Corporate provisions in Final Regulations under Section 163(j)

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On July 28, 2020, Treasury and the IRS released highly anticipated final regulations under section 163(j) and related amended regulations under sections 382 and 383 (Final Regulations).¹ This legal alert focuses on provisions in the Final Regulations that are of particular significance for C corporations, including provisions addressing consolidated groups. These provisions in the Final Regulations address:

- Allocation of interest expense and interest income between excepted and non-excepted trades or businesses within a consolidated group: Treas. Reg. § 1.163-10.
- Section 382: Treas. Reg. § 1.163(j)-5(e).

Additional coverage by Eversheds Sutherland of the Final Regulations is available at the following link: The newest addition to your summer reading list: Section 163(j) regulations arrive just in time for the dog days of summer and at TaxReformLaw.com.

Background

The Tax Cuts and Jobs Act (TCJA)² replaced “old” section 163(j) with an entirely new section 163(j) that limits the ability of taxpayers, including C corporations, to deduct business interest expense. In contrast to “old” section 163(j), new section 163(j) generally applies to all taxpayers and all business interest expense deductions.

Generally, section 163(j) limits a taxpayer’s deduction for business interest

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expense to the sum of the taxpayer’s current year business interest income, 30% (or generally 50% in the case of taxable years beginning in 2019 or 2020) of the taxpayer’s adjusted taxable income, and certain floor plan financing interest expense (Section 163(j) Limitation). Section 163(j) does not apply to certain small businesses and excepted trades or businesses (including certain real property, farming, and regulated utility businesses). Amounts of business interest expense that cannot be deducted because of the Section 163(j) Limitation can be carried forward and treated as business interest paid or accrued in the next taxable year.

On November 26, 2018, Treasury and the IRS released proposed regulations under section 163(j) (Proposed Regulations) that were published on December 28, 2018. Additional coverage by Eversheds Sutherland of the Proposed Regulations is available at the following link: INXS? IRS issues proposed regulations under section 163(j).

Following publication of the Proposed Regulations, Congress amended section 163(j) as part of the Coronavirus Aid, Relief, and Economic Security Act. However, these amendments are not addressed in this legal alert as they are not of particular significance for C corporations.

Section 163(j) treatment of C corporations and consolidated groups in general

The Section 163(j) Limitation applies to “business interest expense,” which is defined as interest expense that is allocable to a trade or business. Since a C corporation does not have investment interest or investment income within the meaning of section 163(d), the Final Regulations treat all interest expense and all interest income of a C corporation as business interest expense and business interest income, respectively, except to the extent that it is allocable to an excepted trade or business.

The Final Regulations in Treas. Reg. § 1.163(j)-4 provide that a consolidated group has a single Section 163(j) Limitation. The group’s current-year business interest expense and business interest income is the sum of each member’s current-year business interest expense and business interest income. In calculating the consolidated group’s adjusted taxable income for purposes of section 163(j), the rules of Treas. Reg. § 1.1502-11 are applied, but without
regard to any carryforwards under section 163(j). In addition, any items from intercompany transactions are generally disregarded to the extent that they offset in amount.

**Carryforwards**

Amounts of business interest expense that cannot be deducted because of the Section 163(j) Limitation can be carried forward and treated as business interest paid or accrued in the next taxable year as a “disallowed business interest expense carryforward.” However, in contrast to old section 163(j), section 163(j) does not allow the carryforward of any excess limitation. Treas. Reg. § 1.163(j)-5(b) provides rules regarding disallowed business interest expense carryforwards for C corporations, including special rules for consolidated groups.

**Ordering rule**

Under an ordering rule, for a C corporation, current-year business interest expense is deducted in the current taxable year before any disallowed business interest expense carryforwards are deducted for that year. After current-year business interest expense has been exhausted, disallowed business expense carryforwards are deducted in the order of the taxable years in which they arose, beginning with the earliest taxable year, subject to certain limitations (e.g., section 382).

**Consolidated groups**

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. An ordering rule, similar to the ordering rule described above, applies to determine how disallowed business interest expenses carryforwards are taken into account for the current consolidated taxable year. Treas. Reg. § 1.163(j)-5(b)(iv) provides an example to illustrate these rules for consolidated groups.

All current-year business interest expense of members of a consolidated group...
is deducted in the current year before any disallowed business interest expense carryforwards from prior taxable years are deducted in the current year. Disallowed business interest expense carryforwards from prior taxable years are deducted in the order of the taxable years in which they arose, beginning with the earliest taxable year, subject to the limitations. Additional ordering rules apply if current-year business expense and disallowed business interest expense carryforwards exceed the consolidated group’s Section 163(j) Limitation for the current year.

A separate ordering rule applies in the case of a departing member. If a corporation ceases to be a member during a consolidated return year, the corporation’s current-year business interest expense from the taxable period ending on the day of the corporation’s change in status as a member, as well as the corporation’s disallowed business interest expense carryforwards from prior taxable years that are available to offset tentative taxable income in the consolidated return year, are first made available for deduction during that consolidated return year. Only the amount that is neither deducted by the group in that consolidated return year nor otherwise reduced under the Code or regulations may be carried to the corporation’s first separate return year after its change in status. This ordering rule has the effect of limiting the amount of disallowed business interest expense incurred during a consolidated return year that a departing member can take with it when it leaves a consolidated group.

Allocation between excepted and non-excepted trades or businesses

Certain trades or businesses are excepted from the application of section 163(j). Treas. Reg. § 1.1502-10 addresses the allocation of interest expense and interest income between excepted and non-excepted trades or businesses of a taxpayer and includes rules for allocating interest expense and interest income among members of a consolidated group.

The Proposed Regulations recognized that a single taxpayer may be engaged in both excepted and non-excepted trades or businesses and included provisions by which a taxpayer allocated interest expense and interest income between excepted and non-excepted trades or businesses. The Final Regulations retain this approach, with adjustments to how to allocate interest expense and income between excepted and non-excepted trades or businesses.
For purposes of applying the allocation rules, all members of a consolidated group are treated as a single corporation. Thus, the group, rather than a particular member, is treated as engaged in excepted or non-excepted trades or businesses. Consistent with this single corporation approach, intercompany transactions are disregarded for purposes of the allocation rules and property is not treated as used in a trade or business to the extent the use of such property in that trade or business derives from an intercompany transaction. Additionally, stock of a member that is owned by another member of the same consolidated group is not treated as an asset and the transfer of any amount of member stock to a non-member is treated by the group as a transfer of the member’s assets in proportion to the amount of member stock transferred.

After a consolidated group has determined the percentage of the group’s interest expense allocable to excepted trades or businesses for the taxpayer year, this single exempt percentage for the entire group is applied to the interest paid or accrued by each member during the taxable year to any lender that is not a member of the group.

**SRLY rules**

The SRLY rules in Treas. Reg. § 1.1502-21(c) limit the extent to which a consolidated group may use the losses of a member that arose when the member was not a member of the consolidated group. In order to prevent the unlimited import of losses into a consolidated group, losses from a member’s SRLY may be used by the consolidated group only to the extent the member contributes to the group’s consolidated taxable income.

Treas. Reg. § 1.163(j)-5(d) provides rules regarding disallowed business interest expense that arose during a SRLY of a member that apply the principles of Treas. Reg. § 1.1502-21(c) and (g) in the context of section 163(j). These rules limit a consolidated group’s use of disallowed business interest expense carryforwards from a member’s SRLY, similar to the operation of Treas. Reg. § 1.1502-21(c). Treas. Reg. § 1.163(j)-5(d)(3) provides examples to illustrate these rules.

**Cumulative Section 163(j) Limitation**
The amount of the carryforwards from a member’s SRLY that may be included in a consolidated group’s business interest expense deduction for any taxable year may not exceed the member’s “Cumulative Section 163(j) SRLY Limitation.” A member’s Cumulative Section 163(j) SRLY Limitation is the member’s aggregate Section 163(j) Limitation for all consolidated return years that the member was a part of the group. The Cumulative Section 163(j) Limitation is determined by reference only to a member’s items of income, gain, deduction, and loss, and reduced (including below zero) by the member’s business interest expense (including disallowed business interest expense carryforwards) absorbed by the group in all consolidated return years of the group.

For purposes of computing the member’s Cumulative Section 163(j) SRLY Limitation, income and expense items arising from intercompany transactions (other than interest income and expense with regard to intercompany obligations) are included in the calculation of the Cumulative Section 163(j) SRLY limitation. The Final Regulations use a cumulative section 163(j) SRLY register to approximate the results under section 163(j) as if the SRLY member had not joined a consolidated group. The cumulative section 163(j) SRLY register operates in a manner similar to, but is separate and distinct from, the cumulative register for net operating losses (NOLs) described in Treas. Reg. § 1.1502-21(c). Use of the cumulative section 163(j) SRLY register is a change from the approach in the Proposed Regulations. Regarding this change, Treasury and the IRS explained that the approach in the Final Regulations approximates the SRLY member’s capacity to utilize carryforwards on a standalone basis while harmonizing with the single-entity application of section 163(j) to consolidated groups.

Treatment of disallowed interest expense Carryforward from a SRLY

Disallowed business interest expense carryforwards of a member that arose in a SRLY are available for deduction by the consolidated group in the current year only to the extent the group has remaining Section 163(j) Limitation for the current year after the deduction of current-year business interest expense and disallowed business interest expense carryforwards from earlier taxable years that are permitted to be deducted in the current year. SRLY-limited disallowed business interest expense carryforwards are deducted on a pro rata basis with non-SRLY limited disallowed business interest expense carryforwards from taxable years ending on the same date.

Overlap of SRLY limitation with Section 382
Treas. Reg. § 1.1502-21(g) provides that, under certain circumstances, the SRLY limitation does not apply to NOL carryovers from a member’s separate return year if section 382 limits the consolidated group’s use of such losses. The Final Regulations apply the principles of Treas. Reg. § 1.1502-21(g) to disallowed business interest expense carryforwards when the application of the SRLY limitation to such carryforwards would result in an overlap with the application of section 382.

Section 382

To prevent trafficking in losses, section 382 generally limits the use of NOLs when a corporation undergoes an “ownership change,” as defined in section 382(g). New regulations under section 382 address the application of section 382 to disallowed business expense carryforwards. Treas. Reg. § 1.163(j)-5(e) and (f) contains cross-references to these new provisions under sections 382 that address the interaction of sections 382 and 162(j).

Pre-change loss

Section 382(d)(3) provides that the term “pre-change loss” includes disallowed business interest expense carryforwards under rules similar to the rules in section 382(d)(1), addressing NOL carryforwards. Treas. Reg. §§ 1.382-2(a) and 1.382-6 provide rules governing the treatment of a disallowed business interest expense as a pre-change loss for purposes of section 382. The Final Regulations depart from the Proposed Regulations in allowing a taxpayer to elect to allocate business interest expense incurred in the year of an ownership change between the “pre-change” and “post-change” periods under a closing-of-the-books method. The Proposed Regulations would have required that a ratable allocation method be used in all cases to allocate current-year business interest expense between pre- and post-change periods.

Treas. Reg. § 1.163(j)-11(c)(4) provides rules governing the application of section 382 to disallowed disqualified interest carryforwards.

Loss corporations
Section 382(k)(1) provides that, for purposes of section 382, the term “loss corporation” includes a corporation entitled to use a carryforward of disallowed business interest. Treas. Reg. § 1.382-2(a) provides rules governing when a disallowed business interest expense causes a corporation to be a loss corporation within the meaning of section 382(k)(1). Treas. Reg. § 1.382-2(a) expands the definition of a loss corporation to include a corporation that is entitled to use a “section 382 disallowed business interest carryforward,” as defined in Treas. Reg. § 1.382-2(a)(7).

Ordering rules

Similar to section 382, section 383 imposes limitations on certain excess credits that limit the ability to traffic in pre-change credits. Treas. Reg. § 1.383-1(d) provides ordering rules for the utilization of pre-change losses and credits and the absorption of the section 382 and section 383 limitations. The Final Regulations amend this provision to reflect that section 382 has been extended to apply to disallowed business interest expense carryforwards. Under the revised ordering rules, the section 382 limitation will generally be absorbed first by pre-change capital losses and recognized built-in losses, followed by disallowed business interest expense carryforwards and then by NOLs and other pre-change losses. In addition, Treas. Reg. § 1.383-1(d)(ii) provides that a loss corporation’s taxable income is offset first by losses subject to a section 382 limitation, to the extent the section 382 limitation for that taxable year has not yet been absorbed, before being offset by losses of the same type from the same taxable year that are not subject to a section 382 limitation. For example, income is offset by a section 382 disallowed business interest expense carryforward before application of any disallowed business interest expense carryforward that is not subject to section 382.

Additional provisions

The following new provisions also address the interaction of sections 382 and 163(j):

- Treas. Reg. § 1.382-2 provides rules governing the treatment of disallowed business interest expense from the “pre-change period” (within the meaning of §1.382-6(g)(2)) in the year of a testing date.

- Treas. Reg. § 1.382-7(d)(5) provides that a “section 382 disallowed
business interest carryforward" (as defined in Treas. Reg. § 1.382-2(a)(7)) is not treated as a recognized built-in loss for purposes of section 382.

- Treas. Reg. § 1.382-7(d)(5) provides that a "section 382 disallowed business interest carryforward" (as defined in Treas. Reg. § 1.382-2(a)(7)) is not treated as a recognized built-in loss for purposes of section 382.

Unified Loss Rule

Treas. Reg. § 1.1502-36 (the so-called "Unified Loss Rule") provides rules for reducing stock basis and attributes when the stock of a subsidiary in a consolidated group is transferred at a loss. The purpose of the Unified Loss Rule is to prevent the consolidated return provisions from reducing a group's consolidated taxable income through the creation and recognition of non-economic loss on subsidiary stock and to prevent members of the group from collectively obtaining more than one tax benefit from a single economic loss.

The Final Regulations treat excess business interest expense as an attribute that is taken into account to reduce basis and attributes under Treas. Reg. § 1.1502-36(c) and (d), respectively. Furthermore, the Final Regulations treat excess business interest expense as a Category D attribute (i.e., Inside Asset Basis) under Treas. Reg. § 1.1502-36(d). Prior to the promulgation of the Final Regulations both commenters on the regulations and as well as other practitioners had argued that excess business interest expenses should be treated as a Class C attribute (i.e., a deferred deduction). The classification of excess business interest expense as a Class D attribute (instead of a Class C attribute) is important because consolidated groups that dispose of subsidiaries may not elect to "reattribute" (i.e., to retain) Class D attributes, meaning that consolidated taxpayers will have fewer options to prevent the elimination of excess business interest expense upon the disposition of a subsidiary's stock.

Transition rules

The TCJA amendments to section 163(j) were effective for tax years beginning after December 31, 2017. There was no transition period or grandfathering of existing debt under the TCJA. Treas. Reg. § 1.163(j)-11 provides transition rules regarding the Section 163(j) Limitation. In addition to addressing the effective date of the Final Regulations in Treas. Reg. § 1.163(j)-11(d), the transition rules in Treas. Reg. § 1.163(j)-11(b) provide substantive rules for application of the Section 163(j) Limitation if a corporation that is subject to the Section 163(j) Limitation joins a consolidated group during a taxable year of the group.
beginning before January 1, 2018.

Effective date

The Proposed Regulations provided that such regulations would apply to tax years ending after the date on which the final regulations were published in the Federal Register. However, the Proposed Regulations permitted taxpayers and their related parties to apply the Proposed Regulations for any tax year beginning after December 31, 2017 so long as taxpayers and their related parties consistently applied the Proposed Regulations for those tax years.

The Final Regulations generally are effective for tax years beginning on or after the date that is 60 days after the date of publication in the Federal Register. Except for provisions for which a specific effective date otherwise applies, the Final Regulations generally permit taxpayers and their related parties to apply the Final Regulations or the Proposed Regulations for any tax year beginning after December 31, 2017 so long as taxpayers and their related parties consistently applied the Proposed Regulations for those tax years.

Application of Section 163(j) Limitation to new member of a consolidated group

Treas. Reg. § 1.163(j)-11(b) addresses application of the Section 163(j) Limitation if a corporation (S) that is subject to the Section 163(j) Limitation joins a consolidated group during a taxable year of the group beginning before January 1, 2018 (for example, if a calendar-year corporation joins a consolidated group with a November 30 taxable year on May 31, 2018). The Final Regulations provide that Section 163(j) will apply to S’s short taxable year that ends on the date of S’s change in status (May 31, 2018), but section 163(j) will not apply to S’s short taxable year that begins the next day when S is a member of the acquiring consolidated group (S’s short taxable year ending on November 30, 2018). Any business interest expense paid or accrued (without regard to section 163(j)) by S in its short taxable year ending on the day of S’s change in status for which a deduction is disallowed under section 163(j) will be carried forward to the acquiring group’s first taxable year beginning after December 31, 2017 (the acquiring group’s taxable year beginning December 1, 2018), subject to limitation under other provisions of the Final Regulations.
1 T.D. 9905. In addition to the Final Regulations, Treasury and the IRS released proposed regulations, Notice 2020-59, and FAQs on related issues. All section references are to the Internal Revenue Code of 1986, as amended, (Code) or to Treasury Regulations issued thereunder.

2 P.L. 115-97.


4 Treas. Reg. § 1.382-2(a)(7) defines the term “section 382 disallowed business interest carryforward” to include the following items: (i) the loss corporation’s disallowed business interest expense carryforwards (as defined in §1.163(j)-1(b)(11)), including disallowed disqualified interest (as defined in §1.163(j)-1(b)(12)), as of the date of the ownership change; and (ii) the loss corporation’s current-year business interest expense (as defined in §1.163(j)-1(b)(9)) in the change year (as defined in §1.382-6(g)(1)) that is allocable to the pre-change period (as defined in §1.382-6(g)(2)) under §1.382-6(a) or (b) and that becomes disallowed business interest expense (as defined in §1.163(j)-1(b)(10)).

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