

Initial Guidance Under Section 163(j) as Applicable to Taxable Years Beginning After December 31, 2017

Notice 2018-28

SECTION 1. PURPOSE

This notice announces that the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) intend to issue proposed regulations providing guidance to assist taxpayers in complying with section 163(j) of the Internal Revenue Code (Code), as amended on December 22, 2017, by “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018,” P.L. 115-97 (the Act). This notice further describes certain of the rules that those proposed regulations will include to provide taxpayers with interim guidance as more comprehensive guidance is developed. The rules described in this notice apply only for purposes of determining the limitation on deductions for interest expense under section 163(j), as amended by the Act. Before the issuance of the regulations described in this notice, taxpayers may rely on the rules described in sections 3 through 7 of this notice.

SECTION 2. BACKGROUND

Prior to the Act, section 163(j) disallowed a deduction for disqualified interest paid or accrued by a corporation in a taxable year if two threshold tests were satisfied. The first threshold test was satisfied if the payor’s debt-to-equity ratio exceeded 1.5 to 1.0 (safe harbor ratio). The second threshold test was satisfied if the payor’s net

interest expense exceeded 50 percent of its adjusted taxable income (generally, taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under section 199, depreciation, amortization, and depletion). Disqualified interest for this purpose included interest paid or accrued to: (1) related parties when no Federal income tax was imposed with respect to such interest; (2) unrelated parties in certain instances in which a related party guaranteed the debt; or (3) a real estate investment trust ('REIT') by a taxable REIT subsidiary of that REIT. Interest amounts disallowed for any taxable year under section 163(j) prior to the Act were treated as interest paid or accrued in the succeeding taxable year and could be carried forward indefinitely. In addition, any excess limitation (i.e., the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) could be carried forward three years.

Prior to the Act, section 163(j)(6)(C) provided that "[a]ll members of the same affiliated group (within the meaning of section 1504(a)) shall be treated as 1 taxpayer." In addition, section 163(j)(9)(B) provided the Secretary with the authority to issue regulations providing for adjustments in the case of corporations that are members of an affiliated group as may be appropriate for carrying out the purposes of section 163(j). The Report of the Committee on the Budget, House of Representatives, House Report 101-247 at 1248 (Sept. 20, 1989) noted that "[i]n cases where a group of commonly controlled U.S. corporations would constitute an affiliated group but for the inclusion within the group of one or more entities other than includible corporations (as defined in section 1504(b)), the committee intends for the regulations to treat all U.S. corporations that are members of such a group as a single taxpayer where such treatment is

appropriate in order to carry out the purposes of the bill or to prevent avoidance of the purposes of the bill.”

Proposed regulations under section 163(j) were issued on June 18, 1991 (Proposed Regulations). 56 FR 27907 (June 18, 1991). The Proposed Regulations contained affiliation rules for section 163(j) purposes (the super-affiliation rules). In particular, proposed § 1.163(j)-5(a)(2) contained a rule that would treat all members of an affiliated group (as defined in section 1504(a)) as one taxpayer for purposes of section 163(j), without regard to whether such affiliated group files a consolidated return pursuant to section 1501. The Proposed Regulations also contained rules in proposed § 1.163(j)-5(a)(3) under which, for purposes of section 163(j), if at least 80 percent of the total voting power and total value of the stock of an includible corporation (as defined in section 1504(b)) is owned, directly or indirectly, by another includible corporation, the first corporation would be treated as a member of an affiliated group that includes the other corporation and its affiliates.

Section 163(j) was amended by the Act to provide new rules limiting the deduction of business interest expense for taxable years beginning after December 31, 2017. See Section 13301(a) of the Act. For any taxpayer to which section 163(j) applies, section 163(j)(1) now limits the taxpayer’s annual deduction for business interest expense to the sum of: (1) the taxpayer’s business interest income (as defined in section 163(j)(6)) for the taxable year; (2) 30 percent of the taxpayer’s adjusted taxable income (as defined in section 163(j)(8)) for the taxable year; and (3) the taxpayer’s floor plan financing interest (as defined in section 163(j)(9)) for the taxable year. The limitation in section 163(j) applies to all taxpayers, except for certain

taxpayers that meet the gross receipts test in section 448(c), and to all trades or businesses, except certain trades or businesses listed in section 163(j)(7). Section 163(j)(2), as amended by the Act, provides that the amount of any business interest not allowed as a deduction for any taxable year as a result of the limitation in section 163(j)(1) is treated as business interest paid or accrued in the next taxable year and may be carried forward. Section 163(j), as amended by the Act, does not provide for the carryforward of any excess limitation. Section 163(j)(6)(C), which treated an affiliated group as one taxpayer, and section 163(j)(9)(B), which authorized the super-affiliation rules, were removed by the Act and no equivalent provisions are included in section 163(j), as amended by the Act.

The Conference Report to Accompany H.R. 1, Report 115-466 (Dec. 15, 2017) (the Conference Report) states in a footnote describing the House Bill that "...a corporation has neither investment interest nor investment income within the meaning of section 163(d). Thus, interest income and interest expense of a corporation is properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of the provision." See Conference Report footnote 688, at 386. Nothing in the Conference Report's description of the Senate Amendment or the Conference Agreement is inconsistent with this approach. The Conference Report also notes, in the description of the House Bill, that "[i]n the case of a group of affiliated corporations that file a consolidated return, the limitation applies at the consolidated tax return filing level." See Conference Report at 386. Nothing in the Conference Report's description of the Senate Amendment or the Conference Agreement is inconsistent with this approach. However, there is no mention in the Conference Report of applying

section 163(j) to affiliated groups (within the meaning of section 1504(a)) that do not file a consolidated return.

SECTION 3. TREATMENT OF DISALLOWED DISQUALIFIED INTEREST FROM LAST TAXABLE YEAR BEGINNING BEFORE JANUARY 1, 2018

Prior to the Act, C corporation taxpayers that could not deduct all of their interest expense under section 163(j)(1)(A) could carry their disallowed disqualified interest forward to the succeeding taxable year under section 163(j)(1)(B). Such interest was treated as paid or accrued in the succeeding taxable year. Similarly, under section 163(j)(2), as amended by the Act, taxpayers that cannot deduct all of their business interest because of the limitation in section 163(j)(1) may carry their disallowed business interest forward to the succeeding taxable year, and such interest is treated as business interest paid or accrued in the succeeding taxable year.

Consistent with the approach of section 163(j)(1)(B) prior to the Act and section 163(j)(2), as amended by the Act, the Treasury Department and the IRS intend to issue regulations clarifying that taxpayers with disqualified interest disallowed under prior section 163(j)(1)(A) for the last taxable year beginning before January 1, 2018, may carry such interest forward as business interest to the taxpayer's first taxable year beginning after December 31, 2017. The regulations will also clarify that business interest carried forward will be subject to potential disallowance under section 163(j), as amended by the Act, in the same manner as any other business interest otherwise paid or accrued in a taxable year beginning after December 31, 2017.

The regulations will also address the interaction of section 163(j) with section 59A, relating to the tax on base erosion payments of taxpayers with substantial gross

receipts, which was added by section 14401 of the Act. The regulations will provide that business interest carried forward from a taxable year beginning before January 1, 2018, will be subject to section 59A in the same manner as interest paid or accrued in a taxable year beginning after December 31, 2017, and will clarify how section 59A applies to that interest. Thus, for example, if interest paid or accrued by a taxpayer to a foreign person that is a related party as defined in section 59A(g) is carried forward to a taxable year beginning after December 31, 2017, and a deduction is otherwise allowable under Chapter 1 of the Code for such interest, then the interest is treated as a base erosion payment described in section 59A(d)(1) and is subject to the rules under section 59A(c)(3).

In addition, the regulations will provide rules for the allocation of business interest from a group treated as affiliated under the super-affiliation rules applicable to section 163(j) prior to the Act to taxpayers under section 163(j), as amended.

Prior to the Act, section 163(j)(2)(B)(ii) also allowed a corporation that was subject to the limitation in section 163(j)(1) to add to its annual limitation any “excess limitation carryforward” from the prior year, as defined in section 163(j)(2)(B)(ii). Section 163(j), as amended by the Act, does not have a provision that would allow an excess limitation carryforward. Thus, the Treasury Department and the IRS intend to issue regulations clarifying that no amount previously treated as an excess limitation carryforward may be carried to taxable years beginning after December 31, 2017.

For further information regarding carryforwards generally, contact Zachary King or Charles Gorham at (202) 317-7003 (not a toll-free number). For further information

regarding the interaction of sections 59A and 163(j), contact Sheila Ramaswamy or Steve Jensen at (202) 317-6938 (not a toll-free number).

SECTION 4. C CORPORATION BUSINESS INTEREST EXPENSE AND INCOME

Consistent with congressional intent as reflected in the Conference Report, the Treasury Department and the IRS intend to issue regulations clarifying that, solely for purposes of section 163(j), as amended by the Act, in the case of a taxpayer that is a C corporation, all interest paid or accrued by the C corporation on indebtedness of such C corporation will be business interest within the meaning of section 163(j)(5), and all interest on indebtedness held by the C corporation that is includible in gross income of such C corporation will be business interest income within the meaning of section 163(j)(6). The regulations described in the foregoing sentence will not apply to a corporation that is an S corporation as defined in section 1361(a)(1). Regulations also will address whether and to what extent 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, to such C corporation, as business interest within the meaning of section 163(j)(5) or business interest income within the meaning of section 163(j)(6).

For further information regarding this issue, contact John B. Lovelace at (202) 317-4723 (not a toll-free number).

SECTION 5. APPLICATION OF SECTION 163(j) TO CONSOLIDATED GROUPS

Consistent with congressional intent as reflected in the Conference Report, the Treasury Department and the IRS intend to issue regulations clarifying that the limitation in section 163(j)(1) on the amount allowed as a deduction for business interest applies

at the level of the consolidated group (as defined in § 1.1502-1(h)). Thus, for example, a consolidated group's taxable income for purposes of calculating adjusted taxable income (as defined in section 163(j)(8)) will be its consolidated taxable income (as determined under § 1.1502-11), and intercompany obligations (as defined in § 1.1502-13(g)(2)(ii)) will be disregarded for purposes of determining the limitation in section 163(j)(1).

Regulations also will address other issues concerning the application of section 163(j) to consolidated groups, including: the allocation of the section 163(j)(1) limitation among group members; the treatment of disallowed interest deduction carryforwards when a member leaves the group; the treatment of disallowed interest deduction carryforwards of a member that joins the group, including whether such carryforwards are subject to a separate return limitation year (SRLY) limitation (see §§ 1.1502-15, 1.1502-21(c), and 1.1502-22(c)); the application of § 1.1502-32 (providing rules for adjusting the basis of the stock of a subsidiary owned by another member) to disallowed interest deductions; and the application of section 163(j) to a consolidated group with one or more members that conduct a trade or business described in section 163(j)(7)(A)(ii), (iii), or (iv), as amended by the Act, or whose members hold an interest in a non-corporate entity such as a partnership that conducts such a trade or business. The Treasury Department and the IRS anticipate that such regulations will not include a general rule treating an affiliated group that does not file a consolidated return as a single taxpayer for purposes of section 163(j), as amended by the Act.

For further information regarding this issue, contact John B. Lovelace at (202) 317-4723 (not a toll-free number).

SECTION 6. IMPACT OF SECTION 163(j) ON EARNINGS AND PROFITS

The Treasury Department and the IRS intend to issue regulations clarifying that the disallowance and carryforward of a deduction for a C corporation's business interest expense under section 163(j), as amended by the Act, will not affect whether or when such business interest expense reduces earnings and profits of the payor C corporation.

For further information regarding this issue, contact John B. Lovelace at (202) 317-4723 (not a toll-free number).

SECTION 7. BUSINESS INTEREST INCOME AND FLOOR PLAN FINANCING OF PARTNERSHIPS, PARTNERS, S CORPORATIONS, AND S CORPORATION SHAREHOLDERS

Section 163(j)(4) requires that the annual limitation on the deduction for business interest expense be applied at the partnership level and that any deduction for business interest be taken into account in determining the non-separately stated taxable income or loss of the partnership. Although section 163(j)(4) is applied at the partnership level with respect to the partnership's indebtedness, section 163(j) may also be applied at the partner level in certain circumstances. The Treasury Department and the IRS intend to issue regulations providing that, for purposes of calculating a partner's annual deduction for business interest under section 163(j)(1), a partner cannot include the partner's share of the partnership's business interest income for the taxable year except 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). Additionally, the Treasury Department and the IRS intend to issue regulations providing that a partner cannot include such partner's share of the

partnership's floor plan financing interest in determining the partner's annual business interest expense deduction limitation under section 163(j). Such regulations are intended to prevent the double counting of business interest income and floor plan financing interest for purposes of the deduction afforded by section 163(j) and are consistent with general principles of Chapter 1 of the Code. Similar rules will apply to any S corporation and its shareholders.

For further information regarding this issue, contact Meghan Howard at (202) 317-5279, Adrienne Mikolashek at (202) 317-6850, or Anthony McQuillen at (202) 317-6850 (not a toll-free number).

SECTION 8. WITHDRAWAL OF PROPOSED REGULATIONS

The Treasury Department and the IRS intend to withdraw the Proposed Regulations in connection with the issuance of proposed regulations under section 163(j), as amended by the Act.

SECTION 9. REQUEST FOR COMMENTS

The Treasury Department and the IRS request comments on the rules described in this notice. In addition, the Treasury Department and the IRS expect to issue regulations under section 163(j) providing guidance with respect to issues not described in this notice and request comments on what additional issues should be addressed by those regulations to assist taxpayers in applying section 163(j). Comments must be submitted by May 31, 2018. All comments received will be available for public inspection and copying.

Written comments responding to this notice should be mailed to:

Internal Revenue Service
CC:PA:LPD:PR (Notice 2018-28)

Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Please include "Notice 2018-28" on the cover page.

Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to:

Internal Revenue Service
Courier's Desk
1111 Constitution Ave., N.W.
Washington, DC 20224
Attn: CC:PA:LPD:PR
(Notice 2018-28)

Submissions may also be sent electronically to the following e-mail address:

Notice.Comments@irscounsel.treas.gov. Please include "Notice 2018-28" in the subject line.

SECTION 10. DRAFTING AND GENERAL CONTACT INFORMATION

The principal authors of this notice are Zachary King and Charles Gorham of the Office of the Associate Chief Counsel (Income Tax and Accounting). Other personnel from the Treasury Department and the IRS participated in its development. For further information regarding this notice, contact Mr. King or Mr. Gorham at (202) 317-7003 (not a toll-free number).