Interest Deduction Limitations Under Section 163(j): New Proposed Regulations, Application to Partnerships and CFCs

Rules for Computing ATI, Determining Deduction Cap, Special Carryover and Transition Rules, Elections and Exemptions

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1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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General Rules and Definitions
Section 163(j) Overview of the Statute

- Repealed prior section 163(j) limitations on the deductibility of a corporation's "disqualified" interest expense, which included interest paid to a related person that is not subject to tax (e.g., a foreign person).
  - Consider the effect of repeal on the provision that permitted disallowed interest expense to be carried forward to the following year.
- Replaced prior rules with new section 163(j), which now limits deductions for all "business interest." ("BIE").
- Effective for taxable years beginning after December 31, 2017.
Section 163(j)
Overview of Proposed Regulations

• Proposed regulations under section 163(j) and related provisions (the “Proposed Regulations”) were released on November 26, 2018.

• Except as otherwise provided, the Proposed Regulations are proposed to be effective for taxable years ending after the date that the Treasury decision adopting the regulations as final is published in the Federal Register.

• In general, taxpayers are permitted to apply the Proposed Regulations to taxable years beginning after December 31, 2017, provided that the taxpayer (and related parties) consistently apply all of the rules in the Proposed Regulations to those taxable years.

• The Proposed Regulations state that the limitation under section 163(j) generally applies after other interest expense limitations and that interest expense capitalized into the basis of assets is not subject to limitation under section 163(j).
Section 163(j)
Definition of business interest

• The statutory language defines BIE as “any interest paid or accrued on indebtedness properly allocable to a trade or business” and does not include “investment interest” under section 163(d).

• The Proposed Regulations define “interest” expansively, including items not traditionally considered interest. The Proposed Regulations set forth four categories of items treated as interest, with specific items identified:

  (1) **Interest on indebtedness and items treated as interest under the Code or Regulations**

  – Includes items such as original issue discount (“OID”), market discount, repurchase premium and deferred payments treated as interest under section 483.

  (2) **Significant non-periodic payments on swaps**

  – These rules apply to non-cleared swaps, and would follow previous law regarding treating a significant non-periodic payment as a separate loan and an on-market swap. The Proposed Regulations reserve on the treatment of cleared swaps.
Section 163(j)
Definition of business interest (cont’d)

(3) Other items treated as interest

- This category covers items not traditionally considered interest, including certain items deductible under section 162. This category includes, but is not limited to:
  - Substitute interest payments under securities lending and repo transactions
  - Items from derivatives that alter a taxpayer’s cost of borrowing or effective yield
  - Loan commitment fees if any portion of the financing is actually provided
  - Debt issuance costs subject to Treas. Reg. § 1.446-5
  - Guaranteed payments for the use of capital under section 707(c)
  - Income on factored receivables

(4) Anti-avoidance rule

- Any deductible expense or loss incurred in a transaction or series of related transactions in which the taxpayer secures the use of funds for a period of time if such expense or loss is predominantly incurred in consideration for the time value of money.
Section 163(j)  
Definition of adjusted taxable income

• Generally, **adjusted taxable income ("ATI")** is a taxpayer’s taxable income without regard to:
  
  – Non-business items;
  
  – **business interest income ("BII")** or BIE;
  
  – Deductions with respect to NOLs and section 199A; and
  
  – For taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization or depletion.

• The statutory language grants the Secretary authority to make adjustments.

• For taxable years beginning before January 1, 2022, ATI may be thought of as similar to EBITDA (and is sometimes referred to as “tax EBITDA” for this purpose).
Overview of the Business Interest Limitation and Partnerships
Section 163(j)
General rules

• New section 163(j) applies to every business – regardless of its form – and disallows the deduction for BIE in excess of the sum of:
  − (i) **BII**,  
    ◦ Any interest income “properly allocable to a trade or business”
  − (ii) **30% of the business’s ATI**, and  
    ◦ Taxable income without regard to certain amounts, including:
      − Non-business items;
      − BII or BIE;
      − Deductions with respect to net operating losses (“NOLs”) and the passthrough deduction (section 199A); and
      − For taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization or depletion
  − (iii) **floor plan financing interest (“FPFI”)**  
    ◦ Generally, interest expense related to the acquisition of motor vehicles, including boats and farm equipment, for sale or lease
Section 163(j) and Partnerships
Defined Terms

• **Interest** is defined broadly and includes guaranteed payments for the use of capital.

• **BIE** is interest expense properly allocable to a non-excepted trade or business.

• **Excess Taxable Income (“ETI”)** generally equals:

\[
\frac{(ATI \times 30\%) - (BIE - FPFI - BII)}{(ATI \times 30\%)}
\]

**Note:** Generally, this is the amount of the partnership’s ATI in excess of the ATI needed to support the partnership’s interest deduction.

• **Excess Business Interest Expense (“EBIE”)** means, with respect to a partnership, the amount of disallowed BIE of the partnership for a taxable year.

• **Excess Business Interest Income (“EBII”)** means, with respect to a partnership, interest income in excess of BIE.
Section 163(j) and Partnerships
Limitation determined at the partnership level

ATI calculation at partnership level; PRS determines if it has deductible BIE, ETI, EBIE, and EBII

PRS allocates deductible BIE, ETI, EBIE, and EBII, if any, to partners using 11-step calculation
Section 163(j) and Partnerships
Limitation determined at the partnership level (cont.)

• If BIE is limited at the partnership level, partners receive an allocation of **EBIE that is carried forward at the partner level**.

• If a partnership has excess ATI (excess capacity to deduct interest), partners receive an allocation of ETI. **ETI frees up EBIE previously allocated from that partnership and is included in the partner’s ATI**.

• BIE that is deductible at the partnership level is taken into account in determining non-separatedly stated income or loss and is not subject to the section 163(j) limit at the partner level.
  – This interest retains its character as “interest” for other purposes (e.g., passive activity loss rules).
Section 163(j) and Partnerships
Limitation determined at the partnership level (cont.)

- Gain or loss from the sale of a partnership interest is generally included in the partner’s ATI to the extent the partnership owns only “non-excepted trade or business assets,” or is included in the partner’s ATI in a proportionate amount to the extent the partnership owns both excepted and non-excepted trade or business assets.

- The gain from the sale of a partnership interest is not included in ATI to the extent gain reflects depreciation, amortization, or depletion that were added back to ATI.
  - A double benefit would otherwise result because the amount of the gain that would be reflected in the partner’s ATI in respect of the sale or other disposition would reflect the decreased basis in such assets as a result of the depreciation, amortization, or depletion.
Section 163(j) and Partnerships
Calculation of EBIE

Example 1a:

Facts
X and Y are equal partners and agree to allocate items of PRS pro rata.

Partnership-level analysis

- PRS Deductible BIE = $30
  = BII $0 + (30% x ATI $100) + FPFI $0
- PRS EBIE = $10
  = BIE $40 – Deductible BIE $30
- PRS will allocate $5 of EBIE to each of X and Y
Example 2a:

**Facts**

X and Y are equal partners and agree to allocate items of PRS *pro rata*.

**Partnership-level analysis**

- PRS Deductible BIE = $20
  \[ \leq \text{BII} \times 0 + (30\% \times \text{ATI} \times \$100) + \text{FPFI} \times 0 \]
- PRS ETI = $33.33
  \[ = \text{PRS ATI} \times 100 \times (\text{ATI} \times 100 \times 30\%) - (\text{BIE} \times 20 - \text{FPFI} \times 0 - \text{BII} \times 0) \]
  \[ = (\text{ATI} \times 100 \times 30\%) \]
- PRS will allocate $16.67 of ETI to each of X and Y

For simplicity, it is assumed that the debtor does not meet the small business exception as applied under section 448(c).
Example 3a:

Facts
X and Y are equal partners and agree to allocate items of PRS *pro rata*.

**Partnership-level analysis**

- PRS Deductible BIE = $40
- $20 + (30% x ATI $100) + FPFI $0
- PRS ETI = $33.33
- $100 x (ATI $100 x 30%) – (BIE $40 – FPFI $0 – BII $20)
- (ATI $100 x 30%)
- PRS will allocate $16.67 of ETI to each of X and Y

For simplicity, it is assumed that the debtor does not meet the small business exception as applied under section 448(c).
Section 163(j) and Partners

Partner items

• Partner’s ATI generally does not include allocable share of partnership items, but does include share of ETI.
  − However, a partner’s ATI does include items related to section 743(b) adjustments, section 704(c)(1)(C) amounts, and remedial items.
  − Partner takes into account its share of EBII from the partnership
    ◦ The proposed regulations have a “no double counting rule”: partner does not include partnership’s BII as its own BII, except to the extent of partnership EBII.
Section 163(j) and Partners
Partner items (cont.)

• Determination of whether interest is "investment interest" or "business interest" is made at the partnership level.
  − If interest is "investment interest" at the partnership level, it is not subject to section 163(j) at the partnership level.
  − Such interest allocated to a corporate partner becomes "business interest" subject to section 163(j) at the partner level and a corporate partner’s allocable share of investment income is treated as business income includible in partner’s ATI.
  − To the extent a partner receives an allocation of EBIE from a partnership whose trade or business is not a passive activity and with respect to which the partner does not materially participate (as described in section 163(d)(5)(A)(ii) and as illustrated in Rev. Rul. 2008-12), the EBIE will be treated as investment interest expense in the hands of the partner for purposes of section 163(d) once the EBIE is treated as paid or accrued in a succeeding year as a result of an allocation of ETI.
Section 163(j) and Partnerships
Partner ATI does not allow deduction of EBIE

Example 1b:

Facts
The same facts from Example 1a except each partner has its own ATI and BIE.

Partner-level analysis

- PRS allocates X and Y each $15 of BIE and $5 of EBIE
- Each of X and Y carry the $5 of EBIE forward until allocated ETI or EBII from PRS in a later year
- X’s Deductible BIE = $20 (in addition to the $5 of carryforward EBIE from PRS)
  \[ \leq \text{BII } 0 + (30\% \times \text{ATI } 100) + \text{FPFI } 0 \]
- Y’s Deductible BIE = $0
  \[ \leq \text{BII } 0 + (30\% \times \text{ATI } 100) + \text{FPFI } 0 \]
- Y has standalone disallowed BIE of $20 in addition to the $5 of EBIE from PRS

For simplicity, it is assumed that the debtor does not meet the small business exception as applied under section 448(c).
Section 163(j) and Partnerships
ETI increases partner ATI

Example 2b:

Facts
The same facts from Example 2a except each partner has its own ATI and BIE.

Partner-level analysis

• PRS allocates X and Y each $10 of BIE and $16.67 of ETI

• X’s Deductible BIE = $20
  \[
  \leq \text{BII }$0 + (30\% \times \text{ATI }$116.67) + \text{FPFI}$0
  \]

• Y’s Deductible BIE = $5
  \[
  \leq \text{BII }$0 + (30\% \times \text{ATI }$16.67) + \text{FPFI}$0
  \]

• Y has disallowed BIE of $15

For simplicity, it is assumed that the debtor does not meet the small business exception as applied under section 448(c).
Section 163(j) and Partners
Partner’s adjustments

- Section 734(b) adjustments are taken into account in calculating the partnership’s ATI.
- Partner basis items (section 743(b) and section 704(c)(1)(C)(i)) and remedial items are not taken into account in calculating the partnership’s ATI but are taken into account by the partners.

Y Pays $50 to Purchase an Interest in PRS

Y Pays $50 for 50% of DRE, which becomes PRS in a 99-5 transaction

Before $100/$0
After $100/$50
Section 163(j) and Partnerships
11-Step calculation

• Does not change section 704 allocations
• Purpose is to determine which partner is allocated deductible BIE, ETI, EBII, or EBIE, when allocations are not pro rata
• This will be an issue any time a partnership specially allocates income or loss, e.g., partnership with gross income preferred and partnership with 704(c) property

Before 11-Step Calculation

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After 11-Step Calculation

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<td>ETI allocated</td>
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<td>$0</td>
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</tr>
</tbody>
</table>
Section 163(j) and Partnerships

Basis reductions

• EBIE is allocated among the partners and treated as a carryforward at the partner level. EBIE is treated as “paid or accrued by the partner” in a later year only to the extent the partner is allocated ETI or EBII from the same partnership in a later year. At that point, it is generally subject to section 163(j) at the partner level in that later year.

• The adjusted basis of each partner’s interest in the partnership is reduced (but not below zero) by the amount of EBIE allocated to such partner.

• If the partner disposes of all or substantially all of its interest in the partnership, the outside basis is increased by the amount of EBIE that has not yet been treated as paid or accrued by the partner (without taking into account any EBIE that is still suspended by section 704(d)).

  − A transfer of a partnership interest in an intercompany transaction that does not result in termination of the partnership is also treated as a disposition for purposes of the basis adjustment rule. Such a transaction may result in a section 743(b) adjustment for the transferee.
Section 163(j) and Partnerships
Basis adjustment for sale of partnership interest

Facts
In Year 1, X and Y are equal partners and agree to allocate items of PRS *pro rata*.
In Year 2, X sells its interest in PRS.

Partnership-level analysis
- In Year 1, X’s basis is increased by $30 (ATI of $50 minus interest of $20)
- In Year 2, X’s basis is increased by $5 immediately before the disposition of its interest in PRS.
Section 163(j) and Partnerships
70/30 issue

Facts
In Year 1, PRS allocates $100 of interest (all EBIE) to X.
In Year 2, PRS allocates $100 of ETI to X.

Issue
After the allocation of EBIE, X’s basis is decreased to $100. If X sells its interest immediately after year 1, the carryforward EBIE would disappear, X’s basis would be increased to $200, and X would have a loss of $100.

After the allocation of ETI in year 2, X can deduct $30 of the EBIE from year 1, and the remaining $70 carries forward (assuming X has no other items). If X sells its interest immediately after year 2, X’s basis is not increased, X continues to have a $70 interest carryforward subject to section 163(j) at X’s level, and X recognizes gain of $100.

What if X can’t use the $70 interest carryforward in a future year?
Would X have been better off not receiving an allocation of ETI?

For simplicity, it is assumed that the debtor does not meet the small business exception as applied under section 448(c).
Section 163(j) and Partnerships
Ordering with other limitations

• Taxpayer-favorable ordering rule to coordinate section 163(j) limitation with section 704(d).
  – Generally, allocations of deductible BIE are deemed to reduce basis first, so that the section 704(d) limit applies disproportionately to allocations of EBIE. EBIE allocated to a partner cannot be “freed” by allocations of ETI to that partner until the EBIE is no longer suspended under section 704(d).

• **Section 163(j) applies before the loss limitation rules** in sections 465 (at-risk rules), 469 (passive activity loss provisions), and 461(l) (limitation on excess business losses of noncorporate taxpayers).
Exceptions
Section 163(j) and Partnerships

Exceptions

**Excepted trades or businesses**

- Trade or business of performing services as an employee
- Electing real property trade or business ("RPTOB")
- Electing farming business
- Utility trade or business
Section 163(j) and Partnerships

Small business exemption

• Small business exemption applies if the taxpayer's annual average gross receipts over the preceding three years does not exceed $25 million (aggregation rules apply). If partnership qualifies:
  − The partner includes its allocable share of the partnership’s gross receipts in determining whether the partner qualifies for the small business exemption.
  − The partner's allocable share of the partnership's BIE is tested at the partner level and partner's allocable share of partnership income is included in the partner's ATI.
  − Partnership cannot make a RPTOB or farming election.

• Note that small business exemption does not apply if the partnership is a “tax shelter” that is ineligible for the cash receipts and disbursements method of accounting under section 448(a)(3).
Section 163(j) and Partnerships
Election made by the entity conducting the trade or business

• Partners generally benefit from RPTOB elections made by partnerships, but only shareholders owning 80% (by vote and value) of stock of corporations and REITs benefit from RPTOB elections made by those entities.

• Limited guidance provided on what constitutes a RPTOB.
  – Rev. Proc. 2018-59 provides safe harbor allowing many infrastructure projects to qualify as RPTOBs.

• Safe harbor for electing REITs.
  – If the value of a REIT’s “real property financing assets” is 10 percent or less of the value of a REIT’s total assets, all of the REIT’s assets qualify for the election; otherwise, the REIT must allocate interest between RPTOBs and other businesses.
    ◦ Look-through rules for interests in partnerships and REITs.

• Related party rental business is not eligible to make the RPTOB election.
The RPTOB Election

The Mechanics

• The 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 any partner with respect to any trade or business conducted by a partner.

• However, an election made by a partnership appears to apply to its partners with respect to the RPTOB conducted by the partnership.
The RPTOB Election
The Mechanics (cont.)

• A taxpayer makes the election by attaching a statement to its timely filed original Federal income tax return, including extensions, with the required information (including a description of the electing trade or business).

• A partnership that satisfies the small business exemption under Prop. Treas. Reg. § 1.163(j)-2(d) is not eligible to make the election.
  – All interest allocated from a “small business” partnership will be BIE in the hands of each partner.
  – A partner takes into account its distributive share of items of income, gain, loss, or deduction from the exempted partnership in calculating the partner’s ATI.
The RPTOB Election
The Consequences

• Election is **irrevocable**, except where the taxpayer ceases to exist or the taxpayer ceases to operate the electing trade or business.
  − A disposal of assets to **related parties** does not terminate the election.
  − A disposal of assets followed by the reacquisition of those assets (or substantially similar assets) within 60 months does not terminate the election.

• Related parties are defined within the meaning of sections 267(b) and 707(b)(1).
The RPTOB Election
The Consequences (cont.)

• Taxpayer is required to use **ADS cost-recovery lives** for non-residential real property (40 years), residential rental property (30 years), and qualified improvement property (40 years absent technical correction).
  
  – ADS required for new **and** existing property.
  
  – The proposed regulations did not address issues related to the change to ADS upon the RPTOB election.
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Strafford: Section 163(j) and Proposed Regulations

The Business Interest Limitation and Corporations (Domestic and Foreign)
Definition of Interest

- **Business Interest (expense) (“BIE”):** Interest paid or accrued on indebtedness properly allocable to a trade or business.

- **Business Interest Income (“BII”):** Amount of interest income includible in gross income of a taxpayer for the taxable year which is properly allocable to a trade or business.
  - *Inconsistency:* BIE is limited to interest on indebtedness while BII is apparently broader as it is not limited to indebtedness.

- The Proposed Regulations, expansively define the term interest to include the following categories of payment:
  - *Interest under general federal income tax principles:*
    - Any amount paid or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement that is treated as a debt instrument for purposes of Section 1275(a) of the Internal Revenue Code (the “Code”) and the Treasury regulations thereunder.
Definition of Interest

- **Interest under general federal income tax principles:**
  - This category also includes any amount treated as interest under other provisions of the Code or the applicable Treasury regulations, such as original issue discount, accrued market discount, and amounts with respect to an integrated transaction.

- **Interest in substance:**
  - Amounts that are closely related to interest and that affect the economic yield or cost of funds of a transaction involving interest, regardless of whether it will be compensation for the use or forbearance of money on a stand-alone basis.
  - This category includes, income, deduction, gain or loss from a transaction used to hedge an interest bearing asset or liability, a debt issuance costs, commitment fees with respect to any portion of the financing that is actually provided, a substitute interest payment in a securities lending or a sale-repurchase transaction, guaranteed payments for the use of capital under Section 707(c), etc.
Definition of Interest

- **Amounts related to certain embedded loans in a Swap transaction**: A swap with significant nonperiodic payments will be treated as two separate and independent transactions consisting of an on-market, level payment swap and a loan. The time value component associated with the loan transaction would be recognized as interest expense to the payor and interest income to the recipient.

- **Anti-Avoidance Rule**: Any deductible expense or loss incurred by a taxpayer in a transaction or series or integrated or related transactions, if such expense or loss is predominantly associated with the time value of money.

**Certain Concerns with the Definition**:

- **Commitment Fees and other Debt Issuance Costs**:
  - Several types of fees are paid by a borrower in connection with a borrowing; e.g., underwriting fees, origination fees, processing fees, commitment fees, appraisal fees, etc.
  - Are these fees for borrowed funds or fees for services?
  - Are they paid to the lender or a third party?
Definition of Interest

Certain Concerns with the Definition:

- **Commitment Fees and other Debt Issuance Cost:**
  - How is the commitment fee treated in case of a revolver or terms loan?
  - In which year would such fees be treated as interest (the year of payment vs. the year in which the credit is drawn)?

- **Guaranteed Payments:**
  - Do partners with a right to guaranteed payments for capital have the same rights as that of a creditor?
  - Would guaranteed payments for the use of cash be the same as guaranteed payments for the use of tangible, intangible, or real property?
  - Leveraged partners investing in a partnership can affirmatively structure returns from the partnership as guaranteed payments to increase their Section 163(j) limitation by increasing business interest income.
Definition of Interest

_Certain Concerns with the Definition:_

- **Guaranteed Payments:**
  - There is inconsistency between the Proposed Regulations and Section 707(c) as the latter treats guaranteed payments as trade or business expense while the Proposed Regulations treat such payments as interest.

- **The Anti-Avoidance Rule:**
  - How to determine accurately whether income or loss is predominantly incurred as consideration for the time value of money?
  - The anti-avoidance rule does not provide for a corresponding interest income treatment with respect to amounts treated as interest expense under the rule.
  - Without further clarification this rule could treat interest with respect to most transactions that have a time value of money component, such as prepaid forward contracts, nonqualified deferred compensation, and open transactions that involve prepayment for goods or services, etc.
C Corporations and Consolidated Groups
C Corporations:

• Generally, all interest paid or accrued and all interest received by a C corporation will be treated as BIE and BII, respectively, allocable to a trade or business.
  
  • Thus, C corporations will not have investment interest that can be excluded for Section 163(j) purposes.
  
  • The only items of interest expense or interest income that will be excluded from BIE or BII will be the items that are allocated to excepted trades or businesses (discussed below).

• In the case of a partnership in which a C corporation is a partner, investment income and expense of the partnership that is allocable to the C corporation is recharacterized as business income and expense of the C corporation.
  
  • This recharacterization rule will not apply to the extent a C corporation partner is allocated a domestic partnership’s Subpart F or GILTI income that is treated as investment income at the partnership level.
General Rules for C Corporations and Consolidated Groups

**C Corporations:**

- The computation of E&P is not impacted by any disallowance or carry forward of interest expense under Section 163(j).
- Special E&P adjustments are required for C corporations that are partners in a partnership that allocates excess business interest expense to such C corporations.

**Result:** US C will not be able to deduct $70 in the current year. However, E&P will be reduced by $100 interest expense. Thus, the distribution of $100 will result in $60 of return of basis and $40 capital gain.

| Gross Income (GI) of US C from all sources | $100 |
| BIE | $100 |
| Taxable Income (GI – BIE) | $0 |
| ATI (TI + BIE) | $100 |
| Deductible BIE (30% ATI) | $30 |
| Accumulated E&P | $0 |
**General Rules for C Corporations and Consolidated Groups**

**Consolidated Groups:**

- A consolidated group is generally treated as a single entity for purposes of IRC § 163(j) limitation and the computation of ATI.
  - A consolidated group’s current-year BIE and BII are the sum of each member’s current year BIE and BII.
- Any obligations between the members of the same consolidated group will be disregarded to determine business interest expense, business interest income, and ATI.

<table>
<thead>
<tr>
<th>USP</th>
<th>USS</th>
<th>Non-Consolidated (USS Level)</th>
<th>Consolidated Group</th>
</tr>
</thead>
<tbody>
<tr>
<td>Separate Taxable Income</td>
<td>$60</td>
<td>USS’s ATI ($30+$50+$70)</td>
<td>$150</td>
</tr>
<tr>
<td>Depreciation</td>
<td>$20</td>
<td>Section 163(j) Limitation (30% of ATI)</td>
<td>$45</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>$0</td>
<td>Disallowed Interest Expense ($70 - $45)</td>
<td>$25</td>
</tr>
<tr>
<td>Separate Taxable Income</td>
<td>$30</td>
<td>Group’s ATI ($60+$20+$30+50+70)</td>
<td>$230</td>
</tr>
<tr>
<td>Depreciation</td>
<td>$50</td>
<td>Section 163(j) Limitation (30% of ATI)</td>
<td>$69</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>$70</td>
<td>Disallowed Interest Expense ($70 - $69)</td>
<td>$1</td>
</tr>
</tbody>
</table>
Foreign Corporations and U.S. Shareholders
Application to Foreign Corporations and U.S. Shareholders

- The Proposed Regulations make it clear that the limitation under Section 163(j) applies to controlled foreign corporations (“CFCs”) that are “Applicable CFCs” and partnerships owned by “Applicable CFCs”.
- Section 163(j) and the Proposed Regulations would apply to determine the extent to which such expense is deductible for purposes of computing an Applicable CFCs’ (i) Subpart F income, (ii) tested income for GILTI purposes and (iii) income that is effectively connected with the conduct of a U.S. trade or business (“ECI”).

  - An applicable CFC is a CFC described in Section 957 but only if it has at least one U.S. Shareholder that owns, directly or indirectly (within the meaning of Section 958(a), at least 10% of its stock. Thus, an Applicable CFC does not include CFCs that are owned by U.S. shareholders only by virtue of constructive ownership rules of Section 958(b).
Application of Section 163(j) to Applicable CFCs

• Under the general rule, the Proposed Regulations provide that the deductibility of a CFC’s business interest expense will be determined in the same manner as a domestic C corporation would compute business interest expense limitation. Such determination will be made on a CFC-by-CFC basis.

  • Generally, all interest paid or accrued and all interest received by a CFC will be treated as business interest expense and business interest income, respectively, allocable to a trade or business.

    • Thus, CFCs will not have investment interest that can be excluded for Section 163(j) purposes.

  • The computation of E&P will not be impacted by any disallowance of interest expense under Section 163(j).
Application to Foreign Corporations and U.S. Shareholders

Application of Section 163(j) to Applicable CFCs

- Mismatch of deduction and income on a CFC-by-CFC basis:

<table>
<thead>
<tr>
<th>CFC 1</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase in Tested Income for GILTI purposes</td>
<td>$100*</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CFC 1</td>
<td>Loan</td>
<td>CFC 2</td>
<td>USP</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$100 Interest</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CFC 2</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BIE</td>
<td>$100</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BII</td>
<td>$0</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ATI</td>
<td>$100</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>30% ATI</td>
<td>$30</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Disallowed BIE</td>
<td>$70</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reduction in Tested Income for GILTI Purposes</td>
<td>($30)*</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Result: Net CFC Tested Income is increased by $70 (Net of $100 increase in Tested Income of CFC 1 and only $30 reduction in Tested Income of CFC 2) for GILTI purposes due to the use of intercompany debt
Application to Foreign Corporations and U.S. Shareholders

**Alternative CFC Group Election Method**

- Taxpayers can make an irrevocable election to apply the Section 163(j) limitation on a CFC Group basis.

- A CFC Group includes two or more Applicable CFCs (each a “CFC Group Member”) if:
  - 80% or more of the stock (by value) is owned either by a single U.S. 10% Shareholder or multiple U.S. 10% Shareholders that are related by more than 50% of the outstanding stock (by value) or 50% of the capital interest or profits interest in the case of a partnership.
  - The ownership in Applicable CFCs must be direct or indirect (not constructive).
  - The stock of each Applicable CFC must be owned in the same proportion by each related U.S. Shareholders, in the case of multiple U.S. Shareholders.
Application to Foreign Corporations and U.S. Shareholders

*Alternative CFC Group Election Method*

- The CFC Group does not include any Applicable CFC that has ECI.
  - An applicable CFC with ECI is treated as a CFC group member solely for purposes of determining a CFC group.

- A partnership is also treated as a member of a CFC Group if: (i) 80% or more of the capital and profits interests of the partnership are owned by one or more members of the CFC group, and (ii) the partnership does not have any ECI (directly or indirectly) (“Controlled Partnership”).
  - The interest in a Controlled Partnership is treated as Stock.

- The election is not effective until all CFC Group Members make an election.
  - If a new member joins the CFC Group, such member must make the election for the prior election to be effective for existing CFC Group Members.
    - Does this mean that a new member can make an otherwise irrevocable election revocable?
Application to Foreign Corporations and U.S. Shareholders

**Alternative CFC Group Election Method**

- Can a CFC Group Member engage in a U.S. trade or business to make the election ineffective?
- Under the CFC Group method, deductible interest will be limited to 30 percent of the entire group’s ATI without regard to business interest income and floor plan financing.
- All CFC Group level computations must be made with respect to a majority U.S. shareholder taxable year.
  - This is relevant in a situation where not all CFC Group Members have the same taxable year.
- If one or more CFC Group Members conduct financial services businesses, the CFC Group Election will be applied by treating those entities as comprising a separate subgroup ("Financial Services Subgroup").
Application to Foreign Corporations and U.S. Shareholders

_Computation of Section 163(j) Limitation for CFC Group Members_

CFC Group Member’s BIE Limitation = Amount of the CFC Group Member’s Allocable Share of the CFC Group’s Applicable Net Business Interest Expense (“ANBIE”).

ANBIE = Sum of the Amounts of BIE of each CFC Group Member less Sum of the Amounts of BII of each CFC Group Member.

Allocable Share = ANBIE x \[\frac{CFC \text{ Group Member’s Net BIE}}{\text{Sum of the Amount of the Net BIE of Each CFC Group Member}}\]

Net BIE = The excess of the amount of the CFC Group Member’s BIE over such Member’s BII, Computed without regard to Section 163(j) and the Regulations thereunder.
Application to Foreign Corporations and U.S. Shareholders

Computation of Section 163(j) Limitation for CFC Group Members

Example

<table>
<thead>
<tr>
<th>CFC 1</th>
<th>CFC 2</th>
<th>CFC 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>BIE</td>
<td>$18</td>
<td>BIE</td>
</tr>
<tr>
<td>BII</td>
<td>$20</td>
<td>BII</td>
</tr>
<tr>
<td>ATI</td>
<td>$20</td>
<td>ATI</td>
</tr>
</tbody>
</table>

Continued...
Application to Foreign Corporations and U.S. Shareholders

Computation of Section 163(j) Limitation for CFC Group Members

Determination of the CFC Group

• As USS 1 and USS 2 are members of the same consolidated group (“USP Group”) they will be treated as a single person.

• USS 1 directly owns 100% stock of CFC 1 and USS directly owns 100% stock of each of CFC 2 and CFC 3. Thus, CFC 1, CFC 2, and CFC 3 will be treated as applicable CFCs. Since all of the applicable CFCs are considered as being owned by a single person, CFC 1, CFC 2, and CFC 3 will be treated as members of the same CFC Group.

Result if CFC Group Election is Made

\[
\begin{array}{|l|c|}
\hline
\text{ANBIE} = \$38 \text{ (Sum of the BIE of each of CFC 1 ($18), CFC 2 ($10), and CFC 3 ($10)) less 20 BII of each of CFC 1 ($20), CFC 2 ($0), and CFC 3 ($0))} & \$18 \\
\hline
\text{Net BIE of CFC 1 ($18 of BIE does not exceed $20 of BII)} & \$0 \\
\hline
\text{Net BIE of CFC 2} & \$10 \\
\hline
\text{Net BIE of CFC 3} & \$10 \\
\hline
\end{array}
\]

Continued . . .
Application to Foreign Corporations and U.S. Shareholders

**Computation of Section 163(j) Limitation for CFC Group Members**

**Result if CFC Group Election is Made**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Determination of the Allocable Share of ANBIE</strong></td>
<td></td>
</tr>
<tr>
<td>CFC 1’s Allocable Share of ANBIE (CFC 1 does not have Net BIE)</td>
<td>$0</td>
</tr>
<tr>
<td>CFC 2’s Allocable Share of ANBIE ($18 x ($10 / $20))</td>
<td>$9</td>
</tr>
<tr>
<td>CFC 3’s Allocable Share of ANBIE ($18 x ($10 / $20))</td>
<td>$9</td>
</tr>
<tr>
<td><strong>Amounts Not Subject to the General Limitation of 30% ATI</strong></td>
<td></td>
</tr>
<tr>
<td>CFC 1</td>
<td>$18</td>
</tr>
<tr>
<td>CFC 2 (Total expense of $10 – Allocable Share of $9)</td>
<td>$1</td>
</tr>
<tr>
<td>CFC 3 (Total expense of $10 – Allocable Share of $9)</td>
<td>$1</td>
</tr>
<tr>
<td><strong>Allowable Deduction</strong></td>
<td></td>
</tr>
<tr>
<td>CFC 1 (all of $18 is not subject to limitation)</td>
<td>$18</td>
</tr>
<tr>
<td>CFC 2 (30% of ATI of $20 = $6 + $1 (the amount not subject to the limitation)</td>
<td>$7</td>
</tr>
<tr>
<td>CFC 3 (30% of ATI of $20 = $6 + $1 (the amount not subject to the limitation)</td>
<td>$7</td>
</tr>
<tr>
<td>Total</td>
<td>$32</td>
</tr>
</tbody>
</table>

*Continued...*
Application to Foreign Corporations and U.S. Shareholders

**Computation of Section 163(j) Limitation for CFC Group Members**

**Result if NO CFC Group Election is Made**

- CFC 1, CFC 2, and CFC 3 will be required to compute their interest deduction limitation on a CFC-by-CFC basis.

<table>
<thead>
<tr>
<th>Entity</th>
<th>Limitation</th>
<th>Interest Expense</th>
<th>Allowable Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>CFC 1</td>
<td>$26 (30% of $20 ATI + $20 BII)</td>
<td>$18</td>
<td>$18</td>
</tr>
<tr>
<td>CFC 2</td>
<td>$6 (30% of $20 ATI)</td>
<td>$10</td>
<td>$6</td>
</tr>
<tr>
<td>CFC 3</td>
<td>$6 (30% of $20 ATI)</td>
<td>$10</td>
<td>$6</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>$30</strong></td>
<td></td>
</tr>
</tbody>
</table>
Application to Foreign Corporations and U.S. Shareholders

**Computation of ATI of an Applicable CFC**

- The principles of Treas. Reg. § 1.952-2 apply for determining a CFC’s income and deductions, and the principles of Section 882 apply for CFCs with ECI for determining such CFCs’ taxable income.

- Any dividend received by an Applicable CFC from a related person reduces the distributee’s taxable income for purposes of computing its ATI.

- If a CFC Group election is in effect, the upper-tier CFC Group Member takes into account a *directly* owned lower-tier CFC Group Member’s excess taxable income ("**CFC ETI**") in determining the upper-tier CFC Group Member’s ATI.

  - Similar to a partnership’s ETI, a CFC’s ETI is the portion of its ATI that is in excess of the amount that can support the BIE deduction of such CFC.

  - CFC ETI of a lower-tier CFC Group Member is added to the upper-tier CFC Group Member’s ATI only to the extent of its ownership percentage (i.e., rolling up of CFC ETI).
Application to Foreign Corporations and U.S. Shareholders

**Computation of ATI of an Applicable CFC**

- A partnership that is a CFC Group Member cannot have a CFC ETI as such partnership’s ETI is allocated to its partners under the partnership rules.

- **Ordering rules with multiple-tier CFC Group Members:**
  - The rolling up process of CFC ETI begins by first computing CFC ETI at the lowest-tier CFC Group Member level and continues through the chain of ownership to the highest-tier CFC Group Member.
  - If a higher-tier member is a partnership, it can take into account its pro rata share of the CFC ETI of a lower-tier member. If such higher-tier partnership member has an ETI it will be allocated to its partners that are CFC group members.

**Rules for Computation of ATI of a U.S. Shareholder**

- Under a double counting rule the Proposed Regulations provide that for purposes of computing ATI of U.S. shareholders taxable income is reduced by Subpart F and Section 956 inclusions, Section 78 gross-up and GILTI inclusions that are properly allocable to the U.S. Shareholder’s non-excepted trades or business from ATI ("**Specified Deemed Inclusions**").
Application to Foreign Corporations and U.S. Shareholders

**Rules for Computation of ATI of a U.S. Shareholder**

- The Specified Deemed Inclusions amount is reduced by the portion of the GILTI deduction allowed under Section 250(a)(1) (50% until 2025, 37.5% thereafter), without regard to the limitation under Section 250(a)(2) (relating to proportionate reduction of FDII and GILTI deduction if such deduction exceed a domestic corporation’s taxable income).

- **Addback Rule if CFC Group election is in effect**
  
  - Under the “Addback Rule,” a direct or indirect U.S. shareholder of a highest-tier CFC Group Member (or members in the case of multiple CFC chains) for which a CFC Group election is in effect, can add to its taxable income a proportionate share of the “Eligible CFC Group ETI”.

**Eligible Group CFC ETI** = Highest-tier CFC Group Member’s ETI (taking into account the rolling up of lower-tier CFC ETI) x Specified ETI Ratio of the highest-tier member x stock ownership percentage (by value) owned (directly or indirectly) by US Shareholders on the last day of the taxable year.

**Specified ETI Ratio** = $\frac{\text{Sum of Subpart F, GILTI, and Section 956 Inclusions for CFCs with Positive CFC ETI}}{\text{Taxable income of all the CFCs in the group with positive CFC ETI}}$
Application to Foreign Corporations and U.S. Shareholders

Rules for Computation of ATI of a U.S. Shareholder

- Addback Rule if CFC Group election is in effect
  - The Addback Rule is capped by “CFC Group Inclusions,” which is the amount of Specified Deemed Inclusions subtracted from taxable income, computed without regard to the Section 78 gross-up, reduced by the portion of the Section 250 deduction allowable by reason of GILTI.
  - The Addback Rule does not apply to determine the ATI of a U.S. Shareholder Partnership that is a U.S. shareholder of a CFC Group.
  - The rules are further modified to determine the ATI of a U.S. corporate partner in a domestic partnership, which is a U.S. shareholder of a CFC Group.
    - E.g., the U.S. shareholder partner is treated as a foreign partnership for purposes of determining U.S. corporate partner’s pro rata share of eligible CFC ETI.
Application to Foreign Corporations and U.S. Shareholders

Rules for Computation of ATI of a U.S. Shareholder

- **Example**

<table>
<thead>
<tr>
<th>Assumptions</th>
<th>CFC 1</th>
<th>CFC 2</th>
<th>CFC 3</th>
<th>CFC 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable Income</td>
<td>$0</td>
<td>$0</td>
<td>$85</td>
<td>$60</td>
</tr>
<tr>
<td>Taxable loss</td>
<td>$0</td>
<td>$5</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>BIE</td>
<td>$0</td>
<td>$5</td>
<td>$15</td>
<td>$40</td>
</tr>
<tr>
<td>BII</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
</tbody>
</table>

- A CFC Group election is in effect for the CFC Group.
- There is no intercompany debt between the CFC Group Members.
- 50% of CFC 3’s items of income and gain are Subpart F income and 50% of CFC 3’s deduction and loss are allocable to Subpart F income. No other item is taken into account for computing “tested income” or “tested loss” for GILTI purposes.
- CFC 4’s items of income are all tested income and deduction are all properly allocable to such income.
- No item of CFC 2’s income or loss is attributable to tested income or tested loss.
- USP has BIE of $20
**Rules for Computation of ATI of a U.S. Shareholder**

**Analysis**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>ANBIE ($0 + $5 + $15 + $40)</td>
<td>$60</td>
</tr>
<tr>
<td>Since there is no intercompany debt, the allocable share of each CFC’s ANBIE will be equal to its separate BIE.</td>
<td></td>
</tr>
</tbody>
</table>

**CFC 4**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>ATI ($60 TI + $40 BIE)</td>
<td>$100</td>
</tr>
<tr>
<td>Interest Deduction Limitation (30% of $100 ATI)</td>
<td>$30</td>
</tr>
<tr>
<td>Disallowed BIE ($40 - $30)</td>
<td>$10</td>
</tr>
<tr>
<td>Tested Income for GILTI purposes ($60 + $10 disallowed BIE)</td>
<td>$70</td>
</tr>
</tbody>
</table>

**CFC 3**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>ATI ($85 TI + $15 BIE)</td>
<td>$100</td>
</tr>
<tr>
<td>Interest Deduction Limitation (30% of $100 ATI)</td>
<td>$30</td>
</tr>
<tr>
<td>Disallowed BIE (Limitation is higher than BIE)</td>
<td>$0</td>
</tr>
<tr>
<td>Subpart F Income (50% of $85 TI)</td>
<td>$42.5</td>
</tr>
<tr>
<td>CFC ETI ($100 (ATI) x ($15 (Numerator*) / $30 (Denominator**))</td>
<td>$50</td>
</tr>
</tbody>
</table>

* Numerator is $15 (i.e., 30% of ATI of $100) – $15 (i.e., allocable share of ANBIE)

** Denominator is $30 (i.e., 30% of ATI)
## Rules for Computation of ATI of a U.S. Shareholder

### Analysis

#### CFC 2

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>ATI ($5 BIE - $5 taxable loss + 100% of CFC 3 ETI (i.e., $50))</td>
<td>$50</td>
</tr>
<tr>
<td>Interest Deduction Limitation (30% of $50 ATI)</td>
<td>$15</td>
</tr>
<tr>
<td>Disallowed BIE (Limitation is higher than BIE)</td>
<td>$0</td>
</tr>
<tr>
<td>CFC ETI ($50 (ATI) x ($10 (Numerator*) / $15 (Denominator**))</td>
<td>$33.33</td>
</tr>
</tbody>
</table>

#### CFC 1

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>ATI ($0 Taxable Income + $0 BIE + 100% of CFC 2 ETI (i.e., $33.33)</td>
<td>$33.33</td>
</tr>
<tr>
<td>Interest Deduction Limitation (30% of $33.33 ATI)</td>
<td>$10</td>
</tr>
<tr>
<td>Disallowed BIE (no BIE)</td>
<td>$0</td>
</tr>
<tr>
<td>CFC ETI (no business interest expense subject to limitation)</td>
<td>$33.33</td>
</tr>
</tbody>
</table>

* Numerator is $15 (i.e., 30% of ATI of $50) – $5 (i.e., allocable share of ANBIE)

** Denominator is $15 (i.e., 15% of ATI)
Application to Foreign Corporations and U.S. Shareholders

Rules for Computation of ATI of a U.S. Shareholder

Analysis

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inclusion of Subpart F income with respect to CFC 3</td>
<td>$42.5</td>
</tr>
<tr>
<td>GILTI Inclusion with respect to CFC 4</td>
<td>$70</td>
</tr>
<tr>
<td>Section 250 GILTI deduction (50%)</td>
<td>($35)</td>
</tr>
<tr>
<td>Total USP CFC Group Inclusion</td>
<td>$77.5</td>
</tr>
<tr>
<td>USP’s Taxable Income ($77.5 - $20 BIE)</td>
<td>$57.5</td>
</tr>
<tr>
<td>USP’s ATI ($57.5 TI + $20 BIE – $77.5 CFC Group Inclusion + $16.67% of Eligible CFC Group ETI*)</td>
<td>$16.67</td>
</tr>
<tr>
<td>Interest Deduction Limitation (30% of $16.67 ATI)</td>
<td>$5</td>
</tr>
<tr>
<td>Disallowed BIE ($20 - $5)</td>
<td>$15</td>
</tr>
</tbody>
</table>

* Eligible CFC Group ETI = $33.33 (CFC 1’s ETI) x 50% (CFC 1’s Specified ETI Ratio**) x 100% (percentage of stock of CFC owned directly by USP).

** CFC 1’s Specified ETI Ratio is 50% ($42.5 / $85). The numerator is equal to the amount of USP’s Subpart F inclusions with respect to CFC 3 and the denominator is equal to the taxable income of CFC 3. The amounts with respect to CFC 1, CFC 2, and CFC 4 are not relevant as none of them have CFC ETI without regard to the rolling up of CFC ETI from lower-tier CFCs. Denominator is $15 (i.e., 15% of ATI)
Application to Foreign Corporations and U.S. Shareholders

**Application to Foreign Persons with ECI (Inbound)**

- The Proposed Regulations modify the definitions of ATI, BIE, BII, and floor plan financing interest expense for non-resident alien individuals (“NRA”) and foreign corporations that are not Applicable CFCs (“Specified Foreign Persons”), that have effectively connected income (“ECI”).

- BIE for a specified foreign corporation is generally the interest as determined under the rules of Treas. Reg. § 1.882-5 (for corporations) and Treas. Reg. § 1.861-9T(d)(2) (for NRAs) that is properly allocable ECI.

- Similarly, BII of a Specified Foreign Person is an interest expense that is ECI.

- The Proposed Regulations further modify Section 163(j) limitation with respect to Specified Foreign Persons that are foreign partners in a partnership, which is engaged in a U.S. trade or business.
### Application to Foreign Persons with ECI (Inbound)

#### Example

<table>
<thead>
<tr>
<th>Assumption – FC is a Specified Foreign Corporation</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Effectively Connected Gross Income (ECI) $100</td>
<td>Effectively Connected Taxable Income ($100 ECI - $20 BIE allocated to ECI - $50 other expenses allocated to ECI). $30</td>
</tr>
<tr>
<td>Non-ECI $40</td>
<td>ATI ($30 of effectively connected taxable income + $20 of BIE) $50</td>
</tr>
<tr>
<td>Total Expense $100</td>
<td>Section 163(j) Limitation ($50 x 30%) $15</td>
</tr>
<tr>
<td>BIE allocable to ECI under the rules of Treas. Reg. § 1.882-5 $20</td>
<td>Disallowed BIE carryforward ($20 BIE - $15 limitation)* $5</td>
</tr>
<tr>
<td>Other expense allocable to ECI $50</td>
<td></td>
</tr>
<tr>
<td>BII $0</td>
<td></td>
</tr>
</tbody>
</table>

*The disallowed BIE Carryforward is not taken into account for purposes of determining interest expense under Treas. Reg. § 1.882-5 in the succeeding taxable year.*
Questions?