Summary of proposed section 163(j) regulations

On November 26, 2018, the IRS and Treasury released proposed regulations (the “Proposed Regulations”) under new section 163(j), which was enacted by the Tax Cuts and Jobs Act (“TCJA”) and imposes limits on deductibility of “business interest.” Business interest subject to this limitation is carried forward and treated as business interest paid or accrued in the next succeeding taxable year (when it is again subject to the limitation). In general, new section 163(j) applies to taxable years beginning after December 31, 2017. This e-mail describes certain major provisions of the Proposed Regulations.

Except as otherwise provided in the Proposed Regulations, the regulations are generally proposed to be effective for taxable years ending after the date the U.S. Department of the Treasury (“Treasury”) decision adopting these regulations as final is published in the Federal Register. However, taxpayers and their related parties generally may apply rules in these regulations to a taxable year beginning after December 31, 2017, provided that the taxpayer and related parties consistently apply all rules of the Proposed Regulations and related provisions, as applicable, to those taxable years.

1. Deduction for Business Interest Expense Limited

**General.** Under section 163(j), the amount allowed as a deduction for business interest expense ("BIE") cannot exceed the sum of:

1. The taxpayer’s business interest income ("BII") for the taxable year;
2. 30 percent of the taxpayer’s adjusted taxable income ("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 for the taxable year.

2. Definition of Interest

**General.** Prop. Treas. Reg. § 1.163(j)-1(b)(20) defines interest expansively and includes items not traditionally considered interest. The definition of interest contains four categories, with specific items identified in certain categories:

- **Interest on indebtedness and items treated as interest under the Code and regulations.** This includes, for example, original issue discount, market discount, repurchase premium, interest on deferred payments under section 483, and amounts treated as interest under section 467 rental agreements.

- **Significant non-periodic payments on swaps.** The Proposed Regulations provide that significant non-periodic payments on non-cleared swaps (generally, swaps that are not cleared through a derivatives clearing organization) are treated as a deemed loan. The time value component of the deemed loan, as determined under the existing notional principal contract regulations in Treas. Reg. § 1.446-3(f), is treated as interest expense to the payor and interest income to the recipient. The Proposed Regulations reserve on the treatment of cleared swaps. The Proposed Regulations also would amend Treas. Reg.
§ 1.446-3(g)(4) to direct taxpayers to this definition for the treatment of significant nonperiodic payments.

- **Other amounts treated as interest.** This category includes:
  - Issuance premium within the meaning of Treas. Reg. § 1.163-13 and amortizable bond premium deductible under section 171(a)(1);
  - Ordinary income or loss with respect to certain debt, including contingent payment debt instruments;
  - Substitute interest payments made pursuant to securities lending or repo transactions;
  - Any gain treated as ordinary under a section 1258 conversion transaction;
  - Income, deduction, gain, or loss from a derivative (as defined in section 59A(h)(4)(A)) that alters the borrower’s cost of borrowing with respect to a liability of the borrower (e.g., interest rate swaps), or that alters a taxpayer’s effective yield with respect to a debt instrument held by the taxpayer;
  - Loan commitment fees if any portion of the commitment is drawn upon;
  - Debt issuance costs subject to Treas. Reg. § 1.446-5;
  - Guaranteed payments for the use of capital from a partnership under section 707(c); and
  - Income on factored receivables.

- **Anti-avoidance rule.** Any deductible expense or loss incurred by a taxpayer in a transaction or series of integrated or related transactions in which the taxpayer secures funds for a period of time is treated as interest expense if the expense or loss is predominantly incurred in consideration of the time value of money.

**Capitalized interest.** Interest expense capitalized under section 263A and section 263(g) generally is capitalized into the basis of assets rather than treated as interest expense for purposes of section 163(j).

3. **Definition of Adjusted Taxable Income**

   **General.** Under the statute, ATI is based on taxable income without regard to certain adjustments, including (i) non-business items; (ii) BIE and BII; (iii) any NOL deduction under section 172; (iv) any deduction under section 199A; and (v) for taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion. The statutory language also provided authority to the Secretary to add other adjustments.

   The definition of ATI in Prop. Treas. Reg. § 1.163(j)-1(b) generally tracks the statute with the following clarifications and additional adjustments. See Part 10 for international provisions that make further adjustments to ATI.

   **Additions:**
   - Consistent with the statute, for taxable years beginning before January 1, 2022, any deduction for depreciation under section 167 or section 168; any deduction for the amortization of intangibles (for example, under section 167 or 197) and other amortized expenditures (for example, under section 195(b)(1)(B), 248, or 1245(a)(2)(C)); and any deduction for depletion under section 611.
   - Any deductions for a capital loss carryback or carryover.
Subtractions:

- Floor plan financing interest expense.

- With respect to the sale or other disposition of property, the lesser of (i) any gain recognized on the sale or other disposition of such property, and (ii) any depreciation, amortization, or depletion deductions for the taxable years beginning after December 31, 2017, and before January 1, 2022, with respect to such property ("depreciation addback adjustment"). This adjustment has the general effect of reducing an increase to ATI upon a disposition of property by adding back depreciation, amortization, or depletion deductions with respect to such property.

- Consistent with the depreciation addback adjustment, the disposition of a partnership interest or stock of a consolidated group member by another member increases the basis of the disposed-of-interest, generally by the amount of the depreciation addback adjustment included in a partner’s distributive share (for partnerships) or reflected in stock basis through investment adjustments (for a consolidated group member).

The Proposed Regulations also provide that a depreciation, amortization, or depletion expense capitalized to inventory under section 263A is not a depreciation, amortization, or depletion deduction for purposes of determining ATI. The term inventory means property held for sale or for lease, or both, by a taxpayer in the ordinary course of its trade or business.

Other adjustments to ATI may be required specific to the type of entity subject to the section 163(j) limitation, for example, for regulated investment companies ("RICs") and real estate investment trusts ("REITs"), partnerships, or the type of item. With respect to RICs and REITs, the rules make clear that the taxpayer’s ATI is increased by the dividends paid deduction.

4. General Operating Rules

**Disallowed BIE carryforward.** Disallowed BIE is carried forward to the next taxable year as BIE. The carried forward BIE is treated as paid or accrued and subject to the section 163(j) limitation in the next taxable year. If the disallowed BIE is carried to a year in which the small business exemption applies to the taxpayer, the section 163(j) limitation does not apply to limit deductibility of interest in that taxable year. See Part 11 for a discussion of the treatment of interest expense disallowed under section 163(j) as enacted prior to the TCJA ("old section 163(j)").

**Small business exemption.** The section 163(j) limitation does not apply if the taxpayer, other than a tax shelter (within the meaning of section 448(d)(3)), meets the gross receipts test of section 448(c) and the section 448(c) regulations (applied as if the taxpayer were a corporation or partnership). An entity meets the gross receipts test if the annual average gross receipts over the preceding three years does not exceed $25 million. An individual’s gross receipts generally includes all items except for “inherently personal amounts.” Generally, each partner in a partnership includes a share of partnership gross receipts in proportion to the partner’s distributive share of items of gross income that were taken into account by the partnership. Similarly, each shareholder in an S corporation includes a pro rata share of the S corporation’s gross receipts. BIE of a partnership or S corporation that qualifies for the small business exemption is subject to the section 163(j) limitation at the partner or S corporation shareholder level. A partner or S corporation shareholder includes items of income, gain, loss, or deduction from the exempt entity when calculating its ATI and also includes its share of BII from the entity.

**Certain beneficiaries.** The ATI of a trust or estate beneficiary is reduced by any income (including any distributable net income) received from the trust or estate by the beneficiary to the extent the income supported a deduction for BIE in computing the trust or estate’s taxable income.

**Relationship of business interest deduction limitation to other provisions affecting interest.** Prop. Treas. Reg. § 1.163(j)-3 provides coordination rules for the interaction between
section 163(j) and other interest deferral, disallowance, or capitalization provisions. Similar to old section 163(j), section 163(j) generally applies only after the application of other provisions that defer or disallow BIE. Accordingly, deferred interest is treated as interest expense for section 163(j) in the year it becomes deductible under other Code provisions. Any permanently disallowed interest under another provision generally is not treated as interest expense for purposes of section 163(j). Notwithstanding the general rule, the Proposed Regulations provide that the section 163(j) limitation applies before the at-risk, passive activity, and new section 461(l) limitations on losses.

Treatment of REMIC interest expense. The Proposed Regulations make clear that the interest expense of a real estate mortgage investment conduit ("REMIC") is not limited pursuant to section 163(j).

Definition of excepted trades or businesses. An "Excepted Trade or Business" includes the trade or business of performing services as an employee, any electing real property trade or business, any electing farming business, and any excepted regulated utility trade or business. A "Non-Excepted Trade or Business" is any trade or business that is not an Excepted Trade or Business.

5. Corporations

General. The Proposed Regulations provide that, solely for purposes of section 163(j), a C corporation can have only BIE and BII (and not investment income or expense). In addition, the regulations provide that a C corporation's items of income, gain, deduction, or loss is properly allocable to a trade or business and, thus, taken into account in determining ATI, unless allocable to an Excepted Trade or Business.

The general treatment of a C corporation extends to items allocated to a corporate partner from a partnership, even if the items constitute investment items at the partnership level. Thus, a partnership's allocation of investment interest (within the meaning of section 163(d)) to a C corporation partner is treated as BIE at the partner level. The general rule is subject to a limited exception for certain allocations of a domestic partnership's inclusions under section 951(a) (subpart F income) or section 951A(a) (GILTI) that are treated as investment income items at the partnership level. See Part 10 for further discussion of these provisions.

Earnings & Profits ("E&P"). The Proposed Regulations provide that a C corporation's E&P is determined without regard to the disallowance of BIE under section 163(j) and, thus, generally a C corporation reduces its E&P upon the accrual or payment of interest. In addition, if a C corporation is allocated excess business interest expense ("EBIE") from a partnership, it must increase E&P upon the disposition of all or substantially all of its partnership interest to reflect the amount of EBIE not yet treated as paid or accrued by the corporation.

Ordering rule for carryforwards of disallowed BIE. In general, section 163(j)(2) provides that any BIE limited under section 163(j) will be carried forward as a "disallowed BIE carryforward," and treated as paid or accrued in the succeeding taxable year. The Proposed Regulations provide an ordering rule for absorbing allowable BIE as between (i) current-year BIE (i.e., interest expense deductible in the current taxable year without regard to section 163(j) and that is not a disallowed BIE carryforward), and (ii) disallowed BIE carryforwards from a prior taxable year (including, for this purpose, "disallowed disqualified interest expense" under old section 163(j)). Specifically, a C corporation's current-year BIE is deducted before any carryforwards, with carryforwards deducted in the order in which they arose, with the earliest taxable year first. Similar rules apply for consolidated groups.

Section 381(a) transactions. The TCJA added section 381(c)(20), which treats the carryover of disallowed BIE under section 163(j)(2) as an item to which the acquiring corporation succeeds in a section 381(a) transaction, i.e., a liquidation described in section 332 and certain reorganizations described in section 368. The Proposed Regulations clarify that the carryover item includes disallowed BIE from the taxable year ending on the date of distribution or transfer, as
disallowed BIE carryforwards. The Proposed Regulations limit the ability of the acquiring corporation to use carryforwards in its first taxable year ending after the acquisition, consistent with treatment of NOL carryforwards under Treas. Reg. §§ 1.381(c)(1)-1 and -2. For example, the limitation in section 381(c)(1)(B) for NOLs is applied similarly to carryforwards of disallowed BIE, with the acquiring corporation limited in utilizing a distributor’s or transferor’s carryforwards to an amount equal to the “post-acquisition portion” of the acquiring corporation’s section 163(j) limitation.

6. Consolidated Return Rules

**General.** The Proposed Regulations apply the section 163(j) limitation at the consolidated group level, with the consolidated group generally having a single section 163(j) limitation. The treatment of consolidated groups does not extend to affiliated, non-consolidated entities, nor to partnerships even if they are wholly owned by consolidated group members.

**The group’s section 163(j) limitation.** The Proposed Regulations provide for specific rules in determining a consolidated group’s section 163(j) limitation and a member’s BIE and BII:

- In determining whether amounts are treated as interest, other than amounts in respect of intercompany obligations (as defined in Treas. Reg. § 1.1502-13(g)), and intercompany items and corresponding items (as defined in Treas. Reg. § 1.1502-13(b)(2) and (b)(3), respectively), all members of a consolidated group are treated as a single taxpayer.
- Intercompany obligations are disregarded and, thus, a member’s BIE, BII, and ATI with respect to an intercompany obligation are ignored.
- A group’s current-year BIE and BII is the sum of the current-year BIE and BII of each of its members.
- The ATI of a consolidated group is calculated based on the group’s consolidated taxable income determined under Treas. Reg. § 1.1502-11, without regard to any disallowed BIE carryforwards or disallowances under section 163(j). To avoid circularity in application, special rules are provided if the group is eligible for a deduction under section 250(a)(1).
- Intercompany items and corresponding items for an intercompany transaction are disregarded in determining ATI to the extent those items offset in amount.

**Basis adjustments.** The Proposed Regulations cross-reference the general rules under Treas. Reg. § 1.1502-32 for basis adjustments to the stock of a member with disallowed BIE, suggesting that an adjustment in a member’s stock for its disallowed current-year BIE does not occur until the expense is absorbed.

**Allocation of section 163(j) limitation to group members.** The Proposed Regulations allocate the consolidated group’s section 163(j) limitation for each taxable year to individual members under the rules described below. This allocation defines the portion of the member’s BIE that may be absorbed by the consolidated group and, in turn, the amount of BIE a member can carry to a separate return year. In general, the approach is as follows:

- If a consolidated group’s section 163(j) limitation is equal to or greater than the aggregate amount of BIE—including disallowed BIE carryforwards—of its members, then each member deducts its BIE without limitation under section 163(j), with current-year BIE deducted first.
- If the consolidated group’s section 163(j) limitation is less than this aggregate amount, then the limitation applies first to current-year BIE and then to disallowed BIE carryforwards as follows.

**Current-year BIE**
If the section 163(j) limitation equals or exceeds the aggregate amount of current-year BIE of group members, each member deducts its current-year BIE without limitation under section 163(j). Any remaining section 163(j) limitation is applied to disallowed BIE carryforwards (see below). If the section 163(j) limitation is less than this aggregate amount, then each member first deducts its current-year BIE up to its own BII and floor plan financing interest for the year, with its remaining current-year BIE deducted (subject to the remaining limitation) on a pro rata basis, based on a member’s relative amount of the group’s remaining current-year BIE.

- **Disallowed BIE carryforward.** After applying the foregoing rules, the remaining section 163(j) limitation, if any, applies to disallowed BIE carryforwards, with each member deducting (subject to the remaining limitation) such carryforwards on a pro rata basis, beginning with the earliest year, based on a member’s relative amount of the group’s disallowed BIE carryforwards.

Any member with remaining BIE carries such expense forward as a disallowed BIE carryforward.

**Departing members of a consolidated group.** The Proposed Regulations provide that a departing consolidated group member retains, to the extent not utilized or otherwise reduced, its current-year BIE through the date of its departure, as well as its disallowed BIE carryforwards. These amounts are carried to the departing member’s first separate return year. The approach is somewhat consistent with the treatment of NOLs under Treas. Reg. § 1.1502-21(b). In this regard, a departing member’s current-year BIE and carryforwards are available to offset consolidated taxable income in the taxable year of departure.

**The SRLY limitation.** In general, the so-called separate return limitation year ("SRLY") limitation in Treas. Reg. § 1.1502-21(c) limits the amount of a member’s NOLs arising in a SRLY (defined in Treas. Reg. § 1.502-1(f)) that may be absorbed by the consolidated group, to the amount of the member’s cumulative contribution to the group’s net income (determined, in certain cases, on a subgroup basis). The Proposed Regulations apply a similar concept to a member’s disallowed BIE carryforwards arising in a SRLY. Because the section 163(j) limitation is determined annually, however, a member applies the limitation on an annual basis, and generally by reference to the member’s standalone section 163(j) limitation. The Proposed Regulations provide certain other rules and limitations in applying a SRLY concept to disallowed BIE carryforwards. In addition, the Proposed Regulations apply a similar overlap rule as in Treas. Reg. § 1.1502-21(g) for NOL carryforwards, to prevent both section 382 and the SRLY limitation from applying to the same carryforward.

**Transition rules for members joining a group.** In general, new section 163(j) applies to taxable years beginning after December 31, 2017. The Proposed Regulations provide for a transition rule for members joining a consolidated group, in which the status of the acquiring group controls the application of section 163(j) to the joining member for the period of membership.

**Treas. Reg. § 1.1502-36: The Unified Loss Rule.** Treas. Reg. § 1.1502-36—referred to as the unified loss rule—provides rules to reduce the basis in the loss stock of a member or to reduce its attributes, including a deferred deduction, upon certain dispositions of the stock. The Proposed Regulations treat disallowed BIE as a deferred deduction for purposes of Treas. Reg. § 1.1502-36 that may be potentially reduced under Treas. Reg. § 1.1502-36(d).

**Excepted and Non-Excepted Trades or Businesses.** As discussed below in Part 12, Prop. Treas. Reg. § 1.163(j)-10 provides the exclusive rules for allocating tax items between Excepted Trades or Businesses and Non-Excepted Trades or Businesses for purposes of section 163(j). Under the Proposed Regulations, the distinction between Excepted and Non-Excepted Trades or Businesses applies at the level of the trade or business, not at the level of a consolidated group member; thus,
the allocation rules apply without regard to which member conducts a trade or business or possesses assets used in a trade or business.

After a consolidated group has determined the percentage of the group’s interest expense that is allocable to an Excepted Trade or Business, this exempt percentage applies proportionally to each member that has paid or accrued interest to a non-member during the taxable year. Thus, in general, each member with interest paid or accrued to such a lender has the same percentage of interest allocable to Excepted Trades or Businesses, regardless of whether any particular member actually engages in an Excepted Trade or Business.

**Transfers of partnership interests in intercompany transactions.** As discussed below, under section 163(j)(4)(B)(iii), the adjusted basis of a partner’s interest in a partnership is reduced by the amount of EBIE allocated to the partner, and is increased upon a sale of all or substantially all of the partnership interest by the amount of any such EBIE that was not treated as paid or accrued at the partner level. The Proposed Regulations provide that a transfer of a partnership in an intercompany transaction—not resulting in the termination of the partnership—is treated as a disposition for such purposes, regardless of whether gain or loss is recognized. In addition, the regulations provide that the reduction and increase (as described above) in the member-partner’s basis in its partnership interest does not result in a stock basis adjustment in the stock of the member. A stock basis adjustment occurs when the EBIE is absorbed by the consolidated group. The Proposed Regulations reserve on the treatment of an intercompany transfer of a partnership interest that terminates the partnership.

7. **Section 382 Issues**

**General.** In general, section 382 limits a loss corporation’s ability to utilize its pre-change losses to reduce its taxable income in a post-ownership change taxable year. The TCJA expands the definition of a loss corporation under section 382(k)(1) to include a corporation entitled to use a carryforward of disallowed interest described in section 381(c)(20), and treats a carryover of BIE as a “pre-change loss” described in section 382(d)(3), under rules similar to those for NOLs in section 382(d)(1). The Proposed Regulations provide that the pre-change loss includes the portion of any disallowed BIE of the loss corporation paid or accrued in the taxable year during which there is a change of ownership (i.e., section 382 applies to both disallowed BIE carryforwards and the portion of the current year BIE before the ownership change, referred to collectively as the "section 382 disallowed business interest expense [BIE] carryforward"). For this purpose, the Proposed Regulations require a ratable allocation of current year interest expense regardless of whether the corporation makes a closing-of-the-books election under Treas. Reg. § 1.382-6(b)(2) to allocate its other items.

The Proposed Regulations reserve on treatment of EBIE including “negative section 163(j) expense” (discussed below) under section 382, and may publish separate proposed regulations on this issue and other section 382 issues.

**Ordering rules for utilizing pre-change losses and credits.** In general, section 383 and Treasury regulations thereunder apply the section 382 limitation to certain credits and net capital losses, and provide an ordering rule under which generally pre-change capital losses are absorbed first, before NOLs and recognized built-in losses ("RBILs"), other pre-change losses, and then pre-change credits. The Proposed Regulations generally provide that the section 382 disallowed business interest carryforward (with alternative rules, depending on the timing of the ownership change) is absorbed after pre-change capital losses and RBILs, but before NOLs. The preamble notes that this ordering allows taxable income to be determined—with allowable interest deductions taken into account—before determining the amount of the NOL that can be utilized.

In addition, the Proposed Regulations provide that a corporation’s taxable income is offset first by section 382-limited losses before using losses of the same type from the same taxable year that are not subject to a section 382 limitation. This rule applies to a section 382 disallowed BIE carryforward, e.g., so that it is used before disallowed BIE not subject to the limitation.
Amendments to the consolidated section 382 provisions. The Proposed Regulations add a new coordination rule in Treas. Reg. § 1.1502-98(b) pursuant to which the rules of Treas. Reg. §§ 1.1502-91 through 1.1502-96 apply to BIE, including disallowed BIE carryforwards, of members of a consolidated group (or corporations that join or leave a consolidated group), with appropriate adjustments.

Effective date. The Proposed Regulations provide for specific effective date rules for section 382-related provisions in the regulations.

8. Partnerships

General principles and additional definitions. Section 163(j)(4) provides that the section 163(j) limitation is applied at the partnership or S corporation level. The partnership determines its own ATI, BIE, and BII and calculates its own section 163(j) limitation. To the extent the partnership has EBIE (net BIE in excess of the section 163(j) limitation), that EBIE is allocated to the partners. Conversely, if the partnership has ETI or EBII, the ETI or EBII is also allocated to the partners.

If a partnership has deductible BIE (i.e., BIE that is less than or equal to the section 163(j) limitation), that allocation of deductible BIE is not again subject to section 163(j) at the partner level. For all other purposes of the Code, deductible BIE and EBIE retain their character as BIE at the partnership level. For example, for purposes of section 469, the deductible BIE (i) retains its character as either passive or non-passive in the hands of the shareholder, and (ii) remains interest derived from a trade or business in the hands of a shareholder even if the shareholder does not materially participate in the S corporation’s trade or business activity.

In addition to the definitions in Prop. Treas. Reg. § 1.163(j)-1, additional definitions are provided for purposes of Prop. Treas. Reg. § 1.163(j)-6.

- **Interest.** As noted above, the definition of interest in Prop. Treas. Reg. § 1.163(j)-1 provides that any guaranteed payments for the use of capital under section 707(c) are treated as interest. However, the preamble provides that the IRS and Treasury intend to adopt rules for the proper treatment of BII and BIE with respect to lending transactions between a passthrough entity and an owner of the entity, to prevent such income and expense with respect to such owner from entering into the section 163(j) calculations for both parties.

- **Section 163(j) items.** A partnership’s or an S corporation’s BIE, BII, and component items of ATI.

- **Section 163(j) excess items.** A partnership’s EBIE, ETI, and EBII.

- **Partner basis items.** Any items of income, gain, loss, or deduction resulting from either an adjustment to the basis of partnership property used in a Non-Excepted Trade or Business made pursuant to section 743(b) or section 704(c)(1)(C)(i).

- **Remedial items.** Any allocation to a partner of remedial items of income, gain, loss, or deduction pursuant to section 704(c) and Treas. Reg. § 1.704-3(d).

Computation of partnership ATI. For purposes of computing ATI, taxable income of the partnership is determined under section 703(a). Section 734(b) adjustments are taken into account for purposes of calculating partnership ATI. Partner basis items (i.e., section 743(b) and section 704(c)(1)(C)(i) items) and remedial items are not taken into account in determining partnership’s ATI.

Computation of partner ATI. A partner’s ATI is determined in accordance with the general definition of ATI and without regard to the partner’s distributive share of any items of income, gain, deduction, or loss of the partnership. The partner’s ATI is increased by the partner’s share of partnership ETI. Partner basis items and remedial items are taken into account as items derived directly by the partner. If a partner recognizes gain or loss upon the disposition of its partnership
interest, and that partnership owns only Non-Excepted Trade or Business assets, the gain or loss on the disposition is included in partner’s ATI. If a partner sells a partnership interest and the partnership in which the interest is being sold owns both excepted assets and non-excepted assets, the partner will generally use the method set forth in Prop. Treas. Reg. § 1.163(j)-10(c) in order to determine the amount properly allocable to a Non-Excepted Trade or Business, and therefore, properly includible in the partner’s ATI.

**Allocation of partnership items to partners.** Allocations of section 163(j) items are made in the same manner as “nonseparately stated taxable income or loss.” The Preamble notes that the phrase “nonseparately stated taxable income or loss” is not defined in section 163(j) or other sections of the Code. If allocations and determinations are made in accordance with the 11-step calculation in Prop. Treas. Reg. § 1.163(j)-6(f), the allocations and determinations of deductible BIE and section 163(j) excess items are considered made in the same manner as the nonseparately stated taxable income or loss of the partnership. These rules are only required for purposes of determining the allocation of section 163(j) items and do not change the partnership’s section 704(b) allocations.

The 11-step calculation provides a framework for a partnership to allocate section 163(j) items to its partners that takes into account the varying economic arrangements, including special allocations. At the conclusion of the 11 steps, the total amount of deductible BIE and section 163(j) excess items allocated to each partner will equal the partnership’s total deductible BIE and section 163(j) excess items. Generally, the partnership first does a partnership-level calculation of its section 163(j) limitation and then determines how the items comprising ATI, BIE, and EBII are allocated to the partners for section 704(b) purposes. The partnership then determines which partners are deemed to receive allocations of EBIE, ETI, or BII, as the case may be, through a series of calculations that are intended to allocate items among partners and correct distortions that may arise as a result of differing allocations of section 704(b) items among the partners.

All partnerships that pay interest or interest-like items and are subject to 163(j) will need to perform the 11-step calculation, even if the partnership’s interest deduction is not limited at the partnership level.

**Carryforwards and basis adjustments.** The amount of BIE limited by section 163(j) and not allowed as a deduction is treated as EBIE and is allocated to the partners under the 11-step calculation. If a partner is allocated ETI or excess business interest income ("EBII") from the same partnership, EBIE is treated as BIE paid or accrued by the partner in that taxable year in which the ETI or EBII is allocated. That amount treated as paid or accrued is then combined with the partner’s other items of BII and BIE and subject to the section 163(j) limitation at the partner level. The adjusted basis of a partner in the partnership is reduced, but not below zero, for EBIE allocated to the partner.

- **Basis adjustments – coordination with section 704(d).** Deductible BIE and EBIE are subject to section 704(d). Section 704(d) limits a partner’s ability to deduct its distributive share of partnership loss to the partner’s adjusted basis in its partnership interest, because the partner’s basis cannot be reduced below zero. Section 704(d) losses are suspended until the partner has sufficient additional adjusted basis in its partnership interest. If a partner is allocated BIE or EBIE that is limited under section 704(d), that loss is suspended as a “negative section 163(j) expense.” For purposes of determining which interest expense is limited by section 704(d), deductible BIE is taken into account before EBIE. Thus, section 704(d) may disproportionately limit EBIE while allowing deductible BIE to flow through to the partner to the maximum extent possible.

If a partner has a negative section 163(j) expense, that amount is not affected by an allocation of ETI and is not treated as EBIE in a subsequent year until the negative 163(j) expense is no longer suspended under section 704(d) (i.e., the partner is allocated sufficient items of income or gain to increase its outside basis to allow the trapped EBIE).
If a partner is allocated ETI and has a negative section 163(j) expense, that ETI is included in ATI until the negative section 163(j) expense is no longer suspended.

- **Basis adjustments – upon disposition.** If a partner disposes of all or substantially all of its interest (whether by sale, exchange, or redemption), the adjusted basis of the partner’s interest in the partnership is increased immediately before disposition by (i) the amount of any basis reduction for EBIE allocated to the partner, less (ii) any amount of EBIE that has been treated as interest paid or accrued by the partner in any year due to an allocation of ETI or EBII. No basis increase is allowed for any negative section 163(j) expense (because the partner’s basis was never decreased by that amount). This rule applies to both taxable and non-taxable dispositions. The Proposed Regulations also provide rules for the consequences of intercompany transfers of partnership interests within a consolidated group, and those rules are discussed in Part 6.

If a partner disposes of less than substantially all of its interest in a partnership (whether by sale, exchange, or redemption), the partner does not increase its basis in its partnership interest. Any EBIE remains EBIE in the hands of the partner until the partner is allocated ETI or EBII or until the partner disposes of all or substantially all of its partnership interest. Negative section 163(j) expense remains negative section 163(j) expense. This rule applies to both taxable and non-taxable dispositions.

**Excepted Trade or Business.** If a partnership is an excepted entity because it operates an Excepted Trade or Business (i.e., the trade or business of performing services as an employee, an electing real property trade or business, an electing farming business, or an excepted regulated utility trade or business), the excepted entity does not calculate a section 163(j) limitation. Any section 163(j) item that is allocable to the partnership’s Excepted Trade or Business are excluded from the partner’s section 163(j) deduction calculation. As discussed in detail in Part 12 below, Prop. Treas. Reg. §1.163(j)-10(c) provides rules for the allocation between Excepted Trades or Businesses and Non-Excepted Trades or Businesses.

**Carryforwards prior to not being subject to section 163(j).** If a partnership allocates EBIE to its partners and later the partnership becomes not subject to section 163(j), the EBIE is treated as paid or accrued by the partner in such succeeding taxable year. That amount is then subject to the partner’s section 163(j) limitation.

**Items on which guidance is reserved.** Certain items were specifically reserved upon in the Proposed Regulations:
- Tiered partnerships.
- Partnership mergers and divisions.
- Self-charged interest.

9. **S corporations**

**General.** The section 163(j) limitation is applied at the S corporation level, and the S corporation determines the amount of deductible BIE under the general rule in Prop. Treas. Reg. § 1.163(j)-2(b). If an S corporation has deductible BIE, that BIE is not again subject to section 163(j) at the S corporation shareholder level. For all other purposes of the Code, however, deductible BIE retains its character as BIE at the shareholder-level. For example, for purposes of section 469, the deductible BIE (i) retains its character as either passive or non-passive in the hands of the shareholder, and (ii) remains interest derived from a trade or business in the hands of a shareholder even if the shareholder does not materially participate in the S corporation’s trade or business activity.

**Allocation of ETI and EBII by S corporations.** Because S corporations are required under section 1366(a)(1) to make pro rata allocations to their shareholders, allocations of ETI and EBII by
EBIE of an S corporation. Unlike EBIE of a partnership, which is allocated to and becomes an attribute of the partners, EBIE of an S corporation is an S corporation attribute that is carried forward to succeeding taxable years of the S corporation. The EBIE is subject to the same ordering rules as a C corporation that is not a member of a consolidated group, as well as the limitation under section 382. Accordingly, an S corporation shareholder’s basis and accumulated adjustment account is not reduced until the EBIE is deductible at the S corporation level. If an S corporation has an EBIE carryforward in the year the S corporation terminates, the EBIE will be carried forward to the succeeding C corporation taxable year. The Preamble notes that the government felt constrained by section 163(j)(4)(D), which did not reference section 163(j)(4)(B), and the legislative history to section 163(j) in extending the principles of section 163(j)(4)(B) to S corporations. They did, however, request comments on adopting a framework for S corporations consistent with the framework applicable to partnerships, including the authoritative support for this alternative approach.

ATI of S corporation shareholder. The Proposed Regulations provide rules for how an S corporation’s income is included in its shareholders’ ATI, how gain or loss from the sale of stock of an S corporation is included in a shareholder’s ATI, and to prevent double counting of BII and floor plan financing interest expense.

- The ATI of an S corporation shareholder is determined without regard to its distributive share of the S corporation’s items of income, gain, deduction, or loss, and is increased by the shareholder’s distributive share of the S corporation’s ETI. Gain or loss from the disposition of stock in an S corporation that owns only Non-Excepted Trade or Business assets is included in the shareholder’s ATI.

  If the S corporation owns (i) non-excepted assets and excepted assets, (ii) investment assets, or (iii) both, the shareholder determines the proportionate share of the amount properly allocable to a Non-Excepted Trade or Business (and includable in its ATI) under Prop. Treas. Reg. 1.163(j)-10(c)(5)(ii)(B)(3).

- For purposes of calculating an S corporation shareholder’s section 163(j) limitation, the shareholder does not include (i) BII from an S corporation that is subject to section 163(j) except to the extent it is allocated EBII from that S corporation, and (ii) the shareholder’s share of the S corporation’s floor plan financing interest expense.

Carryforwards prior to not being subject to section 163(j). If an S corporation has a disallowed BIE carryforward and becomes not subject to section 163(j), that amount continues to be carried forward at the S corporation level, is no longer subject to the section 163(j) limitation, and is taken into account in determining the nonseparately stated taxable income or loss of the S corporation.

10. International

Calculation of ATI and section 250 deduction. The Proposed Regulations provide that if a taxpayer is allowed a deduction under section 250(a)(1), the taxpayer should take into account the deduction when computing ATI, but the taxable income limitation in section 250(a)(2) does not apply for this purpose. Taxpayers, however, may be required to add back the section 250(a)(1) deduction to the extent that some or all of the deduction is attributable to an inclusion under section 951A (GILTI).

Application to CFCs in computing GILTI and subpart F. The Proposed Regulations provide a general rule that section 163(j) applies to determine the deductibility of a CFC’s BIE in the same manner as those provisions apply to determine the deductibility of a domestic C corporation’s BIE. Thus, each CFC with BIE separately applies section 163(j) to determine the extent to which that expense is: (i) deductible for purposes of computing subpart F income as defined under section 952,
(ii) tested income as defined under section 951A(c)(2)(A), and (iii) income which is effectively connected with the conduct of a U.S. trade or business ("ECI"), as applicable.

The Proposed Regulations provide for an election, which is intended to address CFC-to-CFC lending and borrowing situations, to apply an alternative method that effectively aggregates groups of CFCs with common ownership for certain purposes of the section 163(j) limitation. These rules limit the amount of BIE of a CFC group member subject to the section 163(j) limitation to the amount of the CFC group member’s allocable share of the CFC group’s applicable net BIE.

Thus, if an election is made to apply the alternative method and if a CFC group has only intercompany debt within the CFC group, then the amount of the CFC group’s applicable net BIE is zero, and no BIE of any CFC group member would be subject to the section 163(j) limitation. Special rules are provided for tiering up any ETI of a lower tier CFC to an upper tier CFC.

- "Applicable net BIE" of a CFC group is the excess, if any, of the sum of the amounts of BIE of each CFC group member over the sum of the amounts of BII of each CFC group member.
- "CFC group member’s allocable share" is computed by multiplying the applicable net BIE of the CFC group by a fraction, the numerator of which is the CFC group member’s net BIE (computed on a separate company basis), and the denominator of which is the sum of the amounts of the net BIE of each CFC group member with net BIE (computed on a separate company basis).
- "CFC group" means two or more CFCs (other than a CFC that has ECI and a CFC that conducts a financial services business), if at least 80 percent of the stock by value of each CFC is owned, within the meaning of section 958(a), by a single U.S. shareholder or, in aggregate, by related U.S. shareholders that own stock of each member in the same proportion.
  - For purposes of identifying a CFC group, members of a consolidated group are treated as a single person, as are individuals filing a joint return, and stock owned by certain passthrough entities is treated as owned by the owners or beneficiaries of the passthrough entity.
  - In addition, the regulations generally treat a controlled partnership (in general, a partnership in which CFC group members own, in aggregate, at least 80 percent of the interests) as a CFC group member and the interest in the controlled partnership is treated as stock for purposes of these rules.

- Special Rule for Financial Services Group: If one or more CFC group members conduct a financial services business, the alternative method is applied by treating those entities as comprising a separate subgroup.

**Computing ATI of a U.S. shareholder.** Ostensibly to avoid double counting of the taxable income of a CFC already taken into account to determine the CFC’s section 163(j) limitation, Prop. Treas. Reg. § 1.163(j)-7(d)(1)(i) provides the general rule (the "double counting rule") that the ATI of a U.S. shareholder is computed without regard to any amounts included in gross income under section 78, section 951(a), and section 951A(a).

If a U.S. shareholder owns directly (or indirectly through one or more foreign partnerships) stock of a CFC group member that is the first tier CFC of a group that has made a CFC group election ("specified highest-tier member"), and the specified highest-tier member has CFC excess taxable income that is treated as being attributable to taxable income of the CFC group that resulted in the U.S. shareholder having specified income inclusions, the U.S. shareholder may add to its taxable income an amount equal to its proportionate share of the eligible CFC group excess taxable income of the specified highest-tier member and any other highest-tier members (the "addback rule").
However, if a U.S. shareholder of a CFC group member with a CFC group election in effect is a domestic partnership (a U.S. shareholder partnership), the addback rule does not apply to determine the ATI of the U.S. shareholder partnership. Its partners that are domestic C corporations may be eligible to apply the addback rule, which is applied by treating the partnership as foreign.

To determine the amount of eligible CFC group ETI of a specified highest-tier member, its the CFC excess taxable income is multiplied by the specified ETI ratio. The specified ETI ratio is a fraction (expressed as a percentage) that compares the amounts of taxable income of each specified highest-tier member and each specified lower-tier member of the specified highest-tier member to the portions of such taxable income that gave rise to inclusions under section 951(a) or 951A(a). The specified ETI ratio includes in the numerator and the denominator of the fraction only taxable income amounts with respect to CFC group members that have CFC ETI without regard to the “roll up” of CFC excess taxable income from a lower-tier member. The purpose of the specified ETI ratio is to address the fact that income that is neither subpart F income nor tested income to the extent of GILTI is included in ATI at the CFC level and therefore may be used by an upper-tier CFC group member. However, the addition to taxable income under the addback rule is limited to the portion of the section 951 and section 951A inclusions, all of which are subtracted from taxable income of any U.S. shareholder under the double-counting rule, that is with respect to CFC group members that generated CFC ETI, reduced by the portion of any specified section 250 deduction that is allowable by reason of such specified deemed inclusions.

Rules for foreign persons with ECI. Prop. Treas. Reg. § 1.163(j)-8 provides that a non-resident alien individual and non-CFC foreign corporations with ECI will apply section 163(j) subject to certain modifications. If the foreign corporation is a CFC with ECI, it first applies the general rules for determining its disallowed interest expense, which is then allocated between ECI and non-ECI at the CFC level. The Proposed Regulations provide that Treas. Reg. § 1.882-5 continues to apply first in accordance with Treas. Reg. § 1.882-5(a)(5), which has not been changed. The new expanded definition of interest (described above) generally does not apply to Treas. Reg. § 1.882-5. A separate apportionment rule allocates disallowed interest of a CFC in coordination with Treas. Reg. § 1.882-5.

Special rules apply for partnerships engaged in a U.S. trade or business that have foreign partners. The rules limit the general BII, BIE, and ATI to the amounts apportioned within the partnership to ECI. Net BII allocable to ECI may be utilized at the partner level. Net BIE allocable to ECI at the partnership level cannot be utilized against other ATI allocable to ECI at the partner level.

11. Transition Rules

General. Prop. Treas. Reg. § 1.163(j)-11 provides that a taxpayer’s interest expense for which a deduction was disallowed under old section 163(j) (i.e., disallowed disqualified interest) is carried forward to the taxpayer’s first taxable year beginning after December 31, 2017, and is subject to potential disallowance under section 163(j) and Prop. Treas. Reg. § 1.163(j)-2. Disallowed disqualified interest expense is not subject to limitation under section 163(j) to the extent allocable to an Excepted Trade or Business. The Proposed Regulations reserve on how to allocate such interest to an Excepted Trade or Business.

Affiliated groups and super affiliation under old section 163(j). Old section 163(j) treated all members of the same affiliated group as a single taxpayer regardless of whether such members filed a consolidated return, but the Proposed Regulations treat members of the same affiliated group as one taxpayer only if such members file a consolidated return. Unlike the “old” proposed regulations, these Proposed Regulations do not provide special “super-affiliation” rules for unaffiliated corporations under common control (e.g., inbound groups that own multiple consolidated groups).

The Proposed Regulations provide rules based upon the rules in proposed regulations issued under old section 163(j) for allocating disallowed disqualified interest carryforwards among members of an affiliated group (including otherwise unaffiliated entities treated as part of the affiliated group
under the “super-affiliation” rules) that was treated as a single taxpayer under old section 163(j), generally based on their respective shares of “related person” interest expense to which old section 163(j) applied.

**Excess limitation not carried forward.** No amount of excess limitation under old section 163(j)(2)(B) may be carried forward to taxable years beginning after December 31, 2017.

**Earnings and profits.** To avoid duplicative adjustments, there is no reduction for disallowed disqualified interest carryforwards under old section 163(j) to the extent E&P was reduced for interest paid or accrued in a prior year.

**Section 382.** The Proposed Regulations provide rules for the application of section 382 to disallowed disqualified interest carryforwards under old section 163(j). In general, disallowed disqualified interest is not treated (i) as a pre-change loss under section 382(d)(3) or (ii) for purposes of determining whether a corporation is a loss corporation under section 382(k)(1), as a carryforward of disallowed interest under section 381(c)(20), for an ownership change on a change date occurring before the date the Proposed Regulations are published as final regulations, unless the rules of Treas. Reg. § 1.382-2(a)(7) apply (i.e., treating disallowed disqualified interest carried forward as part of a section 382 disallowed business interest carryforward). The Proposed Regulations cross-reference section 382(h)(6)(B) (regarding built-in deduction items).

12. **Allocation of Items Between Excepted and Non-Excepted Trades or Businesses**

Prop. Treas. Reg. § 1.163(j)-10 provides rules for determining the amount of a taxpayer’s interest expense, interest income, and other tax items that are properly allocable to Excepted Trades or Businesses and Non-Excepted Trades or Businesses. Prop. Treas. Reg. § 1.163(j)-10 is applied after a taxpayer has determined whether any interest expense or interest income paid, received, or accrued is properly allocable to a trade or business. For instance, a taxpayer must apply Treas. Reg. § 1.163-8T to determine which items of interest expense are investment interest under section 163(d) before allocating interest expense between Excepted Trades or Businesses and Non-Excepted Trades or Businesses. Furthermore, a taxpayer’s activities are not treated as a trade or business for this purpose if those activities do not involve the provision of services or products to a person other than the taxpayer.

A taxpayer is only required to apply the rules of Prop. Treas. Reg. § 1.163(j)-10 where the taxpayer has (i) any interest paid or accrued that is properly allocable to a trade or business and (ii) tax items allocable both to an Excepted Trade or Business and a Non-Excepted Trade or Business.

**Allocation of interest income and interest expense by tax basis.** In general, interest expense and interest income are allocated between Excepted Trades or Businesses and Non-Excepted Trades or Businesses based upon the relative amounts of the taxpayer’s adjusted basis in the assets used in its Excepted Trades and Businesses and Non-Excepted Trades or Businesses. The Proposed Regulations provide rules for determining basis. For example, the basis of depreciable property other than inherently permanent structures is generally its basis determined by using the alternative depreciation system under section 168(g) without regard to the additional first-year depreciation deduction. Generally, these determinations are made on a quarterly basis. In addition, rules are provided for allocating basis for an asset that is used in more than one trade or business.

- **De minimis rule.** Prop. Treas. Reg. § 1.163(j)-10(c)(1)(ii) provides that if at least 90 percent of the taxpayer’s basis in its assets for the taxable year is allocable to either Excepted Trades or Businesses or Non-Excepted Trades or Businesses, all of the taxpayer’s interest expense and interest income for that year is properly allocable to an Excepted or Non-Excepted Trade or Business, as the case may be.

- **Consolidated groups.** Consistent with Prop. Treas. Reg. § 1.163(j)-4(d), a consolidated group is treated as a single corporation that is treated as engaged in Excepted Trades or Businesses.
Businesses and/or Non-Excepted Trades or Businesses, as the case may be. As a result, certain transactions should be disregarded or treated differently in applying Prop. Treas. Reg. § 1.163(j)-10 to consolidated groups (e.g., intercompany transactions, along with the resulting offsetting items, are disregarded and a transfer of any amount of member stock to a non-member is treated by the group as a transfer of the member’s assets proportionate to the amount of member stock transferred). Once the consolidated group has determined the percentage of the group’s interest expense that is allocable to an Excepted Trade or Business, this “exempt percentage” is applied proportionally to each member that has paid or accrued interest to a person other than a group member during the taxable year. These rules are discussed further in Part 6 above.

Direct allocations. If a taxpayer has qualified nonrecourse indebtedness, within the meaning of Treas. Reg. § 1.861-10T(b), Prop. Treas. Reg. § 1.163(j)-10(d) generally provides that the taxpayer must directly allocate interest expense from the indebtedness to the taxpayer’s assets as provided in Treas. Reg. § 1.861-10T(b). A taxpayer engaged in the trade or business of banking, insurance, financing, or a similar business that derives active financing income must directly allocate interest expense and interest income from that business to the taxpayer’s assets used in that business.

Allocation of items other than interest expense and interest income. Prop. Treas. Reg. § 1.163(j)-10(b) provides rules for the allocation of tax items other than interest expense and interest income, for purposes of calculating ATI.

- Gross income. Gross income other than dividends and interest income is allocated to the trade or business that generated such gross income.

- Allocation of dividend income. If the taxpayer receives dividend income (within the meaning of section 316) that is not investment income (within the meaning of section 163(d)), and the taxpayer is required to apply the Look-Through Rules (discussed below), the taxpayer’s dividend income is allocated between the payor corporation’s Excepted Trades or Businesses and Non-Excepted Trades or Businesses in accordance with those rules. If the taxpayer receives a dividend that is not investment income, and the taxpayer is not required to apply the Look-Through Rules, the taxpayer treats the dividend income as allocable to a Non-Excepted Trade or Business.

- Allocation of gain or loss from dispositions of stock. If a taxpayer recognizes gain or loss upon the disposition of stock in a non-consolidated C corporation that is not property held for investment (within the meaning of section 163(d)(5)) and the taxpayer is required to apply the Look-Through Rules (discussed below), the taxpayer allocates the gain or loss to Excepted Trades or Businesses and Non-Excepted Trades or Businesses based upon the relative amounts of the corporation’s adjusted basis in the assets used in its trades or business. If the taxpayer does not apply the Look-Through Rules, the taxpayer treats the gain or loss as allocable to a Non-Excepted Trade or Business.

- Allocation of gain or loss from dispositions of partnership interests and S corporations. If a taxpayer recognizes gain or loss upon the disposition of interest in a partnership or stock in an S corporation that owns a Non-Excepted Trade or Business and/or investment assets, the taxpayer includes in its ATI its share of gain or loss allocable to an Excepted Trade or Business or a Non-Excepted Trade or Business by applying the Look-Through Rules.

- Allocation of expenses, losses, and deductions (other than interest). In general, the Proposed Regulations provide that taxpayers should apply the principles of Treas. Reg. § 1.861-8(b) for purposes of allocating other deductions. Those rules generally provide that deductions should be allocated in the same manner in which the gross income to which the deduction is “definitely related” is allocated. The Proposed Regulations do not
incorporate any of the special allocation rules of Treas. Reg. § 1.861-8(e), but Treasury and the IRS request comments on this issue. Other deductions are ratably apportioned to all gross income.

**Look-Through Rules.** The provisions of Prop. Treas. Reg. § 1.163(j)-10(c)(5)(ii) (the “Look-Through Rules”) generally provide a look-through approach with respect to equity interests for purposes of allocating asset basis between Excepted Trades or Businesses and Non-Excepted Trades or Businesses. As discussed above, these rules also generally apply for purposes of allocating other items of income and expense in calculating ATI.

- **Partnerships and S corporations.** The Proposed Regulations treat a partner’s interest in a partnership as an asset of the partner. The partner’s adjusted basis in a partnership interest is reduced, but not below zero, by the partner’s share of partnership liabilities (as determined under section 752). For purposes of determining the extent to which a partner’s adjusted basis in its partnership interest is allocable to an Excepted Trade or Business or Non-Excepted Trade or Business, the partner may look through to the partner’s share of the partnership’s basis in its partnership’s assets taking into account any adjustments under section 734(b) and 743(b). A partner’s “proportionate share” of partnership assets is determined using a reasonable method taking into account special allocations under section 704(b). However, a partner is required to apply the Look-Through Rules if the partner’s direct and indirect interest in the partnership is greater than 80 percent of the partnership’s capital or profits. Similar to the de minimis rules above, if at least 90 percent of a partner’s share of a partnership’s basis in its assets is allocable to either Excepted Trades or Businesses or Non-Excepted Trades or Businesses, the partner’s entire basis in its partnership interest is treated as allocable to either Excepted Trades or Businesses or Non-Excepted Trades or Businesses. If a partner chooses not to look through to the partnership’s basis in the partnership’s assets, the partner generally will treat its basis in the partnership interest either as an asset held for investment or a non-excepted trade or business asset as determined under section 163(d). Similar rules apply for S corporations.

- **Non-consolidated C corporations and CFCs.** A taxpayer who owns at least 80 percent of the vote and value (within the meaning of section 1504(a)(2)) of a non-consolidated C corporation or CFC is generally required to look through the taxpayer’s interest in the corporation. If at least 90 percent of a taxpayer’s share of a corporation’s basis is allocable to either Excepted Trades or Businesses or Non-Excepted Trades or Businesses, the taxpayer’s entire basis in the corporation is treated as allocable to either Excepted Trades or Businesses or Non-Excepted Trades or Businesses.

**Reporting Requirements.** The Proposed Regulations include a requirement to maintain records substantiating the taxpayer’s business allocations, and require taxpayers making business allocations to file an annual statement of basis calculations and allocation methodologies. If the taxpayer fails to satisfy these requirements, the Proposed Regulations permit the IRS to treat all of the taxpayer’s interest expense as properly allocable to a Non-Excepted Trade or Business (i.e., subject to section 163(j)), unless the taxpayer can show reasonable cause for failure to comply with, and the taxpayer acted in good faith with respect to, the recordkeeping and reporting requirements.

**Anti-abuse rule.** Under an anti-abuse rule in Prop. Treas. Reg. § 1.163(j)-10(c)(8), a taxpayer’s adjusted basis in an asset will not be taken into account for purposes of this section if one of the principal purposes of the acquisition, disposition, or change in use of that asset is to increase artificially the amount of basis allocable to Excepted Trades or Businesses or Non-Excepted Trades or Businesses.

**Consolidated Returns.** The Proposed Regulations provide for special rules on allocations related to a consolidated group (see above).
Disallowed disqualified interest under old section 163(j). The regulations reserve on allocation of disallowed disqualified interest carried forward under old section 163(j).

Section 511 organizations. The Proposed Regulations provide that organizations subject to tax under section 511 should continue to apply the allocation rules under section 512 and the regulations thereunder, rather than the rules provided in Prop. Treas. Reg. § 1.163(j)-10, in determining whether items of income or expense are allocable to an Excepted Trade or Business.

13. Real Property Trade or Business Election

Section 163(j) does not apply to an "electing real property trades or business" (a "RPTOB"), which is defined as an Excepted Trade or Businesses. Section 163(j)(7)(A)(ii) provides that a RPTOB means any trade or business which is described in section 469(c)(7)(C) and which makes an election (the "RPTOB Election"). Prop. Treas. Reg. § 1.163(j)-9 provides guidance on the RPTOB Election and a safe harbor for REITs that wish to make the RPTOB Election. If the RPTOB Election is made, the alternative depreciation system is required for nonresidential real property, residential rental property, and qualified improvement property.

RPTOB election procedure. The Proposed Regulations clarify that the RPTOB Election is made on a trade-or-business basis, not necessarily for a particular entity. Where a taxpayer has multiple trades or businesses, an election should be made for each trade or business. An election made by a partnership does not apply to a trade or business conducted by a partner outside the partnership, but applies to the partner with respect to the RPTOB conducted by the partnership. Consistent with section 163(j)(7)(A)(ii), the Proposed Regulations provide that the RPTOB Election is irrevocable, except as otherwise provided (see below). A taxpayer makes the election by attaching a statement to its timely filed original Federal income tax return, including extensions, with the required information.

Termination of the RPTOB Election. The Proposed Regulations generally provide that an RPTOB Election terminates automatically if the taxpayer ceases to exist or the taxpayer ceases to operate the electing trade or business. The election does not terminate where a taxpayer transfers all of the assets of a RPTOB to a related party (within the meaning of section 267(b) or 707(b)(1)) or in a nonrecognition transaction. However, if the transferee does not utilize the assets in an Excepted Trade or Business, the transferor’s RPTOB Election does terminate, notwithstanding whether the transfer was between related parties or in a nonrecognition transaction. The Proposed Regulations also provide an anti-abuse rule to prevent a situation in which the taxpayer transfers the assets in the trade or business and the taxpayer or a related party reacquires those assets or substantially similar assets within 60 months of the original transfer.

RPTOB Election safe harbor for REITs. The Proposed Regulations provide a safe harbor for REITs intending to make the RPTOB Election. Very generally, if a REIT holds real property (defined by reference to section 856), interests in partnerships holding real property, or shares in other REITs holding real property, the REIT is eligible to make an RPTOB Election for all or parts of its assets. If, at the close of the taxpayer year, the fair market value of the REIT’s "real property financing assets" is 10 percent or less of the value of the REIT’s total assets at the close of the taxpayer year, all of the REIT’s assets are treated as assets of an Excepted Trade or Business. If the value of a REIT’s "real property financing assets" is more than 10 percent of the value of the REIT’s total assets, the REIT is required to allocate interest expense, interest income, and other items of expense and gross income between the REIT’s Excepted Trades or Businesses and Non-Excepted Trades or Businesses. "Real property financing assets" include mortgages, guaranteed mortgage pass-thru certificates, REMIC regular interests, and debt instruments issued by publicly offered REITs.

For purposes of determining the extent to which a REIT owns "real property" and "real property financing assets," the Proposed Regulations provide the following rules:
• **Partnership interests.** A REIT treats its proportionate share of partnership assets that meet the definition of real property under section 856 as assets of an Excepted Trade or Business pursuant to the partnership look-through rule under Prop. Treas. Reg. § 1.163(j)-10(c)(5)(ii)(A)(2).

• **Shares in other REITs.** If a REIT ("shareholder REIT") owns an interest in another REIT ("subsidiary REIT"), the shareholder REIT applies the partnership look-through rule as if the subsidiary REIT were a partnership. The shareholder REIT first determines the extent to which its adjusted basis in the subsidiary REIT is allocable to an excepted trade or business versus a Non-Excepted Trade or Business. To the extent that any part of shareholder REIT’s adjusted basis is allocable to a Non-Excepted Trade or Business, shareholder REIT must determine the extent to which the value of its shares in subsidiary REIT is attributable to real property assets versus real property financing assets. If no portion of the shareholder REIT’s adjusted basis is allocable to a Non-Excepted Trade or Business, applying the 10 percent test described above, the entire value of shareholder REIT’s interest in subsidiary REIT is treated as attributable to real property assets. If shareholder REIT receives insufficient information to apply the partnership look-through rule, the subsidiary REIT is treated as a Non-Excepted Trade or Business.

**Anti-abuse rule; related party rental business not eligible to make RPTOB Election.** A trade or business that leases substantially all of its real property to a trade or business under common control with the lessor cannot make the RPTOB Election. A trade or business leases substantially all of its real property if the trade or business leases at least 80 percent of its real property. Two trades or businesses are under common control if 50 percent or more of the direct and indirect ownership of both businesses are held by related parties within the meaning of sections 267(b) and 707(b). That anti-abuse rule does not apply does not apply to REITs that lease qualified lodging facilities and qualified health care properties.

14. **Definition of Real Property Trade or Business**

**RPTOB.** Prop. Treas. Reg. § 1.469-9(b)(2) defines the terms “real property,” “real property operation,” and “real property management” as used in the definition of RPTOB. The Proposed Regulations reserve on defining nine other terms relevant to the determination of whether a trade or business is a real property trade or business.

**Real property.** In general, real property is defined to include land, buildings, and other inherently permanent structures that are permanently affixed to land. Property produced for sale that is not real property in the hands of the producing taxpayer or a related person, but that may be incorporated into real property by an unrelated person, is not treated as real property of the producing taxpayer (for example, bricks, nails, paint, and windowpanes).

**Real property operation.** The Proposed Regulations define “real property operation” to mean handling, by a direct or indirect owner of the real property, the day-to-day operations of a trade or business relating to the maintenance and occupancy of the real property that affect the availability and functionality of that real property used, or held out for use, by customers where payments received from customers are principally for the customers’ use of the real property. The principal purpose of such business operations must be the provision of the use of the real property, or physical space accorded by or within the real property, to one or more customers, and not the provision of other significant or extraordinary personal services, within the meaning of Treas. Reg. § 1.469-1T(e)(3)(iv) and (v), to customers in conjunction with the customers’ incidental use of the real property or physical space.

**Real property management.** The Proposed Regulations define “real property management” to mean handling, by a professional manager, the day-to-day operations of a trade or business relating to the maintenance and occupancy of real property that affect the availability and functionality of that property used, or held out for use, by customers where payments received from customers are
principally for the customers’ use of the real property. The principal purpose of such business operations must be the provision of the use of the real property, or physical space accorded by or within the real property, to one or more customers, and not the provision of other significant or extraordinary personal services, within the meaning of Treas. Reg. § 1.469-1T(e)(3)(iv) and (v), to customers in conjunction with the customers’ incidental use of the real property or physical space. However, other incidental personal services may be provided to the customer in conjunction with the use of real property or physical space, as long as such services are insubstantial in relation to the customer’s use of the real property or physical space and the receipt of such services is not a significant factor in the customer’s decision to use the real property or physical space. A professional manager is a person responsible, on a full-time basis, for the overall management and oversight of the real property or properties and who is not a direct or indirect owner of the real property or properties.

**Effective date of Prop. Treas. Reg. § 1.469-9(b)(2)**. The proposed rules under Prop. Treas. Reg. § 1.469-9(b)(2) apply to taxable years beginning after December 31, 2018. Although it is not entirely clear, Treasury and the IRS appear to have intended to allow taxpayers and their related parties to rely on Prop. Treas. Reg. § 1.469-9(b)(2) if applied consistently by the taxpayers and their related parties, until the date the regulations are finalized.

15. **Multistate Considerations**

As described above, the proposed regulations provide that a federal consolidated group generally has a single section 163(j) limitation computed and applied to BIE without regard, for example, for intercompany obligations and items from certain intercompany transactions. For states that conform to section 163(j), state filing methodologies will affect how the section 163(j) limitation is computed. Absent guidance from the states, separate company section 163(j) calculations will be required, with full regard for intercompany obligations and intercompany transaction, in separate reporting and certain combined reporting states that do not adopt the federal consolidated return regulations to compute state taxable income. Most states do not adopt the federal consolidated return regulations, with Illinois, Oregon, and New York as notable exceptions. Accordingly, separate company section 163(j) calculations, will be required for the majority of the states, and can be expected to result in wide variances to the federal consolidated section 163(j) limitation.

We anticipate that some states will enact additional legislation or promulgate administrative guidance regarding section 163(j) in 2019. Legislative developments may include the application of the federal consolidated return treatment of section 163(j) to state filings that would otherwise require analysis of the section 163(j) limitation on a separate company basis.

Further, the Proposed Regulations reiterate a partnership subject to section 163(j) will apply the limitation at the partnership level, but any applicable carryforward allocated to a partner is classified as a partner item. For states that impose an entity level tax, it is anticipated the excess interest carryforward will not impact partnership level state filings. Similarly, the carryforward may not be able to be utilized by a partnership in calculating non-resident withholding or composite returns for state filings.