

**MEMO# 31503**

November 28, 2018

# **Proposed Regulations on Limitation on Interest Expense Deduction; Comments Requested**

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November 28, 2018 TO: ICI Members

Tax Committee SUBJECTS: Tax RE: Proposed Regulations on Limitation on Interest Expense Deduction; Comments Requested

The Treasury Department and the Internal Revenue Service (IRS) have issued [proposed regulations](#) regarding the limitation on the deduction for interest expense in section 163(j), as amended by the 2017 tax legislation commonly referred to as the “Tax Cuts and Jobs Act” (the Act).<sup>[1]</sup> In general, amended section 163(j) limits the deduction for net business interest expense to 30 percent of the taxpayer’s adjusted taxable income (ATI). Business interest is any interest paid or accrued on indebtedness allocable to a trade or business and does not include investment interest.

The proposed regulations, among other things, would clarify the application of section 163(j) to regulated investment companies (RICs), as requested by the Institute.<sup>[2]</sup> The proposed regulations also include other rules that could impact RICs.

## **Business Interest Income and Expense**

The proposed regulations would provide that the amount allowed as a deduction for business interest expense for the taxable year cannot exceed the sum of: (1) the taxpayer’s business interest income for the taxable year; (2) 30 percent of the taxpayer’s ATI for the taxable year (or zero if the taxpayer’s ATI for the taxable year is less than zero); and (3) the taxpayer’s “floor plan financing interest expense” (generally interest on indebtedness used to finance the acquisition of motor vehicles held for sale or lease).<sup>[3]</sup>

When section 163(j) was amended, it was unclear whether a RIC should be treated as having interest income and expense that is allocable to a trade or business, or whether a RIC has investment interest income and expense not subject to the limitations. The legislative history to the Act indicated that corporations cannot have investment interest or expense and can have only business interest and expense.

The proposed regulations thus specify that, solely for purposes of section 163(j), all interest expense of a taxpayer that is a C corporation would be treated as properly allocable to a trade or business. Similarly, all interest income of a taxpayer that is a C corporation would

be treated as properly allocable to a trade or business.[\[4\]](#) The proposed regulations also clarify that these rules would apply to RICs.[\[5\]](#) Therefore, RICs would be subject to the limitation under section 163(j) under the proposed regulations.

## **Calculation of ATI**

The proposed regulations also would clarify that, for purposes of section 163(j), all items of income, gain, deduction, or loss of a taxpayer that is a C corporation similarly would be treated as properly allocated to a trade or business.[\[6\]](#) These amounts thus would be included in the calculation of ATI for purposes of determining the interest expense limitation. Because these rules apply to RICs, this means that all of a RIC's income, gains, deductions or losses would be included in calculating the RIC's ATI.[\[7\]](#)

It also was unclear whether the interest expense limitation under section 163(j) should be applied before or after application of the dividends paid deduction (DPD) in section 561. The proposed regulations would clarify that ATI is a RIC's taxable income without any adjustment that would be made under section 852(b)(2) to compute investment company taxable income.[\[8\]](#) Therefore, the 30 percent limitation would be applied before the DPD. The proposed regulations would, however, increase ATI by the amount of the dividends received deduction (DRD) calculated under section 243.[\[9\]](#)

## **Definition of Interest**

The proposed regulations include an expansive definition of "interest" for purposes of section 163(j). In general, interest would include an amount paid, received, 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 (and not as stock) under the Internal Revenue Code and the regulations thereunder.[\[10\]](#) It would include, among other things, original issue discount (OID), qualified stated interest, acquisition discount, and amounts paid or received in connection with a sale-repurchase agreement treated as indebtedness.[\[11\]](#)

The proposed regulations also include rules regarding swaps with significant nonperiodic payments. For non-cleared swaps,[\[12\]](#) the swap would be treated as two separate transactions consisting of an on-market, level payment swap and a loan.[\[13\]](#) The parties to the contract would be required to account for the loan independently of the swap, and the time value component associated with the loan would be recognized as interest expense to the payor and interest income to the recipient.[\[14\]](#)

The proposed regulations also include special rules for other amounts that would be treated as interest, including: premium and ordinary income or loss on certain debt instruments; substitute interest payments; section 1258 gain; income, deduction, gain, or loss from certain derivatives that alters a taxpayer's effective yield with respect to a debt instrument; and certain fees, including commitment fees.[\[15\]](#)

Finally, the proposed regulations include an anti-avoidance rule that would treat as interest expense any expense or loss, to the extent deductible, incurred by the taxpayer in a transaction or series of integrated or related transactions in which the taxpayer secures the use of funds for a period of time, if such expense or loss is predominantly incurred in consideration of the time value of money.[\[16\]](#)

## **Interest Expense Carryforwards**

Pursuant to section 163(j)(2), the proposed regulations would provide that any business interest expense that is disallowed in the current year would be carried forward to the

succeeding taxable year as business interest expense (subject to the limitation under section 163(j)).[\[17\]](#)

For C corporations, the proposed regulations provide that the disallowance and carryforward of a deduction for business interest expense would not affect whether or when the business interest expense reduces the taxpayer's earnings and profits.[\[18\]](#) This approach reflects the fact that the payment or accrual of business interest expense generally reduces a C corporation's dividend paying capacity in the year that the expense is paid or accrued, without regard to the application of section 163(j). The proposed regulations provide a special rule for RICs, however. If interest expense paid or accrued by a RIC (or allocated to it from a partnership) is disallowed or deferred under section 163(j), such expense would not reduce the RIC's investment company taxable income or the amount of dividends that the RIC must pay from its earnings and profits. Accordingly, if a RIC were disallowed a deduction for business interest expense in a taxable year, the RIC's earnings and profits would be adjusted only in the taxable year or years in which the business interest expense is deductible (or, if earlier, in the first taxable year in which the taxpayer is no longer a RIC).[\[19\]](#)

RICs and other C corporations would be required to deduct current-year business interest expense in the current taxable year before any disallowed business interest expense carryforwards from a prior taxable year.[\[20\]](#) They would deduct disallowed business interest expense carryforwards in the order of the taxable years in which they arose, beginning with the earliest taxable year (subject to certain limitations, including the limitation under section 382).[\[21\]](#)

### **Interest Income and Expense Received from Partnerships**

The proposed regulations provide that, for purposes of section 163(j), any investment interest that a partnership pays or accrues and that is allocated to a partner that is a C corporation (including a RIC) would be treated by that partner as business interest expense.[\[22\]](#) Similarly, any investment income or investment expenses that a partnership receives, pays, or accrues and that is allocated to a C corporation partner would be treated by that partner as business income or expense.[\[23\]](#) This characterization at the C corporation partner level would not affect the characterization of these items as investment interest, investment income, or investment expenses at the partnership level.[\[24\]](#)

### **Application to Controlled Foreign Corporations**

The proposed regulations generally would provide that section 163(j) and the regulations thereunder apply to determine the deductibility of a controlled foreign corporation's (CFC's) business interest expense in the same manner as those provisions apply to domestic C corporations.[\[25\]](#) Thus, a CFC would apply these rules to determine the extent to which any business interest expense is deductible for purposes of computing Subpart F income under section 952 or whether it has income that is effectively connected with the conduct of a US trade or business (ECI). Because the limitation would be applied at the CFC level, the proposed regulations also would provide that, for purposes of computing ATI of a US shareholder in the CFC that has Subpart F income, those deemed inclusions (with certain adjustments to account for foreign-derived intangible (FDII) and global intangible low-taxed income (GILTI) under section 250) generally would be subtracted from the taxable income of the US shareholder.[\[26\]](#)

### **Effective Date**

The proposed regulations would apply to taxable years ending after the date that they are

adopted as final regulations and published in the Federal Register. Taxpayers, however, may apply the proposed regulations to a taxable year beginning after December 31, 2017, so long as they apply them consistently.

## Comments Requested

The government has requested comments on the proposed regulations within 60 days after the proposed regulations have been published in the Federal Register (on or about January 28, 2019). Therefore, please provide any comments to me ([kgibian@ici.org](mailto:kgibian@ici.org) or 202-371-5432) no later than **Monday, January 7, 2019**.

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## endnotes

[1] See Institute Memorandum No. 30991, dated December 21, 2017 ([https://www.ici.org/my\\_ici/memorandum/memo30991](https://www.ici.org/my_ici/memorandum/memo30991)).

[2] See Institute Memorandum No. 31114, dated March 5, 2018 ([https://www.ici.org/my\\_ici/memorandum/memo31114](https://www.ici.org/my_ici/memorandum/memo31114)).

[3] Prop. Reg. § 1.163(j)-2(b).

[4] Prop. Reg. § 1.163(j)-4(b)(1).

[5] Prop. Reg. § 1.163(j)-4(a).

[6] Prop. Reg. § 1.163(j)-4(b)(2).

[7] Prop. Reg. § 1.163(j)-4(b)(4)(i).

[8] Prop. Reg. § 1.163(j)-4(b)(4)(ii).

[9] Prop. Reg. § 1.163(j)-4(b)(4)(iii). See Prop. Reg. § 1.163(j)-4(c)(4)(ii), Example 2.

[10] Prop. Reg. § 1.163(j)-1(b)(20)(i).

[11] *Id.*

[12] The proposed regulations reserve on the issue of cleared swaps.

[13] Prop. Reg. § 1.163(j)-1(b)(20)(ii).

[14] *Id.*

[15] Prop. Reg. § 1.163(j)-1(b)(20)(iii).

[16] Prop. Reg. § 1.163(j)-1(b)(20)(iv).

[17] Prop. Reg. § 1.163(j)-2(c)(1).

[\[18\]](#) Prop. Reg. § 1.163(j)-4(c)(1).

[\[19\]](#) Prop. Reg. § 1.163(j)-4(c)(2).

[\[20\]](#) Prop. Reg. § 1.163(j)-5(b)(2).

[\[21\]](#) *Id.*

[\[22\]](#) Prop. Reg. § 1.163(j)-4(b)(3)(i).

[\[23\]](#) *Id.*

[\[24\]](#) Prop. Reg. § 1.163(j)-4(b)(3)(ii).

[\[25\]](#) Prop. Reg. § 1.163(j)-7(b)(2).

[\[26\]](#) Prop. Reg. § 1.163(j)-7(d)(1)(i).