

WV Tax Institute

Loss Disallowance Rules Changes
New section 163(j) and section 382

"Old" Section 163(j)

- The "old" section 163(j) (still effective for taxable years beginning on or before 12/31/21017) disallowed a deduction for disqualified interest paid or accrued by a corporation in a taxable year if two threshold tests were satisfied:
 - 1) the payor's debt-to-equity ratio exceeded 1.5 to 1.0 (the safe harbor ratio); and
 - 2) the payor's net interest expense exceeded 50 percent of its adjusted taxable income (generally, taxable income computed without regard to deductions for net interest expense net operating losses, domestic production activities under section 199, depreciation, amortization, and depletion).
- Disqualified interest included interest paid or accrued to:
 - 1) related parties when no Federal income tax was imposed regarding the interest;
 - 2) unrelated parties in certain instances in which a related party guarantees the debt; or
 - 3) to a Real Estate Investment Trust ("REIT") by a taxable RWEIT subsidiary of that trust.

"Old" Section 163(j)

- Any disallowed interest could be carried forward indefinitely.
- In addition, any excess limitation (the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) could be carried forward there years.
- Old section 163(j) still applies for taxable years beginning before December 31, 2017.
- What happens to interest expense carryforward from the old section 163(j)?
 - See Notice 2018-28 Section 3 "the Treasury Department and the IRS intend to issue regulations clarifying that taxpayers with disqualified interest disallowed under prior section 163(j)(1)(A) for the last taxable year beginning before January 1, 2018, may carry such interest forward as business interest to the taxpayer's first taxable year beginning after December 31, 2017. The regulations will also clarify that business interest carried forward will be subject to potential disallowance under section 163(j), as amended by the Act, in the same manner as any other business interest otherwise paid or accrued in a taxable year beginning after December 31, 2017."

"New" Section 163(j)-Overview

- The "new" section 163(j) limits the amount of business interest expense ("BIE") a taxpayer may deduct for a taxable year. Effective for taxable years beginning after 12/31/2017.
- Under section 163(j), a taxpayer may only deduct business interest for a taxable year in an amount that does not exceed the sum of:
 - 1) business interest income ("BII") of such taxpayer for such taxable year,
 - 2) 30% of the adjusted taxable income ("ATI") of such taxpayer for such taxable year, plus
 - 3) the floor plan financing interest of such taxpayer for such taxable year.

"New" Section 163(j)-Overview

- Does section 163(j) target earnings stripping?
- What happens to the section 385 regulations?
 - Proposed Regulation REG-130244-17 would remove the documentation requirement under 1.385-2
 - However, the funding rules under 1.385-3 are still in place

"New" Section 163(j)-Hot off the Press

- Proposed Regulations are currently at OMB. Anytime between now and mid-November is most likely
 - Unclear if all items will be addressed (e.g. interplay with GILTI, SRLY implications, etc.)
- Compliance --- draft Form 8990 has been released.
 - No surprises but no indication on how certain items are resolved
 - No specific compliance for consolidated groups

Key Definitions

- "Business interest" is defined to mean "any interest paid or accrued on indebtedness properly allocable to a trade or business. Such term shall not include investment interest (within the meaning of ... [subsection 163(d)])." Section 163(j)(5).
 - Corporations do not have "investment interest" under section 163(d).
 - Is there such a thing as interest that is neither investment interest nor interest "properly allocable" to a trade or business? Is interest allocable/apportioned to CFC stock considered properly allocable to a trade or business?
 - See *Higgins v. Commissioner*, 312 U.S. 212 (1941) (investing in stock and debt is generally not a trade or business)
 - Compare section 163(j)(7) (defining exceptions from the term "trade or business")
 - NOTE: it would be helpful for the interest to not be considered "business interest" – may not be any other provision to limit deductions (e.g., section 265 – interest attributable to tax-exempt assets)

Key Definitions

- "Business interest" is defined to mean "the amount of interest includible in the gross income of the taxpayer for the taxable year which is properly allocable to a trade or business. Such term shall not include investment income" Section 163(j)(6).
- "Floor plan financing interest" is defined to mean interest paid or accrued on indebtedness used to acquire of motor vehicles, held for sale or lease, and the indebtedness is secured by the motor vehicles. Section 163(j)(9).

Adjusted Taxable Income

- "Adjusted taxable income" is defined to mean the taxpayer's taxable income computed without regard to:
 - 1) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business;
 - 2) any business interest or business interest income;
 - 3) any NOL deduction under section 172;
 - 4) the amount of any deduction for qualified business income under section 199A; and
 - 5) in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion. Section 163(j)(8).

Shorthand --- ATI as a tax EBITDA (and then tax EBIT after 2021) calculation

General Operation

- Under section 163(j), a taxpayer may only deduct business interest for a taxable year in an amount that does not exceed the sum of:
 - 1) the business interest income of such taxpayer for such taxable year,
 - 2) 30 percent of the adjusted taxable income of such taxpayer for such taxable year, plus
 - 3) the floor plan financing interest of such taxpayer for such taxable year.
- Business interest that the taxpayer is not allowed to deduct in the current taxable year is carried forward and "treated as business interest paid or accrued in the succeeding taxable year" (unlimited carryforward).

General Operation

In each of the years 2018-2020, Corp. Z has \$100,000 of adjusted taxable income, \$1,000 of business interest income, and \$40,000 of business interest expense.

	2018	2019	2020
Business Interest Expense	\$40,000	\$49,000 • (\$40,000 + \$9,000)	\$58,000 • (\$40,000 + \$18,000)
Business Interest Limitation	\$31,000 • (30% * \$100,000) + \$1,000)	\$31,000	\$31,000
Disallowed Interest	\$9,000 • (\$40,000 – \$31,000)	\$18,000 • (\$49,000 – \$31,000)	\$27,000 • (\$58,000 – \$31,000)

Exceptions

- Exemption for Certain Small Businesses
 - The section 163(j) limitation does not apply to a taxpayer if the taxpayer's average annual gross receipts for the three taxable years preceding the current taxable year do not exceed \$25 million. Sections 163(j)(3) and 448(c).
- Exception for Utilities
 - The definition of "trade or business" does not include a trade or business that furnishes or sales, (i) electrical energy, water, or sewage disposal services; (ii) gas or steam through a local distribution system; or (iii) transportation of gas or steam by pipeline. Section 163(j)(7)(A)(iv)(I)-(III).
 - Note: excepting these items from the "trade or business" definition means the interest expense is not properly allocable to a trade or business and therefore is not "business interest" subject to limitation.

Exceptions

- Exception for electing real property business
 - The definition of "trade or business" does not include "any electing real property trade or business." Section 163(j)(7)(A)(ii).
 - By cross reference, "electing real property trade or business" means (i) any real property development, redevelopment, construction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business; and (ii) the trade or business elects to be excluded from the definition of "trade or business" under section 163(j). Sections 163(j)(7)(B) and 469(c)(7)(C).
 - An electing real property trade or business is required to use the alternative depreciation system for any nonresidential real property, residential rental property, and qualified improvement property. Sections 163(j)(10)(A) and 168(g)(1)(F).

Exceptions

- Exception for electing farming business
 - The definition of "trade or business" does not include "any electing farming business." Section 163(j)(7)(A)(iii).
 - "Electing farming business" is defined to mean: (i) a farming business that makes the election under section 163(j) to be excluded from the definition of "trade or business"; or (ii) any trade or business of a specified agricultural or horticultural cooperative that elects to be excluded from the definition of "trade or business" under section 163(j). Section 163(j)(7)(C).
 - An electing farming business is required to use the alternative depreciation system for any property with recovery period of 10 years or more. Sections 163(j)(10)(B) and 168(g)(1)(G).

General Operation

- Does section 163(j) apply on a consolidated group basis?
 - Notice 2018-28 Section 5 "the Treasury Department and the IRS intend to issue regulations clarifying that the limitation in section 163(j)(1) on the amount allowed as a deduction for business interest applies at the level of the consolidated group (as defined in § 1.1502-1(h)). Thus, for example, a consolidated group's taxable income for purposes of calculating adjusted taxable income (as defined in section 163(j)(8)) will be its consolidated taxable income (as determined under § 1.1502-11), and intercompany obligations (as defined in § 1.1502-13(g)(2)(ii)) will be disregarded for purposes of determining the limitation in section 163(j)(1)."
 - Section 163(j) regulations are currently at OMB. Expected to address: "the allocation of the section 163(j)(1) limitation among group members; the treatment of disallowed interest deduction carryforwards when a member leaves the group; the treatment of disallowed interest deduction carryforwards of a member that joins the group, including whether such carryforwards are subject to a separate return limitation year (SRLY) limitation; the application of § 1.1502-32 (providing rules for adjusting the basis of the stock of a subsidiary owned by another member) to disallowed interest deductions; and the application of section 163(j) to a consolidated group with one or more members that conduct a trade or business described in section 163(j)(7)(A)(ii), (iii), or (iv), as amended by the Act, or whose members hold an interest in a non-corporate entity such as a partnership that conducts such a trade or business."

General Operation

- 163(j) and Section 382
 - Section 382 – limits the amount of pre-change losses that may be used to offset taxable income after a change in ownership for a loss corporation
 - Change in ownership defined in section 382(g)
 - TCJA modified the definition of a loss corporation in section 382(k)(1). "Such term shall include any corporation entitled to use a carryforward of disallowed interest described in section 381(c)(20)."
 - Thus, a loss corporation (and obligation to track change in ownership) may arise solely due to disallowed section 163(j) carryovers.

Section 382 / 383

- Section 382
 - Applies to potentially limit net operating loss (NOL) carryovers and net unrealized built-in losses (NUBIL)
 - Loss Corporation definition now includes 163(j) carryovers
- Section 383
 - Applies to potentially limit capital loss carryovers, foreign tax credit carryovers, general business credit carryovers (e.g. R&D tax credit), and AMT credit carryovers

Section 382 / 383

- Treas. Reg. 1.383-1(d)(2) provides ordering rules for the absorption of the 382/383 limitation
 - Capital RBIL
 - Capital Losses
 - Ordinary RBIL
 - Including section 382(h)(6)(B) – built-in items of deduction
 - NOLs and other losses not described above
 - Foreign Tax Credits
 - General Business Credits
 - AMT Credits

Section 382 / 383

- Example of usage: LossCo has an annual 382 limit of \$1,000,000 from a 12/31/2018 change date and has the following loss carryovers into 2019:
 - Capital Losses of \$300,000
 - NOLs of 1,500,000
 - R&D credits of \$250,000
- 2019 attribute usage: first all \$300,000 of capital losses, then additional \$700,000 of NOLs. No additional NOLs or any R&D credits are available. All \$1,000,000 of limit used.
- 2020 attribute usage: Next \$800,000 of NOLs is freed up. The remaining \$200,000 of 382 limitation converts into a 383 limit of \$42,000 (at 21%) that frees up such amount of R&D credits
- 2021 attribute usage: The \$1,000,000 section 382 limit converts into a \$210,000 section 383 limit. This frees up the last of the R&D credits.
 - Query: what if there were \$100,000 of pre-TCJA AMT credit carryovers?
- Query #2: what if there were \$1,000,000 of disallowed 163(j) carryovers?

Section 163(j) and Section 382

- Example of usage: LossCo has an annual 382 limit of \$1,000,000 from a 12/31/2018 change date and has the following loss carryovers into 2019:
 - Capital Losses of \$300,000
 - NOLs of 1,500,000
 - R&D credits of \$250,000
 - 163(j) of \$1,000,000
- Alternative #1 --- 163(j) is a 382(h)(6)(B) item and comes before NOLs
- Alternative #2 --- 163(j) is an "other" attribute and used at the same time as NOLs (pari passu?)
- Alternative #3 --- forthcoming regulatory guidance will provide new ordering that accounts for 163(j) or provides taxpayer electivity

Section 163(j) and Section 382

- Example of usage: LossCo has an annual 382 limit of \$1,000,000 from a 12/31/2018 change date and has the following loss carryovers into 2019:
 - Capital Losses of \$300,000
 - NOLs of 1,500,000
 - R&D credits of \$250,000
 - 163(j) of \$1,000,000
- Problems with 163(j) prioritization: potentially using up 382 limitation on an attribute that may nevertheless not be usable once it is run through the BIE limitation.

Section 163(j) and SRLY

- Alt. Example: LossCo has a 12/31/2018 SRLY event (but no 382 ownership change) and has the following loss carryovers into 2019:
 - Capital Losses of \$300,000
 - NOLs of 1,500,000
 - R&D credits of \$250,000

 - 163(j) of \$1,000,000

- Does SRLY apply to the 163(j) carryovers?
- Separate, additional register?
- Crediting usage across registers?