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## US Federal Tax Alert

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### New interest expense limitation under IRC section 163(j)

Section 163(j) of Internal Revenue Code was amended by Tax Cuts and Jobs Act (TCJA) to provide new rules limiting the deduction of business interest expense for tax years beginning after December 31, 2017. On November 26, 2018, the IRS issued proposed regulations addressing changes made to this section.

Prior to the enactment of TCJA, the IRC section 163(j) limited the deductibility of interest paid or accrued by U.S. person to related-persons (or to an unrelated person if the debt was guaranteed by a related person) in situations where all or a portion of such interest is exempt from U.S. taxes. The TCJA amended IRC section 163(j) which now limits the deductibility of net business interest expense that exceeds 30% of a taxpayer's "adjusted taxable income" plus floor plan financing interest<sup>1</sup> for taxable years beginning after December 31, 2017.

Relief has been provided to small taxpayers since the interest expense limitation under IRC section 163(j) does not apply to taxpayers with gross receipts of \$ 25 million or less. There was no such threshold under the old law.

We have summarized the guidance issued by IRS through TCJA and proposed regulations below;

#### **DEFINITION OF INTEREST**

Unlike the prior 163(j) definition, the proposed regulations adopt a broad definition of interest (expense and income) by including not only amounts that would be interest under general tax principles, but also items that would not otherwise be treated as interest for U.S. federal income tax purposes.

The following payments shall now be included in the definition of interest –

- Original issue discount,
- Debt issuance costs;
- Loan commitment fees;
- Substitute interest payments; and
- An expense or loss predominantly incurred in consideration of the time value of money in a transaction or series of integrated or related transactions in which a taxpayer secures the use of funds for a period of time.

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<sup>1</sup>"Floor plan financing interest" is defined as interest paid or accrued on "floor plan financing indebtedness." These provisions allow taxpayers incurring interest expense for the purpose of securing an inventory of motor vehicles held for sale or lease to deduct the full expense without regard to the limitation under IRC section 163(j)(1).

The proposed regulations would treat a swap with significant nonperiodic payments as two separate transactions consisting of (1) an on-market, level-payment swap and (2) a loan, the time value component of which would be interest expense to the payor and interest income to the recipient.

## **ADJUSTED TAXABLE INCOME**

Unlike prior IRC section 163(j), the proposed regulations do not adopt a cash flow approach to Adjusted Taxable Income (ATI) i.e. adjustment for working capital shall not be made for the computation of ATI.

The proposed regulations define ATI as the taxable income of the taxpayer for the tax year with certain adjustments. ATI is defined as the taxable income of the taxpayer without regard to the following:

- items not properly allocable to a trade or business;
- business interest expense and business interest income;
- net operating loss deductions; and deductions for qualified business income under IRC section 199A.
- For tax years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion shall also be excluded from the calculation of ATI.

## **TRANSITION RULES**

The proposed regulations provide that disallowed disqualified interest carried forward under old IRC section 163(j) are included as disallowed business interest expense carry forward under the new IRC section 163(j) of a taxpayer and shall be carried forward indefinitely to the extent that the amounts otherwise qualify as business interest expense of the taxpayer under these proposed regulations. In contrast to old IRC section 163(j), the proposed regulations do not provide for the carry forward of any excess limitation.

## **RELATIONSHIP OF BUSINESS INTEREST DEDUCTION LIMITATION TO OTHER PROVISIONS AFFECTING INTEREST**

These proposed regulations provide ordering and operating rules to control the interaction of the IRC section 163(j) limitation with other provisions of the Code. The proposed regulations provide that the IRC section 163(j) applies after the application of provisions that subject interest expense to disallowance, deferral, capitalization, or other limitation. However, the IRC section 163(j) would apply before the operation of the loss limitation rules in IRC sections 465 and 469. The deduction under IRC section 250(a)(1)(A), with respect to the foreign derived intangible income (FDII) shall be computed after the application of IRC section 163(j).

For the purpose of computing tax on base erosion payments (BEAT), when a corporation has business interest expense paid or accrued to both unrelated parties and related parties, the amount of business interest expense allowed under IRC section 163(j) is treated as first paid to related parties (proportionately between foreign and domestic related parties) and then as paid to unrelated parties.

## **CONSOLIDATED RETURN RULES**

The proposed regulations take a broad, single-entity approach i.e. a consolidated group would be subject to a single IRC section 163(j) limitation.

“Separate return limitation year” (or “SRLY”) limitation applies to disallowed business interest expense carry forwards. A member with disallowed business interest expense that departs a consolidated group generally would take its carry forwards with it. However, as is the case with NOLs, the group would have the priority claim to deduct the member’s business interest expense items, to the extent available under IRC section 163(j), including both the departing member’s current-year business interest expense (through the date of departure) as well as the departing member’s disallowed business interest expense carry forwards from prior years.

## **INTERNATIONAL IMPLICATIONS OF IRC SECTION 163(j)**

These proposed regulations provide the general rule that IRC section 163(j) and the section 163(j) regulations apply to determine the deductibility of a CFC’s business interest expense in the same manner as those provisions apply to determine the deductibility of a domestic C corporation’s business interest expense. Thus, a CFC with business interest expense would apply IRC section 163(j) to determine the extent to which that expense is deductible for purposes of computing subpart F income as defined under IRC section 952, tested income as defined under IRC section 951A(c)(2)(A), and income which is effectively connected with the conduct of a U.S. trade or business (ECI), as applicable.

## CONCLUSION

New IRC section 163(j) clearly impacts tax payers that have been excessively leveraging on debt. Unfortunately, the new interest limitation is not limited to foreign related party debts but includes domestic and foreign *unrelated* party debts as well. Tax payers should carefully plan their capital structures by considering the impact of the broad limitations brought in by the new Regulations.

## KEY SOURCES

IRC section 163(j) proposed regulations-

<https://www.irs.gov/pub/irs-drop/REG-106089-18-NPRM.pdf>

Basic questions and answers about the limitation on the deduction for business interest expense-

<https://www.irs.gov/newsroom/basic-questions-and-answers-about-the-limitation-on-the-deduction-for-business-interest-expense>



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