

**MEMO# 32657**

August 5, 2020

# IRS Issues Final Regulations on Section 163(j) Limitation on Interest Expense Deduction

[32657]

August 5, 2020 TO: ICI Members

Tax Committee SUBJECTS: Tax RE: IRS Issues Final Regulations on Section 163(j) Limitation on Interest Expense Deduction

The Treasury Department and the Internal Revenue Service (IRS) have issued [final 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).[\[1\]](#) 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 final regulations generally follow the proposed regulations on issues most relevant to regulated investment companies (RICs).[\[2\]](#) The final regulations, among other things, confirm the application of section 163(j) to regulated investment companies (RICs), as requested by the Institute.[\[3\]](#) The regulations also include other rules that could impact RICs.

The Treasury Department and the IRS also released [proposed regulations](#) under which a RIC that earns business interest income may pay “section 163(j) interest dividends” that certain shareholders may treat as interest income for purposes of section 163(j).[\[4\]](#) A separate member memorandum will cover the proposed regulations.

## Business Interest Income and Expense

The final regulations 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).[\[5\]](#)

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.

Like the proposed regulations, the final regulations specify that, solely for purposes of section 163(j), all interest expense of a taxpayer that is a C corporation is treated as properly allocable to a trade or business. Similarly, all interest income of a taxpayer that is a C corporation is treated as properly allocable to a trade or business.[\[6\]](#) The regulations also clarify that these rules apply to RICs.[\[7\]](#) Therefore, RICs are subject to the limitation under section 163(j) under the final regulations.

## **Calculation of ATI**

The final regulations 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 is treated as properly allocated to a trade or business.[\[8\]](#) These amounts thus are 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 is included in calculating the RIC's ATI.[\[9\]](#)

It 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. Like the proposed regulations, the final regulations clarify that ATI is a RIC's taxable income without any adjustment made under section 852(b)(2) to compute investment company taxable income.[\[10\]](#) Therefore, the 30 percent limitation is applied before the DPD. The regulations require, however, an increase to ATI by the amount of the dividends received deduction (DRD) calculated under section 243.[\[11\]](#)

## **Definition of Interest**

Like the proposed regulations, the final rules include an expansive definition of "interest" for purposes of section 163(j), with some modifications. In general, interest includes 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.[\[12\]](#) It includes, among other things, original issue discount (OID), qualified stated interest, and accrued market discount.[\[13\]](#)

As proposed, the definition of interest in the final regulations also includes certain swaps with significant nonperiodic payments. These swaps are treated as two separate transactions consisting of an on-market, level payment swap and an embedded loan.[\[14\]](#) The parties to the contract are required to account for the embedded loan independently of the swap, and the time value component associated with the loan is recognized as interest expense to the payor and interest income to the recipient. The final regulations provide exceptions to the embedded loan rule for cleared swaps and non-cleared swaps that require the parties to meet the margin or collateral requirements of a federal regulator or that provide for margin or collateral requirements that are substantially similar to a cleared swap or a non-cleared swap subject to the margin or collateral requirements of a federal regulator.[\[15\]](#) The final regulations also delay the applicability of these rules to give taxpayers time to implement necessary systems to apply these rules.

The final regulations also adopt special rules, as proposed, for other amounts that are treated as interest for purposes of section 163(j), including: bond issuance premium treated

as ordinary income or deductible bond premium; ordinary income or loss on debt instruments under the rules for a contingent payment debt instrument, a nonfunctional currency contingent payment debt instrument, or an inflation-indexed debt instrument; and section 1258 gain.[\[16\]](#)

The final regulations include in the definition of interest certain substitute interest payments, as originally proposed. In response to comments, however, the final regulations provide that a substitute interest payment is treated as interest expense to the payor only if the payment relates to a sale-repurchase or securities lending transaction that is not entered into by the payor in the payor's ordinary course of business. Further, a substitute interest payment is treated as interest income to the recipient only if the payment relates to a sale-repurchase or securities lending transaction that is not entered into by the recipient in the recipient's ordinary course of business.

Notably, the final regulations do not include in the definition of interest commitment fees or debt issuance costs, as was originally proposed. The final regulations also eliminate the proposed rules that would have included in the definition of interest any income, deduction, gain or loss from certain hedging transactions with respect to debt instruments. The anti-avoidance rules, however, may apply to such hedging transactions.

The final regulations modify the anti-avoidance rule in the proposed regulations to address issues raised by commenters. Notably, the final regulations now provide that any expense or loss economically equivalent to interest is treated as interest expense for purposes of section 163(j) if a principal purpose of structuring the transaction is to reduce an amount incurred by the taxpayer that otherwise would have been interest expense or treated as interest expense under the regulations under section 163(j).[\[17\]](#)

## **Interest Expense Carryforwards**

Pursuant to section 163(j)(2), the final regulations provide that any business interest expense that is disallowed in the current year is carried forward to the succeeding taxable year as business interest expense (subject to the limitation under section 163(j)).[\[18\]](#)

For C corporations, the regulations provide that the disallowance and carryforward of a deduction for business interest expense does not affect whether or when the business interest expense reduces the taxpayer's earnings and profits.[\[19\]](#) 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). Like the proposed regulations, the final rules provide a special rule for RICs. 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 does 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 is 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).[\[20\]](#)

RICs and other C corporations are 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.[\[21\]](#) They must 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).[22]

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

The final 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) is treated by that partner as business interest expense.[23] Similarly, any investment income or investment expenses that a partnership receives, pays, or accrues and that is allocated to a C corporation partner is treated by that partner as business income or expense.[24] This characterization at the C corporation partner level does not affect the characterization of these items as investment interest, investment income, or investment expenses at the partnership level.[25]

## **Application to Controlled Foreign Corporations**

The final regulations generally 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.[26] Thus, a CFC applies 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).

## **Effective Date**

The final regulations are effective 60 days after date of publication of the final regulations in the Federal Registrar.

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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. 31503, dated November 18, 2018 ([https://www.ici.org/my\\_ici/memorandum/memo31503](https://www.ici.org/my_ici/memorandum/memo31503)).

[3] 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)).

[4] See Institute Memorandum No. 31841, dated July 9, 2019. ([https://www.ici.org/my\\_ici/memorandum/memo31841](https://www.ici.org/my_ici/memorandum/memo31841)).

[5] Reg. § 1.163(j)-2(b).

[6] Reg. § 1.163(j)-4(b)(1).

[7] Reg. § 1.163(j)-4(a).

[8] Reg. § 1.163(j)-4(b)(2).

[9] Reg. § 1.163(j)-4(b)(4)(i).

[10] Reg. § 1.163(j)-4(b)(4)(ii).

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

[12] Reg. § 1.163(j)-1(b)(22)(i).

[13] *Id.*

[14] Reg. § 1.163(j)-1(b)(22)(ii)(A).

[15] Reg. § 1.163(j)-1(b)(22)(ii)(B).

[16] Reg. § 1.163(j)-1(b)(22)(iii).

[17] Reg. § 1.163(j)-1(b)(22)(iv).

[18] Reg. § 1.163(j)-2(c)(1).

[19] Reg. § 1.163(j)-4(c)(1).

[20] Reg. § 1.163(j)-4(c)(2).

[21] Reg. § 1.163(j)-5(b)(2).

[22] *Id.*

[23] Reg. § 1.163(j)-4(b)(3)(i).

[24] *Id.*

[25] Reg. § 1.163(j)-4(b)(3)(ii).

[26] Reg. § 1.163(j)-7(b).

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