

# I.R.S. NOTICE 2018-28 ANNOUNCES CODE §163(J) REGULATIONS ON INTEREST PAYMENT DEDUCTIONS

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## REVISIONS TO CODE §163(J)

The I.R.S. recently issued Notice 2018-28, announcing that it intends to release regulations on various issues pertaining to the limitation on the deductibility of certain interest payments under Code §163(j), also referred to as the anti-earnings stripping rule. This rule attempts to prevent base erosion by limiting excess interest deductions.

Under the Tax Cuts and Jobs Act of 2017 (“T.C.J.A.”), Code §163(j) was amended to provide that a taxpayer’s annual business interest expense is limited to

- business interest income,
- 30% of adjustable taxable income (“A.T.I.”) (roughly equivalent to earnings before interest, taxes, depreciation, and amortization (“E.B.I.T.D.A.”)), and
- floor plan financing interest (relating to certain car dealers) for the tax year.

From 2022 onwards, depreciation and amortization will not be taken into account. Thus, a taxpayer’s annual business interest expense will be based on 30% of earnings before interest and taxes (“E.B.I.T.”). An exception applies to certain regulated public utilities and small businesses.<sup>1</sup>

Unlike the predecessor rule, the amended Code §163(j)

- is not limited to corporate interest paid to or guaranteed by a related party that is tax exempt, as under U.S. domestic law or an applicable income tax treaty,<sup>2</sup> and
- does not include a safe harbor rule (debt-equity ratio of 1.5:1).

## FORTHCOMING REGULATIONS

Notice 2018-28 states certain issues will be addressed in forthcoming regulations:

1. **Clarification that Disqualified Interest Disallowed Under Pre-T.C.J.A. Code §163(j) May Be Carried Forward to the First Tax Year Under Amended Code §163(j)**

A taxpayer with disqualified interest disallowed under the pre-T.C.J.A. Code §162(j)

<sup>1</sup> To qualify for the exemption, average gross receipts may not exceed \$25 million (adjusted for inflation from 2018 onwards) for the prior three years.

<sup>2</sup> In the case of a reduced withholding tax rate on interest payments, the limitation is applied on a *pro rata* basis.

rules for the last tax year beginning before January 1, 2018, (“pre-T.C.J.A. disqualified interest”) may carry forward such interest as business interest to the taxpayer’s first tax year beginning after December 31, 2017. The pre-T.C.J.A. disqualified interest will be subject to the rules of amended Code §163(j). Furthermore, the new Base Erosion and Anti-Abuse Tax (“B.E.A.T.”), which is primarily applicable to large corporations, will apply to the pre-T.C.J.A. disqualified interest.

**2. Clarification of the Application of Affiliation and Super-Affiliation Rules Under Amended Code §163(j)**

Under the pre-T.C.J.A. Code §163(j), all members of the same affiliated group, within the meaning of Code §1504(a), were treated as one taxpayer for the purpose of applying the limitation. Under the “Super-Affiliation Rules” issued under proposed regulations of pre-T.C.J.A. Code §163(j), this treatment applied without regard to whether the affiliated group filed a consolidated return. The legislative history called on the I.R.S. to issue regulations for groups of commonly controlled U.S. corporations that would constitute an affiliated group but for the inclusion of one or more entities other than includible corporations.

Notice 2018-28 states that the forthcoming regulations will include rules for allocating business interest from a group treated as affiliated under the Super-Affiliation Rules of the pre-T.C.J.A. Code §163(j) regulations. As discussed in 5 below, the regulations likely will not include a general rule that treats an affiliated group that does not file a consolidated return as a single taxpayer for purposes of the amended Code §163(j).

**3. Clarification that No Amount Previously Treated as an “Excess Limitation Carryforward” Under Pre-T.C.J.A. Code §163(j) May Be Carried to a Tax Year Beginning After December 31, 2017**

Unlike pre-T.C.J.A. Code §163(j), amended Code §163(j) does not permit a taxpayer to add to its annual limitation any excess limitation carryforward from the prior tax year. The forthcoming regulations will affirmatively state that amended Code §163(j) does not include the excess limitation carryforward.

**4. A C-Corporation’s Business Interest Income Includes Investment Income and Its Business Interest Expense Includes Investment Interest Expense**

The regulations will clarify that, solely for the purpose of Code §163(j), all interest paid or accrued by a C-corporation on its debt will be treated as business interest, and all interest on debt held by a C-corporation that is includible in gross income of the C-corporation will be business interest income. These provisions do not apply to S-corporations.

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

**5. Rules for Applying Amended Code §163(j) to Consolidated Groups at the Group Level**

The regulations will address issues such as the following:



- The computation of A.T.I. as consolidated taxable income and disregard of intercompany obligations
- The allocation of the Code §163(j) limitation among group members
- The treatment of disallowed interest deduction carryforwards if a member is to leave or join a group, and whether carryforwards would be subject to a separate return limitation year ("S.R.L.Y.") limitation
- The application of Treasury Regulation §1.1502-32 (providing rules for adjusting the basis of the stock of a subsidiary owned by another member) to disallowed interest deductions
- The application of Code §163(j) to a consolidated group with one or more members who conduct a trade or business excepted from the Code §163(j) limitation or whose members hold an interest in a non-corporate entity that conducts such a trade or business

Unlike pre-T.C.J.A. Code §163(j), the I.R.S. anticipates that the new regulations will not include a general rule to treat an affiliated group that does not file a consolidated return as a single taxpayer for purposes of amended Code §163(j).

**6. A C-corporation's Earnings and Profits ("E & P") Are Not Impacted by the Disallowance and Carryforward of a Business Interest Expense Deduction**

The regulations will clarify that the disallowance and carryforward of a deduction for a C-corporation's business interest expense under amended Code §163(j) will not affect whether the business interest expense reduces the E&P of the payor C-corporation.

**7. Rules for Partnerships and Partners and for S-corporations and Shareholders**

Under amended Code §163(j), the annual limitation on the deduction for business interest expense must be applied at the partnership level. Any deduction for business interest must be taken into account in determining the non-separately stated taxable income or loss of the partnership. Although applied at the partnership level with respect to the partnership's indebtedness, Code §163(j) may also be applied at the partner level in certain circumstances, such as for the purpose of calculating the partner's carryforward.

The regulations will provide that, for purposes of calculating a partner's annual deduction for business interest under amended Code §163(j), a partner cannot include the partner's share of the partnership's business interest income for the tax year. An exception to this rule applies to the extent of the partner's share of the excess of (i) the partnership's business interest income over (ii) the partnership's business interest expense (not including floor plan financing).

Similar rules will be set forth for an S-corporation and its shareholders.