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Objectives

• After participating in today’s presentation, you will be able to:
• Identify certain potential tax planning or tax savings opportunities presented by the new final and proposed section163(j) regulations
• Understand certain key differences between the recently released regulations under section163(j) and the 2018 proposed regulations
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NEW SECTION 163(J) REGULATION PACKAGE: OVERVIEW OF OPPORTUNITIES
Section 163(j) background

- Section 163(j) generally limits deductions for business interest expense each tax year to the sum of:
  - Business interest income for the tax year, plus
  - 30% (50% for some years) of adjusted taxable income (ATI) for the tax year
  - Option to use 2019 ATI for some 2020 years

- ATI derived from taxable income, with additions and subtractions, including
  - ‘Add-back’ for deductions for depreciation, depletion, and amortization (DD&A), for tax years beginning before 1/1/2022
    - Add-back increases ATI, so it increases section 163(j) limitation (i.e., increases max. amount of interest deductible)
New regulations present new opportunities

• New final and proposed section 163(j) regulations released on 7/28/2020

• These regulations may present opportunities:
  • Amended returns to increase interest deductions
    • For certain partnerships, administrative adjustment requests (AARs) are the mechanism for adjusting prior year taxable income
  • Refinancing or restructuring to improve interest deduction results
  • Consider new rules’ effects on tax returns, estimates, and tax provisions
Which regulations apply now?

- Final section 163(j) regs generally effective for tax years beginning on or after __/__/2020 (60 days after Federal Register publication date)
- Tax years beginning before __/__/2020: taxpayers may—
  - Apply the final regs (the typical choice), or
  - Apply the 2018 proposed regs (but still may apply the final regs’ rule for capitalized depreciation)
    - Taxpayers and their related parties (under section 267(b)/section 707(b)) should make the same choice
- Most taxpayers also will be able to rely on the 2020 proposed regulations, which are not yet effective
- Consistency requirements may apply
How to claim an increased interest deduction tax benefit

• Accounting method change? No
  • Final regs’ preamble says section 163(j) calculation is not an accounting method

• Amended returns? Yes
  • Certain partnerships required to file an AAR rather than an amended return

• AARs (administrative adjustment requests)? Yes
  • For many partnerships
PROPOSED CAPITALIZED DEPRECIATION AND INTEREST DEFINITION GONE
DD&A add-back to ATI

- Section 163(j) limitation based on 30% (50% for some years) of adjusted taxable income (ATI)
- ‘Add-back’ for deductions for depreciation, depletion, and amortization (DD&A), for tax years beginning before 1/1/2022
- Add-back increases ATI, so it increases section 163(j) limitation
Proposed capitalized depreciation rule: gone

- 2018 proposed regulations would have prohibited any add-back for DD&A capitalized under section 263A
  - Harmful to manufacturers, oil and gas companies, and other goods producers

- Final regulations abandon the proposed capitalized depreciation rule

- All capitalized DD&A treated as an add-back for tax years beginning before 1/1/2022 under the final regs
  - Regardless of the period in which the capitalized DD&A is actually recovered

- Final regulations also require subtraction in ATI computation when depreciable/amortizable property is sold
Proposed definition of interest: gone

• Section 163(j) only limits deductions for business interest expense
• 2018 proposed regs’ had overbroad definition of interest for §163(j)
  − Would have included, for example:
    • Debt financing costs
      − Applicable tax rules classify some as interest and some as noninterest costs
    • Hedging income and deductions
      − Generally not interest loss for federal tax purposes

• Final regulations abandon most controversial aspects of the proposed definition of interest
  − Anti-abuse rule retained (modified from 2018 prop regs’ version)
PARTNERSHIP AND REAL ESTATE ITEMS
Tiered Partnerships

• Current approaches
  • Entity: Keep 163(j) carryforwards in ‘silo’ one tier above source partnership
  • Aggregate: Allocate all 163(j) items to ultimate taxpayers, hold carryforwards in ‘silo’ at ultimate taxpayer level

• 2020 Proposed Regulations would adopt modified entity approach
“Self-charged interest” on loans from owner to passthrough

• 2018 Proposed Regulations preamble
  • Treasury and IRS intended to issue regulations excluding some self-charged interest (between a pass-through entity and its owners) from section 163(j) calculations, but no rules proposed

• 2020 Proposed Regulations
  • Self-charged interest rule included
  • Only applies to loans from direct partners to partnerships
    • Not to loans from indirect partners
    • Not to S corporations
Business interest vs. investment interest: interest tracing

• 2020 Proposed Regulations

• Generally preserve previous interest tracing and allocation rules, except:

• New proposed debt-financing distribution rule
  • Would apply for all debt tracing purposes, not just section 163(j) (e.g. 163(d) investment interest deduction limitation, passive activity losses)
Small business taxpayer exemption from section 163(j)

- Final regulations leave syndicate/tax shelter rule in place

- Small business passthroughs’ current year interest expense not subject to section 163(j) at entity or owner level
  - Final regulations: no retesting of current year business interest expense allocated from a small business taxpayer to its partners

- Final regulations confirm that small business taxpayers may make the real property trade or business election
Real estate specific items in final regulations

- OpCo/PropCo structures
  - Broadens exceptions from 2018 proposed regulations’ anti-abuse rule for some non-abusive situations
  - Anti-abuse rule would still apply to many taxpayers’ arrangements

- Additional definitions of real estate businesses
  - Net leasing
  - Hospitality
  - Assisted living (also Notice 2020-59)

- Additional rules for REITs
• The Final Regulations confirm section 163(j) applies to controlled foreign corporations (CFCs) for purposes of computing:
  • subpart F income,
  • tested income under section 951A (global intangible low-taxed income or GILTI), and
  • income that is effectively connected with a U.S. trade or business (ECI).
• The Final Regulations, however, generally reserve, and reissue in proposed form, rules pertaining to the application of section 163(j) to CFCs and U.S. shareholders of CFCs.
New CFC group election regime

- section 163(j) generally applies to a CFC as if it were a domestic corporation and on a CFC-by-CFC basis
- However, a CFC group election may be made to apply section 163(j) on a group basis with respect to applicable CFCs that are specified group members of a specified group
  - If a CFC group election is made, it cannot be revoked for 60 months following the end of the first period for which it is made
  - Likewise, if a CFC group election is revoked, it cannot be made for 60 months following the end of the first period for which it is revoked
- Consolidated return principles (subject to certain modifications) apply
No CFC Group Election – FS1 Computes 163(j) limitation on its own
- $50 + $65 + $35 = $150
- $150 x *30% = $45
Deductible interest expense = $45
Disallowed interest expense = $20

CFC Group Election – the attributes of FS1 and FS2 are combined and a consolidated 163(j) limitation is computed
- $40 + $50 + $65 + $35 + $10 = $200
- $200 x *30% = $60
Deductible interest expense = $60
Disallowed interest expense = $5

*50% limitation applies for 2019 and 2020.
Annual safe harbor election

- The 2020 Proposed Regulations provide a safe harbor that exempts certain CFCs from section 163(j)
- **Eligibility**: BIE cannot exceed 30% (50% in 2019 or 2020) of the lesser of:
  - tentative taxable income (taxable income determined by only taking into account items subject to section 163(j)), or
  - the sum of subpart F and GILTI (including any deduction under section 250)
U.S. shareholders of applicable CFCs

- A U.S. shareholder generally excludes from ATI its subpart F inclusions, GILTI inclusion, and section 78 gross-up on deemed paid taxes.
- However, a U.S. shareholder of a stand-alone CFC or a CFC specified group member for whom a CFC group election is in effect may include a portion of its subpart F and GILTI income inclusions from such CFCs in ATI.
  - No amount will be included in a U.S. shareholder’s ATI with respect to an eligible stand-alone CFC or CFC group that makes the safe harbor election.
Foreign persons with ECI

- Treasury and the IRS reserved on issuing final regulations with respect to foreign persons with ECI and instead reissued proposed regulations.
- The 2020 Proposed Regulations provide specific rules applicable to partnerships with ECI, foreign corporations with ECI, and coordination rules with the branch profits tax.
STATE AND LOCAL TAX
Section 163(j) SALT Issues

• Key issues
  • Conformity to limitation
    • TCJA
    • CARES
    • Treasury Regulations
  • Federal-to-state differences in filing entity/group
  • Federal-to-state differences in definition of ATI
  • State-level related party interest addbacks and elimination in combination

• Examples
THANK YOU FOR YOUR TIME AND ATTENTION