The background of the slide is a top-down photograph of a workspace. It features a silver laptop with a black keyboard and a trackpad. To the left of the laptop is a white computer mouse. In the center, a pair of white earbuds lies on the surface. In the bottom right corner, a white cup of coffee with a dark, frothy top is visible on a white saucer.

VIRTUAL COFFEE TALK: 163(j) Final and Proposed Regulations

Kevin M. Jacobs and Mark Luscombe

Sept. 1, 2020 | 11:00 a.m. to 12:00 p.m. ET



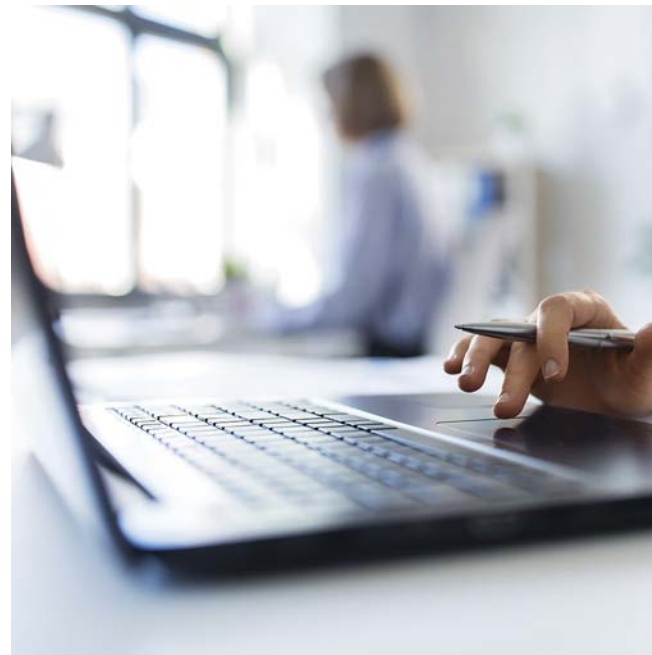
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Agenda

- 1 State of the law
- 2 Interest and the section 163(j) limitation
- 3 Consolidated groups
- 4 Foreign corporations
- 5 Additional insights

State of the law

- **December 22, 2017**
TCJA was enacted, including new section 163(j)
- **December 28, 2018**
Proposed section 163(j) regulations are issued (“2018 proposed regulations”)
- **March 27, 2020**
CARES Act was enacted, modifying section 163(j)
- **July 28, 2020**
 - Final section 163(j) regulations are released (“final regulations”)
 - New proposed section 163(j) regulations are released (“2020 proposed regulations”)



Options are a good thing ... so long as you can model

Generally, the final regulations are applicable to taxable years that begin on or after 60 days following the final regulations being published in the Federal Register.

For taxable years prior to the application of the final regulations, taxpayers have many options!



POLLING QUESTION

What is your experience with the section 163(j) regulations?

- ☐ I read the statute.
- ☐ I am very familiar with the 2018 proposed regulations, but I haven't had a chance to really digest the 2020 packages.
- ☐ I have read the 2020 packages and understand most of the provisions.
- ☐ I understand the 2020 package and truthfully, came for the CPE.

Exempt entity versus excepted trade or business

Exempt entity	Excepted trade or business
<p>An exempt entity is entity that qualifies for the small business exemption, which requires a “taxpayer” to average annual gross receipts for the past three taxable years of not more than \$25 million (adjusted for inflation) under section 448(c), and that is not a section 448(d)(3) tax shelter.</p>	<ul style="list-style-type: none">• Electing real property trade or business• Electing farming business• Certain activities of regulated utilities

Section 163(j) – at a very high level

The amount of business interest expense (BIE) that a taxpayer can deduct in a taxable year is limited (the section 163(j) limit) to the sum of:

- The taxpayer's business interest income (BII),
- 30% of the taxpayer's adjusted taxable income (ATI), and
- The taxpayer's floor plan financing (FPF).

Any BIE in excess of the section 163(j) limit (disallowed business interest expense or DBIE) is carried forward to the next taxable year. Section 163(j) applies to taxable years beginning after December 31, 2017 (i.e., there is no grandfathering for pre-existing debt).

CARES Act tweaks

- Taxpayers other than partnerships
- Partnerships
- Partners in Partnerships



What is “interest”

2018 Proposed Regulations	Final Regulations
<p>An amount paid, received, or accrued as compensation for the use or forbearance of money under the terms of an instrument or a contractual arrangement, including a series of transactions, that is treated as a debt instrument, or an amount that is treated as interest under other provisions of the Code or the Income Tax Regulations.</p>	
<p>A non-cleared swap with significant nonperiodic payments is treated as consisting of an on-market, level payment swap and a loan, with the time value component of the loan treated as interest.</p>	<p>Same as 2018 proposed regulations, except for swaps that are subject to margin or collateral requirements of a federal regulator (e.g., the SEC) or substantially similar requirements.</p>

What is “interest” (continued)

2018 Proposed Regulations	Final Regulations
<p>Specifically listed items treated as interest, including debt issuance premium, acquisition debt premium, ordinary income on certain debt instruments, factoring income, substitute interest payments, gain on conversion transactions, debt issuance costs, commitment fees, guaranteed payments, and hedging gains and losses that affect the yield of a debt instrument.</p>	<p>Same as 2018 proposed regulations, except:</p> <ul style="list-style-type: none">• Substitute interest is interest only if the payment relates to a sale-repurchase or securities lending transaction that is not entered into in the ordinary course of business; and• Debt issuance costs, commitment fees, guaranteed payments, and hedging gains and losses are not identified as interest.
<p>Anti-avoidance rule for amounts predominantly incurred in consideration of the time value of money.</p>	<p>Anti-avoidance rules for:</p> <ul style="list-style-type: none">• Expenses or losses economically equivalent to interest if a principal purpose is to reduce the amount that otherwise would be interest; and• Income if a principal purpose is to artificially increase business interest expense.

BIE seems so simple ...

The determination of what constitutes BIE is actually more difficult than it may first appear.

1. Taxpayers need to determine whether the interest expense is attributable to a trade or business.
2. If it is attributable to a trade or business, taxpayers need to determine whether the interest expense is allocable to an excepted trade or business or non-excepted trade or business.

POLLING QUESTION

Have you relied upon the 2018 proposed regulations?

- ☐ Yes
- ☐ No
- ☐ No, I did not know I could

Calculation of ATI

ATI = Tentative taxable income (TTI) with the following adjustments:

Additions	Subtractions
BIE, other than DBIE	BII
NOL and capital loss carryover or carryback deduction	FPF
For taxable years beginning before 2022, deductions for depreciation, amortizations, and depletion	With respect to a sale or disposition of property or stock of a member of a consolidated group or partnership interest, depreciation, amortization and depletion for taxable years beginning before 2022
Section 199A deduction	Deemed inclusions reduced by section 250 deduction
Deductions or losses not allocable to a non-excepted trade or business	Income or gains not allocable to a non-excepted trade or business

Capitalized depreciation, amortization, and depletion expenses

- 2018 proposed regulations
 - It is not treated as a DAD expense and therefore there is no adjustment to reflect the expense
- Final regulations
 - It is treated as a DAD expense and therefore there is an adjustment to reflect the expense in the year the expense is capitalized



Depreciation, amortization, and depletion subtraction adjustment

	2018 proposed regulations	Final regulations	2020 proposed regulations
Sale of property	Lesser of the DAD deductions or the gain recognized	DAD deductions	Taxpayers can choose to use the lesser of DAD deductions or the gain recognized
Sale of stock of a consolidated group member	DAD deductions reflected in basis of stock	DAD deductions reflected in basis of stock	Taxpayers can choose to use the lesser of DAD deductions reflected in stock basis or the gain recognized on sale of stock
Sale of partnership interest (excluding deemed sale on distribution of money or property)	Distributive share of DAD deductions, if sale of all or substantially all of partnership interest	Distributive share of DAD deductions, based on proportionate approach	Taxpayers can choose to use the lesser of distributive share of DAD deductions on property held at the time of the sale or the gain recognized on sale of partnership interest

Consolidated groups

The final regulations generally adopt the rules in the 2018 proposed regulations.

- The consolidated group has a single section 163(j) limitation
- Intercompany obligations are generally disregarded for section 163(j) purposes
- DBIE of a new member is subject to separate return limitation year (SRLY) rule (unless 382 overlap rule applies)



Foreign Corporations

Section 163(j) applies to both:

- Foreign corporations that have income effectively connected with a U.S. trade or business (ECI) and
- Foreign corporations that are a controlled foreign corporation (CFC) in which a U.S. shareholder owns (within the meaning of section 958(a)) stock (an applicable CFC)



CFC group rules — 2018 proposed regulations

- Who can join
 - Two or more applicable CFCs if at least 80% of the value of the stock of each applicable CFC is owned by a single U.S. shareholder (or a consolidated group) or, in the aggregate, by related U.S. shareholders that own stock of each member in the same proportion
 - Partnerships in which CFC group members own, in the aggregate, at least 80 percent of the interests, is treated as a CFC group member
 - A CFC that has ECI cannot be a member, other than for purposes of determining if another entity is a group member
- Ability to revoke election
 - None

CFC group rules — 2020 proposed regulations

- Who can join
 - One or more chains of applicable CFCs connected through stock ownership with a group parent, but only if the group parent owns at least 80% of the value of the stock of at least one other applicable CFC, and at least 80% of the value of the stock of the other applicable CFCs is owned by one or more of the CFC group members
 - A CFC that has ECI can be a member, but its ECI activities are excluded from the group calculation
 - CFC financial service subgroups are eliminated
- Ability to revoke election
 - After 60 months, but cannot be made again until 60 months after revocation

CFC group rules comparison

- 2018 proposed regulations
 - Excess taxable income (ETI) rolls up to upper tier entities
 - This can increase the amount of interest deductions upper tier entities and United States shareholders can deduct, but does place a premium on the location of the business interest expense
- 2020 proposed regulations
 - A CFC group calculates a single section 163(j) limitation
 - This reduces the pressure on the location of the debt within the CFC group for deductibility purposes but adds greater complexity (e.g., currency translation rules, treatment of CFCs with different taxable years and SRLY rules)

US shareholders rules — 2018 proposed regulations

In general, a US shareholder does not include its subpart F or GILTI inclusions (and corresponding section 78 inclusion and section 250 deduction without regard to the taxable income limitation) in calculating ATI.

If a CFC group election is made, then a US Shareholder, in computing its ATI, can increase its taxable income by the lesser of the highest-tier CFC group member's ETI and the US Shareholder's subpart F or GILTI inclusions (and corresponding section 250 deduction without regard to the taxable income limitation).

A domestic partnership cannot benefit from the CFC group election, but a domestic C corporation partner can.

US shareholders rules — 2020 proposed regulations

In general, a US shareholder does not include its subpart F or GILTI inclusions (and corresponding section 78 inclusion and section 250 deduction without regard to the taxable income limitation) in calculating ATI.

In computing its ATI, a US shareholder, can increase its tentative taxable income by the same percentage of its subpart F or GILTI inclusion (and corresponding section 250 deduction without regard to the taxable income limitation) as the CFC's (or CFC group's) excess ATI.



Additional 2020 proposed regulations details

- Annual safe harbor
 - If BIE does not exceed 30% of the lesser of: (1) tentative taxable income attributable to non-excepted trade or business and (2) eligible amount (sum of subpart F and GILTI as if wholly owned by domestic corporations that are USSH, reduced by section 250 deduction as if taxable income limitation does not apply)
 - The election is only available for standalone applicable CFCs or all CFC group members (so long as there is no pre-group DBIE carryforward)

POLLING QUESTION

Which upcoming TCJA regulation package will most impact you?

- ☐ The final carried interest regulations
- ☐ The final BEAT regulations
- ☐ The proposed previously taxed earnings & profits (PTEP) regulations
- ☐ The final (GILTI and subpart F) high tax exception regulations
- ☐ Some other regulations package

Other section 163(j) guidance

- So many questions ... so little time
- Section 163(j) is not a method of accounting
- Partnership guidance
- S corporations' guidance



Thank You for Attending

**Virtual Coffee Talk: 163(j)
Final and Proposed
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Kevin M. Jacobs

- Kevin M. Jacobs is a Managing Director with Alvarez & Marsal Taxand in Washington D.C. and the National Tax Office Practice Leader. He brings more than 15 years of experience in tax matters in both the public and the private sector.
- Prior to joining A&M, Mr. Jacobs was a Senior Technician Reviewer (TCJA) with the IRS Office of Associate Chief Counsel (Corporate) for more than six years, where he advised on tax issues such as corporate re-organizations and corporation-shareholder issues, earning and profits, recovery and allocation of stock basis, liquidations, redemptions, bankruptcies, spin-offs and consolidated returns.
- Mr. Jacobs was the principal Associate Chief Counsel (Corporate) attorney on several regulatory projects including the proposed section 382(h) regulations on built-in gains and losses, the global intangible low-taxed income regulations, and debt-equity regulations. He provided substantial contributions to numerous other guidance projects, such as the limitation on interest deductions regulations, and assisted in overseeing the Corporate Division's response to TCJA, including the coordination with Treasury's Offices of Tax Legislative Counsel and International Tax Counsel. Previously, Mr. Jacobs spent more than nine years at law and certified public accounting firms (Ropes & Gray LLP, Latham & Watkins LLP, Dewey Ballantine LLP and Arthur Andersen LLP).
- Mr. Jacobs earned a bachelor's degree in accounting, a master's degree in accounting (with a concentration in taxation), a J.D. (magna cum laude) from the University of Florida and an LL.M. in taxation from New York University. He is admitted to practice before multiple courts, including the Supreme Court of the United States, the U.S. Tax Court and the U.S. Court of Federal Claims. He is admitted to the District of Columbia and Florida Bars and is a licensed Certified Public Accountant (CPA) in Florida and Colorado. Mr. Jacobs is a member of several organizations including the American Bar Association and the New York State Bar Association. He is also a frequent speaker on numerous corporate transaction tax matters.



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