidated group's current year BIE, disallowed BIE carryforward, and utilization of BIE carryforwards. The five steps are:

- Step 1: determine whether the consolidated section 163(j) limitation for the current year is equal to or exceeds the members' aggregate current-year BIE. If so, none of the members' current-year business interest is disallowed (and skip steps 2 and 3);

- Step 2: if the members' aggregate current-year BIE exceeds the consolidated section 163(j) limitation for the year, each member deducts its current-year BIE up to the amount of its business interest income or floor plan financing interest expense for the current year;

- Step 3: if there is any consolidated section 163(j) limitation remaining after step 2, each member with remaining current-year BIE deducts a *pro rata* amount of its current-year BIE based on its allocable share of the consolidated group's remain section 163(j) limitation;

- Step 4: If there is any remaining consolidated section 163(j) limitation, the members' disallowed BIE carryforwards from prior years are deducted on a *pro rata* basis under the principles of step 3, beginning with the earliest year (subject to any SRLY (defined below) and section 382 limitations); and

- Step 5: Any member with remaining BIE carries the expense forward to the succeeding tax year as a disallowed BIE carryforward.

KPMG observation

Although a single-entity approach generally is applied to consolidated groups, groups are still required to determine which member is entitled to a deduction for interest expense (an issue that can be uncertain when multiple members are co-obligors or guarantors on external debt), as well as location of BII and floor plan financing interest expense.

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For purposes of the stock basis/investment adjustment rules of Reg. § 1.1502-32, rules similar to those applicable to the absorption of losses would apply. In particular, basis in the stock of a member with disallowed current-year BIE is adjusted only in the tax year in which the disallowed interest expense is absorbed (and not when initially disallowed). Similarly, investment adjustments with respect to excess BIE from a partnership are made when the excess BIE is converted into BIE and deducted and absorbed in the C corporation partner's consolidated group.

The Final Regulations provide that a "separate return limitation year" ("SRLY") limitation applies to disallowed BIE carryforwards. A section 163(j) SRLY limitation does not apply to the extent of an "overlap" in the application of section 382 and the SRLY limitation under the principles of Reg. § 1.1502-21(g) (the current rules applicable to loss carryovers).

KPMG observation

The helpful SRLY-382 overlap rule can be expected to apply to a group's acquisition of a previously unrelated target with disallowed BIE carryforwards. However, the section 163(j) SRLY limitation remains a trap for the unwary in situations not covered by the overlap rule (e.g., where a consolidated group acquires a target corporation in a transaction that does not constitute a section 382 ownership change, such as an acquisition from a related person).

The Final Regulations provide that disallowed BIE carryforwards of a member rising in a SRLY can be deducted by the consolidated group in the current year to the extent the excess of (i) the aggregate section 163(j) limitation of such member determined by reference only to the member's items of income, gain, deduction, and loss while it has been a member of the consolidated group, over (ii) the member's BIE (including disallowed BIE carryforwards) absorbed by the group in all consolidated return years. The mechanics of the section 163(j) SRLY limitation can result in a negative section 163(j) SRLY limitation under the Final Regulations. In computing the member's section 163(j) SRLY limitation, intercompany items generally are included, with the exception of interest items with regard to intercompany obligations. Further, SRLY-limited BIE carryforwards are deducted on a pro rata basis with non-SRLY-limited disallowed BIE carryforwards from tax years ending on the same date. The Final Regulations provide that the section 163(j) SRLY limitation applies on a subgroup basis, under the principals of the subgroup rules applicable to SRLY-limited NOLs, with appropriate adjustments.

KPMG observation

After considering comments received on the 2018 Proposed Regulations, Treasury replaced the "annual" register approach of the 2018 Proposed Regulations with the "cumulative" register described above. This is consistent with the SRLY limitations applied to other attributes, which generally operate on a cumulative basis, although the Preamble to the Final Regulations notes that the section 163(j) SRLY limitation is separate and distinct from the cumulative register for NOLs.

The Final Regulations appear to disregard any losses generated by a member in a particular year in determining its "cumulative" section 163(j) SRLY limitation register. For example, if a corporation had $250 of disallowed BIE carryforwards that were subject to a SRLY limitation at the time it joined a consolidated group, and it generated $100 of section 163(j) limitation in its first year in the group but was only able to deduct $30 of its carryforwards due to the group's section 163(j) limitation, the corporation's section 163(j) SRLY limitation register would be $70 (the $100 capacity less the $30 actually deducted in the year). If, in the following year, the corporation generated a

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$40 loss and the group as a whole had a $0 section 163(j) limitation, the corporation's section 163(j) SRLY limitation register would not be reduced by its loss for the year. This seems to cause the "cumulative" section 163(j) SRLY register to operate more like the alternative "catch and release" approach suggested by commenters and rejected by Treasury. It is unclear whether the drafters of the Final Regulations intended this result. A corporation's section 163(j) SRLY limitation register can go negative in situations where non-SRLY limited interest is deducted. For example, if the corporation in the prior example generated $120 of current year BIE in its third year in the group and was able to fully deduct that interest, the corporation's cumulative register would be reduced by the $120 of business interest deductions, from $70 to a negative $50. This occurs because the rules require current year BIE to be deducted before carryforwards, and because the corporation's current year BIE is generated within a consolidated year of the group and thus is not subject to a SRLY limitation in that group.

A member with disallowed BIE that departs a consolidated group generally takes its carryforwards with it. However, as is the case with NOLs, the group has the priority claim to deduct in the year of departure the departing member's BIE items, to the extent available under section 163(j), including both the departing member's current-year BIE (through the date of departure) as well as the departing member's disallowed BIE carryforwards from prior years. Also, consistent with the rules applicable to NOLs, a departing member's disallowed BIE carryovers potentially are subject to attribute reduction under the consolidated unified loss rule of Reg. § 1.1502-36(d) ("ULR"). Disallowed BIE carryovers generally are treated as deferred deductions under Category C of Reg. § 1.1502-36(d)(4), and thus potentially available for a reattribution election under Reg. § 1.1502-36(d)(6)(B) to the extent they otherwise would be subject to reduction under the ULR (excess BIE from a partnership, however, is treated as a Category D attribute, and thus cannot be reattributed). A departing member's carryforwards of disallowed BIE that survive this gauntlet of rules are carried forward to its first separate return year, albeit potentially subject to section 382 limitation (or, if applicable, to the section 163(j) SRLY limitation in an acquiring group). The Final Regulations do not provide further guidance on the treatment of disallowed BIE carryforwards of a consolidated group in the context of a life-nonlife group.

Section 381(a) transactions

An acquiring corporation in a section 381(a) transaction (generally, a tax-free section 368(a)(1) asset reorganization or a section 332 subsidiary liquidation) succeeds to the disallowed BIE carryforwards of a target corporation. The Final Regulations, consistent with the 2018 Proposed Regulations, include provisions which generally limit the amount of the target's disallowed BIE carryforwards that the acquirer can deduct in the acquirer's first tax year ending after the acquisition. These rules are similar to the rules in Reg. §§ 1.381(c)(1)-1 and 1.381(c)(1)-2 that apply to an acquiring corporation's use of a target corporation's losses in the acquisition year.

Sections 382 and 163(j)

Congress provided in section 163(j) that disallowed BIE carryovers are subject to the section 382 loss limitation rules following an "ownership change" (generally, a cumulative greater-than-50-percentage-point change in the stock ownership of a corporation over a three-year period).

For a tax year in which a mid-year ownership change occurs, the Final Regulations provide a default rule that requires the pro rata allocation of current-year BIE between the pre- and post-ownership change periods based on the number of days in each period. At the same time, the Final Regulations provide that if a closing-of-the-books election is made under Reg. § 1.382-6(b), current-year BII and expense is allocated to the pre- and post-ownership change periods as if the corporation's books were closed on the date of the ownership change.

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The Final Regulations also address the allocation of disallowed BIE carryforwards to the pre- and post-ownership change periods, an issue that had not been explicitly addressed by the 2018 Proposed Regulations. The Final Regulations provide that, in the absence of a closing-of-the-books election, disallowed BIE carryforwards are allocated *pro rata* to each day in the year of the ownership change, whereas if a closing-of-the-books election is made, such carryforwards are allocated ratably to the pre- and post-ownership change periods based on the relative excess section 163(j) capacity in each period (calculated under specific steps provided in the Final Regulations).

KPMG observation

The 2018 Proposed Regulations would have mandated the daily pro rata allocation method for all BIE. A mandatory pro rata allocation could have been distortive in the context of a leveraged acquisition, because it could result in the allocation of a disproportionate amount of post-acquisition interest expense to the pre-acquisition period (thus potentially subjecting it to limitation under section 382). In response to practitioner requests, the Final Regulations authorize the closing-of-the-books method when an election to apply that method is made for section 382 purposes. This is a welcome development.

Consistent with the 2018 Proposed Regulations, the Final Regulations modify the existing ordering rule governing the absorption of pre-change losses and tax credits subject to limitation under sections 382 and 383, to provide that disallowed BIE carryforwards are absorbed after pre-change capital losses and all recognized built-in losses, but before NOLs, other pre-change losses, and pre-change credits.

Moreover, the Final Regulations clarify that section 382 disallowed business interest carryforwards are not treated as recognized built-in losses under section 382(h)(6) (to confirm there is no "double detriment" under section 382 with respect to such carryforwards).

The Final Regulations do not provide guidance regarding the application of section 382(e)(3) in the context of section 163(j). Section 382(e)(3) generally provides that, in determining the value of a foreign loss corporation, taxpayers can take into account only items connected with conduct of a U.S. trade or business. Under this rule, if a foreign corporation with no U.S. trade or business undergoes an ownership change, its section 382 limitation can be zero, meaning its disallowed BIE carryforwards cannot be used after the ownership change.

KPMG observation

With the section 163(j) limitation applying to BIE incurred by controlled foreign corporations ("CFCs"), the above result is potentially onerous and unintended. The Preamble of the Final Regulations states that Treasury is " aware of this issue and other issues relating to the application of section 382 to CFCs," and that it will "continue to study the application of section 382 to CFCs and may address this issue in further guidance."

CARES Act changes to section 163(j)

The CARES Act amended section 163(j) to allow a taxpayer to elect to utilize its ATI from the last tax year beginning in 2019 ("2019 ATI") as its ATI for a tax year beginning in 2020 for purposes of calculating its

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section 163(j) limitation (subject to a proration rule for short tax years). For purposes of that election, the 2020 Proposed Regulations generally provide that the 2019 ATI of an acquiring corporation in a section 381(a) transaction equals the acquiring corporation's 2019 ATI (i.e., the ATI of a target corporation prior to its acquisition is not included in 2019 ATI).

KPMG observation

The 2020 Proposed Regulations do not take into account the target's pre-acquisition ATI, even though it may be significantly larger than the acquirer's ATI and even if the acquisition occurs in a section 381(a) transaction, which generally represents a continuation of the target and its activities. For taxpayers choosing not to elect to follow the 2020 Proposed Regulations, the treatment of section 381(a) transactions for purposes of the calculation of 2019 ATI is not entirely clear.

Implications for passthrough entities

Implications of section 163(j) for partnerships and S corporations

Section 163(j) is applied to partnership business indebtedness at the partnership level. To the extent a partnership's business interest deduction is limited, the deferred business interest ("excess business interest expense") must be allocated to the partners, which reduces the partners' bases in their partnership interests. Section 163(j)(4) provides that excess business interest expense ("BIE") is then treated as paid or accrued by the partner to the extent the partner is allocated "excess taxable income," which is adjusted taxable income ("ATI") of the partnership in excess of the amount the partnership requires to deduct its own interest under section 163(j). To the extent excess BIE is treated as paid or accrued by a partner, such BIE is then subject to a section 163(j) limitation at the partner level.

Like partnerships, section 163(j) is generally applied to S corporation business indebtedness at the S corporation level. However, unlike partnerships, any limitation of an S corporation's BIE is carried forward at the S corporation and potentially deducted by the S corporation in future tax years.

The 2018 Proposed Regulations addressed many of the issues created as a result of the application of section 163(j) at the partnership level, but also reserved on many issues. The Final Regulations generally follow the provisions that were contained in the 2018 Proposed Regulations, with some modifications, and the 2020 Proposed Regulations address most of the issues that were reserved in the 2018 Proposed Regulations. Significant changes and other provisions applicable to partnerships and S corporations in the Final Regulations and the 2020 Proposed Regulations are noted below.

Excess business interest income

As noted above, section 163(j)(4)(B)(ii)(I) provides that excess BIE allocated to a partner from a partnership is treated as paid or accrued by the partner only to the extent the partner is allocated excess taxable income from such partnership. The 2018 Proposed Regulations would have provided that excess BIE is also treated as paid or accrued by a partner to the extent the applicable partnership allocates excess business interest income ("BII") (business interest income of the partnership in excess of the

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amount the partnership requires to deduct its own interest under section 163(j)) to the partner. The Final Regulations retain this rule.

Guaranteed payments for the use of capital

The 2018 Proposed Regulations would have included guaranteed payments for the use of capital under section 707(c) as an amount treated as interest for purposes of section 163(j). The Final Regulations remove guaranteed payments for the use of capital from the list of items automatically treated as interest, but add a principal purpose test to the interest anti-avoidance rule, and include an example of a guaranteed payment for the use of capital that is treated as interest under the anti-avoidance rule.

The anti-avoidance rule applies if an expense is economically equivalent to interest and a principal purpose of structuring the transaction as a guaranteed payment for the use of capital is to reduce an amount incurred by the taxpayer that otherwise would be treated as interest. The fact that the taxpayer has a business purpose for obtaining the use of funds or that the funds were obtained at a lower pre-tax cost does not affect the determination of whether the transaction had a principal purpose of avoidance. If the anti-avoidance rule applies, the partner's income from accrual or receipt of the guaranteed payment for the use of capital is generally treated as interest income.

KPMG observation

While the removal of guaranteed payments for the use of capital from the definition of interest is helpful, the example of a guaranteed payment for the use of capital that is subject to recast under the anti-avoidance rule raises concerns that guaranteed payments for the use of capital may still often be treated as interest. In the example, a partnership that has significant debt and interest expense is considering obtaining a loan from a third party to expand business operations. The example states that, "for the purpose of reducing the amount of additional interest expense [the partnership] would have otherwise incurred by borrowing," one of the partners agrees to make a contribution to the partnership in exchange for a guaranteed payment for the use of capital. The example concludes that the guaranteed payment for the use of capital is subject to recast under the anti-avoidance rule. The facts of the example seem to mandate the conclusion by stating the purpose of the contribution is to reduce additional interest expense, but provides little guidance on when a guaranteed payment would not be subject to the anti-avoidance rule in situations where a partnership may consider borrowing or obtaining additional capital from a partner to fund its operations.

KPMG observation

The potential recast of a guaranteed payment for the use of capital as BIE to the partnership and BII to the contributing partner also raises questions about the application of the new self-charged interest rule in the 2020 Proposed Regulations (discussed below) to these payments. Similar to the self-charge interest rule in the 2020 Proposed Regulations, Reg. § 1.469-7 uses the term "lending transaction" to describe self-charged transactions and clarifies that guaranteed payments for the use of capital under section 707(c) are included within the meaning of a lending transaction. This may provide an argument that guaranteed payments for the use of capital that are treated as interest expense and income under the anti-avoidance rule could benefit from the self-charged lending rules of the 2020 Proposed Regulations.

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Self-charged interest

The 2020 Proposed Regulations would provide that in the case of a lending transaction between a partner and a partnership in which the partner holds a direct interest, if the lending partner is allocated excess BIE from the borrowing partnership, the lending partner is deemed to receive an allocation of excess BII equal to the lesser of (1) its excess BIE from the borrowing partnership for the tax year, or (2) the interest income on the loan for the tax year. Double counting rules would apply to prevent interest income from being used more than once in calculating the partner's section 163(j) limitation. The proposed self-charged interest rule would not apply to S corporations because BIE of an S corporation is carried over by the S corporation as a corporate level attribute.

Allocation of deductible BIE and excess items – 11 steps

The Final Regulations retain the complex 11-step method for allocating deductible BIE and excess items (excess business interest expense, excess BII, and excess taxable income) and decline to provide alternative allocation methods, such as allowing taxpayers to adopt a reasonable method.

However, in the case of partnerships that allocate all items of income and expense on a pro rata basis, the Final Regulations provide an exception to the 11-step calculation requirement. In such case, partners may simply allocate the partnership's section 163(j) items pro rata.

KPMG observation

The pro rata exception does not appear to provide taxpayers with a calculation method that they were not otherwise entitled to under the 2018 Proposed Regulations. This is so because in the case of a partnership where all items are allocated pro rata, allocations of deductible business interest expense and excess items pro rata should not vary from the allocations that would have resulted under the 11-step calculation method.

Debt financed distributions

In order to characterize interest expense associated with debt incurred to make distributions to partners or S corporation shareholders, the 2020 Proposed Regulations would adopt rules similar to the rules set forth in Notice 89-35, 1989-1 C.B. 675, with certain modifications.

Specifically, the 2020 Proposed Regulations would require that debt incurred to make a distribution to partners or S corporation shareholders would first be allocated to the entity's available expenditures (those expenditures made in the same tax year, but only to the extent debt proceeds are not otherwise allocated to them). Any additional distributed debt proceeds would then be allocated to distributions to the partners or shareholders.

The tax treatment of each partner's or shareholder's share of interest expense allocated to distributions is generally determined based on each partner's or shareholder's use of the funds. However, to the extent the owner's share of interest expense allocated to distributions exceeds the entity's interest on the portion of debt distributed to that particular owner ("excess interest expense"), the tax treatment is determined by allocating the excess interest expense among all of the entity's assets, pro rata, based on the adjusted basis of the assets, reduced by any allocable debt. The tax treatment of the interest allocated to available expenditures is determined based on how the distributed proceeds were allocated among the available expenditures.

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Interest allocated to the entity's available expenditures and excess interest expense would be characterized (e.g., as business, investment, or passive non-trade or business) at the entity level. To the extent the interest is characterized as BIE, section 163(j) would be applied to such interest at the entity level. Interest allocated to distributions to partners or shareholders, other than excess interest expense, would be characterized and subject to section 163(j), if applicable, at the owner level.

Additionally, the 2020 Proposed Regulations address the impact of transfers of partnership interests or S corporation stock on the characterization of interest, including an anti-avoidance rule, the repayment of debt used to finance a distribution, and the characterization of debt allocated to a contribution to the capital or purchase of a partnership interest or S corporation stock.

KPMG observation

The proposed treatment of debt financed distribution interest is similar to the long-standing ruled provided in Notice 89-35, but would be less flexible and may have negative implications depending on a partner's or S corporation shareholder's use of the funds and the passthrough entity's asset composition. In addition, the 2018 Proposed Regulations do not appear to contain a transition rule for interest expense incurred by a partnership or S corporation prior to finalization. As a result, partnerships, S corporations and their owners should plan for a potential change to the treatment of interest on existing indebtedness.

KPMG observation

Query how the debt financed distribution interest allocation rules under the 2020 Proposed Regulations interact with the debt financed distribution exception to the partnership disguised sale rules, which requires that the proceeds of the debt incurred to make the distribution are allocable under Reg. § 1.163-8T to a transfer of money or other consideration to the distributee partner made within 90 days of incurring the liability.

Trader partnerships

The 2018 Proposed Regulations would have provided that interest expense of a partnership engaged in per se non-passive activities under section 469, such as trading activities, is fully subject to section 163(j) at the partnership level, even if the interest expense may also be subject to limitation under section 163(d) as investment interest expense at the partner level for certain non-materially participating partners. The 2020 Proposed Regulations would reverse this rule and would require the partnership to bifurcate its items between partners that materially participate and those that are passive investors.

Any interest expense allocated to the active partners would be subject to section 163(j) at the partnership level (taking into account all other items allocated to the active partners), and all items allocable to passive investors would be separately stated and allocated to such partners and would be subject to section 163(d) at the partner level.

Because a partnership may not have knowledge about whether a partner could be considered to materially participate in the partnership's trading activity under the section 469 grouping rules, the 2020 Proposed Regulation would amend the section 469 regulations to prevent the grouping of the trader partnership's activities with other activities.

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KPMG observation

The proposed limitation to grouping per se passive activities such as trading is intended to simplify the determination of whether a limited partner can properly be treated as not materially participating in the partnership's activities and prevent two interest limitations from applying to the same interest expense. However, this proposed change may be detrimental to certain limited partners who otherwise could be treated as materially participating in a trading partnership for purposes of section 469, and also may complicate the analysis for general partners as to whether they materially participate in a particular trading partnership.

Basis addback upon disposition

Section 163(j)(4)(B)(iii)(II) provides that if a partner disposes of a partnership interest, the adjusted basis of the partnership interest is increased immediately before the disposition by the entire amount of the partner's remaining excess BIE ("Basis Addback Rule"). Under the 2018 Proposed Regulations, the Basis Addback Rule would have only applied if a partner disposes of all or substantially all of the partner's partnership interest. Thus, if a partner disposes of less than substantially all of the partner's interest in a partnership, the partner would not have been able to increase its basis by any portion of the remaining excess BIE.

The Final Regulations modify this rule to provide that a partial disposition of a partnership interest triggers a proportionate basis addback with respect to the disposed partnership interest, and a corresponding decrease to such partner's excess BIE. The proportionate basis addback is calculated in a manner similar to that set forth in Revenue Ruling 84-53, 1984-1 C.B. 159 (i.e., based on the ratio of the fair market value of the disposed interest to the total fair market value of the partnership interest immediately prior to the disposition.)

Treasury requests comments on whether a current distribution of money or other property by the partnership to a continuing partner as consideration for an interest in the partnership should also trigger a basis addback and, if so, how to determine the appropriate amount of the addback.

Basis addback to partnership's basis in assets

The 2020 Proposed Regulations would extend the Basis Addback Rule to the partnership's basis in its assets. Specifically, if the Basis Addback Rule is triggered with respect to a partner, the partnership would increase the adjusted basis of partnership property by an amount equal to the partner's basis addback. The basis increase would be allocated among partnership capital gain properties in the same manner as a positive section 734(b) basis adjustment. However, the positive section 734(b) basis adjustment would be non-depreciable or non-amortizable regardless of whether the property to which the adjustment is allocated is depreciable or amortizable property.

KPMG observation

The extension of the Basis Addback Rule to the partnership's basis in its assets can be helpful to the remaining partners, as it prevents the shifting of built-in gain to the remaining partners by providing for an increased 734(b) adjustment. The section 734(b) basis adjustment would also

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reduce a positive section 743(b) basis adjustment that would result on transfer of a partnership interest. The section 734(b) basis adjustment is detrimental to the extent partners anticipated the creation of depreciable or amortizable basis with respect to the partnership's assets.

Special disposition rule with respect to 2019 excess BIE

Pursuant to the CARES Act, in the case of excess BIE of a partnership for any tax year beginning in 2019 that is allocated to a partner, 50% of such excess BIE is treated as BIE that is paid or accrued by the partner in the partner's first tax year beginning in 2020 and is not subject to the section 163(j) limitation at partner level (the "50% of 2019 EBIE Rule").

The 2020 Proposed Regulations provide that if a partner disposes of its partnership interest in the partnership's 2019 or 2020 tax year, the 50% of 2019 EBIE Rule still applies, and thus, the disposition will not result in a basis increase with respect to such EBIE.

KPMG observation

It was not clear from the CARES Act changes to section 163(j) whether a partner that disposed of a partnership interest in 2019 or 2020 would be eligible to deduct 2019 excess business interest expense with respect to such partnership interest pursuant to the 50% of 2019 EBIE Rule. The interpretation of this rule in the 2020 Proposed Regulations is a taxpayer favorable outcome.

Excess BIE in tiered partnerships

In the Preamble to the 2018 Proposed Regulations, Treasury reserved on the application of section 163(j) to tiered partnership structures and requested comments on whether excess BIE should be allocated by an upper-tier partnership ("UTP") to its partners, and how and when the basis of a UTP should be adjusted when a lower-tier partnership ("LTP") has BIE that is limited under section 163(j). The 2020 Proposed Regulations would apply an entity approach to the treatment of excess BIE in tiered partnerships that would involve a series of complex rules:

- When excess BIE is allocated to a UTP ("UTP EBIE"), the UTP's basis in LTP is reduced in accordance with section 163(j)(4)(B)(iii), but the UTP partners' bases in UTP would not be reduced until the UTP EBIE is treated as paid or accrued by UTP.

- In order to properly track the reduction in LTP's asset value associated with BIE to one or more tiers of UTP partners, any direct or indirect UTP would treat any BIE paid accrued by LTP as a section 705(a)(2)(B) expenditure solely for purposes of section 704(b). Any capital account reduction resulting from such section 705(a)(2)(B) expenditure would occur regardless of whether LTP's BIE is deductible or subject to limitation under section 163(j). If a UTP subsequently treats UTP EBIE as paid or accrued, no further section 704(b) capital account reduction would occur.

- UTP EBIE would be treated as a nondepreciable capital asset with a fair market value of zero and basis equal to the amount by which UTP reduced its basis in LTP on account of the allocation of UTP EBIE. As a result, UTP EBIE would be a built-in loss asset on UTP's balance sheet.

- UTP EBIE would therefore have two components, a carryforward component and a basis component. Both the carryforward component and basis component of UTP EBIE would be reduced upon an allocation of excess taxable income or excess BII from LTP, or in the event UTP disposes of

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its interest in LTP. However, the basis component may also be reduced by a negative section 743(b) or section 734(b) adjustment.

- To the extent UTP is allocated excess taxable income or excess BII from LTP, UTP would determine a particular tranche of UTP EBIE that is treated as paid or accrued by UTP using any reasonable method (for example, on a first in, first out ("FIFO"), or last it, last out ("LIFO"), basis). The specific tranche of UTP EBIE that is treated as paid or accrued would be allocated to the "specified partner" whose section 704(b) capital account was reduced as a result of the section 705(a)(2)(B) expenditure with respect to the applicable tranche of UTP EBIE. In addition, any negative section 743(b) or section 734(b) basis adjustments associated with the tranche of UTP EBIE would be taken into account.

- If a UTP partner transfers all or a portion of a UTP partnership interest, the transferee would become the "specified partner" with respect to all or a portion of the transferor's interest in the UTP EBIE. Special rules would apply in the case of certain nonrecognition transactions.

- If UTP disposes of an interest in LTP, UTP would determine the UTP EBIE that is reduced using any reasonable method (for example, on a FIFO or LIFO basis) and increase UTP's basis in LTP accordingly, taking into account any negative section 743(b) or section 734(b) basis adjustments.

- The 2020 Proposed Regulations would also include an "anti-loss trafficking" rule to prevent a transferee of a specified partner's interest from benefitting from any UTP EBIE for which the transferee did not have a corresponding section 704(b) capital account reduction. This rule would apply to the extent a negative section 743(b) or section 734(b) basis adjustment does not achieve the intended result.

KPMG observation

The proposed rules to track UTP EBIE would add significant complexity to the already complex section 163(j) regime applicable to partnerships. The UTP EBIE rules have some similarities to tracking section 704(c) property and layers. It appears that UTP would need to track UTP EBIE from a particular LTP as separate "property" and each year's allocation of UTP EBIE from a particular LTP as a new "layer." The proposed rules would also dictate that a negative section 743(b) or section 734(b) adjustment can attach to UTP EBIE, which would prevent a transferee of a UTP interest from benefitting from a potential future deduction related to the UTP BIE. The Proposed Regulations do not provide a transition rule related to the treatment of excess business interest expense allocated prior to the finalization of these rules, which may raise additional complexity to the extent UTP EBIE has not been tracked in accordance with the 2020 Proposed Regulations.

Allocable ATI and allocable BII of UTP partners

The 2020 Proposed Regulations would provide a new set of formulaic rules to determine each UTP partner's allocable share of ATI and BII. These rules also would be used by any partnership that elects to compute its 2020 tax year section 163(j) limitation using its 2019 ATI, as provided under the CARES Act.

Publicly traded partnerships

In order to be freely marketable, publicly traded partnership ("PTP") units must be fungible. PTPs generally use the section 704(c) remedial allocation method coupled with a section 754 election and resulting section 743(b) basis adjustment to ensure fungibility of units. However, because the allocation of the components of ATI, taking into account section 704(c), generally is not pro rata, a PTP's allocation

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of deductible BIE and section 163(j) "excess items" (excess taxable income, excess BII and excess BIE) may not be pro rata and would negatively impact unit fungibility. In addition, certain partners' remedial and basis items may cause fungibility concerns for tax years 2018 through 2021 because depreciation, depletion, and amortization are added back to tentative taxable income in determining ATI.

To address these concerns, the 2020 Proposed Regulations would provide the following additional rules:

- A PTP would determine a partner's share of section 163(j) excess items in accordance with the partner's share of corresponding section 704(b) items that comprise ATI (the "Pro Rata Inside Basis Rule").

- Solely for the purposes of section 163(j), a PTP would allocate gain relating to section 704(c) property based on partners' section 704(b) sharing ratios and would determine each partner's remedial items as if the partner were entitled to a share of inside basis equal to its share of section 704(b) items (the "Partner Basis Items Rule").

- A PTP would treat a section 743(b) basis adjustment amount related to a remedial item as an offset to the related section 704(c) remedial item (the "Section 704(c) Remedial Income Rule").

KPMG observation

While noted as a fungibility concern in the Preamble to the 2020 Proposed Regulations, the Partner Basis Items Rule appears to not apply to the allocation of losses relating to section 704(c) property, which could cause fungibility issues. This may have been inadvertent. In addition, there are fungibility concerns for a PTP unit where a section 743(b) adjustment does not correlate to an inherited remedial section 704(c) amount (e.g., where a buyer purchases its interest at a time when the PTP has a revaluation loss). The Section 704(c) Remedial Income Offset Rule does not appear to apply to this situation.

KPMG observation

It was unclear under the 2018 Proposed Regulations whether an item of remedial income related to a remedial allocation of depreciation, depletion or amortization ("DDA") items would result in an increase to ATI at the partner level prior to 2022. A partner generally decreases the partner's ATI for the partner's distributive share of DDA remedial items, subject to the addback of these amounts for tax years 2018-2021. If an item of remedial income related to DDA were to be treated as a "negative" item of DDA, a reduction to ATI could result. The 2020 Proposed Regulations' treatment of remedial income as an increase to a partner's ATI appears to confirm that remedial items of income are not considered "negative" DDA items.

Qualified expenditures

A partnership's ATI is reduced by deductions for expenditures under sections 173 (circulation expenditures), 174(a) (research and expenditure expenditures), 263(c) (intangible drilling and development expenditures), 616(a) (mine development expenditures), and 617(a) (mine exploration expenditures) ("qualified expenditures"). These expenditures, however, may not reduce the taxable income of a

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partner to the extent that the expenditures are capitalized at the partner level under section 59(e)(4)(C) or section 291(b). The 2020 Proposed Regulation would provide that a partner's distributive share of a partnership's qualified expenditures that are capitalized by a partner under section 59(e) increase the ATI of the partner. A similar rule would apply to S corporations.

KPMG observation

A similar issue exists for partnerships with oil and gas property. In the case of a partnership, oil and gas depletion and the gain or loss on the disposition of oil and gas property are computed separately by the partners and not by the partnership. If a partnership holding oil and gas property is subject to section 163(j), it is unclear whether the gain, loss, or depletion with respect to oil and gas property would affect the partnership's determination of ATI. In addition, the 2020 Proposed Regulations do not address the situation where a partner is required to capitalize certain qualified expenditures of a partnership under section 291(b). Treasury is aware of both issues and requests comments.

Exempt partnerships or S corporations

Under the 2018 Proposed Regulations, a partnership or S corporation that qualifies as an exempt entity would not be subject to section 163(j), however the exempt partnership's or S corporation's BIE would have been subject to section 163(j) at the partner level. The Final Regulations change course and provide that an exempt partnership's or S corporation's BIE does not retain its character as BIE and is therefore not subject to section 163(j) at the partner level or shareholder level.

The Final Regulations also clarify that Reg. §§ 1.163(j)-6(m)(3) and (4), which provide special rules for partnerships or S corporations with prior year business interest limitations that thereafter become "not subject to section 163(j)," only apply to the extent the entity becomes eligible for the small business exemption and do not apply to the extent the entity becomes not subject to a section 163(j) limitation because it made an election to have an excepted trade or business.

Short S corporation tax years

The Final Regulations modify Reg. §§ 1.1362-3(c), 1.1368-1(g)(2), and 1.1377-1(b)(3) to provided that a separate section 163(j) limitation will apply when an S corporation has either an actual short tax year, or in the limited circumstances where the S corporation elects to treat its tax year as two separate tax years.

Implications for foreign corporations

International implications of section 163(j): Reg. §§ 1.163(j)-7, -8

Application to CFCs under Final Regulations

Consistent with the 2018 Proposed Regulations, the Final Regulations explicitly apply section 163(j) to controlled foreign corporations ("CFCs"). The Final Regulations apply the section 163(j) limitation on a

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CFC-by-CFC basis in the same manner as the "Default Rule" under the 2018 Proposed Regulations, which precludes netting of business interest income ("BII") of one CFC against the business interest expense ("BIE") of another CFC. The Final Regulations also adopt unchanged the rule in the 2018 Proposed Regulations for computing CFC tentative taxable income, which requires that CFC-level tentative taxable income be calculated based on Reg. § 1.952-2 principles (or under the rules of section 882), and excludes dividends from related persons (as defined within the meaning of section 954(d)(3)) from the recipient CFC's tentative taxable income.

In addition, U.S. shareholder adjusted taxable income ("ATI") excludes CFC income inclusion items under the Final Regulations, such as amounts included in the gross income of a U.S. shareholder under sections 78, 951(a), or 951A(a).

KPMG observation

The Final Regulations provide only skeletal rules that apply to CFCs. In response to taxpayer comments concerning administrative and compliance burdens relating to the application of section 163(j) to CFCs under the elective "CFC Group Method" in the 2018 Proposed Regulations, the Final Regulations fully reserve on all rules administering the CFC Group Method. Instead, Treasury re-proposed substantially modified rules pertaining to the CFC Group Method in the 2020 Proposed Regulations.

Application to CFC Group Members under the 2020 Proposed Regulations

Single Section 163(j) Limitation for a CFC Group

Under the 2020 Proposed Regulations, a single section 163(j) limitation is computed for a CFC Group. For this purpose, the current-year BIE, disallowed BIE carryforwards, BII, and ATI would be determined first on a separate-company basis for each CFC Group Member. The CFC Group's single section 163(j) limitation would be computed based on the sum of all of these separately determined amounts.

KPMG observation

Under the 2018 Proposed Regulations' CFC Group Method, lower-tier CFC Group Members would be permitted to "share" their excess taxable income ("ETI") with upper-tier CFCs in the same chain of ownership (the "CFC ETI tiered roll-up" rule). The CFC ETI tiered roll-up rule, however, would preclude the allocation of an upper-tier CFC's ETI to a lower-tier CFC as well as the sharing of CFC ETI to cross-chain CFCs.

Treasury's decision to reject the CFC ETI tiered roll-up framework introduced in the 2018 Proposed Regulations in favor of a single CFC Group-wide section 163(j) limitation amount is intended to address administrability and legal entity or operational restructuring concerns expressed in certain taxpayer comments.

Application of U.S. consolidated return group principles to CFC Groups

The 2020 Proposed Regulations generally would apply U.S. consolidated return group principles, subject to certain modifications, to CFC Groups for purposes of allocating the single section 163(j) limitation amount to the CFC Group Members. The 2020 Proposed Regulations also provide ordering rules that

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would determine the deductibility of a CFC Group's current-year BIE and disallowed BIE carryforwards. Generally, current-year BIE would be deducted first and the deductibility of disallowed BIE carryforwards would be determined using a FIFO approach.

Consistent with the U.S. consolidated return group rules approach, the 2020 Proposed Regulations would apply SRLY principles to disallowed BIE carryforwards of a CFC Group member generated before it joined the CFC Group ("pre-group disallowed BIE carryforwards"). SRLY subgroup rules would apply to pre-group subgroups, subject to certain modifications in the CFC context.

Reg. § 1.1502-75(d) principles (regarding when a U.S. consolidated group remains in existence) would also apply for purposes of determining when a CFC group ceases to exist.

KPMG observation

The application of U.S. consolidated return group principles to CFCs would be a seismic change to the determination of CFC-level attributes. Although the preamble speaks of the changes made as intended to 'reduce [certain] administrative and compliances burdens,' consolidated return principles are themselves far from simple to apply. Thus, it seems difficult to assess the extent to which the 2020 Proposed Regulations really represent a reduction in compliance burden as compared to the 2018 Proposed Regulations.

Definition of specified and CFC Groups

In response to taxpayer comments criticizing the very strict eligibility requirements of the prior CFC Group Method under the 2018 Proposed Regulations, the 2020 Proposed Regulations would broaden the potential applicability of CFC Group Method.

Under the 2018 Proposed Regulations, a "CFC Group" is defined as two or more applicable CFCs (that is, CFCs with one or more section 958(a) U.S. shareholders), if at least 80% of the stock measured **by value** of each CFC member is directly or indirectly owned within the meaning of section 958(a) by a (1) a single U.S. shareholder or (2) certain related U.S. shareholders that own stock of each CFC member in the same proportions.

The 2020 Proposed Regulations modify and break apart the 2018 Proposed Regulations' definition of a CFC Group into two defined terms – a Specified Group and a CFC Group. The term "Specified Group" broadly retains the modified section 1504(a) affiliated group stock ownership thresholds as applied between applicable CFCs under the prior CFC Group definition; however, the 2020 Proposed Regulations would no longer require that a U.S. shareholder (or group of related U.S. shareholders) be the highly related parent of the CFC Group. Instead, the definition of a Specified Group provides that a Specified Group parent may be either a "qualified U.S. person" *or* an applicable CFC. A "qualified U.S. person" is a single corporation (including an S corporation) or a U.S. citizen or tax resident. Consistent with the 2018 Proposed Regulations, a U.S. consolidated return group is treated as a single corporation for this purpose.

In addition to the modified affiliated group relatedness requirement, the 2020 Proposed Regulations also provide a detailed "with or within" specified period rule that identifies when an applicable CFC may qualify as a Specified Group Member with respect to a Specified Group. An applicable CFC would be a Specified Group Member of a Specified Group for a particular year only if the following conditions are satisfied:

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1) The applicable CFC's tax year ends with or within the Specified Group's "specified period", which is generally the Specified Group parent's tax year end (determined without regard to section 898(c)(2)), **and**

2) The applicable CFC satisfies the modified affiliated group relatedness requirement on the last day of its tax year that ends with or within the specified period.

The 2020 Proposed Regulations also introduce detailed rules that apply to mid-year joining and departing member scenarios.

Under the 2020 Proposed Regulations, a "CFC Group" generally refers to all Specified Group Members of a Specified Group for which a CFC Group Election is in effect.

Inclusion of CFCs with ECI and financial services CFCs in CFC Groups

The 2018 Proposed Regulations excluded applicable CFCs with US ECI and certain financial services CFCs from being CFC Group Members. Unlike the 2018 Proposed Regulations, the 2020 Proposed Regulations do not provide for CFC financial services subgroups. Instead, applicable CFCs engaged in financial services could be included in a CFC Group under the 2020 Proposed Regulations.

Also, the 2020 Proposed Regulations would provide that an applicable CFC with ECI is not precluded from being a CFC Group member. The ECI items of the applicable CFC, however, would not be included in the CFC Group calculations. The ECI of the applicable CFC would be treated as income of a separate CFC (an "ECI Deemed Corporation"), which would be excluded from the CFC Group and subject to a separate section 163(j) calculation for its ECI in accordance with the proposed rules that apply to foreign persons with ECI.

Making or revoking a CFC Group Election

Unlike the 2018 Proposed Regulations, the 2020 Proposed Regulations require taxpayers to affirmatively file a CFC Group Election statement in accordance with certain time and manner instructions provided therein to apply the CFC Group Method.

In response to taxpayer comments to the 2018 Proposed Regulations, the 2020 Proposed Regulations provide that the CFC Group Election is not irrevocable. Rather, a CFC Group Election cannot be revoked for at least 60-months following the end of the specified period for which it was made. Once revoked, the CFC Group election cannot be made again for another 60-month period.

Once a CFC Group election is made under the 2020 Proposed Regulations, the CFC Group remains in existence until the CFC Group election is revoked or until the end of the specified group's last specified period.

If a taxpayer elected to apply the CFC Group Method under the 2018 Proposed Regulations for a tax year, such election would not remain in effect for any tax year in which the taxpayer relies on the 2020 Proposed Regulations. Instead, the taxpayer would need to make a CFC Group Election in accordance with the rules provided in the 2020 Proposed Regulations for a year in which the taxpayer follows the 2020 Proposed Regulations to apply the CFC Group Method.

Effect of CFC inclusions and attributes on U.S. Shareholder ATI

Consistent with the 2018 Proposed Regulations, the Final and 2020 Proposed Regulations) provide that U.S. shareholder ATI generally excludes CFC income inclusion items, such as amounts included in the

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gross income of a U.S. shareholder under sections 78, 951(a), or 951A(a).

If, however, a CFC Group Election is made, the U.S. shareholder would be allowed to include in ATI a certain amount of CFC Group ETI not to exceed the U.S. shareholder subpart F and GILTI inclusions (without regard to the section 78 amount) with respect to the CFC Group. Unlike the 2018 Proposed Regulations, the 2020 Proposed Regulations would also allow U.S. shareholder ATI to include a portion of its deemed income inclusions attributable to the ETI of any "stand-alone applicable CFC", which is defined as an applicable CFC that fails to qualify as a specified member of a specified group.

Application of CARES Act section 163(j) provisions to CFCs

163(j) limitation based on 50% of ATI for 2019 & 2020 and election to use 2019 ATI in 2020

The 2020 Proposed Regulations provide special rules for applying the 2019 and 2020 ATI-related provisions in section 163(j)(10) enacted under the CARES Act to CFC Groups.

Specifically, the 2020 Proposed Regulations would provide that the ATI of the CFC Group would be determined by reference to the CFC Group's 2019 and 2020 specified periods, as applicable, without regard to whether the tax years of the individual CFC Group Members actually begin in 2019 or 2020. The 2020 Proposed Regulations provide detailed rules for identifying which tax years of the constituent CFC Group Members would be included in a CFC Group's 2019 and/or 2020 specified periods for purposes of computing CFC Group ATI.

The 2020 Proposed Regulations also provide certain time and manner rules for making the elections allowed under section 163(j)(10) for the CFC Group. If a taxpayer relies on the 2020 Proposed Regulations for their 2019 and/or 2020 tax year, then the rules in the 2020 Proposed Regulations would modify the application of the time and manner rules under Revenue Procedure 2020-22 for CFC Groups and CFC Group Members.

Other miscellaneous rules

New anti-abuse rule

The 2020 Proposed Regulations contain a new anti-abuse rule that would apply in certain situations when U.S. shareholders may affirmatively plan to limit BIE deductions as part of a tax-planning transaction. The anti-abuse rule generally ought not to apply if a CFC Group Election is in effect. In those situations to which the anti-abuse rule would apply, CFC-level ATI would be increased to undo the effects of the affirmative planning on the BIE deduction limitation.

A new anti-abuse rule applies in certain situations when U.S. shareholders may inappropriately affirmatively plan to limit BIE deductions as part of a tax-planning transaction. See 2020 Prop. Reg. § 1.163(j)-7(g)(4). For example, if a US shareholder projects excess GILTI credits in Year 1 and excess GILTI limitation Year 2, and accordingly executes a tax-planning transaction resulting in BIE limitation for a CFC in Year 1 with the intent to carry forward the BIE deduction to Year 2, such transaction may be subject to the anti-abuse rule.

New safe-harbor election

The 2020 Proposed Regulations would introduce an annual safe-harbor election that, if made, would preclude the disallowance under section 163(j) of any BIE of CFC Group Members and/or stand-alone applicable CFCs, as applicable. The safe-harbor election is intended to reduce the compliance burden on applicable CFCs that would not have disallowed BIE if they applied the section 163(j) calculations.

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U.S. shareholder's ATI would not be increased by any portion of the ETI of a stand-alone applicable CFC or CFC Group Member for which the safe-harbor election is in effect.

Applicability dates and reliance

KPMG observation

For tax years in which the Final Regulations are effective or otherwise followed (e.g., 2021 and beyond for calendar-year taxpayers not electing retroactivity), the section 163(j) limitation must be applied to CFCs on a CFC-by-CFC basis and U.S. shareholder ATI must exclude any CFC income inclusion items unless the taxpayer were to follow the 2020 Proposed Regulations for those same tax years. Accordingly, many taxpayers will likely rely on the 2020 Proposed Regulations for any tax year for which the Final Regulations apply.

Application of section 163(j) to foreign persons with U.S. effectively connected income ("ECI") Reg. § 1.163(j)-8

Foreign persons are subject to net basis U.S. taxation only on their income that is effectively connected with a U.S. trade or business. Accordingly, the 2020 Proposed Regulations would modify the application of section 163(j) to "scale" the limitation to the applicable U.S. tax base.

KPMG observation

The 2018 Proposed Regulations also provided rules with respect to the application of section 163(j) to foreign persons with ECI. But "the Treasury Department and the IRS [became] aware of certain distortions that can result under the 2018 Proposed Regulations. Accordingly, proposed Section 1.163(j)-8 [was] revised, and re-proposed [with an effective date of tax years beginning on or after 60 days after the date the final regulations are published in the Federal Register, the same effective date as the -7 regulations]."

Section 882 principles would apply for purposes of determining the foreign person's BIE allocable to ECI, and thus permit a taxpayer to determine ATI, taking into account only ECI items. The 2020 Proposed Regulations provide for two different computation methods: one for a "relevant foreign corporation", a foreign corporation whose entity classification is relevant under the check-the-box rules (i.e., its classification affects the U.S. federal income tax liability of any person, other than its liability solely under section 881 or 882), and a second one for nonresident alien individuals and foreign corporations whose entity classification does not affect the liability of any person under the check-the-box rules (in which case the only relevant tax liability is the foreign corporation's own tax liability under section 881 or 882).

KPMG observation

The 2018 proposed regulations provided for a separate computational method for all CFCs that had ECI. Since the ECI of many CFCs, after section 958(b) repeal, would not affect the U.S. federal income tax liability of any person (other than its own liability under section 881 or 882 which would already be covered under the general rules applicable to non-CFC foreign corporations), the

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proposed rules now provide a separate computation method only if the corporation's classification might affect the U.S. federal income tax liability of any person, other than the corporation's own liability solely under section 881 or 882 (e.g., a separate computation method would apply to a CFC only if it has a section 951(b) U.S. shareholder that owns, within the meaning of section 958(a), stock of the CFC).

The definitions for ATI, BIE, BII, etc. are modified to limit such amounts to ECI and expenses properly allocable thereto. A non-resident alien individual or a foreign corporation (including a relevant foreign corporation) would first determine its interest expense under section 1.882-5 and then determine the amount of disallowed BIE under section 163(j).

A nonresident alien individual or foreign corporation other than a relevant foreign corporation then determines its 163(j) calculation by taking into account only the portion of the relevant items (e.g., ATI, BIE, BII, etc.) that relate to ECI. A relevant foreign corporation allocates its deductible BIE under a formulary method to ECI and non-ECI amounts proportionately based on the relative amounts of ECI and non-ECI BIE in each category.

In the case of a relevant foreign corporation that is a CFC that is part of a CFC group (under the -7 rules), the ECI items are hived off and are treated as items of a separate corporation that is not included in the CFC group but rather is subject to these rules.

Consistent with the overall theme of treating partnerships as entities for purposes of section 163(j), different rules apply to the extent foreign persons (including relevant foreign corporations) earn ECI through partnerships.

The proposed rules also provide that the section 163(j) limitation does not affect the determination of U.S. net equity for purposes of applying the branch profits tax under section 884.

State and local tax considerations

Section 163(j) state considerations for corporations

Differences in federal and state law add complexity in determining how section 163(j) applies at the state level. Those differences generally fall into three categories: (1) filing methodologies; (2) conformity to the Internal Revenue Code; and (3) modifications under state law. With respect to filing methodologies, most states do not follow the federal consolidated return rules and instead require taxpayers to file on a separate company basis or use a combined report with membership that often does not match that of the federal consolidated group. Because the Final Regulations provide for a single section 163(j) limitation for a federal consolidated group, this disconnect with state filing methods necessitates recalculating the section 163(j) limitation for state purposes (possibly multiple times given the lack of a uniform filing method among states). As for conformity to the Internal Revenue Code, approximately 35 states currently adopt section 163(j) for purposes of their corporate income taxes. That conformity, however, is far from uniform. For example, certain states that do not automatically conform to federal tax law

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changes remain tied to the pre-CARES Act version of section 163(j). Finally, states often require modifications to the calculation of state taxable income that can affect the ability of a taxpayer to deduct its interest expense. Those modifications include more general provisions limiting the ability of taxpayers to deduct certain interest paid to related parties and more specific modifications related to the section 163(j) limitation (e.g., Virginia allows taxpayers a deduction for 20% of the amount disallowed federally by section 163(j)).

Lack of state conformity to federal consolidated return rules

One of the key provisions in the Final Regulations with significant implications for state corporate income taxpayers is the confirmation that a federal consolidated group has a single section 163(j) limitation. Under the Final Regulations, the calculation of a consolidated group's limitation requires intercompany obligations between members of the same consolidated group to be disregarded for purposes of determining business interest expense and business interest income. For groups of affiliated corporations that do not elect to file a federal consolidated return, however, the section 163(j) limitation for each of the members of that group is determined separately and the intercompany obligations are not disregarded in determining the limitation. While providing clarity for federal taxpayers, this approach creates compliance headaches in many states and can result in significant differences between the section 163(j) limitation calculated at the state and federal levels.

For state purposes, a member of the federal consolidated group is often required to file a separate company state return and calculate state taxable income beginning with federal taxable income determined as if the corporation had not elected to file a federal consolidated return. This is the general approach in states that require separate company return filing. Also, certain states that require combined reporting start the calculation of the combined group's state taxable income with each group member's separate company federal taxable income. Over half of the states that adopt section 163(j) require these separate company calculations. Even in combined reporting states that do conform to the federal consolidated return rules, taxpayers may find state-specific section 163(j) calculations are necessary. For example, the membership of a state combined group may not mirror the federal consolidated group because of differing rules for which entities must be included in the group (e.g., many states use a greater than 50% ownership threshold for group inclusion rather than the 80% ownership threshold used for a federal consolidated return). For taxpayers filing federal returns on a consolidated basis, this could result in significant differences in the applicable state section 163(j) limitation from what is computed on the taxpayer's federal consolidated income tax return (and any associated carryovers of disallowed interest expense deductions).

Even in states that generally conform to the federal consolidated return regulations, the application of the consolidated group rules in the Final Regulations could create state-specific issues. For example, some states require or permit groups of related taxpayers to elect a combined or consolidated filing method that often consists of more or less members than the federal consolidated group (e.g., where the ownership threshold for group membership is greater than 50% rather than the 80% ownership requirement for a federal consolidated return group). In those cases, the state section 163(j) limitation may need to be recomputed by applying the consolidated group rules in the Final Regulations to the state combined group.

KPMG observation

Of the states that conform to section 163(j), only a handful have issued guidance on translating a federal consolidated group section 163(j) limitation into the calculation of state taxable income. That guidance has not always been intuitive. While not generally conforming to the federal consolidated

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return rules, New Jersey has released guidance providing that "taxpayers should make adjustments applying the section 163(j) limitation as though they had been included on a single federal consolidated return" to account for situations in which the federal consolidated group may differ from the New Jersey combined group. Also, despite its requirement that corporations file on a separate company basis, the Pennsylvania Department of Revenue has issued guidance providing that no section 163(j) limitation is expected at the state level if there is no limitation for the federal consolidated group of which the separate company is a member. Only if there is a federal limitation at the consolidated group level is the separate Pennsylvania filer required to compute a Pennsylvania limitation.

In states that require combined reporting but that may not follow the federal consolidated return rules, states have taken different approaches for addressing whether and to what extent one member's excess limitation may be used by other members of the group. Massachusetts, for example, allows a combined group to apply one entity's excess limitation to offset another entity's excess business interest expense. Conversely, Michigan does not allow an entity's excess limitation to be shared among group members.

As if the state specific computations were not complicated enough, there will be additional complexities on 2019 returns because certain states do not adopt the changes in the CARES Act that increase the amount of interest allowed to be deducted to 50% of Adjusted Taxable Income ("ATI").

Disallowed carryforwards

Interest expense deductions disallowed under section 163(j) may generally be carried forward indefinitely. In states that require the calculation of the section 163(j) limitation to be done on a separate company basis, the carryforwards of disallowed interest deductions may be significantly different from those calculated for federal purposes. With respect to those carryforwards, the Final Regulations provide guidance on the application of section 382 limitations and SRLY-type rules for federal consolidated groups. In states that require corporations to file on a separate company basis or use their own rules for allocating tax attributes to members of a combined group, a complicated analysis may be required to determine which entities may carry forward unused section 163(j) interest expense deduction carryforwards and whether any limits apply to the use of those carryforwards in the state, especially in situations in which there is a merger or acquisition. Few states have provided guidance on this issue to date.

Related-party interest expense

Of the states that conform to section 163(j), almost half currently have rules that disallow the deduction of interest or intangible-related interest paid to related parties. The intersection of these two provisions creates an ordering problem unique to state corporate income tax: Is the state related-party interest limitation applied before or after the section 163(j) limitation?

How a state answers this question also affects future years when a taxpayer deducts interest disallowed in a prior year under section 163(j). The taxpayer in that case would need to trace which portion of the federal limitation related to interest subject to the state addback provision in the year it was limited by section 163(j).

KPMG observation

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Fewer than 10 states have released guidance addressing this issue. Generally, taxpayers are required to proportionally apply the limitation to related and third-party interest expense. At least one state (Massachusetts), however, applies a different approach. Massachusetts requires taxpayers to apply the section 163(j) limitation **after** applying the related party addback rules. The Massachusetts approach is generally more favorable to taxpayers because the section 163(j) limit is not computed using related party interest expense that may be disallowed.

State considerations for partnerships

As with corporations, the effects of section 163(j) on the state taxation of partnerships and their partners vary depending on whether states conform to the federal provision. Even if a state adopts section 163(j) generally, it may not conform to the recent amendments to section 163(j) in the CARES Act, or it may have its own state law provisions that alter the application of section 163(j) for state purposes. For a state that does not conform to a computation used in determining federal taxable income, such as section 163(j), a disconnect arises that leads to separate computations, reporting, and tracking.

For example, if a decoupling state does not apply section 163(j) to a partnership and its partners in a year in which section 163(j) would limit the partnership's interest deduction, the partnership and its partners would likely be allowed a greater interest deduction in that state than would be allowed federally. In a subsequent tax year, if the partnership's "excess items" result in the partners taking a deduction for the interest expense from the prior tax year on their federal returns, then the partners, who already deducted this interest expense for the prior tax year in the decoupling state, would not be permitted another deduction for this same interest expense on the tax return filed with this decoupling state. Tracking is required as a result of the variance in timing of deductibility between the potential future tax year federal deduction for this interest expense at the partner level and the current state deduction taken for unlimited interest expense in a decoupling state at the partnership and partner levels.

KPMG observation

In the partnership context, the various filings that are potentially affected by section 163(j) limitations can include tax returns for partnerships taxed at the entity level, partnership filings that report state income to partners, nonresident withholding returns, partner composite tax returns, and partner individual or corporate tax returns. While partnerships are required to report state source income and nonresident withholding credits up through multiple layers of tiered partnerships, for conforming states, the "entity approach" retained by the 2020 Proposed Regulations correspondingly limits the state reporting for section 163(j) to the direct partner level. However, for decoupling states, the additional deduction for interest expense paid or accrued in the current tax year results in the need to report that adjustment up through multiple tiers. This also requires reporting a corresponding adjustment in a later tax year if the interest expense disallowed by section 163(j) becomes deductible in computing federal income, so that the expense is not deducted again in computing income for that decoupling state.

Both the Final Regulations and the 2020 Proposed Regulations include various provisions regarding partner basis. State decoupling from section 163(j) can result in the requirement to track state-specific partner basis in certain states. For example, California has not conformed to section 163(j) and requires partners to track California-specific basis values. Adjustments may also be needed in jurisdictions like New York State and City, which conform to section 163(j) under the Tax Cuts and Jobs Act, but that have generally decoupled from the more recent CARES Act changes to section 163(j). This also affects entity-level taxes imposed on partnerships such as the New York City

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Exempt and excepted businesses and entities

Exempt small businesses

The Final Regulations provide rules for implementing the small business exception in section 163(j)(3) for certain taxpayers meeting the $25 million gross receipts test of section 448(c), including rules for the application of section 448(c) to individuals in their own capacity and as owners of interests in flow-through entities. Section 448(c)(2) aggregates the gross receipts of multiple taxpayers that are treated as a single employer under sections 52(a) and (b) and 414(m) and (o).

The Final Regulations provide that the exemption for certain small businesses that meet the gross receipts test of section 448(c) does not apply to a tax shelter as defined in section 448(d)(3). Section 448(d)(3) defines a tax shelter by cross-reference to section 461(i)(3), which defines a tax shelter, in relevant part, as a syndicate within the meaning of section 1256(e)(3)(B). Reg. § 1.448-1T(b)(3) provides, in part, that a syndicate is a partnership or other entity (other than a C corporation) if more than 35% of its losses during the tax year are allocated to limited partners or limited entrepreneurs, whereas section 1256(e)(3)(B) refers to losses that are allocable to limited partners or limited entrepreneurs. To clarify and provide consistency, new proposed regulations would require the use of the allocation rule in Prop. Reg. § 1.448-1T(b)(3) in defining the term "syndicate."

Excepted trades or businesses and definition of a real property trade or business

Section 163(j) provides elective exceptions for certain real property trades or businesses and for certain farming businesses. The Final Regulations provide applicable rules and mechanics with respect to electing into these exceptions that largely adopt the rules from the 2018 Proposed Regulations, although with a few notable exceptions.

Exempt small businesses and the election to be an excepted trade or business

The Preamble to the 2018 Proposed Regulations stated the view that a business that qualifies as an exempt small business is not eligible to elect to be an excepted trade or business. In a departure from that view, the Final Regulations permit a real property trade or business or a farming business that meets the requirements of the small business exemption to elect to be an excepted trade or business. This can benefit equity investors in the entity that holds the business by enabling them to allocate their own debt to an excepted trade or business under Reg. § 1.163(j)-10.

Protective elections

The Preamble to the Final Regulations provides that a real property trade or business as defined under section 469(c)(7)(C) need not rise to the level of a section 162 trade or business, such as the rental of real property under a triple net lease arrangement. The Final Regulations permit such a real property trade or business to protectively elect to be an excepted trade or business.

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KPMG observation

A business that does not rise to the level of a section 162 trade or business generates non-trade or business interest expense, which, upon allocation to a C corporation or REIT partner, would be recharacterized as business interest expense for that partner. The ability for such a real property trade or business to nevertheless make an election to be an excepted real property trade or business benefits those REIT and C Corporation partners because the allocated interest expense would be interest from an excepted business (for the REIT, even if it does not make a safe harbor REIT election). Such an election also allows a C corporation partner or REIT partner to allocate its own interest expense to an excepted business.

REIT safe harbor

The Final Regulations retain and favorably modify the REIT safe harbor that was included in the 2018 Proposed Regulations. As proposed, the REIT safe harbor allowed a REIT to make an election to be an electing real property trade or business if the REIT held (1) real property (as defined in section 1.856-10), (2) interests in partnerships holding real property, or (3) shares of other REITs holding real property. The Final Regulations provide that the REIT safe harbor is available to REITs that hold real property directly, or indirectly through partnerships or tiered partnerships, or that hold shares in REITs holding real property either directly or indirectly through partnerships or lower-tier REITs.

In a helpful expansion of the REIT safe harbor, certain REIT-controlled partnerships are also eligible for the REIT safe harbor under the Final Regulations, and thus, are able to elect to be an excepted real property trade or business. The Final Regulations provide that a partnership may apply the REIT safe harbor election at the partnership level if one or more REITs own, directly or indirectly, at least 50% of the partnership's capital and profits, the partnership meets the REIT gross income and assets tests as if the partnership were a REIT, and otherwise satisfies the requirements of the REIT safe harbor as if the partnership were a REIT. A REIT (or eligible partnership) may choose not to apply the REIT safe harbor and instead elect for one or more of its trades or businesses to be electing real property trades or business, assuming that they qualify, in which case, the taxpayer may not rely on any of the safe harbor provisions.

KPMG observation

In our experience, most publicly traded UpREITs borrow at their operating partnership level rather than at the REIT level. Thus, the REIT safe harbor, as expanded in the Final Regulations, will be helpful in allowing UpREITs in typical commercial structures to benefit from the electing real property trade or business exception.

Modification to REIT safe harbor allocation rule

The Final Regulations require, as did the 2018 Proposed Regulations, that in applying the REIT safe harbor, a REIT must determine the extent to which the value of its assets are allocable to "real property financing assets." Under this rule, a REIT treats all of its assets as assets of an electing real property trade or business if 10% or less of the value of a REIT's assets consist of "real property financing assets" at the close of the applicable tax year, but is required to allocate interest expense, interest income, and other items of expense and gross income between the electing real property trade or

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business and non-excepted trades or businesses if its financing assets at the close of the tax year exceed 10% its assets.

The Final Regulations permit a REIT shareholder of a lower-tier REIT to determine the extent of the lower-tier's real property financing assets based upon an applicable financial statement (within the meaning of section 451(b)(3)) of the lower-tier REIT. Otherwise, the shareholder REIT may rely only upon information provided directly from the lower-tier REIT to make the determination of the percentage of real property financing assets.

The anti-abuse rule

The Final Regulations retain the anti-abuse rule proposed in the 2018 Proposed Regulations that prevents a real property trade or business from being eligible for the election to be treated as an excepted trade or business if at least 80% of its real property is leased to a trade or business under common control (treating businesses as under common control if 50% of their direct and indirect ownership is held by persons that are related within the meaning of section 267 and section 707(b)). The Final Regulations clarify that the 80% determination is made by reference to the fair market rental value of the property used in the business. For this purpose, the fair market rental value is the amount of rent that a prospective lessee that is unrelated to the lessor would be willing to pay for a rental interest in real property, taking into account the geographic location, size, and type of the real property.

New exceptions to the anti-abuse rule

The 2018 Proposed Regulations contained an exception to the anti-abuse rule for REITs leasing qualified lodging facilities and qualified healthcare properties and requested comments on whether this exception should be expanded to capture certain "PropCo/OpCo" structures. In response to comments, the Final Regulations provide two new additional exceptions to the anti-abuse rule. The first new exception, the "de minimis exception," permits an election to be a real property trade or business by a lessor that leases at least 90% of the fair market rental value of lessor's rental property to one or more of: (1) a party not under common control with the lessor or the lessee, (2) a party under common control that has made an election to be an electing real property trade or business or electing farming business (but only to the extent that the lessor's real property is used as part of the excepted trade or business); or (3) a party under common control that is an excepted regulated utility trade or business (but only to the extent that the lessor's real property is used as part of the excepted trade or business).

If the de minimis exception does not apply because the lessor does not meet the 90% standard for that exception, then a second new exception, the "look-through exception," may apply. This provision allows the lessor to make a real property trade or business election to the extent that the lessor leases the real property to the parties described above in the de minimis exception and to the extent that the lessee, if under common control with the lessor, ultimately subleases the real property either to a commonly controlled party that is a trade or business that has made an election to be an electing real property trade or business or electing farming business, or to an excepted regulated utility business to the extent the real property is used as part of such business, or to a party not under common control with the lessor or the lessee.

If only a portion of the real property satisfies the requirements of the look-through exception, then the business must allocate the basis of the assets between excepted and non-excepted businesses under the allocation rules of Reg. § 1.163(j)-10. Accordingly, the Final Regulations also modify the allocation rules of Reg. § 1.163(j)-10 to require allocation of the basis of real property leased under the look-through rule between the excepted and non-excepted portions of the real property trade or business based on their respective relative fair market rental values.

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KPMG observation

It is important to note that in order for a lessor to avail itself of the de minimis exception or the look-through exception where lessor leases to a party under common control that is a real property trade or business or farming trade or business (or where the lessee subleases to such a trade or business), the lessee (or sublessee) real property trade or business or farming business, as the case may be, must actually make an irrevocable election to be an excepted business and consequently must adopt the alternative depreciation system ("ADS").

Expansion of the anti-abuse rule exception for REITs leasing qualified lodging facilities and qualified health care properties; proposed revenue procedure safe harbor

In addition to adding the two exceptions to the anti-abuse rule explained above, the Final Regulations expand the availability of this exception to partnerships making a real property trade or business election that lease qualified lodging facilities and qualified health care properties (as each is defined for purposes of the REIT rules).

Further, Notice 2020-59, which includes a proposed revenue procedure, was issued concurrently with the Final Regulations. The proposed revenue procedure would provide a safe harbor for a trade or business that manages or operates a qualified residential living facility to be treated as a real property trade or business solely for purposes of qualifying to make the real property trade or business election under section 163(j)(7). The safe harbor is intended to mitigate uncertainty as to whether a lessee residential facility that provides supplemental assistive, nursing, or routine medical services can qualify as electing real property trades or businesses. The revenue procedure defines a qualified residential living facility and supplemental assistive nursing or other routine medical services. The proposed revenue procedure makes clear that satisfying the requirements of the safe harbor allows a taxpayer to treat the business as a real property trade or business solely for purposes of making an election to be an excepted business and is not a determination that the business is a trade or business under section 469. The proposed revenue procedure is proposed to apply to tax years beginning after December 31, 2017 and taxpayers can rely on the proposed safe harbor in the proposed revenue procedure until the proposed revenue procedure is published as a revenue procedure in the Internal Revenue Bulletin.

KPMG observation

The new exceptions provided in the Final Regulations offer new opportunities for trades or businesses to elect to qualify for the electing real property trade or business exception, some of which also require an entity under common control to make an election to be an electing real property trade or business or electing farming business. As noted in the Preamble to the Final Regulations, Revenue Procedure 2020-22 provides procedures for making late elections to become an electing real property trade or business or an electing farming business, which would require a partnership to either file an amended return under Revenue Procedure 2020-23, or alternatively to file an administrative adjustment request. Alternatively, partnerships could simply make the election going forward for future tax years. In any event, businesses may wish to model the effects of making such an election to fit within the new exceptions.

The Preamble to the Final Regulations notes that the definitions of real property trades or businesses and farming businesses have been amended in the Final Regulations to reflect that future guidance may be needed to determine whether a particular trade or business can make an election, and thus those

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definitions now include a new provision noting that the Secretary may issue guidance on whether a trade or business can be an electing real property trade or business or electing farming business.

Corporate partner cannot make real property trade or business election for partnership

The Preamble to the Final Regulations confirms that a corporate partner in a partnership that conducts a real property trade or business cannot make an election to be an excepted real property trade or business for the partnership. A corporate partner can treat its share of the partnership's real property trade or business as an electing real property trade or business only if the partnership itself makes the election. By way of explanation, the Preamble to the Final Regulations notes that the election has consequences, including the requirement that the business's property be depreciated using ADS.

KPMG observation

However, given the ability of an exempt small business and a non-section 162 real property trade or business to make an election to be an excepted real property trade or business, the inability for a corporate partner to elect on behalf of a real property trade or business partnership is mitigated in some circumstances.

Definition of real property trade or business

The Final Regulations adopt, with a few changes, proposed amendments to Reg. § 1.469-9(b) from the 2018 Proposed Regulations that provided rules relating to the definition of a real property trade or business under section 469(c)(7)(C). Like the 2018 Proposed Regulations, the Final Regulations define "real property" to include land, buildings, and other inherently permanent structures that are permanently affixed to land. The definition further provides that property manufactured or produced for sale that is not real property in the hands of the manufacturer or producer, but that may be incorporated into real property through installation or any similar process or technique by any person after its manufacture or production (for example, bricks, nails, paint, and windowpanes), is not real property in the hands of any person prior to the completed incorporation or installation of such property into the real property.

Although the definition of a real property trade or business under section 469(c)(7)(C) contains a list of many categories of qualifying trades or businesses, the 2018 Proposed Regulations defined only two of these terms: "real property operation" and "real property management," but reserved on the other categories. Notably, the Preamble to the 2018 Proposed Regulations, though not the 2018 Proposed Regulations, themselves, indicated that those undefined categories of real property trades or businesses under section 469(c)(7)(C) would require a nexus to the creation, acquisition, or management of rental real estate. Although the Preamble to the Final Regulations acknowledges that the other categories (real property construction, reconstruction, development, redevelopment, conversion, acquisition, or brokerage businesses) should not necessarily be required to have a direct nexus or relationship to rental real estate in order to be treated as real property trades or businesses, it goes on to assert that "the expectation nevertheless remains that the end products or final objectives of such businesses should at least have the potential to be used as rental real estate or as integral components in rental real estate activities." The Preamble to the Final Regulations does not point to any statutory authority for this conclusion or provide any illustration of a meaningful distinction that it is intended to draw.

The Final Regulations favorably modify the definitions of the two previously defined categories of real property operation and real property management by removing what was a subjective and difficult–to-apply standard of distinguishing a real property trade or business from the provision of services by looking to the third-party lessee's subjective reasons for leasing the property. In addition, the Preamble to

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the Final Regulations explains that a revision to the last sentence of each of these definitions is intended to clarify that incidental services, even if significant, do not disqualify a business as a real property trade or business.

The 2020 Proposed Regulations define two additional categories of real property trades or businesses: development and redevelopment trades or businesses. These definitions include timber trades or businesses. As explained in the Preamble to the 2020 Proposed Regulations, because Congress "most likely intended" that these businesses would be excepted from section 163(j), but they are specifically excluded from the definition of farming, Treasury determined that they should be included in the definitions of real property development and real property redevelopment.

Allocating interest expense, interest income, and other items of expense and gross income to excepted and non-excepted trades or businesses

The amount of a taxpayer's business interest expense that is properly allocable to excepted trades or businesses is not subject to limitation under section 163(j) and the amount of a taxpayer's other items of income, gain, deduction, or loss (including interest income) that is properly allocable to excepted trades or businesses is excluded from the calculation of the taxpayer's section 163(j) limitation. Reg. § 1.163(j)-10 provides rules for allocating these items among excepted and non-excepted trades or businesses. Like the 2018 Proposed Regulations, the Final Regulations reiterate that a taxpayer must determine whether interest expense or interest income is properly allocable to a trade or business prior to determining whether these items are properly allocable to an excepted or non-excepted trade or business. A non-C corporation taxpayer will generally make this initial determination by applying Reg. § 1.163-8T, as well as 2020 Prop. Reg. §§ 1.163-14 and 15 for partnerships and S corporations to the extent applicable. The Final Regulations generally retain the asset basis approach and entity look-through rules to determining whether business interest expense is properly allocable to an excepted or non-excepted trade or business.

Asset basis testing periods

The 2018 Proposed Regulations would have required a quarterly determination of the taxpayer's adjusted basis in excepted and non-excepted trade or business assets to determine the average relative amount of asset basis for its excepted and non-excepted trades or businesses for a tax year. To alleviate the administrative burdens associated with this approach, the Final Regulations permit a taxpayer to average beginning and end of year asset basis so long as the percentage of the taxpayer's basis attributable to excepted trade or business assets at the beginning and end of the year does not differ by more than 20%.

De minimis rules

The Final Regulations retain the mandatory application of the various "90% or more" de minimis rules for determining the percentage of a taxpayer's asset basis for excepted and non-excepted businesses.

Look-through rules

The Final Regulations generally retain the ability for a taxpayer to look-through a partnership, S corporation, non-consolidated C corporation or CFC for purposes of allocating the taxpayer's basis in a partnership interest or stock to excepted or non-excepted trades or businesses and to characterize non-investment dividend income as excepted or non-excepted trade or business income.

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- The 80% vote and value ownership threshold is retained for a shareholder to be required to look through a domestic non-consolidated C corporation or CFC. However, under the Final Regulations, if a shareholder owns at least 80% of the value, but less than 80% of the vote, of a domestic non-consolidated C corporation or CFC, the shareholder may elect to look-through the entity.

- The Final Regulations apply the constructive ownership rules under section 318(a) for purposes of determining eligibility for the corporate look-through rules, but only direct ownership is taken into account for purposes of the dividend look-through rule.

- The Final Regulations provide that a partner's basis in its partnership interest (which does not include the partner's allocable share of debt for this purpose) is to be adjusted to take into account the modified adjusted basis rules that apply to direct ownership of property, but only if the partner applies the look-through rules to such partnership interest. The modified adjusted basis rules include the use of unadjusted basis for land and inherently permanent structures and the use of adjusted basis under the alternative depreciation system for depreciable property other than inherently permanent structures.

KPMG observation

The addition of an adjustment to a partner's basis in a partnership interest to account for the modified adjusted basis of the assets held by the partnership is a helpful change that will substantially reduce distortions. For example, if a taxpayer directly owns an inherently permanent structure in an excepted trade or business, the taxpayer would use the taxpayer's original cost basis in the structure for purposes of determining how much of the taxpayer's basis is attributable to an excepted or non-excepted trade or business. Under the 2018 Proposed Regulations, if the taxpayer owned the same inherently permanent structure indirectly through a partnership, the taxpayer's basis in the partnership interest would not have been increased to account for depreciation taken on the structure that reduced the taxpayer's basis in the partnership interest, even if the taxpayer applied the asset basis look-through rules. The absence of an adjustment to the taxpayer's basis in the partnership interest would potentially reduce the amount of the taxpayer's business interest expense allocable to the excepted trade or business held by the partnership. Under the Final Regulations, the taxpayer's basis in the partnership interest is increased to account for the depreciation of the structure to more closely align the taxpayer's business interest allocation to a situation where the taxpayer owns the inherently permanent structure directly.

- Under the 2018 Proposed Regulations, a taxpayer would not have been able to look-through an entity that is eligible for the small business exemption. The Final Regulations allow a taxpayer to look through an entity that is eligible for the small business exemption, provided the small business entity makes an election for its trade or business to be an excepted trade or business under Reg. § 1.163(j)-9.

KPMG observation

The ability to look through an entity that is eligible for the small business exemption will enable a direct or indirect owner of such exempt entity to allocate business interest expense to an excepted trade or business held directly or indirectly by such exempt entity. It is important to note, however, that the Final Regulations appear to only allow the application of the look-through rule to exempt

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businesses that make an excepted business election under Reg. §1.163(j)-9. It appears that such an election can only be made by an exempt business to the extent the exempt business directly holds a business that is eligible to be an excepted trade or business. Accordingly, if an upper-tier exempt entity does not directly hold a business that is eligible to be an excepted trade or business, a taxpayer that owns an interest in such exempt entity will not be able to look through such exempt entity in order to allocate the taxpayer's business interest expense to an excepted trade or business owned indirectly by such exempt entity.

Disallowed disqualified interest

The 2018 Proposed Regulations reserved on the allocation of business interest expense, including carryforwards, for which a deduction was disallowed under old section 163(j) in the taxpayer's last tax year beginning before January 1, 2018, and that was carried forward under old section 163(j) ("Disallowed Disqualified Interest"). The Final Regulations provide that a taxpayer may allocate Disallowed Disqualified Interest between excepted and non-excepted trades or businesses using a "historical approach" or an "effective date approach." Under a historical approach, the taxpayer would allocate Disallowed Disqualified Interest between excepted and non-excepted trades or businesses by applying the Reg. § 1.163(j)-10 allocation rules in the tax year in which such interest expense was actually paid or accrued. Under an effective date approach, the taxpayer would allocate Disallowed Disqualified Interest between excepted and non-excepted trades or business by applying the Reg. § 1.163(j)-10 allocation rules as if the Disallowed Disqualified Interest was paid or accrued in the taxpayer's first tax year beginning after December 31, 2017.

KPMG observation

The option to use the either the historical approach or the effective date approach provides a great deal of flexibility in determining the allocation of Disallowed Disqualified Interest between excepted and non-excepted trades or businesses. The treatment of Disallowed Disqualified Interest initially would have been determined on a taxpayer's 2018 tax return and Reg. § 1.163(j)-10(c)(4) provides that disallowed business interest expense carryforwards are not re-allocated between non-excepted and excepted trades or businesses in a succeeding tax year. Accordingly, it seems that a taxpayer would have to amend its 2018 tax return (or file an administrative adjustment request, if applicable) to change the allocation of Disallowed Disqualified Interest between the taxpayer's excepted and non-excepted trades or businesses under the historical approach or the effective date approach.

Direct allocations for qualified nonrecourse indebtedness

The Final Regulations continue to require a taxpayer to allocate qualified nonrecourse indebtedness, within the meaning of Reg. § 1.861-10T(b) (with certain modifications), directly to the excepted or non-excepted assets encumbered by such indebtedness. Under the 2018 Proposed Regulations, for purposes of allocating a taxpayer's business interest expense between excepted and non-excepted trades or businesses, a taxpayer would have been required to reduce the taxpayer's basis in excepted or non-excepted trade or business assets, as applicable, by the taxpayer's entire basis in the assets encumbered by such qualified nonrecourse indebtedness. To alleviate the distortions that would have resulted from this rule, the Final Regulations only require a taxpayer to reduce the basis in the taxpayer's excepted or non-excepted trade or business assets up to the amount of the qualified nonrecourse indebtedness, but not below zero.

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