

Current Debt/Equity Trends and Section 163(j) Update

Dallas Bar Tax Section

March 4, 2019

Disclaimer

This presentation is provided solely for the purpose of enhancing knowledge on tax matters. It does not provide tax advice to any taxpayer because it does not take into account any specific taxpayer's facts and circumstances.

These slides are for educational purposes only and are not intended, and should not be relied upon, as accounting advice.

The views expressed by the presenters are not necessarily those of Ernst & Young LLP or Vinson & Elkins L.L.P.

Table of contents

1. Background/Basic Elements of Section 163(j)
2. Treatment of Partnerships
3. Excepted Businesses
4. Other Debt/Equity Issues

1. Background/Basic Elements of Section 163(j)

Section 163(j) general rule and scope

In general

New Section 163(j) limits the amount of business interest expense that can be deducted to the sum of

- ▶ Taxpayer's business interest income for the taxable year,
- ▶ 30% of the taxpayer's adjusted taxable income (ATI), and
- ▶ Taxpayer's floor plan financing interest for the taxable year
- ▶ **Note, ATI is essentially EBITDA for taxable years beginning before January 1, 2022 and EBIT thereafter***

Exceptions

Generally applies to all taxpayers except for certain small businesses that meet the gross receipts test and certain trades or business

- ▶ Gross receipts test -- average annual gross receipts of the taxpayer for the three prior taxable years does not exceed \$25 million
- ▶ Excepted trades or businesses are trade or business of providing services as an employee, electing real property businesses, electing farming businesses, and certain utility businesses

- ▶ "Old" Section 163(j) only applied to payments to 1) a related party where no US tax was imposed on the interest; 2) to an unrelated party where a related party guaranteed the debt; or 3) on certain real estate investment trust (REIT) payments
- ▶ Interest was disallowed if the payor's ratio of debt-to-equity exceeded 1.5 to 1 and the payor's net interest expense exceeded 50% of its ATI plus any excess limitation carryforward. Disallowed interest could be carried forward.

** There are key differences between ATI and EBITDA that should not be overlooked.*

Order of applicability

- ▶ Character of instrument: debt or equity – Section 385
- ▶ Interest rate charged on debt – Section 482
- ▶ Deductibility of interest – Section 267
- ▶ Timing of deduction – Section 163(j)

Key is not to overlook the ordering of the analysis; 163(j) does not provide a safe harbor for interest expense deductibility, rather the first thresholds must be passed.

Proposed Section 163(j) regulations

Overview

Prop. Reg. §	Description
1.163(j)-1	Definitions
1.163(j)-2	General computational rules
1.163(j)-3	Ordering and other rules
1.163(j)-4	C corporations
1.163(j)-5	Carryforwards of C corporations
1.163(j)-6	Partnerships and S corporations
1.163(j)-7	Controlled foreign corporations (CFCs) and their shareholders
1.163(j)-8	Foreign persons with effectively connected income (ECI)
1.163(j)-9	Excepted trade or business elections and real estate investment trust (REIT) safe harbor
1.163(j)-10	Allocations between non-excepted and excepted trades or businesses
1.163(j)-11	Transition rules

Proposed Section 163(j) regulations

Applicable date

- ▶ In general
 - ▶ Taxable years ending after the date the Treasury decision adopting final regulations is published in the Federal Register
- ▶ Early adoption
 - ▶ The proposed regulations may be relied on for taxable years beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the proposed regulations, and if applicable, other proposed regulations issued in the same regulatory package during those taxable years

Prop. Reg. §1.163(j)-1(b)(1)

Definition of ATI

1

Compute taxable income in accordance with Section 63

- Treat all BIE as deductible without regard to Section 163(j) limitation

2

Add:

- Any BIE
- Any net operating loss deduction under Section 172
- Any deduction under Section 199A
- Any deduction for capital loss carryback or carryover
- Any deduction or loss that is not properly allocable to a non-excepted trade or business
- For taxable years beginning before January 1, 2022:
 - Any deduction for depreciation
 - Any deduction for amortization of intangibles and other amortized expenditures
 - Any deduction for depletion

Note> Depreciation, amortization or depletion expenses capitalized to inventory under Section 263A are not depreciation, amortization, or depletion deduction for purposes of ATI definition

3

Subtract:

- Any business interest income
- Any floor plan financing interest expense
- Any income or gain that is not properly allocable to a non-excepted trade or business
- Certain adjustments for sales or other dispositions of property, stock, or partnerships interests

Note> Other adjustments may need to be made as provided in Prop. Reg. §§1.163(j)-2 through -11

Prop. Reg. §§1.163(j)-1(b)(2) and (3)

Definition of business interest income and expense

Business interest expense

- ▶ In general, interest expense that is allocable to a non-excepted trade or business or that is floor plan financing interest expense
- ▶ Also includes disallowed BIE carryforwards

Business interest income

- ▶ In general, interest income that is allocable to a non-excepted trade or business

Prop. Reg. §1.163(j)-1(b)(20)

Definition of interest

- ▶ Interest defined to include “**any amount paid or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement**, including a series of transactions, that is treated as a debt instrument for purposes of Section 1275(a) and §1.1275-1(d)” and includes:
 - ▶ OID
 - ▶ Qualified stated interest
 - ▶ Acquisition Discount
 - ▶ Repurchase premium to the extent deductible by the issuer under Reg. §1.163-7(c)
 - ▶ Deferred payments treated as interest under Section 483
 - ▶ Amounts treated as interest under Section 988
 - ▶ Forgone interest under Section 7872
 - ▶ Amounts paid or received in connection with a sale-repurchase agreement treated as indebtedness (exception for sale-repurchase related to tax-exempt bonds)

Prop. Reg. §1.163(j)-1(b)(20)

Definition of interest, cont'd

- ▶ The proposed regulations would also treat as interest certain amounts that are **closely related to interest and that affect the economic yield or cost of funds of a transaction involving interest, but may not be compensation for the use or forbearance of money** on a stand alone basis
 - ▶ Income, gain, or loss from a transaction used to hedge an interest-bearing asset or liability
 - ▶ Substitute interest payments under a securities lending or sale-repurchase transaction
 - ▶ Commitment fees
 - ▶ Debt issuance costs
 - ▶ Partnership guaranteed payments for capital
 - ▶ Factoring Income

Prop. Reg. §1.163(j)-1(b)(20)

Definition of interest, cont'd

- ▶ An **anti-avoidance rule** treats as interest **expense** for purposes of Section 163(j) an expense or loss predominantly incurred in consideration of the time value of money in a transaction or series of transactions in which the taxpayer secures the use of funds for a period of time
 - ▶ This rule is not “symmetrical” in that it does not result in such amounts being treated as interest income to the recipient
 - ▶ Note that the rule refers to “securing the use of funds” – as opposed to the use of other property
- ▶ **Note that the JCT Blue Book description indicates that the proposed regulations’ definition of interest for purposes of Section 163(j) may be overbroad**

Prop. Reg. §1.163(j)-1

Other definitions

Trade or business

- ▶ Consistent with the meaning in Section 162
- ▶ Excepted trade or business:
 - ▶ Performing services as an employee
 - ▶ Electing real property trade or business
 - ▶ Electing farming business
 - ▶ Certain regulated utility trades or businesses
- ▶ Non-excepted trade or business means any trade or business that is not an excepted trade or business

Electing real property trade or business

- ▶ Trade or business as described in (i) Section 469(c)(7)(C) and Reg. §1.469-9(b)(2) or (ii) Prop. Reg. §1.163(j)-9(g)
- ▶ Special rule for REITs
- ▶ Must make an election as provided in Prop. Reg. §1.163(j)-9, which affects ability to claim bonus depreciation under Section 168(k)
- ▶ Election is irrevocable

Prop. Reg. §§1.163(j)-2 and -3

Relationship to other provisions affecting interest

- ▶ In general, Section 163(j) applies *after* the application of provisions that subject interest expense to disallowance, deferral, capitalization, or other limitation
- ▶ Section 163(j), however, applies *before* the operation of the loss limitation rules in Sections 465 and 469 and before the application of Section 461(*l*)
- ▶ With respect to potential base erosion payments under BEAT, Section 163(j) applies first to limit the deductibility of interest payments to unrelated parties (thus prioritizing interest payments to related parties and making more likely that BEAT will apply in a given year)
 - ▶ Interest expense carryforwards under Section 163(j) are treated as absorbed from the earliest year first and from related party payments before unrelated party payments
- ▶ Treasury Department and IRS request comments regarding the interaction between Section 163(j) and the rules addressing income from the discharge of indebtedness under Section 108
- ▶ Anti-avoidance rule
 - ▶ Arrangements entered into with a principal purpose of avoiding the rules of Section 163(j) or the proposed regulations, including the use of multiple entities to avoid the gross receipt test (\$25mm w/in 3 years), may be disregarded or recharacterized

Prop. Reg. §§1.163(j)-5(b)(1) and (2)

C corporation carryforwards

- ▶ In general, the amount of any BIE of a C corporation not allowed as a deduction for any taxable year under Section 163(j) is carried forward to the succeeding taxable year as a disallowed BIE carryforward
 - ▶ Current year BIE is deducted in the current taxable year before any disallowed BIE carryforwards from a prior taxable year are deducted in that year
 - ▶ Disallowed BIE carryforwards are deducted in the order of the taxable year in which they arose beginning with the earliest taxable year, subject to certain limitations
 - ▶ Disallowed disqualified interest carried forward under old Section 163(j) is treated as carried forward from the taxable year in which a deduction was disallowed under old Section 163(j)
- ▶ No carryforward of excess Section 163(j) limitation to subsequent years; if a Section 163(j) limitation for a year is not fully utilized to absorb BIE, the excess is lost

	Example 1		Example 2	
	Year 1	Year 2	Year 1	Year 2
Income	2,000	-0-	-0-	2,000
Int. Exp.	300	300	300	300
Allowed Exp.	300	-0-	-0-	600
Exp. Carryover	N/A	300	300	N/A

Consolidated Section 163(j) limitation

- ▶ A US consolidated group has a single Section 163(j) limitation
 - ▶ The Section 163(j) limitation is based upon the consolidated taxable income (CTI) of the group, as adjusted to reflect ATI.
- ▶ Location of items of income/loss (including BII and BIE) within the group generally does not affect the Section 163(j) limitation (i.e., single entity principles apply).
- ▶ Intercompany obligations are ignored.
- ▶ A group's consolidated ATI is determined without regard to intercompany items and corresponding items from intercompany transactions to the extent they offset.
 - ▶ Thus, even if one group member conducts solely an excepted business (ETB) (e.g., an electing real property business) and another member conducts solely a non-excepted business (NETB), transactions between such members do not affect ATI.

Prop. Reg. §1.163(j)-5(b)(3)

Carryforwards for consolidated groups

In general

- ▶ A consolidated group's disallowed business interest expense carryforwards for the current consolidated return year are
 - ▶ the carryforwards from the group's prior consolidated return years plus
 - ▶ any carryforwards from separate return years
- ▶ If the group's Section 163(j) limitation for the current year equals or exceeds the aggregate amount of the members' current-year business interest expense, then no amount of the group's current-year business interest expense will be subject to disallowance in the current-year under Section 163(j)

Remaining Section 163(j) limitation

- ▶ If the group has any remaining limitation for the current year, then disallowed business interest expense carryforwards permitted to be deducted in the current year will be deducted in the order of the taxable years in which they arose, beginning with the earliest taxable year
 - ▶ Disallowed business interest expense carryforward from taxable years ending on the same date that are available to offset consolidated taxable income for the current year generally will be deducted on a pro-rata basis
 - ▶ If losses subject to and not subject to the Section 382 limitation are carried forward from the same taxable year, losses subject to the limitation are deducted before losses not subject to the limitation

2. Treatment of Partnerships

Section 163(j)(4); Prop. Reg. § 1.163(j)-6

Treatment of Partnerships

General

- ▶ Section 163(j) limitation applies at the partnership level
- ▶ Deductions for business interest expense are taken into account in determining the nonseparately stated taxable income or loss of the partnership

Key Terms

- ▶ **Deductible Business Interest Expense (DBIE):** The amount of a partnership's business interest expense that is deductible in the current taxable year following application of section 163(j) limitation
- ▶ **Section 163(j) Excess Items:**
 - ▶ **Excess Business Interest Income (EBII):** The amount by which a partnership's business interest income exceeds its business interest expense in a taxable year.
 - ▶ **Excess Business Interest Expense (EBIE):** The amount by which a partnership's business interest expense exceeds its deductible business interest expense in a taxable year.
 - ▶ **Excess Taxable Income (ETI):** The amount of ATI unused by the partnership to support its deductible business interest expense in a given taxable year.

$$ETI = ATI \times \frac{(.3(ATI) - (BIE - BII))}{.3(ATI)}$$

Allocation of DBIE and Section 163(j) Excess Items

- ▶ Partnerships **do not carryforward** section 163(j) excess items, but rather allocate these items to their partners.
- ▶ Proposed Regulations provide an 11-step computation generally aimed to permit a partner to deduct business interest expense where it received the corresponding amount of BII/ATI supporting such deduction (and to allocate EBII/ETI to a partner allocated more items comprising ATI than necessary to support its allocation of BIE).
- ▶ Partner's share of BIE, BII or items comprising ATI determined under section 704 of the Code and regulations thereunder (i.e., 11-step computation applicable solely for the purpose of determining each partner's DBIE and section 163(j) excess items).

Section 163(j)(4); Prop. Reg. § 1.163(j)-6 Treatment of Partnerships (Cont.)

Character of Business Interest Expense

- ▶ DBIE is not subject to any additional application of section 163(j) at the partner level. However, for ***all other purposes of the Code***, DBIE and EBIE retain their character as business interest expense at the partner level.

ATI of the Partnership

- ▶ Use general rules with the following modifications/clarifications
 - ▶ Taxable income determined under Section 703(a)
 - ▶ Partnership takes into account items resulting from adjustments made to the basis of its property under section 734(b); however, partner basis items (i.e., adjustments pursuant to Section 743(b) or built in loss property under Section 704(c)(1)(C)(i)) and remedial items not taken into account in partnership ATI.

ATI of the Partner

- ▶ Determined without regard to its distributive share of any items of income, gain, deduction or loss and increased by its distributive share of ETI
- ▶ Takes into account partner basis items and remedial items
- ▶ While not computed in ATI, Business Interest Income of the partner increased by EBII allocated to it

Section 163(j)(4); Prop. Reg. § 1.163(j)-6 Treatment of Partnerships (Cont.)

Treatment of Carryforwards/Basis Adjustment

- ▶ EBIE is treated as business interest expense paid or accrued by the applicable partner in the next succeeding taxable year in which such partner is allocated ETI or EBII from such partnership
- ▶ Any EBIE treated as BIE will then be subject to the partner's section 163(j) limitation, but only taking into account the ETI/EBII **allocated from such partnership**
- ▶ The adjusted basis of the partner's partnership interest reduced (not below zero) by amount of EBIE allocated to the partner (subject to increase in the case of certain subsequent dispositions of substantially all of its partnership interest)

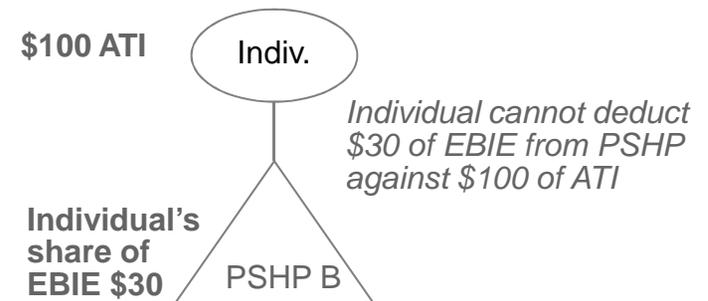
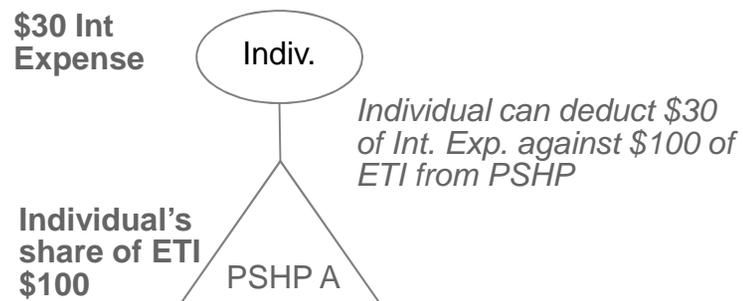
Excepted Trade or Business

- ▶ Excepted section 163(j) items excluded from the partner's section 163(j) calculation

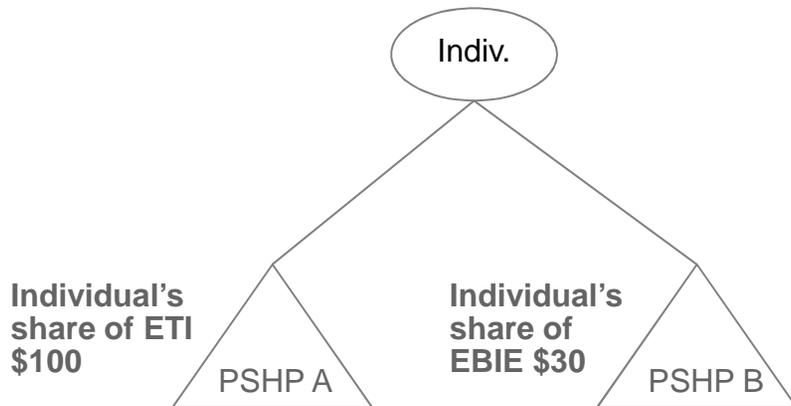
Reserved

- ▶ Treasury reserved on treatment of tiered partnerships, partnership mergers and divisions and self lending transactions.

Example



Section 163(j)(4); Prop. Reg. § 1.163(j)-6 Treatment of Partnerships Example



Facts

- ▶ Individual allocated \$100 of ETI from PSHP A, which will increase its ATI by \$100.
- ▶ Individual allocated \$30 of EBIE from PSHP B, which will remain EBIE unless and to the extent in a succeeding taxable year Individual is allocated ETI/EBII from PSHP B.

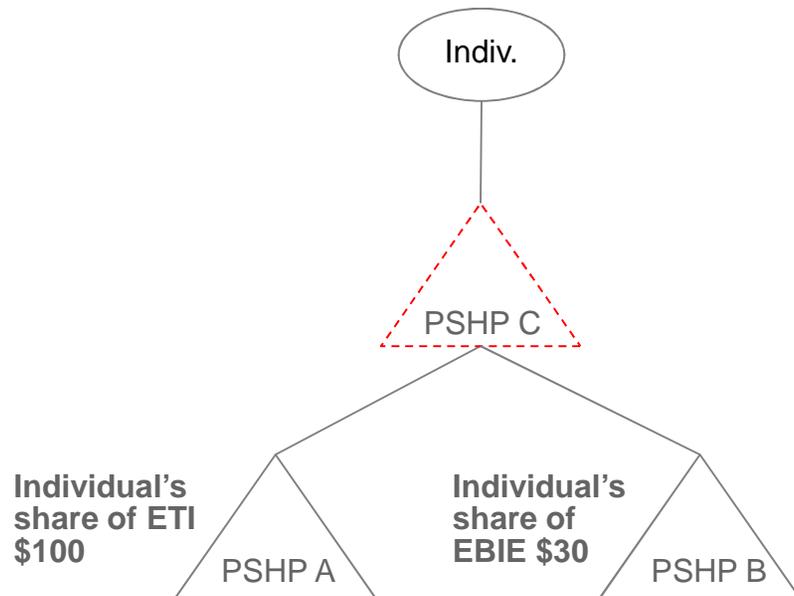
Result

- ▶ Individual **cannot** use its \$100 ATI from PSHP A to treat \$30 of EBIE from PSHP B as BIE.

Can an alternative structure change this result?

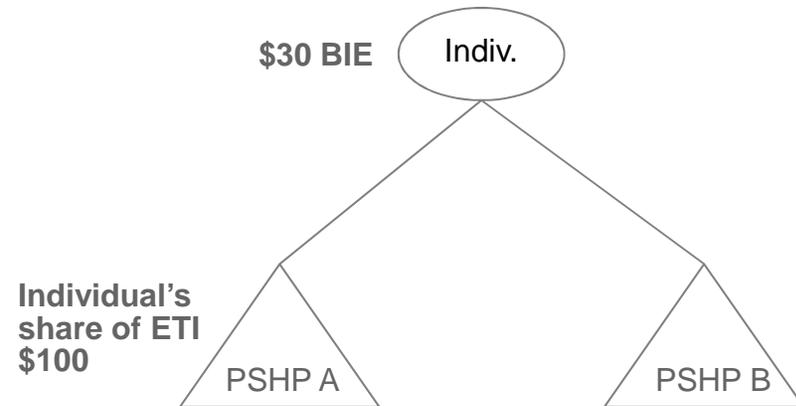
Section 163(j)(4); Prop. Reg. § 1.163(j)-6 Treatment of Partnerships Example (Cont.)

Option 1: Aggregator Partnership



While the Treasury has reserved on the application of the proposed regulations to tiered partnerships, EBIE from PSHP B will likely either remain EBIE at PSHP C level or individual level. In any event, ETI from PSHP A likely not able to absorb EBIE from PSHP B.

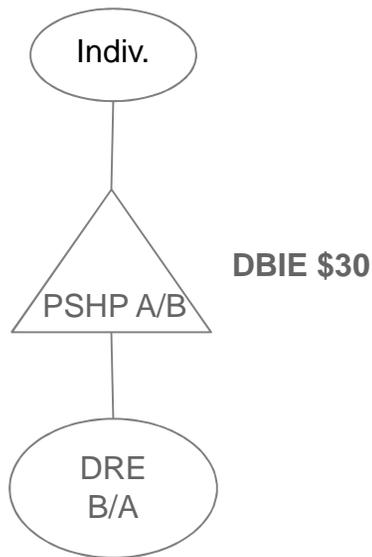
Option 2: Move Borrowing from PSHP B to Individual Level



Here, the Individual's share of ETI from PSHP A will be available to absorb its \$30 BIE.

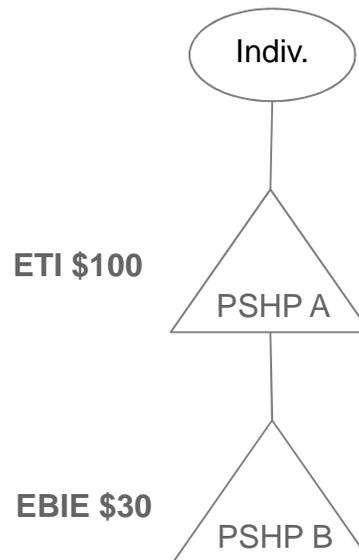
Section 163(j)(4); Prop. Reg. § 1.163(j)-6 Treatment of Partnerships Example (Cont.)

Option 3: Combine Entities



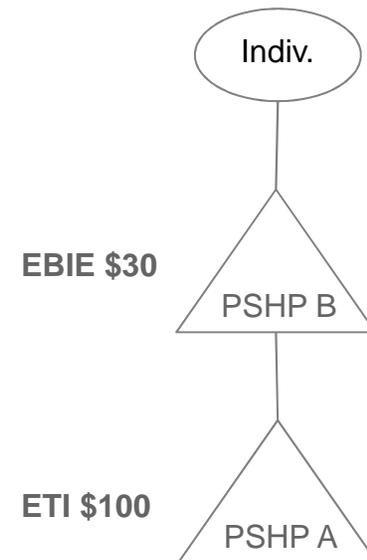
If Individual can combine the two entities, the adjusted taxable income produced in former PSHP A can be used in its section 163(j) calculation and business interest expense incurred by former PSHP B should be deductible business interest expense.

Option 4A: Tiered Entities



If not feasible to combine entities, EBIE will likely remain EBIE at either PSHP A or Individual level (reserved in regulations) and will likely remain EBIE unless and to the extent in a succeeding taxable year, PSHP A/Individual is allocated ETI/EBI from PSHP B. **EBIE likely cannot be absorbed by ETI of PSHP A.**

Option 4B: Tiered Entities



Although not entirely clear, ETI should either increase ATI of PSHP B or Individual (reserved in regulations). **In either case, ETI should absorb EBIE of PSHP B.**

3. Excepted Businesses

Code §§ 163(j)(7); 163(j)(4) Excepted/Exempted Trades or Businesses

Section 163(j) does not apply to excepted/exempted trades or businesses

- ▶ Excepted trades or businesses include:
 - ▶ **Electing real property businesses**
 - ▶ **Certain regulated utility businesses**
 - ▶ Electing farming businesses
 - ▶ The trade or business of providing services as an employee
- ▶ **Exemption for certain small businesses**

Prop. Reg. §§ 1.163(j)-1(12); 1.163(j)-9; 1.469-9(b)(2) Electing Real Property Trade or Business

What is an Electing Real Property Trade or Business?

- ▶ (1) Real Property Trade or Business
 - ▶ Trade or Business
 - ▶ Real Property
 - ▶ Enumerated Types
 - ▶ REIT Safe Harbor
- ▶ (2) Affirmative, Irrevocable Election Made

Prop. Reg. §§ 1.163(j)-1(12); 1.163(j)-9; 1.469-9(b)(2) Electing Real Property Trade or Business (Cont.)

Real Property Trade or Business

- ▶ **Trade or Business:** Code Section 162
- ▶ **Real Property:** Land, buildings, and other inherently permanent structures permanently affixed to land
- ▶ **Enumerated Types:**
 - ▶ Real Property management and operation
 - ▶ Either by direct ownership or through a professional manager, the handling of the day-to-day operations of a trade or business that relates to the **maintenance** and **occupancy** of real property where payments received from customers are **principally** for the customers' use of the real property and not for the provision of other **significant/extraordinary personal services**.
 - ▶ Personal services must be incidental and insubstantial
 - ▶ Treasury reserved on defining real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, leasing, or brokerage trade or business
 - ▶ Connection to rental real estate
- ▶ **Anti Abuse Rule:** Taxpayer cannot make election with respect to a real property trade or business it conducts where at least 80% of real property leased to a trade or business under common control

Prop. Reg. §§ 1.163(j)-1(12); 1.163(j)-9; 1.469-9(b)(2) Electing Real Property Trade or Business (Cont.)

REIT Safe Harbor

- ▶ REITS eligible for election where REIT holds (1) real property, (2) interests in partnerships holding real property or (3) shares in other REITs holding real property
- ▶ Real property defined under **Section 856**, not Section 469
- ▶ REIT can hold up to 10% “real property financing assets” and all assets will be treated as assets of excepted business (otherwise, allocation rules apply)
- ▶ Anti-Abuse rule of former slide does not apply to certain REITs

Prop. Reg. §§ 1.163(j)-1(12); 1.163(j)-9; 1.469-9(b)(2) Electing Real Property Trade or Business (Cont.)

Affirmative, Irrevocable Election Made

▶ Scope, Time and Manner

- ▶ Election made at the trade or business level
- ▶ Taxpayer attaches an election statement to its federal income tax return
- ▶ Election applies for taxable year for which it is made and subsequent years (until termination)

▶ Termination

- ▶ Election terminates where taxpayer ceases to engage in the electing trade or business
 - ▶ Transferring of substantially all of its trade or business assets to an unrelated acquiror in taxable asset sale, ceasing to exist for federal income tax purposes, or ceasing operation of trade or business

▶ Consolidated Group/Partnerships

- ▶ Elections made by agent of consolidated group and by partnership on its federal income tax return

▶ Anti-Abuse Rule

- ▶ If a taxpayer or a related party reacquires substantially all of the trade or business assets (or substantially similar assets) within 60 months, prior election will still be valid

Prop. Reg. §§ 1.163(j)-1(12); 1.163(j)-9; 1.469-9(b)(2) Electing Real Property Trade or Business (Cont.)

Impact on Section 168

- ▶ An electing real property trade or business must depreciate its nonresidential real property, residential real property and qualified improvement property using the alternative depreciation system
- ▶ **Nonresidential real property**
 - ▶ Depreciation life of 40 years, rather than 39 years
- ▶ **Residential real property**
 - ▶ Depreciation life of 30 years, rather than 27.5 years
- ▶ **Qualified improvement property**
 - ▶ Qualified improvement property means any improvement to the interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service.
 - ▶ Under the current statutory reading, qualified improvement property would have a depreciation life of 40 years, instead of 39 years
 - ▶ Once expected technical corrections are passed, would have a depreciation life of 20 years, instead of 15 years
 - ▶ Will be **ineligible** for bonus depreciation

Prop. Reg. § 1.163(j)-1(13)

Excepted Regulated Utility Trade or Business

Excepted Regulated Utility Trade or Business

- ▶ **Furnishes or Sells Certain Regulated Items**
 - ▶ Electrical energy, water, or sewage disposal services
 - ▶ Gas or steam through a local distribution system
 - ▶ Transportation of gas or steam by pipeline
- ▶ **Rates for Furnishing Sales of Certain Regulated Items Properly Established/Approved**
 - ▶ Rates must have been established or approved by:
 - ▶ a State (or political subdivision thereof), an agency or instrumentality of the United States, or a public services or public utility commission or other similar body of any State (or political subdivision thereof) **and** in each case determined on a cost of service or rate of return basis; **or**
 - ▶ established or approved by the governing or ratemaking body of an electric cooperative.

Impact on Section 168

- ▶ “Qualified Property” excludes any property primarily used in excepted regulated utility trade or business
- ▶ Ineligible for bonus depreciation

Prop. Reg. § 1.163(j)-10

Allocations between Excepted and Non-Excepted Businesses

General Rule

- ▶ Prop. Reg. § 1.163(j)-10 provides rules for determining the amount of a taxpayer's interest expense, interest income, and other tax items that is properly allocable to excepted and non-excepted trades or businesses.
- ▶ Taxpayer first determines whether interest paid or accrued is allocable to a trade or business before applying these rules.
- ▶ Only relevant where taxpayer engages in **both** a non-excepted and excepted trade or business.

Consolidated Group

- ▶ Treated as a single corporation (i.e., the group—not a particular member—is treated as engaged in an excepted or non-excepted trade or business).
- ▶ Percent of group's interest expense allocable to an excepted trade or business applied proportionally to each member that has paid or accrued interest to a non-group member in the taxable year.

Prop. Reg. § 1.163(j)-10

Allocations between Excepted and Non-Excepted Businesses (Cont.)

Interest Expense and Interest Income

Asset Allocation

- ▶ Allocated to the taxpayer's excepted and non-excepted trades or businesses based upon the *relative amounts of the taxpayer's adjusted basis in the assets used in its excepted or non-excepted trades or businesses*
 - ▶ According to Preamble, taxpayer does not reallocate disallowed business interest expense carryforwards

Quarterly Determination

- ▶ Taxpayer determines adjusted basis in its assets applying these rules as of the close of each quarter of its taxable year and averages those amounts

De Minimis Exception

- ▶ If 90% or more of taxpayer's adjusted basis in its assets is allocable to either excepted or non-excepted trades or businesses, all of the taxpayer's interest expense and interest income follow suit

Assets used in Both Excepted and Non-Excepted Trades or Businesses

- ▶ Proposed regulations set forth permissible methodologies for allocating asset basis between or among two or more trades or businesses. Taxpayer instructed to use the method that most reasonably reflects use of asset.
- ▶ Letter ruling required to change method
- ▶ **Excepted Regulated Utility Trade or Business:** Must allocate basis in the particular asset based on the relative amount of outputs

Anti-Abuse Rule

Prop. Reg. § 1.163(j)-10

Allocations between Excepted and Non-Excepted Businesses (Cont.)

Look Through Rule

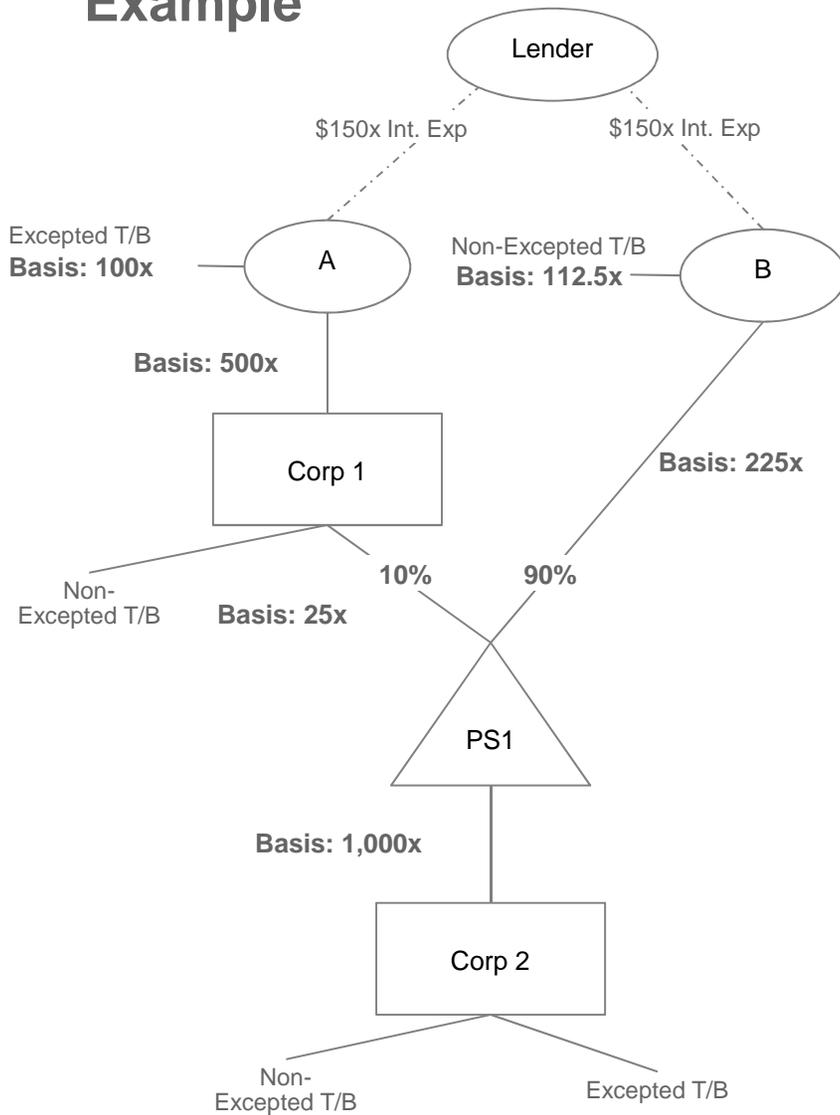
- ▶ If a taxpayer owns interests in a partnership, non-consolidated domestic C corporation, CFC or S corporation, the taxpayer *may* (and in some cases is *required* to) apply certain rules (the “**Look Through Rules**”) to determine the extent to which its basis in the partnership interest or stock is allocable to excepted and non-excepted trades or businesses
- ▶ **Partnership/S Corporation**
 - ▶ Taxpayers generally would be *permitted* to apply Look Through Rule to interests in partnership/S corporation
 - ▶ If taxpayer owns 80% or more of the partnership’s capital or profits, or owns greater than or equal to 80% of stock by vote and value, *required* to apply Look Through Rule
- ▶ **Non-Consolidated Domestic C corporation**
 - ▶ If a taxpayer owns at least 80% by vote and value of the stock in a non-consolidated domestic C corporation, *required* to apply Look Through Rule (section 1504(a)(2) test)
- ▶ **Small business exception** → Look Through Rule cannot apply
- ▶ A limited **tracing rule** applies for certain qualified nonrecourse indebtedness

Prop. Reg. § 1.163(j)-10

Allocations between Excepted and Non-Excepted Businesses (Cont.)

Allocation of Income/Expense other than Interest Expense and Interest Income	
Type of Income/Expense	Method of Allocation
Dividend Income (not investment income)	<ul style="list-style-type: none"> • If required, apply Look Through Rules to allocate income between excepted and non-excepted trades or businesses • Otherwise, all income treated as allocable to a non-excepted trade or business
Sale of Partnership Interest or S Corporation Stock	<ul style="list-style-type: none"> • If required (or chosen), apply Look Through Rules to allocate gain/loss between excepted and non-excepted trades or businesses • Otherwise, all gain/loss treated as allocable to a non-excepted trade or business (except to the extent treated as an investment asset of a non-C corporate partner)
Sale of Non-Consolidated C Corp Stock	<ul style="list-style-type: none"> • If required, use Look Through Rules to allocate gain/loss between excepted and non-excepted trades or businesses • Otherwise, treat gain or loss as allocable to a non-excepted trade or business (if not investment property)
Expenses, Losses and other Deductions	<ul style="list-style-type: none"> • Allocate expenses (other than interest expense), losses and other deductions that are definitely related to a trade or business to the trade or business to which they relate • Ratably apportion other deductions to all gross income
Other Income	<ul style="list-style-type: none"> • Allocate gross income other than dividends and interest income to the trade or business that generated such gross income

Prop. Reg. § 1.163(j)-10 Allocations between Excepted and Non-Excepted Businesses Example

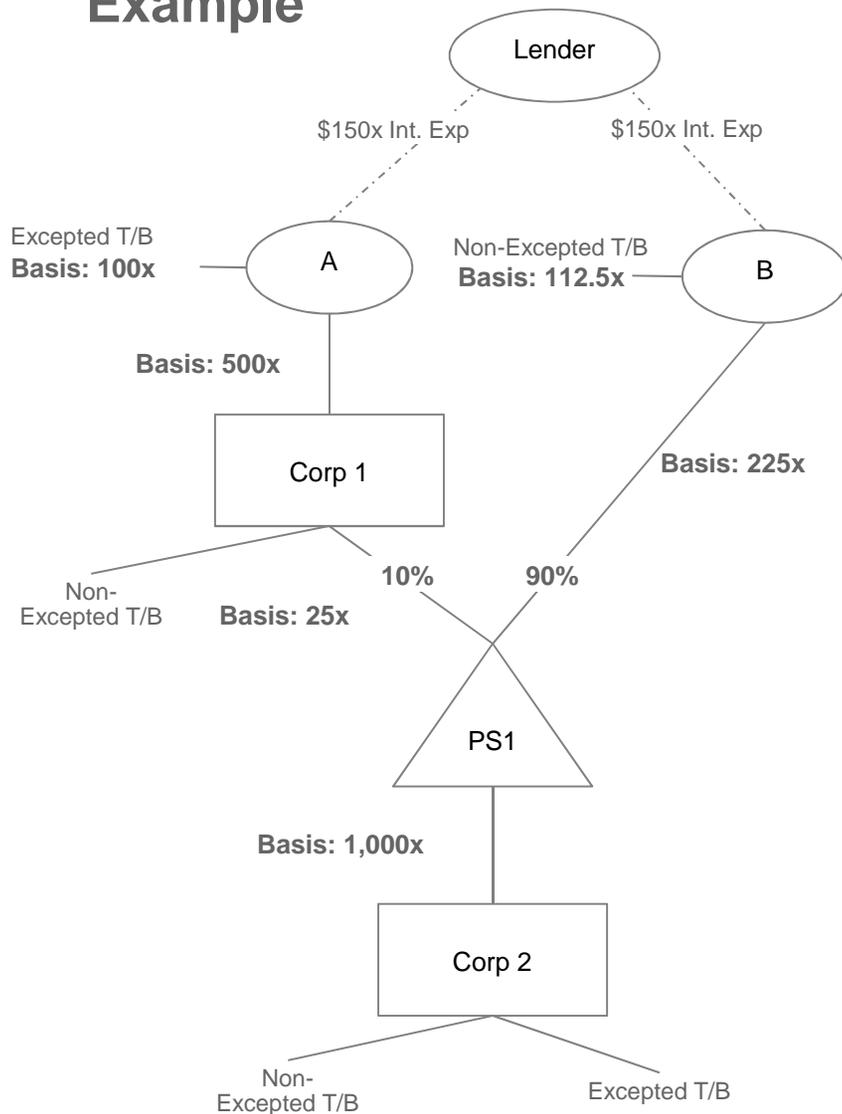


Facts

- ▶ **Corp 1** engages in a non-excepted trade or business
- ▶ **PS1** holds Corp 2 stock
- ▶ **Corp 2** engages in a non-excepted and excepted trade or business. Applying the asset allocation rules, 50% of its asset basis is attributable to each
- ▶ **Individual A**
 - ▶ paid or accrued \$150x of interest expense allocable to a trade or business under tracing rules
 - ▶ engages in an excepted trade or business
 - ▶ basis in its business assets is \$100x
- ▶ **Individual B**
 - ▶ paid or accrued \$150x of interest expense allocable to a trade or business under tracing rules
 - ▶ engages in a non-excepted trade or business
 - ▶ basis in its business assets is \$112.5x

This is example 3 of the proposed regulations, which is the only example that walks through the Look Through Rules

Prop. Reg. § 1.163(j)-10 Allocations between Excepted and Non-Excepted Businesses Example

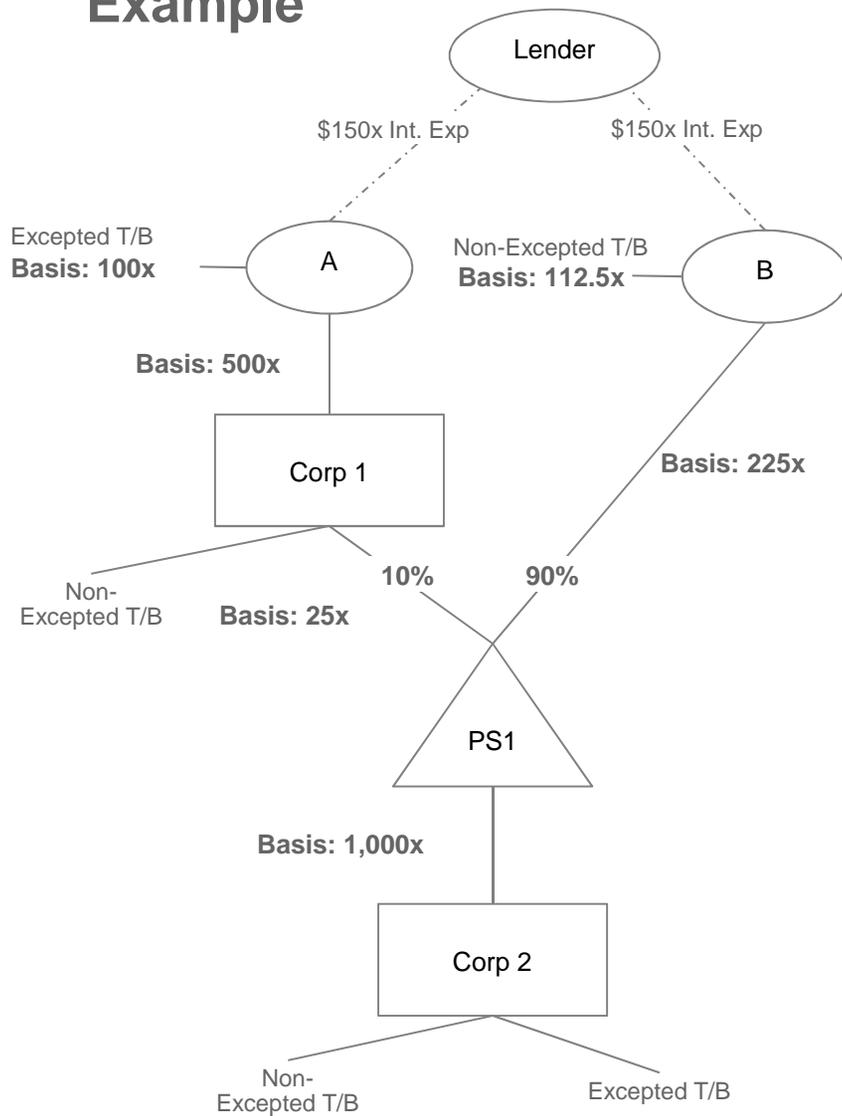


Analysis

► Individual A

- Engages in an excepted trade or business **and** holds stock
- **Must** look through Corp 1, **may** look through PS1 and **cannot** look through Corp 2
- Because Individual A **cannot** look through Corp 2, Corp 1's basis in PS1 is treated as allocated to a non-excepted trade or business (remember, Corp 1 cannot hold an investment asset, so all of PS1's stock will be treated as a non-excepted trade or business asset)
- Because Corp 1 also independently engages in a non-excepted trade or business, all of A's \$500x basis in Corp 1 is attributable to a non-excepted trade or business applying the Look Through Rules, because all of Corp 1's assets are allocated to a non-excepted trade or business
- A's other \$100x basis in its business assets is allocable to an excepted trade or business
- Therefore, 1/6 of A's \$150x interest expense allocable to an **excepted trade or business**, and 5/6 of A's \$150x interest expense allocable to a **non-excepted trade or business**

Prop. Reg. § 1.163(j)-10 Allocations between Excepted and Non-Excepted Businesses Example



Analysis

► Individual B

- Engages in a non-excepted trade or business and holds a partnership interest
- **Must** look through both PS1 and Corp 2
- From B's perspective, half of PS1's basis in Corp 2 ($\$500x$) is allocable to an excepted trade or business and half is allocable to a non-excepted trade or business ($\$500x$) because 50% of Corp 2's assets are used in each
- When B looks through its interest in PS1, $\$112.5x$ of B's basis in PS1 (50% of $\$225x$) is allocable to an excepted trade or business and $\$112.5x$ is allocable to a non-excepted trade or business
- B's other $\$112.5x$ basis in its business assets is allocable to a non-excepted trade or business
- Therefore, 1/3 of B's $\$150x$ interest expense allocable to an **excepted trade or business**, and 2/3 of B's $\$150x$ interest expense allocable to **non-excepted trade or business**

Section 163(j)(3); § Prop. Reg. 1.163(j)-2(d) Exemption for Certain Small Businesses

General Rule

- ▶ Section 163(j) does not apply to taxpayers (other than tax shelters) with average annual gross receipts of \$25 million or less determined under section 448(c)
 - ▶ Tested for three taxable years immediately preceding the current taxable year
 - ▶ For taxpayers other than partnerships and corporations, the gross receipts test is applied as if the taxpayer were a corporation or partnership
 - ▶ Annual determination; thus, qualification may change from year to year
 - ▶ Apply aggregation rules under sections 52 and 414
 - ▶ Parent-Subsidiary Controlled Group and Brother-Sister Controlled Groups (and combinations of both) aggregated
 - ▶ Generally, in most cases, more than 50% common control sufficient to trigger aggregation

Partnerships/S Corporations

- ▶ Partners in partnerships and shareholders in S corporations include share of partnership or S corporation gross receipts in this calculation

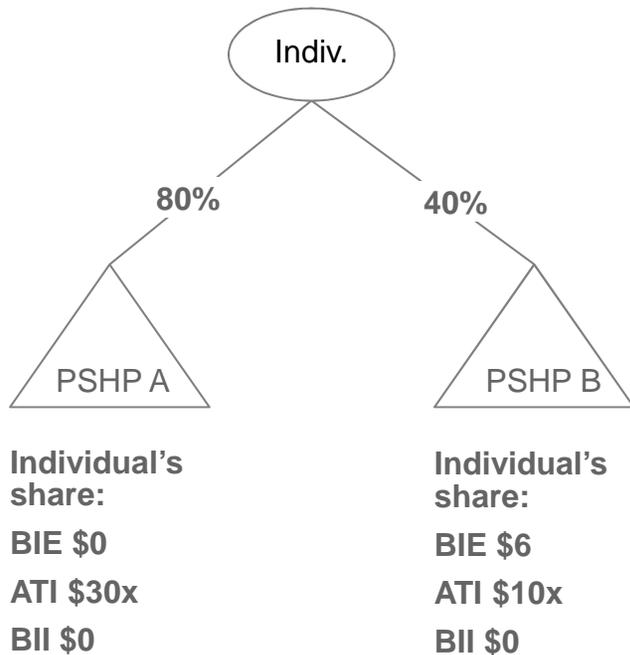
Electing Real Property Trade/Business

- ▶ Exempt small businesses ineligible to make an election to be an electing real property trade or business

Anti Avoidance Rule

- ▶ Arrangements entered into with a principal purpose of avoiding section 163(j) (or the regulations), including using multiple entities to avoid the gross receipts test of section 448(c), may be disregarded or recharacterized

Section 163(j)(3); § Prop. Reg. 1.163(j)-2(d) Exemption for Certain Small Businesses Example



Facts

- ▶ Assume PSHP B is eligible for small business exemption and PSHP A is not
- ▶ Individual does not have “common control” with these entities (and ineligible for exemption), so no aggregation
- ▶ PSHP A and PSHP B each conduct a real property trade or business that would be otherwise eligible to make an election to be an excepted trade or business
- ▶ However, PSHP B **ineligible** to make this election, and the Look Through Rule does not apply with respect to it
- ▶ Individual computes its ATI taking into account its distributive share of PSHP B items and does not appear to be able to make an election on behalf of PSHP B to treat PSHP B's items as allocable to an excepted trade or business

4. Other Debt/Equity Issues

Current Trends

- ▶ Generally speaking, there remains a global benefit to debt over equity
 - ▶ Interest expense deductibility
 - ▶ Reduced withholding tax

 - ▶ Due to changes in global tax reform and heightened visibility, debt vs. equity characterization and transfer pricing issues also have heightened visibility in IRS audits and due diligence
 - ▶ OECD BEPS
 - ▶ 385 Regulations
 - ▶ *Illinois Tool Works (TC Memo 2018-121)*
 - ▶ *Beekman-Dynamo (TC Memo 2018-61)*

 - ▶ Remember ordering of rules:
 - ▶ Character of instrument: debt or equity – Section 385
 - ▶ Interest rate charged on debt – Section 482
 - ▶ Deductibility of interest – Section 267
 - ▶ Timing of deduction – Section 163(j)
-

Taxpayer Analysis

- ▶ Does it make sense to early adopt the proposed regulations?
- ▶ How will the expanded definition of “business interest expense” impact section 163(j) limitation?
- ▶ In light of global tax reform, where is the optimal placement of third party debt and intercompany debt?
- ▶ Capital structure review
 - ▶ Debt/equity characterization
 - ▶ Anti-hybrid rules
 - ▶ BEAT
 - ▶ GILTI