

New Guidance on 163(j) Business Interest Deductions

April 17, 2018

On April 2, 2018, the Treasury Department and the Internal Revenue Service (the “IRS”) issued Notice 2018-28 (the “Notice”). The Notice provides guidance on the revised section 163(j) introduced by the Tax Cuts and Jobs Act (the “TCJA”).

New Section 163(j) limits a business’s deduction for net interest expense (business interest expense less business interest income) to 30% of its adjusted taxable income. Disallowed amounts can be carried forward until used. These rules do not apply to certain real estate businesses that elect out or to businesses with average gross receipts of \$25 million or less.

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The Notice includes some important clarifications. Guidance in the notice can be relied upon until the new regulations are issued. Our summary below highlights these key areas of guidance and other notable provisions.

Treatment of Disallowed Interest and Excess Limitation

Prior to the TCJA, 163(j) disallowed interest on debt owed to or guaranteed by certain related parties. The Notice makes clear that taxpayers can carry forward amounts previously disallowed under old 163(j), which will be treated like any other interest expense. Amounts carried forward are subject to the new base erosion rules.

Under new 163(j), taxpayers can no longer carry forward excess limitation.

Business Interest Expense and Income for Corporations

All interest income and expense of a C corporation (but not an S corporation) will be business interest income and expense for 163(j) purposes. Regulations will provide character rules for C corporations’ interest income and expense from flow-through investments.

Comment: The Notice makes clear that corporate taxpayers with significant interest income from investments, such as insurance companies and banks, will be able to use this interest income to offset their interest expense.

Application to Consolidated Groups

The net interest expense limitation for a consolidated group is determined on a consolidated basis. Obligations between consolidated group members are not taken into account.

Comment: Regulations will include technical rules on how to allocate 163(j) limitations within a consolidated group and how to treat carryforwards for disallowed interest expense of corporations joining or leaving a consolidated group.

Comment: Unlike old 163(j), the IRS does not anticipate expanding these provisions to affiliated groups that do not file a consolidated return.

Impact on Earnings and Profits

Interest expense of a corporation disallowed under 163(j) will still reduce the corporation's earnings and profits (E&P).

Comment: Reduced E&P means reduced likelihood that corporate distributions are treated as taxable dividends. This rule creates an incentive for corporations to issue debt even if the interest would be disallowed under 163(j) as long as interest payments are not otherwise subject to U.S. withholding.

Partnership Excess Business Interest Income

Partnerships with excess business interest income can pass through the excess to their partners. Only the excess is passed through: double counting is not allowed.

Comment: This change prevents partnership excess business interest income from getting trapped at the partnership level and benefits taxpayers

with tiered structures that have business interest income and expense at different levels.

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Please do not hesitate to contact us with any questions.

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